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# Fundamentals of SBA Lending:

*An Introduction to the SBA 7(a) and 504 Loan Programs*

**Edward W. Ahart, Esq.**

**Thomas L. Hofstetter, Esq.**

Schenck Price Smith & King, LLP  
220 Park Avenue

Florham Park, NJ 07932

(973) 539-1000

# Edward W. Ahart, Esq.

- Partner at Schenck Price Smith & King, LLC in Florham Park, New Jersey and chair of the firm's Corporate Practice Group.
- Served for over thirty years as a member of the Firm's Management Committee, including twenty years as the Firm's Managing Partner and Chair of its Management Committee.
- Mr. Ahart's practices primarily as a business attorney, concentrating in advising businesses, business owners, directors and managers on governance and entity structural issues, along with transactions including mergers and acquisitions, divestitures, finance and business contracts.
- He has represented numerous financial institutions and has served as acting general counsel and outside counsel to many such entities.
- A considerable percentage of his practice is comprised of the representation of closely held and family-owned businesses, including many insurance agencies, as well as several not-for-profit companies and foundations.
- Mr. Ahart is a frequent speaker on corporate governance, transactional and financing matters and at independent Insurance Agents & Brokers of New Jersey (IIABNJ).

# Thomas L. Hofstetter, Esq.

- Skilled SBA lending attorney who is partner at Schenck Price Smith & King, LLC in Florham Park, New Jersey, chair of the firm's Banking & Finance Practice Group and member of Workout Restructuring Practice Group and Corporate Law Group.
- Experience crosses a broad spectrum of lending areas, including real estate and asset-based secured loans, construction loans, foreclosures and loan workout arrangements.
- Member of the National Association of Government Guaranteed Lenders (NAGGL) 7(a) Trade Origination serving as chair of Region II Regional Liaison Committee, member of Technical Issues Committee and instructor for the organization.
- Member of 504 National Association of Development Companies (NADCO) 504 Trade Organization.
- Regularly presents in person and online seminars and conducts training sessions for clients regarding all aspects of closing commercial loans and SBA loans, including annual updates on the SBA SOPs.
- Represents several national and community lenders with regard to 7(a) and 504 Loans, designated counsel for several 504 Certified Development Companies (CDCs).
- Former General Counsel of a Community Bank and Section Chief for the Federal Deposit Insurance Corporation.

# Agenda

- SBA 7(a) Loan Program
- 504 Loan Program
- 7(a) & 504 Comparison
- Standard Operating Procedures
- Documenting SBA Loans
- Potential Issues/Time Sensitive Matters

# 7(a) Program Overview

- The 7(a) Loan program is SBA's primary business loan program
- The program has broad eligibility requirements and credit criteria to accommodate a wide range of financing needs
- Maximum loan size = \$5 million
- Maximum SBA guaranty to lender =
  - 85% for loans of \$150,000 and less
  - 75% for loans over \$150,000
- SBA-charged fees:
  - One-time guaranty fee passed on to the borrower – 2%-3.75% of guaranteed amount (based on size of loan)
  - Ongoing fee paid by lender – currently .55% per annum

# 7(a) Program Process

- The SBA does not lend directly
- Small business submits application to lender
- If lender finds loan eligible and creditworthy:
  - Lender with delegated authority approves loan, gets loan number from SBA, notifies applicant
  - Lender without delegated authority submits loan to SBA for approval
- Lender must certify that it would not provide the subject loan under the proposed terms and conditions unless it can obtain an SBA guaranty
- SBA's approval is a guaranty that it will reimburse lender for 75-85% of the lender's loss on the loan if borrower defaults
- Lender funds approved loan

# 7(a) Interest Rates and Fees

- The actual interest rate for a 7(a) loan is negotiated between applicant and lender, but subject to SBA maximum
- Both fixed and variable interest rate structures are available
- “Maximum Rate” is comprised of two parts: (1) a base rate; and (2) an allowable spread
- Three acceptable base rates:
  - 1) Wall Street Journal Prime
  - 2) London Interbank One Month Prime plus 3%
  - 3) SBA Peg Rate
- SBA-charged fees:
  - One-time guaranty fee passed on to the borrower – 2%-3.75% of guaranteed amount (based on size of loan)
  - Ongoing fee paid by lender – currently .55% per annum

