

SBA Loans and the Need for Life and Disability Insurance



If you're an entrepreneur looking to start your business, or perhaps you already have a business but would like to stabilize or expand your business, one of the most common sources of funding has been the U.S. Small Business Administration ("SBA"). For fiscal year 2018, the SBA reported that there were approximately 60,353 loans made under the SBA's 7(a) loan program, with a total dollar amount of \$25.37 billion. There were an additional 5,874 loans made under the SBA's 504 loan program, for a total dollar amount of over \$4.75 billion.ⁱ

The 7(a) program is the most common SBA loan program. It guarantees loans to small businesses of up to \$5 million. Within the 7(a) program are also the SBA Express and SBA Export Express programs for smaller loan amounts. The 504 program is primarily for the purchase of fixed assets such as real estate and equipment for businesses.

The SBA does not actually make loans, but rather guarantees a portion of the loans made by a network of approved banks and other financial institutions. This makes it less risky for a lender to make the loan to the business knowing that the SBA stands behind

the loan. The percentage of the loan that the SBA will guarantee depends upon the size of the loan and the loan program used.

SBA loans may come with fees and prepayment penalties. There may also be requirements on the personal use of assets as well as the types of businesses that loans would be made to. Notably, and a surprise to many borrowers, is the requirement to have life and/or disability insurance to secure the loan.

A lengthy document from the SBA known as SOP 50 10 5(B) ("SBA SOP") provides the requirements for lenders to participate in the SBA lending programs. The life insurance requirement is listed in Subpart B(5), Chapter II(D) and states in relevant part:

1. *Lender must determine if the viability of the business is tied to an individual or individuals. In these situations, the lender must require life insurance. SBA Express and Pilot Loan Program lenders may follow their internal policy for similarly sized non-SBA guaranteed commercial loans.*

3. *For each policy required under this paragraph, lender must obtain a collateral assignment, identifying the lender as assignee, that is acknowledged by the Home Office of the Insurer. The lender must assure that the borrower pays the premiums on the policy.*

In addition, the SBA Loan Closing Document for 7(a) loans states: “the Lender should require life or disability insurance where there is a concern over whether the business could survive in the absence of an individual or small group of individuals that provide the management for the small business concern.”

What the SBA is describing is commonly known as key person insurance. Key person insurance provides the business with a level of financial protection in the event of the untimely death or disability of the main person or persons responsible for the daily operation and success of the business. In the context of an SBA loan, if the “viability of the business is tied to an individual or individuals” then key person life and disability insurance must be purchased. The amount and type of insurance should be consistent with the size and term of the loan.

Simply purchasing the insurance isn’t enough. The lender is required to ensure that the insurance policy benefits are collaterally assigned to the lender to secure the loan. Thus, if the business owner dies or becomes disabled, the life or disability insurance benefits will be paid over to the lender in satisfaction, partially or totally, of the loan.

To summarize, in order to meet the many requirements of an SBA loan, the borrower may also need to:

1. Purchase life insurance.
2. Purchase disability income insurance.
3. Ensure the life and disability insurance are collaterally assigned to the lender.
4. Continue paying premiums for the life of the loan.

Failure to comply with any of those requirements may result in the denial of the loan, or if the loan was already approved, a default on the loan causing an acceleration of payment on the loan balance.

The SBA SOP briefly discusses the type of life insurance that may be appropriate, but it focuses solely on the loan and not the overall needs of the business and the business owner. Several of the types of life insurance mentioned are increasingly becoming obsolete (i.e., decreasing term or credit life insurance) in the insurance industry. Therefore, your best option is to contact your local Security Mutual life insurance advisor to go over all your business and personal insurance needs, not just the SBA loan requirements, to help to avoid duplication and potential conflict in meeting your overall objectives.

U.S. Small Business Administration. “SBA Small Business Lending Momentum Continues in FY18.” SBA.gov. <https://www.sba.gov/node/1629321> (accessed March 19, 2020)

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