

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.

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Practice Tip - Sealing A 12-Year Statute Of Limitations

Have you ever wondered what is the purpose of having the word "seal" at the end of a signature line of a loan document or contract? Under Maryland law, a document that is signed "under seal" is subject to a 12 rather than a 3-year statute of limitations.



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News Flash!

SBA 504 loan program increases size limits.

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The first section of the SOP deals with lender and CDC participation. Now, all lenders applying for PLP, CLP or Express status must provide a statement that the lender is in good standing with its primary regulator and disclose any enforcement actions over the last 2 years. In the event the application is denied, a lender must wait one year prior to any re-application. Certain businesses are now eligible for PLP/Express processing. They include medical facilities, applicants doing business in foreign countries and farm businesses. SBA Express lenders must have a satisfactory review from OCRM (Office of Credit Risk Management) with no major objections from its director and the fees for OCRM review now include any oversight fees or expenses incurred by the SBA in carrying out oversight activities.

A lender may not establish a preferential collateral position for itself. A lender cannot take side collateral only securing its interest where it is participating with an SBA loan in connection with a transaction, require compensating balances not under the control of a borrower, or have a piggyback structure.

The revised SOP reduces the documentation required to be provided to the SBA upon loan closing. A lender no longer needs to send the SBA Form 1050 Settlement Sheets to the SBA after closing (keep them in your loan file). A lender will need to send the signed SBA Authorization and any amendments to the SBA upon closing. With respect to Express loans, credit scoring may be used only if lender already uses credit scoring for non-express loans and while credit decisions are left to the business judgment of the lender, early loan defaults on Express loans will be reviewed by the SBA.

The second section of the SOP deals with loan processing. Certain business are now eligible for SBA loans, including mortgage service companies that disburse loans and sell them within 14 days of loan closing, mini-warehouses, office suites, shopping centers, flea markets, check cashing businesses (at least 50% of revenue is from cashing checks), and mobile home parks if at least 50% of the income is derived from services rather than rental income. The SOP has clearly identified eligibility concerns regarding franchises. These requirements should be reviewed for franchises, license agreements, dealer agreements, jobber and similar agreements.

Eligibility requirements for businesses deriving revenue from sexual material have been revised. A business cannot derive more than 5% of its gross revenue from the sale of products, services or the presentation of any depictions or displays of a prurient sexual nature (used to be de minimus rule) to be eligible for an SBA loan. With respect to businesses with religious affiliations, a lender must consider the overall activities and business environment of an applicant (SEE SBA eligibility worksheet in SOP 70 50 3) to determine eligibility.

There are revised standards for Form 912- Character Issues. If applicant answers "yes" to item 7 – not eligible. If applicant answers "yes" to item 8 or 9, then there must be a background check, unless "yes" was a single misdemeanor that was subsequently dropped without prosecution (this does not include probation before judgment). And now, verification of alien status must be completed prior to disbursement (used to be prior to PLP submission approval).

With respect to refinances, the borrower's new installment amount must be at least 20% less than existing installment (in the aggregate) and in an express loan refinance, PLP lender cannot refinance its own debt if it results in less exposure to the PLP lender.



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In change of ownership transactions, the seller may only remain a consultant for a period not to exceed 12 months, if real estate is involved, real estate cannot be financed by a non-SBA loan unless the lien positions are in a shared lien position (*pari passu*) and if the seller has an SBA loan with the same lender, new loan cannot be processed PLP.

If the nature of a business requires a resident owner, loan proceeds may be used for the purchase of an existing building or construction that includes residential space not to exceed 49% of the total property. Other revisions include requirements that the maximum loan amount including loans to affiliates (made within 90 days) is \$2,000,000, working capital loans should not exceed 7 yrs (unless there is written justification of extending term to no more than 10 yrs) and maturity shall not exceed remaining useful life of existing assets (in refinance situations). On the plus side, a lender may now use the maturity based upon the maximum asset class comprising the largest percentage of the use of proceeds instead of a blended rate, although, the maturity cannot be longer than the guaranty. The SOP also identifies the maximum interest rate spreads for the various loan programs.