# 7(a) Loan Maturities

- SBA loan programs are generally intended to encourage longer term small business financing, but actual loan maturities are based on the following factors:
  - Ability to repay
  - Purpose of the loan proceeds
  - Useful life of the assets financed
- Maximum loan maturities:
  - 25 years for real estate
  - Up to 10 years for equipment – depending on useful life of the equipment
  - 7 to 10 years for working capital



# 7(a) Loan Structure

- Most 7(a) loans are repaid with monthly payments of principal and interest
- Fixed-rate loan payments stays the same
- Variable rate loans, lender can establish the payment amount when interest rates change or at other intervals, as negotiated with the borrower
- Interest-only payments can be requested by applicants during the start-up and expansions phases to allow the business to generate income before it starts making full loan payments
- Balloon payments or call provisions are not allowed on any 7(a) loan

# Prepayment Penalties

- Lender may not charge a prepayment penalty if the loan is paid off before maturity.
- SBA, however, will charge a prepayment fee if the loan has a maturity of 15 or more years and is pre-paid during the first 3 years.

# 7(a) Collateral Requirements

- The SBA does not permit its guaranty to be used as a substitute for available collateral.
- SBA expects every 7(a) loan to be fully secured, but will not decline a request to guaranty a loan if the only unfavorable factor is insufficient collateral, provided all available collateral is offered.
- Every SBA loan is to be secured by all available assets (both business and personal) until the recovery value equals the loan amount or until all assets have been pledged to the extent that they are reasonably available.
- Personal guaranties are required from all of the principal owners of the business.
- Liens on personal assets of the principals may also be required if business assets do not fully secure the loan.
- When loan proceeds are being used to purchase assets, a first security interest in those assets must be obtained.
- When loan proceeds are being used to refinance debt, the loan must be secured with at least the same security as the debt that is being refinanced.

# 7(a) Lender Designations

- **SBA Certified Lenders**: Banks and other lenders who have a track record of following SBA procedures and success with SBA-guaranteed loans. By following these procedures, the lender can receive faster loan turn-around from the SBA, who makes the final credit and eligibility decisions. The expertise of the bank's loan officers helps make the SBA process faster and more accurate.
- **SBA Preferred Lenders**: These lenders have the highest level of autonomy the SBA affords to lenders. According to the SBA, Preferred Lender Program (PLP) banks have authority for "loan approval, closing, and most servicing and liquidation authority and responsibility." Criteria for a bank to join the PLP include nomination by an SBA Field Agent and:
  - The ability to process, close, service and liquidate loans
  - The ability to develop and analyze complete loan packages
  - A satisfactory performance history with SBA
  - Lenders must be approved for these designations every two years

# Responsibilities of 7(a) Lenders

- Depending on lender designation, submit complete applications for guaranty
- Execute loan authorizations
- Close loans in accordance with SBA program requirements (SOP 50 10)
- Maintain complete loan files
- Service loans in accordance with SBA program requirements. This can be outsourced, but the lender is responsible for contractor in the eyes of the SBA.
- Liquidate loans in accordance with SBA program requirements. This also is typically outsourced.

# Eligibility Requirements

- 7(a) loan eligibility is based on four different factors:
  - 1) Size – all recipients must be classified as “small” based on SBA size standards
  - 2) Nature of Business
  - 3) Use of Proceeds
  - 4) Miscellaneous Factors

# “Small” Business

- Loan recipients must be classified as “small” by the SBA.
- Business size is based on one of two standards – either:
  - 1) By industry – measured in terms of either # of employees or gross revenues (established by SBA); OR
  - 2) “Alternate Size Standard”:
    - Maximum tangible net worth - \$15 million or less, AND
    - 2-year average net income after Federal income taxes of \$5 million
- Standards apply to applicant and any affiliates (combined)
- Determination of franchise eligibility regarded as a sub-set of size determination

