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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

Memorandum

To:	Members, Committee on Small Business
From:	Committee Staff
Date:	April 3, 2017
Re:	Hearing: "Taking Care of Small Business: Working Together for a Better SBA"

On Wednesday, April 5, 2017 at 11:00 am in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to receive testimony by the Honorable Linda McMahon, Administrator of the Small Business Administration (SBA), on her priorities as Administrator. This memorandum discusses the primary programs offered by the SBA.

Before addressing the SBA's programs in detail, a brief overview of the SBA may be useful. 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. §§ 631-57s, is to "aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns . . . ." *Id*. at § 631(a). In 1958, Congress enacted the Small Business Investment Act of 1958, *id*. at §§ 661-97g, to "stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations...." *Id*. at § 661.

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. 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 businesses, either by the SBA directly or through its partners, are delivered through one of the 68 district offices established throughout the United States.[3]

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[1] J. BEAN, BIG GOVERNMENT AND AFFIRMATIVE ACTION 8-9 (2001).

[2] This is the SBA's terminology and covers for-profit, non-profit, and state governmental entities that help the SBA carry out its mission of assistance to small businesses.

[3] Each state and territory has at least one district office. https://www.sba.gov/tools/local-assistance/districtoffices. 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. In addition to these district offices, the SBA also has regional offices located in each one of the ten federal regions.

I. Capital Access Programs

A. The 7(a) Loan Program

The 7(a) Loan Program, named after § 7(a) of the Small Business Act, 15 U.S.C. § 636(a), serves as the SBA's primary mechanism to offer needed debt capital to small businesses when they are not able to obtain sufficient credit from normal lending channels.[4] 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 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 permanently increased in Title I of the Small Business Jobs Act of 2010, Pub. L. No. 111-240, to $5 million.[5] 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 varies 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 who has 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).[6] In addition to this up-front guarantee fee, there also is an ongoing guarantee fee paid by the lender to the SBA that amounts to 0.55 percent (or 55 basis points where each basis point is equal to .01 percent) of the unpaid balance of the guaranteed portion of the loan. *Id*. at § 636(a)(23).

Any lender is eligible, after completing an application process and receiving approval from the Administrator, to originate loans for which the SBA will issue a guarantee. A subset of these lenders, denoted "preferred lenders," have 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[7] from the SBA, rather than the

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

[5] 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.

[6] 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.

[7] The rationale for the Express Loan program 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 is 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 the Express Loan program.

normal 75 or 85 percent. Even though the guarantee percentage of a loan is lower, 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.

B. The Certified Development Company Loan Program

The Certified Development Company (CDC) Loan Program provides long-term fixed-asset financing to small businesses to acquire real estate, or machinery or equipment for expansion or modernization as long as the loans[8] 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."[9] In this loan program, the small business contributes 10 percent of the value of the project, a commercial bank contributes 50 percent,[10] and a CDC contributes 40 percent through the issuance of a debenture, a bond, whose repayment is guaranteed by the federal government. The maximum size of the debenture issued by a CDC will vary depending upon the purpose of the project and the type of borrower. However, as a general rule, CDCs can finance significantly larger projects than those available under the 7(a) Loan Program.[11] 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. 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. The Small Business Jobs Act of 2010 created a two-year temporary authorization to permit 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. Unlike a normal CDC loan which requires that the loan create or save jobs, the CDC refinancing program authorized the SBA to impose, but did not require, job savings or retention requirements; the SBA opted not to impose any when it implemented the program. In December 2015, Congress made the CDC Loan Refinancing Program permanent with one key change, as

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[8] MARKS, ROBBINS, FERNANDEZ & FUNKHOUSER, *supra* note 4, at 147.

[9] Section 504 of the Small Business Investment Act of 1958, 15 U.S.C. § 697a, authorizes the SBA to securitize instruments issued by 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 that title does not adequately reflect what the loan program does.

[10] 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.

[11] The sizes of the debentures were $1.5 million if the project does not meet certain statutory goals, $2 million if it meets certain public policy goals, and $4 million dollars for loans to small manufacturers. The Small Business Jobs Act of 2010 raised these limits to $5 million for most projects and $5.5 million for certain projects of small manufacturers. 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). With the typical forty percent guarantee, the largest project that can be financed in the CDC program is $13.75 million.

the refinancing is now contingent upon both job creation and job retention as found within a traditional CDC loan.[12]

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,[13] which are entitled to approve loan packages without first submitting the loans to the SBA.[14] These PCLs 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.

