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Revised SBA Rules Move Cap Call Lending Closer, But Still a Bridge Too Far?

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When the U.S. Small Business Administration's ("SBA's") revised rules for its Small Business Investment Company ("SBIC") program went into effect last August, it looked like a greenfield market for capital call financing had been opened. For the first time, the agency permitted capital call financing to levered SBICs without requiring SBA pre-approval. Given that the 298 active SBICs manage more than $40 billion in AUM and hold more than $10 billion in unfunded commitments, the opportunity looked rather compelling. But for reasons that we expand on here, limitations the collateral package and lender remedies may lead lenders to treat SBIC capital call lines more like a low advance-rate, unsecured product (with certain enhancements) and less like traditional subscription line of credit.

Background

Small businesses represent a not-so-small part of the U.S. economy. In fact, independent businesses with fewer than 500 employees accounted for 47% of private sector employment and 44% of GDP as of year-end 2021, according to SBA research. Access to capital is important to small businesses, and aside from its loan guaranty programs and lending programs, the SBA supports small business financing through its SBIC program. In effect, the **SBIC program** is a fund-of-funds that provides subsidized leverage to licensed participants in a

public-private partnership. One point of intrigue for fund finance lenders is that many **SBIC fund sponsors** are platforms they're already familiar with.

The primary driver for a fund to seek an SBIC license is to obtain access to below-market cost long-term financing from the SBA. This financing primarily takes the form of the standard debenture, which is a ten-year unsecured note with semi-annual interest payments issued by the SBA. (A discount debenture option is available in some cases but this zero coupon option is rarely used in practice due in part to the effective interest rate). Debentures are limited to the lesser of $175 million or three times the SBIC's private capital raised.

Unleveraged SBICs do not have access to SBIC debentures. Nonetheless, a primary motivating factor for a private equity fund to obtain an unleveraged SBIC license is the ability to raise limited partner capital from banks (which is generally prohibited for non-SBICs) as well as being subject to fewer restrictions while remaining a qualified investment for Community Reinvestment Act purposes.

The Recent Rule Refresh

Flowing out of President Biden's Investing in America agenda, the SBA kicked off a rulemaking process in October 2022 to revise SBIC program regulations with the stated intent of easing program participation for managers and funds investing in underserved market segments, capital intensive investments, and technology critical to national security and economic development. That rulemaking process came to conclusion when the final Small Business Investment Company Investment Diversification and Growth Rule (the "Final Rule") went into effect on August 17, 2023.

The Final Rule implements significant changes, including (1) the addition of a new accrual debenture (which accrues interest over a ten-year term, unlike the standard debenture where interest is paid semi-annually, to attract more venture and growth equity investors), (2) alterations to distribution structures, (3) changes to the licensing process and minimum capital requirements, (4) application fee restructuring, (5) streamlined licensing for subsequent funds, (6) new management team qualification criteria, (7) relaxed capital call line approvals, (8) updated reporting requirements, (9) the introduction of a watchlist program, and (10) a number of other operational and clarifying changes.

Limited Accommodation for Secured Lending

Understandably, as the primary creditor to SBICs through debenture issuance, the SBA has little to no incentive to accommodate third-party secured lending to SBIC funds – especially levered funds. While SBA approval was not required for unsecured third-party debt, prior to the implementation of the Final Rule, the Act provided that SBA "(1) shall not permit a licensee having outstanding leverage to incur third party debt that would create or contribute to an unreasonable risk of default or loss to the Federal Government; and (2) shall permit such licensees to incur third party debt only on such terms and subject to such conditions as may be established by the Administrator, by regulation or otherwise." In practice, SBA rarely approved secured third-party debt facilities because the collateral for such debt consists of the same assets (namely, uncalled capital) the SBA relied on to protect its creditor position.

During the comment period the SBA sought input from the public with respect to a number of concerns, including:

(i) the existence of any third party debt (whether secured or unsecured) posing a credit risk to the SBA since, with certain limited exceptions, the SBA is subordinated to the first $10 million of such debt. With respect to capital call lines, specifically, the risk that should an SBIC default on its leverage and be transferred by the SBA to a liquidation status, the remaining commitments of the SBIC would be a significant source of capital for repayment of the SBIC's leverage - and such commitments would not be available to the SBA if they have already been called to satisfy a default under the SBIC's unsecured credit facility;

(ii) loan provisions that provide, upon a default (which may include events other than a payment default), a lender could make a capital calls directly on the SBIC's investors and use the proceeds to repay its line of credit; and

(iii) loan provisions that permit a lender to compel the SBIC's General Partner to make a capital call, together with remedies including specific performance and/or injunctive relief.

The New Capital Call Accommodation

Public comments appeared to leave the SBA's questions on cap call lending largely, if not entirely, unaddressed. An accommodation for capital call lending nonetheless made it into the final rule. (In part the capital call line provisions are presented as an offset to the heightened reporting requirements enacted in the rule).

Under the Final Rule, a leveraged SBIC may now obtain, without SBA's written approval, a capital call line of credit from a federally regulated financial institution so long as it meets all of the following conditions:

- The maximum amount available under the capital call line is no more than unfunded "Regulatory Capital", as reflected on the most recent certificate of leverageable capital and Regulatory Capital;
- The payment obligations under the capital call line may be secured, but only by unfunded Regulatory Capital;
- The lender under the capital call line may have a right to debit the SBIC's depository account(s) at the lender's institution, so long as such lender's right to debit is limited to circumstances involving a default of the SBIC's obligation to pay principal, interest, or fees due ("Payment Default") under the capital call line and only to the amount of such Payment Default;
- Each borrowing under the capital call line must be repaid, in full, within 120 days after it is drawn;
- The term of the capital call line may not exceed 12 months, but may be renewable, provided that each renewal does not exceed 12 months and the SBIC remains in compliance with the other conditions of this paragraph; and
- The capital call line does not contain any provision permitting the lender to dictate when capital calls are made or otherwise ceding to the lender any control of the SBIC or its operations; provided, however, that the capital call line may include a provision authorizing

the lender, in the event of a Payment Default, to endorse, on the SBIC's behalf, checks and other forms of payment in the lender's possession and to apply the proceeds of such instruments to such Payment Default, with unapplied and remaining proceeds promptly to be paid to the SBIC.

Conclusion: A Missed Opportunity

For many fund lenders, the SBA's narrow capital call line accommodation may fall short for a number of reasons: (1) the lender is left with less than the standard collateral package because of the prohibition on lender-initiated capital calls; (2) the permitted collateral grant does not appear to include the collateral account; (3) the lender's remedies with regard to the collateral account limits debits to arising out of payment defaults (does a "payment default" arising from non-payment of accelerated debt (from a non-payment covenant default) count as a "payment default?); and (4) the lender's path to anticipatory remedies are restricted. Loan balances in excess of $10 million would also be required to rank *pari passu* with SBA debentures.

In summary, while the SBA has taken a step in the right direction, some fund lenders may conclude that capital call lending to SBICs is not worth the effort for now. Other lenders, however, no longer having to seek an unlikely SBA approval, may see an opportunity for low advance-rate facilities to levered SBICs. The door is at least now open for a cap call facility – albeit one that straddles the line between a traditional cap call collateral package and an unsecured financing, since a limited collateral package plus enhancements like setoff rights is now available. We hope to see a future iteration of the rule allow a more market-standard framework.