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The SOP includes five requirements to be addressed where written request for reinstatement after cancellation of guaranty is made. A lender may not charge default interest or separate servicing fees for past due financials nor can it recover software costs to prepare SBA documents. Referral fees are not permitted in Express loans

Changes to guarantor rules include, if no one person or entity owns 20% or more, the loan must still include at least 1 guarantor and if 20% or more owners are 401(k)/ESOP plans, a lender does not need ESOP guaranty so long as the beneficiaries of the plan guaranty the loan (borrower cannot be an EPC).

One of the biggest areas for concern are changes in the equity requirements. The SBA's position is that this is not a policy change, however, it is clear that a lender will need to document the following requirement in order to prove equity injection: an applicant must be able to demonstrate that repayment of a home equity loan may be made from personal resources (not including income of business owner or business cash flow).



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On a positive note, with respect to standby debt, a seller may be able to charge interest only payments (and the debt will still be considered equity) when there is historic cash flow to support payment. A lender does need the personal residence to meet the "fully secured" definition if the equity is less than 25% of the property's fair market value.

Other requirements include, if the applicant's spouse and the applicant own more than 20% of the business, then lender must consider taking as collateral assets that are owned individually as well as jointly, and each spouse owning 5% or more of the borrower must personally guaranty the loan if, together with his or her spouse, they own 20% or more, and a lender must use reasonable and prudent efforts to verify equity (gift letters, promissory notes or financial statements are not enough).

For loans above \$250,000, where commercial property is pledged, a lender will need an appraisal (USPAP standard prepared). This requirement does not extend to real estate securing a personal guaranty. If construction/renovation is included, an as completed value appraisal is required (if it is within 90% of the estimated value, lender may close but must document the file as to why the appraisal was less). If it comes in less than 90% of the estimate, a lender will need SBA permission to close (PLP lender may assume the risk and close without SBA approval, however, the appraisal is subject to review and approval by the SBA upon repurchase). In business valuations, if the loan is greater than \$350,000 or there is a close relationship between the buyer and seller, then a lender will need independent business valuation by an accredited organization. If the business has been transferred within 36 months, the lender will need a second review of the appraisal (2nd appraiser or senior member of lender's staff with site visit).

Another area for concern is the revised environmental requirements. Included in the SOP are appendices setting forth applicable definitions, reliance letters, a list of environmentally sensitive industries and gas station requirements. Where an environmental indemnity agreement is required, the Environmental indemnity agreement included in appendix must be used and cannot be modified. This will, in effect,

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

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keep gas stations out of the SBA portfolio in most instances.

If the property is not used in an environmentally sensitive industry, then an environmental questionnaire is required if the loan is less than \$150,000, and an environmental questionnaire and Records Search with Risk Assessment is required for loans over \$150,000.0. If the property is used in an environmentally sensitive industry, start with Phase I. If the project is a gas station, a lender must comply with gas station requirements in appendix. This will, in effect, keep gas stations out of the SBA portfolio in most instances.

Changes under the Authorization include the following: lenders should remember that a Form 912 is required for all officers, directors, owners of 20% or more (key employees eliminated), a lender no longer need dual payee checks for inventory, FF&E if a lender has receipts, invoices or other supporting documentation and when the building is not collateral, lender may use prudent lending standards to determine if flood insurance is required (including whether flood insurance is not economically feasible or available). With respect to life insurance, if the viability of the business is tied to an individual or individuals, then a lender must require life insurance (does not include Express/Pilot loans). The life insurance requirements should be consistent with the size and term of the loan. Also, only the first SBA Form 1050 Settlement Sheet must be signed by the borrower at closing. For all subsequent disbursements, the lender only needs to attach additional disbursements to the original form (without the borrower's signature).

Revisions to the construction requirements are also beneficial to borrower. The level for additional construction review and due diligence (ie, bonds, contract review, etc) has been increased from \$125,000 to \$350,000. A lender may use construction management firm in lieu of bonding the project and additional requirements for do it yourself construction include, the borrower must be experienced in the type of construction and have appropriate licenses, the cost should be the same or less than if an unaffiliated contractor is used and no profit shall be earned by the borrower.

Finally, a lender must use form 2237 for all post closing requests, loans must be disbursed within 48 months from approval date (guaranty is cancelled for any further disbursements).

The SOP modernization effort will continue with the SOP 50-51 (Liquidation and Acquired Property) next in line for revision and is slated for completion in early 2009.

