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Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

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Prepayment Fees, by Whatever Name, are Not Interest

The U.S. District Court in the Southern District of Texas determined that prepayment fees do not constitute interest regardless of what they are labeled in a payoff statement. Provided the fees are consideration for the ability to prepay the loan and not compensation for the loan, the fees are not considered interest by Texas law and therefore not usurious.

SBA Issues New Version of Lender and Development Company Loan Programs SOP 50 10 5 (B) Effective October 1

The Small Business Administration recently issued a new version of the SOP 50 10 5(B) with an effective date of October 1, 2009. Changes include new provisions for intangible assets, rates, business valuation, credit card debt refinancing and more.

Lender's "Bona Fide Purchaser" Argument Accepted At Eleventh-Hour

The 6th U.S. Circuit Court of Appeals held that a bank could dispute a criminal forfeiture of a bank account on grounds that the bank preserved its claim to "bona fide purchaser" status, even though such claim was raised for the first time extremely late in the proceedings, (i.e., at the forfeiture hearing itself).

Tip of the Month: SBA Releases New Guaranty Purchase Package Tabs



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Mortgagee Unable To Claim Insurance Proceeds Because of Incorrect Insurance Designation

A court in New York determined that a mortgagee was unable to collect on a casualty insurance policy, because mortgagee was not designated on the policy despite the fact that the policy's designee had assigned the mortgage to the mortgagee.

On December 13, 2000, First Union National Bank assigned a mortgage encumbering property owned by Complete Analysis, Inc. in Peekskill, New York to NC Venture I, L.P. Complete Analysis purchased an insurance policy that covered the property for fire loss from Valley Forge Insurance Co. on March 26, 2002. Apparently unaware of the assignment, Complete Analysis designated First Union as the mortgagee on the insurance policy. The property was destroyed by fire on August 13, 2002. When NC Venture, as mortgagee by assignment from First National Bank, attempted to collect on the insurance policy, Valley Forge refused to pay, claiming that the policy had not been validly assigned and that NC Venture had no rights under the policy. NC Venture sued, claiming breach of contract.

Valley Forge asserted numerous defenses to the obligation to pay NC Venture under the policy: attacking the validity of the assignment; calling attention to other policies under which NC Venture could collect; calling attention to NC Venture's ability to collect under its foreclosure proceedings; limiting the amount of any potential payments; and claiming NC Venture failed to mitigate damages. NC Venture claimed that it was the assignee of proceeds resulting from a loss that already occurred, not that it was assigned the policy directly. NC Venture argued that the policy's prohibition on assignments of the policy without prior consent applied only to assignments of the policy by the policy owner, not to assignments of the mortgage or to assignments of rights by the mortgagee under the policy.

Valley Forge argued it was obligated under the policy to pay proceeds of the policy only to mortgagees named within the policy. Because NC Venture was not listed in the policy in any capacity and because the policy was limited to its terms, Valley Forge argued it was not obligated in any way to NC Venture. The Court stated that New York law provides that claims proceeds may be assigned after a loss, but if the policy forbids assignment before a loss without consent, that condition will be upheld. Here, because the policy prohibited any change to the policy without Valley Forge's consent and because NC Venture was not listed as the mortgagee under the policy, the Court denied NC Venture's motion for summary judgment.

This case is a reminder to mortgagees to ensure that they are properly listed as mortgagee, additional insured and loss payee under any insurance policies covering their collateral, especially if the acquire an already outstanding loan.

It is cited as *NC Venture I, L.P. v. Valley Forge Insurance Co. a/k/a Valley Forge Insurance Co., Inc.*, 2008 WL 3409146 (N.Y.Sup.).

Prepayment Fees, by Whatever Name, are Not Interest

The U.S. District Court in the Southern District of Texas determined that prepayment fees do not constitute interest, regardless of what they are labeled in a payoff statement. Provided the fees are consideration for the ability to prepay the loan and not compensation for the loan, the fees are not considered interest by Texas law, and will not be considered usurious.

In June 2007, Silver Hill Financial LLC loaned Achee Holdings, L.L.C. \$280,000 secured by a deed of trust on real estate in Galveston, Texas. The promissory note signed by Achee included two prepayment penalties if Achee prepaid the loan during a "lockout period" of three years: 1) a "lockout fee" of all interest which would have accrued under the loan from the date of prepayment through the end of the lockout period, and 2) a "prepayment consideration" of 5% of the outstanding principal balance at the time of prepayment. In November 2007 (within the lockout period), Achee sold the property that



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secured the loan and prepaid the loan, incurring what the payoff statement called "lockout interest" (called a "lockout fee" in the note) of \$92,083.81 in addition to the 5% prepayment consideration. Achee paid the fees at the time of sale, but filed a complaint in March 2008 requesting return of the lockout interest, claiming it exceeded what was allowable under Texas law.

