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Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, House Small Business Committee
From: Barry Pineles, Chief Counsel, Committee on Small Business
Re: Full Committee Hearing: "The Budget Outlook for the Small Business Administration"
Date: April 18, 2013

On Wednesday, April 24, 2013, at 1:00 pm in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for the purposes of reviewing the Small Business Administration (SBA) FY 2014 budget and the agency's ability to meet its core functions for the remainder of FY 2013 under sequestration required by the Budget Control Act of 2011. The only witness will be the Hon. Karen Mills, Administrator of the SBA. The enclosed memorandum discusses various SBA programs and how they are treated in the budget including comparison to prior years. Should you or your staff have any questions, please do not hesitate to contact the Committee's Chief Counsel, Barry Pineles at x55821.

Before addressing the issues in the budget in detail, a very brief overview of the SBA is useful to place the ensuing discussion in an appropriate framework. The agency was created in 1953 by President Eisenhower as a replacement for the Small Defense Plants Administration (an entity created to help maintain a robust small business industrial base for providing goods to the military) and the Reconstruction Finance Corporation (started during the Great Depression as a federal lender to businesses).[1] The mission of the SBA, as evinced in the Small Business Act, 15 U.S.C. §§ 631-57p, is to "aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns…" *Id.* at § 631(a).

The SBA meets its statutory obligation through three major components: 1) assisting small businesses in obtaining needed capital; 2) helping small businesses navigate the federal procurement marketplace; and 3) offering managerial counseling and assistance to small businesses (generally referred to as "entrepreneurial development"). Each of these components is executed through multiple congressionally mandated programs, often in conjunction with non-federal "partners."[2] Most of the services provided to small

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[1] J. BEAN, BIG GOVERNMENT AND AFFIRMATIVE ACTION 8-9 (2001).
[2] This is the SBA's terminology and covers both for-profit, non-profit, and state governmental entities that help the SBA carry out its mission of assistance to small businesses.

businesses, either by the SBA directly or through its partners, are delivered through one of the 84 district offices established throughout the United States.[3]

The President has requested an overall budget for the SBA of $810.2 million, which represents a reduction of $108 million from FY 2012 (almost of all which stems from a reduction in subsidy costs for its capital access programs as will be discussed later in this memorandum).[4] However, the President has sought $486 million for salary and expenses, which represents an increase of $65 million from FY 2012.[5] If the agency obtains the entire amount of its budget request, it will have 2,270 employees – an increase of 201 from FY 2012.[6]

Certain initiatives offered in the SBA budget have real merit. That is particularly true with respect to increasing the number of procurement center representatives (PCRs) since these individuals are instrumental in helping small businesses win federal contracts – a proven job generator for an ailing economy. However, most of the initiatives represent the SBA's desire for how programs ought to be run rather than how Congress mandates that they be run. This is particularly true with respect to entrepreneurial development programs where the agency requests approximately $60 million for its own new initiatives while maintaining at sequestration levels the programs actually authorized by Congress.[7]

Capital Access Programs

The 7(a) Loan Guarantee Program

The 7(a) Loan Guarantee Program (named after § 7(a) of the Small Business Act, 15 U.S.C. § 636(a)) serves as the SBA's primary business loan program to assist small businesses obtain financing when they may not be able to obtain sufficient credit from normal lending channels.[8] Loans are not made directly by the SBA; rather the SBA issues guarantees of repayment of loans made by commercial lenders. The size of the

[3] Each state and territory has at least one district office. In larger states, there are multiple district offices, including smaller so-called branch offices. This distinguishes the SBA from most other federal agencies that provide services locally through one of ten federal regional headquarters.

[4] Neither in the Appendix to the FY 2014 (in which detailed budget requests and appropriations language is provided) nor in the separate submission of the SBA supporting the request are comparisons made to the FY 2013 due to the effect of both continuing resolutions and the impact of sequestration under the Budget Control Act. According to this SBA, comparisons were made between FY 2014 and the last year in which an appropriation was enacted for the agency. Compounding the difficulty in assessing the budget is that the SBA did not supply a FY 2013 figure that incorporated the reductions resulting from sequestration on the agency's FY 2013 spending. *E.g.*, UNITED STATES SMALL BUSINESS ADMINISTRATION, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2012 ANNUAL PERFORMANCE REVIEW 17-20, Tables 1-4 (April 2013) [hereinafter SBA Budget Submission].

[5] *Id.* at 17, Table 1.

[6] *Id.* at 26, Table 9.

[7] SBA meet U.S. Const. Art. I, § 1 "All legislative powers herein granted shall be vested in a Congress of the United States…."

[8] K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, THE HANDBOOK OF FINANCING GROWTH 146 (2005).

guarantee is related to the size of the loan with guarantees of 85 percent for smaller loans (those under $150,000) and 75 percent for loans in excess of $150,000. Maximum loan size used to be set at $2 million dollars, but that upper-level cap was increased in § 1111 of Title I of the Small Business Jobs Act of 2010, Pub. L. No. 111-240, to $5 million.[9] Interest rates vary depending on the size of the loan with the largest loans having the lowest interest rates (usually 2.25 or 2.75 percent above prime depending on the maturity date of the loan).

The SBA is authorized to charge an up-front guarantee fee which will vary depending on the size of the loan with a maximum cap of 3.75 percent of the amount guaranteed. 15 U.S.C. § 636(a)(18)(A). For example, a borrower having a gross loan amount of $3 million with a 75 percent guarantee (a SBA-guarantee amount of $2.25 million) would pay $84,375 as the guarantee fee (.0375 * 2.25 million).[10] In addition to this up-front guarantee fee, there also is an ongoing guarantee paid by the lender to the SBA and amounts to 0.55 percent (sometimes referred to 55 basis points, where one basis point is equal to .01 percent) of the unpaid balance of the guaranteed portion of the loan. *Id.* at § 636(a)(23). The SBA expects to waive the fees paid by lenders and borrowers for loans of less than $150,000[11] without requiring any appropriated funds.

Any lender is eligible, after receiving approval from the Administrator, to originate loans for which the SBA will issue a guarantee. A subset of these lenders, denoted "preferred lenders," has substantial expertise with the SBA lending programs and regulations. Preferred lenders are authorized to approve loans using documentation and loan forms developed by the SBA to issue guarantees without first submitting the loan packages to the agency for approval.

In addition, preferred lenders may utilize the Express Loan program, *id.* at § 636(a)(31), in which the preferred lender may use their own forms and documentation but only will be eligible for a 50 percent guarantee of loans up to $350,000[12] from the SBA rather than the normal 75 or 85 percent. Even though the guarantee percentage of a loan is lower,

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[9] 124 Stat. 2504, 2507 (2009) (Small Business Jobs Act). With a maximum gross loan amount of $5 million and a guarantee percentage of 75 percent, the SBA will guarantee up to $3.75 million for a small business loan under the 7(a) loan program.

[10] By statute, the lender actually pays the fee but the lender is permitted to charge the cost of the fee to the borrower. 15 U.S.C. § 636(a)(18)(A). From the perspective of the borrower, this up-front guarantee fee is similar to points that would be paid on a residential mortgage but, unlike that case, the legal obligation to pay the fee rests with the lender.

[11] SBA Budget Submission, *supra* note 4, at 5. For a full discussion of this fee waiver, please see the section in this memorandum entitled "Federal Credit Reform Act and SBA Capital Access Programs."

[12] In the Small Business Jobs Act of 2010, loan limits for the Express Loan program were raised for one year to a maximum of $1 million. Small Business Jobs Act, § 1135, 124 Stat. at 2520. The rationale for the Express Loan program (somewhat defeated by increasing the loan size) is that the processes and documentation to approve a normal SBA loan are sufficiently time consuming that banks cannot make a profit on such small loans. Another advantage to the banks is that the ongoing cost of Express Loans are lower since the outstanding guarantee amount for a loan will be less (0.55 percent of a 50 percent guarantee will be less than 0.55 percent of the same size loan with an 85 percent guarantee). A significant component of SBA lending is done by large preferred lenders through its Express Loan program.

the government runs a substantial risk from the Express Loan program because the quality of loan documentation is not as substantial as in the normal 7(a) loan program.

Before leaving the discussion of the 7(a) loan program, it is necessary to discuss floor plan financing. Using inventory that is sold to consumers as collateral for a loan to enable a business to purchase inventory is a common financing technique used by car, boat, recreational vehicle, furniture, and appliance dealers, among others. This is called floor-plan financing because the businesses are purchasing inventory that will placed on their showroom floor. Historically, the SBA did not permit the use of loan proceeds to purchase inventory, even if the inventory is used as collateral for the loan. *See* 13 C.F.R. § 120.130(c) (2008). In 2009, the SBA created a pilot program (without Congressional authorization or comment from the public) to permit floor plan financing for products that receive titles from states, such as automobiles, boats, manufactured homes, and motorcycles. The Small Business Jobs Act of 2010 created a statutory mandate that the SBA continue its floor plan financing initiative (with slight modifications as added in statute) until September 30, 2013 at which point the statutory program ceases. However, there is no prohibition in § 7(a) of the Small Business Act that prevents the SBA from using its regulatory authority to continue floor plan financing programs within the parameters of any other loan made pursuant to § 7(a) of the Small Business Act.

