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

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Expanded by 61 C.G. 517
(B-202453, 7-13-82)

B-194153

September 6, 1979

The Honorable Charles H. Percy
United States Senate

Dear Senator Percy:

This is in response to your request for a legal opinion concerning the initiation of a proposed pilot program that is designed to bring new industrial development projects to five depressed areas in the City of Chicago. The Economic Development Administration (EDA), an agency within the Department of Commerce would participate in the program under the authority set forth in 42 U.S.C. § 3142 (1976). EDA would guarantee loans made to private borrowers by private lending institutions with the guaranteed portion of the loan to be subsequently assigned to the City of Chicago and financed through the "public credit markets."

Implementation of the proposal would involve close cooperation between EDA and the Economic Development Commission (EDC) of the City of Chicago. Officials of both agencies have concluded that in order to alleviate conditions that result in unemployment, underemployment, and economic stagnation in certain economically depressed areas within the City, large amounts of private capital are necessary to attract major investments into these areas. It is felt that to obtain substantial private investment, financing at attractive terms and rates must be available. As stated in your letter:

> " * * * The project seeks to demonstrate how short-term lending by commercial banks for working-capital needs and interim-construction financing can be supplemented by permanent funding for major fixed-asset expenditures from the public credit markets in a manner which permits business to implement an urban reinvestment program."

As further explained in your letter the proposed plan would work basically as follows: A business entity contemplating fixed-asset expenditures or requiring working-capital resources for a facility within the City would request assistance from a subsidiary of EDC, known as EDFA. If EDFA determines that the proposed project would create or preserve employment opportunities and would satisfy other necessary criteria, it would approve the project and request the involvement of a private lending institution. If the lender then satisfied its own standards, it would request EDA to guarantee the loan in accordance with the terms set forth in 42 U.S.C. § 3142 (1976). EDA would then determine whether it was willing to guarantee the loan and, if so, would consent to a subsequent assignment of the guarantee. The guaranteed and non-guaranteed portions of the loan (representing 90 and 10 percent of the loan, respectively) would be "separated", with the non-guaranteed portion to be retained by the private lending institution and the guaranteed portion to be "sold" to the City of Chicago.

The city would finance this purchase in the following manner. After it had been determined that the proposed project would serve a "public purpose" by creating or preserving employment opportunities, the City would agree to issue bonds in a sufficient quantity to cover the cost of purchasing the guaranteed portion of the loan. Proceeds from the bond sale would be placed in an escrow account until the project had been completed, approved by the originating lending institution and EDFA, and certified by EDA. Then, when construction was completed and the project approved, the funds in the escrow account would be used to purchase the guaranteed portion from the lender. (In the event, construction was not properly completed and approved, the funds in the escrow account would be used to redeem the bonds at par.)

After the purchase of the guaranteed portion of the loan was consummated, the borrower would continue to make monthly payments, based on level-debt service, to the lending institution that originated the loan. The lender would retain that portion of each monthly payment that represented its remaining interest in the loan--the non-guaranteed 10 percent--and would forward an amount representing repayment of the guaranteed portion to the Trustee, designated by the city. The Trustee would in turn use those funds to make principal and interest payment to the bond holders when due.

It is EDA's belief, that the EDA loan guarantee is the key to this financing strategy. In this regard, the letter we received from the Assistant Secretary for Economic Development, Department of Commerce, the head of EDA, states the following:

> "The Agency's mission is to create jobs for unemployed persons. Accessing the private credit market to raise capital for long term financing of this effort can be most effectively accomplished by allowing the EDA guarantee to support in full the bond issues sold to the secondary market."

The first question you pose arises as a result of the manner in which the guaranteed and non-guaranteed portion of the loan would be handled. It is proposed that each loan would be evidenced by two-notes--with one representing 90 percent of the loan, being fully guaranteed by EDA, with the other note, representing the remaining 10 percent of the loan amount, being wholly non-guaranteed. You, EDA, and EDC, maintain that the success of the entire program depends on this feature. You ask whether an EDA guaranteed loan can legally be evidenced by two or more notes resulting in EDA's guarantee of 100 percent of one note and none of the other. If certain conditions are satisfied, we believe this proposal may be implemented.

The statutory basis for the loans in questions is set forth in 42 U.S.C. § 3142, supra, which authorizes the Secretary of Commerce, who has delegated this authority to the Assistant Secretary of Economic Development in charge of EDA, to guarantee loans "made to private borrowers by private lending institutions" to provide "working capital" and allow for the purchase of "fixed-assets". Guarantees for both types of loans are limited by the statute as follows:

> "* * * no such guarantee shall at any time exceed 90 per centum of the amount of the outstanding unpaid balance of such loan."

Ordinarily, these guaranteed loans (just like any other type of loan) would be evidenced by a single note. The note, and/or the related documentation, would indicate that in the event of a default by the borrower the Government would honor the guarantee by purchasing the guaranteed portion of the note, including principal and accrued unpaid interest. In your letter, with which EDA appears to be in full agreement, you maintain that the two-note mechanism is legally permissible as well:

> "The statutory authority thus runs to the guaranteeing of a loan which may be evidenced by a note or notes. A note is merely the evidence of the borrower's obligation to repay the loan and as such is distinguishable from the loan itself. A single loan may be evidenced by one, two or more notes provided that the obligations evidenced by each note do not in the aggregate exceed the borrower's obligation to repay the loan.

