

**SBA REGULATIONS RELATING TO  
UNCONDITIONAL OWNERSHIP  
REQUIREMENTS FOR INDIAN  
TRIBES**

*Report Number: 10-07  
Date Issued: January 25, 2010*



U.S. Small Business Administration  
Office of Inspector General

# Memorandum

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To: Joseph G. Jordan  
Associate Administrator for Government  
Contracting and Business Development  
/s/ Original Signed

Date: January 25, 2010

From: Debra S. Ritt  
Assistant Inspector General for Auditing

Subject: Audit of SBA Regulations Relating to Unconditional Ownership Requirements for Indian Tribes, Report No. 10-07

During our review of Alaska Native Technologies, LLC (ANT), we determined that SBA's business development regulations do not clearly implement the Small Business Act's (Act) statutory requirement that firms owned by Indian tribes be unconditionally owned. We also determined that SBA's regulatory definition of unconditional ownership appears inconsistent with restrictions discussed in the legislative history of the Act. We are notifying you of these issues so that you can take immediate action.

To participate in the 8(a) program, the Act requires that small business concerns be socially and economically disadvantaged. Section 8(a)(4)(A)(ii) of the Act defines a socially and economically disadvantaged small business concern as one that is at least 51 percent unconditionally owned by, among others, an economically disadvantaged Indian tribe.<sup>1</sup> The Act does not define unconditional ownership. However, SBA's regulations implementing the Act define unconditional ownership as ownership that is not subject to any arrangement that removes present or future rights of the ownership interest through a mechanism the disadvantaged individual or entity does not control.<sup>2</sup> The purpose of unconditional ownership is to ensure that disadvantaged owners are the primary beneficiaries of the 8(a) program.

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<sup>1</sup> 15 U.S.C. § 637(a)(4)(i)(II).

<sup>2</sup> 13 CFR 124.3 specifically prohibits conditions precedent, conditions subsequent, executory agreements, voting trusts, restrictions on voting rights, or other arrangements that cause or potentially cause ownership benefits to go to other than the disadvantaged individuals upon whom eligibility was based.

Under SBA's regulations Indian tribes are not subject to the unconditional ownership requirement,<sup>3</sup> but instead, must comply with the "special ownership requirements" of 13 CFR 124.109. Those special ownership requirements state the tribe must own 51 percent or more of the concern, but do not seem to contain an unconditional ownership requirement.<sup>4</sup> Notwithstanding the Act's unconditional ownership requirement, SBA's regulations do not appear to mandate that an Indian tribe's ownership be unconditional.

Additionally, SBA's regulations have defined unconditional ownership inconsistent with the Act's legislative history. The legislative history of the unconditional ownership requirement only addresses arms-length<sup>5</sup> transactions with legitimate financing institutions.<sup>6</sup> The regulatory definition, however, allows the "pledge or encumbrance of stock or other ownership interest as collateral, including seller financed transactions." These pledges or encumbrances must only follow the undefined "normal commercial practices," with the owner retaining control of its ownership interest.<sup>7</sup> SBA's regulatory definition, with its reliance on the undefined "normal commercial practices" and permissiveness toward seller financed transactions invites program abuse.

In ANT's case, the 8(a) firm was started with [FOIA ex. 4] in goodwill<sup>8</sup> representing the value of the expertise and contacts of a non-disadvantaged individual (NDI). Prior to ANT's existence, the goodwill was reportedly a self-valued<sup>9</sup> intangible asset of a company owned by the NDI. [FOIA ex. 3]

The NDI's company contributed goodwill worth [FOIA ex. 4] to ANT. The remaining goodwill, valued at [FOIA ex. 4] was sold to an Indian tribe that consequently contributed the goodwill to the formation of ANT. The parties agreed to share ownership of ANT, with the tribe owning 51 percent and the NDI's company owning the remaining 49 percent. No cash was contributed in the formation of the 8(a) firm, and a Certified Public Accountant has yet to recognize the [FOIA ex. 4] in goodwill on ANT's audited financial statements.

Choosing not to use a financial institution, the tribe opted to use seller-financing to pay for its [FOIA ex. 4] purchase of goodwill. To settle the debt, the seller (the NDI's

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<sup>3</sup> 13 CFR 124.105.

<sup>4</sup> 13 CFR 124.109(c)(3).

<sup>5</sup> A transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination.

<sup>6</sup> The conference committee discussed the relationship between financing and unconditional ownership in House Conference Report 100-1070 (October 7, 1988). Congress amended the statute through Public Law 101-37, effective June 15, 1989. The 1989 revisions added the word "unconditional" to correct an omission in the 1988 statute. The legislative history describes unconditional ownership as critical to Congressional intent regarding ownership of a firm. 135 Cong. Rec. S4489-01, S4490 (April 19, 1989).

<sup>7</sup> 13 CFR 124.3.

<sup>8</sup> Goodwill is the advantage of having established a business. It has no value basis unless it is purchased and generally is the difference between the purchase price and the fair market value of the assets acquired.