The Certified Development Company Program

The Certified Development Company (CDC) Program provides long-term fixed-rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization as long as the loans[13] meet certain policy and job creation standards. The program was created by Congress in Title V of the Small Business Investment Act of 1958, 15 U.S.C. §§ 695-97g, and is referred to colloquially and incorrectly as the "504 Loan Program."[14] The typical structure of a loan in this program is as follows: the small business borrower contributes 10 percent of the value of the project, a commercial bank contributes 50 percent,[15] and a certified development

[13] K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, THE HANDBOOK OF FINANCING GROWTH 147 (2005).

[14] Section 504 of the Small Business Investment Act of 1958, 15 U.S.C. § 697a, authorizes the SBA to securitize instruments issued by Certified Development Company (CDCs) and sell them to private investors. The reference is a misnomer because the authority of CDCs to make loans and the purposes for which such loans can be made is found in § 502 of the Small Business Investment Act of 1958, 15 U.S.C. § 696. The incorrect nomenclature has been a longstanding complaint of the Committee under both Republican and Democratic chairs because it does not adequately reflect what the loan program does. However, the SBA remains adamantine in its opposition to rename the program because it would upset standard industry practice and require the SBA to make modifications to its paperwork, regulations, and the like; the SBA has the audacity to claim that these modifications would be too expensive even though the agency is seeking more than $47 million for new initiatives. It is important to note that the program has actually gone through name changes (once being called the "502 loan program" and then redesignated as the "503 loan program"). Despite these name changes, and contrary to SBA assertions of an impending apocalypse if the program was redesignated, the sun continued to use fusion power to create heat and world continued to rotate on its axis despite the retitling of the program.

[15] If the borrower fails to pay and there is a bankruptcy proceeding, the commercial bank lender will be paid back before the federal government. The bank then is considered to hold a first lien on the property. The SBA has standards which it will use to consider buying out the bank's interest in order to enhance the

company or CDC contributes 40 percent through the issuance of a debenture whose repayment is guaranteed by the federal government. The maximum size of the debenture that can be issued by a CDC will vary depending upon the purpose of the project and the type of borrower,[16] one general statement is that CDC lending can finance significantly larger projects than those available under the 7(a) loan program. Interest rates on CDC debentures are pegged to an increment above the interest rate for 5- and 10-year Treasury notes. As with 7(a) loans, there is a fee structure but it is a somewhat more complicated calculation of various fees paid by borrowers, first lien lenders, and the CDC. 15 U.S.C. § 697(b)(7), (d).

Historically, CDC loans could not be used for purposes of refinancing existing debt.[17] The rationale behind the prohibition was that refinancing, while potentially beneficial to the business to reduce debt, was not a key component of economic development that led Congress to create the CDC program. In 2009, Congress authorized refinancing through the CDC program if certain stringent conditions were met.[18] Congress then created a two-year temporary authorization to permit[19] CDCs (using the same basic lending structure outlined above) to refinance existing non-governmental debt, i.e., debt not issued by the SBA or any other federal agency without regard to the restriction imposed on refinancing in 2009 – in other words any non-federal debt could be refinanced. Unlike a normal CDC loan which requires that the loan create or save jobs, the CDC refinancing requires no job creation or savings at all. Furthermore, the program permits loans issued in the past two years that are not more than 30 days in arrears to obtain refinancing. All other aspects of the CDC loan program apply to this refinancing initiative.

Unlike the 7(a) loan program, the vast majority of loan packages in the CDC must be approved by the SBA. Of the approximately 270 authorized CDCs in the United States, only a handful are designated as "Premier Certified Lenders" or PCLs which are entitled to approve loan packages without first submitting the loans to the SBA.[20] These PCLs

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ability to recover on a default. *See In re EDF Resource Capital, Inc.,* Final Agency Decision, slip op. at 23-24 (Dec. 17, 2012) (describing policy on purchase of banks' first lien positions).

[16] The sizes of the debentures are $1.5 million if the project does not meet certain statutory goals, $2 million if it meets certain goals, and $4 million dollars for loans to small manufacturers. In 2010, Congress raised the applicable limits to $5 million for most projects and $5.5 million for certain projects of small manufacturers. Small Business Jobs Act, § 1112, 124 Stat. at 2508. Thus, for a project with a $2 million dollar debenture, the project size is actually $5 million ($2 million debenture, $2.5 million from a commercial bank lender, and $500,000 from the borrower).

[17] 13 C.F. R. § 120.884(a). This limitation does not occur for the refinancing of interim construction financing. Typically, construction of commercial real estate involves short-term debt during the period of construction. D. LING & W. ARCHER, REAL ESTATE PRINCIPLES: A VALUE APPROACH 655-58 (2005). The business then refinances with longer-term debt once construction is complete. *Id.* SBA regulations governing the CDC program recognize this convention and permit refinancing of the interim loan obtained during construction (should such a loan have been obtained prior to the financing through the CDC). 13 C.F.R. § 120.882(d).

[18] America Recovery and Reinvestment Act, Pub. L. No. 111-5, Tit. V., § 504, 123 Stat. 115, 155-56 (2009) (ARRA). The conditions imposed by Congress for refinancing debt were designed to ensure that refinancing would achieve the economic development objectives of the CDC Program.

[19] Small Business Jobs Act, § 1122, 124 Stat. at 2510-12. That authority ceased on September 27, 2012.

[20] *See In re EDF Resource Capital, Inc.,* Final Agency Decision, slip op. at 11 (Dec. 17, 2012). The primary rationale for the establishment of PCLs no longer exists. Historically, it took the SBA up to 3

also have the authority to liquidate (just as preferred lenders do in the 7(a) loan program) loans that go into default without the assistance or approval of the SBA.

Microloan Program

When starting a business, the vast majority of very small businesses do not actually utilize banks to take out commercial loans. Rather, they rely on loans and contributions from relatives (colloquially referred to as "angels" or "angel investors") and revolving credit loans using their own credit cards. There are some potential entrepreneurs that cannot even rely on angels or revolving credit to find funds for their startups. The Microloan Program is designed to provide credit for those entrepreneurs that would not otherwise have any access to credit, even revolving credit.

The SBA created a microloan pilot program in 1991. Congress then created a statutory microloan program to assist low-income individuals who do not have the financial or technical resources needed to start and operate a small business. In the 1997 reauthorization, the Microloan Program became permanent.

As with all SBA financial assistance programs (except disaster loans), the SBA does not make a microloan directly to a small business. Rather, it makes a loan to a non-profit called a microloan intermediary. These loans are made at interest rates 1.25 percent below the market rate for 5-year United States Treasury notes. Intermediaries are prohibited from obtaining all of their loan funds from the federal government. At least 15 percent of funds made available for loans must come from sources other than the federal government.[21] 15 U.S.C. § 636(m)(3)(b). Appropriated funds cover the cost of subsidizing the interest rate differential in the Microloan Program. The intermediary, in turn, makes loans of up to $50,000 to borrowers.[22] Loans in excess of $20,000 only can

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months of review at a SBA district office to approve a CDC loan package. PCLs avoided these delays because they could approve loans without SBA review of each individual loan. However, the cost of this authority was a requirement that the PCL maintain loan loss reserves in order to meet its statutory obligation to reimburse the SBA for 10 percent of the loss on any loan made using the PCL's delegated authority (a PCL need not use delegated authority to make loans). *Id.* at 13. The SBA, after intercession and complaints by the Committee on Small Business in 2003-04, centralized review of CDC loans in its Citrus Heights, CA loan processing facility. The time frame for processing such loans has now dropped to anywhere from 2 to 5 business days. Without significant delay in the loan approval process and no requirement for loan loss reserves, it is not surprising that very few CDCs have sought to convert themselves into PCLs since 2003-04.

[21] In this regard, the Microloan Program is no different than the other SBA-sponsored financing programs. The 7(a) loan program requires that a bank put up anywhere from 15 to 50 percent of each individual loan depending on the size and duration of the loan. CDC loans require the borrowers to obtain financing from sources other than the debenture provided by the SBA. Small business investment companies must provide their own capital before obtaining leverage from the SBA.

[22] Maximum loan size in the program was $35,000 before 2010 when it was raised to $50,000. Small Business Jobs Act, § 1113, 124 Stat. at 2508. In selecting intermediaries for the program, the SBA is to give preference to those intermediaries who will maintain an average loan size in its portfolio of $10,000. 15 U.S.C. § 636(m)(3)(A)(ii). The rationale behind this is twofold. First, it ensures that intermediaries actually focus on microloans rather than normal commercial loans. Second, an average loan limit size of $10,000 prevents intermediaries from competing with banks operating the 7(a) loan program using subsidized interest rates.

be made if the borrower can demonstrate that comparable credit is not elsewhere available. *Id.* at § 636(m)(3)(E). Borrowers then repay the intermediary which in turn repays the SBA. Unlike the banks operating in the 7(a) loan guarantee program, the SBA requires that the intermediaries provide education and training to its borrowers. The intermediaries can provide such training or contract for some other enterprise to provide training and counseling.[23] Funds for training and counseling are provided, in part, by appropriated funds made available to the intermediaries.

