LERCH EARLY & BREWER

Commercial Lending Bulletin

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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.

This newsletter is sent via email in HTML format. If you wish to print a copy of the newsletter, you may access a .pdf version by following the "Printer-Friendly version" link below.

We appreciate any feedback and invite you to contact us with any questions. If you do not want to receive any further newsletters from us, follow the link at the bottom of this email to be removed from our list of recipients.

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A Georgia court recently decided that a purchaser of loan collateral was liable to the lender for conversion of the funds when the purchaser deducted and retained costs of harvesting the collateral from the purchase price.

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Recent decisions in Tennessee and Texas indicate that a lender's error in drafting or execution of guaranty lead to costly litigation and, in some cases, can have a negative impact on the lender.

NEWS ALERT - SBA Temporarily Eliminates Up Front Fees And Increases Its Guaranty To 90% To Encourage Lending
On March 16, 2009, the SBA issued Policy Notice 5000-1097, *Implementation of Section 501 of the Recovery Act - Fee Elimination Provisions* and Policy Notice 5000-1098, *Implementation of Section 502 of the Recovery Act - Up to a 90 Percent Guaranty on 7(a) Loans.*

Thank You!
Thank you to all of our clients and friends who attended our first meet and greet of 2009.

SBA Updates its Regulations of SBA Loans – Financing Business Acquisitions at Risk

EFFECTIVE MARCH 1, 2009, THE SBA HAS MADE SEVERAL NEW AND SUBSTANTIAL CHANGES RELATED TO THE PROCESSING OF 7(A) AND 504 LOAN APPLICATIONS.

This update is part of the previous Agency plan to update the SOP governing SBA loans every six months and present the public with an up to date and user friendly document. The proposed changes

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could dramatically decrease the type and frequency of certain types of loans.

The most substantial change in the SOP concerns the amount of "goodwill" which can be financed. The new policy provides that in order for goodwill to be financed: (1) the lender should explore seller-financing with a subordinate lien to the SBA-guaranteed loan and (2) the lender may finance a limited amount of goodwill, which in no event may exceed 50% of the loan amount, up to a maximum amount of $250,000. Additionally, any loan proceeds used to finance goodwill must be specified in the Use of Proceeds section of the Authorization. This particular change had created quite a controversy in the financial community because of the perceived limitation on loans to many business ventures which do not have significant hard assets to finance, but which do include substantial goodwill. For example, a profitable dry cleaning business may only have fixed assets of $300,000, yet the business generates over $1,000,000 in income a year. When this revision was first announced, there was an uproar in the lending community. Most business acquisitions involve service companies which own a minimal amount of fixed assets to be sold. The value of the business is found in its value as a "going concern" – goodwill. A typical $2,000,000.00 business acquisition may include $1,500,000.00 or more of goodwill. This new rule effectively eliminates the use of SBA loans to finance any business acquisitions, and given the minimal collateral values, it is unlikely that lenders will otherwise finance business acquisitions without a government guaranty.

Subsequently, SBA Information Notice 5000-1086 was issued on February 27, 2009 to address this issue. While the SBA did not remove the new cap on financing goodwill, it has agreed to allow lenders to submit a proposed business acquisition including goodwill in excess of $250,000.00 for direct consideration by the SBA. The SBA will approve or deny each application on a case by case basis. This process will continue until August 31, 2009, at which time the SBA plans to provide further guidance on the issue of financing goodwill.

The SOP also revised guidance on debt refinancing. The new policies allow a lender to use SBA loans to refinance (1) long term debt with a demand note or balloon payment, (2) revolving lines of credit (both short term and long term) where the original lender is unwilling to renew the line or the borrower is restructuring in order to obtain either a lower interest rate or longer term, (3) debt with a maturity that was not appropriate for the purpose of the financing (i.e. the equipment has a useful life of ten years but the loan was for only three years), and (4) debt that is does not otherwise qualify as an SBA loan, but which the lender believes no longer meets the needs of the borrower, however the applications for this exception may only be processed through standard 7(a) procedures.

Changes have been made regarding appraisals and business valuations. When collateral is new construction or involves substantial renovation, the appraisal must estimate what the market value will be at the completion of construction. Substantial renovation shall mean rehabilitation expenses of more than 1/3 of the purchase price or fair market value at the time of application. Additionally, after the construction is completed, the lender must obtain a statement from the appraiser of the "as-completed" value. If the value is less than 90% of the original estimated value, the appraiser must state the reason for the change in value, e.g., changes in market conditions or deviations from original plans.

Business valuation requirements have also changed. If the amount being financed minus the appraised value of real estate and/or equipment is $250,000 or less, the lender may perform its own valuation of the business being sold. If the amount being financed minus the appraised value of real estate and/or equipment is great than $250,000 or if there is a close relationship between the buyer and the seller, the lender must obtain an independent business valuation from a qualified source.