Obviously, this article is not a comprehensive restatement of the revised SOP 5010. However, we hope it will assist you in your underwriting any SBA loan submitted to the SBA on or after August 1, 2008. As always, please contact us if you have any specific questions regarding these changes.

Borrower's Evidence of 'Bait and Switch' Keeps lender Fraud Litigation Alive

A federal District Court recently held that a developer had sufficiently alleged unlawful conduct by a lender in offering a loan it would never be able to make to a developer and permitted the developer to defeat a motion to dismiss its claim of fraud against the lender.

Kennedy Funding, Inc. was engaged in the business of commercial real estate lending. Royale Luau Resort, LLC became involved in a commercial real estate transaction for the proposed purchase and development of condominiums on a parcel of land in Florida. Royale contacted KFI and sought to enter into a commercial loan transaction. In April 2005, Royale and KFI, executed a "Loan Commitment," which stated a loan amount of \$92 million. The commitment was to become effective upon delivery to KFI of a signed copy of the commitment, the payment of \$25,000 for the preparation of the commitment and a \$2.76 million commitment fee to be paid to KFI in two installments: \$500,000 at the time the commitment was signed, and the balance to be paid at the closing or upon election not to proceed to a closing. On April 8, 2005, Royale wired the \$500,000 portion of the commitment fee and the additional \$25,000 fee to KFI.

The commitment stated that KFI was not obligated to loan more than 60% of the appraised "market

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value of the real estate Collateral as completed by KFI loan proceeds"; in other words, an "as-built" appraisal. The developer alleged in its lawsuit that KFI instructed its appraiser to provide low estimates of the real property. Specifically, Royale alleged that the appraiser did not use an "as completed" appraisal, but rather an "as intended" appraisal, which did not take into consideration the value of a completed condominium building. The appraiser declared the market value of the property to be \$29.7 million, while the purchase price for the property was \$32 million. To further compound matters, the appraiser provided a "disposition value" appraisal of the property totaling \$17.8 million, as it applied a 40% discount to the "as intended" appraisal. Royale alleged, therefore, that KFI was aware that any loan based upon the disposition value appraisal would be grossly insufficient to allow Royale to purchase the property, much less redevelop it into a condominium building. Ultimately, KFI made a loan offer to Royal of \$10 million.

Not surprisingly, Royale and KFI never closed on the loan. Instead, on March 22, 2007, Royale filed a complaint alleging violations of the New Jersey Consumer Fraud Act. KFI moved to dismiss all but the breach of contract and breach of covenant of good faith and fair dealing claims.

The U.S. District Court, District of New Jersey stated that the New Jersey Consumer Fraud Act ("CFA") provides that "[a]ny person who suffers any ascertainable loss of moneys or property, real or personal, as a result of the use or employment by another person of any method, act, or practice declared unlawful under this act... may bring an action or assert a counterclaim therefor in any court of competent jurisdiction." Further, the elements of a CFA claim are: 1) unlawful conduct by the defendant; 2) an ascertainable loss on the part of the plaintiff; and 3) a casual relationship between the defendant's unlawful conduct and the plaintiff's ascertainable loss.

The District Court noted that this was not the first case involving KFI and analogous fraud allegations, as at least one case had facts which were conspicuously similar to the Royale case. There, as here, the potential borrower expressly stated the need for a loan in a certain amount and, despite paying an exorbitant, nonrefundable commitment fee prior to the appraisal, the potential borrower learned that it would not get the amount of financing needed, and the fee was never returned by KFI. Additionally, in both cases there was a dispute between KFI and the potential borrower regarding the proper valuation of the subject property. The court ultimately ruled that Royale sufficiently alleged facts that, if true, amounted to a "bait and switch scheme," and therefore the Court permitted Royale to proceed with its claim of fraud under the CFA. KFI's motion to dismiss the CFA claim were denied.

The above case is cited as Royale Luau Resort, LLC v. Kennedy funding, Inc., et al., No. 07-1342 (HAA) (D.N.J. 02/19/08, unpublished).

A Disclaimer of Agency Fails if Agency Relationship Exists

A Colorado court found that a disclaimer of an agency relationship contained in a lease/purchase agreement is irrelevant in analyzing whether an agent has express authority to act on the principal's behalf.