Since the introduction of microfinance programs in the United States, the number of organizations providing direct services to entrepreneurs as microdevelopment organizations or MDOs is about 550. Of these, only about 175 operate as intermediaries in the SBA program. Typically intermediaries make about 2,500 loans each year to borrowers with a total value of about $32 million. The default rate on loans by the SBA to intermediaries is close to zero. The default rate for borrowers from intermediaries is quite low – although not as low as that on the 7(a) loan program.[24]

Small Business Investment Company Program

Small business investment companies (SBICs) are for-profit enterprises organized under state law as either a corporation or partnership or a variant thereof. SBICs receive a license to operate from the SBA pursuant to authority in Title III of the Small Business Investment Act of 1958. The SBA may not grant a license until it is satisfied that the licensee has: a) sufficient capital to operate soundly and profitably; and b) has qualified management. 15 U.S.C. § 681(c)(3)(A). If the SBA is satisfied with these aforementioned determinations, then the agency, prior to issuing a license, must consider: a) the need for investment in the area in which the applicant will operate; b) the reputation of the owners of the applicant; and c) the prospect that the ownership will manage the business in a profitable manner. Once the SBA is satisfied, it will then issue a license. Thus, the licensing process requires the SBA to consider the business plan of the SBIC before issuing a license. *See* 13 C.F.R. § 107.130.

The SBA licenses two types of SBICs – debenture SBICs and participating security SBICs. The primary difference between debenture SBICs and participating security SBICs is in how the entities repay the federal government for their leverage. The divergent repayment schedules lead the SBICs to invest at different stages of a company's development.

Some of the most famous names in corporate America, including Nike, Dell Computer, Federal Express, Callaway Golf, and Outback Steakhouse, were recipients of debenture

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[23] The training and counseling requirement is direct adaptation of the model followed by the inventor of microfinance, Dr. Mohammed Yunus of Bangladesh. He founded the Grameen Bank to make very small loans available to potential entrepreneurs. Dr. Yunus recognized that its borrowers needed significant advice on how to manage money in order to create a small business that could repay loans. However, in Bangladesh and other foreign countries that have duplicated the Grameen Bank model, the lender became the only available entity to provide such advice.

[24] The SBA readily admits that it does not have good data on the default rate of loans made by intermediaries.

SBIC funding. These companies were established and utilized debenture SBIC funding for expansion because they had sufficient cash flow to repay the SBICs that, in turn, could repay their leverage borrowing from the SBA. In essence, the basic philosophy of the debenture SBIC is to invest in companies in which the return on the investment will be split between an increase in the value of the company and monetary payments back to the SBIC.

The structure of repayments in the participating SBIC program leads to a very different type of investment. Since the requirements of repayment are not as immediate in this program as in the debenture SBIC program, these SBICs may invest in firms that are startup firms, rather than established firms looking for expansion capital. In essence, participating security SBICs receive the bulk of their investment payback in the growth of the value of the companies in which they invest. One such successful investment by participating securities has been Build-a-Bear. It goes without saying that investments relying solely on an increase in the value of a company are going to be more volatile than investments in companies that can pay a "dividend" as a well as have some growth. Volatility, however, does not lead to consistent returns and that has created significant problems for the participating security firms leading to potential significant losses.

Once licensed, the SBIC is able to draw leverage in tiers. For every dollar of private investment, an SBIC is entitled to draw up to three dollars in government funding (but is not required to draw that maximum amount). The leverage derives from securities that are sold in the private market (essentially a loan by private investors to the SBIC) and the federal government guarantees that the "lenders" to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage. In essence, there are two separate "loan" transactions; a loan of leverage by the SBA to the SBIC and a loan of private funds by investors to the SBIC who receive either a debenture or participating security (depending on the type of SBIC) to the total value of funds provided by the private investors as "collateral." The SBA guarantees the repayment of the funds provided to the SBIC by the private investors who purchased the leverage. As with the 7(a) and CDC loan programs, there are fees paid upfront by the investment company (a fee up to 3 percent of the value of the leverage to purchase a commitment of leverage), 15 U.S.C. § 683(i), and an ongoing fee for the SBA's guarantee, which is paid as an additional interest charge on the amount owed to the government by the SBIC for the issuance of the leverage. *Id.* at § 683(b).

The SBA also imposes significant oversight and control on the operations of SBICs primarily through its control on the issuance of leverage. The SBA only will issue leverage (even if the SBIC has purchased a commitment for leverage) when the SBIC demonstrates that it needs the leverage. 13 C.F.R. § 107.1120(a). In addition, the agency will not issue leverage if it determines that the grant of the leverage will unduly place the government at risk of loss. *Id.* at § 107.1120(c)(2)(ii). The SBA also conducts examinations of licensees to ensure they are compliance with all applicable regulations and ensure that they are not placing the government at undue risk. *Id.* at § 107.690. SBICs are limited in the amount of funds that may be invested in anyone company. *Id.* at § 107.740. Finally, the SBA can stop the SBIC from making investments if the

investment losses are sufficiently severe to place the company in "capital impairment." *Id.* at § 107.1830-50.

Disaster Loan Program

The SBA provides the primary financial resource for those homeowners, small businesses, and small not-for-profit organizations[25] attempting to recover from a disaster. The vast majority of disaster loans are physical disaster loans (loans to replace buildings destroyed as a result of a disaster) provided to homeowners for losses not otherwise covered by either private insurance or that purchased pursuant to the National Flood Insurance Program. Small businesses also are eligible for physical disaster loans. In addition, small businesses (whether their place of business was destroyed or not) also are eligible for economic injury disaster loans (loans to cover the costs while the business and area recover).[26] A small business is limited to a maximum loan amount of $2.0 million for a combination of physical and economic injury disaster loans.[27] Loans made under the disaster loan authority are made directly by the SBA[28] to borrowers so in this regard it is different than other SBA capital access programs.

Finally, small businesses are eligible for the Immediate Disaster Assistance program created by § 12084 of the 2008 Farm Bill. The program enables small businesses to receive loans under $25,000 from private banks with 85 percent of the loan guaranteed by the SBA. Businesses must otherwise be eligible to receive a disaster loan from the SBA and if the business ultimately receives a disaster loan from the SBA, it must use the proceeds to immediately pay back the immediate assistance loan. The idea of the program was to let eligible small businesses get some assistance from private banks that would be able to process loans more quickly than the SBA.[29]

Not all businesses located in a declared disaster are eligible for a SBA disaster loan. First, only businesses that do not exceed the threshold size standards set forth in the agency regulations, *id.* at § 121.201, are eligible to receive assistance from the SBA. Second, Congress prohibits the SBA from lending to people not legally in the country, people who have not filed tax returns (or owe the federal government back taxes), or are not current on child support payments. Finally, the disaster loan program is a loan

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[25] Small not-for-profit organizations were added by § 12061 of the Food Conservation and Energy Act of 2008, Pub. L. No. 110-234, 122 Stat. 1406 (2008) (hereinafter Farm Bill).

[26] Businesses can obtain so-called "business interruption" insurance. To the extent that a business has such insurance, the amount of an economic injury disaster loan would be reduced by the coverage afforded under the business interruption insurance policy.

[27] Until June 18, 2008, the amount of disaster assistance awarded to small businesses was limited to a total of $1.5 million. Section 12078 of the Farm Bill increased the overall disaster loan amount to $2.0 million. That same section of the Farm Bill authorized the SBA to waive the $2.0 million cap.

[28] There are exceptions to the SBA making direct loans. In case of disasters on the scope of Hurricane Katrina, the private banks may be authorized to make disaster loans at below commercial rates with the difference being paid by the federal government to the private lenders. 15 U.S.C. § 636(c). Since being authorized, the SBA has never used this authority.

[29] In any given disaster, the overwhelming number of loans that the SBA makes is to homeowners whose homes were destroyed.

program and the SBA is required by statute to reject any loan applicant who, in the agency's determination, is unlikely to have the resources to repay the loan.

The Federal Credit Reform Act and SBA Capital Access Programs

The Federal Credit Reform Act (FCRA), 2 U.S.C. § 661, requires government agencies to estimate the net present value cost to the government of any loan program that the agency operates. In the case of the SBA, the agency is required to comply with that standard for all of its capital access programs. Essentially, the FCRA requires that SBA receive in income (be it through an appropriation or from fees paid by lenders and borrowers or some combination of both) sufficient monies to cover any losses[30] in its capital access programs for any loan made in the fiscal year for which the net present value of the cost is calculated. For example, if the SBA plans on making $10 billion in 7(a) loans for FY 2014 and estimates that net present value of the cost to the government (loan defaults)[31] will cost the government $100 million, the agency must receive $100 million dollars in FY 2014 to cover that cost (this is the so-called subsidy rate).[32] If no appropriated funds are needed to cover the costs under the FCRA, then a program is said to be operating at zero subsidy. Each separate capital access program has its own subsidy rate.

