University of Pittsburgh

From the Selected Works of Mirit Eyal-Cohen

February 23, 2011

Why is Small Business the Chief Business of Congress?

Mirit Eyal-Cohen, *University of Pittsburgh School of Law*

Available at: https://works.bepress.com/mirit_eyal-cohen/1/
WHY IS SMALL BUSINESS THE CHIEF BUSINESS OF CONGRESS?

Mirit Eyal-Cohen*

ABSTRACT

Small business is a sacred cow in America. In 1958, Congress created the Small Business Investment Company ("SBIC"), a unique public-private program that provides long-term capital to small entrepreneurs. From its inception, however, the SBIC has been plagued by inefficiency and failure. Yet, Congress continues to pour millions of dollars into the SBIC program, with no end in sight. What explains this failed policy course?

This article argues that the SBIC program exemplifies the pitfalls of legal and political institutional path dependency and should be replaced by private institutional lending system. Pursuant to this account, past decisions can influence future legal developments even in the face of material social change.

Political institutions can entrench ineffective paths by sustaining dynamics of "increasing returns" through processes of "positive feedbacks" and "self-reinforcement". Increasing returns occur when the benefits of a choice augment simply because over time more people opt for that choice.

Our romantic ideal of small business as an economic and social catalyst has sprouted positive cultural feedbacks. Thereafter, the establishment of the House and Senate Small Business Committees and the Small Business Administration sustained this culture, self-reinforcing the SBIC program inefficient path where we remain invested to this day.

TABLE OF CONTENTS

I. INTRODUCTION ................................................................. 2
II. PATH DEPENDENCE AS REFLECTED IN A POLITY ................................ 8
III. POSITIVE SMALL BUSINESS FEEDBACK ......................................... 10
   A. Small Business as the Epitome of American Liberty ................. 11
   B. Small Business Culture in Light of Endogenous Crises ........... 13
   C. Small Business Culture in Light of Exogenous Crises ............... 17
   D. Small Business Culture Promotes Social Justice .................... 20

* Assistant Professor of Law, University of Pittsburgh School of Law. S.J.D. University of California, Los Angeles; L.L.B., L.L.M, M.A. (History of the Americas) Tel-Aviv University. I thank Steven A. Bank, Paul L. Caron, Anthony C. Infanti, Mike J. Madison, Julie Makinen, Peter B. Oh, and Rhonda Wasserman, as well as participants from the University of Cincinnati School of Law faculty workshop and Law & Society Annual Meeting. I also thank research assistants Rachel Moses, Anthony Levanduski and Associate Director of Public Services at Barco Law Library Marc Silverman for their invaluable work.
IV. A NETWORK OF SELF-REINFORCING SMALL BUSINESS ORGANIZATIONS............................................................................................................................................... 24
A. Congressional Small Business Committees .......................................................... 25
B. The Birth of the SBA ......................................................................................... 27
C. From SBA to SBIC ......................................................................................... 29

V. LOCKED IN AN INEFFECTIVE PATH .................................................................. 32
A. Early Problems of the SBIC Program................................................................. 33
1. Human Capital Problems ............................................................................. 34
2. Agency Costs ............................................................................................... 36
   i. Poor Risk Management ......................................................................... 36
   ii. Deficiencies in the SBA’s Monitoring of SBICs ................................ 37
B. SBICs Today ........................................................................................................ 41

VI. CONCLUSION ..................................................................................................... 46

I. INTRODUCTION

Congress is well aware that 97% of all corporations are small.\(^1\) When the recent economic recession struck, the acute impact of the credit freeze on small business became a political rallying cry.\(^2\) Senator Mary L. Landrieu (D-LA) declared that “[s]mall business in America needs a champion in Washington right now,” while Senator Maria Cantwell (D-WA) demanded to know “[w]hen are we going to stand up for small businesses in America who have had trouble getting access to . . . capital, who have been penalized?”\(^3\)


\(^2\) See, e.g., Ylan Q. Mui, Thawing Credit Freeze for Small Firms; Microlending on the Rise, An Alternative to Traditional Banking, WASH. POST (Mar. 8, 2010) at A09.

\(^3\) LeMieux, Landrieu, Senate Democrats Fight to Include Credit Relief for Small Businesses, Congressional Documents and Publications July 22, 2010; see also id. (“One of the biggest hurdles is the ability for [small] businesses to secure loans or investors.”) (George LeMieux (R-FL)); 150 CONG. REC. H 2921, 2967 (2009) (“As a person in a small business and representing a number of small businesses for over 22 years, I can tell you small business employers do not want an inferior policy for their employees.”)
between long-term finance demand and the supply of loans or equity-type credit. Congress enacted a set of economic stimulus initiatives that introduced larger tax breaks for small businesses, increased the lending authority of the Small Business Administration ("SBA"), and spurred lending through the Small Business Investment Company ("SBIC") program.

It was the continuation of a pattern established decades earlier: Just before the onset of the Great Depression, President Calvin Coolidge proclaimed that "[t]he chief business of the American people is business." That mantra eventually was appropriated by small business. The creation of the SBIC program in 1958 was intended to stimulate economic activity by creating jobs and assisting in the national economic recovery. But what originally was meant to be a remedy inadvertently set into motion a path of waste that Congress has sustained now for over half a century. The fault, however, does not lie exclusively with politicians. They have been locked into this position because society has become enamored with the idea of small business. That romantic ideal has taken root within a myriad of legal organizations, and can no longer be easily undone.

Distilled to their essence, the recent initiatives to help small businesses are just old wine in new bottles. Most notable, the SBIC through which the SBA has channeled small business funding epitomizes how public-sector initiatives can fail within the private sector. For decades, the SBA has licensed the use of partnerships, LLCs, and corporations to make long-term loans to small businesses. These SBICs have been propped up even further by federally guaranteed loans, as well as a myriad of preferential treatment and concessions from the

(Representative John Tierney (D-MA)).


7 See 15 U.S.C.A. § 681 (2010) ("A small business investment company shall be an incorporated body, a limited liability company, or a limited partnership organized and chartered or otherwise existing under State law solely for the purpose of performing the functions and conducting the activities contemplated under this subchapter … [and] subject to the approval of the Administration.").

8 These loans can amount up to half of an SBIC’s paid-in capital. See, e.g., Small Business Investment Act of 1958, 15 USCS § 633 (1958)("The Small Business Investment Act of 1958").
government, all for the express purpose of encouraging investment in small business. Indeed, this expansive and sustained commitment by the government to the SBIC program has earned it the moniker of a “fourth banking system.”

And, by most accounts, this system is entirely broken. Studies of the SBIC program have found it has generated limited profits and incurred considerable losses to the federal government, thereby failing to provide sufficient capital to spur significant assistance to small business. Further, the program conducts minimal review of its loan recipients, and involves bureaucracy on an order that deters many venture capitalists. And the various exemptions and tax concessions granted to SBICs contribute to the increasing complexity of the legal system and compound the already elevated compliance costs of small business entities.

But the program’s survival, much less its problems, is a historical accident. When the SBIC program was introduced in 1958, it was chosen from a set of alternatives to support small business available at that time. Since that path was chosen, Congress repeatedly renewed the

---

9 Some of the preferential tax treatment the government grants investors in SBICs include full deductibility of dividends from SBICs by the receiving corporation. 26 U.S.C. § 243 (2009). Losses up to $100,000 from sale of stock of an SBIC are treated as ordinary losses, and thus deductible against ordinary income, which is taxed at higher tax rates; special non-recognition gain rules also permit investors to roll over publicly traded stock gains into SBICs without paying capital gain tax. See id. §§ 1242, 1044. Moreover, other government agencies have eased the regulatory burden on SBICs and provided them with more flexible rules. See, e.g., Allan F. Conwill, Regulation, Protection or Oppression? The Investment Company Act Impact on the Publicly Held SBIC (Oct. 3, 1963), http://www.sec.gov/news/speech/1963/100363conwill.pdf.

10 ADDISON W. PARRIS, THE SMALL BUSINESS ADMINISTRATION 150 (Ernest S Griffith & Hugh Langdon Elsbree) (1968); see also id. (Describing the SBIC as an addition to the existing “three traditional financial institutions in the United States- the commercial banks, savings institutions, and investment banks.”).


13 See, e.g., JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED—AND WHAT TO DO ABOUT IT I (2009) (Detailing the inherent problems with the SBIC program today).


15 See, e.g. H.R. 10345 proposed by John Wright Patman (D-TX) to form a small business capital banks system, Infra note 167.
program in all of its inefficient infamy. And each and every subsequent session of Congress has expanded the SBIC program, adding to the monolithic waste that persists to this day. The problem is that nobody knows why this is the case, much less how to steer funding toward small business in a more sensible manner.

One explanation for the program’s persistence may be simply politics. Pursuant to public choice theory, politicians arguably have been beholden to the interests of their constituents, many of whom own, operate, or work for a small business; and, indeed, there is some historical evidence to this effect. Further, the exalted status that small business as a bedrock of America perhaps insulates the SBIC program; no politician wants to be seen attacking “Main Streets across America” and taking money away from small businesses that are regarded popularly as “the engine of job creation in this country.”

Politics, however, cannot entirely explain the complex history of SBICs. That program is one of many divisions of the SBA, which has seen its lending authority constricted in numerous ways over the years. In contrast, the SBIC program has remained largely intact and even expanded to serve a myriad of social purposes. With the assistance of the House and Senate Select Small Business Committees and the SBA, the SBIC program has managed to displace far more efficient alternatives to small business funding, reflecting a heavy investment by our legal system that outweighs any advantages from possible change.

The missing piece of this puzzle lies in path dependence theory. Past decisions can affect our decisions today, even if society has changed

17 Phillips Shavecoff, S.B.A. Under Fire; Program To Assist Minorities Discounted N.Y. TIMES, May 16, 1971, at F3; A Bright Forecast for Small Businesses, N.Y. TIMES, June 24, 1984, at L120 (avowing to the notion that the business of our country is small business).
18 See, e.g., Eyal-Cohen, supra note 1, at 16 (demonstrating how lobbying efforts and rhetoric were some of the factors that influenced the creation of the Small Business Corporation in 1958).
19 Senate Democrats Fight to Include Credit Relief for Small Businesses, Congressional Documents and Publications, July 22, 2010 (Patty Murray (D-WA)).
20 Id. (Amy Klobuchar (D-MN)). But see IACI Eye On Boise, July 19, 2010 (“In reality, the real cynical political motivation for touting 'small business' is to create an 'us versus them' mentality that is not only a misrepresentation of reality, but a dangerous path of rhetoric that leads to an economic caste system.”).
21 See e.g. proposals to limit and even abolish the SBA in Reagan’s administration infra Part III.B.
22 See small business culture infra Part III.
23 See generally Douglas Holtz-Eakin, Should Small Businesses Be Tax-Favored? 48 NAT’L TAX J. 387, 387 (1995) (asserting that constructing a case of systematic favoritism of small businesses is quite difficult, especially through the tax code); See also supra note 16, at 28 (1996) (estimating the cost of annually subsidizing small business to be $5 billion). See also infra Part III.
significantly and those past circumstances may no longer be relevant.\(^{24}\) Four conditions may lead to path dependency for a policy choice: increasing returns, self-reinforcement, positive feedback, and lock-in.\(^{25}\) A path becomes dependent, or locked in inefficiency, due to a practice of "increasing returns"\(^{26}\) that occurs when organizations self-reinforce the positive outcomes of a certain choice compared with other possible options.\(^{27}\) When all of these conditions are present, an inefficient policy path can become locked-in, with the cost of switching to a superior alternative becoming prohibitively high.\(^{28}\)

Path dependency also can explain the persistence of legal and political institutions.\(^{29}\) Once in place, institutions are difficult to change while having a tremendous effect on the possibilities for generating sustained economic growth.\(^{30}\) Consequently, even if superior choices...


\(^{30}\) See, e.g., Pierson, supra note 26, at 259 (noting that, “despite massive social, economic, and political changes over time, self-reinforcing dynamics associated with
become available down the road, the entrenchment of certain institutional arrangements obstructs further change or any chance to reverse the initial choice. Moreover, alternatives that were once plausible may become inefficient to recover further down the road. In this way legal and political institutions can interfere with the natural progress of development and change, and may render an unwelcome path determined result.

The SBIC program received little attention from legal scholars. Likewise, the question of why our legal system maintains this inefficient program over a century has never been explored or examined through the prism of social history or the path dependence paradigm. This article argues that the SBIC program exemplifies the pitfalls of legal and political institutional path dependency. Part II provides a general account of the path dependence theory as applied in a political realm. Part III demonstrates how our romantic ideal of small business has sprouted positive cultural feedback. That positive feedback portrayed our belief in democratic entrepreneurship and small business as a means to stimulate economic activity and social change. Part IV delineates how that feedback has been self-reinforced by small business congressional committees and the SBA that ultimately cultivated the creation of the SBIC program. Part V establishes how the feedback and reinforcement have resulted in lock-in despite empirical evidence of dismal results by the SBIC program from its inception to the present. Our legal system collective action processes mean that organizations have a strong tendency to persist once they are institutionalized”).

See, e.g., Margaret Levi, A Model, a Method, and a Map: Rational Choice in MARK I. LICHGATE & ALAN S. ZUCKERMAN, COMPARATIVE AND HISTORICAL ANALYSIS, COMPARATIVE POLITICS: RATIONALITY, CULTURE, AND STRUCTURE 19-41 (1997) (using the metaphor of a tree where, “from the same trunk, there are many different branches and smaller branches. Although it is possible to turn around or to clamber from one to the other—and essential if the chosen branch dies—the branch on which a climber begins is the one she tends to follow.”).

remains heavily invested in an unsuccessful path, believing the costs of change outweigh any advantages from possible change. Finally, Part VI concludes that the time is ripe to break the SBIC path dependency through radical reform and to return to the initial proposal to finance small business through private local banks.

