REPORT TO THE SUBCOMMITTEE ON MINORITY SMALL BUSINESS ENTERPRISE SELECT COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

Answers To Questions Regarding Arcata Investment Company And SBA's Section 8(a) Procurement Program

B-132740

Small Business Administration

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

NOV. 21, 1973

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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The Honorable Joseph P. Addabbo
Chairman, Subcommittee on
Minority Small Business Enterprise
Select Committee on Small Business
House of Representatives

Dear Mr. Chairman:

As you requested on October 30, 1972, we reviewed certain aspects of Federal programs to develop minority enterprise as set forth in House Report 92-1615, dated October 18, 1972.

We reviewed the Small Business Administration's (SBA's) management of the Government's investment in the Arcata Investment Company, SBA's correspondence files and examination reports, and Arcata's financial statements. We also discussed with agency officials the disposition of Arcata's assets after it became insolvent.

We also reviewed 20 contracts awarded to 6 firms in SBA's Dallas regional office area and reviewed files and interviewed officials in Oklahoma City and Dallas concerning these firms. We visited the companies, interviewed company officials, reviewed files of several Federal agencies which contracted with SBA under the 8(a) program, and interviewed officials at the SBA central office in Washington, D.C.

The specific areas of review set forth in the House Report and the information we obtained follow.

The legality of SBA's agreement with Palo Alto Capital Company and the consequences of this agreement.

SBA had authority under the Small Business Investment Act of 1958 to enter into this agreement. (See app. II).

The legal consequences of Arcata's surrendering of its license to SBA, with particular attention to the Government's rights against Arcata.

The license surrender did not, of itself, release Arcata from any liability to SBA. (See app. II).

The handling of this entire problem over more than a 2-year period and the method of negotiations between Arcata and SBA.

We believe SBA had two options available before it approved the purchase of a second debenture from Arcata in June 1970. After SBA received Arcata's application in March 1970, it could have requested Arcata to immediately submit its program evaluation report as a condition to approval, or SBA could have deferred approval until it received Arcata's program evaluation report on July 29, 1970. Analysis of Arcata's report might have raised enough doubt to require SBA's Examination Division to conduct a special examination of Arcata's portfolio to determine its actual status and value. Such an examination would probably have disclosed that Arcata was insolvent and that there was little prospect that Arcata could repay a second debenture of $300,000.

Although SBA's selection of Palo Alto for servicing certain Arcata loans was legally sound, we have reservations about this decision because of Palo Alto's past performance and its increasing retained earnings deficit. (See app. I).

Whether the current operation of the 8(a) program is being conducted pursuant to proper legal and legislative authority?

Whether the present administration of the 8(a) program by SBA is in direct violation of Section 2 of the Small Business Act which states that, it is the declared policy of Congress that the Government should aid, counsel, assist and protect, insofar as possible, the interest of (all) small business concerns?

Whether the operation of the appropriated $8 million differential in the 8(a) program is being properly and legally administered and distributed?

All three questions are answered by the case of Ray Baillie Trash Hauling, Inc. v. Kleppe. The court concluded the broad and general language of the Small Business Act was sufficient authority for establishing SBA's 8(a) program and, although the 8(a) program competitively favors minority enterprise small business concerns, the favoritism is not illegal.

Although not mentioned in the statute or SBA's governing regulation, differential payments are not illegal and are not an abuse of the agency's power. (See app. III).

In our review of the program's administration, we found:

--A lack of definitive eligibility requirements makes it difficult for SBA field personnel to determine eligibility for 8(a) assistance. Without such requirements, it is impossible to insure that only eligible small businesses receive 8(a) assistance and business development expense (BDE) allowances.

--Inconsistent guidelines for awarding BDE have resulted in individual justifications of BDE which are inconsistent with stated policy. This causes confusion in the SBA field offices as to what constitutes BDE and when it can be paid.

--8(a) contractors often do not maintain accounting systems which accumulate cost information by individual contract or product. Therefore the contractor cannot provide realistic cost or pricing data for use in later price proposals and SBA cannot determine the reasonableness of BDE already approved.

SBA examined this report and generally agreed with its contents.

We trust that this information will be beneficial in your evaluation of these specific aspects of Federal programs to develop minority enterprise.

We do not plan to distribute this report further unless you agree or publicly announce its contents.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

BDE	business development expense
MESBIC	minority enterprise small business investment company
OBD	Office of Business Development
SBA	Small Business Administration
SBIC	small business investment company
SOP	Standard Operating Procedure

THE SMALL BUSINESS ADMINISTRATION'S REGULATION OF ARCATA INVESTMENT COMPANY

MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES

Under the Small Business Investment Act of 1958, the Small Business Administration (SBA) licenses, regulates, and provides supplemental financing to privately and publicly owned small business investment companies which provide small business with long-term investment capital.

In 1969, SBA initiated the minority enterprise small business investment company (MESBIC) program to establsih small business investment companies which would specialize in providing capital to minority businessmen. As of December 31, 1972, 53 MESBICs had been established with total private funds of about $18.4 million.

ARCATA, THE FIRST MESBIC

The Arcata Investment Company was incorporated under California law on July 16, 1968, and was licensed by SBA as a small business investment company (SBIC) on August 13, 1968. The licensee is wholly owned by Arcata National Corporation, a publicly held corporation.

