

The Problem with SBA Loans: Easy to Get and Hard to Exit

There are approximately 600,000 new businesses formed each year in the United States.¹ These businesses need liquidity to operate and grow. However, traditional lenders often view new businesses as too risky.² To help small businesses access capital, the Small Business Administration (“SBA”), an arm of the federal government, partners with approved lenders to offer SBA 7(a) loans.³

Under the SBA 7(a) loan program (an “SBA Loan”), the SBA guarantees up to 85% of loan (depending on the size of the loan) to the Lender.⁴ Because the SBA is guarantying the loan, the lender is willing to lend to businesses that are greater credit risks including new businesses.⁵

Additionally, the process to obtain an SBA Loan is easier than a traditional loan. The SBA requires, among other things, that the business be profitable, be formed and located in the U.S., and the owners’ have equity and used their own money in the business.⁶ In addition, the SBA’s lending partner will likely require additional information including tax returns, organizational documents, financial statements, and an adequate credit score.⁷

While obtaining an SBA Loan is relatively easy, SBA Loans generally require significant collateral in addition to a security interest in the business’s assets and the SBA’s guaranty. An

¹ Sam Carlson, Business Failure Statistics – Failure Rate by Location, Industry, and More ..., Available at <https://shopsavvy.mobi/business-failure-statistics/> (last accessed October 18, 2022).

² What Is the SBA 7(a) Loan Guaranty Program?, p. 1. Available at <https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-fact-sheets/pub-fact-sheet-sba-7a-guaranteed-loan-jul-2015.pdf#:~:text=What%20is%20the%20SBA%207%28a%29%20Loan%20Guaranty%20Program%3F,they%20cannot%20otherwise%20obtain%20credit%20at%20reasonable%20terms.> (last accessed October 18, 2022).

³ Id.

⁴ Id.

⁵ Id.

⁶ <https://www.sba.gov/funding-programs/loans/7a-loans#section-header-2> (last accessed October 18, 2022).

⁷ Id.

SBA Loan will often be collateralized with (i) the owner's personal guaranty, (ii) a junior mortgage on the owner's home, and (iii) a life insurance policy insuring the owner's life.⁸ The more collateral a lender has the lower the risk that the lender will lose any money upon a default in the SBA Loan.

Lender's make this process extremely easy, and business owner's are generally happy when they leave the Lender's office with their SBA Loan. Like newlyweds, the business owners see only blue skies and daisies. However, there are storm clouds on the horizon: Of those 600,000 new businesses formed each year, 20% of them fail in the first year and approximately 50% fails before the fifth year.⁹

Significantly 82% of businesses fail because they take on more debt than their cash flow can service.¹⁰ Most businesses' initial reaction to a cash flow crunch is to find more easy money. The new business often turns to merchant cash advance companies ("MCAs") or stops paying its sales and/or withholding taxes.¹¹ Each eases the short-term cash flow crunch, but makes it less likely that the new business will survive because each exacerbates the cash flow crunch in the long term.¹²

Eventually, the borrower's SBA Loan gets turned over to the lender's workout department. "Workout" is a euphemism. The nice loan officer that provided the SBA Loan ceases to be involved in the SBA Loan, and the difficult workout officer is the borrower's sole contact with the

⁸ <https://www.sba7a.loans/sba-7a-loans-small-business-blog/sba-7a-loans-and-collateral-down-payment> (last accessed on October 18, 2022).

⁹ Sam Carlson, Business Failure Statistics – Failure Rate by Location, Industry, and More ..., Available at <https://shopsavvy.mobi/business-failure-statistics/> (last accessed October 18, 2022).

¹⁰ *Id.*

¹¹ See, e.g., <https://www.yourfundingtree.com/the-downsides-of-getting-a-merchant-cash-advance/> (last accessed October 18, 2022); Paul L.B. McKenney, *Don't Take That "Loan!"*, 29 Mich. Bus. LJ 2, 7-8 (2009).

¹² *Id.*

Lender. The workout officer wants to know how the SBA Loan will be repaid. Here is where things get tricky because the Lender must take certain proscribed steps in order to preserve the SBA guaranty.¹³ If those steps are not taken, the SBA's guaranty may be diminished or extinguished, leaving the Lender subject to much greater risk of loss.¹⁴

In fact, the "workout" process for an SBA Loan is referred to as "liquidation". Further, because the primary goal of managing a problem SBA Loan is to preserve the Lender's SBA guaranty¹⁵, the Lender will be much less flexible in finding a solution to the problem SBA Loan. Instead, and consistent with the SBA SOP 50 57 2 – 7(a) Loan Servicing and Liquidation, the Lender will likely move to litigation, liquidate the business, and recover on the collateral including the personal guaranty.¹⁶ This process puts the business owner at significant risk.¹⁷ As one bank lawyer put it, "You can't leave the sandbox and keep your toys."

The most prudent course of action is to seek to refinance from an SBA Loan to a non-SBA Loan if the business is healthy enough to make that move. A business with a more traditional business loan has more options when its loan becomes problematic because the workout officer is focused on the greatest recovery for the Lender instead of preserving the SBA guaranty. Often an out-of-court workout solution can be reached that allows the business to continue.

Under most circumstances, the business should not sell its future receivables to an MCA or worse to more than one MCA (a process known as "stacking"). While doing so provides a very

¹³ SBA SOP 50 57 2 – 7(a) Loan Servicing and Liquidation, Chapter 21.

¹⁴ Thomas Wallace, *Managing Problem Loans under U.S. Small Business Administration 7(a) Guarantees*, the RMA Journal (February 2001).

¹⁵ *Id.*

¹⁶ SBA SOP 50 57 2 – 7(a) Loan Servicing and Liquidation, Chapter 21.

¹⁷ *Id.* See also Thomas Wallace, *Managing Problem Loans under U.S. Small Business Administration 7(a) Guarantees*, the RMA Journal (February 2001).

short-term solution to the cash flow problem, it creates a much larger cash flow problem when the MCAs begins recovering their share of the future receivables (usually on a weekly basis).¹⁸

Under no circumstances should it stop paying its sales or withholding taxes, which are trust fund taxes.¹⁹ Liability for failure to pay trust fund taxes has a very long statute of limitations, has personal liability to the business's responsible person, and is non-dischargeable in bankruptcy.²⁰

Instead, if the business is encountering cash flow difficulties, the business should promptly consult with its accountant and engage insolvency professionals. Together, the accountant and insolvency professional will endeavor to chart a path back to health or seek to minimize the effects of a business wind down on its owners.

If the business cannot refinance from its SBA Loan, has taken on MCAs, and/or has trust fund tax liabilities, the best option may be to restructure the business may be a chapter 11 bankruptcy filing. If your business is experiencing cash flow problems, early intervention is critical to a successful reorganization or exit strategy. The attorneys at Schafer and Weiner, PLLC have significant experience assisting businesses and business owners with addressing SBA Loans in "liquidation". Don't hesitate to contact us.

¹⁸ See, e.g., <https://www.yourfundingtree.com/the-downsides-of-getting-a-merchant-cash-advance/> (last accessed October 18, 2022).

¹⁹ Paul L.B. McKenney, Don't Take That "Loan!", 29 Mich. Bus. LJ 2, 7-8 (2009).

²⁰ *Id.* See also 11 U.S.C. § 523(a)(1).