II. PATH DEPENDENCE AS REFLECTED IN A POLITY

Economist Paul David identified four common conditions that may contribute to path dependency in an economy that faces different technological choices: increasing returns, self-reinforcement, positive feedback, and lock-in.\(^{33}\) Increasing returns means the more a choice is made, the greater its benefits due to the fact that more people opt to make this particular choice.\(^{34}\) Self-reinforcement describes a condition where once a choice has been made, it creates complementary institutions that maintain this choice.\(^{35}\) Next, positive feedback processes are positive externalities created when the same choice is made by other people, i.e., there exists a benefit to people from having their choice be the prevailing one.\(^{36}\) Finally, the lock-in effect describes a circumstance by which an inefficient choice is repeated because a sufficient number of people have become invested in that choice.\(^{37}\) While the path dependence theory

\(^{33}\) Paul A. David, supra note 24, at 332.

\(^{34}\) For example, the more a contract term is used by firms, the greater the benefit from the common use of standard terms. Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd behavior and Cognitive Biases*, 74 Wash. U. L. Q. 347 (1996). Another example is the Polya Urn. In this experiment, there is a large urn containing two balls, one black, and one red. Each time, one ball is removed, and then returned to the urn, accompanied by an additional ball of the same color. This process is repeated until the urn is full. This experiment demonstrates that early draws in each trial, although random, will have an increasing effect on the final result. See generally Greg Hill, *History, Necessity, and Rational Choice Theory*, 9 Rationality & Society 9, 189-213 (1997).


\(^{36}\) For example, the more consumers use a certain software, the more applications are written to accompany this software and improve the software’s features, which attracts more users to purchase this software. Marina Lao, *Reclaiming A Role For Intent Evidence In Monopolization Analysis*, 54 Am. U.L. Rev. 151, 182 (2004) (describing positive feedbacks created when more users use Windows software).

\(^{37}\) Building on the software example above, because consumers face high switching costs to another software they become “locked in” and dependent on the initial software. Daryl Lim, *Copyright Under Siege: An Economic Analysis of the Essential Facilities Doctrine and the Compulsory Licensing of Copyrighted Works*, 17 Alb. L.J.
stresses that the future path depends largely on past choices, it also acknowledges that sudden shocks can alter the course of history.  

When applying these common conditions of path dependency to politics, political scientist Paul Pierson noted that four aspects of the political realm reinforce increasing returns processes: (1) the central role of political collective action; that is, the effectiveness of one's political action depends heavily on the actions of others and requires positive feedback to provide confidence that a large number of other people will do the same; (2) the high density of institutions encourages social actors to make commitments causing their cost of exit from established arrangements to rise dramatically; (3) power asymmetry in politics allows certain actors that are in a position to impose rules on others to make open political conflict unnecessary; and (4) the fact that the political system is usually complex and murky induces increasing returns in an attempt to make social interpretations of the current political system.

Pierson concludes that path dependence in politics puts organizations in the center and says "despite massive social, economic, and political changes over time, self-reinforcing dynamics associated with collective action processes mean that organizations have a strong tendency to persist once they are institutionalized." Explicitly, political institutions have a great influence in reinforcing path dependence in our

---

38 Douglas J. Puffert, *Path Dependence, Network Form, and Technological Change*, in William Sundstrom, Timothy Guinnane, and Warren Whatley, eds., *History Matters: Economic Growth, Technology, and Population*. http://www.econhist.vwl.lmu.de/nettech1.pdf ("A process of economic allocation is called path dependent when the sequence of allocations depends not only on fundamental, a priori determinants—typically listed as technology, factor endowments, preferences, and institutions—but also on particular contingent events.").

39 One example to increasing returns dynamics in a polity is the persistence of government structures of ancient European settlements. In remote and unattractive areas colonists tended to create colonies lacking strong property protections and safeguards against government expropriation, while in areas with more welcoming climates, Europeans were more inclined to establish colonies with more representative governance structures and trade-friendly policies. These initial institutional arrangements persisted as those colonies developed political structures and reinforced their path. Daron Acemoglu., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 Am. Econ. Rev. 1370, 1398 (2001).

40 Pierson, supra 26, at 257-262.

41 *Id.* at 259.
society by sustaining dynamics of “increasing returns” through "self-reinforcement” and "positive feedback” processes in a political system.\footnote{Id. at 251. Paul Pierson & Theda Skocpol, \textit{Historical Institutionalism in Contemporary Political Science}, in Ira Katznelson & Helen V. Milner (eds), \textit{Political Science: State of the Discipline}, 693-721 (2002),http://gking.harvard.edu/ArticleS/PieSko02.pdf. Pierson noted that what economists call "increasing returns" could generally describe self-reinforcing or positive feedback processes when analyzed against the distinctive characteristics of social processes. Pierson also noted “for some theorists, increasing returns are the source of path dependence, for others, they typify only one form of path dependence.” Pierson, supra note 26, at 251.}

Nobel Prize winning economist Douglass North emphasized the role of path dependence in explaining patterns of institutional emergence, persistence, and change.\footnote{Douglass C. North, \textit{the Historical Evolution of Politics}, 14 \textit{Int'l Rev. L. & Econ}. 381 (1994); \textit{See} generally Douglass C. North, \textit{Institutions, Institutional Change and Economic Performance} 92-104 (1990) (considering the structure of institutions and their impact on the organizations that operate according to them.)} He asserted it is important to distinguish between organizations and institutions, because while both provide the structural framework supporting human discourse, institutions are considered the rules of the game that contain constraints and enforcement characteristics, whereas organizations are the players. Organizations usually exercise their influence to maintain themselves and to stifle upstarts and change. This is even more pronounced when they also serve as agents of certain groups in society, and thus are not obligated to the general good of all citizens but only to the ones they represent. Once in place, institutions are hard to change, and they have a tremendous effect on the possibilities for generating sustained economic growth.\footnote{Douglass C. North, \textit{Institutions, Institutional Change and Economic Performance}, supra note 42, at 100.}

### III. Positive Small Business Feedback

Culture influences institutional performance. Yet, culture is a broad term that includes but is not limited to values, ideas, beliefs and other symbolic, meaningful systems that shape human behavior.\footnote{Geert Hofstede, \textit{Culture and Organizations}, 10 \textit{International Studies of Management & Organization}, 15-41, 15 (1980).} It affects how we interpret and process information, how we act, and how we expect others to act.\footnote{\textit{See}, e.g., Jenna Bednar and Scott E Page, \textit{Culture, Institutional Performance, and Path Dependence}, University of Michigan Institute of Governmental Studies (July 1, 2005),http://www.cscs.umich.edu/~spage/instpath.pdf.} Small business culture originated from Americans’ increasingly romantic and protective feelings about small businesses. Americans have long held dear general values of “freedom” and decentralization, and these values are reflected in the culture’s positive feelings toward small businesses. Entrepreneurs, Americans believe, epitomize individuality and freedom, and are a counterpoint to large corporations. This association of small businesses with fundamental
American values reinforced policies favoring small businesses. The fundamental importance of small business, grounded in our culture, supported the SBIC program. Small business culture produced a build-up of behavioral routines, social connections, and cognitive structures that provided "positive feedback" to the government of the positive externalities small business create in society that would seemingly disappear if the path were altered. Keepers of free competition, indicators to a healthy economy, and promoters of minorities and social justice were some of the positive feedback attributable to small concerns. Congressional interest in the SBIC program over time has increased due to that positive feedback that viewed the program as another means to stimulate economic and social change. Mistrust of big corporations and the belief in democratic entrepreneurialism were other social values instrumental in reinforcing the path. Along with those dynamics of positive feedback, small business organizations provided effective reinforcement that together contributed to the persistence of the SBIC program.

Originating from values of freedom and dispersion of power, a set of beliefs was formed about the benefits small businesses generate. Their volatile condition in times of economic crises and natural disasters nurtured the path of small business favoritism. This type of solicitude toward small business at times became a bias, not always justified on its merits. Congress sought to protect independent entrepreneurs from the power of trusts, crime, recessions, natural disasters, discrimination, poverty, heavy red tape and compliance costs. As America weathered internal economic crises, external natural catastrophes and changes in social status of minorities, these important events in twentieth century history sustained the development small business positive feedback.

A. Small Business as the Epitome of American Liberty

America has a love-hate relationship with big business. While big businesses are associated with efficiency in production and are credited with raising the standard of living, they are feared for the power they possess over prices, wages and social values. On the other hand, the public and small businesses have had a long, continuous love affair. It

---


48 Richard J. Pierce, Jr., Small is Not Beautiful: the Case against Special Regulatory Treatment of Small Firm, 50 Admin. L. Rev. 537, 542 (1998)(noting that the myth that small is good and big is bad that is deeply rooted in our cultural beliefs as responsible for that phenomenon).

49 Id.

started with the writers of the Constitution creating checks and balances against concentration of political power. It continued with the widely accepted proposition that one prerequisite for a good society and a prosperous economy is numerous small businesses.\footnote{See, e.g., [PARRIS], supra note 10, at vi. ("The fear of centralization has recurred throughout our history, and there has long been a suspicion among many Americans that economic power is political power. Hence, there have always been voices inveighing against interests and championing diffusion….Sprung from the theories of the Founding Fathers, this conviction remains a basic American principle.").}

American culture celebrates liberty and shuns concentrations of power.\footnote{The Declaration of Independence para. 2 (U.S. 1776) ("all men are… endowed … with certain unalienable rights, that among these are life, liberty, and the pursuit of happiness"). See also [WOOD], THE CREATION OF THE AMERICAN REPUBLIC, 1776-1787 viii (1969) (discussing the concepts of "liberty," "virtue," and "republicanism" in that period).} Inherited from British common law, a suspicion of corporate charters was witnessed by the founding father’s view that such special privileges generally led to monopoly.\footnote{Daniel A. Crane, Antitrust Antifederalism, 96 Calif. L. Rev. 1, 6 (2008).} Similarly, the choice of a federalist system reflected a mixture of reliance on and mistrust in a centralized authority, and resulted in a Constitution that created a federal government with checks and balances.\footnote{"From the start, American have regarded their government with a mixture of reliance and mistrust …’If men were angels,’ observed the 51\textsuperscript{st} Federalist Paper, ‘no government would be necessary.’” Arthur M. Schlesinger, Jr., Government: Crises of Confidence, in CHRISTOPHER DWYER, KNOW YOUR GOVERNMENT- THE SMALL BUSINESS ADMINISTRATION 7 (1991).}

Until the end of the nineteenth century, small businesses were the norm -- most businesses were modest and had relatively local dealings.\footnote{BLACKFORD, supra note 50, at 11 ("[T]housands of small, personally owned and operated firms…formed the glue of American's business system.")} They played an important role in developing the nation’s economy as thousands of small firms handled the production and distribution of goods and services.\footnote{Id.} With the advancement of technology that permitted economies of scale and scope came the “transportation revolution” by which big firms emerged and began to dominate the production industry, specifically railroads.\footnote{TAMIR AGMON & RICHARD DROBNICK, SMALL FIRMS IN GLOBAL COMPETITION, 9-10 (1994).} Big businesses soon developed into giant trusts by vertically integrating enterprises to combine mass production with mass distribution, and controlled all the production and sale stages of their products. Small firms survived this age of giants by occupying market niches ignored by big businesses.\footnote{BLACKFORD, supra note 50, at 11-14. Sanford L. Jacobs, Small Business; Small concerns find a niche- solving problems of big firms, WALL ST. J., Apr. 21. 1986, at 25 (Arguing small concerns find segments of the market big companies are not serving).}

Concern for small business remained at the heart of American society.\footnote{See, e.g., [BROILES], supra note 35, at 14.} The very nature of the nation’s democracy, said Lawrence M.
Friedman, is "small local people, with small, local minds, wield enormous power over schools and over municipal politics." The national ethos of the “American dream” and “the land of endless opportunity” have been irrevocably entwined with preserving free private enterprise and the need to guarantee the well-being of small business.

Yet, to protect entrepreneurial interests, the government had to regulate the market and limit the freedom of some market actors, sometimes restricting the same economic freedom it sought to promote. Over the years, antitrust laws and trade regulations were some of the measures taken to regulate abuses of corporate power. This type of restrained capitalism has been the subject of much debate over the years and its boundaries are still being reexamined today.

B. Small Business Culture in Light of Endogenous Crises

Over the years, internal predicaments within the market affected Congress's sense of responsibility to the well-being of small business. Merger waves, hostile takeovers and other anti-competitive dealings originating within the market had a large effect on strengthening small business culture. Although Congress could not prevent anti-competitive conduct altogether, it felt responsible for the effect that conduct had on small business. Congress responded by trying to regulate large business while increasing small business favoritism.

