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DECISION

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

FILE: B-181432 DATE: August 11, 1975

MATTER OF: Small Business Administration Fiscal Agent

DIGEST: Small Business Administration (SBA) does not have authority under existing legislation to guarantee unconditionally each new holder of SBA-guaranteed loans against errors in certification of outstanding loan balance performed by private entity acting as SBA's fiscal agent in secondary market for such loans. Implementation of proposal would substantially enlarge SBA's existing guarantee responsibility and would subject SBA to new risks it does not presently have. However, SBA can appoint private entity to serve as its fiscal agent, provided it merely guarantees holder against fiscal agent's failure to properly forward loan payments from borrower.

The Administrator of the Small Business Administration (SBA) has requested our concurrence with SBA's position that it has authority to enter into a relationship with a "private entity" which would serve as the centralized fiscal and transfer agent in the secondary market for the SBA-guaranteed portions of loans to small business borrowers.

Based on the explanation provided by the Administrator, the market in guaranteed portions (GPs) of SBA guaranteed loans presently operates in the following manner. Participating lending institutions make loans to small business concerns and SBA may guarantee up to 90 percent of the outstanding balance of the loan. After the loan has been disbursed by the lender and the required guarantee fee has been paid to SBA, the lender is free to sell the GP.

The sale of the GP is evidenced by the execution of a tripartite agreement between the lender, the holder, and SBA. SBA and the lender warrant to the holder that, as of the date of the agreement, a certain specified sum of money is owed by the borrower to the lender with a specified percentage of the principal being guaranteed by SBA with interest. The lender promises the holder that it will promptly remit to the holder the full amount, including any prepayments, of all payments

of principal and interest (less a servicing fee) made by the borrower with respect to the GP. SBA unconditionally promises the holder that if the borrower defaults in repaying the loan or if the lender fails, for any reason, to discharge its obligations to the holder, SBA will purchase the GP from the holder, based on the guaranteed percentage of the outstanding balance of the loan principal, plus accrued interest from the date of the lender's last full interest payment to the date of purchase by SBA. See 51 Comp. Gen. 474 (1972) and B-140673, December 3, 1974.

SBA now proposes to contract with a private entity to act as SBA's fiscal and transfer agent with the responsibility of remitting payments to the holders of SBA guaranteed loans as well as warranting the amount of the outstanding balance of every guaranteed loan each time it is transferred. SBA further proposes to unconditionally guarantee the holder of the GP with respect to all such actions and representations by the fiscal agent. SBA believes that the services the fiscal agent would perform would be helpful in further developing and expanding the secondary market for GPs and would encourage private lenders to make such loans to small business concerns.

The Administrator explains the purposes of this arrangement as follows:

> "The above-described [existing] arrangement works well enough when the GP is sold directly to a holder intending to keep the GP for its entire term. However, in connection with the second transfer of the GP, and with subsequent transfers, problems have arisen that affect the complete liquidity of GPs and thereby limit the development of the market for GPs.
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> "First, perfection of the transfer of a GP is not accomplished until both the lender and SBA have been notified. Prior to receipt of notice of transfer, each party is discharged from its respective obligations to the transferee to the extent of payments made or forwarded to the transferor, who is the holder of record. In some instances, the transferee of a GP has erroneously relied upon the transferor to notify the lender and SBA. Moreover, SBA does not maintain a central transfer registry, and lacks the capacity to do so. Notification to SBA, therefore, means a notification to the District Office or Branch Office servicing the area in which the borrower is located.

"Second, the second transferee, and all subsequent transferees of the GP, cannot be completely certain as to the amount of the outstanding guaranteed balance. SBA and the lender only warrant the balance as of the date the GP is transferred to the first holder. Thereafter any subsequent transferee must make its own calculation, based on the accounting statements that the lender is required to transmit to the holder when payments of principal and interest are remitted. The amount of this balance is not warranted by SBA. Second and subsequent transfers are thereby inhibited to some extent by this element of uncertainty.

"Third, the development of the secondary market is further hampered by the absence of a recognized source of information on traders, investors, yields, and prices.

"These obstacles would be eliminated if SBA were authorized to contract with a fiscal and transfer agent that would serve as a central registry of holders for the lender and SBA, for the purpose of remitting payments to the holders, and for warranting the amount of the outstanding balance as of the time of transfer. It would therefore be necessary for SBA to guarantee unconditionally the performance of the FA in addition to the present unconditional guarantees of the perspective obligations of the borrower and the lender.

"With the FA in the picture, remittances would be made by each lender to a single payee, the FA. Instead of drawing and mailing separate checks on account of each GP to each holder, the lender could remit by one check to the FA. In turn, the FA would remit by one check to each holder, regardless of the number of GPs a particular holder might have. With each check, the FA would transmit a statement of account that would amount to a warranty of the outstanding balance by SBA. In the event of a transfer of the GP, only the FA would be have to be notified, and the holder of record on the books of the FA would be the only holder recognized by SBA and the lender.

