Cite as: *Matter of 21st Century Technologies, Inc.*, SBA No. BDP-299 (2008)

United States Small Business Administration
Office of Hearings and Appeals

IN THE MATTER OF:	
21st Century Technologies, Inc.	SBA No. BDP-299
Petitioner	Decided: September 29, 2008

APPEARANCES

Martin D. Teckler, Esq. and Sean P. Bamford, Esq., K & L Gates LLP, Washington, D.C., for Petitioner.

Sam Q. Le, Esq., Office of General Counsel, Small Business Administration, Washington, D.C., for the Agency.

DECISION AND REMAND ORDER

ARKOW, Administrative Law Judge:

I. Introduction and Jurisdiction

On June 25, 2008, 21st Century Technologies, Inc. (Petitioner) appealed a Small Business Administration (SBA) determination denying Petitioner entry into the 8(a) program. The SBA found that Petitioner did not establish that Dr. Darrin Taylor, one of Petitioner's socially disadvantaged owners, was economically disadvantaged because his net worth exceeded SBA's $250,000 regulatory threshold. The SBA also found that Petitioner did not establish it had inadequate access to credit and capital.

I find that the SBA made an error of law in its conclusion that SBA does not consider community property laws when deciding whether an individual is economically disadvantaged. I also find that the record is insufficiently complete to decide whether the SBA's conclusion that Petitioner did not establish it had inadequate access to credit and capital is warranted. These errors require remand for a new determination.

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. The appeal is timely. 13 C.F.R. § 134.202(a)(i).

II. Issues

Whether the SBA determination must be remanded to reconsider its findings and

conclusions.

Whether the SBA's motion for summary decision and Petitioner's cross-motion for summary decision should be granted.

III. Relevant Facts

1. On January 2, 2008, Petitioner filed its amended application for admission into the 8(a) BD program. Administrative Record (AR), Ex. 14.

2. Dr. Taylor, one of the individuals upon whom Petitioner's 8(a) eligibility is based, and his wife, Felicia Taylor, reside in Texas, which is a community property state.

3. On December 26, 2007, Petitioner paid Dr. Taylor $331,800 for stock it had issued to Dr. Taylor. On February 29, 2008, Petitioner paid Dr. Taylor $49,770 for cancelled stock options held by Dr. Taylor. Appeal, at 9.

4. On March 10, 2008, Dr. Taylor and Mrs. Taylor executed an "Agreement for Community Property" that specified that the $331,800 resulting from the stock purchase and $49,770 resulting from the stock option cancellation were community property. Appeal, Ex. H.

IV. SBA Determinations

A. Initial Determination

On February 22, 2008, the SBA denied Petitioner's 8(a) application. AR, Ex. 4. The SBA found that (1) Dr. Taylor was not economically disadvantaged because his net worth exceeded the $250,000 limit provided for in 13 C.F.R. § 124.104(c)(2), and (2) Petitioner's business financial condition was well above average when compared to other firms in the same or similar line of business not owned and controlled by socially and economically disadvantaged individuals and, thus, Petitioner had access to credit and capital. 13 C.F.R. § 124.104(c).

B. Final Determination

On May 12, 2008, after evaluating Petitioner's April 4, 2008, request for reconsideration, the SBA determined that Petitioner did not provide sufficient documentation to overcome the original reasons for decline. AR, Ex. 1.

The SBA noted Dr. Taylor's revised SBA Form 413, Personal Financial Statement, wherein Dr. Taylor split the value of proceeds from the stock and stock option sales to account for community property law. The SBA asserted, however, that its regulations "do not consider community property laws in determining the economic status of an applicant individual" and that the "only reference to community property law in the 8(a) regulations is in the ownership section. . . ." AR, Ex. 1 at 1-2.

