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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

December 18, 2018

The Honorable Linda McMahon
Administrator
United States Small Business Administration
409 3rd Street, SW
Washington, DC 20416

RE: Comments on Proposed Rule governing business loan programs (RIN 3245-AG74); 83 Fed. Reg. 189 (Sep. 28, 2018).

Administrator McMahon:

I write in my capacity as Ranking Member of the U.S. House of Representatives Committee on Small Business. The Committee has jurisdiction over the Small Business Administration's (SBA) business loan programs. On September 28, 2018, SBA announced it was proposing to amend several regulations governing those programs, and invited commentary thereto from the public.[1] Accordingly, I hereby submit the following comments to the proposed regulations (the "Proposed Rule").

I. Credit Elsewhere and the Personal Resources of Owners of the Small Business Applicant

Overall, I am pleased SBA is re-instituting a personal resources test, which would help provide clarity to the portion of the "credit elsewhere" test requiring lenders to determine whether some or all of the requested loan amount is available from non-federal sources connected to the loan applicant.[2] However, I have concerns with some of the details of the new personal resources test, particularly regarding the impact on small-dollar borrowers. I, therefore, encourage SBA to finalize the regulation at 13 C.F.R. § 120.102 with a simplified version of the personal resources test that is easier for borrowers to understand, sets appropriate threshold levels responsive to the needs of small-dollar borrowers, and clarifies important definitions.

First and foremost, SBA should also more clearly define what assets are considered "liquid." This should include a distinction between retirement savings held in a savings account (generally considered liquid), and retirement savings held in an IRA, 401(k), or other account containing a withdrawal penalty (generally considered illiquid). This would be consistent with

[1] 83 Fed. Reg. 189 (Sep. 28, 2018).
[2] *Id.*

SBA's practice under prior versions of the personal resources test.[3] These definitions should also clearly distinguish between education savings held in a 529 account and those held in a general savings account, and between stock that is or is not publicly traded.

Moreover, the version of the personal resources test in the Proposed Rule changes the standard used to determine how much capital must be injected by each 20-percent owner from the 7(a) loan amount to the "total financing package."[4] Based on my engagement with stakeholders, it remains unclear why SBA decided to move away from basing the capital injection requirement on the 7(a) loan amount, and I am concerned that the term "total financing package" could confuse borrowers. The possibility for such confusion could be largely mitigated by setting a standard based on the 7(a) loan amount, which is a clearly understood term. More concerning is how a vague term like "total financing package" could be subject to competing, inconsistent interpretations resulting in some 20-percent owners being required to inject a certain amount of personal resources in to the business, while other analogous 20-percent owners may not. Consequently, in order to prevent needless borrower confusion over the term "total financing package," and to promote consistency in the application of the personal resources test, SBA should amend the proposed personal resource test such that the standard for requiring a capital injection from 20-percent owners is based on the 7(a) loan amount, and not on the "total financing package."

II. Permissible Fees That a Lender or Agent May Collect From an Applicant or Borrower in Connection With a 7(a) Loan Application

I appreciate the need to combat predatory agent fees, especially for small-dollar borrowers, and the effective role fee caps could play in that effort. With the various other enforcement and oversight tools at SBA's disposal for combating predatory agent fees, I would like to know how SBA arrived at the conclusion that setting industry-wide agent fee caps was the best solution. Considering the nature of this change, I believe it is in the best interest of all stakeholders to reassess this language to ensure all unintended consequences and alternatives can be considered. I look forward to continued collaboration with SBA on this important issue as we work to find legislative and regulatory means for enhancing access to capital for small dollar borrowers and promoting responsible lending practices. I also look forward to a dialogue with SBA regarding whether a public study is needed to assess the impact of web-based packaging and referral agents on access to capital for small-dollar, women, minority, veteran, and rural borrowers, and whether SBA can glean any best practices from the private sector in how it works to enhance access to capital.

