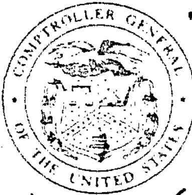
11284

DECISION



THE COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

[Propriety of Interest Penalty Assessed Against Bank By SBA]

FILE: B-181432 DATE: September 4, 1979

MATTER OF: Bank of Trade, San Francisco, California - SBA Guaranteed Loan.

DIGEST: Regulation providing that lender must notify Small Business Administration (SBA) of default by borrower who received SBA-guaranteed loan within 45 days of default or suffer interest penalty equal to accrued interest on guaranteed portion of loan from date of default until date SBA receives notice, was incorrectly applied by SBA. SBA assessed interest penalty against lender which included interest borrower paid lender after default occurred. Since "accrued interest" should be understood to mean earned interest that has never been paid by borrower, SBA should reimburse lender for that portion of interest penalty representing interest that was paid by borrower. AGC00002

This decision is in response to a request from the Vice President of the Bank of Trade (Bank), San Francisco, California, for our Office to review an action taken by the Small Business Administration (SBA) in assessing a $7,118.57 "interest penalty" against the Bank in connection with SBA's purchase of the guaranteed portion of a loan which the Bank made to the owners of La Reserve Restaurant (Borrower). DLG02662 DLG02663

SBA has indicated that its action was based, in part, on rulings by the Comptroller General interpreting SBA's regulations case. It is our judgment that SBA's action in assessing the interest penalty at issue here was not required by or in accordance with its own regulations or the decisions of our Office.

On December 27, 1976, SBA approved the Bank's request for SBA to guarantee 90 percent of a $150,000 loan to be made to the Borrower. The Borrower's note to the Bank, which was dated April 1. 1977, provides for three initial installment payments of interest on funds advanced (to begin one month from the date of note), followed by 117 installments of principal and interest, of $2,002 each (to begin 4 months from the date of the note).

The Bank made the first disbursement on the loan on May 18, 1977, and promptly paid the required guarantee fee to SBA on the next day. (The balance of the $150,000 loan was fully disbursed

~~006423~~

to the Borrower by September 21, 1977.) Apparently because the loan was a construction loan and the Borrower was generating no income, the Bank did not require the Borrower to make either the initial payments or the first combined interest and principal payments when scheduled. It appears, however, that the Bank neither requested nor received SBA's prior written approval to change any of the repayment terms of the loan, as required by the Loan Authorization and Blanket Guaranty Agreement.

On October 28, 1977, the Borrower made the first payment on this loan which, in accordance with the terms of the note and the Loan Authorization, was applied by the Bank first to all accrued unpaid interest on the disbursements that had been made up to that time, with the balance of the payment being applied to reduce the outstanding principal. The Borrower made three subsequent payments on November 9, 1977, January 24, 1978, and February 15, 1978, but the loan was never brought current. SBA later determined that these installments paid accrued interest on the loan up to January 16, 1978. (Although the initial interest default was cured by the payment on October 28, 1977, the "principal" default was a continuing one that was never cured since the Borrower did not make up the missed principal payments that, under the terms of the note, were due in August and September. See B-193134, July 27, 1979.) On March 20, 1978, the Bank notified SBA by telephone that the loan was overdue. Subsequently, pursuant to the Bank's request, SBA purchased the guaranteed portion of the loan from the Bank.

In its pre-purchase review, SBA determined that pursuant to its regulations, as well as rulings by our Office, concerning the requirement that lenders must notify SBA of a default within a specified period of time, an interest penalty totalling $7,118.57 should be deducted from the amount that would otherwise be paid to the Bank, due to the Bank's failure to notify SBA of the default within 45 days. SBA computed the amount of the penalty in the following manner. First, SBA determined the date of default to be June 1, 1977, when the Borrower failed to make the interest payment that was due on that date. (Although the note as written provided in effect that the first interest payment was due on May 1, 1977--one month from the date of the note--SBA determined that no interest was due at that time since the first disbursement of the loan funds was not made until May 18, 1977.)

SBA further concluded that the default was a continuing one that was never cured and that therefore the Bank should have notified SBA within 45 days of default as required by 13 C.F.R § 122.10(b)(1) (1978). The Bank did not actually notify SBA until March 20, 1978.