C. Microloan Program

When starting a business, the vast majority of these very small business owners do not actually utilize banks to take out commercial loans. Rather, they rely on loans and contributions from relatives and revolving credit loans using their own credit cards. There are some potential entrepreneurs that cannot even rely on angel investors 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.

The SBA began a pilot Microloan 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 1997, Congress made the authority for the Microloan Program 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.[15] These loans are made at interest rates 1.25 percent below the market rate for a 5-year rate for United States Treasury notes. Intermediaries are prohibited from

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[12] The change was incorporated into of the Consolidated Appropriations Act, 2016 Act, Pub. L. No. 114-113. Specifically, this can be found as part of Division E, Title V.

[13] The SBA revoked the charter of two PCLs (they were related enterprises) for violating a panoply SBA regulations, including the fact that they were related organizations but not operating in adjacent geographical areas. The first was terminated on December 17, 2012. The other was terminated on January 31, 2014. Since the inception of the SBA, these have been the only two lenders (whether they are 7(a) loan lenders or CDCs) whose authority has been revoked for reasons other than not closing a sufficient number of loans. This includes the failure of the SBA to remove the authority of a lender involved in committing fraud in the 504 loans program. To date, the SBA has not even revoked the lender's preferred lender status. This reveals a significant problem in the SBA's lender oversight program.

[14] The primary rationale for the establishment of PCLs no longer exists. Historically, it has taken SBA up to 3 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 larger loan loss reserves than other CDCs. The SBA, after intercession and complaints by the Committee on Small Business in 2003-04, centralized review of CDC loans in its Sacramento loan processing facility. The time frame for processing such loans has now dropped to approximately 2 to 5 business days. Without significant delay and no requirement for additional loan loss reserves, very few CDCs have sought the authority to be a PCL.

[15] SBA, Partner Identification & Management System (2016), *available at* https://www.sba.gov/sites/default/files/articles/microlenderrpt_160927.pdf. Although 210 microloan intermediaries exist, only 140 are making at least 4 microloans each year, which is considered the threshold for success by SBA.

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.[16] Unlike the 7(a) and CDC Loan Programs, appropriated funds cover the cost of subsidizing the interest rate differential in the Microloan Program.[17] The intermediary, in turn, makes loans of up to $50,000 to borrowers.[18] Loans in excess of $20,000 only can 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. 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 in the 7(a) program.[19]

Unlike the banks operating in the 7(a) Loan Program, the SBA requires that the intermediaries provide education and training to its borrowers. The intermediaries can provide such training or contract other enterprises to provide training and counseling. Funds for training and counseling are provided, in part, by appropriated funds made available to the intermediaries.

D. 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 (such as a limited liability company). 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: 1) sufficient capital to operate soundly and profitably; and 2) has qualified management. 15 U.S.C. § 681(c)(3)(A). If the SBA is satisfied with these determinations, then the agency, prior to issuing a license, must consider: 1) whether there is a need for investment in the area in which the applicant will operate; 2) the reputation of the owners of the applicant; and 3) 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.

Once licensed, the SBIC is able to "borrow" money from the federal government to invest in small businesses. These borrowed funds are denominated "leverage" (as in leveraging private dollars with federal funds) in tiers. For every dollar of private investment, a SBIC is

[16] 15 U.S.C. § 636(m)(3)(B). 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.

[17] Intermediaries make loans at interest rates that exceed their cost of funds but lower than a commercial bank might charge for a customer with a similar credit history. The intermediaries then plow the excess income to reimburse their cost of operation and to supplement the funds borrowed from the federal government.

[18] Maximum loan size in the program was $35,000 before it was raised in the Small Business Jobs Act of 2010 to $50,000. 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.

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

entitled to draw up to three dollars in government funding (but is not required to draw that maximum amount). Rather than simply borrowing directly from the federal government, SBICs sell securities to private investors (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: 1) a loan of leverage by the SBA to the SBIC; and 2) a loan of private funds by investors to the SBIC who receive a debenture to the total value of funds provided by the private investors as "collateral." As with the 7(a) and CDC Loan Programs, there are fees paid up-front 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 additional interest charge on the amount owed to the government by the SBIC for the issuance of the leverage. *Id*. at § 683(b).

Title III of the Small Business Investment Act of 1958 authorizes two types of SBICs – debenture SBICs and participating security SBICs. The primary distinction between the two entails the schedule for repayment of the leverage which led 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 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. Participating security SBICs receive the bulk of their investment payback in the growth of the value of the companies in which they invest. It goes without saying that investments relying solely on an increase in the value of a company will be more volatile than investments in companies that can pay a "dividend" as a well as experience 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.