"I feel there is no apparent legal reason why a single EDA-guaranteed loan could not be evidenced by two notes: A Guaranteed Note representing the fully guaranteed obligation under the loan including principal and interest; and the Nonguaranteed Note representing the unguaranteed portion of the borrower's obligations to repay the loan. This of course results in a note, representing 90% of the loan, which note however is 100% guaranteed. This does not seem to be any different in substance than the current guarantee mechanism by which EDA guarantees 100% of 90% of the loan and 0% of 10% of the loan. It thus appears that the evidencing of an EDA-guaranteed loan by use of two notes is permissible under statutory authority governin the EDA-loan guaranteed program."

The legislative history of this provision was not helpful in resolving this specific question. If anything, the legislative history indicates that Congress anticipated that the loans made under this program would be for relatively short terms and, so, it decided not to establish a maximum maturity for the guaranteed loans. Unlike congressional discussion of the Small Business Administration among others, Congress in enacting this legislation did not indicate an intent to promote a secondary market in these notes and presumably did not consider the point here involved.

As a general proposition, your position that the loan may be evidenced by more than one note is supported by several court decisions. For example, it has been held that "a note is not the debt in itself but is merely evidence of indebtedness from the maker to the payee." See Pierpont v. Hydro Manufacturing Co., Inc., 22 Ariz. App. 252, 526 P. 2d 776 (1974); and cases cited therein. Also See 55 Comp. Gen. 126 (1975), in which our Office recognizes the distinction between a loan and the "obligation" or note underlying the loan. These cases, and others as well, imply that a loan can be evidenced by more than one note. In this regard, it has specifically been held that "as a matter of law two notes may represent the same debt." See Elders v. Feutrel, 110 S.C. 307, 96 S.E. 541, (1918).

Also, viewing the matter from a different angle, a number of cases have held that when there are two or more notes outstanding between the borrower and lender, the total amount owed on the notes should be considered in determining the applicability of a statutory maximum. See Annot. 99 ALR 923 (1935) and cases set forth therein including Rennie v. Oklahoma Farm Mortg. Co. 99 Okla. 217, 226 P. 314 (1924); and Walker v. People's Finance & Thrift Co., Ariz. 42 P. 2d 405 (1935)., See also B-148894, ~~January~~ 29, 1962.
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In our view, whether two notes should be combined and treated as one loan (or one note considered to represent two loans) depends on the substance of a particular transaction, including the apparent intention of the parties to the transaction and the purpose of the statutory provision involved. In the matter at hand, we do not believe that the proposal to evidence each guaranteed loan by two notes is legally objectionable. Whether one note with a 90 percent guarantee, or two notes representing 90 and 10 percent of the total loan amount respectively--the first fully guaranteed and the second without any guarantee--are involved the end result is precisely the same in our view and conforms to the statutory requirement that no more than 90 percent of the outstanding balance of a loan be guaranteed by EDA. Finally, it appears that the primary purpose of the proposed two-note arrangement is to effectuate the basic legislative purpose rather than to circumvent it. Therefore, we have no objection to the use of two notes to represent one loan. Our approval of this aspect of the proposed arrangement is not, of course, intended to constitute our endorsement as to the advisability of, or otherwise indicate our agreement with, this approach.

Having reached this conclusion, we do have several caveates to point out, however. First, since the two notes involved represent only one loan, we believe that the substantive terms of the two notes, such as the maturity dates and interest rates, must be the same. Secondly, the Government's potential liability must in no way be increased by adoption of the two-note mechanism.

The primary responsibility for protecting the Government's interests must necessarily rest with EDA, as the administering agency, but we do have several recommendations. We believe that the basic loan authorization should indicate that the loan will be represented by two notes, one fully guaranteed and the other with no guarantee. It should further specify that all payments--whether full or partial--paid by the borrower to the originating lending instituteion should be proportionately divided and distributed in accordance with the respective interests of the lender holder the unguaranteed note and the assignee holding the guaranteed note. Also in the event of a default resulting in EDA's purchase of the guaranteed note, the appropriate loan documents should state that any subsequent recovery from the borrower must be divided between EDA and the lender in accordance with their respective interests in the loan.

Your second question involves the acceptability of the following four options in the event of a default on an EDA guaranteed loan:

"EDA could:

"1) Continue timely repayments under the terms of the Loan Agreement, the Note and the Guarantee throughout the life of the loan while pursuing remedies with the borrower.

"2) Prepay the loan at par plus a premium, with such premium declining over the life of the loan. EDA's guarantee would need to cover the premium as well as the principal amount of the loan in order to give required security to the long-term investor.

"3) Prepay the loan at par with no premium. EDA would prepay only the outstanding principal amount plus interest accrued to the date of payment on the Guarantee to the long-term investor. In this case, since EDA would not pay a premium, the lender would likely require a slightly higher yield than if there were a prepayment premium. Additionally, active trading of the bonds in the secondary market would likely be discouraged by the lack of a prepayment premium and this marketability factor would necessitate an additional increment in the yield required by the lender. In essence, the investor would likely factor a 'premium adjustment' into the required yield to offset call provisions.