Capital Access Programs and FY 2014 Budget

In the previous two fiscal years, FY 2012 and FY 2013, fees paid by lenders and borrowers for the 7(a) and CDC Programs did not cover the cost of those programs as determined under the FCRA. As a result, the programs operated under a positive subsidy rate, i.e., appropriated funds were needed to cover the costs of the guaranteed loans in those FY cohorts. The situation for FY 2014 is somewhat different and more complex as the subsidy rates for the various programs have changed with the economic outlook.

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[30] Losses are calculated by taking the net present value of defaults and subtracting out the net present value of recoveries, i.e., the value of collateral received by the government from defaulted loans.

[31] It is important to note that it is not the loans that go into default in FY 2014. It is the loans that were made in FY 2014 that go into default at some point in the future that is the cost being estimated under the mandate of the FCRA.

[32] The subsidy rate goes down when the amount of income needed to cover losses goes down and the subsidy rate goes up when the amount of income needed to cover losses goes up. The subsidy rate also often is expressed as a percentage where each $1 million dollars in appropriated funds accounts for $100 million in lending or a subsidy percentage of 1 percent. So in the text example, $100 million in appropriations would permit the SBA to lend 100 times that amount or $10 billion. Similarly, if the subsidy rate is 2 percent, the agency would need $200 million to fund $10 billion in lending. If the subsidy rate was 0.5 percent, the agency would need only $50 million to support $10 billion in lending. Finally, it is possible for the subsidy rate to be negative, i.e., that the fees charged by the SBA actually exceed the costs of running the program and therefore the government is actually overcharging borrowers and lenders. Unlike the refunds for overpayment in taxes, there is no way to return these overpayments to the borrowers and lenders.

7(a) Lending

The President's FY 2014 budget estimates that the SBA will be able to guarantee nearly $15.7 billion in loans at zero subsidy. In fact, according to the agency, sufficient funds will be available given that the agency is charging the statutorily permitted maximum fees so that the SBA will actually have more fee income than is needed to support the $15.7 billion in loans.

The SBA has determined to use the additional fee income to support waiving the fees for both borrowers and lenders of loans under $150,000.[33] According to the SBA, the rationale is that there is a market gap in loans of under $150,000 based on the reduced demand for such loans. The SBA contends that the reduction in fees will stimulate lending for loans of less than $150,000.[34] In the ARRA, Congress reduced fees to borrowers and lenders.[35] After ARRA's enactment lending activity increased. However, coetaneous with the fee reduction in the ARRA was an increase in the guarantee percentage for all loans to 90 percent.[36] Thus, the logical lacuna in the SBA ratiocination is that the agency has never calculated whether the increase in lending arose from the fee reduction or the increase in the guarantee fee. Without such parsing of data, it is impossible to determine whether the SBA's efforts at fee reduction will result in an increase in loans. Further complicating the matter may simply be the fact that, given the continued bleak economic climate for small businesses,[37] little appetite exists for loans of under $150,000.

An alternative approach would be to implement an across-the-board reduction in fees to borrowers and lenders without regard to loan size. This would help all small businesses without the speculative nature of the SBA's effort to goad increases in loans under $150,000. Moreover, by reducing fees for all small businesses, the SBA would not be in the position of having some borrowers subsidize the waiver of fees for other borrowers, including those that might be direct competitors.[38]

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[33] SBA Budget Submission, *supra* note 4, at 36.

[34] The waiver of fees does not require any Congressional action. Section 7(a) of the Small Business Act imposes a ceiling on the fees that can be charged. Below that ceiling, the agency has the authority to set fees at whatever level it desires as long as the fees cover the cost of the program. If the SBA set the fees below the ceiling and did not cover the cost of the program, the agency would need an appropriation and explanation why it did not raise fees before requesting the appropriation.

[35] ARRA, Tit. V, § 501, 123 Stat. at 151-52.

[36] *Id.* at § 502, 123 Stat. at 152-53.

[37] Nelson Schwartz, *As Wall St. Soars in Tough Era, Company Size is a Big Factor*, N.Y. TIMES, April 15, 2013, at A1 (describing economic woes of small business owners).

[38] For example, assume that there are two individuals, each of whom wants to start a residential cleaning service. One owner borrows $148,000 and pays no upfront fees and the bank lender pays no ongoing guarantee fee. Another owner obtains a loan for $152,000 and must pay the full upfront fee and the bank the full ongoing fee. The residential home cleaning business that borrowed $2,000 above the SBA's arbitrary cap then pays maximum statutory fees, as does its lender, while the residential cleaning service that borrowed $2,000 under the cap pays no upfront fees and its bank pays no ongoing fee.

It is important to note that both alternatives (SBA fee waiver or across-the-board fee reduction) are predicated on demand for loans not exceeding $15.7 billion. Although history suggests that loan demand will not exceed this level, if either alternative spurs sufficient demand, the SBA either must raise fees or request an appropriation. Given the fact that the SBA will not have determined the actual usage rate for loans until well into the 2014 fiscal year, requesting additional appropriations in the normal course will not be possible. Therefore, the SBA will have to raise fees; borrowers later in FY 2014 then will pay higher fees than those obtaining loans earlier in the fiscal year.

As another alternative, the SBA could have maintained the maximum fees that the agency currently charges borrowers and lenders and return the excess to the Treasury to reduce the budget deficit. Given the job generating capacity of small businesses, it does not make sense to force them to pay higher fees simply to reduce the budget deficit; expansion of small businesses through access to credit on reasonable terms will do more to help the economy (and ultimately reduce the budget deficit) than maintaining higher fees for the 7(a) loan program.

CDC Loan Program

Although the 7(a) Loan Program is operating at zero subsidy for the first time in a few years, the CDC Loan Program will continue to operate with a positive subsidy rate. Two major factors continue to push the CDC Loan Program into the positive subsidy range. First, the economic downturn increased the SBA's estimate of future defaults (businesses unable to repay their loans). Second and most significantly, the expected value of collateral recovered is expected to go down as a result of declining commercial real estate values. For FY 2014, the SBA is requesting $107 million in order to support $7.5 billion in lending (including the limited refinancing created in the ARRA) by CDCs.[39] Historical usage rates strongly suggest that $7.5 billion is sufficient to meet the needs of small businesses seeking loans from CDCs.

The SBA also requests $7.5 billion to support commercial refinancing in the CDC Loan Program. This request is predicated on Congress restoring the commercial refinancing authority from the Small Business Jobs Act that expired in September 2012. The SBA requested no appropriation for this program and asseverates that fees charged will permit it to operate at zero subsidy.[40]

That claim is undermined by the Office of Management and Budget's (OMB) recalculation of the subsidy rate for the commercial refinancing program. Despite substantial fees being charged to both borrowers and CDCs for commercial refinancing, those fees did not move the program to zero subsidy. For loans made in FY 2011, OMB reestimated the subsidy rate from zero to 5.49 percent and those made in FY 2012 from

[39] SBA Budget Submission, *supra* note 4, at 37. To be specific, the $107 million will not support $7.5 billion in lending given a subsidy rate of 1.71 percent. Additional funds from unspent appropriations in FY 2013 also will be carried over and added to the $107 million to support the $7.5 billion in lending.
[40] *Id.*

zero to 2.49 percent.[41] Nowhere in the SBA Budget Submission does the agency make any attempt to address the contradictory evidence from OMB. As a result, the commercial refinance program will require either even higher fees (thereby undermining whatever utility the program may have) or a substantial appropriation to cover the costs of the program. Given the capacity of many small businesses to obtain refinancing of up to $5 million through the 7(a) Loan Program, it appears that commercial refinancing may pose an undue risk to the federal fisc at a time of significant budgetary constraints.

Disaster Loan Program

The subsidy rate for disaster loans is estimated to be 8.48 percent for FY 2014. This would normally necessitate a request for an appropriation. However, there is no request for funds in FY 2014 because the Disaster Loan Account at Treasury is a revolving fund that is replenished when loans are repaid. The SBA has sufficient funds in this account, including carryover from previous fiscal years, to meet the needs of natural disaster victims for all but the most severe disasters.[42] For atypical disasters, such as Hurricanes Katrina or Sandy, Congress enacts supplemental appropriations.

