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Best Practices When Liquidating Real Estate-Secured SBA Loans

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For several years, the United States Small Business Administration (SBA) has experienced continuous growth with its flagship 7(a) and 504 business loan programs.

For fiscal year 2018, the SBA made over $24 billion in loans under the 7(a) program and just under $5 billion in 504 loans. As of fiscal year 2018, the SBA oversees a $92 billion SBA 7(a) loan portfolio, up from $56 billion in 2011. The average 7(a) loan has increased from approximately $368,000 in 2014 to $420,000 in 2018.

Although charge-off rates are at post-Great Recession lows, defaults occur. When an SBA loan goes into default and workout is impossible, the lender must liquidate all collateral that has "Recoverable Value." This article looks at some issues a lender must consider when liquidating real property collateral.

The threshold issue is Recoverable Value. To calculate Recoverable Value, the lender starts with liquidation value (determined from a current appraisal) and subtracts the balance owed on senior liens, foreclosure expenses, and holding costs. Absent a compelling reason not to, the SBA requires a lender to liquidate a real estate parcel if the Recoverable Value is at least $10,000.00. For many lenders, this will be a much lower threshold than non-SBA loans in their portfolio.

The SBA expects lenders to liquidate real property, so they maximize recovery in the shortest time. A lender may have these recovery options:

Deed in Lieu of Foreclosure

With a Deed in Lieu of Foreclosure, a property owner conveys fee-simple title to a secured creditor as an alternative to foreclosure. The SBA requires a written agreement as to the dollar credit to be applied to the loan balance. A Deed in Lieu is recorded subject to all existing liens, often making it a non-option.

Non-Judicial Foreclosure

Non-judicial foreclosure, or foreclosure by power of sale, is the most common method of foreclosure in North Carolina. The name is somewhat misleading because it involves a judicial proceeding. But it is a limited proceeding before the Clerk of Court, not a full-blown lawsuit. A non-judicial foreclosure usually is faster and less expensive than a judicial foreclosure.

Judicial Foreclosure

A judicial foreclosure is a lawsuit -- a civil action in North Carolina. Judicial foreclosures are typically used where there are loan documentation errors or other problems rendering non-judicial foreclosure unavailable. The lender files a complaint in the county where the property is located asking it be sold under judicial process and the proceeds applied to the debt. The complaint must allege, at minimum, a debt, default on the debt, a deed of trust securing the debt, and the plaintiff’s (lender's) right to enforce the deed of trust. All affected parties are served and entitled to assert defenses, conduct discovery, and file motions to defeat the lender's right to foreclose. If the lender prevails, the court enters a judgment on the debt and orders a judicial sale of the mortgaged property. The entire process can be lengthy and expensive.

Short Sale by Obligor

With a short sale, the owner sells the property for less than the loan balance with the lender's agreement. The lender releases its lien at closing. If the sale proceeds to be received by the lender equal or exceed the Recoverable Value, a short sale may be appropriate. Lenders must seek approval – with supporting documentation -- from the SBA before agreeing to a short sale. The SBA imposes several requirements on short sale approval. For example, the sale must be an arms-length transaction, and no sale proceeds may go to the seller or junior lienholders (other than token amounts of $500 or less to release lien).

Before selecting a method, a lender should perform initial due diligence with counsel. At a minimum, a lender should have its loan documents reviewed, order a title report, check the military service status of all obligors, determine the use of the property and order an appraisal, and assess potential environmental risks.

Loan Document Review

The loan document review will reveal a lender's ability to conduct a non-judicial foreclosure. A properly-drafted North Carolina Deed of Trust always grants the lender to right to non-judicial foreclosure upon default. Loan document review should also provide information on any lease of the property and whether it would survive or be extinguished by a foreclosure sale. A review may also reveal an Assignment of Rents entitling the lender to collect rents from the tenant during foreclosure.

Title Report

The title report will identify all liens and other encumbrances against the property. Sometimes, a lender will be surprised by what a title report reveals – e.g., the Obligor transferred the property to someone else. The title report will tell the lender if there are senior or junior liens on the property. Junior lienholders are rarely an issue for the lender. They are entitled to notice of the foreclosure sale. At times, they – like tenants in possession of the property -- may be able to purchase the property from the obligor or outbid the lender at a foreclosure sale to protect their interests.

If there are senior liens, the lender should already know about it as it would have been acknowledged at the original loan closing and listed as an exception on the lender's title insurance policy. But that is not always the case. A senior lien is a problem because it impacts the value of the property, and a senior lienholder can eliminate a junior deed of trust through foreclosure. If a lender discovers a senior lien, it should quickly verify the lien amount and the loan status. It then must decide the most prudent and commercially reasonable way to satisfy the lien. This situation becomes perilous if the senior lienholder commences its own foreclosure against the property. The lender must notify the SBA loan center immediately and take all commercially-reasonable steps to protect any equity in the property available for the loan.

Military Service Status

If the property owner or obligor is in active military service, the lender should consult counsel about the Servicemembers Civil Relief Act and the ability to initiate foreclosure.

Property Use Determination and Appraisal

A lender should investigate the use of the property and order an appraisal. The use of the property can affect liquidation options. For example, if the property is an obligor's primary residence, the lender must comply with special requirements before foreclosure. Certain uses may raise environmental issues that merit further investigation. The appraisal will provide the property's current market value, essential for determining the Recoverable Value.

It is vital that lenders familiarize themselves with the SBA's Standard Operating Procedures (SOPs) for loan liquidation, and work with counsel to comply. Failure to do so could cause the release of the SBA from liability on its guaranty or the recovery by the SBA of funds already paid on a guaranty purchase.

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