

# *SBIC TechNotes*

May 1998 - Number 3

## **GUIDELINES FOR COMPLETION OF “CONTROL CERTIFICATION” BY LICENSEES**

The Small Business Investment Act and the SBIC program regulations generally prohibit an SBIC from controlling a small business in which it has invested. However, an SBIC may take *temporary* control of a small business under certain conditions. An SBIC that takes temporary control must file an explanatory statement, called a “Control Certification”, in accordance with § 107.865(e) of the SBA regulations.

SBA reviews each Control Certification to determine whether there is an appropriate regulatory basis for temporary control by the SBIC. However, we often do not have enough information to make this determination. This leads to a prolonged review process, and greater uncertainty for licensees, as we must go back to SBICs to request additional information. In this issue of SBIC TechNotes, we are providing guidelines for completing the Control Certification which will make the review process smoother for both SBICs and SBA.

When an SBIC assumes temporary control, it must file a “Control Certification” with SBA within 30 days. The Control Certification has no required format, but must contain the following information:

1. The date on which the licensee took control of the small business;
2. The basis for taking control; and
3. The licensee’s agreement to relinquish control within 5 years.

Items 1 and 3 are straightforward. Under item 2, the SBIC must provide sufficient information to allow SBA to determine whether control is permitted under § 107.865(d), which reads as follows:

- (d) *Temporary Control permitted.* You may acquire temporary Control:
- (1) Where reasonably necessary for the protection of your existing investment;
  - (2) If there has been a material breach of the Financing agreement by the Small Business;
  - (3) If there has been a substantial change in the Small Business’s operations or products during the past 2 years, or such a change is the intended result of the Financing, and the Investor Group’s Financing constitutes the Small Business’s major source of capital; or
  - (4) In the case of a Start-up Financing, if you or the Investor Group constitute the Small Business’s major source of capital.

In describing the basis for taking control in your Control Certification, it is not sufficient simply to cite one of the provisions of § 107.865(d)—to say, for example, that “XYZ Partners assumed control to protect its existing investment” or “XYZ Partners took control because of a material breach of the financing agreement.” You must describe the specific circumstances that led to your action and explain how these circumstances relate to the regulation. In addition, if you have taken control pursuant to paragraph (d)(3) or (d)(4), you must provide enough information to show how you (or the Investor Group) have met the “major source of capital” requirement. For this purpose, subject to review of the specific facts, “capital” means the small business’s total equity and long-term debt; to satisfy the requirement, you must have provided more than 50 percent of the total capital.

Of the various conditions under which temporary control is permitted, we have found that § 107.865(d)(3) is the least understood. In particular, there has been some uncertainty as to what constitutes a “substantial change.” The intent of this provision is to allow investors greater protection when the investee has made or is making changes in its business of such magnitude that the circumstances and level of risk are comparable to those associated with a new business. Subject to review of the specific facts, SBA will generally consider the following to be examples of a substantial change in products or operations:

- Addition of a significant new product line involving new plant, equipment and/or production processes
- Development or acquisition of a significant new line of business involving a different type of expertise, new target markets, and/or different distribution channels
- Major increase in scale of operations, such as expansion from regional to national
- Expansion from wholesale to retail operations or vice versa
- Change from owner and operator of sales outlets to franchisor

A change of management, in and of itself, will generally not be considered a substantial change in operations. The regulation also does not encompass extensions of products or services offered into closely related areas, routine organizational changes, and other adjustments typically made in the ordinary course of business.

In evaluating a specific investment, SBA will consider not only the nature of the change, but also whether its impact is significant relative to the small business as a whole.

If you have any questions about how to apply the temporary control regulations to a particular situation, we strongly encourage you to consult with your SBA account executive or area chief.