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B-140673, Feb 2, 1972, 51 Comp Gen 474

Number: B-140673

Date: 1972-02-02

B-140673, FEB 2, 1972, 51 COMP GEN 474

SMALL BUSINESS ADMINISTRATION - LOANS - GUARANTEED LOAN PROGRAMS - DEFAULT, ETC., BY BORROWER - BANK'S DEMAND PAYMENT STATUS ALTHOUGH UNDER THE LOAN GUARANTEE PROGRAM CONDUCTED PURSUANT TO SECTION 7(A) OF THE SMALL BUSINESS ACT, THE SMALL BUSINESS ADMINISTRATION (SBA) HAS THE DISCRETIONARY POWER TO ARRANGE FOR A BANK TO MAKE DEMAND PAYMENT (IMMEDIATE PURCHASE) FOR THE PERCENTAGE OF THE LOAN GUARANTEED, EITHER UPON DEFAULT OF THE LOAN OR WHEN THE BORROWER BREACHES A MATERIAL COVENANT OF THE LOAN AGREEMENT, PAYMENT BY SBA TO A BANK UNDER THE LOAN GUARANTEED PROGRAM "WHERE SBA OFFICIALS HAVE KNOWLEDGE, PRIOR TO PAYMENT, OF THE POSSIBILITY OF BANK NEGLIGENCE, FRAUD, OR MISREPRESENTATION," IN ORDER TO PROTECT CERTIFYING OFFICERS WOULD NOT BE IN THE BEST INTEREST OF THE UNITED STATES AND MAY NOT BE APPROVED. HOWEVER, SBA MAY PAY AN INNOCENT HOLDER OF A GUARANTEED LOAN NOTE UPON DEFAULT OF A BORROWER SINCE PAYMENT WILL NOT WAIVE ANY RIGHT OF SBA AGAINST THE BANK INVOLVED.

TO THE ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION, FEBRUARY 2, 1972:

YOUR LETTER OF NOVEMBER 23, 1971, PRESENTS TO US A QUESTION ARISING INCIDENT TO THE LOAN GUARANTEE PROGRAM CONDUCTED PURSUANT TO SECTION 7(A) OF THE SMALL BUSINESS ACT, PUBLIC LAW 85-536, 72 STAT. 384, 387. YOUR QUESTION, IN EFFECT, RELATES TO THE DEGREE OF RISK WHICH MAY BE UNDERTAKEN BY THE SMALL BUSINESS ADMINISTRATION (SBA) IN CARRYING OUT ITS FUNCTIONS UNDER THE PROGRAM.

UNDER THE PRESENT LOAN GUARANTEE PROGRAM - AS DISTINGUISHED FROM SBA'S PRIOR DEFERRED PARTICIPATION PROGRAM - WHEN SBA HAS APPROVED A BANK'S APPLICATION FOR GUARANTEE OF A PERCENTAGE OF A LOAN TO A SMALL BUSINESS CONCERN, THE BANK MAY DEMAND PAYMENT (IMMEDIATE PURCHASE) OF SUCH PERCENTAGE AS SOON AS THE LOAN IS IN DEFAULT FOR 60 DAYS, OR A MATERIAL CONVENANT HAS BEEN BREACHED BY THE BORROWER. PARTICIPATING BANKS ARE REQUIRED TO EXECUTE CERTAIN ASSURANCES AND PROCEDURES FOR THE PROTECTION OF SBA. THE PRIOR DEFERRED PARTICIPATION PROGRAM WAS APPROVED BY THE COMPTROLLER GENERAL BY LETTER OF OCTOBER 12, 1959 (B 140673), WHEREIN IT WAS STATED THAT "THIS POWER (UNDER SECTION 7) TO MAKE LOANS IS BROAD AND VESTS IN THE ADMINISTRATOR CONSIDERABLE DISCRETION AS TO THE DETAILS FOR EXECUTING THE LOAN ARRANGEMENTS." IN VIEW OF THIS DISCRETIONARY POWER, WE LIKEWISE WOULD HAVE NO OBJECTION TO THE PRESENT LOAN GUARANTEE PROGRAM.