Arcata's primary purpose was to finance small businesses in economically depressed areas in California. Arcata planned to invest, through loans and equity investments, in minority and ghetto owned and operated businesses in order to stimulate entrepreneurial talent in the communities and to help develop an economic base for minority business involvement and expansion. It expected the minority-owned businesses, for which Arcata would provide the seed capital, to become profitable ventures; the operation was to be an investment and not a grant program. SBA supported the SBIC program but recognized the high risk and speculative nature of such investments.

Arcata became known as the first MESBIC because it was an investment company that specialized in providing venture capital and management assistance to minority businesses.

APPENDIX I

SBA's PURCHASE OF THE FIRST DEBENTURE

The parent company, Arcata National Corporation, provided initial investment capital of $150,000 to Arcata Investment Company. On March 5, 1969, SBA purchased a $300,000 debenture from Arcata at a 5-7/8 percent per annum interest rate. The principal was to be repaid at $60,000 a year over 5 years, beginning 11 years after the purchase date.

As of June 30, 1969, Arcata had loaned $212,538 to 19 small businesses at an 8-percent interest rate and had invested $5,250 in stocks of 2 of these businesses. Arcata's financial report at June 30, 1969, disclosed that the company had a $63,646 retained earnings deficit which represented 42.4 percent of its private paid-in capital and surplus. (A MESBIC, as well as an SBIC, was considered to be "capitally impaired" when its retained earnings deficit exceeded 50 percent of its private paid-in capital and surplus.)

SBA notified Arcata in October 1969 that it was encroaching upon a deficiency. The problem was resolved to SBA's satisfaction when the parent company increased Arcata's paid-in capital by $150,000 in December 1969, which decreased its capital impairment percentage.

The deficiency resulted from two poor investments in local supermarkets. Arcata had guaranteed a bank loan for $27,000 to one grocery store which defaulted on the loan and had established an $18,000 allowance for losses against a direct loan of $26,500 made to the other store which apparently was not getting community backing and was having operating difficulties.

SBA's PURCHASE OF THE SECOND DEBENTURE

Due to the $150,000 increase in Arcata's private capital, Arcata was eligible for an additional $300,000 in SBA funds and applied for this financing on March 27, 1970. Arcata submitted the necessary forms, including its certification that its financial condition had not worsened since it filed its last financial report. After a review of the information available to the Investment Division, SBA approved the purchase of the second debenture on June 8, 1970.

Some of the information available to the Investment Division prior to approval were (1) a financial report of March 31, 1970, which SBA received on May 22, 1970, and (2) a report by SBA's SBIC Examination Division covering the 13-month period ended Janaury 31, 1970.

The financial report showed that Arcata had loaned about $508,000 and had established an allowance for uncollectibles of $23,603, or about 5 percent of these high-risk loans. An SBA official said that a 10-percent reserve would be considered about average for a regular SBIC. We also noted that in the Investment Division's analysis of the March 31, 1970, financial report, SBA used an estimated loss of 40 percent. SBA based this estimate on its knowledge that the portfolio would be composed of the highest risk ventures and not on any facts presented.

The examination report noted that the licensee's files contained adequate information, including the financial statements, on the portfolio companies. The small, 5-percent allowance for uncollectibles for these known high-risk loans was not questioned. The workpapers did show that no attempt was made to valuate the reserve allowance because the portfolio consisted of very small firms almost all of which had borderline chances to become successful.

After SBA approved the purchase of the $300,000 debenture, it received the June 30, 1970, financial report from Arcata showing a writeoff of $347,576 of the loans as estimated or actual losses. Arcata also had estimated the loss of all the $22,000 invested in capital stock.

The large financial loss from investments had increased the retained earnings deficit of $67,158, or about 22 percent of paid-in capital and paid-in surplus at March 31, 1970,

to a deficit of $448,938, or about 149 percent of paid-in capital and paid-in surplus at June 30, 1970. In September 1971, SBA amended its regulations for MESBICs whereby it considered firms capitally impaired when the deficit equaled or exceeded private paid-in capital and surplus.

An SBA official said that, when Arcata applied for the second loan, SBA had no reason to suspect that a large writeoff of outstanding loans would be made on the June 30, 1970, financial report. The document approving the loan in June 1970 stated that the March 31, 1970, financial report revealed no information that would raise any serious doubt as to Arcata's ability to repay the requested funds. However, Arcata employed a new manager as of July 1, 1970; and the Arcata Management Company, a business development organization established by Arcata National Corporation, had begun surveying and auditing Arcata's clients in June 1970. The management change and audit quickly resulted in disclosure of Arcata's impaired condition.

SBA requires each licensee to submit a program evaluation report by June 30 on the current status of its portfolio loans as of March 31 of each year. SBA did not receive Arcata's report until July 29, 1970, but it approved the purchase of a second debenture on June 8, 1970.