In the 1800s, monopolies were a key feature of the U.S. economy, which eventually spurred lawmakers to enact antitrust legislation. In the age of giant railroads, oil, steel and sugar trusts, companies such as U.S. Steel and Standard Oil controlled the supply and prices of products in their industries. To protect competition in the "movement of commerce," that is, the transportation industry, Congress enacted the Interstate

\[\text{Japanese Views on Economics, Law, and Values, 1 Tex. Wesleyan L. Rev. 109 (1994)}\]

(comparing the differences between the American and the Japanese conceptions of fair competition and belief in government intervention in the market economy.)

\[\text{60 Lawrence M. Friedman, Access to Justice: Some Comments, 73 Fordham L. Rev. 927, 930 (2004).}\]

\[\text{61 See, e.g., Lee H. Hamilton (D., IN) 124 Cong. Rec. 5433 (1978) ("[T]he independent entrepreneur is a central figure in American folklore- an integral part of the 'American Dream'.")}\]

\[\text{62 For the expansion of federal jurisdiction attributable to protecting entrepreneurial interests see, e.g., Felix Frankfurter & James M. Landis, The Business of the Supreme Court: A Study in the Federal Judicial System 64-65 (1928).}\]

\[\text{63 Critics often claim that the government became too involved in business. For a description of the change in the model of corporate regulation, See, e.g., Susan J. Stabile, Using Religion to Promote Corporate Responsibility, 39 Wake Forest L. Rev. 839, 872 (2004).}\]

\[\text{64 Mergers Still Threaten Small Business, Says House Panel’s Report, Wall St. J., at 3 (Nov. 9, 1962).}\]

\[\text{65 Robert H. Bork, Legislative Intent and the Policy of the Sherman Act, 9 J. of L. & Econ. 7, 32 (1966).}\]
Commerce Act in 1887. Three years later, Congress broadened competition policy with the enactment of the Sherman Act "to protect trade and commerce against unlawful restraints and monopolies." It also created the Federal Trade Commission as an independent regulatory agency and empowered it to assist the Justice Department in enforcing antitrust laws. During the Gilded Age and the creation of a modern industrial economy monopolies and trusts were formed. In response, the government enacted antitrust laws that sought to balance and regulate, yet not destroy, concentrations of economic power.

Congress sought to maintain a free market by supporting small firms. Small firms became a symbol of fair competition, free flow of ideas, and freedom to pursue a new venture. Thereafter, preconceptions of the role of government as protector of competition followed this era and reinforced the path of small business favoritism. Great merger waves

---

71 See, e.g., Representative Abraham J. Multz (D., NY) discussing the Robinson-Patman Act, 97 Cong. Rec. 6773 (1951) ("Competition is healthy. But unfair, cutthroat competition has the effect of destroying competition by forcing independents out of business and leaving the field clear for monopoly."). See also Monopolistic Practices and Small Business. Staff Report to the Federal Trade Commission, Subcommittee on Monopoly, Committee on Small Business, Select. Senate, 82-2 CIS-NO: S5250 (1952); Samuel Augustus Nunn, Jr. (D., GA) 128 Cong. Rec. 9177 (1982) ("I have briefly reviewed these statistics to demonstrate that small business is not a special interest group in our American economy. Small business is the heart of the free enterprise system, that sector most likely to take the steps necessary to get this Nation back of the road to economic recovery.").
72 Representative Paul Brown (D., GA), 103 Cong. Rec. 10208 (1957) ("Small business is a symbol of opportunity, enterprise, innovation, and achievement. It is an independent way of life, standing for something quite essential to our freedom.").
during 1895-1905, 1925-29, 1965-68, and the early 1980s renewed debate over the extent of government intervention necessary to maintain free competition. During those waves, Congress was reluctant to limit conglomerates and interfere in market forces too greatly.

Congress assumed the role of guardian of small firms. Instead of directly restricting large firms, it sought indirectly to help small business complete with their counterparts. To reduce the incentives for big businesses to merge, Congress eliminated benefits associated with mergers and takeovers. Congress also increased the lending authority of small business organizations as a way to enable small businesses to resist mergers or acquisitions, and tripled the damages in antitrust claims against large companies.

Although trends in antitrust regulation and enforcement changed over the decades, small business as symbol of free enterprise remained an unwavering element of small business culture. For example, small business favoritism through antitrust laws was interrupted during the merger wave of the 1980s and the laissez-faire macroeconomic policies.

---

74 Harvard economics professor Andrei Shleifer and University of Chicago finance professor Robert W. Vishny claim four major merger waves occurred in the twentieth century. The first one came as a reaction to the Sherman Antitrust Act in 1890, and ended in the beginning of the twentieth century with several Supreme Court decisions and the Clayton Act. The second merger wave began in late 1920, coinciding with a buoyant stock market, and ended in the Great Depression. The third wave came in the late 1960s, when conglomerate mergers were initiated in a stock market boom. The last one was the takeover wave of the 1980s, which was characterized by a great number of hostile takeovers. See Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of The 1980s*, 249 SCIENCE 745 (1990).

75 Louis M. Kohlmeier, Antitrust Offensive, Wall St. J., Mar. 25, 1969, at 1 ("Already the House Ways and Means Committee is considering a measure to limit the tax benefits to conglomerates that issue debentures in exchange for stock of a company being acquired.").


77 Small business favoritism through antitrust was interrupted during the merger wave of the 1980s and the laissez-faire macroeconomic policies of the Reagan administration that can be summed up as 'bigness doesn't necessarily mean badness.' Reagan's new agenda sought to deregulate and relax antitrust enforcement efforts against large businesses in the name of efficiency. The Reagan administration, which contained many supporters of the "Chicago School" of economics, contended that antitrust law overprotects inefficient small businesses. See generally Sean Wilentz, *The Age of Reagan: A History, 1974-2008* (2009); John Ehrman, *The Eighties: America in the Age of Reagan* (2008); Robert E. Taylor & Stan Crock, *Giant Steps*, WALL ST. J., Jul. 8, 1981, at 1 (quoting Reagan's new Attorney General William French Smith who attacked past enforcement of antitrust laws as "misguided and mistaken... efficient firms shouldn't be hobbled under the guise of antitrust enforcement"). The Reagan administration was able to veer off in an opposite direction, and bigness was no longer a symbol of villainy but of promising prosperity. Yet, even this temporary halt in the path of small business preferences did not have a long-term effect on small businesses preferential status. It was not long before small business culture regained its standing in the eyes of the government, viewing small entrepreneurs as the gatekeepers of free competition.
of the Reagan administration, which can be summed up as “bigness doesn't necessarily mean badness.”

For a brief period, small businesses lost their special status in the eyes of the administration, while big companies were portrayed as victims, unreasonably prosecuted under antitrust laws. In his efforts to balance the budget and close the nation's deficit, Reagan suggested cutting federal borrowing, including the SBA's loan program. Reagan went as far as proposing to abolish the SBA by eradicating its loan programs and placing some of its remaining functions in the Commerce Department.

---


79 At some point, Reagan's policies even started to harm small business. For example, the antitrust division in the Reagan administration did not actively prosecute many antitrust cases. Robert E. Taylor & Stan Crock, supra note 77 ("Cases didn't get filed on the basis of Populist ideas of economic pluralism," says Mr. Shenefield, the former antitrust chief.). In another case, government officials testified at a hearing of the House Monopolies subcommittee in favor of certain mergers of large financial-services companies. Big Financial-Services Mergers Don't Hurt Competition or Consumers, U.S. Aides Say, WALL ST. J., Jul. 9, 1981, at 6.

80 Robert E. Taylor & Stan Crock, supra note 77 ("a bill to give surer antitrust exemptions to companies that combined forces on export business.").

81 Laurie McGinley, Treasury Borrowing Needs Are Projected At $203 Billion New Cash In Fiscal Year 1984, WALL ST. J., Jan. 31, 1983, at 5 ("Under the administration's proposal, the Small Business Administration's subsidized direct-loan program would end, as would the mortgage-purchase activities by the Government National Mortgage Association.")

Nevertheless, this temporary halt in largesse toward small businesses did not have a long-term effect on their preferential status. Strong support from small business committees and Democrats hindered Reagan’s efforts to eradicate the SBA and ultimately lead to an increase in the SBA’s lending authority. \(^{83}\) It was not long before small business culture was resurgent, and the government again viewed small entrepreneurs as the gatekeepers of free competition.

C. Small Business Culture in Light of Exogenous Crises

Small business's failure to acclimate to extrinsic, apolitical forces was viewed by the government over the decades as a national problem. The government felt particularly responsible for the condition of small businesses and at times culpable for the woes they experienced. A historical sequence of extreme events that originated outside the socio-economic system such as hurricanes, earthquakes, and floods had a large effect on the expansion of small business favoritism. Consequently, the government used its power to regulate the market and to grant small business temporary relief that became permanent even when the threat had passed.

In his book *Crisis and Leviathan*, Robert Higgs argues that the main reason for the expansion of the government lies in its responses to crises such as economic turmoil, natural disasters and war. \(^{84}\) The extension of government emergency power, according to Higgs, endures long after each crisis has passed, encroaching on civil and economic liberties and fostering extensive corporate welfare. \(^{85}\) As government's power grows, writes Higgs, it becomes autonomic and maintains its size and scope. \(^{86}\) Aside from the expansion of government, economic shocks such as the one presently in effect also generate benefits to certain groups that persist even after the crisis is resolved. \(^{87}\)

Seen as a particularly vulnerable part of the production chain, small business favoritism was further expanded during crises. For example, on March 27, 1964, a forceful earthquake struck Alaska followed by seismic

---

\(^{83}\) See, e.g. *Fearing Effects of Large Mergers, Plans House Hearings on Antitrust Policy*, WALL ST. J., Jul. 23, 1981, at 21 (House Judiciary Committee Chairman Peter Rodino (D-NJ) questioning whether small businesses could survive in an economy in which all economic assets were concentrated in a few large corporations.); *Raiding Republican Turf, WALL ST. J.*, May 15, 1984, at 62 (Democrats woo small business); *Senate Committee Insists That It Has Votes To Save SBA, WALL ST. J.*, Mar. 1, 1985, at 6; *Senate Business Panel Backs Funding of SBA, WALL ST. J.*, Mar. 27, 1985.

\(^{84}\) ROBERT HIGGS, CRISIS AND LEVIATHAN 17 (1989).

\(^{85}\) Id., at 11.

\(^{86}\) Id., at 189.

\(^{87}\) Id., at 168.
waves devastating much of Anchorage and many seacoast towns. Although there were no casualties, the impact of the quake was serious. 88 That same year, a series of six Atlantic hurricanes killed over 200 civilians and caused an estimated at $2.5 billion in property damage in Florida, Louisiana, Texas, Georgia, and North Carolina. 89 Floods in Montana and the Ohio River Valley, forest fires in California and a big cloudburst in Arizona were other natural catastrophes that year. 90

As an immediate response to these catastrophes, the government enlarged lending to small business. Congress authorized the SBA to make immediate disaster loans totaling about $49.5 million. Consequently, the SBA halted its regular small business loan program to preserve money for disaster lending. 92 In September 1964, President Johnson asked Congress to bail out the SBA with a $60 million supplemental appropriation to its depleted reserves in the wake of the hurricanes, earthquakes and floods. 93

Yet, these allowances, which were created to support small firms in a time of emergency, remained in place after the danger had passed. Two years after the Alaska calamity, Congress voted to continue to divert money to meet heavy demand for SBA disaster loans 94 Started as a temporary solution to an immediate problem, the SBA disaster assistance programs became permanent and remain operative to this day. Over the years, the loan program was expanded to offer low interest loans to homeowners, renters, non-profit organizations, and businesses of all sizes. 95 Much like the 1960s disasters, the same pattern of government response can be seen in recent disasters including the Deep Water Horizon oil spill. 96

91 Small Business Agency Curbs Loans to Firms: Cites Disaster Lending, WALL ST. J., Nov. 10, 1964, at 3.
92 The unusual number of disasters reduced its revolving funds "to the point where conservation measures are required." Id.
93 Johnson Requests $60 Million to Replenish the Small Business Administration's Loan Fund, WALL ST. J., Sep. 24, 1964, at 12.
94 The legislation also created two revolving funds, one for the physical disaster program and one for SBA's regular projects. See Small Business Agency's Loan Limit and Funds Increased by Senate, WALL ST. J., Mar. 9, 1966, at 5.
95 SBA Disaster Assistance, http://www.sba.gov/services/disasterassistance/.
96 As a response to the Deepwater Horizon oil spill, the government approved an increase to the SBA lending authority. The SBA approved 128 economic injury assistance loans, totaling more than $8.5 million, for small businesses in the Gulf Coast affected by the spill. Additionally, the agency granted deferments on 531 existing SBA
Lastly, recessions are another type of event over which Congress has little control. But lawmakers, nevertheless, attempt to address the effect of recessions on small business. Because small businesses often have tiny reserves, they can be deeply affected by recessions. Such was true in the recessions at the beginning of the 1970s and the 1980s. High inflation, which added to debts, had an especially devastating effect on small concerns, which had perennial difficulty in obtaining capital in the first place. Between 1973-1975 and 1980-1982, recessions forced many businesses to close and many people lost their jobs. Tight credit aggravated entrepreneurs’ failures. In the midst of those recessions, lawmakers and presidents recognized the extra trouble small businesses faced. To fight unemployment, recession, and other economic ills, the government increased allocations to small business, provided other benefits to such firms, and granted the SBA increased lending authority.

97 Recessions in the 1980s caused 5,550 small businesses to go under, 14% above the rate of the recession during the early 1970s. See Amal Nag, Slump Devastates Small Businesses; Failures Threaten to Slow Recovery, WALL ST. J., Oct. 10, 1980, at 27 ("We are seeing a fairly unique situation that is hurting small businesses worse than any previous recession…”).


99 Lack of credit and high interest rates contributed to business failures in the 1980s. See Sanford L. Jacobs, Steep Borrowing Costs Tied to Prime Rate Make Going Tough for Small Businesses, WALL ST. J., Feb. 22, 1980 at 19 ("'I'm sick. I'm just sick,' the 58-year-old entrepreneur says. 'I'm worried more and more as I go along. This interest rate is too much'… high interest rates 'are the greatest contributor to current business failures'.")