<sup>9</sup> The goodwill was valued by the NDI and the Indian Tribe that owns 51% of ANT.

company) required the tribe to (1) pay 50 percent of its share of ANT's profits to the seller, and (2) pledge its 51-percent ownership interest in ANT to secure its obligation. This effectively reduced the tribe's share of ANT's profits to 25 percent, while the NDI's company received 75 percent. Notwithstanding the pledge of its ownership interest, the tribe retained the 51-percent ownership required by SBA regulations. Despite the tribe's 51-percent ownership, the NDI's company was the primary beneficiary of the program. Even if SBA's regulations required the Indian tribes' ownership to be unconditional, the regulatory definition of unconditional ownership would probably have allowed the pledging of the tribe's ownership interest to secure purchase of the "goodwill." This pledge in the seller-financed transaction discussed above facilitated the re-direction of the 8(a) program's primary benefits from the tribe to the NDI. Transactions that encumber an ownership interest occurring outside of arms-length transactions with legitimate financing institutions invite program abuse similar to the abuse that occurred with ANT.

In fiscal year 2008, 39 Indian tribes participated in the 8(a) program. Those tribes owned 54 participants, 31 of which received 8(a) obligations totaling \$129.5 million. Without the unconditional ownership requirement, non-disadvantaged individuals or entities can reap the primary benefits from contracting preferences that allow tribally-owned firms to receive sole-source contracts of any value. Likewise, excessive flexibility regarding an owner's ability to pledge or encumber an ownership interest allows capital arrangements that steer the benefits of the 8(a) program to non-disadvantaged individuals or entities.

## **RECOMMENDATIONS**

We recommend that the Associate Administrator for Government Contracting and Business Development:

1. Revise Title 13 CFR, Part 124 to mandate that tribally-owned firms be unconditionally owned as required by the Small Business Act.
2. Study the effect of allowing seller-financed transactions to encumber ownership shares, and if appropriate, revise Title 13 CFR, Part 124 to provide that a stock or other ownership interest that is pledged or encumbered is not unconditionally owned unless the pledge or encumbrance occurs within an arms-length transaction with a legitimate financial institution.

## **AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE**

On November 19, 2009, we provided a draft of the report to SBA's Office of Government Contracting and Business Development for comment. On January 5, 2010, the Associate Administrator for Government Contracting and Business Development provided written comments, which are contained in their entirety in Appendix I.

We consider the actions proposed by management to be non-responsive to recommendation 1. Because management expressed that it needed to study the effect of allowing seller-financed transactions, we consider management's comments to be responsive to recommendation 2 and have revised the recommendation accordingly. The Agency's comments and our evaluation of them are summarized below.

### **Management Comments**

#### *Recommendation 1*

Management stated that it will review/evaluate public comments and feedback received from listening tours and tribal consultations regarding proposed rule changes to determine whether to revise Title 13 of the Code of Federal Regulations, Part 124 to mandate that tribally-owned firms be unconditionally owned.

#### *OIG Response*

We believe that an evaluation of public comments is irrelevant when Agency regulations are not consistent with the enabling statute. In addition, if the legally mandated requirement for unconditional ownership is not being enforced for one tribally-owned 8(a) firm, it is not being enforced for other tribally-owned firms. Our report clearly shows that the inconsistency exists, and that it invites program abuse. Therefore, the Agency should revise its regulations to ensure that the regulations are consistent with the Small Business Act.

#### *Recommendation 2*

Management agreed that the pledge or encumbrance of ownership interest in an 8(a) firm should take place only through an arm's length transaction. However, the Agency believed that requiring such transactions be conducted with legitimate financial institutions would cripple an 8(a) firm's access to capital.

## *OIG Response*

Management did not address the concerns raised in our recommendation, but indicated that it needed to study the issue. Accordingly, we revised the second recommendation to include, as an alternative to immediately changing the regulation, that the Agency study the effect of changing the definition of unconditional ownership and then make any appropriate change to its regulations. The study should examine the effect of allowing seller-financed transactions to encumber ownership shares focusing, specifically on: (1) how many disadvantaged individuals in the 8(a) Program have encumbered ownership interests arising from their purchase of the 8(a) company or assets of the 8(a) company, (2) what constitutes normal commercial practices for seller-financed transactions, and (3) what, if anything, would be the effect on 8(a) participation levels if disadvantaged individuals were only allowed to encumber or pledge their shares in arms-length transactions with legitimate financial institutions. An assessment of whether changing the regulation would affect program participation should identify the availability of other SBA programs such as the 7(a) loan guaranty program, to assist disadvantaged business owners as an alternative to seller-financing of transactions.

## **ACTIONS REQUIRED**

Based on your comments, we have revised recommendation 2 and request your response on the attached SBA Form 1824, *Recommendation Action Sheet* within 30 days from the date of this report. Your response should identify the specific action(s) taken or planned and the target date(s) for completion. Because you have non-concurred with recommendation 1, we plan to refer the issue to the next higher level of management for resolution, in accordance with Standard Operating Procedure 20 35.