Microloan Program

There are two types of subsidies for the Microloan Program – appropriated funds so that intermediaries can provide counseling to borrowers and the funds needed to subsidize the interest rates at which loans are made to the intermediaries by the SBA. For FY 2014, the SBA is requesting $4.6 million in appropriations to support $25 million in interest rate subsidies for microloan intermediaries.[43] To fund technical assistance by intermediaries, the SBA is requesting $19.85 million – an increase of less than $500,000 from FY 2012. Given the repayment rate from microloan intermediaries, the interest rate subsidy does not present any risk to the federal treasury and supports a program that has demonstrated significant ability to create successful entrepreneurs. However, the SBA has never explained to the Committee whether its other entrepreneurial development programs can provide some of the technical assistance offered by microloan intermediaries.

SBIC Program

The debenture program has a longstanding history of taking in sufficient fees to meet the costs of providing guarantees to private investors who purchase the debentures from SBICs. As a result, the SBA does not request an appropriation for the SBIC program. However, the SBA does request an increase in authorization for the program from $3 billion to $4 billion[44] in the amount of leverage that it can provide to SBICs. Given that

[41] OMB, FEDERAL CREDIT SUPPLEMENT BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2014 Table 8 at 69 (April 2013).
[42] SBA Budget Submission, *supra* note 4, at 25, Table 8.
[43] *Id.*
[44] *Id.* at 8.

the program operates at zero subsidy and the expected demand from small businesses for investment by SBICs, the increase in authority seems sensible.

FY 2014 Administrative Costs for Capital Access Programs

Due to the way the budget accounts are established, there are separate accounts for administrative expenses to operate the business and disaster loan programs which are then rolled into the overall request for the salaries and expense appropriation for FY 2014. For the business loan account, those funds are $152 million (an increase of $3.6 million from FY 2012)[45] and $192 million for administering the disaster loan program (which represents a significant increase from FY 2012).[46]

In January 2013, Congress appropriated significant sums to provide assistance to victims of Hurricane Sandy. The SBA received an additional $260 million for direct administrative expenses associated with making and servicing disaster loans.[47] The SBA's budget justification makes no effort at explaining whether the agency will ultimately utilize all of the $260 million only for loans made to Hurricane Sandy victims or whether substantial carryover sums will be available for other disasters (as is normally the case).[48] Given past history, it seems implausible that SBA will use all the funds from the 2013 Disaster Relief Appropriations Act for just Hurricane Sandy.

Information Technology Expenses and Initiatives

One item highlighted in the FY2014 Budget for savings is a reduction of $2 million in the further modernization of the Loan Management Accounting System (LMAS). The Inspector General long ago identified the inadequate LMAS as one of the most serious vulnerabilities facing the agency and the SBA's effort to update the system remains problematic.[49] Given that the agency oversees a loan portfolio in excess of $100 billion and the potential risk to the taxpayer, it makes little sense to reduce the amount of funds available for such modernization.

Rather than devoting necessary funds to continue modernizing the LMAS, the SBA is requesting $7 million for SBA One. According to its budget justification:

[45] As a reminder, this increase in salaries and expenses is offset by a significant reduction in the funds needed to cover the costs of providing guarantees in the SBA capital access programs.

[46] *Id.* at 17, Table 1. Part of the increase arises from a new OMB requirement that the SBA have two accounts for administrative expenses in the Disaster Loan Program. One account would be for those disasters declared by the President pursuant to authority of the Robert T. Stafford Disaster Relief and Emergency Assistance Act and the other would be account for disasters declared by the Administrator pursuant to authority granted in § 7(b) of the Small Business Act.

[47] Act of Jan. 29, 2013, Pub. L. No. 113-2, Div. A, Disaster Relief Appropriations Act, Tit. XI, Chap. 5, 127 Stat. 4, 27.

[48] Congress authorized that the administrative expenses be used until expended, *id.*, which means that they can be carried over to other years and for other disasters.

[49] *SBA Oversight: Hearing Before the Subcomm. on Financial Servs. and General Gov't of the House Comm. on Appropriations*, 113th Cong., Statement of Inspector General Gustafson 2 (2013), *available at* http://appropriations.house.gov/uploadedfiles/hhrg-113-ap23-wstate-gustafsonp-20130410.pdf. For example, the database still will be programmed in a long-displaced language COBOL.

> SBA One will move the Agency to a single application for most SBA loans and allow borrowers and lenders to populate forms from secure information storage. A key result will be to make the SBA loan application process easier for SBA lending partners so the Agency can engage with more CDFI [community development financial institutions] and other community lenders.... One of the main goals of SBA One is to get 1,000 lenders making more than 10 SBA loans per year, up from the historical average of just 500 to 750 lenders....[50]

Reducing the complexity of the SBA loan application process for both borrowers and lenders is a laudable goal. However, given the SBA's past efforts at information technology management (including the problems with LMAS, the poor search functions on its website, and the inadequate information provided to potential government contractors on its RFPez website) strongly suggests that the agency should not take on new information technology initiatives, no matter how beneficial, until the SBA completes the LMAS project.

Of course, the SBA budget justification never explains why it is necessary to have more lenders participating in the program. Once the SBA lends the maximum number of dollars in a year, it can lend no more; more lenders cannot increase the amount the agency can guarantee for its 7(a) or CDC Loan Programs. Only Congress can accomplish that.

Nor does the agency mention that one of the major issues complicating the application process for lenders and borrowers is the SBA's standard operating procedures or SOPs. The SOPs provide guidance to the lenders run and total nearly 500 pages; if the agency wishes to make the process less complicated, it should spend less money on information technology and undertake a greater effort to eliminate unnecessary requirements in the SOPs. This, in turn, will enable smaller lenders to participate in the program because they will not need personnel devoted to learning the intricacies of the SOPs.

Little doubt exists that the SBA will utilize some of its personnel to create new lending initiatives not specifically authorized by statute. These are called pilot programs, and the SBA establishes them by placing a notice in the Federal Register and modifying its lengthy SOPs. The SBA claims it has the authority to conduct these programs pursuant to authority in § 7 of the Small Business Act and 13 C.F.R. § 120.3 (a regulation of the agency that permits it to waive any regulation on a temporary basis). Nevertheless, the SBA uses this authority to implement major permanent regulatory changes using temporary regulatory authority, such as the Community Express Loan program that has been in existence since 1999 under this temporary authority. These programs, started without substantial oversight, can increase the number of loans that may default which, in turn, will increase the potential subsidy rate or simply drain the coffers of the agency as happened in a pilot program to assist a PCL.[51] Rather than focusing on new initiatives,

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[50] SBA Budget Submission, *supra* note 4, at 5.

[51] *In re EDF Resource Capital, Inc.*, Final Agency Decision, slip op. at 28 (Dec. 17, 2012) (pilot program cost SBA $8.9 million in unreturned advances).

the SBA should concentrate its budgetary request on ensuring proper management of its existing capital access programs.

Lender Oversight

The efforts to increase the number of lenders raise another important matter – the adequacy of SBA's lender oversight. As already noted, the SBA oversees a guaranteed-loan portfolio of slightly more than $100 billion. According to the Inspector General, inadequate oversight constitutes a significant risk for the agency.[52] Since loans are guaranteed by the federal taxpayer, potential problems are not isolated to the agency; the federal taxpayer ultimately may pay the cost of these vulnerabilities.

The SBA does not have general regulatory authority over most of its lenders in the 7(a) Loan Program.[53] Although the SBA does not regulate 7(a) lenders, it does have the power to exclude such lenders from participating in its programs should those federally regulated entities violate SBA rules. *See id.* at § 120.1400. For CDCs and a set of lenders known as small business lending companies,[54] the SBA has plenary regulatory authority. *See id.*

The SBA claims that it revokes the authority for 7(a) lenders to participate as preferred lenders. One might then assume that the SBA's exercise of its authority has been quite diligent; alas that conclusion would be faulty. The agency revokes preferred status because the lender does not generate a sufficient number of loans to qualify as a preferred lender. When the SBA is actually faced with fraud being perpetrated by a lender, such as the case with Business Loan Express (a small business lending company with preferred lender status),[55] the SBA did not revoke its authority to issue loans (and in fact the company continues to participate in the program). In fact, during the 60-year history of the agency, it only has revoked the authority of one lender to participate in its program and that was in 2012 after a nearly two-year process.

The aforementioned history fully demonstrates that the SBA does not have sufficient lender oversight capacity. One would then suspect that the agency would significantly bolster funds allocated to lender oversight; one would be wrong. The SBA estimates that its costs for lender oversight will increase by less than $1 million.[56] Yet, the agency is

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[52] *SBA Oversight: Hearing Before the Subcomm. on Financial Servs. and General Gov't of the House Comm. on Appropriations*, 113th Cong., Statement of Inspector General Gustafson 3 (2013), *available at* http://appropriations.house.gov/uploadedfiles/hhrg-113-ap23-wstate-gustafsonp-20130410.pdf.

[53] Almost all of the lenders involved in the 7(a) Loan Program are banks or credit unions subject to strict regulation by other federal regulators, such as the Federal Deposit Insurance Corporation or the National Credit Union Administration.

[54] Small business lending companies are lenders in the 7(a) Loan Program that are not subject to regulation by a federal banking regulator. 15 U.S.C. § 650 (a)(1). Section 23 provides a comprehensive oversight regime akin to the powers of federal banking regulators for small business lending companies.