Arcata's report on March 31, 1970, on the status of the 37 loans indicated that repayment of 7 loans, or 29 percent of the dollar amount, was in jeopardy and some loss was probable; and that repayment of 16 loans, with 44 percent of the dollar amount of the portfolio, was possible but not assured, pending improvement in the small business firms. As noted in an SBA examination report of Arcata for the 13-month period ended February 1971, 5 of the firms reported in jeopardy failed by June 30, 1970. Although Arcata had established no allowance for losses for four of these firms and only $18,000 allowance for one of the firms, it wrote off about $135,000 of loans to these five firms.

In our opinion, SBA had two options before it approved the second debenture. After it received Arcata's application on March 27, 1970, it could have requested Arcata to immediately submit its program evaluation report as a condition to approval or it could have deferred approval until it received Arcata's program evaluation report. Analysis of Arcata's report might have raised enough doubt to require

SBA's SBIC Examination Division to conduct a special examination of Arcata's portfolio to determine its actual status and value. Such an examination would probably have disclosed that Arcata was insolvent and that there was little prospect that Arcata would be able to repay the second debenture.

APPENDIX I

SETTLEMENT AGREEMENTS

The financial report of June 30, 1970, received by SBA in November 1970, showed Arcata was insolvent. SBA sent a letter on December 1, 1970, to Arcata's Board of Directors requesting the licensee's parent to make a cash contribution of $448,938, the amount of the retained earnings deficit, as paid-in surplus and thus eliminate the deficit. An official of the parent company informed SBA it could not comply with the request. SBA then had to try to resolve the Arcata situation without any adverse action that would affect the total MESBIC program. (Arcata was the first MESBIC, and SBA was still trying to recruit companies to establish additional MESBICs.)

SBA examined Arcata again for the 13-month period ended February 28, 1971. The examiners found that Arcata was capitally impaired because the retained earnings deficit was 150 percent of the paid-in capital and surplus. Also, according to the minutes of the Board of Directors meeting on December 11, 1970, the parent company would not decide whether to put additional funds into Arcata until legislative and regulatory changes were made in the MESBIC program.

Palo Alto Capital Company (Palo Alto), another MESBIC in Palo Alto, California, offered in August 1971 to thoroughly review and analyze Arcata's portfolio to determine which firms might have a chance for survival. Then it would service these firms' investment loans.

Palo Alto determined that 22 firms, with loans amounting to $255,590, might be viable. Since SBA wanted to keep the minority-owned portfolio businesses in operation, it entered into a tripartite, 5-year agreement on April 21, 1972, with Arcata and Palo Alto for the disposition of all assets of Arcata which had become insolvent.

Arcata was to assign the loans of the 22 firms to Palo Alto for management, administration, and servicing. Palo Alto would be allowed to keep from collections received no more than $150,000 for allowable costs and expenses during the 5 years. Without SBA's approval, it could keep no more than $35,000 the first year; $35,000 the second year; $30,000 the third year; $25,000 the fourth year; and $25,000 the fifth year.

Palo Alto began servicing the loans on January 1, 1972, although the agreement was not signed until April 1972. During the first year, it collected $28,973 from the Arcata portfolio loans and reported its management and servicing costs as $24,000. Palo Alto could withold up to $25,000 from the annual remittances to SBA as a reserve for future allowable costs. SBA was to receive all receipts in increments over a 5-year period after Palo Alto was reimbursed. We believe, however, that SBA will receive no collections during the 5 years and that very few good assets will be available at the end of the agreement period. Three of the 22 firms Palo Alto is managing have failed, and 9 firms were delinquent in their payments at the end of the first year.

SBA also entered into a bilateral agreement on July 20, 1972, with Arcata. SBA was assigned the remaining loans of 25 small businesses not considered viable. The 25 businesses had received loans and equity investments amounting to $466,183 from Arcata, and most businesses were in default or bankruptcy and their assets thus had to be liquidated. Arcata surrendered its license as a small business investment company when it entered into this agreement.

SBA's SELECTION OF PALO ALTO FOR SERVICING SELECTED ARCATA LOANS

SBA's examination of the Palo Alto Capital Company for the 11-month period ended January 31, 1972, showed 6 of Palo Alto's 15 portfolio loans were insolvent and were expected to be complete losses to Palo Alto. These 6 loans represented 45 percent of amounts invested by Palo Alto. We question the propriety of SBA's selection of Palo Alto to manage and service Arcata's loans when Palo Alto was having significant problems with its own investments.

SBA licensed Palo Alto as a MESBIC on October 16, 1969, and had examined the Palo Alto portfolio three times by January 1972. Palo Alto's retained earnings deficit was 4 percent of its paid-in capital and surplus in February 1970, 54 percent in January 1971, and 74 percent in January 1972. But it was not considered capitally impaired when the settlement agreement was reached, because SBA amended its regulations in September 1971 so that MESBICs were not considered capitally impaired until their retained earnings deficit equaled their paid-in capital and surplus.

Palo Alto's operating expenses are paid in part by its parent company, Varian Associates. Until Palo Alto has enough income to defray all of its expenses--about $26,000 before it began servicing the Arcata loans--its parent company is paying all expenses above $15,000 a year. Palo Alto estimated that its annual expenses after it services the new loans will be about $40,000. It expects to devote about 80 percent of its efforts to the Arcata loans in the last half of calendar year 1972 because these loans had been somewhat unattended over the past year. Palo Alto reported to SBA that its servicing costs during 1972 for the Arcata loans were $24,000.

