

NAVIGATING THE NEW SOP CHANGES AND KEY TECHNICAL ISSUES

Presented by:

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Agenda:

- ❑ Eligible Uses of Loan Proceeds in EPC/OC Transactions
- ❑ Change of Ownership – Stock Purchases
- ❑ Key Technical Issues
- ❑ Allowable Legal Fees
- ❑ Allowable Fees for Packaging & Other Services
- ❑ Debt Refinancing
- ❑ CAPLines
- ❑ Post-Approval Loan Modifications
- ❑ Changes to Small Loan Advantage Program

Recommendations

- 1) If you have any recommendations for future SOP changes and updates, email them to:
SOP50-10Modernization@sba.gov
- 2) Note: Latest Loan Authorization dated 9/15/2011 (Version 2011) – refers to SOP 50 10 5(C) (which went into effect 10/1/2010)
- 3) The latest version of the Servicing and Liquidation Matrix went into effect in August 2010 while the Liquidation SOP 50 51 3 went into effect November 15, 2010
- 4) If conflict between LA and SOP, latest prevails.
Document decision in file.

Eligible Passive Company/ Operating Company

- ❑ General Rule: passive companies ineligible for SBA financing because they do not operate business and create jobs
 - Exception: EPC/OC Rule - Typically allows EPC to purchase CRE and lease space to OC
- ❑ Confusion regarding the eligible uses of loan proceeds by an OC in connection with SBA loans to EPCs
- ❑ In 2010, SBA began prohibiting OC (in an EPC/OC structure) to use loan proceeds for inventory and intangibles
- ❑ This caused the need for two loans when inventory or intangibles were included
- ❑ In May, 2012, SBA "clarification" permitted OC to use proceeds pursuant to historical uses
- ❑ When OC receives loan proceeds (i.e., M&E, inventory or WC), EPC and OC must be co-borrowers, and only one set of documents is needed

EPC/OC (Continued)

- ❑ EPC ownership restrictions remain in place:
 - It can own fixed assets
 - It cannot own stock in the business
 - It cannot receive working capital
- ❑ Re-interpretation is only for loans received by SBA on or after May 17th, 2012—not retroactive
- ❑ Two recommended denials in early 2012 by NGPC
- ❑ Current NGPC policy reversal – Center will not re-examine 1,000s of EPC/OC loans deemed ineligible based upon 2010 Agency interpretation

Change of Ownership – Overview

- ❑ Asset Purchases are fine – Buyer is buying assets of Seller and establishing new corp.
 - Non-compete
 - Bulk sale compliance
 - Nothing new
- ❑ Stock redemption: Seller co. retires stock
- ❑ Stock purchase: Buyer co. acquires Seller's stock

- ❑ CONCEPT – “associates/individuals” cannot benefit from SBA financing.

Change of Ownership – Stock Purchases/Redemptions

- ❑ Sole proprietors and general partnerships are eligible for SBA loans – not for change of ownership transactions, except through standard processing
- ❑ SBA loan proceeds prohibited to an individual purchasing stock in a business
- ❑ “Business entity” must be the borrower— SBA cannot guaranty loans to individuals

SOP 50 10 5(E), pgs. 139-140

Change of Ownership – Stock Purchases/Redemption (Continued)

3 Basic Scenarios in Change of Ownership

Change of Ownership – Stock Purchases/Redemption (Continued)

- ❑ Scenario A—Loan is made to the business so that it can purchase the shares from a departing (existing) owner resulting in the remaining owners holding 100% of the stock
- ❑ In a change of ownership between existing individual owners, applicant business (LLC or Sub S corp.) must use loan proceeds to purchase departing owner(s) stock (stock redemption). Departing shareholder's stock redeemed as treasury stock. Result is remaining shareholder(s) now own 100% of outstanding stock.
- ❑ Departing member's interest is "redeemed" by assignment back to LLC

Change of Ownership – Stock Purchases/Redemption (Continued)