[55] SEN. T. COBURN, BACK IN BLACK: SMALL BUSINESS ADMINISTRATION 2 (2011) (noting fraud committed by Business Loan Express CEO), *available at* http://www.coburn.senate.gov/public/index.cfm?a=Files.Serve&File_id=fb5f3412-f034-4cfe-91f0-24e5b1cfaa8c

[56] SBA Budget Submission, *supra* note 4, at 27, Table 10.

requesting significant new funds to identify new lenders for which the SBA will not be able to oversee. The lapse in logic needs no further expatiation.

Government Contracting Programs

The goal of the federal procurement system is: "to deliver on a timely basis the best value product or service to the customer, while maintaining the public's trust and fulfilling public policy objectives." 48 C.F.R. § 1.102(a). To achieve this objective, the basic premise is that open competition among the largest number of potential government contractors will be the best method for achieving the goal of the federal procurement system. *Id.* at § 6.101.[57]

The starting point for federal procurement then is full and open competition. However, it is not the end point. Congress determined that it could accomplish other relevant public policy objectives through federal government procurement. One such objective is to promote the growth of small business by ensuring that they receive "fair proportion of the total purchases and contracts for property and services for the Government in each industry category...." 15 U.S.C. § 644(a). Congress established that federal agencies should have a goal of awarding 23 percent of the total value of all prime contracts to small businesses. *Id.* at § 644(g)(1)(A)(i). It is important to note that this constitutes an aspiration rather than an imprecation (or set-aside); other than shaming by Congress, other executive branch agencies, and the press, no penalties exist for the failure to reach this goal.

To achieve the statutory goal, Congress created a number of programs designed to increase opportunities for small businesses. The Small Business Reserve Program requires that contracts of value between $3,000 and $150,000 be set aside only for competition among small businesses if at least two small businesses can perform the contract at a fair market price. *Id.* at § 644(j).[58] In addition, Congress created other programs designed to assist specifically targeted groups of small businesses thereby providing assistance to meeting the overall 23 percent goal. These programs are: 8(a) businesses; HUBZone businesses; service-disabled veteran-owned businesses; and women-owned businesses. Each program provides a specific goal for the award of prime contracts and permits contracting officers to limit competition to businesses within a specific category and in all cases, except small businesses owned by women, to award contracts on a sole source basis, i.e., without competition at all.

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[57] The cited section of the Federal Acquisition Regulation implements § 2711 of the Competition in Contracting Act (colloquially known among the government contracting cognoscenti as CICA) which requires, except as otherwise provided by statute, full and open competition. 41 U.S.C. § 3301. CICA's use of the term "full and open" was designed to ensure that all government contractors (and not some limited subset selected by contracting officers) had the opportunity to bid on the provision of goods and services. 48 C.F.R. § 2.101; *accord* J. CHIERICHELLA & J. ARONIE, MULTIPLE AWARD SCHEDULE CONTRACTING 68 (2006).

[58] The limit set forth in § 15(j) of the Small Business Act specifies the maximum for the reserve at $100,000. Section 1908 of Title 41 contains a government-wide inflation adjustment for procurement thresholds moving the reserve to $150,000. *See* 48 C.F.R. 19-502. 2.

The 8(a) Program

This program assists socially and economically disadvantaged (generally minorities) small businesses and is colloquially referred to as the "8(a)" program after section 8(a) of the Small Business Act, 15 U.S.C. § 637(a). The program is designed not solely as a contracting program, but as a business development program. 13 C.F.R. § 124.1. The primary mechanism for providing business development is to obtain federal government contracts for program participants. Technical assistance is provided to program participants pursuant to § 7(j) of the Small Business Act, 15 U.S.C. § 636(j).

Section 8(a) authorizes the SBA to enter into contracts with other federal agencies to provide goods and services to the government. The SBA then enters into a contract with a firm that has been certified pursuant to the 8(a) program to provide the goods and services. In essence, the SBA becomes the prime contractor to the federal agency and the 8(a) firm becomes the subcontractor to the SBA. *Contract Management, Inc. v. Rumsfeld*, 434 F.3d 1145, 1147 (9th Cir. 2006).

Contracts under the 8(a) program may be awarded as a sole source contract or in a competition solely reserved for firms certified to participate in the program. It is important to note that the SBA delegated its authority to enter into two contracts with firms in the program to other federal agencies. Thus, the agencies now enter into contracts directly with 8(a) participants rather than negotiating with the SBA as the prime contractor. This change was made during the Clinton Administration and contravenes the specific language of the Small Business Act requiring that the SBA and the federal agency enter into a prime contractor relationship.[59]

SBA regulations define who is socially and economically disadvantaged. 13 C.F.R. §§ 124.103-04. Participation is limited to nine years from the date of entry of the program. Participants may "graduate" if the firms have spent nine years in the program or have achieved the objectives set forth in the business plan that they file with the SBA when they enter the program.

Many graduates of the 8(a) program do not succeed when they graduate. The possible reasons for the lack of success may include overreliance on non-competitive government contracts or the absence of adequate technical assistance that ensures capacity to operate in normal commercial or federal contracting markets.

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[59] The SBA entered into memoranda of understanding (MOU) with each federal agency to delegate the authority to enter into 8(a) contracts directly with small businesses. In those MOUs, the SBA claims that it remains the prime contractor thereby elevating form over substance. The delegations patently violate the clear statutory language that the SBA is "to enter into contracts with the United States Government and any department, agency or officer thereof having procurement powers obligating the Administration to furnish articles, equipment…." 15 U.S.C. § 637(a). If a statute is clear on its face, no agency interpretation is valid that contravenes such statutory imprecation. *See Chevron, U.S.A., Inc. v. NRDC*, 467 U.S 837, 842 (1984).

HUBZone Program

The Historically Underutilized Business Zone (HUBZone) program was created in 1997 to provide federal government contracting opportunities to small businesses located in geographic areas where unemployment has been above the national average. *Metro Machine Corp. v. Small Business Administration*, 305 F. Supp. 2d 614, 616 (E.D. Va.), *aff'd per curiam*, 102 Fed. Appx. 352 (4th Cir. 2004). Small businesses located in HUBZones are given a ten-percent price preference when bidding against firms not located in a HUBZone. The theory behind the price preference is that, all else being equal,[60] the contracting agency would essentially favor the HUBZone firm. The HUBZone firm then would hire additional employees to service the contract, thereby enhancing economic development.

There are additional requirements for maintenance of HUBZone status. The most significant is that a firm must have at least 35 percent of its employees residing in a HUBZone. *Id.* It is important to note that the employees need not live in the HUBZone in which the business is located but can be located in any HUBZone. Presumably, increasing the number of employees with incomes will improve the overall economic development an area even if the employee does not reside in the HUBZone in which the business is located.

Contracting officers relied on the certifications and, until recently, the SBA did not check to determine whether the firm's assertion on qualification for eligibility was correct. After investigations by the Government Accountability Office that found serious flaws in the self-certifications, the SBA revamped the program to include verification by agency personnel of HUBZone status. The issue of self-certification remains a primary vulnerability in the program. More significantly, if ineligible firms receive contracts as a result of incorrect status, it undermines the economic development goals of the program by denying legitimate firms federal government contracts.

Service-Disabled Veterans Program

Congress, in 1999, amended § 15 of the Small Business Act to require the President to establish a government-wide procurement goal of not less than three percent for small businesses owned and controlled by service-disabled veterans. Veterans Entrepreneurship and Small Business Development Act, Pub. L. No. 106-50, 113 Stat. 233, 247 (1999). Little movement was made to increase participation by service-disabled veterans in the federal procurement process; four years later, Congress added a new § 36 to the Small Business Act with the inclusion of § 308 of the Veterans Benefits Act of 2003, Pub. L. No. 108-183, 117 Stat. 2651, 2662 (codified at 15 U.S.C. § 657f).[61] The provision authorized but, unlike the HUBZone program, did not mandate that contracting officers set aside specific contracts for competition solely among small businesses owned

[60] Economists would refer to this condition as *ceteris paribus*.

[61] The bill originated with the Committee on Veterans' Affairs and the Committee on Small Business waived jurisdiction.

by service-disabled veterans. Even after the enactment of § 36, federal agencies were not meeting the three percent goal and the President issued an executive order, Exec. Order No. 13,360, 69 Fed. Reg. 62,549 (Oct. 26, 2004), *reprinted in* 3 C.F.R. 231 (2005), mandating that the heads of agencies develop strategies for implementing and achieving the goals of § 36.

