Alan Belkin
OGM

DECISION

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

FILE: B-187945

DATE: March 22, 1977

MATTER OF: First National Bank of Tahlequah, Oklahoma

DIGEST: SBA should not withhold money from Bank representing accrued interest on loan guaranteed by SBA which is otherwise due Bank as its share from liquidation of borrower's collateral. Since SBA determined, pursuant to our decision B-181432, February 19, 1976, that Bank's failure to notify SBA of borrower's default within 30-day period then required did not seriously harm United States, SBA's payment to Bank of guaranteed percentage of principal plus accrued interest was proper. SBA has no legal or factual basis to withhold money in question on grounds that it was not advised of interest default, notwithstanding Bank's purported waiver of its rights to receive interest.

This decision to the Administrator of the Small Business Administration (SBA) is in response to his request for our concurrence in the payment of $19,392.88 to the First National Bank (Bank) of Tahlequah, Oklahoma, representing accrued interest on an SBA guaranteed loan from the date of default to the date the guaranteed portion of the principal was purchased by SBA, which sum is otherwise due the Bank as its share of the proceeds resulting from liquidation of the borrower's collateral. Our concurrence is requested because this payment would necessarily entail SBA's disregarding the Bank's agreement to accept reimbursement of the principal only without interest. The facts concerning this matter, based on the information contained in SBA's submission, are set forth below.

In 1975, the Bank began the process of obtaining SBA's guaranty on a $350,000 loan to Indian Nations Asphalt, Inc. Since the borrower's business was seasonal in nature, with no significant income during cold weather, it was agreed orally that the borrower should only be required to repay principal during the 6-month period from June through November; that is, while the borrower would be required to pay interest on a monthly basis during the 60-month term of the loan, the principal would be amortized in 30 monthly installments that would only be due during the summer and fall months.

On May 8, 1975, SBA authorized the Bank to commence disbursement of the loan and agreed to guarantee 80 percent of the principal and interest on the loan. The first disbursement on the loan was made on May 19, 1975, at which time the guaranty fee was paid as required. The last disbursement was made on July 1, 1975. When the first disbursement was made on May 19, 1975, the borrower executed its promissory note which had been prepared by SBA. Contrary to the prior agreement that had been reached between the parties, however, the note provided for the payment of larger installments of principal during the months of June to November than was intended and, if adhered to, would have resulted in full amortization of the loan in 24 rather than 30 installments. Specifically, the note called for principal payments of $15,070 plus interest during the months of June to November, whereas it was apparently intended by all of the parties involved that the total monthly installment due during this period, including both principal and interest, should have been $15,070. Neither the Bank nor the borrower realized that the note was not consistent with their prior agreement.

The borrower's operations were late getting under way and when the first payment became due on June 19, 1975, the borrower defaulted. In the apparent belief that the borrower would soon get its operation going, the Bank did not notify SBA of the default within the 30-day period set out in the Guaranty Agreement as a condition precedent to SBA's liability. See B-181432, February 19, 1976. By letter of August 8, 1975, some 50 days after the initial default occurred, the Bank advised SBA of the June default as well as the July default and the anticipated August default. Specifically, the Bank's letter informed SBA that: "As a result of the late start [the borrower] now owes three payments of $15,070 each as of August 19, 1975."

The Chief of the Portfolio Management Division (PMD) of SBA's District Office has taken the position that, in accordance with the terms of the promissory note as written, the Bank's letter of August 8 only advised SBA of a default in the payment of the principal while implying that the interest had been paid. However, a notation on the SBA Form 327 dated August 11, 1975, concerning this loan, which notation was written and signed by the SBA loan officer and approved by the same Chief of PMD, reads in pertinent part as follows:

> "In reviewing the file, I noticed that the Note calls for six principal payments each year in the amount of $15,070, in addition to interest to be collected each month throughout the year. This is an error as the principal payments should be $11,667 for the months of June through November of each year with interest monthly in addition to that amount. The payments set up on the Notice include interest . . . ." (Emphasis added.)

Subsequently, by letter dated August 11, 1975, SBA concurred with the Bank's suggestion that the borrower's principal payments be deferred "which would result in the first payment being due September 19, 1975." At the same time SBA advised the Bank that "the interest should be collected each month and we are not extending any interest in this action." When the September 19 payment became due, the borrower again defaulted. Although the Bank did not give SBA written notice of this default, an SBA management assistance officer was advised of the default and his report to this effect, dated September 30, 1975, was placed in SBA's files. Later, in response to a routine inquiry from SBA concerning overdue loans, the bank notified SBA by letter dated December 8, 1975, that the loan was in default and that the borrower was not likely to be in a position even to pay interest for 60-90 days. This letter, in SBA's files, bears the undated handwritten notation "We know." Finally on March 3, 1976, the Bank advised SBA that it considered the borrower's position to be hopeless. Although the letter did not expressly demand that SBA honor its guaranty, SBA treated the letter as a request for purchase of the guaranteed portion.