# General SBA Size Standards

Industry	SBA Standard
<b>Manufacturing</b>	From 500 to 1,500 employees
<b>Whole Sale Trades</b>	Up to 100 employees
<b>Retail Trades</b>	\$2 million to \$33.5 million in average annual receipts
<b>Construction</b>	\$7 million to \$33.5 million in average annual receipts
<b>Agriculture, Forestry, Fishing &amp; Hunting</b>	\$750,000 to \$17.5 million in average annual receipts



# Nature of Business

- Must be organized for profit
- Must be an operating (not passive) business
- SBA has general prohibitions against lending to businesses involved in lending, speculating, passive investment, pyramid sales, loan packaging, and gambling
- Other prohibitions include businesses promoting religion, certain private clubs, and municipalities.

# Permitted Uses of 7(a) Proceeds

- Expansion/renovation
- New construction
- Purchase of land, equipment and/or fixtures
- Lease-hold improvements
- Working capital
- Inventory
- Business acquisition
- Start-ups and refinancing (only under certain conditions)

# Miscellaneous Eligibility Factors

- “Credit Elsewhere Test”
- Utilization of personal asset requirements – Personal Resources Test Recently Eliminated
- Anti-discrimination rules
- Limitations on lending to agricultural enterprises

# Eligibility Summary

- Generally, SBA loans must meet the following criteria:
  - Every loan must be for a sound business purpose
  - There must be sufficient invested equity in the business so it can operate on a sound financial basis
  - There must be potential for long-term success
  - The owners must be of good character and reputation
  - All loans must be so sound as to reasonably assure repayment

# 7(a) Benefit to Borrowers

- Business able to obtain financing which would not otherwise be provided due to terms, collateral, equity, and/or time in business
- Fixed maturity
- No balloon payments
- No prepayment penalty if maturity under 15 years

# 504 Program Overview

- The 504 Loan program is an economic development program that supports American small business growth and helps communities, business expansion and job creation
- Long-term, fixed-rate loans for financing fixed assets – usually real estate and equipment
- Most often used for growth or expansion
- 504 loans are made through Certified Development Companies (CDCs)
- CDCs are nonprofit intermediaries that work with the SBA, banks and businesses looking for financing

# 504 Loan Structure

- Under the general 504 loan structure:
  - Borrower is required to provide 10% of the equity in the project
  - A private lender provides 50% of the funding
  - CDC provides the remaining 40 %

# SBA 504 Guaranteed Debenture

- The CDC loan is backed by a 100% SBA guaranteed debenture
- Debentures are sold monthly in pools to private investors
- The advantage of the program is that the CDC portion (typically 40% of the project cost) is a fixed, below market rate loan for 20 years
- In exchange for below-market financing, the SBA expects the small business to create or retain jobs or meet certain public policy goals
- 504 loans are designed to promote economic growth within the community



# 504 Public Policy Goals

- Some public policy goals of the 504 Loan program include:
  - Business district revitalization
  - Expansion of exports
  - Expansion of minority business development
  - Rural development
  - Increasing productivity and competitiveness
  - Restructuring to meet mandated standards and policies
  - Changes due to federal budget cuts
  - Expansion of businesses owned and controlled by veterans and women

# 504 Collateral Requirements

- CDC:
  - The CDC takes a subordinate second mortgage to secure its portion of the financing.
  - Other assets of the business or principals are generally not required to secure the loan.
  - Additional collateral may be required if the business is a start-up, if the credit has unusual risk, or the asset being financed is considered a “single purpose” asset or does not appraise high enough.
- Private Lender:
  - For its 50% participation in the project, the private lender will have a first lien on all of the project assets.
  - The first mortgage loan from the private lender is not guaranteed by the SBA.