100 Representative Virginia Smith (R., NE) spoke on the floor during National Small Business Week, commenting "During these difficult economic times, the spirit of small business..." 128 Cong. Rec. 9572 (1982). See also, Thomas Petzinger, Jr., infra note 258.

101 See, e.g., Credit Crunch, Year-End Recession Loom, Democrats of Joint Economic Panel Warn, WALL ST. J., Mar. 26, 1973. Jerry Landauer, Democrats’ Slowness in Paying Their Bills Irks Small Businesses, WALL ST. J., Feb. 5, 1980, at 1. ("When President Carter, in the midst of his Iranian and Afghanistan troubles, took time out to address 2,000 representatives of small business last month, it was considered a powerful testament to the political importance of the group...But... As far as they're [Small Businesses] concerned, the President could start by getting the Democratic Party to honor its debts."); Sanford L. Jacobs, Updates on Some 1982 Stories of Interest to Small Concerns, WALL S.J., Jan 3, 1983.

102 Kennedy Readies Program to Curb Jobless Roll Rise, WALL ST. J. Nov. 21, 1960, at 3 (announcing that more loans will be granted to small business concerns at interest rate lower than the currently rate charged by the SBA to help provide additional jobs). See also Small Business Agency Cuts Interest Loans In 101 Distressed Area, WALL ST. J., Apr. 6, 1961, at 3.

103 For example, during the 1960s the government approved many expansions of the SBA loan program as ways to address the tight credit problem of small firms. Small
Economic recovery and stimulus acts were part of the artillery used to fight economic crises. 104 Once created, that path of assistance often remains unchanged. 105 To address the problem of tight credit, the government sought to enlarge the availability of funding, 106 relax the limitations on federally guaranteed loans, and encourage transactions with small businesses. It also collaborated with banking associations to provide joint long-term loans.

D. Small Business Culture Promotes Social Justice

Since many minority firms are small businesses, affirmative action is

---

104 The Economic Recovery Tax Act of 1981, Pub.L.No. 97-34, 95 Stat. 172 (1981). In this act, Congress created the “Accelerated Cost Recovery System” (ACRS), and liberalized the depreciation rules by changing the recovery period of certain assets retroactively. Although this measure was presented as a small-business aid, it did not provide aid to concerns that did not have enough new assets put into service or enough profits to offset against those deductions. Eventually, those rules, resulted in some small firms trading their depreciation benefits with their larger counterparts. 128 Cong. Rec. 9177 (1982). Other examples are the Tax Reform act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). See also Sanford L. Jacobs, How Changes in the Tax Law Will Affect Small Companies, WALL ST. J., Oct. 19, 1981, at 31.


106 Arlen J. Large, R & D Funding for Small Firms Sets Off Big Fight in Congress, WALL ST. J., Apr. 19, 1982, at 29, Senator Warren Rudman (R., NH), 127 Cong. Rec. 29733 (1981) (“Let there be no mistake about this: S. 881 is not a small business relief bill. Rather, it is designed to address a specific problem in the most efficient manner.”)

107 For example, the Reagan Administration established the Small Business Innovation Research program, a set aside program requiring federal agencies to allocate a share of their research and development budgets to small research and development firms. P.L. 97-219. The Small Business Innovation Development Act of 1982. P.L. 97-219.

108 Long-Term Loans Offered to Small Firms in Joint Banking Industry-SBA Program, WALL ST. J. at 5 (Sep. 7. 1962). SBA Boosts Ceiling For Interest Charges on Fixed-Rate Loans, WALL ST. J., Jul. 1, 1980 at 42. (The SBA allowed banks to charge more interest over the prime on its SBA loans that are 90% guaranteed by the government to encourage banks that were increasingly hesitant to lend on such terms, even when the government assumed most of the risk.). Yet, when business failures continued to soar, small businesses blamed the SBA for not addressing the problem properly. Sanford L. Jacobs, SBA’s Plan to Cut Loan Rates Generates Lots of Opposition, WALL ST. J., Oct. 26, 1981, at 29. (“None of this solves the basic problem of brutally high interest rates that many small companies simply can’t afford.”)
another positive feedback in small business culture.\textsuperscript{109} Financed primarily by personal and family savings, aiding small businesses has been seen as a way to aid minorities by encouraging their economic independence.\textsuperscript{110} Small businesses play a central role in creating jobs and nurturing entrepreneurship among minorities.\textsuperscript{111} Because Asians, Blacks, Hispanics and Native Americans have long faced discrimination in the workplace, fostering minority business ownership was considered an anti discrimination measure to improve their employment prospects and well-being.\textsuperscript{112}

Small businesses have also been a place for women to get ahead.\textsuperscript{113} During World War II, when industrial jobs considered quintessentially masculine were transferred to women as part of the war effort,\textsuperscript{114} women began to gain respect and fair treatment in the workplace.\textsuperscript{115} During the postwar period, American values returned to domesticity and familial roles of women. Still, small businesses offered an opportunity for women to earn money outside the home, even if the jobs were often fairly

\textsuperscript{109} For example, in 2002, more than half of Black-owned businesses had less than $10,000 in business receipts in 2002, compared with one-third of White-owned firms and 28.8 percent of Asian-owned firms. Of employer firms with 500 or more employees, more than 18 percent of total white-employer firm receipts. Asians had the smallest proportion of businesses—0.04 percent—with 500 or more employees, and these large firms accounted for less than 7 percent of Asian business receipts. \textit{See Minority in Business: A Demographic Review of Minority Business Ownership, Small Business Association, Office of Advocacy, April 10, 2007, at 25, http://www.sba.gov/advo/research/rs298tot.pdf.}

\textsuperscript{110} Id. at 13.


\textsuperscript{114} \textsc{Ruth Milkman}, \textit{Gender At Work: The Dynamics of Job Segregation by Sex During World War II} (1987).

\textsuperscript{115} Id. at 10.
traditional. Employed women mostly worked in the retail sales, personnel and educational service industries, the so-called female ghetto.116 "The years of mid century essentially marked time for women in business," concluded Angel Kwolek-Folland, a leading historian of women in American business.117 At the end of the twentieth century, American women were starting new businesses at twice the rate of men and owned almost a third of existing firms.118

Over the years, government agencies altered their approach to small businesses, shifting from a neutral stance on race and gender to one with race and gender preferences.119 Congress increased federal assistance programs and anti-poverty bills providing preferential treatment, grants, education, and jobs to help minorities and women.120 The SBA boosted minority hiring within the agency and began to act against racial discrimination by lenders.121 The SBA investigated complaints of racial discrimination and upon discovery of such conduct accelerated the loan maturity or took the borrower to court.122 Affirmative action became a priority in the SBA, which created the position of Special Assistant for Minority Groups to supervise minority recruitment within the agency. The SBA also founded the Women's Speaker's Bureau to encourage women to pursue business careers, to set aside top-level positions for women, and to authorize micro-loans to women-owned businesses.123

Another path the government took to promote minority small business was developing a minority loan program with favorable

---

116 Id. at 12.
118 When discussing the Small Business Tax Fairness Act, Congressman William Reynolds Archer, Jr. (R-TX), Chairman of the Committee on Ways and Means, noted that this year, would be the first year in our entire history where women will own more than half of all businesses, about 8 million across the nation. Congressman William Reynolds Archer, Jr (R-TX) 146 CONG. REC. 792, 843 (March 9, 2000). In 2002, it was reported that of 22,974,655 existing firms, 6,489,259 firms (28.2%) were owned by women. Minority in Business: A Demographic Review of Minority Business Ownership, Small Business Association, Office of Advocacy, April 10, 2007, at 5, http://www.sba.gov/advo/research/rs298tot.pdf
119 Scholars attributed this tendency to administrative pragmatism, reaction to the urban riots of the 1960s, or elitism. JONATHAN J. BEAN, BIG GOVERNMENT AND AFFIRMATIVE ACTION: THE SCANDALOUS HISTORY OF THE SMALL BUSINESS ADMINISTRATION 39 (2001).
120 Poverty Fight Plans, Wall St. J. at 1 (May 29, 1964) (for example, as part of President Johnson's anti poverty bill, the administration enabled the SBA to expand its limit for minority loans).
121 BEAN, supra note 119, at 40.
122 Id, at 42.
conditions.\textsuperscript{124} It was a well known that minority entrepreneurs found it harder to start a business in crime-ridden areas.\textsuperscript{125} They were refused loans by traditional lenders because they were considered to have a greater risk of failure than white entrepreneurs.\textsuperscript{126} Yet for minority men and women, becoming entrepreneurs was a way to move up the economic ladder.

The government also created the Office of Minority Business Enterprise program at the SBA, which established Minority Enterprise Small Business Investment Companies (MESBIC) to encourage new minority businesses.\textsuperscript{127} These programs sought to help blacks, Mexican-Americans, Puerto Ricans, Native Americans and others become businesspersons and offered incentives for corporations to locate plants in urban slums.\textsuperscript{128} Yet, soon the MESBIC program was criticized for its inefficiency and for providing meager funding to minority small businessmen.\textsuperscript{129} Scandals related to the MESBIC program and investigations that revealed funds awarded through questionable grants further undermined the program’s credibility.\textsuperscript{130} Consequently, supporters of race-neutrality pressed Congress to open the program to the general "disadvantaged" population.\textsuperscript{131}

Yet, when the government tried to deviate from the path of affirmative action and scrutinize the SBA minority development programs, it encountered political resistance.\textsuperscript{132} The path of affirmative

\textsuperscript{124} \textit{Business in Riots to Get SBA Loans}, Wall St. J., Jul. 31, 1967, at 26 (President Johnson ordered the Small Business Administration to make long-term, low interest loans available to homeowners and small businessmen in riot-torn areas of Detroit to help them rebuild.).


\textsuperscript{126} John A. Prestbo, \textit{Going it Alone}, WALL ST. J., Apr. 10, 1969, at 1. (Many banks shun new business loans as too risky even when money is not tight).

\textsuperscript{127} Senate Select Committee on Small Business, Study of Minority Business Enterprise Programs, 95th Cong. 2nd Sess. (Oct. 5, 1978). \textit{See also} 49 Brooklyn L. Rev. 433, 472-473 (arguing that the SBIC/MESBIC program has not been successful in providing debt and equity capital to small businesses).


\textsuperscript{129} For example, in 1977 a task force of investment bankers concluded that SBIC/MESBIC assistance to small businesses was "inefficient and inappropriate, [and] that it reached only two-tenths of one percent of small business in existence at that time." \textit{Long Term Implications of Current Budgetary and Economic Trends on Unemployment, Minority Business and Education: Hearing Before the Task Force on Human Community Resources of House Comm. on Budget, 96th Cong., 1st Sess. 74 (1979)} (statement of Dr. Edward Irons). \textit{See also} Burt Schorr, \textit{Ailing Entrepreneurs}, WALL ST. J., Sep. 23, 1969, at 1. (U.S. Assisted Black Businesses Lag After Initial Financing. SBA finds new firms need working capital, advice; Nixon program imperiled.)

\textsuperscript{130} BEAN, \textit{supra} note 119, at 87. See, e.g. the Whitewater Scandal, one of the most known political scandals in 1999 when President Clinton was charged with influencing an SBIC to grant an SBA minority loan to a firm owned by the Clintons. \textit{Infra} note 244.

\textsuperscript{131} Id., at 88.

\textsuperscript{132} \textit{Trade Secrets... Minorities, SBA Clash... Malls Exhibitors}, WALL ST. J., Oct. 5, 1981, at 31 ("Minority Business supporters clash with the Small Business administration
action for minority businesses has been criticized for intensifying the segregation of minorities and their reliance on local markets. Nevertheless, it remains a strong part of small business culture to this day.

IV. A NETWORK OF SELF-REINFORCING SMALL BUSINESS ORGANIZATIONS

Along with small business culture, institutional path dependence contributed significantly to the persistence of the SBIC program. Our nation's political and cultural organizations helped shape current small business benefit patterns. They assisted the government in determining which alternatives should be pursued to benefit the constituents they represent and at the same time reinforced their own existence. Three major small business organizations provided these self-reinforcement dynamics -- the House and Senate Small Business Congressional Committees and the Small Business Administration. While these organizations were beneficial in serving as agents for, and promoting the interests of, small firms, they were also influential in blocking changes to the original path of the SBIC program. These organizations played a major role in leading Congress down a path from a traditional rational-based test, by which preferences are given to those who deserve them, toward an unrelenting favoritism of small business.

Through the establishment of certain agencies and organizations that created self-reinforcement dynamics, small business incumbents paved the path for SBICs and, once created, shaped it over the years. During the 1940s, unique conditions allowed Congress to take a specific trajectory and form specialized small business committees. These Select Small Business Committees and later the SBA played a central role in encouraging Congress to create, expand, and sustain the SBIC over SBA Administrator Michael Cardenas' efforts to limit the 8(a) program, which sets aside government contracts for minority companies. Mr. Cardenas wants to hustle some companies out of the program. Some have grown big. Some have abused the system and refuse to repay SBA advances. The SBA has proposed rules that would boot out companies after three or five years, depending on the type of business; those already in the program could be terminated sooner."

133 BEAN, supra note 119, at 53.
134 Id., at 90. Technically the SBA minority enterprise program was color-blind and therefore resisted constitutional challenge.
135 Congress provided for small business preferential treatment, See, e.g., Louis B. Schwartz, "Justice" and Other Non-Economic Goals of Antitrust, 127 U. PA. L. REV. 1076 (1979) (reviewing a list of 'interrelated' federal statutes of small business preferences, such as the Reclamation Act of 1902, which limited the sale of water from federal irrigation projects to a single owner; the Public Utility Holding Company Act of 1935 that relaxed restrictions to large utility firms provided that local firms were left unharmed; the Small Business Act of 1942, declaring congressional policy to assure "small- business concerns [a] fair proportion" of government procurement contracts; and, the Surplus Property Act of 1944, giving preference to small purchaser when disposing of federal war production facilities.)
program. Other Congresses continued this path, broadening the scope of the SBIC program, even when conditions did not warrant doing so. Rarely has Congress considered abolishing or limiting the SBIC program; rather, it followed the SBA and the small business committees’ recommendations to add funding authority and expand subsidies to SBICs to rectify hitches in the program.