At this point, SBA's submission explains the circumstances of the Bank's "waiver" of interest in pertinent part as follows:

> "1. On March 16, 1976, SBA's Loan Officer signed SBA Form 327, formally recommending purchase of the guaranteed share of the loan. The Form 327 was prepared in accordance with the guidelines set forth in SBA's Standard Operating Procedure (SOP 50 50 2), as revised to reflect your decision of February 19, 1976, concerning the legal effect of failure to give timely notice of default. In accordance with that SOP, the Loan Officer found 'after careful review . . . that the United States has not been seriously harmed by the lender's failure to give timely notice' and that finding stands unchallenged.
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> "2. The PMD, who was the Loan Officer's superior, took the position that SBA had not been notified of the borrower's failure to pay interest until more than 6 months had elapsed. At that time, SOP 50 50 2 stated, in effect, that there was a conclusive presumption of serious harm to the United States when notification of default was not received within 6 months. He therefore concluded that SBA had no authority to purchase the interest portion of the loan.

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"4. In his endorsement of the Form 327, the Regional Director recommended that SBA purchase only the principal portion and directed the District Director to obtain a letter from the bank accepting the purchase of principal only.

"5. By letter dated April 12, 1976, the bank agreed, stating 'it is apparent that the accrued interest on the above loan does not fall within the limits of your guarantee. For that reason, this bank is agreeable to accepting the principal balance due on the loan.'

"6. The quoted letter constitutes the bank's waiver of interest. There is no formal written document apart from that letter.

"7. The bank has offered two explanations for its apparent waiver of interest. It was given to understand that if the District Officer had to make a choice on all-or-nothing basis, i.e., to honor the guaranty as to both principal and interest or to deny liability in toto, it would choose the latter option. The bank is a small bank for which $280,000, the amount of guaranteed principal, was a substantial sum; and accordingly it took what was offered. The bank also says that it understood that its waiver of interest was not absolute, but merely temporary pending resolution of the question by SBA's Central Office."

Having concluded that the Bank was not entitled to the accrued interest, SBA, in purchasing the loan, inadvertently drew its check for an amount that included the accrued interest from June 19, 1975, to the date of purchase in 1976. When the error was discovered the Bank was billed for the accrued interest but declined to repay SBA. SBA now has in its possession the sum of $19,392.88, representing part of the Bank's share of the proceeds from liquidation of the borrower's collateral. This sum can be set-off against the amount of accrued interest that was inadvertently paid to the Bank if it is determined that the Bank was not entitled to that interest and is therefore presently indebted to SBA in that amount. SBA now believes, however, that the original decision to withhold the interest was erroneous and it requests our Office to concur in the release of the money in question to the Bank, notwithstanding the Bank's waiver. In this regard, the submission points out that:

> "* * * the bank's waiver of its right to interest rests upon the beliefs shared with the SBA officials with whom it dealt, that (1) the bank failed to give SBA notice of default in the payment of interest, as distinguished from default in principal, within 6 months of the default; and (2) that there is a legally significant distinction between notice of default in payment of principal and notice of default in payment of interest."

It is now SBA's view that both of those beliefs were erroneous. Furthermore SBA is of the opinion that the Bank's letter of April 12, 1976, waiving its right to receive accrued interest should not prohibit SBA from paying the Bank the money in question since the Bank was induced to consent to the waiver in apparent ignorance of the contents of its own files and in reliance on an erroneous legal proposition advanced by one with authority to recommend denial of liability. For the reasons set forth hereafter, we agree with SBA's position in this matter.

In our decision B-181342, February 19, 1976, supra, which formed the basis for SBA's initial determination that the Bank was not entitled to the accrued interest, we concluded that SBA lacked authority to purchase a guaranteed loan when the lending institution involved had not notified SBA of the borrower's default within 30 days as required by the Guaranty Agreement and the regulations. However, our decision further stated:

> "* * * in view of the large number of loans in this category that have already been purchased by SBA and considering SBA's longstanding practice of honoring the guarantee despite the failure of the lending institutions to submit timely notice of default, we will not take exception to payments already made. With respect to defaults which have already occurred, but concerning which SBA has not yet purchased the underlying loan, we will not question payment provided that SBA is able to make the determination on a specific case-by-case basis that the United States has not been seriously harmed by the failure to give timely notice. Our Office will take exception to any future payments on defaults which arise after the date of this decision if the notice requirements are not strictly complied with.

The situation here involves a delinquent default notice on a loan in the second category in which the default occurred prior to February 19, 1976, the date of our decision, but where the loan was not purchased by SBA until after that date.* In our decision we indicated that SBA could purchase loans involving a pre-February 19 default, providing that SBA made the determination that the United States had not been seriously harmed by the Bank's failure to give timely notice. SBA has made such a "no-serious harm" determination in this case and that determination is not at issue here.

The only legal issue involved in this case is whether or not there is a legally significant distinction between notice of default with respect to payment of principal and notice of default with respect to payment of interest. This is particularly important in light of a former provision in SBA's Standard Operating Procedure (SOP 50 50 2) which provided at the time the Bank's claim was initially under consideration, that there was a conclusive presumption of serious harm to the United States when notice of default was not received within 6 months. If the PMD is correct in regarding the August 8 letter as notification of default of principal only, the conclusive presumption could operate to preclude payment of interest.

