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Cooperative Lending - Personal Guarantee Requirement

Report to the United States Senate and United States House of Representatives

U.S. SMALL BUSINESS ADMINISTRATION

Report on Cooperative Lending – Personal Guarantee Requirement

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Report on Cooperative Lending – Personal Guarantee Requirement

Executive Summary
As required by Section 862(g) of the John S. McCain National Defense Authorization Act for Fiscal Year 2019 (NDAA 2019)[1], the following information presents the Report to the United States Senate and the United States House of Representatives on the U. S. Small Business Administration's (SBA) Cooperative Lending.

Section 862(g) of the NDAA 2019 requires the Administrator of SBA, in coordination with lenders, stakeholders, and Federal agencies, to study and recommend practical alternatives for cooperatives that will satisfy the loan guarantee requirements of the Administration in its lending programs.

After numerous telephone discussions with the United States Department of Agriculture (USDA) Rural Development Agency, SBA officials met with officials of USDA in person on February 12, 2019. During the meeting, SBA and USDA discussed their respective agency policies and procedures related to cooperative lending.

In addition, SBA held two public forums to provide a platform for relevant stakeholders to propose practical alternatives to satisfying SBA's personal guarantee requirement. The first public forum was held at SBA Headquarters at 409 3rd Street, SW Washington, DC 20416 on March 12, 2019. The second public forum was held via teleconference on March 29, 2019. In both instances, SBA published a notice in the Federal Register to provide advance notification to the public and stakeholders of the public forums.

Each of the public forums benefited from a diverse representation from the cooperative industry. Members of cooperatives, lenders and associations that support the formation of cooperatives participated in both public forums.

During the public forums, participants provided testimonies and offered proposals to satisfy SBA's guarantee requirement, including additional equity requirements and waivers of guarantee requirements for cooperatives located in specialized areas, such as cooperatives located in HUBZones[2] or Food Deserts[3], or if the cooperative membership attains certain demographic minimums for women and/or minority ownership in the cooperative. Some participants also proposed to reinstate the SBA's Intermediary Lending Pilot (ILP) Program[4] .

The following sections provide more detailed information on the meeting with USDA and the two public forums.

Personal Guarantee Requirement

SBA requires that each loan must be guaranteed by at least one individual or entity. This requirement is to ensure that SBA adequately mitigates the risk to the loan program and, ultimately, to the taxpayers.

Section 862(g)(1) of the NDAA 2019 provided the following "Sense of Congress" as to cooperatives: "It is the sense of Congress that cooperatives have a unique business structure and are unable to access the lending programs of the Administration effectively due to loan guarantee requirements that are incompatible with the business structure of cooperatives."

Study and Report

SBA met with the USDA Rural Development Agency and held two public forums, one in person at SBA Headquarters and one via teleconference. SBA elected to hold the second public forum as a teleconference in order to provide a greater opportunity for public involvement.

Meeting with USDA Rural Development Agency

On February 12, 2019, representatives from SBA's Office of Financial Assistance met with representatives from USDA's Rural Development Agency at USDA Headquarters at 1400 Independence Ave., S.W., Washington, DC 20250 to discuss the agencies' respective policies and procedures on loans to cooperatives. At the meeting, there were four SBA representatives and seven USDA representatives present.

Unlike SBA, USDA does not require each loan to be guaranteed by at least one individual or entity. However, USDA does require each loan to be fully collateralized[5]. SBA-guaranteed loans, on the other hand, are not always fully secured. As a possible alternative to a personal guarantee, USDA presented an instance where the agency required the cooperative members to sign a covenant to withhold distribution of cooperative profits until the agency loan was paid in full.

First Public Forum at SBA Headquarters – March 12, 2019

SBA held a public forum at SBA Headquarters on March 12, 2019. There were 19 attendees representing 17 organizations from the cooperative industry. Seven SBA representatives were present. Eleven attendees provided testimonies on their experiences with cooperative loans and lending, and some proposed practical alternatives to the SBA guarantee requirement, which are discussed below. The attendees providing testimony included representatives from Ohio Employee Ownership Center, Fredericksburg Food Co-op, Cooperative Fund of New England, National Cooperative Bank, US Federation of Worker Cooperatives, Democracy Collaborative, National Cooperative Business Association, Capital Impact Partners, Worker Cooperative Conversion, Carolina Common Enterprises, and Equal Exchange Cooperative.