**A. Congressional Small Business Committees**

During the 1940s, Capitol Hill officially opened its doors to small business, and it has not left since. The Senate Special Committee to Study and Survey Problems of American Small Business Enterprises was established in 1940 and its authority was later transferred to the Senate Select Small Business Committee. In 1941, the House of Representatives established a committee to investigate national defense program in its relation to small business that later was converted into the House Select Small Business Committee. While those committees started as temporary agents with no operative or legislative authority, they were re-approved every year until given permanent standing status. Although unable to consider bills, the committees’ mandates

---

136 The House Small Business Select Committee was formed in 1941 and was reauthorized every year until 1975 when it became a standing committee. The Senate Select committee is a standing committee formed in 1950 by S. Res. 58, 96th Cong. Rec. 2057 (1950). In 1953, Congress enacted the Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232 (1953), which formed the SBA to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns," and was made permanent in the Small Business Act of 1958, Pub. L. No. 85-536, 72 Stat. 384 (1958).

137 Tax Revision Hearings Open; Relief for Small Firms Urged by Witnesses, Wall St. J., Jan. 8, 1958, at 9 (“The witnesses yesterday urging tax help for small business… maintained the Government would not lose tax revenues from the changes since business activity and employment would expand as a result of the increased investment by the small firms.”).


139 H. Res. 294, 77th Cong., 87 Cong. Rec. 9418 (1941) (“defense contacts are being given to the larger corporations, with whom the small manufacturer cannot compete, and that certain sections of the country are getting a disproportionate share of defense work while other sections are neglected.” (Statement of Rep. Sabath)).


141 The House Select Small Business Committee was given permanent status in 1974 as part of Rep. Bolling's proposal to Rep. Hansen's reform proposal of the House committees. H. Res. 988, 120 Cong. Rec. 33705 (1974). The Select Senate Committee became a standing committee on 1981. S. Res. 101, 127 Cong. Rec. 5130 (Mar. 25, 1981). When the Senate unanimously approved the resolution to grant the small business committee a permanent status, it explained it was sending "a clear signal to the American people that the problems of small business are not to be ignored or forgotten.” 127 Cong. Rec. 31940 (Dec. 16, 1981). On June 29, 2001, its name was changed to the Senate
included inquiring generally into the problems of American small business, and proposing ways to advance and preserve the interests of small businesses.142

These Small Business Committees have had considerable influence. They often hold hearings with scholars, businessmen, and government agencies and prepare reports urging the House and Senate to adopt or amend legislation. In the midst of merger waves, the Small Business Committees warned Congress of the threat to small businesses and suggested what steps lawmakers should consider in addition to tightening antitrust legislation.143 To improve the competitive position of small firms, the committees encouraged Congress to grant a greater proportion of government research and development contracts to small business concerns on a regular basis and promoted greater use of competitive bidding by the Pentagon in the procurement contracts reserved for small businesses.144 Congress frequently followed these recommendations.145

Nevertheless, the most significant contribution of these committees came in the creation of the SBA and later the SBIC. The committees supervised the SBA and the SBIC closely in a friendly capacity.146 This was relatively easy given their similar mandates, common clientele, and friendships between committee and SBA members.147 Although they lacked legal authority to control SBA activities, the committees exercised power to discuss and criticize the SBA's operations. They held extensive hearings on various government policy and program matters affecting small business and the SBA.148 Having such allies Capitol Hill helped

Committee on Small Business and Entrepreneurship. S. Res. 123, 147 CONG. REC. 12492 (June 29, 2001).

142 See, e.g., Greater Federal Aid to Small Businesses Urged by House Unit, WALL ST. J., Jan. 10, 1963, at 13. Consequently, small business committees were frequent initiators of leading small business acts in Congress, See, e.g., Senate Unit Asks Change in Small Business Investment Program to Make It a Success, WALL ST. J., Apr. 27, 1960, at 6. See also Arlen J. Large, R & D Funding for Small Firms Sets Off Big Fight in Congress, WALL ST. J., Apr. 19, 1982, at 29.


145 Id. President Kennedy allocated a greater number of defense contracts to small business.


147 For example, many committee members continued to support the agency's actions even when they served on other committees and held other strategic positions. PARRIS, supra note 10, at 172.

148 For example, at some point the House committee called to abolish the SBA's Loan Policy Board for lack of efficiency in promoting small business loans. See Wild Horses and Wooly Lenders, WALL ST. J., at 16 (Jan. 19, 1965). The committees' chairmen were considered very knowledgeable about small business, and had significant influence over the SBA. PARRIS, supra note 10, at 172-173. For the history of the long-time chairman of the Senate Small Business Committee between 1955 and 1967 Senator John Sparkman (D., Ala) see The biography of John J. Sparkman at the John J. Sparkman
small business organizations maintain and strengthen their influence in Congress and contributed to the perpetuation of their preferences.\[^{149}\]

**B. The Birth of the SBA**

One of the most significant moments in small business history was the creation of the Small Business Administration. The SBA grew out of a series of agencies tracing back to the Reconstruction Finance Corporation (RFC) from the times of the Great Depression, and was modeled after the War Finance Corporation of World War I (both of which supported state and local government loans to banks, railroads, and firms of all sizes).\[^{150}\] By 1942, large industries’ were enjoying a big share of wartime defense contracts, and Congress became concerned about the state of competition. To promote the participation of small businesses in war production and to give them financial viability, Congress created the Smaller War Plants Corporation (SWPC).\[^{151}\] The SWPC offered direct loans, encouraged financial institutions to provide credit to small firms, and urged federal agencies and big businesses to increase the participation of small business in procurement contracts. Yet, the SWPC was soon dissolved and its lending authority was dispersed due to criticism regarding its lack of information and expertise.\[^{152}\]

Following dissolution of the SWPC, the Senate Small Business Committee proposed a bill to create a new small business agency.\[^{153}\]

---

\[^{149}\] PARRIS, supra note 10, at 172 (reporting that Congressman Patman and Senator Sparkman both left their respective Small business chairs to serve on the Banking and Currency committees.) But see, in 1981 the Senate Small Business Committee initiated a two-month investigation and hearings on SBA procurement practices. The committee found evidence of ignored procurement rules and of administration officials granting personal favors and pushing through contract awards without competition. Yet, such incidents were exceptions to the general good relations between the committees and the SBA as they both worked for the same cause of serving as the small businessperson's liaison in the government, preserving and promoting small business preferential treatment. Sanford L. Jacobs, *SBA's Procurement Practices Come Under Senate Scrutiny*, WALL ST. J., Apr. 27, 1981, at 33.

\[^{150}\] PARRIS, supra note 10, at 5.


\[^{152}\] The SWPC dissolved in 1945, and its lending and contract powers were disbursed between the RFC and the Office of Small Business (OSB) in the Department of Commerce. During the Korean War, Congress attempted again to assist small businesses by creating the Small Defense Plants Administration (SDPA) with a mandate similar to the SWPC’s (excluding lending authority, which remained in the hands of the RFC). Amid calls to abolish the RFC in 1952 because of some dubious loans it had made the Senate Committee on Banking and Currency created a subcommittee headed by Senator William J. Fulbright (D, AR) to hold hearings and investigate allegations of corruption by the RFC's leaders. PARRIS, supra note 10, at 4-18.

July 30, 1953, President Eisenhower signed the Small Business Act, which created the Small Business Administration in order to provide a governmental source of funding for small business as a temporary agency set to expire on June 30, 1955.\(^{154}\) Disappointed with the effect of antitrust laws and encouraged by the congressional select small business committees, Congress repeatedly re-affirmed the SBA. With the support of congressional small business committees, the SBA soon became a permanent agency and was sought as the official source of information for various agencies on how proposed legislation would affect small business.\(^{155}\) At times, it seemed that Congress had handed the SBA unsolicited authority.\(^{156}\)

The SBA’s most significant mandate was to narrow the equity gap of small business funding, and increase the supply of credit.\(^{157}\) Since its establishment, the SBA has initiated and developed various small

make direct and “guaranteed” loans to small businesses; directed it to provide technical and management assistance to small business concerns; authorized it to enter into contracts with Federal Agencies and then sublet those contracts to minority firms under Section 8(a) of the Act; and directed it to assist small businesses in obtaining government contracts.

Historian Jonathan Bean summarized Congress’s purpose in establishing the SBA: “The primary legislative intent was to retain a governmental source of credit for small business…. Anticommunist ideologies supported the creation of a small business agency to defend independent enterprise from the ‘Pinkos and the Marxist Reds’ who threatened the American life. Clearly, the shades of meaning invested in the SBA were as varied as the small business ideology itself. The only losers were the laissez-faire conservatives.” Jonathan J. Bean, Big Government and Affirmative Action: The Scandalous History of the Small Business Administration 9 (2001).

In 1955, although then Small Business Administrator only requested Congress to extend the life of the Administration for 2 years, Chairman of the Senate Small Business Committee proposed instead to grant the SBA permanent status, stating “To abolish the Small Business Administration altogether would be such an obviously backward step…. To allow the agency to drift, uncertain of its future, would jeopardize the large investment on services and in appropriations already made.” 101 CONG. REC. 7638 (June 6, 1955) (Statement of Senator Edward J. Thye (R-MN)).


At one time, the SBA rejected additional authority the Senate had tried to give it in determining government procurement policy. See Small Business Agency Opposed Bill Giving It Role in Government Contract Policy, WALL ST. J., Mar. 16, 1961, at 28. (“The Small Business Administration told irritated Democratic Senators that it opposed their major plans for the SBA to assume a major role in determining government procurement policy….Moreover….the SBA was less than enthusiastic over another provision of the bill which would give the agency an additional $75 million for loans to small businesses.”) Later, the SBA revised its position. See SBA Alters Plan to Help Small Firms Get Federal Orders; Asks More Lending Funds, WALL ST. J., Apr. 17, 1961, at 5.

business lending programs. The SBA routinely requests greater funding authority, even though the efficiency of its lending programs to small business has often been questioned. Among its efforts to improve the availability of small business funding, the SBA frequently advocates for legislation to offer financial assistance and bolster the sagging small business credit program.

C. From SBA to SBIC

In 1958, the combined efforts of the congressional small business committees and the SBA were successful in creating the SBIC program. The Small Business Investment Company program was meant to expand funding to small businesses by creating cooperation between private investors and the government. The program's principal function was to fill the "equity gap." This disparity between high demand for small business long-term finance and the availability of loans or equity-type credit to such concerns prompted a series of hearings in 1958. As a

158 For example, in 1964 President Johnson and the SBA initiated a new lending program designed to target "Mom and Pop" stores with less than four employees. Federal Lending Plan to Very Small Firms Disclosed; 5124 Loans Already Made as Test, WALL ST. J., May 27, 1964, at 6; Poverty Fight Plans, WALL ST. J., May 29, 1964, at 1.

159 An exception was noted in 1961 when the SBA rejected additional authority given to it by Senate. See Small Business Agency Opposed Bill Giving It Role in Government Contract Policy, WALL ST. J., Mar. 16, 1961, at 28. Yet, the SBA soon altered its position: SBA Alters Plan to Help Small Firms Get Federal Orders; Asks More Lending Funds, WALL ST. J., Apr. 17, 1961, at 5.

160 SBA Says Its Loan Activity Will Fall Fiscal '60- But Official Asks House to Raise Lending Authority by $150 Million for Fiscal '61, WALL ST. J., May 25, 1960, at 30; Usually the SBA's requests were granted, and the agency continued to expand. See Senate Panel Endorses Bill for SBA to Sell 'Participation' Loans, WALL ST. J., Mar. 2, 1966, at 4; Johnson's Plan to Sell Loans to Cut Deficit in Fiscal '67 Budget Is Opposed in Congress, WALL ST. J., Apr. 1, 1966, at 8; But see Small Business, WALL ST. J., Mar. 9, 1981, at 25. ("A Deep Cut in the Small Business Administration's loan authority is called for under Reagan budget-tightening. The agency had planned $4.2 billion of lending for fiscal 1981, which ends Sept. 30. The President's budget-cutters want that figure reduced to $3.5 billion.").

161 Small Business Agency Seeks to Spur Loans by Commercial Banks, WALL ST. J., Sep. 1, 1961, at 2. (The SBA was criticized for becoming the most rapidly expanding agency in Washington and for making too many loans.)


163 See, e.g. John A. Prestbo, Going it Alone, WALL ST. J., Apr. 10, 1969, at 1. ("Many banks shun new business loans as too risky even when money is not tight, and the SBA's loan funds are limited. As a result, neophyte businessmen frequently must seek financial backing from private investors in turn for equity in the enterprise.")

result, several bills were introduced to narrow the equity gap.\textsuperscript{165} One of the proposals was the product of a collaboration between then-Senator Lyndon B. Johnston (D-TX) and Congressman John Wright Patman (D-TX), chairman of the House Select Committee on Small Businesses and co-author of the Robinson-Patman Act of 1936.\textsuperscript{166}

The Johnson-Patman Small Business Investment bill proposed the creation of a Small Business Capital Bank System.\textsuperscript{167} The idea was for local banks to be funded by the Federal Reserve System to fulfill the long-term requirements for capital in their area without the need for periodic appropriations.\textsuperscript{168} A new independent Small Business Investment Administration would supervise those banks since the new program was viewed as having different purposes and separate types of financing mechanisms from the small-scale disaster and distress loans the SBA had managed thus far.\textsuperscript{169} In essence, the new program sought to expand the flow of long-term debt and capital equity to small concerns that were regarded as too much of a credit risk for conventional lenders.