The financial report of September 30, 1972, showed that six delinquent loans of Palo Alto's were written off as uncollectibles. It is now servicing 9 of its own loans and 22 loans assigned from Arcata. Although we found no documentation as to why SBA selected Palo Alto, an official in SBA's Investment Division said that since Palo Alto was a MESBIC like Arcata and thus was servicing similar loans, it could render better management assistance to minority businesses than SBA's own servicing personnel. Palo Alto offered to service Arcata's loans, and SBA concluded that the MESBIC

program would be served more effectively if SBA accepted this offer. Since Palo Alto had been incurring a loss each year, the additional income guaranteed for the next 5 years from managing the assigned loans would help Palo Alto remain solvent.

We have reservations about SBA's decision to assign the better loans of Arcata to Palo Alto because of Palo Alto's past performance and its increasing retained earnings deficit. But an SBA official said that incurring losses in these high-risk loans does not necessarily indicate poor management and that SBA highly regards the president/manager of Palo Alto.

SBA LOSSES FROM BUSINESSES FINANCED BY ARCATA

SBA purchased $600,000 of debentures from Arcata. We estimate that borrowers will repay about $180,000. The loss of Government funds has resulted from many of the portfolio firms becoming insolvent.

After analyzing the investment portfolio, the parent company of Arcata informed SBA that it accepted full responsibility for Arcata's poor investment decisionmaking which was the most important factor underlying Arcata's failure rate. The parent company believed, however, that, even with a normal rate of business failures, a MESBIC would ultimately end in a capitally impaired position because a SBIC's financial structure is not compatible with the financing requirements of the many small- and medium-sized minority-owned businesses.

The Small Business Investment Act of 1958 was amended by Public Law 92-595, approved October 27, 1972, to recognize a MESBIC's special needs in financing disadvantaged small businesses. SBA may now purchase shares of nonvoting stock in a MESBIC.

The following table shows the actual and estimated losses as of December 1972 on the loans to be serviced by Palo Alto and SBA in the next 4 years.

	Original loan amount	Losses		
		Actual	Estimated	Total
Arcata's portfolio investments:				
Loans to be liquidated by SBA	$466,183	$ 85,900	$370,960	$456,860
Loans to be serviced by Palo Alto	255,589	16,650	68,350	85,000
Total	$721,772	$102,550	$439,310	$541,860

SBA purchased two debentures from Arcata totaling $600,000. At the time of the settlement agreements, the total balances outstanding of Arcata's loans to the 47 firms were $721,772. Arcata transferred loans of $466,183 to 25 of these firms to SBA for liquidation. SBA considers these loans valueless and expects only about a 2-percent recovery.

The losses from the $255,589 of Arcata loans serviced by Palo Alto can not be readily determined. The report received from Palo Alto in January 1973, after the first year of servicing, shows that three firms had failed with a total loss of $16,650. Nine others with total loan balances of about $89,530 were delinquent.

The estimated loss of $85,000 shown in the above table for the Arcata loans serviced by Palo Alto is based on our projected loss rate of 33 percent on all loans serviced by Palo Alto. Under the tripartite agreement, Palo Alto is allowed to recover costs of up to $115,000 in the next 4 years, plus $24,000 for management costs in the first year. It earned $9,517 in interest on the loans in the first year. The higher management costs must therefore be paid largely from principal payments made on the loans. On the basis of the first year's report, we believe that SBA will recover very little of the repaid funds on loans assigned to Palo Alto.

SBA also provided $1,870,912 in direct or guaranteed bank loans to 25 of the Arcata portfolio firms. In February 1973, SBA estimated a loss of $729,335 on these loans. The following table summarizes SBA's direct and insured loans to these firms.

	Original loan amount	Losses		
		Actual	Estimated	Total estimated by SBA
Firms assigned to SBA	$ 798,200	$306,646	$255,801	$562,447
Firms serviced by Palo Alto	1,072,712	166,888	-	166,888
Total	$1,870,912	$473,534	$255,801	$729,335

SBA provided $798,200 in direct loans or insured bank loans to 13 of Arcata's portfolio firms being liquidated by SBA. SBA had written off loans amounting to $306,646 to seven of these firms by February 1973; SBA estimates an additional loss of $255,801 from these 13 loans.

SBA had made direct loans or insured bank loans amounting to $1,072,712 to 12 of the portfolio firms serviced by Palo Alto. As of February 1973, SBA had written off one full and two partial loans in the amount of $166,888 to three of these firms. We believe SBA is being very optimistic by not anticipating any further losses from these loans. At December 31, 1972--the end of the first year of servicing--Palo Alto considered three firms with direct loans as having marginal potential to remain viable.

ANSWERS TO LEGAL QUESTIONS REGARDING

ARCATA INVESTMENT COMPANY

AND PALO ALTO CAPITAL COMPANY

1. The legality of SBA's agreement with Palo Alto Capital Company and the consequences of this agreement.

2. The legal consequences of Arcata's surrendering of its license to SBA, with particular attention to the Government's rights against Arcata.