E. Disaster Loan Program

The SBA provides the primary financial resource for those homeowners, small businesses, and small not-for-profit organizations[20] 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

[20] 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. 923, 1406 (2008) (hereinafter "2008 Farm Bill").

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).[21] A small business is limited to a maximum loan amount of $2 million for a combination of physical and economic injury disaster loans.[22]

Loans made under the disaster loan authority are made directly by the SBA[23] to borrowers, so in this regard it is different than other SBA capital access programs. This means that application review, processing, closing, and servicing are all performed by the SBA.[24] To be eligible for this type of SBA loan, the victim suffering damage must first submit an application to the Federal Emergency Management Agency (FEMA) to determine whether they are eligible for grant assistance. If the victim is not eligible for assistance from FEMA, their application is automatically referred to the SBA.

For the SBA to offer disaster assistance, a disaster declaration must be issued. A disaster declaration is an official notice recognizing that a specific geographical area has been damaged.[25] The importance of a declaration is that it sets forth the type of assistance available, the interest rate, and the eligible recipients. Only victims located in the designated geographical area are eligible for assistance.[26] After a major disaster, the governor of the affected state is responsible for requesting that the President of the United States issue a disaster declaration.[27] By requesting a presidential disaster declaration, the governor is affirming that assistance is beyond the capability of the state to adequately respond and that federal intervention is required.[28]

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

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[21] 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.

[22] 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 2008 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 if circumstances determined such a waiver was necessary to help resuscitate the area affected by the disaster.

[23] 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 because it has been able to process loans in a relatively timely manner, even after Superstorm Sandy. In general, changes made to the disaster program (both legislatively and administratively) have enabled the SBA to process disaster loans in an expeditious manner.

[24] 13 C.F.R. § 123.16.

[25] *Id*. at § 123.2.

[26] *Id*. at § 123.4.

[27] 42 U.S.C. § 5170.

[28] *Id*.

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 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.

F. 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 (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.

If the fees generated exceed the cost, the program is said to be operating at a negative subsidy (the government is in essence making a profit). When fees do not cover the cost, Congress must appropriate funds to make up the difference, and the program is said to be operating with a positive subsidy rate. Finally, if fees received by the government exactly cover the cost, the program is said to operate at zero subsidy.[31]

Because the fees have been sufficient, the 7(a) Loan Program, CDC Loan Refinancing Program, and the SBIC Program have been running on a zero subsidy cost to the American taxpayer for the last three fiscal years, including FY 2017.[32] After requesting subsidies in FY 2015, the CDC Loan Program has been running on a zero subsidy cost the last two fiscal years.[33] The SBA has requested a small subsidy for the Microloan Program for the past three fiscal years.[34]

II. Government Contracting Programs

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[29] It is important to recognize that the overwhelming number of loans made by the SBA after a disaster are physical injury loans made to homeowners whose property was destroyed – not to business owners.

[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] The use of the term "zero subsidy rate" also has a colloquial (but not technically accurate) connotation that the program does not require any appropriated dollars to cover its cost, irrespective of whether the actual subsidy rate is zero or negative.

[32] SBA, FY 2017 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2015 ANNUAL PERFORMANCE REPORT 22 [hereinafter SBA FY 2017 Congressional Budget Justification], *available at* https://www.sba.gov/sites/default/files/FY17-CBJ_FY15-APR.pdf.

[33] *Id*.

[34] *Id*.

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). Federal procurement rules presume that open competition among the largest number of potential government contractors will be the best method for achieving the objective of best value to the government. 48 C.F.R. § 6.101.

The starting point for federal procurement then is full and open competition. Congress determined that it could accomplish other relevant public policy objectives through federal agency purchases of goods and services. Another aim is to promote the growth of small businesses 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 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. 48 C.F.R. §§ 19.203(b), 19.502-2(a). The other programs are targeted at specific classes of small businesses: 8(a) businesses; Historically Underutilized Business Zone (HUBZone) businesses; service-disabled veteran-owned businesses; and women-owned businesses. The programs also enable contracting officers to limit competition to businesses within a specific category and to award contracts on a sole source basis, i.e., without competition at all.

A. The 8(a) Program

This program assists socially and economically disadvantaged 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 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.

SBA regulations define who is socially and economically disadvantaged. 13 C.F.R. §§ 124.103, .104. 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.