III. Loans to Qualified Employee Trusts

I strongly object to the proposed rule governing SBA-guaranteed loans to qualified employee trusts (employee stock ownership plans, or "ESOPs"). Specifically, SBA is proposing to amend its regulation at 13 C.F.R. § 120.350 to prohibit applications for SBA-guaranteed loans to ESOPs for the purposes of either helping finance the growth of the business or to purchase

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[3] *See, e.g.*, SOP 50 10 5(F), Subpart B, Chapter 2 (pg. 86), https://www.sba.gov/sites/default/files/files/SOP%2050%2010%205%28F%29%20June%2018%202014%20Updated%20for%20Credit%20Score%20%28final%20highlightedl%29_5.pdf.

[4] *See supra* note 1.

ownership or voting control of the employer from being processed under a lender's delegated authority.[5] If finalized in its proposed form, 13 C.F.R. § 120.350 would be in direct contravention of the policy enacted by Congress in Section 862 of the John S. McCain National Defense Authorization Act for Fiscal Year 2019 (NDAA),[6] which charges SBA with promoting enhanced employee ownership of ESOPs by maximizing the ability to affordably access capital. Therefore, I strongly object to the proposed regulation on the processing of ESOP loan applications, and urge that the final version of 13 C.F.R. § 120.350 be aligned with the policy embodied in Section 862 of the NDAA – allowing applications for these loans to be processed under a lender's delegated authority.

As has been stressed to SBA recently, nearly half of all privately-held businesses in the U.S. are owned by individuals who are at or near retirement age, representing more than 2.3 million companies, and employing close to 25 million workers in total (one in six workers nationwide). Though more than half of these small business owners expect to retire within the next ten years, fewer than 15 percent have a formal exit plan in place. Only a small percentage of these businesses will be passed on to family members or bought by another local company. Instead, many of these businesses could be bought out by competitors or even close due to a lack of planning or inability to find a buyer; both of which result in damage to local communities from lost jobs and revenue.

This "baby boomer cliff" is a very real concern for the business owner who may not have enough money on which to retire, and employees of those businesses, who struggle with the uncertainty of their boss' future retirement plans. As this trend accelerates in the coming years, it is crucial that those small business employees be empowered to transition the business to an employee-owned model, preserving the firm's independence and protecting it from the risk of decline, buyout, or outright closure.

In order to address this issue, Congress included numerous provisions in the NDAA[7] seeking to ease a small firm's transition to an employee-owned model. Notably, Section 862(b) expands the 7(a) loan guaranty program to ESOPs to align the program with current industry financing practices.[8] Most importantly, though, is the provision in Section 862(b)(2), which expressly adds loans to ESOPs to the group of loans guaranteed by SBA which may be processed under a lender's delegated authority.[9] Thus, the Congressional intent of the legislation authorizing SBA to allow for delegated authority clearly recognizes the ability of experienced lenders to process these transactions. However, the agency did not follow through with this intent and instead summarily denied such transactions from delegated authority based on the "complex nature of these transactions."[10] Such revocation of delegated authority should be based on the lender's ability to process a transaction, not solely on the type of transaction. In fact, many of the lenders delegated with partial or full authority to approve loans are some of the most technically savvy lenders to take on the "complex nature of these transactions." Finally, with appropriate supporting

[5] *See supra* note 1.
[6] Pub. L. 115-232, § 862.
[7] Pub. L. 115-232.
[8] Pub. L. 115-232, § 862(b).
[9] Pub. L. 115-232, § 862(b)(2).
[10] *See supra* note 1.

documentation and requisite oversight currently in place, SBA has the necessary tools to ensure loan processing of ESOP transactions is performed properly.

The new law was written with the intent to increase the availability of capital to ESOPs and other employee-owned models because it is clear SBA is not fulfilling its full potential in assisting new and transitioning companies. As a result, employee-owned businesses have been put at a disadvantage. It is therefore our strong recommendation that SBA amend this section of the current proposed rule such that the final version of 13 C.F.R. § 120.350 align with this clearly-articulated Congressional intent to allow the delegation of authority for these transactions. It is of the upmost importance and a simple policy goal to encourage more and quicker lending to ESOPs, so they may affordably access capital needed to transition their businesses to an employee-owned model.