- ❑ Scenario B—an outsider is buying the stock of all of the existing owners
 - Business obtains loan with SBA guaranty and uses proceeds to purchase all of the stock outstanding
 - “Simultaneously,” new owner buys the stock from the business (with his/her own money) at a price to be determined
- ❑ In a change of ownership where an outside individual wants to purchase all of the stock of the business, applicant business must use loan proceeds to redeem the stock of all existing owners (stock redemption) and simultaneously issue stock to the new owner(s). New owner(s) will purchase stock from company using his/her own funds (may not be with an SBA-guaranteed loan). The amount paid by for the stock may not be determined by the SBA

Change of Ownership—Stock Purchases (Continued)

- ❑ Scenario C—If the buyer of the stock is a business entity and that business is acquiring/merging with the selling business, then the buyer may use an SBA-guaranteed loan to purchase all of the stock and absorb the selling business and retire the purchased stock. A co-borrower structure is not permissible (per SBA senior officials).

Key Technical Issues

□ Franchise Eligibility

- Made more complex in last few years
- Focus is on right to profit from independent business operations and prohibit excessive control from franchisor
- Challenges:
 - 1) Broad definition of franchise – includes licensing agreements, jobber agreements ≠ franchise agreement
 - 2) Registry ≠ eligibility – Certificate of Franchise Documents plus matching agreement(s), note, etc.
 - 3) Non Registry – All tests re control and right to profit
 - 4) “Totality of circumstances test” – as to whether brand, product or service is “critical” to business

SOP 50 10 5(E), pgs. 93-102

Key Technical Issues (Continued)

□ Equity Injection

- 1) Lenders must prove existence of B's equity injection into business account and must prove from where the B got the money – or its source
- 2) Source cannot be HELOC unless payment ability outside business
- 3) SBA requires verification of gifts by bank statements
- 4) Necessity for last 2 months bank statements and funds into business account – can be problematic

SOP 5010 5(E), pgs. 187-188



Key Technical Issues (Continued)

□ Collateral

- All available collateral standard is only in SOP ≠ CFR
- SBA defines “available” very broadly/subjectively
- Lenders required to take interest in collateral with no equity or reasonable recovery value and to encumber spouse’s property even if spouse has no interest in business

SOP 50 10 5(E), pgs. 188-199

Key Technical Issues (Continued)

□ Life Insurance

- Rule: Must have life insurance on key individuals. If you don't, and individual dies, and loan defaults = no guarantee
- Should be a credit call and waivable (i.e., if viable succession plan/collateral)
- Cancer survivors and others cannot get life insurance and coverage cannot typically be force placed

SOP 50 10 5(E), p. 209

Key Technical Issues (Continued)

- Underwriting review in early defaults
 - OIG's look back at underwriting decisions following early defaults in loans over \$1MM runs counter to SBA avowed purpose of providing capital for small businesses and honoring guarantee (OIG assumes "mistake" and obligation to pursue via Improper Payment Act)
 - Borrower must show that funds not available from alternative sources (credit elsewhere personal resources)
 - As Walter Intlekofer used to say, Lenders need to be able to make credit decisions w/out being second-guessed if circumstances not directly related to credit decisions cause an early default. No longer the case.

Key Technical Issues (Continued)

□ FDIC Loss Share Agreements

- Lenders who have acquired failed financial institutions via purchase agreement with FDIC are facing issues regarding reimbursement under FDIC loss share agreements
- SBA believes any recovery – post FDIC reimbursement – must be shared with SBA

Allowable Legal Fees, Including In-House Legal Counsel

- Lenders may pass through fees for in-house legal counsel, provided:
 - Fees are reasonable and customary
 - Are incurred in connection with an SBA guaranteed loan
 - Must be on an hourly basis
 - Are for required services actually performed
 - The costs do not exceed those of outside counsel
- Fees may be reviewed at any time and lender must refund any fee considered “unreasonable” by SBA

