Protecting outside investors when using SBA financing

By Steve Mariani

Each year there is a large percentage of our transactions that we finance which will include one or more silent investors. These investors are typically willing to assist with the required down payment but will always prefer to limit their exposure to just the funds being injected and nothing more. I get it, and so does the SBA, if this is truly a silent investor situation. The real determination that SBA demands all lenders explore are the below 2 items, which are included in the actual SOP's.

I always like to begin by referring to the actual rule as written before describing how our firm addresses these investor scenarios.

Page 191:
When deemed necessary for credit or other reasons, SBA or, for a loan processed on a delegated basis, the Lender, may require other appropriate individuals to provide full or limited guaranties of the loan without regard to the percentage of their ownership interests, if any. For example, an individual with a minority ownership or no ownership interest in the Applicant or OC who is critical to the operation of the business may be required to provide a personal guaranty.

Page 325:
For example, an individual with a minority ownership or no ownership interest in the Applicant or OC who is critical to the operation of the business may be required to provide a personal guaranty (13 CFR § 120.160(a)).

These above rules allow a lender to demand a full guaranty from any person they believe to be "critical to the operation of the business". This could include operational mangers, key employees, silent investors or anyone the lender deems to be critical or involved in the business at an influential level.

Understanding that the SBA requires a full guaranty from every owner (or husband and wife combination) owning 20% or more of the new entity, we know this investor MUST remain under this threshold if we have any chance of protecting their personal guaranty and personal assets.

There are actual 2 ways that we suggest a silent investor inject funds into a project. The first is a straight gift, which will be accompanied by a notarized gift letter from the giftor stating this is a gift and no repayment is ever required. This option is not our favorite method but it is effective when a mom and dad want to assist a son or daughter in purchasing a business. This method is most effective and makes the most sense when the monies being gifted are coming from a close family member. Logically speaking, what friend actual gifts another friend a few hundred thousand dollars to buy a business. Lenders do and will consider this question when reviewing the injection. There is a second, better method, that we prefer.

A friend/investor may have actual ownership in the new entity. Now this investor has become a “minority partner” and as long as their shares remain under the 20% mentioned above, a personal guaranty should not be required. As an example, if the investor/friend owns 10% (any amount under 20%) of the new entity, they are permitted to inject 100% of the down payment as an “owner” of the new business. We must document this investor’s intentions and the involvement in the new entity, if any. We must determine them to not be directly involved in any way and must show they are truly “silent” before application submission.

This rule is important to understand as it is subject to the interpretation of the lender and many read it differently. I know of more than one lender that demands any person injecting funds into the project also fully guaranty the loan no matter what amount of ownership or involvement they might have. Lenders are permitted to demand this and add any additional underwriting criteria they deem necessary to secure an internal approval as long as the minimum SBA rules are followed.

At Diamond Financial, we do not allow our lending sources to exceed the actual SBA written rules. We also educate each and every buyer at each level to be sure we utilize the rules most appropriate to their direct structure.

In the end, we are grateful for investors as they allow more transactions to happen and we want to be sure we keep them protected. If you have buyers with great credit and direct industry experience but less money than required, let them find an investor and we’ll keep them protected.

For more specific answers on these or any other SBA rules, please contact us at Askdiamond@easysba.com. A no cost, no obligation email solution to answer all of your SBA questions.

Diamond Financial specializes in larger, goodwill type transactions and we are always happy to share the information that makes them happen. Call us and experience the power of the experts and our 3 day yes or no guaranty!

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