The SBA now requires lenders to submit Environmental Investigation Reports to the SBA center processing an application and if the lender is processing the application under its preferred lender status, the loan file must include all necessary environmental reports. A Reliance Letter is required even if the Environmental Investigation Report is addressed to the lender.

These noted changes and many more will affect how lenders are able to use the 7(a) and 504 programs with current borrowers and may change the nature of your SBA loan program. For more information, discussion and answers about these changes, feel free to contact Alison W. Rind or Arnold D. Spevack.

For some positive news relating to the SBA this week, see the News Alert at the end of our bulletin regarding elimination of guarantee fees and the increase of the guaranty percentage.

Actual Knowledge of Security Interest Puts Purchaser on Notice

A GEORGIA COURT RECENTLY DECIDED THAT A PURCHASER OF LOAN COLLATERAL WAS LIABLE TO THE LENDER FOR CONVERSION OF THE FUNDS

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OUR SERVICES

Providing lenders with only the highest and most knowledgeable levels of lending counsel in all phases of commercial lending transactions.

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Providing our clients with the

WHEN THE PURCHASER DEDUCTED AND RETAINED COSTS OF HARVESTING THE COLLATERAL FROM THE PURCHASE PRICE.

In May 2003, Bank of Dawson extended a farm loan to Jason Wiggins, who granted a security interest in his cotton crop to the Bank. The Bank perfected its security interest by filing a financing statement and based on information from Wiggins that he intended to sell his crop to Worth Gin Co. Inc., the Bank sent a letter to Worth giving them notice of the security interest. In November 2003, Worth harvested Wiggins's cotton crop and purchased it from him. Worth deducted from the purchase price an amount for debts Wiggins owed in connection with the harvesting costs Worth incurred and issued a check jointly payable to Wiggins and the Bank. The Bank sued Worth for the amount deducted, asserting that it had a security interest in Wiggins's cotton crop. The trial court ruled in favor of Worth and the Bank appealed.

Worth's president stated at a deposition that while he had seen the letter from the Bank before purchasing the crop, the documents the letter referenced, including the financing statement, were not included. The Bank countered that Worth had actual knowledge of its security interest in the cotton crop.

The Court found that an organization has knowledge of a fact when "for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence". While the deposition testimony of Worth's president gave rise to an inference that the documents referenced were inadvertently omitted, this did not create an issue of material fact in light of the other evidence that Worth had actual knowledge. The Court stated that there was uncontroverted evidence that Wiggins granted the Bank a security interest and Worth was aware of this at the time of purchasing the cotton crop from Wiggins based upon information provided by both Wiggins and the Bank to Worth. Since neither Worth nor Wiggins could produce evidence to satisfy their claim that the Bank had authorized the deduction of the harvesting costs, this claim also failed. The Court found that the evidentiary record established that as a matter of law, Worth purchased the crop with knowledge of the Bank's lien and is therefore liable to the Bank for the harvesting costs it retained.

The above case illustrates the need for timely and precisely written financing statements. Most Courts will find that the filing of a financing statement provides constructive notice to all parties of a potential security interest.

The case above is cited as *Bank of Dawson v. Worth Gin Co. Inc., No. A08A1400* (Ga. App. Ct. 12/01/08).

Errors In Drafting And Execution Have Affect on Guaranty

RECENT DECISIONS IN TENNESSEE AND TEXAS INDICATE THAT A LENDER'S ERROR IN DRAFTING OR EXECUTION OF GUARANTY LEAD TO COSTLY LITIGATION AND, IN SOME CASES, CAN HAVE A NEGATIVE IMPACT ON THE LENDER.

In Tennessee, a lender, Samick Music Corp, entered into a security agreement with Hammell Music Inc., which gave Samick a security interest in all inventory supplied to Hammell. On the same day, Thomas Hoy signed a guaranty which was intended to make him a guarantor of Hammell's debts. However, Hoy signed in the space for "Dealer", resulting in the guaranty stating that Hoy guaranteed the debts of Thomas Hoy, as dealer. When Hammell defaulted, Samick sued Hoy to enforce the guaranty.

When reviewing a contract, the Court will look first at the written instrument to see if it is complete and unambiguous. In this case, the Court found that the result was nonsensical, but the contract was clear. The language was plain and there were no allegations of fraud or mistake alleged by Samick that would allow the Court to look at any evidence outside of the contract. In this instance, Hoy was not a guarantor of Hammell's debt and the action brought by Samick was dismissed.

