

# United States Senate

WASHINGTON, DC 20510

August 1, 2019

Ms. Dianna L. Seaborn  
Director, Office of Financial Assistance  
U.S. Small Business Administration  
409 3<sup>rd</sup> Street, SW  
Washington, DC 20416

Dear Director Seaborn:

We write regarding your June 17, 2019 letter responding to Senator Cortez Masto's request for information about Small Business Administration (SBA)-guaranteed loans to four franchises. Your response did not fully address the questions, nor did you confirm whether the SBA is following its own protocols when guaranteeing loans to entrepreneurs purchasing a franchise.

In your response, you reported that the SBA guaranteed 256 loans to entrepreneurs from four franchise brands who were later unable to repay them; hundreds of entrepreneurs lost their collateral, their savings, may have lost their home, and even forced to declare bankruptcy after buying one of these four franchises. Your letter noted that nearly one in three loans to Experimac franchises failed within three years of operation.<sup>1</sup>

Your letter provided information on loan failure rates in Nevada, but failed to provide the information about failure rates in other states as requested. Your response also failed to provide the information about default rates by year, as was requested. Without charge-off rates by year, it is impossible to see if defaults are historic, recent or chronic.

Your letter implies that once a franchisee has signed a contract with a franchise, then every loan that meets "SBA size standards and types of business activities" is eligible as long as a lender wishes to make the loan. However, the SBA's own Standard Operating Procedure -- Lender and Development Company Loan Programs, SOP 50 10 5(J)<sup>2</sup> -- clearly requires the SBA ensure that the lender does a financial analysis to verify the loan is likely to be repaid:

1. "Thus, if the Lender's financial analysis demonstrates that the Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available or outside sources of cash." Page 170. Underlining in original.

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<sup>1</sup> Seaborn, Dianna. Small Business Administration Letter to Senator Catherine Cortez Masto. June 17, 2019.

<sup>2</sup> Small Business Administration. "Lender and Development Company Loan Programs. Standard Operating Procedure. SOP 50 10 5(J)." January 1, 2018. Retrieved from: [https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29\\_FINAL\\_.pdf](https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29_FINAL_.pdf)

2. *“a) Lender’s Credit Analysis: Lender’s credit memorandum and analysis must address the Applicant’s ability and likelihood to repay the loan from the cash flow of the business and past performance by documenting the following:*

*[...]ii. Financial analysis of repayment ability:*

- (a) For existing businesses based on the three most recent years of historical financial information (tax returns or balance sheet with debt schedule and income statement) plus an interim financial statement. (13 CFR § 120.191) SOP 50 10 5(J) Subpart B. Page 172*
- (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required.*
- (c) The financial analysis for all Applicants must address the following as applicable:*
  - (i) Historical cash flow for existing businesses, that demonstrates total debt service coverage after the SBA loan; if the historic cash flow does not show sufficient debt service coverage, Lender must obtain from the Applicant and analyze two years of detailed projections including the supporting assumptions;*
  - (ii) Calculation of operating cash flow (OCF) defined as earnings before interest, taxes, depreciation and amortization[...]*

- (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required.” Page 171-172.*

3. *“Debt Service (DS) is defined as the future required principal and interest payments on all business debt inclusive of new SBA loan proceeds. The Applicant’s debt service coverage ratio (OCF/DS) must be equal to or greater than 1.15 on a historical and/or projected cash flow basis and 1:1 on a global basis. To perform a complete analysis of debt service, it is important for a Lender to obtain a current debt schedule prepared by the Applicant, including any shareholder debt.” Page 182.*

4. *“b) The Borrower and/or OC will maintain proper books and records, allow Lender and SBA access to these records, and furnish financial statements or reports annually or whenever requested by Lender;” Page 227.*

We request more information about SBA-guaranteed loans to these four franchises. We also request information that explains how the SBA provides oversight of lenders. Problems noted a few years ago continue to occur, including:

1. In a July 2011 report, the SBA Office of Inspector General (OIG) reported that SBA must enforce its requirements and ensure the bank receive and verify financial performance

data prior to making a loan.<sup>3</sup> SBA's OIG found that a bank violated 7(a) loan program rules by disregarding relevant and available data, which indicated that the franchises' revenue projections were unreasonable. Had the lender complied with SBA's requirements to use and assess the feasibility of realistic projections, 12 loans to Huntington Learning Center franchisees would have been declined. The OIG recommended that the SBA "[I]mprove the quality of franchise loan data by implementing a plan to ensure the completeness and accuracy of data pertaining to new franchise loans made in the future and correct existing incomplete loan records."