SOP 50 10 5(E), p. 170

Allowable Fees for Packaging and Other Services

- Fees charged by packagers, referral agents and lender service providers may now be based on a percentage of the loan amount
 - For loans up to \$50,000 – 3%
 - For loans over \$50,000
 - 2% on the first \$1,000,000
 - Additional .25% for all amounts over \$1,000,000
 - Maximum fee, \$30,000.00
- Fees must be reasonable and customary – standard fee impermissible
- Must be consistent with those fees charged on similarly-sized, non-SBA guaranteed commercial loans

SOP 50 10 5(E), pgs. 168-170

E-tran and LSPs

- ❑ SBA clarified in the SOP that if a lender gives a Lender Service Provider access to E-tran, it is responsible for the actions of the service provider while it is in the lender's e-tran account
- ❑ This includes any entry or certification made by the service provider

SOP 50 10 5(E), p. 178

Debt Refinancing

- Refinancing
 - Why was the original loan made? Business purpose?
 - Was loan's original purpose eligible?

SOP 50 10 5(E), p. 133

Debt Refinancing

- ❑ Refinancing of other debt in the personal name of the owner(s), such as a HELOC, that was used for business purposes, is now allowed
- ❑ Borrower must certify debt being refinanced was used exclusively for business purposes
- ❑ Borrower must provide supporting documentation:
 - Copy of note
 - Settlement statement
 - Invoices
 - Tax records (Schedule C – not Schedule A) and business financial statements
 - If the interest deducted on the Schedule C exceeds the amount related to the debt being refinanced, the applicant must provide the IRS Form 1098 related to the debt
- ❑ Burden of proof is on the lender

CAPLines

What are CAPLines?

- The CAPLines program is designed to help small business meet their short-term and cyclical working capital needs. The programs can be used:
 - A provides up to an 85% guarantee. There are four distinct loan programs under the CAPLine umbrella.

CAPLines Loan Programs

The **Contract Loan Program** is used to finance material, labor, and overhead needs for a specific contract or contracts.

The **Seasonal Line of Credit Program** is used to support buildup of inventory, accounts receivable or labor and materials above normal usage for seasonal inventory.

The **Builders Line Program** provides financing for small contractors or developers to construct or rehabilitate residential or commercial property.

The **Working Capital Line** is a revolving line of credit that provides short term working capital.

CAPLines – Monitoring & Servicing

- Borrowing base CAPLines
 - Borrowing base reports with supporting doc., such as A/R aging and inventory reports must be received and reviewed by Lender on a monthly basis
 - insures that advances on the LOC are supported by eligible A/R and inventory
 - For lines over \$1MM, Lender must conduct an annual field exam, which includes a physical verification of assets that compose the borrowing base, including samplings of A/R and inventory. Exams must be conducted prior to initial disbursement and annually thereafter at a minimum.

CAPLines – Monitoring & Servicing

- Non-Borrowing Base CAPLines
 - Lenders must conduct a credit review (including cash flow analysis), a collateral analysis to ensure the 1:1 collateral ratio is maintained, an owner/guarantor credit review, and a site visit, all on an annual basis
 - If LOC is under-collateralized, then additional collateral must be obtained or Lender must consider lowering the LOC
- Monitoring
 - Lender must have systems, processes and procedures to ensure that Borrower's financial statements are collected and covenants tested in a consistent and timely manner

CAPLine Debt Refinancing

- ❑ Only short term, revolving debt can be refinanced with a Working Capital Capline—no term debt
- ❑ Revolving debt must be terminated when it is paid off
- ❑ If any existing SBA guaranteed debt is being paid off, the lender's exposure cannot be reduced
- ❑ This edition also clarifies that an SBA Express or Patriot Express revolving line of credit can be refinanced into a Working Capital CAPLine

SOP 50 10 5(E), Subpart B, Chapter 2, Paragraph IV.E.11

CapLines Contract Payments

- ❑ SOP 50 10 5E permits final payment of contracts which are typically received 30-60 days after contract completion.
- ❑ “Interest only payments,” however, for any period exceeding the borrower’s cash cycle, seasonal cycle, contract final payment date, or project completion date are not permitted