SBA's regulations provide that whenever notification of default is not received within 45 days, unless otherwise excused, the lender shall not receive accrued interest on the guaranteed portion of the loan from the date of default until the date SBA receives notice. SBA interpreted this to require that the interest that became due on the guaranteed balance of the loan between June 1, 1977, and March 20, 1978, should be deducted from the amount to be paid to the Bank. In this fashion, SBA determined that $7,118.57, representing "accrued" interest during that period on the guaranteed portion of the unpaid balance, was the appropriate penalty, even though most of that amount was ultimately paid to the Bank by the Borrower. Therefore, since the interest that had accrued on the loan between January 16, 1978, the date to which SBA calculated the payments to have brought interest current, and August 7, 1978, when the loan was purchased by SBA, only totalled $5,017.01, SBA refused to pay interest on the guaranteed portion and deducted the difference between the two amounts--a total of $2,101.56--from its payment on the guaranteed portion of the unpaid principal when it did purchase the loan.

The question of SBA's authority to purchase the guaranteed portion of a loan when the lender has not complied with the notice requirements set forth in SBA's regulations and the Loan Guaranty Agreement was first considered in our decision in B-181432, February 19, 1976. In that decision, we held that thereafter SBA could not legally purchase loans guaranteed pursuant to section 7 of the Small Business Act, as amended, 15 U.S.C. § 636(a) (1970), unless the lending institutions involved had complied with the requirement then set forth in the regulations and the general Loan Guaranty Agreement that they notify SBA within 30 days after the Borrower's default. In response to our decision SBA amended the notice provision in its regulations and Loan Guarantee Agreement on March 8 and then again on August 10, 1976, to increase the amount of time within which banks could notify SBA of a borrower's default, as well as to change the legal effect of a bank's failure to timely notify SBA.

The regulations which are controlling here read in pertinent part as follows:

> "Simplified blanket guaranteed loans are loans made by a lender under a Guaranty Agreement between SBA and the lender which is applicable to future loans to small business concerns as authorized by SBA. Under such a Guaranty Agreement, SBA is obligated to purchase not more than 90 percent of the outstanding balance of each loan authorized thereunder together with accrued interest in the event the borrower has defaulted for not less than 60 days. SBA also has

> the right to purchase at any time the guaranteed percentage of any loan. Any eligible loan which the lender would make only with the guaranty of SBA may be authorized by SBA under said Guaranty Agreement. Written notification of any uncured default in any guaranteed loan shall be received by SBA within 45 days after such default. (Default as used in this subparagraph means nonpayment of principal or interest on the due date.) Where SBA receives written notice of uncured default after 45 days from the date of default by the borrower, the lender shall not be entitled to receive at any time accrued interest on the guaranteed portion of unpaid principal of the loan from the date of default by the borrower to the date of receipt by SBA of written notice of said default; Provided, however, That SBA shall not purchase the guaranteed percentage unless SBA shall first determine that said delay in notification of default did not cause any substantial harm to the Government." 13 C.F.R. § 122.10(b)(1) (1978).

In a letter dated October 29, 1976, from the Director, Community and Economic Development Division (CED), General Accounting Office, SBA was advised that the regulations that were in effect when a particular loan went into default would be controlling. In that letter the Director, CED, stated that with respect to loans that went into default subject to the above-quoted regulation, SBA could not pay accrued interest on the guaranteed portion of the loan from the date of default until the date notice was received if notice was not received by SBA within 45 days.

This decision does not question SBA's determination that the default in this case occurred when the Borrower failed to make the interest payment that was due on June 1, 1977. (We recognize that an argument could be made that the first interest payment was not due until June 8, 1977--one month from the date of first disbursement--and therefore that the Borrower could not have been in default before that date. However, we believe that SBA's position is not unreasonable; SBA believes that the terms of the note providing for monthly payments to become due on the monthly anniversary of the date of the note--April 1, 1977--should be controlling, with the necessary implication that no payments would become due until the initial disbursement of the loan had been made.)