Some participants in the 8(a) program do not succeed when they "graduate" from it. The reasons 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.

B. HUBZone Program

The 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, 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. Most significantly, firms must locate their principal place of business in a HUBZone-designated area and have at least 35 percent of their employees residing in a HUBZone-designated area. *Id*. It is important to note that the employees need not live in the HUBZone in which the business is located, but can live in any HUBZone. Presumably, increasing the number of employees with incomes will improve the overall economic development in an area even if the employee does not reside in the HUBZone in which the business is located. For many years, small businesses certified to the SBA and contracting officers that they met the eligibility criteria for inclusion in the HUBZone Program.

Contracting officers relied on these self-certifications and, until recently, the SBA did not check to determine whether the firm's assertion on qualification for eligibility was correct. However, after a series of investigations by the Government Accountability Office (GAO) that found serious flaws in the self-certification by small businesses, the SBA revamped the program to include full front-end certification by agency personnel of HUBZone status. However, such verification by the agency is not an ongoing process. The issue of self-certification after initial entry remains a major vulnerability.[35] 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.

C. Service-Disabled Veterans' Program

[35] GAO, SMALL BUSINESS CONTRACTING, OPPORTUNITIES EXITS TO FURTHER IMPROVE HUBZONE OVERSIGHT 24, (Feb. 2015) (GAO-15-234).

In 1999, Congress amended § 15 of the Small Business Act to require that the President establish a government-wide procurement goal of not less than 3 percent for small businesses owned and controlled by service-disabled veterans.[36] 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.[37] 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 by service-disabled veterans. Even after the enactment of § 36, federal agencies were not meeting the three percent goal, so President George W. Bush issued Executive Order No. 13,360, which requires the heads of agencies develop strategies for implementing and achieving the goals of § 36.

D. 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.[38] 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 the procurement of goods of less than $5,000,000 for contracts with a manufacturing industrial classification or $3,000,000 for all other contracts. Section 825 of the Carl Levin and Howard P. Buck McKeon National Defense Authorization Act for FY 2015 authorized, but did not mandate, contracting officers to award sole source contracts to firms qualified for the women’s procurement program.

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.

E. Subcontracting Issues

Section 15(o) of the Small Business Act, 15 U.S.C. § 644(o), prohibits the award of a contract if the small business subcontracts more than 50 percent of the work (with exceptions that are not relevant for this memorandum) to large businesses. This policy is reflected in federal acquisition rules which require a clause be inserted in all contracts alerting small businesses to

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[36] Veterans Entrepreneurship and Small Business Development Act, Pub. L. No. 106-50, 113 Stat. 233, 247 (1999).
[37] Pub. L. No. 108-183, 117 Stat. 2651, 2662 (codified at 15 U.S.C. § 657f).
[38] Small Business Reauthorization Act of 2000, § 811, Pub. L. No. 106-554 (codified at 15 U.S.C. § 637(m)).

the prohibition in section 15(o).[39] In essence, the Small Business Act and federal procurement regulations prevent a small business from acting as a front for a large business during the bid phase,[40] or can result in contract termination if the violation is discovered after the contract award.[41] Despite these potential penalties, violations of the subcontracting limitations continue unabated. If the purpose of small business contracting programs is to ensure that small businesses are the ultimate recipients of the economic benefits from the award of contracts, then this practice of improper subcontracting, also colloquially referred to as pass-throughs, undermines the Congressional rationale for the creation of the programs in the first instance.

Many small government contractors recognize their limitations in producing large-scale projects or goods needed by the federal government. Typical examples are usually large weapon systems needed by the military, such as aircraft carriers or fighter jets. Despite their limitations in producing such items, Congress recognized that small businesses still might make valuable contributions to the overall development of the larger project by completing smaller tasks conforming to their portfolios, such as developing the flight consoles or turbines for fighter jets. To further these opportunities for small businesses, Congress mandated that small businesses have the maximum opportunity to participate in contracts for major systems. 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 should subject the contractor to liquidated damages.[42] *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)(11). To carry out this mission, SBA personnel are directed to review compliance with subcontracting plans. *Id*. at § 637(d)(11)(C). However, neither federal procurement rules nor SBA regulations specify what decisional calculus should be used by the contracting officer or SBA personnel in assessing

[39] The clause provides that a small business will perform at least 50 percent of the cost of the contract except in construction, including the manufacturing of supplies. For general construction, small businesses must perform 15 percent of the cost (exclusive of materials) and specialty trade construction, 25 percent. 48 C.F.R. § 52.219-14. The clause only applies if the contract is awarded to a small business through a procedure other than full and open competition, i.e., one of the set-aside programs established in the Small Business Act.

