Cite as: *Matter of Digital Management, Inc.*, SBA No. BDP-288 (2008)

United States Small Business Administration
Office of Hearings and Appeals

IN THE MATTER OF:	
Digital Management, Inc.	SBA No. BDP-288
Petitioner	Decided: July 11, 2008

APPEARANCES

David P. Metzger, Esq., Patricia L. Stasco, Esq., and Kristen E. Ittig, Esq., Arnold & Porter LLP, Washington, D.C., for Petitioner.

William L. Gery, Esq., Office of General Counsel, Small Business Administration, Washington, D.C., for the Agency.

SUMMARY DECISION[1]

ARKOW, Administrative Law Judge:

On February 5, 2008, the Respondent U.S. Small Business Administration (SBA) terminated Digital Management, Inc. (Petitioner) from the 8(a) Business Development (BD) Program (8(a) Program or the Program) because Petitioner's owner, Mr. Jay Sunny Bajaj, overcame his economic disadvantage. Petitioner appealed the determination on March 19, 2008.

On June 2, 2008, I ordered the parties to brief whether early graduation rather than termination is the required proceeding when an 8(a) Program Participant's owner is no longer economically disadvantaged.

Because there is no genuine issue of a material fact relevant to my decision, I may decide this case summarily.

I conclude the SBA acted arbitrarily, capriciously, and contrary to law by terminating rather than graduating Petitioner based on SBA's allegation that Petitioner's owner overcame his economic disadvantage.

[1] This appeal petition is decided under the Small Business Act of 1958, 15 U.S.C. § 631 *et seq.*, and 13 C.F.R. Parts 124 and 134.

Issue

Whether terminating an 8(a) Program Participant when the SBA alleges that the Participant's owner is no longer economically disadvantaged is arbitrary, capricious, or contrary to law. *See* Small Business Act, § 8(a)(9)(C), 15 U.S.C. § 637(a)(9)(C); 13 C.F.R. § 134.406(b).

I. Briefs and Arguments

A. SBA

On June 9, 2008, SBA filed its brief arguing that SBA properly terminated Petitioner from the 8(a) Program because there were reasonable grounds for termination and insufficient grounds for early graduation.

SBA argues that the Small Business Act (or the Act), 15 U.S.C. § 637(a)(6)(C)(ii), states that SBA may only pursue graduation proceedings if both the Program Participant *and* its disadvantaged owners are no longer economically disadvantaged. SBA asserts that it terminated Petitioner from the 8(a) Program based solely on SBA's finding that Mr. Bajaj, Petitioner's owner, was no longer economically disadvantaged. SBA maintains that it did not find Petitioner, the Program Participant, no longer economically disadvantaged, which is a prerequisite to pursuing early graduation proceedings under 13 C.F.R. § 124.302.

SBA further argues that the Act, 15 U.S.C. § 636(j)(10)(G), defines graduation as the Program Participant successfully completing the Program by substantially achieving the targets, objectives, and goals in its business plan. In addition, 13 C.F.R. § 124.302(a)(1) provides that SBA may only graduate a firm prior to the expiration of its Program term when the firm has substantially achieved the targets and objectives of its business plan. SBA maintains that because Petitioner has not successfully completed the Program, graduation is inappropriate.

SBA then disagrees with the notion that all grounds for termination are based on negative conduct by the Program Participant. SBA asserts that while most of the examples cited as grounds for termination in 13 C.F.R. § 124.303 connote negative behavior, termination may also be based on the Participant's owner receiving a windfall. Here, Mr. Bajaj received proceeds from a family trust and thus SBA asserts termination was the only appropriate ground because Petitioner's owner was no longer economically disadvantaged.

B. Petitioner

On June 16, 2008, Petitioner filed its reply asserting that when SBA found its owner was no longer economically disadvantaged,[2] SBA's only appropriate course was to pursue early graduation. Petitioner argues SBA's interpretation of the Small Business Act is misguided because economic disadvantage never applies to the Program Participant, but instead applies only to the owner. Moreover, SBA only provides assistance to the Program Participant, not its

[2] Petitioner maintains SBA erroneously concluded that Petitioner's owner was no longer economically disadvantaged.

owner. Thus, under SBA's reading, SBA could never initiate early graduation proceedings because there can never be an instance where both the Program Participant and its owner are no longer economically disadvantaged. Indeed, Petitioner argues "even SBA would oppose its own interpretation if it examined it more closely." Reply, at 4.