"SBA does not have the resources to assume the above described FA functions. However, as a result of preliminary inquiries, SBA has reason to believe that at least one large financial institution would be willing to function as the fiscal and transfer agent for SBA's secondary market at no cost to SBA or to any of the other parties; this institution believes that the "float" on the large sums of money likely to be involved in these transactions could be adequate compensation for its services.

"Besides the above-mentioned services that will stimulate the greater growth of the market in GPs, the FA will provide a useful service to SBA. The FA will be able to furnish SBA with complete and up-to-date information (perhaps already programmed for use in SBA's computers) on payments and contingent liabilities in connection with guaranteed loans, so that SBA can make more immediate use of the guaranty authority that is restored by borrowers' payments.

"If the employment of the FA is to accomplish the above-described results, we consider it necessary that the FA have authority to bind SBA in certain respects. In other words, SBA must guarantee the holder against default by the FA with respect to certain functions. The FA must have authority to bind SBA and the lender to its warranty of the amount of the outstanding balance each time the GP is transferred. This warranty would be based on the lender's records and statements of account and the FA's own records and control of remittances. In case of discrepancy, SBA would have the right to proceed against the lender, which in most cases will be a bank. In the case of errors by the FA, SBA would have the right to recover from the FA, which is expected to be a responsible party."

It is SBA's position that the rationale of our decision in B-140673, December 3, 1974, wherein we held that SBA's authority to conditionally guarantee the borrower's performance to the lender included authority for an unconditional guarantee to an innocent holder of the lender's obligation to remit, supports a further extension of SBA's guarantee authority to the extent and for the purposes just set forth. For the reasons discussed below, we cannot concur in SBA's position. It is our view that neither section 7(a) of the Small Business Act, from which SBA's guaranteed loan

program was derived, nor any other statutory provision contained in the Small Business Act, can reasonably be interpreted so as to allow SBA to implement fully the arrangements proposed in the Administration's letter.

Section 7(a) of the Small Business Act, as amended, 15 U.S.C. § 636(a) (1976), authorizes SBA to make loans to small business concerns " * * * either directly or in cooperation with banks or other lending institutions through agreements to participate on an immediate or deferred basis." Pursuant to section 7(a)(3) of the Act, 15 U.S.C. § 636(a)(3) (1976), SBA's participation in a deferred loan cannot exceed 90 percent of the balance of the loan outstanding at the time of the disbursement. Section 7(a) has been interpreted by our Office as authorizing SBA to institute a loan guarantee program. (The primary distinction between the two programs is that a participating lending institution can demand that SBA purchase the outstanding balance of the deferred participation loan at any time, but can only demand that SBA purchase the outstanding balance of a guaranteed loan under the particular circumstances prescribed in the regulations and loan guarantee agreement, usually upon default by the borrower. See 13 C.F.R. § 122.10 (1977).)

Insofar as SBA's authority to guarantee loans was created by statute, specifically, section 7(a) of the Small Business Act, it is clear that such guarantee authority is not without limitation. In issuing a loan guarantee, SBA is promising the lending institution as well as any subsequent purchaser of the GP of the loan, that it will purchase the outstanding balance of the GP upon demand by the holder thereof if the borrower fails to pay any installment of principal or interest when due, and such default has remained uncured for at least 60 days. See 13 C.F.R. § 122.10(b)(1)(1977).

In 51 Comp. Gen.474, supra, we held that upon default by the borrower, SBA could purchase the GP from an innocent holder who had previously purchased the GP, notwithstanding SBA's knowledge of possible negligence, fraud, or misrepresentation by the lending institution that had actually made the loan. Of course, SBA would retain its legal rights against the lending institution that had made the loan to recover any damages it might suffer as a result of the bank's misconduct. Essentially, that decision had the effect of assuring an innocent holder that SBA's obligation to honor its guarantee upon default by the borrower would not be vitiated by the lender's misconduct. The integrity of the SBA guarantee thus remains intact for innocent purchasers of the GP on the secondary market.

Our Office extended the scope of this decision in B-140673, December 3, 1974, supra, which was heavily relied upon in SBA's submission as supporting its position. Based in large part on some unusual facts and circumstances, we held that SBA could purchase the outstanding balance of the GP of a SBA-guaranteed loan from an innocent holder when the original lender failed to forward the borrower's payment, even though the borrower had not defaulted on the loan. SBA indicated that the primary reason for its request for a decision in that case was because the Securities and Exchange Commission had determined that the SBA-guaranteed portions of small business loans which are subject to sale or assignment are "securities" within the meaning of the Security Act of 1933, and are subject to provisions of that Act requiring securities registration. However, the security registration requirement would not apply if SBA's guarantee was absolute and fully protected the purchaser of the GP in all circumstances, including instances where a lender failed to pass through to the purchaser all payments received from the borrower. The Administrator of SBA advised us that "the security registration requirements of the Securities Act of 1933 are impractical for SBA-guaranteed notes, and that unless the SBA can comply with the 'government exemption,' the ability of the primary lenders to resell the notes will be so limited as to seriously inhibit secondary market operations." It was in that context and for that relatively limited purpose that we decided that SBA could purchase the outstanding balance of the GP of a loan from an innocent holder even though the borrower had not defaulted on the loan.