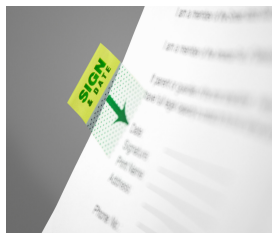
In its complaint, Achee claimed that the lockout interest (also known as the lockout fee) was in reality an interest payment and that it was usurious. The Court defined interest as "compensation for the use, forbearance or detention of money" and the elements of usury as "a loan of money, an absolute obligation to repay the principal, and the exaction of a greater compensation than allowed by law for the use of the money by the borrower."

Texas law as codified and as expounded in the case law forbids prepayment of loans unless the borrower's contract with the lender specifically allows it. Where prepayment is allowed, a prepayment premium is deemed a "consideration for the right of prepayment," not compensation for the use of money. The Court stated that the rationale behind this rule is that the borrower can always avoid the prepayment premium by paying the note as agreed.

Here, because the parties specifically agreed to the lockout fee in the note, the Court determined that it was consideration for the right to prepay the loan, not compensation for the use of money, and therefore did not constitute interest and could not be usurious regardless of what the fee was called. This case is cited as *Achee Holdings, L.L.C. v. Silver Hill Financial LLC, et al.*, 2009 WL 347751 (S.D. Tex).

SBA Issues New Version of Lender and Development Company Loan Programs SOP 50 10 5(B) Effective October 1

The Small Business Administration recently issued a new version of the SOP 50 10 5(B) for Lender and Development Company Loan Programs with an effective date of October 1, 2009. Some of the major changes to the SOP and their effects on lenders are:



Intangible Assets: The SBA's policy on goodwill is among the most significant changes. Effective October 1, 2009, if the portion of a business's purchase price allocated to "intangible assets" is in excess of \$500,000, then the borrower must provide an equity injection of at least 25% of the purchase price. Intangible assets may include (but are not limited to) goodwill, client/customer lists, patents, copyrights, trademarks and covenants not to compete. Seller financing also may be considered part of a borrower's equity injection, provided that such

seller financing is on full standby for at least two years. A lender still may process a request for approval if a 25% equity injection cannot be met by submitting the application under CLP or GP processing for approval.

Under the previous version of the SOP, if the amount of goodwill being financed exceeded \$250,000 or 50% of the sales price (whichever was lower), the lender's only option was to submit the application under CLP or GP processing for waiver of the policy. Effective October 1, 2009, the threshold for financing goodwill without CLP or GP approval is now \$500,000, and even greater if the borrower provides the 25% equity injection. Also, because this is a policy change, any submission to the SBA for approval is not "an exception to policy," which would require headquarters approval, but can be processed at the service center. This will assist buyers, sellers and lenders in closing transactions in a more timely manner and with more certainty.

Fixed or Variable Rates: The new SOP allows loans to have either fixed or variable interest rates. The SBA periodically will publish the maximum allowable fixed interest rate in the Federal Register and will provide an explanation of the calculation of the published rate. The new SOP also allows lenders who are renewing loans to split the interest rate between a fixed and a variable rate: one for the guaranteed portion, the other for the non-guaranteed portion. The lender must notify the Commercial Loan Servicing Center of changes to the Note terms related to the interest rate after the loan is disbursed.

lenders in complex real estate and development transactions.

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Practice Areas

Business and Taxation

Commercial Lending

Community Associations

Creditors' Rights & Workouts

Elder Law

Employment and Labor

Estate Planning and Probate

Business Valuation: Additionally, the new SOP requires that business valuations must include the evaluator's opinion of value, the qualifications of the evaluator, and the evaluator's signature certifying the information in the valuation. The cost of the valuation may be passed to the borrower. Similar to the requirements with appraisals, if the lender requires a business valuation for closing, the loan application and authorization must include a business valuation estimate. At closing, if the valuation is 90% or more of the estimate, the lender may close the loan. If the valuation is less than 90% of the estimated value, the lender must provide written justification for change in value (if the loan is processed PLP) or must submit to the SBA for prior written permission to proceed with the closing if the loan is processed as a CLP or GP loan. In situations where valuation may be an issue, a lender may decide to process CLP or GP to obtain SBA approval of the valuation.

Refinancing of Credit Card Debt: The new SOP clarifies the regulations regarding refinancing of credit card debt. Any credit card debt refinanced with a 7(a) loan must have been for a business-related purposes and the borrower must provide certification. If the credit card is in the business name, the lender must confirm the name on the card and have the borrower certify that the debt being refinanced was solely incurred for business purposes. If the credit card is in the borrower's name, the lender must obtain supporting documentation, such as monthly statements itemizing charges and receipts describing the charges for any charge over \$100.

Long Term Debt: When refinancing long-term debt, the new SOP requires that the new installment amount must be at least 10% less than the existing installment amount (the prior percentage was 20%). This refinancing amount does not apply to refinancing of long term debt structured with a demand or balloon note, business credit card debt or revolving lines of credit where the original lender is unwilling to renew the line.

7(a) Loan Increases: All increases to 7(a) loans regardless of disbursement status must be approved by the SBA. If the loan increase exceeds 20% of the original loan amount or the request is made more than 18 months after the original approval date, the request must include analysis showing that (1) the purpose of the increase is the same as the original purpose of the loan, and (2) the borrower's cash flow can support the increased payment amount.