Disbursement on Contract CAPLines

- ❑ For ALL loans not yet closed or fully disbursed (delegated and non-delegated), requests for post-approval loan modifications or notifications of unilateral actions are to be submitted to the LGPC
- ❑ After a loan is closed and fully disbursed, such requests or notifications to be submitted to appropriate CLSC
- ❑ If a change is made using E-Tran Servicing, no further notification to SBA is necessary

CAPLines: Proceeds From Sales and Servicing Fees

- Proceeds from cash sales and A/R must be used to pay down the LOC
 - If L has B's deposit accounts, L is not reqd. to utilize lock boxes or control accounts – but must monitor payments recd. to ensure they are properly applied to BB CAPLines
 - If L does not have B's deposit accounts, then L must enter into a control agreement or lock box w/ B and depository institution
- CAPLines Ls can charge an extraordinary servicing fee
 - Normally, 2% cap
 - However, on W/C CAPLines, with prior SBA ok, a L may charge more than 2%, so long as reasonable and prudent based on effort required and – not higher than fees charged on L's non-SBA guaranteed loans

Post-Approval Loan Modifications

- ❑ For all loans not closed or fully disbursed, requests for post-approval loan modifications or modifications of unilateral actions are to be submitted to the LGPC
- ❑ After a loan is closed and fully disbursed, such requests or notifications are to be submitted to the appropriate CLSC
- ❑ If a change is made using E-Tran Servicing, no further notification to SBA is necessary

SLA 2.0

Changes to Small Loan Advantage Program - Overview

Changes include:

- ❑ An increase in the maximum loan amount to \$350,000
- ❑ Criteria and mechanism for credit scoring pre-screening of applicants
- ❑ Credit criteria and analysis requirements clarified
- ❑ Confirmation of the collateral requirements for SLA loans

Small Loan Advantage

- ❑ Expansion to all SBA participating lenders—previously limited to PLP lenders
- ❑ All SLA loan applications will be credit-scored by SBA prior to loan approval (or issuance of a loan number for applications submitted by PLP lenders). The current minimum acceptable score is 140, which is subject to change

Small Loan Advantage (Continued)

- ❑ Change in forms from the S/RLA forms (SBA Forms 2301 Parts A, B and C) and the PLP Eligibility Checklist (SBA Form 7) to the forms used in the SBA Express and Pilot Loan Programs (SBA Forms 1919 and 1920 Parts B and C)
- ❑ All SLA loan applications will continue to be submitted electronically

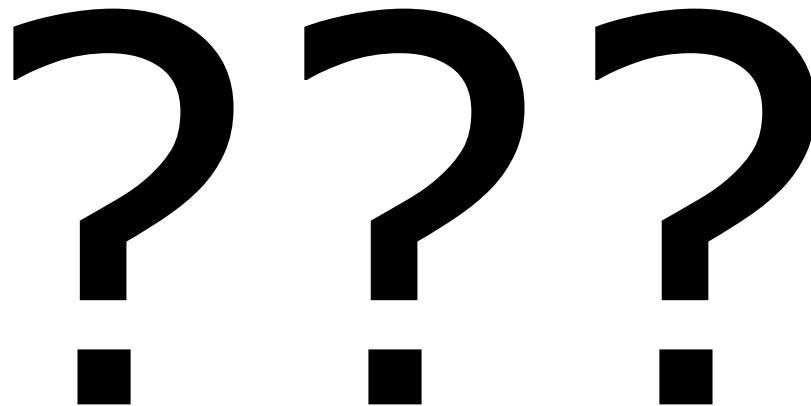
Small Loan Advantage (Continued)

- ❑ Lenders will continue to have the option of using their own notes and guaranty forms, rather than SBA Forms 147, 148 and 148L
- ❑ In closing and disbursing SLA loans, lenders will follow the same closing and disbursement procedures and documentation as it uses for its similarly-sized non-SBA guaranteed commercial loans

Small Loan Advantage (Continued)

- ❑ An increase in the maximum loan size from \$250,000 to \$350,000
- ❑ Lenders may make more than one SLA loan to a borrower (and its affiliates)

Questions



Thank you!

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