"4) If there was a default on a loan which was funded through the issuance of tax-exempt bonds, then EDA might choose to defease the bonds. That is, a sum of money would be given the the Trustee which sum plus interest to accrue thereon would be sufficient to pay principal and interest when due to bondholders. This may be an economically viable option when a certain amount of money which is less than the total par or par plus premium when due can be invested in riskless securities the payment of principal and interest on which will be sufficient to meet all principal and interest payments on the bonds when due."

The current procudure EDA follows in the event of a default in a guaranteed loan is that set forth in the third alternative. EDA indicates that it wishes to continue this procedure. It joins you, however, in seeking our views on the legality of the other alternatives.

We agree with EDA that the appropriate course of action in the event of a default on an EDA guaranteed loan is set forth in the third option. The statute requires that EDA's guarantees not exceed 90 percent of the loan's outstanding unpaid balance including certain accrued interest. This amount (except for accruing interest) becomes fixed at the time of default and EDA is precluded from making any payment exceeding that amount. Based on our understanding of the other options, we believe that each one might ultimately subject EDA to a liability exceeding 90 percent of the outstanding unpaid balance, plus interest, of the loan. Also, EDA's guarantee may not run to any party other than the holder of the note.

Having responded to the two specific questions set forth in your letter, one aspect of the proposal, which neither you nor EDA raised, remains. After a loan is made, the proposal provides that the guaranteed portion, i.e., the entire guaranteed note, would be sold or assigned to the City of Chicago, or a Trustee designated by the City, and would support the bonds sold in the secondary market by the City. The proposal apparently intends that EDA's guarantee, which would in the first instance be directed to the private lending institution that originated the loan, would ultimately run to the City, and, perhaps by implication, to the bond purchasers. We find several aspects of this arrangement to be very troublesome from a legal standpoint.

First, EDA specifically states that the proposal would allow "the EDA guarantee to support in full the bond issue sold to the secondary market." A similar statement appears in your letter as well. By statute, EDA's liability is limited to purchasing the guaranteed portion of the loan when and if the borrower defaults. EDA's guarantee may not extend directly to the purchasers of bonds issued by the City of Chicago nor protect them against a default by the bond issuer in making timely payments of principal and interest on the bonds.

Second, even if we assume that EDA's liability would be limited to guaranteeing the City of Chicago or its Trustee against a default by the borrower, we question EDA's authority, particularly in this situation, to guarantee notes held by an entity that clearly does not qualify as a "private lending institution" and could not have qualified for the guarantee had it initiated the loan.

The extent of the City's involvement is, thus, of particular concern. The legislative history of this provision indicates that the guaranteed loan program would involve "private" not "public" lenders. See H.Rep. No. 539, 89th Cong., 1st Sess. (1965) and S. Rep. No. 193, 89th Cong., 1st Sess. (1965). For example, during the Senate debate on the bill, Senator Douglas offered the following explanation of the purpose of the legislation:

> "Mr. PRESIDENT, the second point I would like to make is that the proposal is designed to encourage investments made by private capital rather than by public expenditures. It would offer inducement for banks and other private lenders to extend loans to private industry which wishes to expand into areas of high and persistent unemployment or low income. This will be done entirely in the private sector. See 111 Cong. Rec. 11912 (1965).

The proposed arrangement involves close cooperation between EDA, private lenders and the City of Chicago. It could ultimately involve EDA's guarantee against a default by the borrower running to the City as well as the use of "public" financing.

In an apparent attempt to address this issue, which was discussed informally with EDA representatives, EDA's letter to us states:

> "Ancillary to the above issue is the legal restriction that EDA only guarantee loans made to private lending institutions. The Chicago proposal is being developed with this provision in mind and when formally approved by EDA, shall conform to this requirement."

In our view this statement does not adequately dispose of the legal issues involved. The question is not the validity of the guarantee to the private lending institution that originated the loan, but whether, as contemplated in this proposal, the guarantee can be assigned to an entity that is not private, is not a lending institution and could not have qualified for a guarantee initially. This proposal appears to us to be an attempt to accomplish indirectly that which clearly could not be accomplished directly. Since the legislation does not allow EDA to guarantee loans made by a lender other than a "private lending institution", the proposed financing arrangement which necessarily contemplates from its inception that the sole source of the funds to be covered by EDA's guarantee would be a non-private "lender", albeit using money it has raised from the private sector, is not in accordance with EDA's statutory authority.

In conclusion, our Office has no legal objection to EDA's proposal to represent an EDA guaranteed loan by two notes. However, it is our view that implementation of the proposed financing arrangement, with all of its ramifications and implications, would involve a significant extension of EDA's statutory authority beyond that which was contemplated by Congress when it enacted this legislation. Since this arrangement allows EDA indirectly to do something that it could not do directly--guarantee a loan by a non-private lender--we believe that this proposal exceeds EDA's statutory authority.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States