# 504 Benefit to Borrowers

- Fees under 3%
- Long-term fixed rate
- Low down payment
- Full amortization
- No balloons

# SBA 504 & 7(a) Compared

	<b>SBA 504 Loan</b> (Commercial Real Estate & Equipment)	<b>SBA 7(a) Loan</b> (General Purpose)
<b>LOAN SIZE</b>	Maximum - \$5 million on the SBA Portion (the debenture) <u>(There is no maximum project amount)</u>	Maximum - \$5 million
<b>INTEREST RATE</b>	Fixed	Predominantly variable; some fixed-rate options
<b>BORROWER INJECTION</b>	10 %	Prudent Lending Test
<b>MATURITY</b>	<ul style="list-style-type: none"> <li>• Either 10 or 20 year term on the SBA CDC portion</li> <li>• Term of bank portion is negotiated with lender</li> </ul>	Generally: <ul style="list-style-type: none"> <li>• 5-10 yrs. for working capital, machinery, and equipment loans</li> <li>• 25 yrs. For real estate loans</li> <li>• Term negotiated with lender</li> </ul>

# SBA 504 & 7(a) Compared

	<b>SBA 504 Loan</b> (Commercial Real Estate & Equipment)	<b>SBA 7(a) Loan</b> (General Purpose)
<b>ELIGIBLE BUSINESS SIZE</b>	<ul style="list-style-type: none"> <li>• Determined by industry type; <u>OR</u></li> <li>• Alternate Size Standard</li> </ul>	<ul style="list-style-type: none"> <li>• Same as 7(a)</li> </ul>
<b>LOAN STRUCTURE</b>	<ul style="list-style-type: none"> <li>• 50% Bank Loan</li> <li>• 40% CDC Loan</li> <li>• 10% Borrower Down payment</li> </ul>	<ul style="list-style-type: none"> <li>• Loan structure negotiable depending on risk</li> <li>• 10% Borrower down payment</li> </ul>
<b>PROCEED USES</b>	<ul style="list-style-type: none"> <li>• Purchase existing building</li> <li>• Land acquisition and ground-up construction</li> <li>• Expansion of existing building</li> <li>• Building improvements</li> <li>• Purchase equipment</li> </ul>	<ul style="list-style-type: none"> <li>• Expand, acquire or start a business</li> <li>• Purchase or construct real estate</li> <li>• Refinance existing business debt</li> <li>• Buy equipment</li> <li>• Provide working capital</li> <li>• Construct leasehold improvements</li> <li>• Purchase inventory</li> </ul>

# SBA 504 & 7(a) Compared

	<b>SBA 504 Loan</b> (Commercial Real Estate & Equipment)	<b>SBA 7(a) Loan</b> (General Purpose)
<b>PROGRAM REQUIREMENTS</b>	<ul style="list-style-type: none"> <li>• 51% owner occupancy for existing buildings</li> <li>• 60% owner occupancy for new construction</li> <li>• Equipment must have minimum 10-year economic life</li> </ul>	<ul style="list-style-type: none"> <li>• 51% owner occupancy for existing buildings</li> <li>• 60% owner occupancy for new construction</li> <li>• All assets financed must be used to the direct benefit of the business</li> </ul>
<b>COLLATERAL</b>	<ul style="list-style-type: none"> <li>• Generally, project assets being financed are used as collateral</li> <li>• Personal guaranties of the principal owners of 20% or more ownership are required</li> </ul>	<ul style="list-style-type: none"> <li>• Subject assets acquired by loan proceeds</li> <li>• Pledge of personal residence unless bank can justify why unnecessary</li> <li>• Personal guaranties of the principal owners of 20% or more ownership are required</li> </ul>
<b>FEES</b>	<ul style="list-style-type: none"> <li>• Fees are financed in the 504 loan</li> <li>• Fees are negotiated for the 50% bank loan</li> <li>• Servicing fee (lowest allowed by SBA) for CDC plus legal review fee</li> </ul>	<ul style="list-style-type: none"> <li>• Fees can be financed in the 7(a) loan</li> <li>• Fees vary with size of loan paired with 504 loan</li> <li>• Additional .25% charged on any loan portion above \$1 million</li> </ul>