The SBA noted that even if SBA considered the assets community property, SBA would still attribute the full amounts to Dr. Taylor because applicants are attributed with the full value of assets transferred to an immediate family member for less than fair market value within two years of application. The SBA thus found Dr. Taylor's net worth to be approximately $388,370, exceeding the $250,000 net worth threshold.

The SBA also found that Petitioner did not overcome the second reason for decline. Namely, the SBA found that Petitioner compared favorably with industry averages of similar non-disadvantaged firms prepared by Risk Management Associates (RMA). SBA rejected Petitioner's contention that the RMA data artificially inflates a firm's ratios by noting that all 8(a) applicants are rated using the same RMA standards. SBA also found unconvincing Petitioner's claim that its stock valuation had dropped by finding that it was unclear whether the valuation considered the 2007 merger of Petitioner and 21CT, Inc., and the number of outstanding shares in 2005.

Finally, the SBA found a letter from a single financial institution confirming Petitioner's inability to secure credit in excess of $500,000 "informative" but "inconclusive because [Petitioner] did not provide any evidence that [it] could not secure additional financing from other lenders." AR, Ex. 1 at 2.

V. Position of the Parties

A. Petitioner's Appeal

On June 25, 2008, Petitioner filed its appeal. Petitioner asserts that SBA ignored its own regulations and Standard Operating Procedure (SOP) 80 05 3A by not applying Texas community property law, which resulted in SBA incorrectly finding Dr. Taylor's net worth exceeded $250,000. Petitioner also maintains that the Agreement for Community Property executed by Dr. and Mrs. Taylor was not a transfer, but merely a statement for the SBA clarifying that the Taylors recognized that the income was community property.

Petitioner also finds error with the SBA's finding that Petitioner had equal access to credit and capital. Petitioner asserts the SBA discounted, without providing a rational basis, Petitioner's evidence that it did not compare favorably to the financial profiles of other small businesses in the same or similar industries. Petitioner also asserts the SBA did not specify in which categories, if any, Petitioner exceeded the industry mean and failed to provide any supporting rationale for its determination that Petitioner had equal access to capital and credit.

Petitioner acknowledges that the SBA may reject an applicant's evidence but asserts the SBA must provide cogent reasons for its rejection and not arbitrarily disbelieve credible evidence. Thus, Petitioner maintains the SBA's final determination was inadequate as a matter of law and the SBA failed to follow applicable regulations and its own procedures.

B. SBA's Motion for Summary Decision

On August 11, 2008, the SBA filed a motion for partial summary decision on whether Dr. Taylor's net worth is excessive. *See* 13 C.F.R. §§ 134.212, 134.408. The SBA asserts that it is entitled to a decision in its favor because there is no genuine issue as to any material fact regarding the amount Dr. Taylor received for his stock and stock option sales. SBA maintains the only issue in dispute concerning the net worth calculation is whether the proceeds from Dr. Taylor's stock and stock option sales are community or separate property.

Contrary to the SBA's determination that states SBA does not consider community property laws, SBA's counsel first states that SBA applies community property law by attributing half of community property items to the applicant unless a separate property agreement has been executed or pre- or post-nuptial agreements are provided. SBA's counsel states that the SBA does not treat community property as belonging to the community but instead treats it as vested in the partners to the community. SBA's counsel states, "This [vesting] is what the [SBA] intended to convey (though perhaps stated with less than ideal clarity) when [it] wrote that SBA does not consider community property laws." Motion, at 13 n.4. SBA counsel then proceeds to analyze why the proceeds from the stock and stock option sales are separate property.

C. Petitioner's Cross-Motion for Summary Decision

On August 29, 2008, Petitioner filed a cross-motion for summary decision. First, Petitioner maintains that SBA's conclusion in its final determination that it does not consider community property laws is clearly incorrect as a matter of law. Petitioner asserts SBA counsel's attempt to explain his view of what the SBA intended when it stated that it does not consider community property laws amounts to a *post hoc* rationalization that may not be considered by the Office of Hearings and Appeals (OHA).