Women's Procurement Program

In 2000, Congress added a new subsection (m) to § 8 of the Small Business Act creating a women's procurement program. Small Business Reauthorization Act of 2000, § 811, Pub. L. No. 106-554 (codified at 15 U.S.C. § 637(m)). The program authorizes, but does not mandate, that the contracting officer may set aside contracts for awards to certain women-owned businesses if the contracting officer believes that two or more such businesses will submit offers at a fair and reasonable price and the contract is for goods and services below certain statutory maxima.[62] As with the other targeted contracting programs, Congress established the Women's Procurement Program in order to assist federal agencies in meeting the statutory goals established for small businesses owned by women. Unlike the 8(a), HUBZone, and service-disabled veterans program, there is no authority to award sole-source (non-competitive contracts).

Implementation of the program depends on the Administrator of the SBA identifying industries in which small business concerns owned and controlled by women are underrepresented in federal government procurement. The Administrator was supposed to identify these after performing a study. After five years in which the SBA did not implement the program, the SBA was sued for action unreasonably withheld, 7 U.S.C. § 706(1). The United States District Court for the District of Columbia found that the SBA unreasonably withheld implementation of the program in a 2005 decision and ordered that the SBA perform a study of historically underrepresented industries as mandated by statute, and kept jurisdiction of the case.

Some five years subsequent to that court order, in late 2010, the SBA finally promulgated regulations to implement the program including the identification of women-owned businesses historically underrepresented in federal government contracting.[63] Since the list of industries will continually change, the SBA does not list those industries in the Code of Federal Regulations but rather on the agency's website. 13 C.F.R. § 127.502. There are about 370 industrial classifications for which women-owned businesses are eligible.[64]

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[62] As with all federal procurements, the maximum limits in the Women's Procurement Program are subject to an inflationary adjustment pursuant to 41 U.S.C. § 1908.

[63] A detailed history of the administrative actions to implement this program would make this already lengthy memorandum even longer. Individuals wishing a more detailed history should contact the Chief Counsel for the Committee.

[64] This represents about 32 percent of all the industrial classifications in the United States. Industries are classified according to the North American Industrial Classification System maintained by OMB.

Subcontracting Assistance

Most small government contractors would recognize their inability to produce certain items needed by the federal government. Typical examples are usually taken from large weapon systems needed by the military, such as aircraft carriers or fighter jets. Despite their inability to produce such items, Congress recognized that small businesses still might make valuable contributions to the overall development and mandated that small businesses have maximum opportunity to participate in these large prime contracts. 15 U.S.C. § 637(d)(1).

To implement this objective, Congress requires large firms that are awarded contracts to submit a subcontracting plan. *Id.* at § 637(d)(5)(A)(iv). The plans must contain, among other things, the efforts that the contractor will take in ensuring proper small business utilization as well as numeric goals for use of small business as subcontractors. *Id.* at § 637(d)(6). Prime contractors are required to make a good faith effort to comply with the subcontracting plans. *Id.* at § 637(d)(8). Failure to make a good faith effort to comply with the subcontracting plan will subject the contractor to liquidated damages.[65] *Id.* at § 637(d)(4)(F).

The SBA is required to assist agencies in ensuring that small businesses have maximum opportunities to offer goods and services as subcontractors. 15 U.S.C. § 637(d)(10). To carry out this mission, SBA personnel are directed to review compliance with subcontracting plans. *Id.* at § 637(d)(10)(C). However, neither the FAR[66] nor the SBA regulations specify what decisional calculus should be used by the contracting officer or SBA personnel in assessing good faith compliance with the subcontracting plan. Given this lack of criteria, it is not surprising that the federal government has never sought, much less obtained, either liquidated damages or termination for default related to the failure to make a good faith effort to comply with federal subcontracting plans. In the National Defense Authorization Act for FY 2013, Pub. L. No. 112-239, 126 Stat. 1632 (2013), Congress amended the Small Business Act in an effort to improve subcontracting plans and prime contractor compliance with those plans. *Id.* at Tit. XVI, §§ 1653-1655, 126 Stat. at 2081-84.

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[65] Liquidated damages refers to "the sum a party to a contract agrees to pay if he breaks some promise, and which, having been arrived at by a good faith effort to estimate in advance the actual damage that will probably ensue from the breach, is legally recoverable . . . if the breach occurs." *Pantuso Motors, Inc. v. CoreStates Bank, N.A.*, 798 A.2d 1277, 1282 (Pa. 2002) (quoting citations omitted). In the case of failure to comply with the subcontracting plan, the liquidated damages are specified in the FAR as the "amount equal to the actual dollar amount by which the contractor failed to achieve each subcontracting goal." 48 C.F.R. § 19.705-7(b). The procedures to obtain liquidated damages are set out in the FAR. *Id.* at § 19.705-7(c).

[66] The FAR simply orders the contracting officer to "look at the totality of the contractor's actions, consistent with the information and assurances provided in its plan." *Id.* at § 19.705-7(d).

Government Contracting Programs and FY 2014 Budget

There are two primary costs to SBA in operating the federal procurement programs set forth in the Small Business Act – personnel costs and general expenses, such as rent, information technology, etc. According to the SBA, the costs for operating the government contracting programs will increase by approximately $9.775 million in FY 2014 over the same costs for FY 2012.[67] The agency does not, for the most part, detail how that increase will be spent but appears to be invested in more information technology to help reach small businesses underrepresented in the federal procurement marketplace with some resources allocated to the continued effort to root out fraud in their government contracting programs, particularly with respect to eligibility in the HUBZone Program.[68]

SBA Government Contracting Personnel and FY 2014 Budget

While continued efforts to combat fraud are important, the SBA also has a mission to increase utilization of small businesses by federal agencies in meeting their procurement needs. That requires the correct personnel to work with small businesses and federal agencies in order to develop procurement strategies that will enable small businesses to compete against much larger businesses. The SBA has two types of individuals devoted to ensuring that small businesses have maximum opportunities to provide goods and services to the federal government. They are PCRs and commercial marketing representatives (CMRs).

PCRs generally are assigned to contracting activities and work under the supervision of the contracting activity personnel (but report to the Office of Government Contracting at the SBA). 48 C.F.R. § 19.402(a)(1). Essentially, PCRs are required to intercede in the contract process (primarily but not entirely at the acquisition strategy phase of the procurement) to advocate on behalf of small businesses. 15 U.S.C. § 644(l)(2)(H). Such advocacy may include, but is not limited to: recommendations to unbundle federal government contracts;[69] appeal failures by agencies to take recommendations concerning acquisition strategies that promote small business utilization; and submit unsolicited small business proposals to procuring activity personnel. Given these responsibilities, PCRs are required to have significant acquisition expertise. *Id.* at § 644(l)(5)(A)(iii).

CMRs are "SBAs subcontracting specialists." 13 C.F.R. § 125.3(e). CMRs promote the use of small businesses by prime federal contractors by, among other things: matching large prime contractors with small business concerns; counseling large prime contractors on the subcontracting responsibilities under § 8(d) of the Small Business Act; and

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[67] SBA Budget Submission, *supra* note 4, at 28, Table 10.
[68] *Id.* at 44-45, 71-74.
[69] Bundling occurs when a federal agency consolidates two or more requirements in a way that a small business will not be able to compete for the contract. *See* 15 U.S.C. § 632(o). Bundling has long been the bane of small businesses and multiple Presidents have tried to impose policies to reduce bundling to little effect. A detailed explication on bundling is beyond the scope of this memorandum.

counseling small businesses on how to market themselves to large prime contractors. *Id.* Most significantly, CMRs conduct reviews of large prime contractor compliance with subcontracting plans. *Id.* at § 125.3(e)(6), (f). Despite these important responsibilities, GAO noted that CMRs perform those functions in addition to others assigned them by the SBA.[70]

PCRs and CMRs play a vital role in helping small businesses obtain federal procurement opportunities. The number of such individuals at the SBA is well short of their need. In a move long supported by the Committee on a bipartisan basis, the SBA finally has determined to increase the number of PCRs and CMRs by a total of 32 and requests $4 million to accomplish this increase.[71] Given their vital role in promoting agency and prime contractor utilization of small businesses, even more of these personnel should be hired. The SBA should reallocate more funds to hiring additional PCRs and CMRs. Further, the agency policy should be revised to ensure that CMRs are not performing other tasks. Resources spent on PCRs and CMRs will have a greater impact on small business growth than the amorphous and ill-defined entrepreneurial development initiatives set forth in the FY 2014 budget – a subject we now address.

Entrepreneurial Development (ED) Programs

The SBA oversees the operation of a multiplicity of programs that provide technical assistance to individuals wishing to start small businesses and to already extant small businesses. The programs range from narrowly targeted efforts to very broad initiatives that take advantage of the resources of America's higher education system and retired business executives. The programs all have one commonality – the SBA shares funding or staffing or a combination of both with non-profit organizations, other federal agencies, and state or local governments. Other than some personnel to oversee the operations of these programs, the primary cost of the programs is the monies appropriated to fund the SBA portion of these outreach efforts.

Small Business Development Centers

The largest ED program in terms of facilities and outreach is the Small Business Development Center (SBDC) program. Basically, the SBDC program is a cooperative grant program between selected state agencies (or institutions of higher education)[72] and

[70] GENERAL ACCOUNTING OFFICE, THE COMMERCIAL MARKETING REPRESENTATIVE ROLE NEEDS TO BE STRATEGICALLY PLANNED AND ASSESSED 9-11 (GAO-03-54) (Nov. 2002).