SBA had statutory authority to enter into these agreements. By virtue of the Small Business Act, which is made applicable to the Small Business Investment Act by 15 U.S.C. 687(f), the SBA Administrator may

> "* * * collect or compromise all obligations assigned to or held by him and all legal or equitable rights accruing to him in connection with the payment of such loans until such time as such obligations may be referred to the Attorney General for suit or collection; * * *." (Public Law 85-536, July 18, 1958, 72 Stat. 385, as amended, 15 U.S.C. 634(b)(2)). (Underscoring supplied.)

The exact terms and conditions under which SBA may collect or compromise the obligations owed are, by regulation (13 CFR 107.204), left to the discretion of the SBA Administrator. Thus, the transfer of a MESBIC's assets appears to be a reasonable procedure in settling a debenture obligation and one to which SBA could agree. Transferring Arcata's then-viable minority enterprise portfolio firms to Palo Alto was an attempt to keep these firms in operation and was consistent with the policy of the Small Business Investment Act (15 U.S.C. 661) of aiding the growth and expansion of small businesses. And as long as the portfolio firms were kept in operation, there was the possibility of repayment to SBA of the money which it had originally invested in Arcata and which it had reinvested in the minority firms. Finally, the transfer to Palo Alto relieved SBA of the burden of managing and servicing these firms. Additional comments regarding SBA's decision to assign Arcata's loans to Palo Alto can be found on page 8 of appendix I.

Arcata's surrender of its SBIC license prevented it from functioning as a SBIC but did not, of itself, release Arcata from any liability to SBA. That release was accomplished by a July 20, 1972, contract between Arcata and SBA, which states in paragraph 3:

> "In consideration of such assignments and in consideration of the assignments of assets described in Schedule A hereto to PACC (Palo Alto Capital Corporation), SBA hereby fully releases and discharges Arcata from all its indebtedness to SBA to the full extent thereof, and SBA hereby assumes and agrees to perform and discharge all of Arcata's obligations and liabilities under the subordination and standby agreements and guarantees described on Schedule B(1) hereto."

The remaining legal consequences of this contract are succinctly set forth in the minority views of the House Report.

> "Further, the settlement with Arcata was without prejudice to civil or criminal causes of action which may lie against any individuals connected with Arcata. There is presently no evidence, however, that any such liabilities exist. In addition, SBA succeeds to any rights Arcata may have had against any of its portfolio companies or their officers or other individuals connected therewith." (H. Rept. 92-1615, p. 27.)

ANSWERS TO LEGAL QUESTIONS REGARDING

SECTION 8(a) PROCUREMENT PROGRAM

"2. 8(a) Procurement Program:

(a) Whether the current operation of the 8(a) program is being conducted pursuant to proper legal and legislative authority;

(b) Whether the present administration of the 8(a) program by SBA is in direct violation of Section 2 of the Small Business Act which states that, 'It is declared policy of Congress that the Government should aid, counsel, assist and protect, insofar as possible, the interest of (all) small business concerns.'

(c) Whether the operation of the appropriated $8 million differential in the 8(a) program is being properly and legally administered and distributed."

Under section 8(a) of the Small Business Act, SBA negotiates procurement contracts with other Federal agencies for goods and services and subcontracts these contracts to small business firms. SBA began using its section 8(a) authority in fiscal year 1968 to enable more eligible disadvantaged persons to own and control small businesses. SBA has continued this program to help disadvantaged firms and individuals develop self-sustaining and viable small businesses.

In fiscal year 1972, SBA, after informing the Congress of its intent to do so, budgeted $8 million for the purpose of reimbursing Federal agencies for amounts paid to 8(a) contractors above those prices the agencies would have paid under competitive bidding. SBA refers to this differential as a business development expense (BDE).

All three questions are answered by the Fifth Circuit Court of Appeals in the case of Ray Baillie Trash Hauling, Inc. v. Kleppe, 477 F. 2d 696, (1973). The court reviewed the authority for SBA's 8(a) program. The plaintiff had contended that SBA lacked the statutory and constitutional authority to establish its 8(a) program. The court held that the broad and general language of the Small Business

Act was sufficient authority for establishing the 8(a) program and that specific statutory language mentioning the program was not required.

The thrust of the second question is whether SBA's 8(a) program is favoring minority enterprise small businesses at the expense of nonminority firms. The plaintiff had contended that the administration of the 8(a) program violates due process. In specifically rejecting this argument, the court holds:

> "* * * in the case at bar we cannot accept the plaintiff's argument that the section 8(a) program is unconstitutional because the plaintiffs may be disadvantaged competitively. There is no constitutional duty to offer government procurement contracts for competitive bidding [under section 8(a) of the Small Business Act, 15 U.S.C. 637(a)(2)]. The SBA has the statutory authority to assist small business concerns through private placement of contracts. We have already held that SBA has not abused its discretion in adopting the section 8(a) program. The program may produce some inequalities among small business concerns as a class. But in the area of socio-economic legislation, the government's action must be upheld if it is rationally related to a proper government purpose. * * * We hold that it is." 477 F. 2d 696, 709. (Emphasis added.)

Although the 8(a) program competitively favors minority enterprise small business firms, the favoritism is not illegal.