IV. Affiliation principles for the Business Loan, Business Disaster Loan, and Surety Bond Guarantee Programs

Overall, I am pleased SBA is re-instituting a series of affiliation principles as part of SBA's size standards that closely mirror the affiliation principles that existed prior to their repeal in 2016. The size standards function as part of the eligibility requirements for SBA's loan guaranty programs, and are a critical mechanism for ensuring SBA-backed loans are reserved for only those businesses that are truly *independent* small businesses that cannot access credit elsewhere. I should note, however, that though re-instituting the pre-2016 affiliation principles is generally a positive step, SBA missed an opportunity to institute contractual safeguards designed to ensure borrowers can sustain their businesses on a truly independent basis, and are *not* beholden to large companies for a significant portion of their revenue/income. Such mechanisms could help protect borrowers from the unpredictability of depending on one large company for all, or almost all of a borrower's income, while addressing the power imbalance that exists between them and large companies. Therefore, I would encourage SBA to finalize a version of 13 C.F.R. § 121.301 that is consistent with the Proposed Rule, but that also includes mechanisms designed to ensure the independence of borrowers and rectify the imbalance of power between borrowers and large companies.

In March 2018, SBA's Office of Inspector General (OIG) issued a report on 7(a) loans made to poultry farmers ("borrower-growers") that found large chicken companies ("integrators") exercised such comprehensive control over borrower-growers through a series of contractual mandates and restrictions, management agreements, operating procedures, oversight, inspections, and market controls that overcame practically all of the borrower-grower's ability to operate their business independent of integrator influence.[11] On the basis of that finding, the OIG concluded that SBA guaranteed approximately $1.8 billion in loans that were likely ineligible.[12] Currently and at the time the loans in question were approved, SBA's regulations in effect stated that "entities are affiliates of each other when one controls *or has the power to control the other. It does not matter whether control is exercised, so long as the power to control exists*" (emphasis added).[13]

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[11] OFFICE OF INSPECTOR GENERAL, EVALUATION OF SBA 7(A) LOANS MADE TO POULTRY FARMERS EVALUATION OF SBA 7(A) LOANS MADE TO POULTRY FARMERS (2018), https://www.sba.gov/sites/default/files/oig/SBA-OIG-Report-18-13.pdf (last visited Dec 11, 2018).

[12] *Id.*

[13] 13 C.F.R. § 121.301(f); *see also supra* note 11.

Further, current SBA regulations state that affiliation "arises where a single individual, concern, or entity controls the management of the applicant concern through a management agreement."[14]

The OIG found integrator control over borrower-grower operations was comprehensive in scope, ranging from the broadest of topics to the most granular. This control included instructions to borrower-growers on how to inspect flocks and broiler houses, prescribing where and how to walk through the houses, the frequency and timing of inspections, and how to record the results.[15] Integrators also directed and closely oversaw borrower-grower operations in other aspects of farm management as well, including broiler house lighting, heating, ventilation, cooling, flock feeding, watering, and culling of birds.[16] Additionally, integrators also exercised significant control over the borrower-grower's facilities management, providing detailed construction specifications for the borrower-grower's broiler houses, site grading, equipment, signage, and other attributes, and exercised oversight throughout the construction process to ensure compliance.[17] Following the construction of the borrower-grower's facility, integrators exercised regular and detailed oversight through inspection of broiler houses, equipment, and facility grounds.[18] Results of these inspections were then recorded in reports detailing deficiencies, and required the borrower-grower's remediation by a specific date and time.[19]