Second Public Forum via Teleconference – March 29, 2019

SBA held a second public forum via teleconference on March 29, 2019. There were 27 participants representing 25 organizations from the cooperative industry. Six SBA representatives participated in the teleconference. Twelve participants provided testimonies on their experience with cooperative loans and lending, and some proposed practical alternatives to the SBA guarantee requirement, which are discussed below. The participants providing testimony included representatives from Neighbor and Food Co-op Association, Center for Community-based Enterprise in Detroit Michigan, National Co-op Grocers Association, Village Co-op Market of Williamsville, National Cooperative Business Association, Cooperation Works, Shared Capital Cooperative, Working World, Community Reinvestment Fund, US Federation of Worker Cooperatives, Project Equity, and Cooperative Fund of New England.

<u>Proposed alternatives with SBA's comments</u>

- USDA Rural Development Agency advised SBA that it was their policy to waive personal guarantees for any loans to Cooperatives if the loan is fully collateralized.

The USDA policy does not satisfy SBA's requirement for a guaranty, rather it permits certain exceptions to guarantees because they require and rely on loans to be fully secured by collateral which then serves as a primary consideration for assured repayment of the loans. USDA employs a significantly discounted value to determine that a loan has full collateral coverage. Alternatively, SBA's lending is predicated upon repayment ability from the cash flow of the business as the primary repayment source, with collateral considered secondarily. In fact, SBA-guaranteed loans cannot be turned down solely based on the inadequacy of collateral which is a common reason that conventional lending is unavailable. Further, because one of the foundational tests of eligibility for SBA-guaranteed loans is the inability to obtain credit elsewhere on reasonable terms from non-Federal sources (which is not applicable for USDA loans), this option would raise serious concerns that generally there are conventional financing options available for loans that are fully collateralized on a discounted basis.

- USDA Rural Development Agency suggested that SBA, in lieu of a personal guarantee, accept a covenant to withhold distribution of cooperative profits until the agency loan was paid in full.

This proposal does not adequately satisfy the personal guaranty requirement because the basis for SBA's personal guaranty requirement is to provide a source of recovery in the event the small business borrower defaults on the loan. A covenant to withhold the distribution of cooperative profits would not mitigate the risk of loss or enhance recovery in the event of a default.

- Proposal for SBA to accept additional equity from the members of the cooperative in lieu of a personal guarantee. Proposals recommended 30% of the total project.

This proposal does not adequately satisfy the personal guaranty requirement because an additional equity injection prior to disbursement of the loan proceeds will not provide any recovery in the event the small business borrower defaults on the loan, which is the purpose of a personal guaranty. Further, under SBA's current policies, a cooperative may utilize additional cash or cash-equivalent assets to form an entity to be the guarantor, as an alternative to having an individual member serve as guarantor.

- Proposal for SBA to waive the personal guarantee requirement for cooperatives located in a HUBZone or Food Desert, for women-owned cooperatives, and for cooperatives owned by minorities.

This proposal does not satisfy the personal guaranty requirement because, as stated above, the basis for SBA's personal guaranty requirement is to provide a source of recovery in the event the small business borrower defaults on the loan. The locality or ownership structure of the borrower does not mitigate the risk of a default.

- Proposal for SBA to reopen the Intermediary Lending Pilot (ILP) Program.

The ILP program was a pilot program authorized for three years under the Small Business Jobs Act of 2010. SBA's authority to make loans under the ILP program expired in 2013, and SBA does not support reauthorization due to the high costs of running the program and overlap with existing programs.

- Proposal for SBA to require the seller to maintain partial ownership for a limited time and provide its personal guarantee for a limited time.

First, this proposal would only apply to situations where the cooperative is acquiring an existing business, which is not always the case with SBA-guaranteed loans to cooperatives. Second, this proposal is not a practical alternative because of the time limitation.