[40] The failure of a small business to agree to perform the required amount of work constitutes a non-responsive bid. *See Centech Group, Inc. v. United States,* 554 F.3d 1029, 1038 (Fed. Cir. 2009).

[41] *In re: Barton Chemical Corp.,* 87-1 BCA (CCH) ¶ 19,623 (violation of subcontracting limitation material breach of contract).

[42] 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 an "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 applicable federal procurement rules. *Id*. at § 19.705-7(c).

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.

III. Entrepreneurial Assistance and Outreach Programs

The SBA oversees the operation of a number of programs that provide technical assistance to individuals wishing to start small businesses and to already existing small businesses. Collectively, these programs are categorized as entrepreneurial development, or ED, programs. The programs range from narrowly targeted programs to very broad programs that take advantage of the resources of America's higher education system and volunteer 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's contribution to these outreach efforts.

A. Small Business Development Centers

With 63 lead development centers and over 900 outreach centers,[43] the Small Business Development Centers (SBDC) is the largest ED program. The SBA executes cooperative grant agreements with selected state agencies (or institutions of higher education)[44] to operate centers where prospective entrepreneurs and existing small business owners can go to obtain assistance.[45] Management and technical 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. Funds provided by the federal government must be matched by the SBDC grantee from non-federal sources, such as private donations or state funds.

B. Women's Business Centers

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[43] SBA FY 2017 Congressional Budget Justification, *supra* note 32, at 5.

[44] 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 and women's business centers to be grantees but grandfathering in existing state agency grantees. To complicate matters, state agencies that are grantees often subcontract the provision of services to institutions of higher education. Neither the SBA nor the section of the Small Business Act creating the program makes a distinction between the grantees and the service centers where small businesses are assisted.

[45] 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 ability to provide small businesses with advice about energy efficient technologies and cyber security.

Women's Business Centers (WBCs) were created to provide training, counseling, and mentoring to women entrepreneurs, especially those women who were socially and economically disadvantaged. There are approximately 100 centers nationwide.[46] 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 name 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 so 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 to provide some of the centers with so-called sustainability funds.

C. SCORE

The SBA provides office space to a corps of executives from both large and small businesses. Nationwide, there are over 11,000 SCORE volunteer experts.[47] 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 as much as helping them draft business or marketing plans. The scope of the service provided by the volunteers depends on their interest and the relationship that develops between the volunteers and the clients they are counseling. Although originally known as the Service Corps of Retired Executives, the program is now known as SCORE because many of the contributing executives are active rather than retired. SCORE's monetary assistance primarily relates to the SBA's costs for providing office space, telephones, Internet access and other ancillary services to its volunteers.[48]

D. 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, 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 Veterans Business Outreach Centers (VBOCs) – a program created by Congress in § 32 of the Small Business Act. 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

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[46] SBA FY 2017 Congressional Budget Justification, *supra* note 32, at 5.
[47] *Id*.
[48] The employees of the SCORE organization primarily provide administrative and coordination functions for counselors and clients. No study has been conducted whether those services could be provided at a lower cost by SBA employees.

of services provided to veterans appears to be comparable to the services provided to all entrepreneurs by SBDCs and WBCs.

According to the SBA, funding for Veterans Business Centers includes VBOCs and untested initiatives created by the SBA including: Boots to Business, Veteran Women Igniting the Spirit of Entrepreneurship, Entrepreneurship Bootcamp for Veterans with Disabilities, and Boots to Business Reboot.[49] It should be noted that the Department of Veterans Affairs also offers such programs and has far more resources to assist veterans than the SBA.

E. Native American Outreach

SBA's 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 is little doubt that the Department of Interior has far more resources to assist Native Americans, including entrepreneurs, than the SBA.

F. Office of International Trade

The Office of International Trade (OIT) provides assistance to businesses involved in export or import business.[50] 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. It is not clear what services the Office of International Trade provides that are not available from other sources, particularly the Department of Commerce.