Because of the plaintiff's lack of standing to sue, the court did not rule on the merits of the plaintiff's other contention that the 8(a) program violates due process by basing eligibility for contracts primarily on race, color, or ethnic origin. However, in one case, Fortec Constructors v. Kleppe, 350 F. Supp. 171 (D.D.C. 1972), it has been held that the eligibility standards for the 8(a) program are not defined racially but in terms of social or economic disadvantage. Precedent, then, would not have sustained Baillie on this unanswered point.

The April 18, 1973, Ray Baillie decision discussed above replaced an earlier decision of January 5, 1973, in the same case. Both decisions reached the same conclusion to the questions asked by the House report. On the basis of the January Ray Baillie decision and the absence of any contrary Court of Appeals decision, we have refused to question the validity of the 8(a) program.

In response to the third question, the payment of differentials to assist in developing minority-owned small businesses is apparently within the authority granted SBA by the Congress. Differential payments are not mentioned in either the SBA statute or the regulation governing the administration of the 8(a) program. This, however, does not make the differential program illegal. This point was made in the Ray Baillie case. The plaintiff in that case contended that the 8(a) program was unauthorized because it was not specifically mentioned in the Small Business Act. The court answered:

> "* * * This argument is without merit. The complex and volatile nature of problems, including allocation of government procurement contracts, often causes Congress to cast its statutory provisions in general terms, leaving to the agency the task of spelling out the specific regulations and programs. In this manner, agency expertise may be fully employed in dealing with such problems. The agency may evaluate the competing alternatives and formulate the policy best suited to the attainment of the statutory goal.
>
> "Furthermore, the agency is left free to respond to the demands of changing circumstances or conditions unanticipated by Congress. Indeed, an agency could easily be prevented from serving its intended purpose if burdened with specific statutory regulations and programs." 447 F. 2d 696, 703.

SBA has determined that differential payments are a necessary part of the 8(a) program and has notified the Congress of its intent to use a portion of the monies

appropriated for its Business Loan and Investment Fund.[1] Congress subsequently appropriated money for this Fund without any restriction with respect to the 8(a) program. (Public Law 92-77, approved August 10, 1971, 85 Stat. 245, 267.) Therefore, the 8(a) program does not appear to be an abuse of the agency's power, even though differential payments are not specificially mentioned by statute or regulation.

In administering the program, SBA uses criteria which are not mandated by statute or regulation but which appear only in SBA internal policy documents. A violation of the criteria would not constitute an illegal action unless the agency's action in a particular case is so far beyond the established criteria that it falls outside even the very broad grant of authority created by the basic statute.

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[1] Hearings before a Subcommittee of the Committee on Appropriations, House of Representatives, 92d Congress, 1st session.

SBA's PAYMENT OF BUSINESS DEVELOPMENT EXPENSES UNDER SECTION 8(a) PROCUREMENT PROGRAM

Because eligible small businesses are often new and their owners are relatively inexperienced, negotiated 8(a) contract prices are frequently not competitive. Prior to fiscal year 1972, any amount paid to a section 8(a) contractor above the competitive market price was paid by the Federal agencies purchasing the goods or services.

The following table shows the amount of BDE SBA paid during fiscal years 1972 and 1973.

BDE Payments Fiscal Years 1972 and 1973
Compared to Total 8(a) Awards

Fiscal year	Total 8(a) awards		BDE actual payments			BDE requests denied
	Number	Value	Authorized	Number	Value	
		(millions)	(millions)		(millions)	
1972	1,719	$153	$ 8	73	$ 4.1	12
1973	2,016	217	14	127	6.1	15
Total	3,735	$370	$22	200	$10.2	27

SBA awarded 41 contracts totaling $2.3 million in BDE during fiscal years 1972 and 1973 to 8(a) contractors in the Dallas regional office area. We reviewed 6 firms which had received 20 of these contracts totaling $1.1 million in BDE. Four of these contractors were under the jurisdiction of the Oklahoma City district office and two were under the Dallas regional office. These firms had been in the program for a long time or had received large amounts of BDE.

CRITERIA FOR ESTABLISHING 8(a) ELIGIBILITY

According to part 124, SBA Rules and Regulations, the principal factor in becoming eligible for 8(a) assistance is qualification as a socially or economically disadvantaged person. These guidelines define a disadvantaged person as one who has

> "been deprived of the opportunity to develop and maintain a competitive position in the economy * * *. Such disadvantages may arise from cultural, social, chronic economic circumstances or background, or other similar cause."

Other than noting that certain minority groups have been so deprived, SBA has not elaborated on what specific factors should be considered in determining whether an individual is disadvantaged. Apparent confusion among SBA field personnel in determining who is eligible has resulted in inconsistent determinations.

For example, in the Dallas region, an established food service company in July 1970 assisted a minority in submitting a business plan to set up a food service firm eligible for 8(a) assistance. The minority had served 20 years in the Army as a cook, baker, and mess sergeant and had worked for several companies managing food service operations at a naval station. SBA disapproved his application because it found no support for his disadvantaged position. SBA concluded that his experience in managerial positions, his salary level, and his economic status made him capable of obtaining contracts through competitive bidding.

In May 1971, the same food service company sponsored another minority in a similar arrangement. The minority had attended college, had owned his own business, and had held various positions, including service as area field director (GS-16) with the Veterans Administration, with the Government over a 16-year period. In spite of his past experience in responsible positions, SBA approved the plan and determined him to be eligible for 8(a) assistance.