We appreciate the courtesies and cooperation of the Small Business Administration during this review. If you have any questions concerning this report, please call me at (202) 205-<sup>[FOIA ex. 2]</sup> or Riccardo R. Buglisi, Director, Business Development Programs Group, at (202) 205-<sup>[FOIA ex. 2]</sup>

## APPENDIX I. MANAGEMENT COMMENTS



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20416

January 5, 2010

Ms. Debra S. Ritt  
Assistant Inspector General for Auditing  
Office of Inspector General  
U.S. Small Business Administration  
Washington, DC 20416

Dear Ms. Ritt:

Thank you for the opportunity to comment on the draft report issued November 19, 2009, entitled, "SBA Regulations Relating to Unconditional Ownership Requirements for Indian Tribes." (Project No.: 9008).

It is important to note that this draft report and subsequent recommendations – stating that "SBA's business development regulations do not clearly implement the Small Business Act's statutory requirement that firms owned by Indian tribes be unconditionally owned" - are based solely upon a review of one firm (Alaska Native Technologies, LLC (ANT)). We believe that the issues that surfaced as a result of a review conducted of ANT are isolated and are not indicative of the tribally-owned firms that participate in the 8(a) Program.

However, SBA has undertaken a comprehensive review of the rules covering a variety of areas of the 8(a) Program, including tribally-owned firms. Public comments are currently being sought regarding the best way to determine whether a tribe meets the criteria of being economically disadvantaged for the 8(a) program.

In addition to seeking public comments, SBA will hold tribal consultation meetings which are intended to provide a forum in which interested parties can discuss their views on the issues impacting tribally-owned firms. These meetings will enable SBA to obtain the views of these stakeholders and obtain their input as it relates to tribal eligibility for 8(a) certification and various approaches to the 8(a) Program regulations. The outcome of these consultations, along with the comments obtained, will significantly impact the finalized regulations and the manner in which tribally owned companies and Alaska Native Corporations and all other small disadvantaged businesses participate in the 8(a) Business Development Program.

The first consultation meeting was held December 16, 2009, in Seattle, WA and the second will be held January 14, 2010, in Albuquerque, NM. In addition to the formal tribal consultations, listening sessions will be held around the country for the general public's participation.



## APPENDIX I. MANAGEMENT COMMENTS

Office of Government Contracting and Business Development's Response to Draft Audit Report

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Following is the Office of Government Contracting and Business Development's response to the recommendations outlined in this draft report.

### RECOMMENDATIONS

Recommendation #1:

1. Revise Title 13 CFR, Part 124 to mandate that tribally-owned firms be unconditionally owned as required by the Small Business Act.

Response:

Our office will review/evaluate the public comments as well as evaluate the feedback received regarding the from the listening tours and tribal consultations regarding the proposed rule changes to determine whether or not there is a need to revise Title 13 of the Code of Federal Regulations, Part 124 to mandate that tribally-owned firms be unconditionally owned.

Recommendation #2:

2. Revise Title 13 CFR, Part 124 to provide that a stock or other ownership interest that is pledged or encumbered is not unconditionally owned unless the pledge or encumbrance occurs within an arms-length transaction with a legitimate financial institution.

Response:

We agree that any pledge or encumbrance of an ownership interest in an 8(a) firm should take place only through an arm's length transaction. Currently, the 8(a) regulations require such transactions to follow normal commercial practices. The term "normal commercial practices" is used multiple times in the Federal Acquisition Regulation and is used by several other agencies, including the IRS and the VA, in their own regulations. However, if there is any ambiguity in the use of the term, SBA is open to seeking comment on changing the language of the regulation to recognize that, as SBA has always required previously, unconditional 8(a) ownership interests may be pledged only through arm's length transactions.

We also believe that, when Congress added the unconditional ownership requirement to the Small Business Act, the emphasis of the change was to require that pledges of 8(a) interests follow normal commercial practices and be performed only through arm's length transactions. The "legitimate financial institution" language was of lesser importance.

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The legislative history shows that Congress sought to address fraud, waste, and abuse uncovered during the Wedtech case and investigation. Based on the experience of that case, we believe that Congress's primary concern was to address holes in *how* 8(a) ownership might be used for financing, not *who* the financier might be. Requiring that "normal commercial practices" be followed during 8(a) financing transactions does a great deal to prevent abuse. Although limiting pledges of 8(a) financing to "legitimate financial institutions" might curb some additional abuse, we believe it also may have a great detrimental effect on the ability of legitimate 8(a) firms to find credit and grow their businesses. By definition, 8(a) owners are already economically disadvantaged. Limiting their ability to obtain credit from other than "legitimate financial institutions" would cut off credit sources that were previously available to the 8(a) firms, and still available to all other small businesses. Before instituting such a change, SBA would need to solicit wide public comment on the issue and study the impact that the change would have on the business development of 8(a) firms.

We look forward to working with the Office of Inspector General as we continue to provide the highest quality of program delivery and oversight of the 8(a) Business Development (BD) Program. Since 2006, significant internal controls have been implemented in an effort to continuously improve 8(a) Program delivery.

Sincerely,

[FOIA ex. 6]

Joseph G. Jordan  
Associate Administrator for  
Government Contracting  
and Business Development

Enclosures