IV. Additional Issues

In previous years, the Committee on Small Business's formal investigations (including examination of specific programs through reviews by GAO) and informal investigations of the SBA have revealed a pattern of problems with the agency. Problems identified by the Committee include, but are not limited to: failure to perform tasks delegated to the SBA by Congress, creation of unauthorized programs, and undocumented ad hoc decisionmaking. In 2015, the GAO issued a report on the overall management of the SBA that found that many long-standing management challenges identified by GAO and the SBA Office of Inspector General (OIG) had not been resolved "due to a lack of sustained priority attention."[51] Management areas identified by GAO that need attention include: strategic planning and program evaluation; human

[49] SBA FY 2017 Congressional Budget Justification, *supra* note 34, at 19.
[50] There are specialized 7(a) guaranteed loans for businesses involved in international trade.
[51] GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES, HIGHLIGHTS (GAO-15-347) (2015) [hereinafter GAO Management Report], *available at* http://www.gao.gov/products/GAO-15-347. In 2016, the Committee held a series of hearings to examine the findings of the GAO Management Report and conduct oversight of the SBA's major programs. The testimony and memorandums from those hearings are available on the Committee's website, https://smallbusiness.house.gov/.

capital management; organizational structure; enterprise risk management; procedural guidance; and information technology.[52] A complete description of the issues that need to be addressed by the SBA would make this already lengthy memorandum even longer, so only a few issues will be highlighted below.

The Standard Operating Procedures, or SOPs, that provide guidance to the lenders encompass about 500 pages. According to the SBA's regulations, lenders must comply with the SOPs in closing loans. As a result, these SOPs then constitute regulations that limit the discretion of the SBA and its lending partners. Yet, the SOPs are not promulgated according to the procedures mandated by the Administrative Procedure Act or the agency's own regulations and is thus regulating through the issuance of non-binding (but the SBA treats as binding) guidance documents. *See Appalachian Power Co. v. EPA*, 208 F.3d 1015 (D.C. Cir. 2000). These ad hoc changes may impose significant costs on lenders as they need to change their processes and procedures.

The SBA, especially since 2009, has created its own initiatives in several areas. The Committee, on a bipartisan basis, has criticized these efforts to divert funds and agency resources from the specifically authorized programs to SBA-created initiatives.[53] The Small Business Act authorizes the SBA to create new lending initiatives not specifically authorized by statute.[54] These are called pilot programs; the SBA establishes them by modifying an SOP and then placing a notice of the pilot program's creation in the Federal Register. The SBA claims it has the authority to conduct these programs pursuant to 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. These programs, such as the Community Advantage pilot program, can add significantly to the subsidy cost of various loan programs.

Since the 2010 Small Business Jobs Act, a number of new reforms have been made each year impacting the SBA, particularly to its government contracting programs. These reforms are critical to small business contractors. Delays in implementation cause hardships for small businesses. For instance, the President signed the fiscal year 2013 National Defense Authorization Act (NDAA) into law on January 2, 2013; 18 months later, SBA had not acted on 75 percent of the items required in the 2013 NDAA. Some of the items in the 2013 NDAA have just recently been resolved in fiscal year 2016. This trend of delayed activity has continued in the following years, compounding as the growing number of reforms remain unaddressed. The true impact of this failure of action is felt most by small businesses. When reforms attempting to align the Small Business Act with small business regulations and the Federal Acquisition Regulations are delayed, a sea of confusion is created for small businesses who cannot be expected to navigate contradictory mandates. When changes to the Small Business Act have occurred but regulatory changes are pending for an extended period of time, small businesses are left in a state of uncertainty and cannot plan accordingly. Additionally, these gaps in implementation create opportunities for fraud, allowing firms to invoke plausible deniability for

[52] *Id*.
[53] This is clearly demonstrated by the Views and Estimates of the Committee on Small Business transmitted to Committee on the Budget for FY2012, FY2013, FY 2014, FY 2015, FY 2016, and FY 2017.
[54] 15 U.S.C. § 636(a)(25).

their bad actions. Systems intended to protect against fraud are not in place, and penalties have not taken effect. Finally, this failure of action frustrates the intent of Congress. SBA must use its resources wisely to prioritize implementing the laws Congress enacts.

Finally, the SBA has done an inadequate job of handling its information technology. Since SBA relies heavily on information technology in the management of its capital access programs (from back office operations utilizing its Loan Management Accounting System) to interfaces with the public and lenders through SBA One, effective information technology security and management of information technology acquisitions is critical. The GAO Management report noted that although the SBA has taken some steps to improve its procurement process, the agency needs to improve its process of acquiring information technology and examining the ongoing performance of its systems.[55] Effective operation and maintenance of the agency's information technology is of critical importance to ensure that SBA meets the needs of small businesses and protects their sensitive information.

[55] GAO Management Report, *supra* note 51, at 29,