A lack of definitive criteria apparently has made it difficult for field office personnel to determine whether an individual is disadvantaged and eligible for 8(a) assistance. Without adequate criteria, we could not determine whether 8(a) assistance and BDE have been awarded only to small businesses owned by disadvantaged individuals.

In a recent audit of the 8(a) program, SBA's internal audit staff examined randomly selected cases at three regional offices and found that firms were approved for 8(a) assistance without adequate documentation that the applicant was

disadvantaged. In some cases, the staff found indications that he may not have been disadvantaged. At each office, there were cases where firms were approved only on the basis of minority ownership.

SBA's internal audit staff noted that field personnel had interpreted the eligibility requirements differently and concluded that

> "Without an adequate definition and related criteria to apply to a 'disadvantaged' determination, there can be no assurance that only disadvantaged persons are in fact benefiting from the program."

They recommended, in July 1973, that the Standard Operating Procedures (SOPs) prescribe specific variables to be considered in determining whether an applicant is disadvantaged. SBA's Office of Business Development (OBD) replied that the new SOP would be expanded to delineate several variables to be considered in determining social and economic disadvantage.

TYPES OF 8(a) CONTRACTORS RECEIVING BDE

According to the SOPs, normally BDE payments are limited to 8(a) manufacturing contracts and do not apply to construction or service contracts. BDE is not normally required on construction contracts because most 8(a) construction contractors are more experienced than other types of firms that need primarily sales help or help in meeting bonding requirements. Most construction contracts have unique requirements which cannot be compared on an item-by-item basis to other construction contracts. Therefore, past experience cannot be used to determine a fair and reasonable price except when the contract requirements are essentially the same (as in painting contracts).

SBA applies this same reasoning to service contracts that are essentially unique and not subjected to determining a fair and reasonable price from experience. Also, the major expense in a service contract is direct labor which does not vary extensively between contractors. SBA therefore believes such contracts do not generally require BDE.

The following table indicates by class the number and amount of 8(a) awards and the number of BDE payments in each class for fiscal year 1972.

8(a) Awards and BDE Payments by Class
Fiscal Year 1972

	Total 8(a) awards						BDE			
Class	Number of firms	Percent of firms	Number of awards	Percent of awards	Value	Percent of total value	Number of firms	Percent of firms	Number of awards	Percent of awards
					(000 omitted)					
Manufacturer/ Supply	128	12.4	203	11.8	$ 47,187	30.7	38	73	59	81
Service	469	45.4	769	44.7	66,401	43.2	11	21	11	15
Construction	337	32.7	649	37.7	27,663	18.2	1	2	1	2
Other	98	9.5	98	5.8	12,139	7.9	2	4	2	2
Total	1,032		1,719		$153,390		52		73	

SBA guidelines do not restrict the number or amount of BDE payments one company can receive. Twenty-three companies received 53 of the 127 contracts which contained BDE provisions in fiscal year 1973. As shown in the following table, SBA paid these companies $2.6 million in BDE. These payments

represented 43.3 percent of the total $6.1 million in BDE payments for fiscal year 1973.

Companies Receiving More Than One BDE Payment
Fiscal Year 1973

Company	Number of 8(a) contracts	Contract amount	Total BDE	Percent of BDE
Catering company	2	$ 1,440,180	$ 72,180	5.2
Furniture company	3	673,567	65,264	10.7
Clothing manufacturer (note a)	2	2,364,100	294,000	14.2
Clothing designer	2	168,037	12,694	8.2
Engineering company (note a)	3	1,425,534	139,352	10.8
Oil company	2	82,200	15,600	23.4
Chemical packaging company (note a)	2	467	81	21.0
Machine shop	2	41,464	5,298	14.7
Food company (note a)	3	5,484,163	524,164	10.6
Canvas products manufacturer	2	1,343,950	87,950	7.0
Contractor	2	279,400	55,675	24.9
Wood product manufacturer	4	488,012	66,090	15.7
Upholstery company	2	366,126	28,492	8.4
Food processor	2	70,883	12,038	20.5
Chemical manufacturer	2	154,270	29,727	23.9
Dairy company	2	995,034	159,050	19.0
Plastic container manufacturer	2	107,550	30,510	39.6
Electronics company	2	135,644	16,009	13.4
Laboratory	2	55,070	8,010	17.0
Meat processor	2	3,204,580	524,500	19.6
Food service company	2	954,454	40,235	4.4
Tool company (note a)	3	1,801,114	262,266	17.0
General manufacturing company (note a)	3	1,281,656	174,579	15.8
Total	53	$22,917,455	$2,623,764	12.9

[a]Companies that received more than one BDE payment in fiscal year 1972 also.

SBA disapproved 15 BDE requests in fiscal year 1973, but not on the basis of lack of funds. Over $7.9 million of the authorized $14 million remained available for BDE payments at the end of the year.

INCONSISTENT GUIDELINES FOR AWARDING BDE

SBA policy on BDE is set forth in the following November 9, 1971, statement.

> "Section 8(a) contracts will be awarded at prices which are fair and reasonable to the Government, considering the objectives of the program. Inclusions in these prices for BDE will be limited to non-recurring situations determined essential to the fulfillment of the program objectives, such as where new equipment or tooling is needed which cannot be amortized over a long period because of the lack of a reasonably certain market, where full labor productivity has not been established because of newness of the enterprise, etc. * * *."