Second, Petitioner reiterates its assertions in its appeal that the SBA discounted, without providing a rational basis, Petitioner's evidence that it did not compare favorably to the financial profiles of other small businesses in the same or similar industries.

D. SBA's Response to Petitioner's Cross-Motion for Summary Decision

On September 18, 2008, SBA filed its response to Petitioner's Cross-Motion. First, the SBA asserts it correctly found in its initial determination that Dr. Taylor's net worth exceeded $250,000 based on Dr. Taylor's statement that his adjusted net worth was $299,480, including the full $331,800 he received from the disputed stock sale.

On reconsideration, Dr. Taylor submitted a new Form 413 showing that his adjusted net worth was $158,569, nearly $140,000 less than Petitioner's initial statement. The SBA asserts it then "accepted the Community Property Agreement at face value, as an agreement to treat the $331,800 Dr. Taylor received from the stock sale as community property." Response, at 5. The SBA then argues that Petitioner is now attempting to say the Community Property Agreement is legally inoperative yet it used the agreement to explain Dr. Taylor's reduced net worth. The

SBA maintains that it correctly found the Agreement constituted a transfer for less than market value under 13 C.F.R. § 124.104(c)(1).

The SBA concedes that the final determination stated that community property law did not apply. The SBA states the expression was a "throwaway line" because the SBA did consider community property law by examining the Community Property Agreement. Response, at 6. The SBA also concedes that it did not properly explain how it found Petitioner to not have diminished capital and credit opportunities. If OHA does not grant the SBA's motion for summary decision, the SBA requests that OHA remand the issue of Petitioner's access to capital and credit for the SBA to more adequately examine.

VI. Discussion

A. Net Worth

To prevail on a motion for summary decision, I must find that "there is no genuine issue as to any material fact, and that the moving party is entitled to a decision in its favor as a matter of law." 13 C.F.R. § 134.212(a); *see also* 13 C.F.R. § 134.408(a).

Both Petitioner and the SBA move for summary decision on whether Dr. Taylor's net worth is excessive. Both Petitioner and SBA counsel agree that the SBA must consider Texas community property law when it evaluates Dr. Taylor's assets but they diverge on whether the assets are properly characterized as community property, which would require the SBA to attribute half of the value of the assets to Dr. Taylor. The parties also disagree on whether the Taylors' Community Property Agreement was an impermissible transfer of assets under 13 C.F.R. § 124.104(c)(1) or merely an affirmation that the property was indeed community property. It would be inappropriate for me to resolve these issues or grant either party's motion for summary decision, however, because the SBA determination explicitly states that the SBA did not consider community property law. This is an error of law. This error of law requires remand for a new initial determination applying Texas community property law. 13 C.F.R. § 134.406(e).

SBA counsel attempts to cure this error of law by arguing the SBA statement that it does not consider community property law was a "throwaway line" and that the SBA really did apply Texas community property law. Indeed, SBA counsel attempts to extract an analysis of community property law from the SBA's unequivocal statement that it did not apply community property law. As Petitioner's argument notes, this analysis is not in the SBA's final determination and may not be considered by OHA. The Supreme Court has held that so-called *post hoc* rationalizations by an agency's counsel may not be accepted to uphold an otherwise deficient agency determination. *See Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 50 (1983) (citing *Burlington Truck Lines, Inc. v. U.S.,* 371 U.S. 156, 168-169 (1962)). This principle has been followed in 8(a) cases. *See, e.g., Matter of L.D.V., Inc.,* SBA No. BDP-257, at 6 (2007).

I agree with both counsel that the SBA erred when it stated that SBA does not consider community property laws. Indeed, although the current regulation is silent on the applicability of

community property law in net worth calculations, its predecessor regulation stated that a half interest in any property claimed as community property would be attributed to the party claiming disadvantaged status when SBA makes its personal net worth determination. *See* 13 C.F.R. § 124.106(a)(2)(i)(A)(1) (1997).