Our decision of February 19 does not draw a distinction between notice of default as to principal and notice of default as to interest. Similarly, the applicable provisions in the SBA regulations and the Guaranty Agreement that were in effect at that time do not support the interpretation that the notice of default from a lending institution has to specify whether the borrower was in default as to principal, interest, or both. To the contrary, the applicable provision in the regulations that was in effect when the default in question occurred provided in pertinent part as follows:

> "(1) Simplified blanket guaranteed loans are loans made by financial institutions under a Guaranty Agreement between SBA and the lending institution 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

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*Subsequent to the date of our decision the applicable provisions in the Guaranty Agreement and the regulations were amended so that banks now have 45 days within which to notify SBA of default without suffering any penalty. However, the situation with respect to defaults that occurred prior to February 19, 1976, has not been changed.

> of the outstanding balance of each loan thereunder together with accrued interest in the event the borrower has defaulted for not less than 60 days. Any eligible loan which the lending institution would make only with the guaranty of SBA may be authorized by SBA under said Guaranty Agreement. Notification to SBA within 30 days of any default is a condition precedent to the lending institution's demand for purchase by SBA. Default means nonpayment of principal or interest on the due date, or the breach by the borrower of any loan covenant which the lending institution determines to be an adverse change in the borrower's ability to repay the loan."
> (Emphasis added.)

See 13 C.F.R. § 122.10(b)(1)(1975) as well as paragraph 7 of the Guaranty Agreement, which contained similar language during the period in question. Under this language, especially the definition of "default" contained therein, a default by the borrower as to either principal or interest is sufficient to trigger SBA's obligation to purchase the guaranteed portion of the outstanding loan balance, in addition to any accrued interest due and owing from the borrower as of the date of purchase by SBA, provided that the Bank either complied with the 30-day notice provision or, if not, that SBA determined pursuant to our decision (as it did here) that no serious harm resulted to the Government as a result of the delinquent default notice. Therefore it was not necessary that the default notice from a lending institution specify whether the borrower's failure to meet its loan obligation involved a default in the payment of principal or interest or both.

Furthermore, this interpretation is supported by the rationale behind the notice requirement. As stated in SBA's submission, and suggested in our decision of February 19, 1976, the purpose of the notification requirement is twofold, i.e., to notify SBA as quickly as possible that the borrower is unable to meet its obligation so that SBA will have the opportunity to take those steps considered necessary and proper either to help the borrower or to salvage what it can through a prompt and orderly liquidation of the borrower's assets. We agree with SBA that this dual purpose was served by the default notice that was actually given to SBA by the Bank in this case, aside from the question of timeliness.

Moreover, with respect to this particular case, we also agree with SBA's position that it actually was notified that the borrower's default included interest as well as principal within the 6-month period specified in SOP 50 50 2. SBA was first notified of the

borrower's default in the Bank's letter of August 8, 1975, which advised SBA that as of August 19, 1975, the borrower "* * * now owes three payments of $15,070 each * * *." In light of the original agreement between the parties that the payments due from the borrower during the months from June to November would total $15,070, including both principal and interest, it is apparent that the Bank intended, in its letter of August 8, to notify SBA that the borrower had failed to pay both the principal and interest that had become due. The confusion arose because the promissory note, drafted by SBA, did not reflect the acknowledged intention of the parties, but provided instead that the payments due during the months of June to November would include $15,070 in principal plus an additional amount of interest. In addition to the fact that it was SBA's error which caused the Bank's notice to appear somewhat ambiguous, it is significant how SBA actually interpreted the Bank's letter. As pointed out above, the SBA official who received the notice of default realized that the original note was in error and noted that "The payments set up on the Notice include interest * * *", thus demonstrating that he understood that the borrower was in default with respect to interest as well as principal.

Furthermore, when the bank again advised SBA by letter dated December 8, 1975, of the default, stating that the borrower was not likely to be in a position even to pay interest for 60 to 90 days, it should have been obvious that the default notice included interest. Since SBA received this letter within 6 months of the original default which occurred on June 19, 1975, it is apparent, pursuant to the prevailing provision then set forth in its own SOP manual, that SBA was not justified in taking the position that a conclusive presumption of harm to the United States had arisen as a result of the delinquent default notice and that therefore the accrued interest would not be paid.

Accordingly, in light of SBA's determination that the United States did not suffer any serious harm as a result of the Bank's failure to notify SBA of the borrower's default within the prescribed 30-day period, and since we do not believe, as explained above, that there was any legal or factual basis for SBA to withhold or threaten to withhold the amount of accrued interest in question, we concur with SBA's position that, notwithstanding the Bank's purported waiver, which it should be allowed to withdraw, the sum of $19,392.88 due the Bank as its share of the proceeds from the liquidation of the borrower's collateral should now be released to the Bank.

Deputy Comptroller General
of the United States