Despite these facts, opponents to the affiliation principles of this Proposed Rule will counterargue that because a borrower-grower's business is an independently-registered business – liable for any tax liability – and because borrower-growers are not partners, agents, or employees of the integrator, they should be deemed independent businesses not affiliated with the integrator.[20] This argument fails to address either of the indicia SBA uses to guide determinations of affiliation – whether an integrator "controls or has the power to control the other..."[21] or "controls the management of the applicant concern through a management agreement."[22] It also plainly fails to reject that integrators had the power to control the borrower-grower once the borrower-grower secured the 7(a) loan – which was the criterion used by SBA to determine affiliation at the time the loans reviewed by the OIG were approved. The facts found by the OIG clearly show integrators not only *had* the power to control borrower-growers, they also used it frequently and ubiquitously. Simply put, borrower-growers are not free to use the proceeds of their 7(a) loans as they independently determine. Viewed in this light, borrower-growers cannot be credibly described as "independent."

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[14] 13 C.F.R. § 121.301(f)(3); *see also supra* note 11.
[15] *See supra* note 11.
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *See, e.g.*, Letter from Senator Cindy Hyde-Smith and Senator Roger F. Wicker to SBA Administrator Linda McMahon (Nov. 19, 2018), https://www.hydesmith.senate.gov/sites/default/files/Hyde-Smith%20Wicker%20letter%20re%20SBA%20proposal%20on%20poultry%20lending.pdf; *see also* Letter from Senator John Boozman, *et. al* to SBA Administrator Linda McMahon (Nov. 19, 2018), https://www.boozman.senate.gov/public/_cache/files/1/1/1137001c-64b8-4bf0-a4d5-4f81df81e51b/93D74D1A3A8DC6E9755259C3D0D024EA.ar-delegation-poultry-letter-11-19-18.pdf.
[21] 13 C.F.R. § 121.301(f).
[22] *See supra* note 14.

Additionally, SBA, the U.S. Department of Agriculture, lenders, and appraisers – all key stakeholders in this industry – agree that broiler houses and their associated equipment are special-purpose buildings which have little value without a production contract with an integrator,[23] demonstrating the high degree of economic dependence that exists between borrower-growers and integrators in this industry. In fact, an executive at one lending institution even went so far as to admit to the OIG that, "without an integrator contract, the houses themselves are worthless."[24] Finally, to show the dependence on the integrator contract, the OIG reviewed four loans that defaulted shortly after the loss of an integrator contract and evaluated how the loss of the contract impacted the borrower-grower's facility.[25] All four facilities lost at least 62 percent in appraised value less sales price, with the two worst-case scenarios losing 94 percent and 89 percent in value, respectively.[26] This crippling economic dependence, combined with the high degree of control integrators are empowered to exert under their contracts with borrower-growers, reveals the true nature of the relationships – affiliative.

Based on the OIG's review of the contractual relationships between borrower-growers and integrators, as well as the analysis of the economic dependence borne by borrower-growers, SBA is reinstating a series of affiliation principles aimed at curtailing the extent to which economically-dependent and thus affiliated businesses may be eligible for SBA's business loan programs. Though this is a positive step towards preserving the intent and integrity of SBA's business loan programs, SBA stopped short of including meaningful contractual safeguards designed to protect vulnerable borrower-growers from the overbearing controls of integrators, balance the unequal bargaining power between borrower-growers and integrators, and promote the independence of all small businesses.

While I acknowledge the affiliation component of this Proposed Rule as a good first step, SBA can and should go a step further to protect powerless borrowers in all industries and finalize a version of 13 C.F.R. § 121.301 that includes strong safeguards designed to ensure they are capable of operating and expanding independently from large companies, and restore parity among all actors in this economy.

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[23] *See supra* note 11.
[24] *Id.*
[25] *See supra* note 11.
[26] *Id.*

In conclusion, as the Ranking Member of the Committee which oversees SBA's lending programs, I urge the agency to be flexible in crafting the final rule and take into consideration the many comments on the Proposed Rule.

I appreciate your consideration of this matter.

Sincerely,

Nydia M. Velázquez
Ranking Member
U.S. House Committee on Small Business