\textsuperscript{165} Small business investment act of 1958, Report of the Committee on Banking and Currency Together with Individual Views to Accompany S. 3651, S. REP. No. 85-1652, at 1 (1958)("This bill is the result of extensive hearings and careful consideration of the long-term credit and equity needs of small businesses by the Committee of Banking and Currency in both sessions of the 85th Congress. In the 1st session of the 85th Congress, the committee held extensive hearings on S. 719, S. 2160, and S. 2286, but deferred action upon these bills pending the results of a study on financing small business by the Federal Reserve System... In the present session of Congress, hearings on this subject were continues and included consideration of S. 2160, S. 2185, S. 2286, S. 3191, S. 3643, and S. 3651, Upon conclusion of these hearings, the committee considered all of these bills and determined to report S. 3651...")


\textsuperscript{167} H.R. 10345 as introduced in Financial Institutions Act of 1957, Part 2, at 1548 ("I propose that the capital stock of each of the 12 small-business capital banks be $10 million. The money will not have to be borrowed by the Government and the Government will not have to pay interest on it. It will be gotten from the Federal Reserve banks out of their surplus funds.") (John W. Patman (D-TX)). A similar bill was introduced in the Senate by Johnson. However, the Banking and Currency Committees of the Senate and the House did not report these bills. Thereafter, on April 21, 1958, the majority leader in the Senate, Senator Johnson introduced S.3651, which later passed the House with amendments. Final report of the Select Committee on Small Business, House of Representatives, Eighty-fifth Congress pursuant to H. Res. 56 a resolution creating a select committee to conduct a study and investigation of the problems of small business, January 3, 1959. -- Committed to the Committee of the Whole House on the State of the Union and ordered to be printed. H.R. REP. 85-2718, at 35, (1959).

\textsuperscript{168} Senator John Sparkman (D-AL), 104 CONG. REC. 10511 (June 9, 1958).

\textsuperscript{169} "First, the individual investment decisions should be made, not by a bureau in Washington, but by local businessmen who will be backing their decisions with substantial amounts of their own money. The second goal of the system is that it should provide for private capital to come in and take over complete ownership and operation of the system." Final report of the Select Committee on Small Business, House of Representatives, Eighty-fifth Congress pursuant to H. Res. 56 a resolution creating a select committee to conduct a study and investigation of the problems of small business, supra note 167, at 35.
or even for the SBA’s own direct loans. In retrospect, the Johnson-Patman Small Business Investment bill would probably have created a more efficient solution than the SBIC program. If approved, the bill would have created an agency free from the need for repeated appropriations from Congress, operated by financiers and bankers, and most importantly, it would have been an independent agency supervised by a professional authority on funding.\(^{170}\)

The Federal Reserve, however, objected to supervising the proposed new agency. This, combined with opposition from the SBA and the congressional select small business committees, put the Johnson-Patman Small Business Investment bill to rest. On August 21, 1958, Congress adopted a different version put forward by Senator Edward Thye (R-MN), chairman of the Senate Small Business Committee. The revised version abandoned the idea of an independent agency as well as the idea of non-appropriated financing, and created the SBIC program as a division of the SBA under the supervision of a deputy administrator.\(^{171}\) A few Republicans objected to the interference of the federal government in the private sector, arguing that Congress should focus on strengthening existing SBA programs.\(^{172}\) Nevertheless, Congress adopted the new SBIC program with the express purpose:

\[\text{…to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply…}^{173}\]

As enacted, the SBIC program provided for cooperative public and private funding. The Small Business Investment Act provided for the formation of small business investment companies licensed by the SBA and chartered by the states\(^ {174}\) with no less than ten investors and a minimum of certain “statutory capital.”\(^ {175}\) Each SBIC was authorized to make long-term loans for a maximum duration and interest set by the SBA or to buy debt instruments convertible into stock from small

\(^{170}\) Id.


\(^{172}\) Individual Views of Senators Homer E. Capehart (R-IN), John W. Bricker (R-OH), and Wallace F. Bennett (R-UT), 104 Cong. Rec. 10529 (June 9, 1958)(“This bill should be defeated…. It would be more realistic and practical for the Congress to strengthen the existing programs of the Small Business Administration rather than to perpetrate this new Intrusion by the Federal Government into private business.”) For a review of the legislative history of the Small Business Investment Act of 1958, See PARRIS, supra note 10, at 155.


\(^{174}\) Id. § 301.

\(^{175}\) Id. § 302.
business firms. To facilitate this program the government provided federal capital to SBICs in the form of loans or debt instruments granted through the SBA. Additionally, the government matched half of the SBICs' paid-in capital through federal loans; for every dollar put up by private investors in an SBIC, the government put up twice that amount.\footnote{For example, in 1958 the Small Business Investment Act required a minimum of $150,000 of private funds invested in an SBIC before it could receive a license. While an SBIC was required to have $300,000 of total initial capital the private investors could start the company with only $150,000, receive another $150,000 from the SBA by issuing debentures and another $150,000 from the SBA through special loans. Therefore, for every dollar private investors provided, the government matched two dollars of the minimum capital needed.} In addition, investors in SBICs enjoyed generous tax concessions from the government meant to encourage their participation in small business investment.\footnote{One of the key innovations of the SBIC program was its ability to make direct investments in the equity of small business. Up to that point, SBA activity focused on guaranteeing loans and not engaging in equity financing, a task that required greater supervision and human resources the SBA did not have. The novel change in this position came through the SBIC program, which added private capital to the equation and involved investors to take charge of those tasks.} Yet, the SBIC soon proved that combining government programs with private market capitalism is not necessarily a recipe for a successful business plan.

\textbf{V. LOCKED IN AN INEFFECTIVE PATH}

As soon as Congress created the SBICs, their numbers grew rapidly.

\footnote{Id. §§ 301-303.}
\footnote{Id. Spotlight on SBICs, WALL ST. J., Jan. 12, 1967, at 28. For the amendments made to the Small Business Investment Act See Parris, supra note 10, at 157-160. Senate Subcommittee on Investigations and Government Operations, at 4. At some times, the government provided $3 dollars per $1 of private investment. Statement of Stephen Vivian on Behalf of the National Association of Small Business Investment Companies Before the House Committee on Small Business Regarding Legislative Proposals for the SBIC program, Committee Hearing on Increasing Investment in Our Nation's Small Businesses, House Committee on Small Business, 110 Cong. 1st Sess., at 52, (2007).}
\footnote{For example, Congress granted investors in SBICs ordinary loss treatment instead of the limited capital loss treatment, a 100% dividend deduction received from small businesses, etc. The SBA acted to expend these tax benefits to SBICs in order to encourage investors. See SBA Consultant Urges Tax Law Changes To Spur small Business Investment Firms, WALL ST. J., May 21, 1959, at 3.}
\footnote{The Small Business Investment Act of 1958 15 USCS § 633,§ 304 (1958).}
\footnote{"Whenever a company provides capital to a small-business concern under this section, such concern shall be required to become a stockholder-proprietor of the company by investing in the capital stock of the company, in an amount equal to not less than 2 percent nor more than 5 percent of the amount of the capital so provided, in accordance with regulations prescribed by the Administrator." Id., § 304(d).}
Nevertheless, their performance was underwhelming.

The record of the SBIC industry after a decade is far from impressive. Indeed, one could well question whether the whole exercise is worth the effort. Profits have been meager by any yardstick. It was not until the year ending March 31, 1967, that the SBIC industry ever showed an over-all profit.181

A. Early Problems of the SBIC Program

From its inception, the success of the SBIC program was questionable. Critics of the SBIC program argued that it simply threw “cheap money” at small business.182 Although the Small Business Committees reported that SBICs were prospering and successful, their contribution to narrowing the equity gap was minor and controversial.183 The number of new SBICs shot up soon after the program was established, but soon began to fluctuate, and after about 25 years interest in the program waned. By the early 1980s, the number of SBICs opting out of the program, voluntarily or via liquidation, generally exceeded the number of new licenses. As a result, the number of SBICs since the mid 1980s has been decreasing.184 One of the reasons for this phenomenon is that investors in SBICs were not aware of what they were getting into; they were enticed by the idea of tax incentives and the privilege of borrowing from the government without fully assessing the effects of risky investments, declining stock markets, and heavy compliance costs.185

181 Parris, supra note 10 at 160. See also Elizabeth M. Fowler, S.B.I.C. Program Has Growth Pains, N.Y. TIMES, Sep. 18, 1966, at 155 (“323 of the S.B.I.C.’s could be called "problems." Some have never gotten started investing; some have heavy losses; some have violated S.B.A. regulations.”)


183 Report of the Select Committee on Small Business Pursuant to a Study and Investigation of the Problems of Small Business, Select House Committee on Small Business, H.R. REP. 87-2569, at 45(1963). (“During the 87th Congress small business investment companies have achieved substantial growth in numbers, the number of dollars available from this source for investment purposes, and in public acceptance.”)

184 Some of the figures are attributed to mergers as well that SBICs experienced at that time. See, e.g. Takeover Targets, WALL ST. J., Mar. 17, 1967, at 1.

185 Shaky SBICs, WALL ST. J., Jul. 16, 1962, at 1 (“Within the next five years, half of the 600 companies now in the program won’t be around.”); Sanford L. Jacobs, Firms Find Harsh Provisions In Hazardous-Waste Statutes, WALL. ST. J., SEP. 12, 1983.
Stories about misuse of government money and violations of SBA regulations began to appear in the press. Some SBICs voluntarily surrendered their licenses, liquidated, or merged because of lack of profitability. In 1966, the Senate Banking and Currency Subcommittee on Small Business held hearings and reported that the number of SBICs in financial trouble increased sharply as the program progressed. That year, the Senate Permanent Committee on Investigations conducted hearings regarding failures of federally insured banks and revealed similar abusive practices in the SBIC context. Consequently, closer investigation of the SBIC companies and their operations revealed the following problems with the SBIC program and its SBA supervision.

1. Human Capital Problems

In the early days of the program, individual investors often sought to make a fast profit. Yet, they acted without the proper knowledge of

---


189 On February 1966, for the first time the SBA began to require prior approval to
how to manage small businesses successfully and did not comprehend the unique problems facing small concerns.\(^{190}\) In most cases, the SBA encouraged the formation of new SBICs by generously granting licenses with few limitations and inadequate supervision.\(^{191}\) The SBA carried out little or no investigation into the individuals requesting SBIC licenses — failing to examine their character, reputation, business experience and qualifications to make prudent loans -- so fraudsters began taking advantage of the program.\(^{192}\) Despite efforts to improve the standards for granting new licenses, the SBA did not have an adequate independent examination mechanism for the SBIC program.\(^{193}\)

The SBICs' boards of directors were the most important element in the SBICs' valuation processes of small business portfolio securities. Therefore, managing the risk each SBIC took upon itself was largely a mutual decision of its board of directors. Accordingly, their knowledge, skill, ability, and integrity were key factors in investment valuations. Further, while obtaining information, learning processes and procedures and requiring proper documentation and reporting from the prospective small business firm were helpful, the portfolio ultimately required management to make a proficient decision.\(^{194}\) One of the severe weaknesses of SBICs throughout their history was the ineffectiveness of this human factor, which was in charge of making the subjective final valuation decision, but did not have direct expertise and the skill set unique to managing small business concerns.\(^{195}\)

Lack of managerial expertise and lack of proper guidance from the

\(^{190}\) Senate Subcommittee on Investigations and Government Operations Report, 8.

\(^{191}\) Small Business Administration Preparing Loan-Guaranty Plan for Investment Firms, W\(\text{A}\)LL\(\text{T}\). J., Dec. 8, 1964, at 9. (In its attempts to spur loans to small business and in light of its own reserves' depletion, the SBA proposed a loan-guaranty plan for SBICs that would require it to put aside less money for reserves.)

\(^{192}\) Spotlight on SBICs, W\(\text{A}\)LL\(\text{T}\). J., Jan. 12, 1967, at 28 (“T\(\text{H}\)e rising number of court actions against SBICs being initiated by the Justice Department in the SBA's behalf to recover Government funds. At year-end, over 60 such cases were pending in court, triple the number of a year earlier…. Collectively, the companies named so far as defendants owe Uncle Sam approximately $22 million.”)

\(^{193}\) Review of Small Business Administration’s Programs and Policies – 1969, Hearings Before the Senate Select Committee on Small Business, 91 Cong. 1\(^{st}\) Sess. (1969); SBIC Chief Calls 232 of the 700 Companies 'Problem' Firms, Warns of $18 Million Loss, W\(\text{A}\)LL\(\text{T}\). J., Jun 15, 1966, at. 2.

\(^{194}\) In the 1990s Hearings of the Committees, the valuation process was identified as a severe weakness in the SBIC program. Senate Small Business Committee Report, at 10. See also the Small Business Administration's Small Business Investment Company Program: A Review of Selected Issues, 102rd Cong. 1\(^{st}\) Sess. (July 16, 1991), S. Part. 102-44, at 35-36.