YOU NOW SEEK APPROVAL OF SBA PAYMENT (IMMEDIATE PURCHASE) TO A BANK UNDER THE LOAN GUARANTEE PROGRAM, IN SITUATIONS "WHERE SBA OFFICIALS HAVE KNOWLEDGE, PRIOR TO PAYMENT, OF THE POSSIBILITY OF BANK NEGLIGENCE, FRAUD OR MISREPRESENTATION." YOU STATE THAT SUCH SITUATIONS ARE RARE, AND THAT, AS ALWAYS, ALL INVESTIGATIVE AND AUDIT PROCEDURES WOULD BE INSTITUTED AFTER PAYMENT IS MADE. YOUR PRIMARY MOTIVE FOR SEEKING OUR APPROVAL OF PAYMENT UNDER THESE CIRCUMSTANCES IS,

APPARENTLY, TO PROTECT CERTIFYING OFFICERS FROM LIABILITY FOR PAYMENTS MADE WITH THE KNOWLEDGE THAT THE STATED IRREGULARITIES MAY EXIST. YOUR LETTER DISCLOSES THAT PURSUANT TO THE PROVISIONS OF THE GUARANTEE AGREEMENT THE BANK MUST -

*** CLOSE AND DISBURSE EACH LOAN IN ACCORDANCE WITH THE TERMS AND CONDITIONS OF AN SBA APPROVED LOAN AUTHORIZATION; THE BANK IS REQUIRED TO FULLY PROTECT AND PRESERVE THE INTEREST OF THE BANK AND SBA IN THE LOAN; PRIOR TO EACH DISBURSEMENT, THE BANK MUST DETERMINE THAT THERE HAS BEEN NO UNREMEDIED MATERIAL OR ADVERSE CHANGE IN THE FINANCIAL OR ANY OTHER CONDITION OF THE BORROWER WHICH IN BANK'S OPINION WARRANTS WITHHOLDING OF THE DISBURSEMENT; IMMEDIATELY AFTER THE FIRST DISBURSEMENT, THE BANK MUST FURNISH SBA WITH A COPY OF THE EXECUTED NOTE AND SETTLEMENT SHEET; IMMEDIATELY AFTER EACH DISBURSEMENT, SBA MUST BE NOTIFIED OF THE AMOUNT DISBURSED; IN MAKING WRITTEN DEMAND THAT SBA PURCHASE THE GUARANTEED PORTION OF ANY LOAN, THE BANK IS DEEMED TO CERTIFY THAT THE LOAN HAS BEEN DISBURSED AND SERVICED IN COMPLIANCE WITH THE AGREEMENT AND THAT THE AGREEMENT REMAINS IN FULL FORCE AND EFFECT; ALL LOAN DOCUMENTS MUST BE ASSIGNED AND DELIVERED TO SBA AS A CONDITION OF PAYMENT BY SBA; AND THE AGREEMENT STATES THAT PURCHASE BY SBA SHALL NOT WAIVE ANY RIGHT OF SBA ARISING FROM LENDER'S NEGLIGENCE, MISCONDUCT OR VIOLATION OF ANY PROVISION OF THE GUARANTEE AGREEMENT.

IN 28 COMP. GEN. 425 (1949), A FIRMLY ESTABLISHED POLICY OF THIS OFFICE WAS, AGAIN, DELINEATED:

*** IT IS AXIOMATIC THAT IN PERFORMING HIS OFFICIAL DUTIES AS A CERTIFYING OFFICER AN EMPLOYEE IS DUTY-BOUND TO ACT IN SUCH A MANNER AND TO TAKE ALL NECESSARY STEPS TO INSURE ADEQUATE PROTECTION OF THE INTERESTS OF THE UNITED STATES. THAT DUTY IS AN INHERENT AND INTEGERAL PART OF THE POSITION OF CERTIFYING OFFICER, AND IN FUNCTIONING AS SUCH AN OFFICER OR EMPLOYEE ALWAYS SHOULD BE MINDFUL OF THAT RESPONSIBILITY *** .

IT WOULD BE EXTREMELY DIFFICULT TO SUPPORT THE POSITION THAT A CERTIFYING OFFICER WHO CERTIFIES THE PAYMENT OF GOVERNMENT FUNDS, WHILE POSSESSING THE KNOWLEDGE THAT THE RECIPIENT THEREOF MAY BE GUILTY OF NEGLIGENCE, FRAUD OR MISREPRESENTATION IN OBTAINING SUCH FUNDS, HAS TAKEN ALL STEPS NECESSARY TO PROTECT THE INTERESTS OF THE GOVERNMENT. SUCH AN OFFICER, IN FACT, WOULD NOT BE SERVING THE PURPOSE OF HIS EMPLOYMENT, AND WAIVER OF LIABILITY FOR SUCH CONDUCT WOULD, IN OUR OPINION, BE UNAUTHORIZED.