We recognize that our holding in that decision allowed SBA to "guarantee" something other than the borrower's performance in repaying a loan, thus extending, in effect, SBA's authority under the statute. However, as indicated in SBA's submission in that case, the actual increased risk to SBA was relatively minimal. In fact, although roughly $250 million of SBA guarantee loans had been transferred from primary lenders to secondary participants in the 5-year period ending June 30, 1974, involving approximately 2500 separate transactions, SBA was not aware of a single complaint by a secondary participant that the lender had improperly withheld payments from the borrower.

However, implementation of the current proposal in its entirety would substantially enlarge SBA's existing guarantee and would, in fact, subject SBA to a risk it does not presently have. SBA's guarantee to the purchaser of the GP of an SBA-guarantee loan as to the amount of the outstanding balance of the GP, which would have to be recalculated each time the GP was transferred, would obligate SBA to purchase the GP in the event the fiscal agent's calculations were in error. SBA does not have any statutory responsibility for certifying the amount of the GP of a loan upon its sale in the secondary market.

In other words, a new contingency -- certification by the fiscal agent of the outstanding balance of the GP -- that did not previously exist, would be created, which would trigger SBA's obligation to purchase the GP of a loan from a third-party holder.

More significantly, from a legal standpoint, there is another distinction between the situation considered in our 1974 decisions and the instant matter. Unlike the present proposal, the relatively minimal extension of SBA's guaranty that we approved in our 1974 decision did not have the effect of obligating SBA to purchase anything more than the outstanding balance of the GP of the loan. Under SBA's current proposal, however, SBA's obligation to honor its guaranty would not be so limited: SBA's obligation to purchase a loan in the event the fiscal agent erroneously certified that the outstanding balance of the GP was larger than it actually was, would require SBA to pay more than the actual outstanding balance of the GP of the loan.

We do not believe in these circumstances that SBA's authority under section 7(a) of the Small Business Act to guarantee small business loans made by participating lending institutions includes authority to indemnify the holder of the GP against representations made by its fiscal agents that are really unrelated to the actions of either the borrower or the lender, and which would substantially increase SBA's potential liability, with respect to both the likelihood of SBA's having to purchase the GP, as well as the amount SBA would have to pay in the event of such purchase.

In reaching this conclusion we are not unmindful of the Administrator's broad authority pursuant to section 5(b)(7) of the Small Business Act, 15 U.S.C. § 634(b)(7)(1976), to take any and all actions determined by him to be necessary or desirable in making, servicing, compromising, modifying, liquidating, or otherwise dealing with loans. The Administrator's authority pursuant to this section was cited in our decision B-140673, December 3, 1974, supra, as forming part of the basis for our holding in that case. However, as we have held in the past, the Administrator's authority pursuant to this section is not unlimited. See B-178250, August 6, 1973, and B-164162, September 20, 1968. We are unwilling to sanction another quantum leap of authority when the consequences might subject the United States to substantial new financial risks not contemplated by the Congress. SBA has not cited any other provisions in its general statutory authority, nor any inherent authority or governmental policies, concerning the propriety of a Federal agency agreeing to be bound in this manner by the representations of a nongovernmental party.

As the foregoing analysis suggests, our legal objection to SBA's proposal is based primarily on that aspect of the proposal that would require SBA to guarantee unconditionally the fiscal agent's certification of the outstanding balance of the GP of a loan whenever the GP is transferred. Subject to SBA's compliance with whatever statutory or regulatory policies and requirements might be applicable concerning a Government procurement of this type of service, we would have no objection to SBA's appointment of a fiscal agent to serve as "centralized registry of holders for the lender and SBA." The fiscal agent would have the responsibility of receiving loan payments from the respective lenders and remitting the appropriate amounts to the proper holders. Furthermore, we would raise no objection to an extension of SBA's existing guarantee to include a failure by the fiscal agent to forward the borrower's payment on the GP of a loan to the holder thereof. This would require a relatively minimal extension of SBA's present guaranty, involving no more than a slightly increased risk to SBA of precisely the same nature that we approved in our December 3, 1974 decision, wherein we held that SBA could purchase the GP of a loan from an innocent holder when the lender had failed to pass the borrower's payment on to the holder, even though the borrower had not defaulted on the loan.

In accordance with the foregoing, it is our view that SBA does not have authority to guarantee unconditionally the purchaser of the guaranteed portion of an SBA-guaranteed loan against an error in the certification of the outstanding loan balance, as of the date of purchase, performed by a private entity acting as SBA's fiscal and transfer agent in the secondary market for such loans. However, we do not believe that an arrangement whereby SBA enters into a contract with such a private entity to serve as its fiscal agent would be legally objectionable provided SBA does no more than guarantee the holder against a failure by the borrower to make timely repayment or a failure by either the lender or the fiscal agent to forward the borrower's payment on the guaranteed portion of the loan.

R. F. Keller

Acting Comptroller General
of the United States