\(^{195}\) “Conflicts of interest and self-dealing transactions, including 'bootstrapping' and 'cross-dealing', were prevalent in the program.” Senate Subcommittee on Investigations and Government Operations Report, 45.
SBA were some of the main reasons for the program's failure.\textsuperscript{196} SBICs did not possess and were not offered sufficient knowledge about the types of businesses they sought to support. While some SBICs provided consulting services to small firms for a small fee,\textsuperscript{197} due to their limited resources, they could not afford the appropriate staff needed to supervise investments. Many managers of SBICs soon discovered that small businesses became high credit risks and defaulted on their loans, contributing to a high rate of SBIC failures.\textsuperscript{198}

2. Agency Costs
   i. Poor Risk Management

   It is no secret that investments in small businesses are more precarious than those in large ones. Consequently, aside from systemic risks associated with external conditions such as national and regional economic and financial cycles, SBICs are exposed to greater risks due to their focus on small business ventures.\textsuperscript{199} Most of these transactions involve venture capital, that is primary risk capital provided to small firms in their early and difficult formative periods.\textsuperscript{200}

   Furthermore, the constricted profit potential of many SBICs contributed to their failures. After granting a long-term loan to a small business, SBIC's only source of income was the spread between the interest the SBIC had to pay to the SBA and the interest and the fees the SBIC collected from its loans or the capital gains it realized on its investments, if any.\textsuperscript{201} Yet, the SBIC also had high costs to cover. Aside from the interest the SBIC owed on government loans, it usually incurred expenses such as rent, utilities, travel, salaries, and investigating and consulting costs on new loans and investments.\textsuperscript{202} If any profit remained

\textsuperscript{196} Shaky SBICs, WALL ST. J., Jul. 16, 1962, at 1 (“...many persons in the SBICs got into the business for the wrong reasons and with the wrong abilities…” The “irresistible” lure of the special tax advantages and the Government loans at reasonable terms brought many into the industry.) See also Spotlight on SBICs, WALL ST. J., Jan. 12, 1967, at 28 (“This program [SBIC] was oversold,” said an SBA official overseeing the cleanup drive. “Too many SBIC operators looked on it as a way to make a fast buck.”)

\textsuperscript{197} The SBA initiated a plan aimed at encouraging up to fine SBICs to hire central management and share office space with other SBICs in hope their work together would lead to their merger. See also SBIC Chief Calls 232 of the 700 Companies 'Problem' Firms, Warns of $18 Million Loss, WALL ST. J., Jun. 15, 1966, at 2.

\textsuperscript{198} Id.


\textsuperscript{201} Id. at 4-6.

\textsuperscript{202} See, e.g., Rise of the SBICs Federally-Aided Units Triple in Number; Pool
after deducting those costs and absorbing any losses incurred on failed investments, the SBIC had to distribute dividends to its stockholders, who were looking to recover their investments.\footnote{203} As a result, many SBICs' executives chose to funnel their low-cost federal money into high-return real estate ventures – a practice the SBA did not restrict.\footnote{204}

Shortly after its establishment, the SBIC program seemed to be providing most loans to large, publicly held investment companies.\footnote{205} Ironically, because of the large sunken costs, SBICs preferred to invest in midsize firms.\footnote{206} The relative profitability of the SBIC program was due only to the shift away from lending to small business and toward larger loans to bigger businesses, contrary to the program's objective.\footnote{207} This trend shut the door on the same people Congress was trying to help. Eventually, the program recuperated from its stagnate state when banks were authorized to form small business investment subsidiaries.\footnote{208}

ii. Deficiencies in the SBA's Monitoring of SBICs

During the 1960s, the SBA faced serious repayment problems and the SBIC program was called into question.\footnote{209} One Wall Street Journal staff reporter wrote:

> When the Government set out to solve the capital problems of small businessmen, its intention may have been excellent… its achievements are nonetheless dismal… As the sorry saga of the SBICs shows once more, however, the interests of the nation are usually served best if all other avenues are explored first before turning over yet another

---

\footnote{203} Funds for Bigger Loans, \textit{Wall St. J.}, Sep. 8, 1961, at 1 (discussing the large legal fees and investment SBIC has to expense for every loan it administers, which makes it less profitable to loan to small business and more to medium businesses).

\footnote{204} Id. at 7.


\footnote{206} Id. (Citing Walter B. Stults, staff director of the Senate's Select Committee on Small Business, which conducted a constant study of how the program is functioning.) See also \textit{Takeover Targets}, \textit{Wall St. J.}, Mar. 17, 1967, at 1.

\footnote{207} \textit{Rise of the SBICs Federally-Aided Units Set Up to Lend to Small Business, Expand Fast- more Sell Stock to Public: Critics Say Some Aid Only Fast-Growing Companies}, \textit{Wall St. J.}, Sep. 28, 1960, at 1 (The entrance of big, publicly held SBICs into the field is leading to the shift away from very small borrowers toward bigger companies that have prospects for growth to a size where their securities will qualify for listing on stock markets or be actively traded over the counter).


\footnote{209} In 1967, it was estimated that the Government might lose about $10 million on defaulted loans. It turned a blaming finger to the SBA for making poor choices of borrowers and inadequate counseling and supervision of those businesses. \textit{See} Burt Schorr, \textit{Antipoverty Selback}, \textit{Wall St. J.}, Jul. 1, 1967, at 1.
task to fumbling Federal fingers.\textsuperscript{210}

The Small Business Investment Act of 1958 imposed on the SBA a duty to supervise and regulate the SBIC program.\textsuperscript{211} Assuming that responsibility, however, proved to be difficult. The SBA was blamed for its failure to administer the SBIC program and prevent the increasing numbers of SBIC failures or their delay in providing new loans.\textsuperscript{212} For the program's first eight years, the SBA made no effort to determine the basic factors necessary for the profitable operation of SBICs.\textsuperscript{213}

One reason for this malfunction was the SBA's accounting system and financial records, which did not provide accurate, complete, or current information on the SBICs' performance.\textsuperscript{214} As a result, the SBA failed to inform itself about the status of its loans to SBICs or the expected government losses.\textsuperscript{215} The SBA was not able to make effective and timely evaluations of SBICs until they reached an "impairment of capital" status,\textsuperscript{216} a point when improving the financial conditions of those companies was virtually impossible.\textsuperscript{217}

SBA standards and procedures to govern the licensing of new SBICs and changes in control of existing companies were inadequate.\textsuperscript{218} Individuals were not regularly required to report on investments they purportedly made and as a result, undesirable and unqualified individuals entered the program.\textsuperscript{219} Furthermore, the SBA did not set proper monitoring mechanisms and often made additional advances of government funds to troubled SBICs without a reasonable prospect to

\textsuperscript{210} A Fumbling Mr. Fix-it, WALL ST. J., Mar. 23, 1967, at 14.
\textsuperscript{212} A Fumbling Mr. Fix-it, WALL ST. J., Mar. 23, 1967, at 14("A number of the SBICs reached by making no loans-at-all, eventually just going out of business. Others plunged right ahead and, not surprisingly, wound up with a raft of financial trouble."). See also Mr. Boutin's Battle, WALL ST. J., Apr. 19, 1967, at 18 (Of the 434 SBICs examined by the SBA, only 38 showed no violations of the agency's regulations, and 28 were put under review to decide if a full investigation was needed.).
\textsuperscript{213} Senate Subcommittee on Investigations and Government Operations Report, 45.
\textsuperscript{214} Senate Subcommittee on Investigations and Government Operations Report, 12, 18, 45.
\textsuperscript{215} For example, in its 1966 report to Congress, the SBA estimated that 232 out of 699 SBICs were in trouble and that $18 million of Government funds advanced to these 232 companies would be lost. However, Bernard Boutin, who was appointed Administrator in May of 1966 rejected this figure and estimated loss to a total of over $50 million. Later, the SBA increased its reserve for losses to $54.1 million as of March 31, 1967. Id. at 46
\textsuperscript{216} Defined by the SBA regulation as a loss of 50% or more of the privately invested capital, which increases the risk of the Government losing all its funds. Id. at 9.
\textsuperscript{217} Id. 14.
\textsuperscript{218} See SBIC Chief Calls 232 of the 700 Companies 'Problem' Firms, Warns of $18 Million Loss, WALL ST. J., Jun. 15, 1966, at 2.
\textsuperscript{219} Id. 45 (Noting that the SBA's administration and supervision of the SBIC program by the SBA was lax and inefficient).
repay.\textsuperscript{220}

The responsibilities of the SBA’s investigatory staff exceeded its resources. Overload on the SBA’s Office of the Inspector General was a big part of why the SBA was impaired in investigating SBICs.\textsuperscript{221} While investigating the SBIC program, the Senate Subcommittee on Investigations and Government Operations reported that the examinations and investigations of SBICs by the SBA to detect conflicts of interest and other violations were inadequate. There was no program for regularly scheduled, routine examinations, and when examinations were made, considerable time elapsed between them. Consequently, when fraud, conflicts of interest, and mismanagement were found, the SBA’s actions to protect the government’s funds and help the SBICs’ management were weak, indecisive, and ineffective, limited to correspondence and conferences with the SBICs’ managers.\textsuperscript{222}

The SBA also had problems enforcing its regulations.\textsuperscript{223} SBA rules did not expressly prohibit or penalize conflicts of interest within a SBIC operation, and in fact, they allowed self-dealing and cross-dealing transactions as long as they were reported to the SBA.\textsuperscript{224} And even when violations existed, the SBA’s enforcement was practically non-existent, mostly because there were no penalties set for violating the agency’s regulations.\textsuperscript{225}

At the end of the 1960s, the SBA tried to assume responsibility and began to investigate violations of its regulations.\textsuperscript{226} The SBA took

\begin{itemize}
\item \textsuperscript{220}Id.
\item \textsuperscript{221}Senate Small Business Committee Report, The Small Business Administration’s Small Business Investment Company Program: A Review of Selected Issues, 102d Cong. 1\textsuperscript{st} Sess. (1991), S. Part. 102-44, at 47 ("During the decade of the 1980s, the compliance examination program for SBICs was subjected to considerable impairment… The SBA suffered such impairments by the simultaneous increase in its responsibilities, and the curtailment or withholding of resources available to perform its mandated functions.").
\item \textsuperscript{223}Deputy Administrator for the SBIC program Richard E. Kelley reported that when he took over the position, the SBA’s examination program collapsed and 75% of all companies were never examined at that time. Id. at 19.
\item \textsuperscript{224}The phrase "self dealing" refers to interlocking dealings between those who grant the money and those who get it. "A majority of the nation’s 600-plus SBICs apparently still avoid self-dealing.") Double Standard, Wall St. J., Jul. 2, 1963, at 1 See also Mr. Boutin’s Battle, Wall St. J., Apr. 19, 1967, at 18. For the first decade of its operation, the SBA officials believed existing SBA regulations were adequate to control conflicts of interest. Senate Subcommittee on Investigations and Government Operations Report, 11.
\item \textsuperscript{225}For example, the Comptroller General of the U.S. reported to the Senate, "A primary basis for selecting an SBIC for examination prior to 1968 was its proximity to one of the SBA field offices…" Senate Subcommittee on Investigations and Government Operations Report, 14.
\item \textsuperscript{226}Id. at 49 (In 1966, "Mr. Boutin further reported that he feels the SBIC program as it now stands is unworkable; that it needs a completely new approach or it will
disciplined action against several executives of SBICs, and tightened its licensing standard for new SBICs. Yet, the SBA soon loosened its supervision to avoid discouraging SBIC investment activity. Congressional actions to provide the SBA with greater enforcement authority were not enough to keep the SBIC program on track. Almost yearly, the SBA’s Office of the Inspector General continues to report deficiencies in the SBA’s own oversight of the SBIC program in its annual report.

227 Drive to Police Small Business Investment Firms Is Successful, Federal Aides Say, WALL. ST. J., Mar. 3, 1962, at 4. The SBA also proposed rules to halt investors who were looking to buy out publicly held SBICs below liquidation value by refusing to allow such liquidation if during the preceding year a “major change” had occurred in the board of directors or in parties controlling 10% or more of its stock. SBA Aims to Spur Mergers, Carb ‘Raiding’ of Small Business Investment Companies, WALL ST. J., May 30, 1964, at 4.

228 For example, in 1964, the SBA had ordered a 90-day freeze on its licensing of SBICs and announced stricter standards would be laid down in the fall because many SBICs were part-time operations that were just sitting still and were not performing the role Congress intended to SBICs. The SBA was also worried that more than half of the 717 SBICs were clustered in just six states. See U.S. Ordered Halt To New SBICs For the Next 90 Days, WALL ST. J., July 6, 1964, at 2. Small Business Agency Fights Parts of Senate Investment Firm Bill, WALL ST. J., Aug. 1, 1961, at 3. The SBA required SBICs to have a full time responsible officer with 5 years investment banking experience, maintain an office accessible to the public, maintain a minimum of private capital, banned family relationship between stockholders. SBIC Licensing Standards Made More Stringent, WALL ST. J., Oct. 16, 1964, at 5.

229 Small Business Administration to Propose Stiffer Curbson Conflict-of-Interest Loans, WALL ST. J., Aug. 6, 1964, at 2 (“Generally, officials say the agency’s current policy is to liberalize regulations governing the investment companies’ day-to-day operations where possible, in order to minimize Government interference.”) Deputy Administrator James Parris, who authorized SBIC self-deals, commented: “Our main concern is securing capital for small businesses. We don’t want to bog small SBICs down with too many regulations.” See Double Standard, WALL ST. J., Jul. 2, 1963, at 1; SBA Studies Proposals Aimed at Improving Profit of Small Business Investment Firms, WALL ST. J., Nov. 17, 1964, at 10. See also Spotlight on SBICs, WALL ST. J., Jan. 12, 1967, at 28 (“The big problem that confronts the SBA: “Devising regulations tight enough to protect the taxpayer’s $276 million investment in these companies without crippling their ability to finance risky small business enterprise, the role Congress intended.”)