In Texas, Vitro America Inc. sued Becky Clark based on a guaranty she signed guarantying the debts of James Clark Inc. The original guaranty contained a drafting error in identifying the borrower. At trial, Vitro, unlike Samick above, sought reformation, or a correction of the guaranty, to correct an error in drafting. Originally, the top half of the one page form extended credit from ACI Distribution, a Vitro entity, to James Clark, Inc. and was signed by Becky Clark as vice president. The bottom half of the one page form contained an individual guaranty which had been filled in to state that Becky Clark personally guaranteed any obligation of ACI Distribution to Vitro America Inc. instead of personally guarantying the debt of James Clark, Inc., the borrower to ACI.

necessary resources to deal constructively with problem loans and the implementation of creative loan work-out arrangements.

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When Vitro sued to enforce the guaranty, Clark contended that she had meant to guaranty the debt of ACI to Vitro and did not intend guaranty any obligation owed by James Clark, Inc. The Court determined that a contract is ambiguous if more than one interpretation was reasonable. Read literally, the contract stated that Becky Clark agreed to guaranty payment by one Vitro entity to another. The Court found the result nonsensical because ACI was the party extending the credit in the first place and no reasonable interpretation would require Becky Clark to guaranty any obligations of ACI. The Court likewise found that the sole reasonable construction of the contract was evident on its face and did not require further evidence. The trial court's ruling was affirmed and Becky Clark was found liable to Vitro America, Inc. for the obligations of James Clark Inc.

In both cases discussed above, the lender failed in some manner to properly state the terms of the guaranty. The effect of such errors differs in the two cases, but what is clear is that lenders must exercise due care when drafting and reviewing the executed loan documents to be sure they are properly signed. Lenders must ensure names are properly spelled and inserted in the appropriate places in an instrument, borrowers and guarantors are properly identified, security instruments and other recorded documents accurately describe the collateral property, and that the terms are clear and unambiguous. If the lender becomes aware after execution of the loan documents that a drafting error exists, it is best policy to have the borrower and guarantors execute correction instruments identifying the error and restating the parties original intention, thereby reforming the contract. Addressing these concerns prior to litigation is less costly and most likely to result in a positive outcome for the lender. Yearly auditing of loan files with careful examination of details such as parties' names, descriptions and spelling will decrease the need to defend costly lawsuits later as well.

The cases above are cited as S*amick Music Corp v. Hoy, No. M2008-00441-COA* (Tenn. Ct. App. 10/22/08) and *James Clark Inc. etc. et al. v. Vitro America Inc. etc., No. 09-08-040 CV* (Tex. Ct. App. 10/10/08).

NEWS ALERT - SBA Temporarily Eliminates Up Front Fees And Increases Its Guaranty To 90% To Encourage Lending

ON MARCH 16, 2009, THE SBA ISSUED POLICY NOTICE 5000-1097, *IMPLEMENTATION OF SECTION 501 OF THE RECOVERY ACT - FEE ELIMINATION PROVISIONS* AND POLICY NOTICE 5000-1098, *IMPLEMENTATION OF SECTION 502 OF THE RECOVERY ACT - UP TO A 90 PERCENT GUARANTY ON 7(A) LOANS*. THE SBA HAS ISSUED POLICY NOTICES CHANGING THE RELEVANT PROVISIONS OF SOB 50-10(5)(A) EFFECTIVE AS FOLLOWS:

Effective as of February 17, 2009 for any loans approved by the SBA (on or after that date), the SBA has temporarily eliminated: for 7(a) loans -- up-front guaranty fees; and for 504 loans -- 3rd party participation fees and CDC processing fees. This does not constitute a permanent elimination of fees; it is only available until the subsidy funds allocated for the program are exhausted (it is anticipated that funds will last through December, 2009). The SBA is working on a refund mechanism and anticipates that refunds will begin in May for guaranty fees already paid to the SBA for loans approved on or after February 17, 2009. Lenders will also need to reimburse borrowers for any guaranty fees paid on loans approved on or after February 17, 2009.

Effective as of March 16, 2009, lenders may apply through the standard 7(a), CLP, PLP, Small Rural Lender Advantage, Community Express, Patriot Express, Export Express and Gulf Opportunity Programs for up to a 90% loan guaranty. The maximum loan amounts guarantied has not changed, however. Please call Alison W. Rind or Arnold D. Spevack if you have any questions concerning the implementation of these Policy Notices. We anticipate that there will be additional information forthcoming concerning the SBA participation in secondary market purchases of SBA loans.

Thank You

THANK YOU TO ALL OF OUR CLIENTS AND FRIENDS WHO ATTENDED OUR FIRST MEET AND GREET OF 2009.

Your participation made it a resounding success. Look out for our upcoming seminar on how the stimulus package will affect SBA lending, to be scheduled once regulations are issued by the U.S. Small Business Administration.

We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Bill Melchior at **wgmelchior@lerchearly.com.**

Additionally, a number of the Firm's other departments periodically issue highly informative newsletters on a variety of other subjects, including Real Estate, Community Associations, and Employment and Labor. If you would like to view one or more of these newsletters, you may access them through our website, **www.lerchearly.com**.

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