Character of the Company: The new SOP also requires the lender to review the character of the operating company as well as the owner. The lender must identify in its credit write-up any Federal, state or local citations or probations that might affect the ability of the business to continue to operate.

Construction Loans: Additionally, for loans that include construction, once construction is completed a lender must obtain a statement from the appraiser that the building was built with only minor deviations from the plans and specifications. This is not a second appraisal. If the appraiser cannot provide the required statement, the lender may not close the loan without the SBA's prior written permission.

Franchise Development Agreements: Changes in the new SOP also include revisions regarding the franchise development agreements. The new SOP states that franchise development agreements are ineligible for SBA loans because such agreements are inherently speculative and considered passive investments. Franchise development agreements are distinguished from area development rights within a franchise agreement. An agreement containing an area development rights may be eligible if it complies with remainder of regulations related to franchise agreements.

Lien on Assets: SBA loans require a lien on all assets of the borrower. However, the SBA has recognized that sometimes there are assets available, such as marketable securities, but the asset holder is not willing to cooperate with the lender. In such cases where a loan is not fully secured and publicly-traded assets are available, the lender must (1) attempt to obtain a lien and (2) if unable to perfect a lien, must document the efforts made to obtain the lien, including all supporting documentation.

Site Visits: Finally, the new SOP clarifies that the site visit policy states that they are required if the lender's internal policy for similarly sized non-SBA loans requires a site visit.



Lenders should also note that the SOP 50 10 5(B) includes many changes in qualifying to become an SBA participating lender, as well as additional requirements for becoming a PLP lender. If you are interested in taking part in the expanding SBA loan market, please review these new requirements in the updated SOP and contact our attorneys with any questions you may have.

[Click here](#) to view the new SOP 50 10 5(B).

Lender's "Bona Fide Purchaser" Argument Accepted At Eleventh Hour

The 6th U.S. Circuit Court of Appeals held that a bank could dispute a criminal forfeiture of a bank account on grounds that the bank preserved its "bona fide purchaser" argument, even though such argument was raised for the first time extremely late in the proceedings (i.e., at the forfeiture hearing itself).

Between 2002 and 2004, more than 40 commercial lenders were defrauded of more than \$100 million in the CyberNET scandal. One of the lenders, Huntington National Bank, extended a multimillion-dollar line of credit to CyberCo Holdings, Inc., for which Huntington received a security interest in nearly all of the assets of CyberCo, including a bank account opened with Huntington. CyberCo deposited receipts of its fraud into this bank account. The federal government seized the bank account and sought criminal forfeiture. A Michigan District Court entered a preliminary order transferring the account to the United States.

Huntington filed a claim, alleging that a perfected security interest permitted it to retain the account. The District Court denied the claim, holding that Huntington's interest in the account was not "superior" to the U.S. stake, which predated Huntington's. Huntington then moved for reconsideration, arguing that the timing of its acquisition of the account was irrelevant because Huntington was a "bona fide purchaser" for the value of its security interest without cause to believe that the property was subject to forfeiture. The District Court denied the motion for reconsideration, concluding that Huntington had waived the bona fide purchaser claim by failing to raise it earlier in the proceedings. Huntington appealed.

The 6th U.S. Circuit Court of Appeals reversed the District Court's decision, concluding that Huntington had not waived its bona fide purchaser claim. Huntington argued against waiver in three ways: (1) it had included a footnote in its merits brief to the District Court, explaining that, while not relying on the bona fide purchaser argument at that point, it reserved the right to do so later; (2) it raised the argument in its motion for reconsideration; and (3) it orally raised, and relied on, the bona fide purchaser argument at the forfeiture hearing.

The 6th Circuit highlighted a procedural distinction between the Circuit Court and the District Court. It explained that none of the efforts made by Huntington to preserve its argument, if undertaken in an appeals court, were likely to succeed unless intervening authority had arisen or a legitimate excuse was raised by the movant, neither of which were applicable in the Huntington. Nevertheless, the Circuit Court explained that Huntington's third effort at preserving the argument — orally raising and relying on the bona fide purchaser argument at the forfeiture hearing — did indeed clear the notice and level of argumentation hurdles required in proceedings carried out in District Court.

The Circuit Court reversed and remanded the issue of Huntington's bona fide purchaser status to the District Court for its consideration of the merits of such an argument.

This case is cited as *U.S. v. Huntington National Bank*, No. 08-1729 (6th Cir. 07/27/09).

Tip of the Month: SBA Releases New Guaranty Purchase Package Tabs



The SBA issued an updated version of the mandatory 10-Tab 7(a) guarantee purchase package system. The new version of the system includes some new material, as well as clarifications of prior policies. When completing your new purchase packages, be sure to read each and every question carefully, as new information may be requested or required at this time. For more information and to review the Regular 7(a) Guaranty Purchase Package Tabs, updated as of July 13, 2009, [click here](#). Please contact **Arnold Spevack** or **Alison Rind** with any further questions.

We'd Like To Hear From You

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