Petitioner then asserts that SBA's early graduation regulation at 13 C.F.R. § 124.302 should govern, and not the more vague termination regulations at 13 C.F.R. § 124.303. Petitioner argues that the specific should prevail over the more general regulations. Because 13 C.F.R. § 124.302(a)(2) provides that early graduation is to be used when "one or more of the disadvantaged owners upon whom the Participant's eligibility is based are no longer economically disadvantaged," and that is precisely SBA's position in this case, SBA should have pursued early graduation.

In contrast, the termination regulation speaks generally to situations where the disadvantaged owner fails to maintain ownership, full-time management, and control of the firm. Moreover, the list of grounds for termination all involve misconduct, and the SBA has never alleged that Mr. Bajaj has engaged in misconduct. Thus, Petitioner argues termination is inappropriate because it would "unjustly impute a stigma or wrongdoing to [Petitioner]." Reply, at 7.

II. Discussion

A. Standard of Review

The SBA determination must be sustained unless a review of the written administrative record demonstrates that the SBA's determination, that Petitioner should be terminated from the 8(a) Program, is arbitrary, capricious, or contrary to law. *See* 13 C.F.R. § 134.406(a), (b). My review of the case is narrow and does not permit me to substitute my own judgment for that of the SBA. Here, I must examine whether the SBA correctly applied its laws and regulations to the facts in deciding to terminate Petitioner. Then, I must determine that the SBA made a clear error of judgment in its decision before I may find the SBA acted arbitrarily, capriciously, or contrary to law. *See Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983).

A clear error of judgment may be found if the SBA fails to properly apply the law and regulations to the facts of the case. The SBA must articulate a reasonable explanation for its action, including a rational connection between the facts found and its determination. *See id.* As long as the SBA determination is reasonable, it must be upheld on appeal. 13 C.F.R. § 134.406(b). Further, the SBA must follow the law and implementing regulations and afford Petitioner due process of law.

B. Analysis

1. Introduction

SBA regulations provide that a business may leave the 8(a) Program by any of the following means: (1) graduation upon completion of its Program term, (2) voluntary early graduation at the Participant's request, (3) early graduation initiated by the SBA, and (4) termination initiated by the SBA. 13 C.F.R. § 124.301.

The SBA's determination cited the following reasons for terminating Petitioner: (1) Petitioner's failure to maintain ownership, full-time day-to-day management, and control by disadvantaged individuals, 13 C.F.R. § 124.303(a)(3); (2) Petitioner's failure to maintain Program eligibility, 13 C.F.R. § 124.303(a)(2); and (3) Petitioner's material breach of its Program Participation Agreement, 13 C.F.R. § 124.303(a)(19). Administrative Record (AR), Ex. 1.

The SBA alleges these termination allegations are appropriate because Petitioner's owner is no longer economically disadvantaged under the standards set forth in 13 C.F.R. § 124.104. The basis for the allegation is Petitioner's owner's receipt of a large sum of money from a family trust, which was beyond Petitioner's owner's control. As a result of the distribution, Petitioner's owner exceeded the SBA's economic disadvantage standards.

I must decide, under these undisputed facts, whether the SBA violated the Small Business Act and its own regulations by terminating Petitioner, rather than graduating Petitioner early.

2. The Small Business Act

a.

The Small Business Act provides, "If the [SBA] determines . . . that a Program Participant *and* its disadvantaged owners are no longer economically disadvantaged for the purpose of receiving assistance . . . the Program Participant *shall* be graduated . . . ." 15 U.S.C. § 637(a)(6)(C)(ii) (emphasis added).

Moreover, 15 U.S.C. § 636(j)(10)(H), specifically provides that "the term 'graduated' or 'graduation' means that the Program Participant is recognized as successfully completing the Program by substantially achieving the targets, objectives, and goals contained in the concern's business plan thereby demonstrating its ability to compete in the marketplace without assistance…." Thus, regardless of the economic disadvantage of the Participant's owner, graduation is required when the Participant firm is successful.

Indeed, the success of the firm does not always mean that the owner overcame his or her economic disadvantage. The owner may have insufficient wealth to exceed the regulatory definition of economic disadvantage. For example, when he or she has large medical expenses, minimal income from the firm, college tuition payments, financial obligations independent of the Participant firm, or, most importantly, reinvests income into the business. *See* 13 C.F.R.

§ 124.104. Following the SBA's interpretation of the Act, in this example, the successful firm could neither be graduated nor terminated. The SBA's interpretation of the Act is logically flawed because it strips the Act of its intended meaning. Success alone can never justify termination.