2. A September 2013 Government Accountability Office (GAO) report concurred, finding that "franchisees noted difficulties meeting anticipated revenue estimates." GAO noted that franchisors' "limited access to information that would aid [franchisees] in business planning." According to GAO's analysis, "the first-year projected revenues on loan applications involving [a] loan agent or her employer were, on average, more than twice the amount of actual first-year revenue for 19 of the 24 franchisees reviewed." GAO noted that first-year revenue estimates are not necessarily available to potential franchisees in the franchise organization's financial disclosure document nor do federal regulations require franchise organizations to provide actual first-year average revenues for start-up businesses in their disclosure document. The GAO recommended that SBA improve its oversight of its loans portfolio, such as default status, number of loans, and loan agent information.<sup>4</sup>

Please answer the following questions:

1. How is the SBA working with franchisees with SBA loans when a franchisee runs into trouble?
  - a. Specifically, when the SBA notices high rates of defaults in a brand, what action does your staff take to prevent loan failures?
  - b. If there is a major change in an agreement, such as changes that occurred with Complete Nutrition or Dickey's Barbecue, what recourse does the SBA have to prevent loan failures?
  - c. What can the SBA do when a franchisor, such as Complete Nutrition, terminates the franchise agreement entirely? Can the SBA require the franchisor make payments on outstanding loans of the franchisees? Has the SBA collected the guarantees paid out by SBA from any franchisor? Will the SBA seek recovery from the lender of all purchase amounts disbursed if the underlying financial information was inaccurate?

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<sup>3</sup> Office of Inspector General, U.S. Small Business Administration. "*Banco Popular Did Not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans.*" Report Number: 11-16. July 13, 2011. Retrieved from: [https://www.sba.gov/sites/default/files/oig/Audit%20Report%2011-16\\_0.pdf](https://www.sba.gov/sites/default/files/oig/Audit%20Report%2011-16_0.pdf).

<sup>4</sup> GAO. "Review of 7(a) Guaranteed Loans to Select Franchisees." September, 2013. Retrieved at: <https://www.gao.gov/assets/660/657723.pdf>.

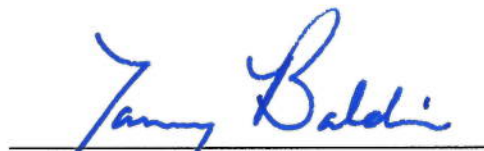
- d. Can the SBA exclude an owner of a troubled franchise brand who has other franchises if there are significant problems with one of the franchise brands in their portfolio?
  - e. Has the SBA stopped loan guarantees to one franchise because of problems in another franchise with the same ownership? If so, which franchise brands?
2. Please provide charge off loan data for all states<sup>5</sup>, broken down by state, for Complete Nutrition, Experimac, Subway and Dickey's Barbecue. Please list the defaults for each franchise brand by state for all states.
3. How many SBA backed loans to these four franchises are behind in their exempt status but are not yet listed as defaulting?
4. Of the 256 charge offs to SBA-guaranteed loans to Complete Nutrition, Experimac, Subway and Dickey's Barbecue franchisees, how soon after the loan closed were those loans charged off? Please provide information for each franchise by how many loans defaulted within a year, two years, three years, etc. and by state for all states as appropriate.
5. Were any of the agents associated with any of those franchise brands previously suspended from the SBA program for misconduct or another reason?
6. Franchisors are not required to provide actual financial information in the Franchise Disclosure Document to franchisees. However, the SBA still requires lenders receive historic financial data. What information on revenue, default and store closings does the SBA require lenders receive from franchisors? Of that material, what is provided to the franchisees taking out the loan to buy the franchise?

Please respond to this request by September 9, 2019. For more information, please contact Carol Wayman at 202.224.3150 or at [Carol\\_Wayman@cortezmasto.senate.gov](mailto:Carol_Wayman@cortezmasto.senate.gov).

Sincerely,



Catherine Cortez Masto  
United States Senator



Tammy Baldwin  
United States Senator

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<sup>5</sup> "States" is defined to include all 50 states, territories, and the District of Columbia.