SBA's recommendation

SBA's recommendation is to better educate the public to the two options available to cooperatives to satisfy the personal guarantee requirement under SBA's current policies and procedures:

1. SBA requires each loan to be guaranteed by at least one individual *or entity*. To satisfy the requirement without an individual guarantee, the cooperative members can form an entity to be the guarantor of the loan. The entity should maintain reasonable assets or equity in order to provide a source of recovery in the event the small business borrower defaults on the loan.
2. In situations where the cooperative is acquiring an existing business, the seller may remain as a partial owner of the small business borrower, but must provide a

full, unlimited guarantee for the life of the loan. The cooperative must own a controlling interest of the small business to qualify for an SBA-guaranteed loan.

Note: Currently, the only exception to the requirement that at least one individual or entity provide a full, unlimited guaranty on an SBA-guaranteed loan is when the loan is made to a business that is 100 percent owned by an eligible Employee Stock Ownership Plan (ESOP), as defined by the Internal Revenue Service (IRS). The IRS tax code and regulations under 26 CFR 54.4975–7(b)(1)(ii) require that loans made to an ESOP be without recourse against the ESOP or its individual qualified members. Therefore, an ESOP trust owning 20 percent or more of the Applicant business is prohibited from providing a guarantee on the loan. As there is no similar law constraining full recourse guarantees in connection with loans to cooperatives, SBA requires at least one full and unconditional guarantee from an individual or entity in connection with an SBA-guaranteed loan to a cooperative.

SBA Implementation Plan

The NDAA 2019 requires SBA to provide a plan for implementation of the recommended practical alternatives that satisfy SBA's personal guaranty requirement.

SBA's current policies and procedures provide two options to cooperative members to satisfy the requirement for a personal guarantee:

1) The members of the cooperative may form an entity with reasonable assets or equity to be the guarantor of the loan; or
2) In situations where the cooperative is acquiring an existing business, the seller may remain as a partial owner and provide a full, unlimited guarantee for the life of the loan. The cooperative must have controlling interest of the business to qualify.

Both of these options are included in SBA's current Standard Operating Procedure (SOP) 50 10 5(K), Lender and Development Company Loan Programs. In addition, through training and outreach to SBA Lenders and SBA employees, the Agency will continue to educate the public on the two options stated above and promote better understanding of our programs.

Conclusion: SBA met with another Federal agency that provides guaranteed loans to cooperatives and met with stakeholders to explore practical alternatives to SBA's personal guarantee requirement for cooperatives. The cooperative industry and public were provided with opportunities to propose recommendations for practical alternatives. The proposed alternatives, however, did not adequately substitute for SBA's personal guarantee requirements. Current SBA policies and procedures permit two options for cooperatives which adequately satisfy the personal guarantee requirement. SBA's current SOP governing the business loan programs incorporates both options. In addition, through training and outreach to SBA Lenders and SBA employees, the Agency will continue to publicize the permissible options and promote better understanding of our programs.

ENDNOTES

[1] Section 862(g) of the John S. McCain National Defense Authorization Act for Fiscal Year 2019 https://www.govinfo.gov/content/pkg/CRPT-115hrpt874/pdf/CRPT-115hrpt874.pdf

[2] Based on SBA's HUBZone Map https://maps.certify.sba.gov/hubzone/map#center=39.828200,-98.579500&zoom=5

[3] Based on USDA's Food Desert map https://www.ers.usda.gov/data/fooddesert/

[4] The ILP pilot program was authorized by the Small Business Jobs Act of 2010. The ILP program allowed SBA to select up to 20 nonprofit intermediaries each year to receive loans up to $1,000,000 for 2011, 2012, and 2013. The terms of the loans were 20 years and carried a 1% interest rate. The intermediary lenders were then tasked with lending up to $200,000 to qualified small businesses. Unlike in SBA's guaranteed business loan programs, in the ILP Program the small business loans are not guaranteed by SBA. Because ILP lenders are obligated to repay their loans to SBA regardless of the performance of the small business loans made under the program, SBA has fewer requirements for small business loans made by ILP lenders. ILP lenders may lend to small businesses without requiring collateral or personal guarantees. SBA received appropriations to fund ILP loans in 2011 and 2012, but not for 2013, and SBA's authority to make new loans under the pilot was not extended. Currently, SBA monitors and maintains ongoing oversight of the existing ILP intermediary lenders.

[5] USDA B&I Guaranteed Loan Program requirement in which discounted collateral value must be equal to or greater than the loan amount. RD Instruction 4279-B, section 4279.131 (b),(1) https://www.rd.usda.gov/files/4279b.pdf