In 1997, the SBA proposed to "streamline the entire Part 124, and to make several substantive changes in part A of the 8(a) BD regulations where needed." 62 Fed. Reg. 43584-01 (Aug. 14, 1997) (proposed rule). "Any regulatory provisions [in Part 124] that SBA deemed duplicative are proposed to be removed, while those that appeared wordy or unclearly written have been rewritten in [the] proposed rule." *Id.* The SBA stated that proposed 13 C.F.R. § 124.104 "clarified that a contingent liability does not reduce an individual's net worth." 63 Fed. Reg. 35726, 35728 (June 30, 1998). When a commenter felt that the SBA needed to set forth in greater detail the criteria SBA uses to determine whether an individual is economically disadvantaged, the SBA stated that it would "study this issue for possible later revision." *Id.* There is no discussion in either the proposed or final rule to 13 C.F.R. § 124.104 (formerly 13 C.F.R. § 124.106) of SBA's intent to not consider community property law when determining an individual's net worth, and the discussion did not indicate the SBA intended to repeal the community property rule.

In a similar streamlining of the size regulations in 1995, the SBA stated it was "streamlin[ing] the size standards operation by simplifying and clarifying existing regulatory language and by eliminating unnecessary, irrelevant, or obsolete provisions." 60 Fed. Reg. 57983 (Nov. 24, 1995) (proposed rule). The SBA then identified eight significant changes proposed to its size regulations. *Id.* OHA later held that the SBA, in revising its size regulations, did not intend to change the preexisting rules except where the Agency explicitly identified the substantive regulatory changes, *i.e.*, the eight significant changes. *Size Appeal of Troy Systems, Inc.*, SBA No. SIZ-4296, at 6 (1998).

Analogously, I find that the SBA's silence on the applicability of community property law to an individual's net worth in its 1997 streamlining of the 8(a) regulations did not cause a change to the preexisting rule of applying community property law to net worth calculations.

Further, SBA regulations provide that, in determining ownership interests when an owner resides in a community property state, the SBA considers applicable state community property laws. 13 C.F.R. § 124.105(k). It is puzzling why the SBA would apply community property laws in determining ownership but not in determining an applicant's individual net worth.

Moreover, SBA's own SOP provides Agency employees with a checklist for evaluating an applicant's economic disadvantage, which states that "[i]f the applicant resides in a community property state, all community property items should be halved." SOP 80 05 3A, Chapter 2B, 31.b(2)(a) (July 24, 2004).

Finally, the SBA has applied community property law in determining economic disadvantage for Small Disadvantaged Business (SDB) applicants.[1] In *Matter of FMH Corp.*, SBA No. SDBA-168 (2006), the SBA applied community property laws and found the SDB applicant's owner was not economically disadvantaged even after dividing his income in half, to account for the fact that he was married and resided in a community property state.

B. Access to Capital and Credit

Petitioner alone moves for summary decision on the second ground for its eligibility denial, arguing the SBA's determination on Petitioner's access to credit and capital was insufficient. SBA counsel concedes that the SBA did not adequately explain how it found that Petitioner does not have diminished capital and credit opportunities. Indeed, the SBA acknowledges that the appropriate relief on this ground is to remand the finding to the SBA for an explanation. I agree. The SBA determination is insufficiently complete on this issue for me to determine whether it is arbitrary, capricious, or contrary to law; remand is thus required. 13 C.F.R. § 134.406(e).

Upon remand, the SBA is instructed to consider Petitioner's financial condition compared to the financial profiles of small businesses in the same primary industry classification[2] or, if not available, in similar lines of business, which are not owned and controlled by socially and economically disadvantaged individuals. 13 C.F.R. § 124.104(c). The SBA should also consider the effect of the current financial crisis on Petitioner's ability to secure sufficient credit. *See* President George W. Bush, Address to the Nation (September 24, 2008) ("As uncertainty has grown, many banks have restricted lending. Credit markets have frozen. And families and businesses have found it harder to borrow money.") (transcript available at http://www.whitehouse.gov/news/releases/2008/09/20080924-10.html).