An internal SBA regulation, dated December 6, 1972, defines BDE as follows:

> "SBA will pay the BDE on 8(a) contracts effective July 1, 1971. This expense is to be construed as the difference between the market price a procuring agency would currently pay by competitive bidding and the amount SBA agrees to pay the 8(a) contractor."

Personnel in the Dallas SBA regional office indicated they were confused as to what consitutes BDE and when it can be paid. They advised us that their concept of BDE had changed from initial startup costs as explained in a SBA policy statement to simply the difference between the contract price and what SBA pays the 8(a) contractor (as defined in another internal regulation).

We found in the Dallas region that BDE payments made to two 8(a) companies were based only on this difference and not on specific, nonrecurring costs.

One of these companies has been in the 8(a) program since October 1970 when it received its first contract for $5 million to process canned hams for the Defense Supply Agency. This contract was awarded before SBA began paying BDE, and we were told that during that period the Defense

Supply Agency paid any differential included in the price. Since November 1971, SBA has awarded additional contracts totaling $5,685,482, including $525,382 BDE (37 percent of all BDE funds distributed by Dallas from inception of program to December 13, 1972) to this company for the same product, BDE payments were justified as the "difference" between the Defense Supply Agency's "fair market price" and the price negotiated between SBA and the 8(a) contractor. We found information in BDE justification files identifying individual cost elements, but we could not find an explanation of why these cost elements were higher. This company has received BDE on six different 8(a) contracts for the same product with the same Government agency.

BDE justification for the last award (December 1972) included cost elements which were higher than similar cost elements of competitive firms for such items as labor, containers, other parts, and product losses or waste. All of these costs are recurring and thus payment of BDE for these items is contrary to SBA's criteria.

An SBA official in the Washington central office advised us that SBA is no longer limiting justification for BDE to nonrecurring situations. He explained that payment of BDE is justified when the cost is "unique" and "unusual," and he provided examples, such as startup costs. But he stated that a more explicit definition of BDE had not been formalized or circulated to the field.

A recent audit by SBA's internal audit staff stressed the need for uniform criteria for payment of BDE. The staff found that

> "* * * criteria for payment of Business Development Expense (BDE) to 8(a) contractors, set forth in SOP 60-43, conflicts with criteria set forth in SOP 60-40. As a result, individual case justifications of BDE are inconsistent with stated policy."

They recommended "* * * that the Central Office reconcile the conflict between policy and procedure statements." OBD replied that "* * * the new Policy and SOP will be in harmony and that the word 'nonrecurring' has been dropped from the Policy." OBD also stated that SBA management is

reviewing the policy on how, when, and where BDE may be used and that OBD will be working on a list of allowable BDEs to be included in the SOP.

CONTRACT PRICING

SBA requirements

SBA guidelines require that 8(a) contractors submit a price proposal to SBA by cost element plus proposed profit. When the contract price exceeds $100,000, the contractor must submit a "Certificate of Current Cost or Pricing Data" in accordance with requirements set forth in the Federal Procurement Regulations and the Armed Service Procurement Regulations. The contractor must certify that, to the best of its knowledge and belief, the cost or pricing data submitted or identified was accurate, complete, and current.

Guidelines state that the basis for determining the fair market price for 8(a) contracts shall be determined by individual negotiation with each procuring agency. These negotiations should result in either a price which is acceptable to SBA, the 8(a) contractor, and the procuring agency, or a difference (BDE) between the 8(a) contractor and the procuring agency price. In postnegotiation actions, the differences are reexamined with the 8(a) contractor to determine possible revision of the contractor's proposal or mutual confirmation that the differences are fair and reasonable.

Verification of contractor proposals

The accuracy of the cost or pricing data that the contractor submits significantly affects the BDE determination. If cost or pricing data are inflated, BDE will be too high. Under SBA's guidelines, the SBA negotiator is required to prepare a negotiations memorandum which includes a comprehensive report of the negotiations session, pricing rationale, and certification that the contractors' costs have all been reviewed and a fair and reasonable price has been determined.

In the cases we examined, the contractors submitted cost or pricing data which, according to SBA negotiation memorandums, were reviewed and analyzed by SBA to arrive at a fair and reasonable price. The cost or pricing data submitted by the contractor was not certified as required by Federal Procurement Regulations and SBA policy in two cases.

We attempted to verify the cost or pricing data submitted by the 8(a) contractors to determine the accuracy of the BDE. Three of the 8(a) contractors did not maintain accounting systems which accumulate cost information by individual contract or product. This situation hinders a contractor's ability to accumulate realistic cost or pricing data for use in later price proposals. When approving the amount of BDE provided an 8(a) contractor, SBA must have cost and pricing data that is as accurate as possible. An accounting system that would generate reliable cost information by individual contract or product would assist 8(a) contractors in completing more accurate pricing proposals for future contracts and would provide SBA a measuring stick for determining reasonableness of BDE already approved. We suggest that SBA examine ways to improve 8(a) contractors' cost accounting systems, particularly 8(a) manufacturing contractors' cost accounting systems.