[71] SBA Budget Submission, *supra* note 4, at 5.

[72] When the program was started in 1980, the grantees either could be state agencies or institutions of higher education. Congress later changed the program only allowing institutions of higher education to be grantees but grandfathered existing state agencies. To complicate matters, state agencies that are grantees often subcontract the provision of services to institutions of higher education. For example, the grantee for the State of Illinois is the Department of Trade but the services are provided by community colleges throughout Illinois. Complicating matters even further, neither the SBA (given its penchant for misnomers – not surprising) nor § 21 of the Small Business Act that created the SBDC program makes a proper distinction between the grantees and the service centers where small businesses are assisted. Both are interchangeably and incorrectly called SBDCs.

the SBA to operate centers where prospective entrepreneurs and existing small business owners can go to obtain assistance.[73] The assistance is provided at no cost to the business. This enables the entrepreneurs to take advantage of the skills and expertise of higher education faculty and students to provide assistance.

Funds are provided pursuant to a complex formula related to the percentage of population of each state relative to the national population. The formula is further complicated by requiring minimum amounts of grants and those minima are calculated from a statutory baseline of $85,000,000 in funding for the program. Funds provided by the federal government must be matched by the SBDC grantee from non-federal sources, such as private donations or state funds.

For FY 2014 Budget, the request for SBDC funding is $104 million – a reduction of almost $10 million from FY 2012 – a reduction of 8.66 percent.[74] The SBA is cutting these funds despite the fact that SBDCs provide more services (as required by § 21 of the Small Business Act) than any other ED partner, and only will lose 2,000 long-term counseling clients due to sequestration.[75]

Women's Business Centers

Women's Business Centers (WBCs) provide training, counseling, and mentoring to women entrepreneurs. WBCs are required to focus on the needs of socially and economically disadvantaged women. Originally, the WBCs were established in 1991 as a three-year pilot program. In 1997, Congress kept the basic premise of the demonstration projects but redesignated the names to Women's Business Centers, extended the time frame for the demonstration projects to five years, modified the matching contributions, and imposed review requirements to ensure that Women's Business Centers were meeting the obligations of their grants. The intent of Congress in 1997 was to provide a limited amount of government funding until the centers were sufficiently established that they could operate solely on the basis of private funds.

Two years later, Congress reacted to complaints that these centers could not raise funds during the end of the telecommunications and Internet bubbles. Congress created a pilot program[76] to provide some of the centers with so-called sustainability funds. Initially, sustainability funds represented about one-third of the total funds appropriated for establishment of WBCs. Today, approximately 50 percent of the funds appropriated are

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[73] The assistance provided by the grantee through its SBDC network is specified in statute and is quite broad to include: business analysts; technology transfer agents; information retrieval specialists; various part-time professionals who donate time, such as lawyers and professional engineers; and laboratories and engineering facilities. SBDCs have the authority to utilize federal national laboratories. They also have the authority and ability to provide small businesses with advice about energy efficient technologies.

[74] SBA Budget Submission, *supra* note 4, at 22, Table 6.

[75] Letter from Karen Mills, Administrator, SBA to Sen. Barbara Mikulski, Chair, Senate Committee on Appropriations 2 (Feb. 19, 2013) (on file with Committee staff).

[76] The sustainability pilot was designed to last only four years, i.e., to 2003. But the pilot program, through authorizing language on appropriations bills, has become something more permanent with the expectation that sustainability funds will always be available.

to go to existing centers operating through the sustainability pilot program (which really is no longer a pilot program) and little effort is made to force the centers to seek more non-federal funding. If the government always appropriated around $14 million (the typical appropriation for the program), new centers would be created as old centers passed their five-year anniversary and lost their federal funding. However, since the creation of the sustainability pilot project and the ever-increasing funds devoted to funding existing centers past their five-year anniversary, far fewer new centers can be established even if the population of potential women entrepreneurs is not coextensive with the geographic area served by the existing centers.

The FY 2014 request for WBCs is $13.05 million, a diminution of $700,000 which represents about a 5.3 percent reduction.[77] The percentage reduction is smaller than for SBDCs even though they serve overlapping populations and SBDCs are required to provide significantly broader level of services.

SCORE

The SBA provides office space to a corps of executives from both large and small businesses. These executives volunteer their time to provide assistance to entrepreneurs. Such assistance can be as simple as suggesting that a business owner contact the SBA to helping them draft business or marketing plans. The scope of the service provided by the volunteers really depends on their interest and the relationship that develops between the volunteers and the business owners they counsel. By statute, the SBA is required to provide funds for office space, telephones, Internet access, reimbursement of out-of-pocket expenses by volunteers, and other ancillary services needed by the volunteers. 15 U.S.C. § 637(b)(1)(B). The SBA is requesting $6.52 million for FY 2014 a reduction of 6.8 percent.[78] This percentage reduction is lower than that of SBDCs even though SCORE is not required to provide as many services as SBDCs.

Veterans Business Development

The SBA has an Associate Administrator for Veterans Affairs that oversees the Office of Veterans Business Development. The Office provides services to maximize the availability, applicability and utility of all programs offered by the SBA to veterans and service-disabled veterans, and reservists. The Office has Veterans Business Development Officers in each SBA district office to prepare and plan businesses operated by veterans. Veterans Business Development Officers are SBA employees that have special expertise in addressing the needs of veterans.

Through cooperative agreements with non-profit entities, the Office manages a Veterans Business Outreach Centers (VBOCs). The program operates in a manner almost identical to that of the SBDCs and WBCs, i.e., the SBA provides funds and the non-profit entities raise matching funds. The scope of services provided to veterans is identical to the services provided to all entrepreneurs by SBDCs and WBCs.

[77] SBA Budget Submission, *supra* note 4, at 22, Table 6.
[78] *Id.*

The FY 2014 Budget request to fund Veterans Outreach is $2.5 million – the same as in FY 2012.[79] This request primarily covers the operation of the VBOCs; funds for SBA employee outreach services at district offices is subsumed in the agency's overall salary and expenses account.

Native American Outreach

The Office of Native American Affairs ensures that American Indians, Native Alaskans and Native Hawaiians seeking to create, develop and expand small businesses have full access to the necessary business development and expansion tools available through the SBA's entrepreneurial development, lending and procurement programs. The Office engages in numerous outreach activities including tribal consultations, development and distribution of promotional materials, attendance and participation in national economic development conferences. There are no separate outreach offices, such as VBOCs or Women's Business Centers, for outreach to Native Americans. Funding for Native American outreach is reduced by $195,000 from FY 2012 to $1.05 million for FY 2014.[80]

Office of International Trade

The Office of International Trade provides assistance to businesses involved in export or import business.[81] The major component is the placement of SBA personnel at United States Export Assistance Centers operated by the Department of Commerce. The Small Business Jobs Act of 2010 mandated that the Office increase the number of SBA personnel from 18 to 30 at the Export Assistance Centers as well as some other managerial changes. The total budgetary resources requested to operate the Office of International Trade for FY 2014 is $12.8 million, which represents an increase of approximately $3.9 million from FY 2012.[82] Almost half of the additional funds are requested for the SBA's contribution to the President's Export Cabinet.[83]

ED Programs and the FY 2014 Budget

The SBA has a panoply of entrepreneurial training programs that overlap by providing identical services often to the population of small businesses. Rather than trying to rationalize these programs in the budget and a proposed legislative package suggesting changes in the Small Business Act, the SBA requests $57 million for a variety of ED initiatives: Entrepreneurial Education; Growth Accelerators; Boots to Business; and Regional Innovation Clusters. According to the SBA, these initiatives are designed to foster joint efforts among the various ED program partners and develop best practices.

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[79] *Id.*
[80] *Id.*
[81] There are specialized 7(a) guaranteed loans for businesses involved in international trade. Less than 10 percent of the loans made under the 7(a) Loan Program are these specialized international trade loans.
[82] *Id.* at 62, International Trade Performance Indicator Table. It is important to note that these funds are subsumed within the overall request for salaries and expenses set out in Table 1. Nevertheless, the data provide an overview of the changing cost allocations within the SBA to the Office of International Trade.
[83] *Id.* at 9.

However, the limited information provided to the Committee reveals that these programs may well duplicate services already provided by SBDCs, WBCs, VBOCs, SCORE, and other federal agencies. Furthermore, none of the programs for which funding has been sought has been authorized in the Small Business Act. Rather than developing new initiatives for educating entrepreneurs, the SBA should focus on maximizing the efficient operation of existing programs. If the SBA believes that it has a better process for providing entrepreneurial education than the current statutorily-authorized mechanisms, it behooves the agency to submit a request for legislative changes in the Small Business Act instead of unilaterally making those determinations in contravention of the Constitution's vesting of the legislative power in Congress.