The SBA must also give appropriate weight to the bank letter confirming Petitioner's inability to secure credit in excess of $500,000. Appeal, Ex. G. If the SBA finds this letter unconvincing, it must provide cogent reasons for that conclusion. It may not "arbitrarily disbelieve credible evidence." *See Matter of Timely Engineering Soil Tests, LLC*, SBA No. BDP-297, at 11 (2008). Rather, if the applicant "establishes a prima facie case supported by credible and credited evidence," the SBA must accept the evidence as true unless "the contrary has been shown or such evidence has been rebutted or impeached by duly credited evidence or by facts officially noticed and stated." *Matter of Woroco Int'l*, SBA No. BDP-174, at 9 (2002) (quoting H.R. Rep. No. 1980, 79th Cong., 2d Sess., at 36 (1946) (discussing § 7(c) of the

[1] The SDB program utilizes 8(a) criteria for social and economic disadvantage. 13 C.F.R. § 124.1002(a), (b)(2).

[2] Primary industry classification is defined as "the four digit Standard Industrial Classification (SIC) code designation which best describes the primary business activity of the 8(a) BD applicant or Participant." 13 C.F.R. § 124.3. Effective October 1, 2000, the North American Industry Classification System (NAICS) replaced the SIC system as the basis for the SBA's small business size standards. *See* 65 Fed. Reg. 30836, 30840 (May 15, 2000) (amending 13 C.F.R. § 121.101). The SBA has converted its table of size standards to the 6-digit NAICS codes. 65 Fed. Reg. 53533 (September 5, 2000).

Administrative Procedure Act, 5 U.S.C. § 556(d))). Here, Petitioner's evidence is credible and the SBA has not shown any substantial reason for discrediting it.

C. Remand Required

Both the motion for summary decision and cross-motion must be denied because each motion hinges on the proper application of Texas community property law when the condition predicate, the SBA determination actually applying community property law, is lacking.

It is "clearly apparent" that the SBA made a mistake of law by failing to apply Texas community property law in calculating Dr. Taylor's net worth. 13 C.F.R. § 134.406(e). Further, the record is insufficiently complete on Petitioner's access to credit and capital for me to determine whether the SBA was arbitrary, capricious, or contrary to law in its conclusion that Petitioner does not have diminished capital and credit opportunities. Accordingly, remand is required. *Id.*

VII. Conclusion

Accordingly, the SBA motion for a partial summary decision is DENIED. Petitioner's cross-motion for summary decision is DENIED.

The case is REMANDED to the SBA for further consideration and a new initial determination of Petitioner's eligibility for the 8(a) program that is consistent with this Decision and Remand Order. The SBA should review the existing record, including evidence in the appeal petition. Evidence need not be resubmitted, and the SBA may request additional evidence from Petitioner.

The SBA is ORDERED to follow the procedures mandated by 13 C.F.R. §§ 124.204-206.

The SBA is FURTHER ORDERED to issue, serve, and file its new initial determination with OHA no later than thirty (30) days from the date of this Decision and Remand Order.

If the SBA declines the application, the SBA is FURTHER ORDERED to treat the decline as an initial decline and afford Petitioner the right to request reconsideration and submit additional information and documentation to support its request.[3] 13 C.F.R. § 124.205. The SBA must also afford Petitioner the right to appeal the SBA determination without requesting reconsideration within the time periods prescribed by 13 C.F.R. § 124.206.

The SBA's determination must provide cogent reasons for its conclusions and specify the facts it found to support those conclusions.

[3] If the SBA certifies Petitioner, it should file and serve OHA a notice of certification.

I retain jurisdiction over this matter during the period of remand.

RICHARD S. ARKOW
Administrative Law Judge