Therefore, I find the use of "and" in the Act does not require that both conditions be met before a Program Participant may be graduated. Rather, it means that both conditions warrant graduation. The Act, 15 U.S.C. § 637(a)(6)(C)(ii), merely adds a graduation requirement to 15 U.S.C. § 636(j)(10)(H) when a Program Participant's owner overcomes his or her economic disadvantage.

b.

Indeed, the legislative history of the Act, Pub. L. 100-656, leads to the conclusion that Congress intended the SBA to graduate an 8(a) Program Participant in two situations: (1) when the Program Participant achieves the Program's objectives, or (2) when the Participant's owner is no longer economically disadvantaged.

The Senate bill provided that a Program Participant may be graduated when the Program Participant:

> (iii) has achieved its business goals and objectives . . . , *or*
>
> (iv) is no longer owned and controlled by an individual or individuals who are determined to be economically disadvantaged.

S. 1993, 100th Cong. § 203 (1988) (emphasis added); *see also* 13 C.F.R. § 124.302(a). The Senate Report explained that:

> [T]he amendment to Section 203 clarifies that individuals who are no longer economically disadvantaged are to be graduated from the program, rather than terminated. This provision recognizes that individuals who have overcome their economic disadvantage have taken significant steps toward building successful businesses and no longer need depend on program benefits for their well-being. Graduation of such companies will make way for other, more disadvantaged individuals and firms that have not yet achieved success.

S. REP. NO. 100-394, at 45 (1988). The Report also stated, "A firm may be graduated if it has exceeded its applicable size standard or if the firm voluntarily determines that it has achieved the goals of its business plan. Further, under an amendment offered by Senator Levin, a firm may be graduated if the owner's net worth makes him no longer economically disadvantaged." S. REP. NO. 100-394, at 54 (1988). In addition:

> Four events are specified which would trigger graduation: (1) expiration of the firm's Program Participation Term; (2) exceeding all size standards applicable to the firm; (3) a decision by the Program Participant to voluntarily leave the

> Program; and (4) a determination that the firm is no longer owned and controlled by economically disadvantaged individuals. The section explicitly states that exiting the Program through *any* of the events that trigger a graduation should be recognized as successful completion of the Program.

S. REP. NO. 100-394, at 92 (1988) (emphasis added).

The conference did not adopt the disjunctive language of the Senate amendment's early graduation requirements despite the conferees stating that they retained the Senate bill requirement. H.R. REP. NO. 100-1070, at 57 (1988) (Conf. Rep.). But there is no indication anywhere in the legislative history, except for the unfortunately confusing use of "and," that Congress intended to require both the Participant firm to be successful and its owner to no longer be economically disadvantaged before graduating a Program Participant early.[3]

3. SBA's Graduation Regulation

SBA's implementing regulation provides that SBA may graduate a Participant early if:

> (1) The concern has successfully completed the 8(a) BD program by substantially achieving the targets, objectives, and goals set forth in its business plan prior to the expiration of its program term, and has demonstrated the ability to compete in the marketplace without assistance under the 8(a) BD Program; *or*
>
> (2) One or more of the disadvantaged owners upon whom the Participant's eligibility is based are no longer economically disadvantaged.

13 C.F.R. § 124.302(a) (emphasis added).

Thus, the regulation provides for two grounds for early graduation, either of which could lead to early graduation. *See* 63 Fed. Reg. 35726, 35732 (June 30, 1998) ("A Participant could be graduated early if it *either* successfully completes the program prior to the end of its program term *or* if one or more of the disadvantaged owners are no longer economically disadvantaged.") (emphasis added). This provision comports with the Act. The SBA's argument implies that the SBA's own regulation erroneously interprets the Act. I disagree.

The SBA published this regulation interpreting the Act's graduation provision after notice and public comment under the Administrative Procedure Act, 5 U.S.C. § 553. There were no comments suggesting the proposed regulation misinterpreted the Act.

Agencies must follow their own regulations. *See Wagner v. U.S.*, 365 F.3d 1358, 1361 (Fed. Cir. 2004) ("[A]n agency is bound by its own regulations."); *Voge v. U.S.*, 844 F.2d 776,

[3] *See* 1A N. Singer, Sutherland on Statutory Construction § 21:14, p.184 (rev. 6th ed. 2002) ("There has been, however, so great laxity in the use of these terms ["or" and "and"] that courts have generally said that the words are interchangeable and that one may be substituted for the other, if consistent with the legislative intent.").

779 (Fed. Cir.1988) ("It has long been established that government officials must follow their own regulations, even if they were not compelled to have them at all. . . ."). The SBA's argument suggests this regulation is wrong and should not be followed. I disagree. The SBA would have to amend its regulations before implementing its new interpretation of the Act.