Moreover, we agree with SBA that the Borrower's default that began on June 1, 1977, was a continuing one that was never cured by the Borrower. Although the Borrower's payment on October 28, 1978, did bring interest current as of that date, the Borrower's default in failing to make the principal payments

in accordance with the terms of the note--which would have required the first payment no later than September 1, 1977--was never corrected. Also, the Borrower's failure to make payments as required by the note cannot be excused on the grounds that the Bank agreed to modify the original loan agreement, since SBA did not give its prior written consent to any such modifications as required by the Loan Authorization and Guaranty Agreement. B-193134, July 27, 1979, supra.

Nevertheless, it is our view that SBA improperly applied the above-quoted regulations in this case. The payments made by the Borrower after the default, although insufficient to cure the default, are significant in another regard. The regulatory provision that was relied upon by SBA provides that whenever notice of default is not received within 45 days from the date thereof, the Bank shall not receive "accrued interest" on the guaranteed portion of the unpaid principal from the date of default until the date SBA has received proper notice. Since the default occurred on June 1, 1977, and SBA was not notified until March 20, 1978--well beyond the 45-day period specified in the regulations--SBA could withhold any interest that accrued during that period. However, as indicated above, the post-default payments made by the Borrower were sufficient to pay all interest due on the loan through January 16, 1978.

The term "accrued interest" is generally defined to mean earned interest that has not yet been paid or received. That this term, as used in 13 C.F.R § 122.10(b)(1), should be read to mean "accrued and unpaid interest" that is still owed by the Borrower, is made even clearer upon consideration of the use of the identical term elsewhere in this same section of the regulations. In setting forth SBA's liability in the event of a default lasting at least 60 days, 13 C.F.R. § 122.10(b)(1), quoted above, provides that SBA is obligated to purchase the guaranteed portion of the outstanding balance "together with accrued interest". This can only refer to the accrued and unpaid interest that the lender has never received from the Borrower, since SBA would obviously be without authority to honor a bank's claim for interest that had been paid by the Borrower, whether received by the Bank before or after the default first occurred.

Accordingly, it is our view that under the regulation, whenever a bank does not notify SBA of a borrower's default within 45 days, SBA's obligation to purchase from the bank the guaranteed portion of the outstanding balance of the loan plus interest on that amount should be reduced by the amount of unpaid interest that accrued on the guaranteed portion between the date of default and the date notice was received. However, if the bank's claim to SBA does not include accrued unpaid interest because the Borrower subsequently

(after the default) paid some or all of the interest due on the loan, SBA should not reduce its payment to the bank by an amount that represents interest which has been paid and which the bank was not even asking to receive from SBA. This interpretation still achieves the obvious purpose of the regulation, to provide a clear financial incentive to banks to notify SBA of a default within 45 days; a bank would presumably have no reason to expect that a defaulted borrower would reduce or eliminate the possible effects of this interest penalty by making post-default payments.

Since the Bank in this case did not notify SBA of the Borrower's default within 45 days, SBA should reduce its payment to the Bank on the guarantee by an amount equal to the unpaid interest on the guaranteed balance of the loan that accrued during the period between June 1, 1977, when the default occurred, and March 20, 1978 when notice was received. Therefore, no deduction should have been made by SBA for the interest on the loan through January 16, 1978, since interest was paid through that date. Indeed, interest for that period was not even included in the Bank's claim.

The only proper penalty to assess against the Bank is an amount equal to interest accrued and unpaid between January 16 and March 21, 1978. (In this connection, SBA originally determined that interest had been paid through February 15, 1978, which coincides with the date of the last payment made by the Borrower. See SBA form 327, dated July 11, 1978. Subsequently, SBA determined that interest was only paid through January 16, 1978. We are assuming that SBA was justified in changing its original determination. However, based on the provision in both the note and the Loan Authorization that each installment received by a bank "shall be applied first to interest accrued to the date of receipt of said installment and the balance, if any, to principal" it is not clear to us why more of the February payment was not applied to accrued unpaid interest so as to bring interest as fully up-to-date as possible. If upon reconsideration of this issue, SBA determines that interest was paid beyond January 16, 1978, the effect of this decision should be adjusted accordingly.)

In accordance with the foregoing, if the Bank's claim is otherwise correct, SBA should reimburse the Bank for that portion of the interest penalty assessed against the Bank that represents interest which was fully paid by the Borrower after the default.

[Deputy] Comptroller General
of the United States