# SBA Standard Operating Procedures

- SOPs are the “Standard Operating Procedures” containing SBA’s loan program policies and regulations
- 50 10 is the primary SOP and covers the “Lender and Development Company Loan Programs”
- It contains the requirements for lenders and CDCs to participate in SBA lending programs
- Additionally, 50 10 discusses:
  - The different levels of delegated status SBA grants to lenders and CDCs
  - It sets forth how lenders and CDCs maintain their participating status with SBA
  - Provides an overview of how SBA oversees its participating lenders and CDCs

# SOP 50 10 Highlights

- 7(a)-Related 50 10 Provisions:
  - General description of 7(a) loan programs
  - Eligibility
  - Loan Terms & Conditions
  - Credit Standard, Collateral & Environmental Policies
  - Loan Authorization
  - Submission of Application for Guaranty
  - Post-Approval Modifications, Loan Closing & Disbursement
  - Post Disbursement, Secondary Market, Securitization & Lender Reporting



# SOP 50 10 Highlights

- 504-Related 50 10 Provisions:
  - Purpose of 504 CDC Program & Credit Standards
  - Eligibility
  - Collateral, Appraisals & Environmental Policies
  - Loan Application Procedures & Controls
  - Loan Conditions/Authorization Requirements
  - Closings
  - Debenture Pricing & Funding
  - Allowable Fees
  - Rule Governing Borrower's Deposit, Debenture Pools

# SBA Loan Application Documents

- While each program has specific forms to fill out and document, the following are typical items that are required from any small business in the loan application phase:

<b>Personal Background</b>	<b>Bank Statements</b>
<b>Resumes</b>	<b>Collateral</b>
<b>Business Plan</b>	<b>Income Tax Returns</b>
<b>Personal Credit Report</b>	<b>Financial Statements</b>

# Documenting SBA Loans & Required Due Diligence

- SBA Authorization
- Title Requirements
- Searches
- Survey
- Property Business Approvals
- Leases
- Construction
- Formation Documents
- Insurance
- SBA Approvals
- Franchises
- Potential Issues/Time Sensitive Matters

# SBA Authorization

- Document issued by or on behalf of SBA to set forth loan requirements
- Loan requirements should match credit requirements
- Sets forth required loan conditions and collateral requirements
- Must be followed strictly
- National Authorization sets forth state specific requirements

# Title Requirements

- i. Lien positions and insured amounts
- ii. Current open mortgages and restrictions of record
- iii. Up-to-date searches
- iv. Proper endorsements
- v. Taxes

# Searches

- i. Judgment
- ii. UCC
- iii. Pending litigation
- iv. County
- v. Franchise tax
- vi. Flood

# Survey

- i. Proper certifications
- ii. Affidavit of no change

# Property/Business Approvals

- i. Certificate of Occupancy
- ii. Zoning letter
- iii. Business Licenses
- iv. Permits



# Leases

- i. Term Compliance
- ii. Tenant Estoppels
- iii. Landlord Non-Interference

# Construction

- i. Contracts
- ii. Plan and Specifications
- iii. Permits/Approval
- iv. Contractor Insurance
- v. Performance Bond
- vi. Lien Waivers

# Formation Documents

- Limited Liability Companies:
  - Certificate of Formation
  - Operating Agreement
  - Certificate of Good Standing
  - Ownership Structure/Titles

# Formation Documents

- Corporations:
  - Certificate of Incorporation
  - By-laws
  - Certificate of Good Standing
  - Ownership Structure/Shareholders
  - Copies of Stock Certificate

# Formation Documents

- Selling Entities:
  - Franchise Tax Search
  - Certificate of Good Standing

# Insurance

- Coverages
- Proper designations on the record
- Proper certificate holders

# Life Insurance

- Copies of policies
- Collateral Assignments and Recording

# SBA Approvals

- Authorization
- Appraisal
- Environmental
- No adverse change
- Injection issues



# Franchises

- Eligibility
- FDD
- Franchise Agreement and Addendums – compliance with SBA
- Certificate of Franchise Documents
- Ownership

# Potential Issues/Time Sensitive Matters

- Bulk Sales
- Life Insurance
- State specific requirements