4. SBA's Past Practice

Since the current 13 C.F.R. § 124.302 was published, in cases appealed to SBA's Office of Hearings and Appeals, SBA practice has been to graduate Program Participants when only the disadvantaged owner is no longer economically disadvantaged. *See Matter of JANUS Research Group, Inc.,* SBA No. BDP-238 (2006); *Matter of C & S Paving, Inc.,* SBA No. BDP-231 (2006); *Matter of Superior Piping, Fabricators & Erectors, Inc.,* SBA No. BDP-220 (2005).

If one accepts SBA's argument, that the Act requires both the Program Participant and its disadvantaged owner to be no longer economically disadvantaged before a Participant could be graduated, then the SBA violated the Act by initiating graduation proceedings in these cases. I hold the SBA was correct in those cases and its attempt to depart from that interpretation of the Act in this case is erroneous.

In a similar vein, it appears that none of the appealed termination proceedings alleged a disadvantaged owner's lack of economic disadvantage as the only ground for termination. That practice is consistent with the current SBA regulation requiring early graduation and not termination upon a finding that a Program Participant's owner is no longer economically disadvantaged.

5. Impact of Exiting the Program

While both termination and early graduation result in an early exit from the 8(a) Program, each has its own significance. Termination, on one hand, connotes negative conduct by the Program Participant or its owners. The SBA disagrees with this conclusion and argues that good cause to terminate need not include negative conduct. While the SBA concedes that most of the examples of good cause for termination in 13 C.F.R. § 124.303(a) do involve negative conduct, it contends that 13 C.F.R. § 124.303(a)(3) does not involve negative conduct. I disagree because 13 C.F.R. § 124.303(a)(3) addresses a failure by the disadvantaged owner to maintain ownership, control, and management of the concern.

Further, if one follows the SBA's argument that termination does not require negative conduct, then it is puzzling why the Small Business Act created two distinct means, graduation and termination, for a Participant to exit the 8(a) Program. The SBA's argument implies that there is no distinction between graduation and termination. That is not the case.

Indeed, termination can be viewed as a blot on a firm's record and may hurt a firm's chances of securing government contracts. The Small Business Act lists six grounds for termination, including various forms of negative conduct characterized as "failures," misconduct, and "willful violations." 15 U.S.C. § 636(j)(10)(F); s*ee* 13 C.F.R. § 124.303(a) (providing a non-exclusive list of acts constituting good cause for termination). Although the Small Business

Act and implementing regulations do not purport to include all possible reasons to terminate a Program Participant, they do provide a sense that they are intended to cover negative conduct by the Program Participant or its owner.

On the other hand, early graduation recognizes success as a Program Participant. Small Business Act, 15 U.S.C. § 636(j)(10)(H) ("'graduation' means that the Program Participant is recognized as successfully completing the program. . . ."); 13 C.F.R. § 124.302(a)(1) (SBA may graduate the firm if "(1) The concern has successfully completed the 8(a) BD program . . . .").

For these reasons, I conclude there is no statutory requirement that a Participant firm be "successful" *and* its owner no longer be economically disadvantaged before the Participant may be graduated.

6. Summary of Analysis

I find the SBA made a clear error of law when it terminated, rather than graduated Petitioner, based on its belief that Petitioner's owner was no longer economically disadvantaged. Specifically, the SBA misinterpreted the Act and ignored SBA's own past practice and, most importantly, SBA's own regulation.

Accordingly, I hold that it is arbitrary, capricious, and contrary to law for the SBA to interpret the Act to require both the economic disadvantage of the Program Participant and its disadvantaged owner before the SBA may early graduate Petitioner. Further, I hold the SBA must follow its own clear and unambiguous regulation, requiring SBA to graduate Petitioner upon finding its owner is no longer economically disadvantaged.[4]

III. Conclusion

Respondent Small Business Administration's decision to terminate Petitioner from the 8(a) BD Program IS ARBITRARY, CAPRICIOUS, AND CONTRARY TO LAW. *See* 15 U.S.C. § 637(a)(9)(C); 13 C.F.R. § 134.406(b).

Subject to 13 C.F.R. § 134.409(c), this is the final decision of the Small Business Administration. *See* 15 U.S.C. § 637(a)(9)(D); 13 C.F.R. § 134.409(a).

RICHARD S. ARKOW
Administrative Law Judge

[4] In view of this holding, I am not deciding whether Petitioner's owner is no longer economically disadvantaged.