WHILE THIS OFFICE SANCTIONED SBA'S PRESENT PRACTICE UNDER THE PRIOR DEFERRED PARTICIPATION PROGRAM OF IMMEDIATE PURCHASE OF THE AGREED PORTION OF THE LOAN PRIOR TO DETERMINATION OF COMPLIANCE BY THE LENDING INSTITUTION INVOLVED, IT WAS NEVER CONTEMPLATED THAT THESE PAYMENTS WOULD BE MADE TO SUCH INSTITUTION IN THE FACE OF KNOWN POSSIBILITIES THAT IRREGULARITIES INVOLVING THAT LENDING INSTITUTION MAY EXIST. WHILE THE CITED LETTER OF OCTOBER 12, 1959, APPROVED THOSE PROCEDURES AS BEING WITHIN THE LIMITS OF THE ADMINISTRATOR'S DISCRETION, IT WAS NOT INTENDED TO IMPLY THAT THIS DISCRETION IS UNLIMITED.

IN VIEW OF THE ABOVE, THE REQUEST FOR APPROVAL OF PAYMENT TO BANKS UNDER THE CIRCUMSTANCES DESCRIBED IN YOUR LETTER OF NOVEMBER 23 MUST BE DENIED.

WE UNDERSTAND, HOWEVER, THAT THERE IS A SECONDARY MARKET FOR THESE SBA PERCENTAGE GUARANTEED LOANS AND THAT BANKS SELL - ON THE BASIS OF THE SBA GUARANTEE - THE NOTES REPRESENTING THE SBA PERCENTAGE GUARANTEED LOANS TO MUTUAL FUNDS, PENSION FUNDS, ETC. THUS, A QUESTION HAS ARISEN AS TO WHETHER SBA MAY PAY A HOLDER OF AN SBA GUARANTEED LOAN NOTE - OTHER THAN THE BANK MAKING SUCH LOAN -

WHERE SBA HAS KNOWLEDGE OF THE POSSIBILITY OF NEGLIGENCE, FRAUD, OR MISREPRESENTATION ON THE PART OF SUCH BANK, BUT WHERE THE PRESENT HOLDER OF THE NOTE DID NOT PARTICIPATE IN AND WAS NOT AWARE OF SUCH NEGLIGENCE, FRAUD, OR MISREPRESENTATION AT THE TIME IT PURCHASED THE NOTE FROM THE BANK.

WE WERE INFORMALLY ADVISED BY SBA REPRESENTATIVES THAT THE SECONDARY MARKET FOR SBA GUARANTEED LOAN NOTES WOULD BE SERIOUSLY CURTAILED IF UPON DEFAULT BY THE BORROWER SBA FAILED TO MAKE IMMEDIATE PURCHASE OF SUCH NOTE FROM A HOLDER WHO DID NOT PARTICIPATE IN, AND WAS NOT AWARE OF, ANY NEGLIGENCE, FRAUD, OR MISREPRESENTATION BY THE BANK AT THE TIME SUCH HOLDER PURCHASED THE NOTE FROM THE BANK.

IN OUR OPINION PAYMENT TO AN INNOCENT HOLDER OF AN SBA GUARANTEED LOAN NOTE IS CLEARLY DISTINGUISHABLE FROM PAYMENT TO A BANK WHICH MAY BE GUILTY OF NEGLIGENCE, FRAUD, OR MISREPRESENTATION IN OBTAINING THE SBA LOAN GUARANTEE. THEREFORE, AND SINCE IT APPEARS THAT PAYMENT BY SBA TO AN INNOCENT HOLDER OF AN SBA GUARANTEED NOTE WOULD NOT WAIVE ANY RIGHT OF SBA AGAINST THE BANK INVOLVED, ARISING FROM THE BANK'S NEGLIGENCE, MISCONDUCT, OR VIOLATION OF THE GUARANTEE AGREEMENT, WE WOULD NOT OBJECT TO SBA MAKING IMMEDIATE PAYMENT TO SUCH HOLDER UPON DEFAULT OF THE BORROWER, IF OTHERWISE PROPER.