In 2005, Sepehr Katiraie entered into dealings with United Leasing and Distributions, Inc. for the purchase of an MRI machine and CT scanner. United represented itself to Katiraie as a broker engaged in loaning money for the purchase of medical equipment and told Katiraie that the medical equipment was valued at \$350,000. Katiraie relied on these representations and his professional corporation, Sepehr Katiraie MD Inc., entered in a lease/purchase agreement with Highline Capital Corp. Katiraie claimed he was not aware that Highline was a separate entity from United. The lease/purchase agreement included a clause stating that Katiraie agreed that "neither the supplier, nor any salesperson, employee or agent of supplier is our agent or has any authority to speak for us or to bind us in any way." After signing the agreement, Katiraie learned that United was not financing the transaction and the value of his medical equipment was far lower than had been previously represented to him, and he refused to pay. Highline defaulted SKMD under the agreement and filed suit against SKMD and Katiraie. Katiraie asserted that he was fraudulently induced into entering into the transaction and counterclaimed

against United.

Katiraie argued that United, acting under either express or apparent authority from Highline, fraudulently induced him to enter into the agreement by misrepresenting United's true role with respect to the transaction and the actual value of the equipment. Highline countered that Katiraie could not establish either an agency relationship or fraudulent inducement because Katiraie signed the lease/purchase agreement that included the clause that United was not an agent of Highline.

When looking at agency, the Court stated that an agent can make its principal responsible for its actions if the agent acted pursuant to either actual or apparent authority, regardless of whether the principal had knowledge of the agent's conduct. Express authority exists whenever the principal directly states that its agent has authority to perform any particular act on the principal's behalf. In this case, the evidence Katiraie proffered suggested that United had express authority to act on behalf of Highline. Highline admitted that before execution of the lease/purchase agreement Katiraie had no direct contact with Highline and United communicated with Katiraie on Highline's behalf. Additionally, Highline sent the lease documents to United and instructed it to have Katiraie sign the documents and return them to Highline. Highline relied on the clause in its agreement that stated that SKMD agreed that Highline had no agent. The Court, however, stated that the test for whether express authority exists contains no requirement of specific assent on behalf of third parties, only that the principal directly state that its agent has authority to perform a particular act on the principal's behalf. Therefore, the disclaimer was irrelevant to the question of whether such a relationship existed.

Lenders are often in situations where they use brokers in order to close a transaction. If a lender provides a broker with express or apparent authority to perform functions on the lender's behalf, any potential liability of the broker would bear equally on the lender. Lenders should review any broker relationships carefully and determine the extent of any authority a broker may have. A disclaimer in loan documents or a commitment letter may not release the lender from liability by any acts committed by the broker.

The case above is cited as Highline Capital Corp v. Ahdoot, et al., Nos. 06-cv-02023-EWN-CBS and 06-cv-02024-EWN-BNB (D. Colo. 02/20/08)

Practice Tip - Sealing A 12-Year Statute Of Limitations

Have you ever wondered what is the purpose of having the word "seal" at the end of a signature line of a loan document or contract? Under Maryland law, a document that is signed "under seal" is subject to a 12 rather than a 3-year statute of limitations.

If a promissory note matures and a suit to enforce collection of the note is not filed within three years, the lender is prohibited from pursuing collection of the note unless the note was signed under seal and thereby has a 12 year statute of limitations.

In a recent case before the Maryland Court of Special Appeals, the Court permitted collection of a loan evidenced by a note where the collection proceeding was commenced more than three years after the note matured. Although the note was not executed "under seal", the deed of trust was executed "under seal" and contained a covenant obligating the grantor to pay the amounts due under the note. The court reasoned that the collection action was pursuant to the payment covenant contained in the deed of trust rather than the note.

We do not recommend relying upon such a ruling in order to enforce a promissory note. The better practice is to make sure that all loan documents are executed "under seal" by placing the word "seal" at the end of the signature line and having the closing sentence of the loan document state that the document was "signed and sealed."

News Flash - SBA 504 loan program increases size limits!

The SBA has increased the size limits for companies eligible for SBA 504 financing. Beginning August 18, companies with a net worth of up to \$8.5 million and as much as \$3 million in annual earnings may borrow from the SBA 504 program. The previous size limits were \$7.5 million in net worth and \$2.5 million in average earnings.

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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@lercheearly.com.

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