230 Bill to Tighten SBIC Rules, WALL ST. J., Sep. 1, 1966, at 3. (A bill to tighten Government regulation of small business investment companies was approved by a Senate banking subcommittee giving the SBA power to revoke SBICs licenses after administrative proceedings, giving the SBA power to remove or suspend SBICs officers and directors for issuing cease-and-desist orders against individuals and SBICs that had violated regulations, and authorizing the SBA to fine or order one-year imprisonment if officers or directors of SBICs used their stock as collateral for a loan to buy additional stock in the same company.)

231 Robert Jay Dilger & Oscar R. Gonzales, supra note 47 at 21 (For example, in 2003, the SBA’s OIG indicated, “an ongoing audit of SBIC oversight indicated that policies and procedures in the Investment Division do not limit financial risk.”).
B. SBICs Today

During the last half century, the SBIC program has widely been considered faulty. At many points, SBICs were at a crossroads, when their ineffectiveness spurred public debate and raised questions about their persistence. Yet, the criticism has been systematically channeled toward ways to improve the program, rather than abolish it. Support for the program from the SBA and the congressional small business committees largely made this possible. While cognizant of the constant problems of the program, those agents continually stressed the importance of the program and offered ways for its improvement.

When enacting the Small Business Investment Act in 1958, Congress sought "to provide an additional source of capital funds to small business concerns" envisioning "the establishment of a new industry composed of a privately owned corporations, which would stimulate and supplement the flow of equity capital and long-term loans to such small business concerns." Today, it is not clear that the SBIC program has indeed been effective in narrowing small business equity gap.

---

232 Senate Small Business Committee Report, The Small Business Administration's Small Business Investment Company Program: A review of Selected Issues, 102nd Cong. (1991), S. Part. 102-44, at 65 ("The SBIC program is in a free fall of crisis proportions leading to extinction if immediate and effective changes aren't made to its basis structure… The crisis is a result of a combination of factors generally classified as deterioration in the asset quality of SBICs caused by factors both internal and external to the SBICs and what is a faulty basic program incentive structure.").

233 See, Id. at 5. (The SBIC program is at strategic crossroads in its history. Currently there are regulatory and legislative proposals that would make major changes to the structure and operations of the program. Most of these proposals are a response to problems that have been identified during oversight hearings held during 1990 by the U.S. Senate's Committee on Small Business…"). See also, H.R. 3854, the Small Business Financing and Investment Act of 2009; H.R. 5554, the Small Business Assistance and Relief Act of 2010; and Pub.L. No. 111-240, the Small Business Jobs Act of 2010, all of which address various SBIC-related issues and the CRS report that discusses the SBA's recommendation to improve the SBIC program. Dilger & Gonzales, supra note 47.

234 See also small business committee review the problems of the SBIC program yet stressing its significance in Hearing on Increasing Investment in Our Nation's Small Businesses, House Committee on Small Business, 110 Cong. (2007).


A Federal Reserve study analyzing the SBIC program's profitability between 1986 and 1991 characterized this period as one of very low profitability and very high failure rates that generated significant losses for the federal government. This study held that there was a negative relationship between the extent to which SBICs used government-guaranteed funds and their economic performance over the examined period.

**Figure 2- SBIC License Activity 2006-2010**

![Figure 2- SBIC License Activity 2006-2010](http://www.nasbic.org/resource/resmgr/Docs/SBIC_Stats_Oct._13.pdf)

At present, figure 2 demonstrates SBICs continue to be liquidated at a rapid pace, exposing the SBA to a higher risk per company. Others are choosing to exit from the program voluntarily. Over the last half

---


238 *Id.*

239 For example, in 2007, the SBA issued 9 new SBIC licenses and the number of
century, instead of narrowing the equity gap of small business funding, the growing demand for funding has increased. The funding ratio offered to small concerns has decreased, with SBICs serving less than 0.2 percent of the small business population, a figure that has been dropping each year. Consequently, there remains a high demand for an institutional source of long-term loan and equity capital for small businesses. There are many small businesses still struggling to find financing for their needs. When financing is found, the terms available are most often unsuitable to the needs of the small business concerns, and thus, many small firms settle for short-term loans or none at all.

Today, the inefficient path of the SBIC program continues. Since its enactment in 1958, the Small Business Investment Act has undergone SBIC licenses surrendered or transferred to liquidation was 28. See SBIC Program Overview, Data Management Branch, Investment Division, October 13, 2010, http://www.nasbic.org/resource/resmgr/Docs/SBIC_Stats_Oct._13.pdf

240 See, e.g. Edward C. Burks, Patman Presses Inquiry on Loans, N.Y. TIMES, Apr. 6, 1969 ("It is no secret that lately the Small Business Administration has fallen far short of the goals and ideals under which it was established… the agency is without funds to make loans to small businessmen.")(Wright Patman, D-TX).

241 The number of financings being provided to small business concerns fell almost 30% between 1989 and 1990. Senate Small Business Committee Report, The Small Business Administration’s Small Business Investment Company Program: A review of Selected Issues, 102nd Cong. (1991), S. Part. 102-44, at 65. Between 1984 and 1990, the number of standard SBIC financings had dropped in more than a half from ~2800 to ~1300. Id, at 25. That number remained the same in 2004, when the SBIC program approved 192 loans out of total of 89,581 loan guarantees to small businesses. However, in 2009, the SBIC program provided less than 0.1% providing 35 loans to small business out of 47,916 total loans. See SBA, Report of Approved Loans by Program, http://www.sba.gov/sites/default/files/files/WDS_ApprovalCount_Report.pdf

242 Generally, the number of loans granted by all SBA program has been decreasing in the last five years. For example, from a peak of 277,292 loans provided by all SBA programs in 2006 that number decreased to 124,360 in 2007, 93,541 in 2008, 69,765 in 2009 and 70,236 in 2010. See SBA, Report of Approved Loans by Program, http://www.sba.gov/sites/default/files/files/WDS_ApprovalCount_Report.pdf

243 See, e.g. the summary and conclusions of the Senate Small Business Committee Report, The Small Business Administration’s Small Business Investment Company Program: A review of Selected Issues, 102nd Cong. (1991), S. Part. 102-44, at 16. It is impossible to compare the number of small business loan applications rejected despite repeated attempts of the author to obtain this data from the SBA.

244 At some point, in addition to the “regular” SBICs licensed under section 301(c) of the Small Business Investment Act of 1958, Congress added a new type of Specialized Small Business Investment Companies (SSBICs) meant to provide financing to small business entrepreneurs whose “participation in the free enterprise system is hampered because of social or economic disadvantage.” 26 U.S.C. § 301(d). See Dilger & Gonzales, supra note 47, at 2. Yet, SSBICs were repealed at the end of the 1990s due to scandals that involved wealthy individuals using the SSBICs for private investments that do not involve minorities. See, e.g. the Whitewater Scandal at Whitewater: A Primer, WALL ST. J., Dec 28, 1993. p. A10; No new SSBIC licenses have been issued since October 1, 1996. The SBA’s 8(a) Business Development Program replaced the SSBIC and continued to support and closely supervise provide business development for small and disadvantaged businesses. 13 C.F.R. §124. Proposals To Strengthen the SBIC Program, Senate Committee on Small Business, 104th Cong. (1995).
numerous revisions, almost one in each congressional session. This is largely because of the support for the SBIC program from the Select Small Business Committee and the SBA as a means of improving the well-being of small business, even when faced with reports of the inefficiency of the program. The SBA continues to provide positive feedbacks by calling for the liberalization of the SBIC program. Accordingly, the SBA promotes parallel liberalization plans in other organizations and agencies. On many occasions, the Small Business Committees proposed easing the compliance and tax burden on SBICs as a way to increase the flow of capital to small business from SBICs. At other times, the committees have urged Congress to grant small businesses and SBICs more funding, and to consider legislation to encourage small business investments.


For example, during the late 1980s the House and Senate Small Business Select committees promoted a proposal expanded the long-term credit assistance for SBICs was in the form of the proposed Corporation for Small Business Investment Charter Act (COSBI). H.R.3392, Corporation for Small Business Investment Charter Act, H. R. REP. 100-708 Pt. 1; S.2686, Corporation for Small Business Investment Charter Act. Yet, lack of conclusive empirical data on the economic effects of Federal credit assistance as well as political ideology postponed the lunch of this proposed entity. James M. Bickley, CONG. RESEARCH SERV., The library of Congress, Proposed Corporation for Small Business Investment Charter Act, Pro-Con Analysis, October 31, 1984. In 1994, the SBA established the SBIC Participating Securities Program (SBIC PSP) to encourage equity investments in early stage small business. Yet, in 2004 in response to extensive losses and criticism over the SBIC program, the SBA decided to close down the SBIC PCP program but kept and advocated for increased federal funding for the Debenture part of the SBIC program. See House Committee on Small Business, Private Equity for Small Firms: The importance of the Participating Securities Program, 109th Cong., April 13, 20205, Serial No. 109-10 (Washington: GPO, 2005), at 5.

See, e.g., Hearing on Legislation Updating and Improving the SBA’s Investment and Surety Bond Programs, House Committee on Small Business, 110th Cong. (2007), where the SBA reported on the SBIC program’s problems and proposed to modify and simplify certain rules for the program.

Small business committees were instrumental in promoting legislation in Congress that eased the tax burden on small business and encouraged investment in these concerns. See, e.g., Greater Federal Aid to Small Businesses Urged by House Unit, WALL ST. J., Jan. 10, 1963, at 13. Proposals To Strengthen the SBIC Program, Senate Committee on Small Business, 104-1, (1995); Hearing on the Impact of New Market Tax Credits, the SBIC Program, and 504 Program on Urban Communities, House Committee on Small Business, 110th Cong. (2007); Proposals To Strengthen the SBIC Program, Senate Committee on Small Business, 104 Cong. (1995).

“Within the SBIC program, specialized SBICs licensed to make investments only in minority-owned businesses have proven excessively costly to taxpayers for a variety of reasons, some relating to the program’s structure and some relating to the business practices of certain SSIBCs.”

See, e.g., Senate Unit Asks Change in Small Business Investment Program to Make It a Success, WALL ST. J., Apr. 27, 1960, at 6. Statement of Stephen Vivian on Behalf of the National Association of Small Business Investment Companies Before the House Committee on Small Business Regarding Legislative Proposals for the SBIC program, Committee Hearing on Increasing Investment in Our Nation’s Small Businesses, House
Moreover, banking institutions, which used to play a significant role in the SBIC program, are rapidly leaving it. The era of big bank-owned and operated SBICs is over. Until the passage of the Gramm-Leach-Bliley Act in 1999, the only way a bank could operate a venture capital or private equity fund was by obtaining an SBIC license. Therefore, banks were key partners of SBIC program and had a significant positive impact on the performance of the program. For example, in the 1990s bank-owned SBICs provided 61% of the total loans and investments, 74% of the total cash and idle funds, and 75% of the disbursements to small concerns. However, with the passage of the act, banks are now permitted to operate private equity subsidiaries without obtaining and maintaining SBIC licenses. As a result, currently, only 15% of all SBICs are bank-owned and less than 5% of dollars now invested by all SBICs is attributable to bank-owned and operated SBICs.

After half a century, it seems we are locked-in in a program that does not fulfill its mission of closing the lending gap to small and pioneering firms. But our legal system is filled with rules and regulations governing SBICs, and so we remain invested in an inefficient path; seemingly remaking it would involve high negative externalities. In the meantime, small businesses remain in need of increased capital.
VI. CONCLUSION

The causes of events are ever more interesting than the events themselves.-- Cicero\textsuperscript{256}

Large and small firms have different funding options.\textsuperscript{257} Because they are perceived as risky ventures, small firms have trouble obtaining capital to finance new equipment or to expand inventories.\textsuperscript{258} While larger firms can raise capital through retained earnings or issuance of new securities, smaller firms cannot issue new stock easily and usually do not have much retained earnings. Congress sought to narrow that gap of small business funding by establishing loan guarantees, special preferences, and the SBIC program.

One of the fundamental conditions to generate social change is critical thinking about the choices made in the past.\textsuperscript{259} In the last two decades, path dependence theory has been used in both legal scholarship and legal practice to explain legal transformation.\textsuperscript{260} The theory does not simply demonstrate that "history matters."\textsuperscript{261} Rather, path dependency theory helps explain how history influences the process of government decision-making and the evolution of legal structures.

In the case of government’s relations with small businesses, it is

\textsuperscript{256} Marcus Tullius Cicero, Epistolae Ad Atticum, Book IX, Section 5, at CAIL C. GAITHER, ALMA E. CAVAZOS-GAITHER, STATISTICALLY SPEAKING: A DICTIONARY OF QUOTATIONS 20 (1996).


\textsuperscript{258} See, e.g., Relief for Small Firms Urged by Witnesses, Wall St. J., Jan. 8, 1958, at 9 (Discussing the Curtis bill proposed to expand funding for small business Congress to encourage the reinvestment of earned income). Thomas Petzinger, Jr., Closed Doors, Wall St. J., Jan. 22, 1980 at 1; Sanford L. Jacobs, Reagan Group Suggests Ending Programs Favoring Small Firms, WALL ST. J., Jan 12, 1981, at 23; Congresswoman Edwards Votes for Small Business Lending Fund Act to Expand Available Credit for Small Businesses and Create Jobs, Congressional Documents and Publications September 23, 2010, ("small businesses continue to face severe challenges due to a lack of capital and tight lending standards").

\textsuperscript{259} "If a society cannot think effectively about the alternative path because it lacks the vocabulary, concepts, or even belief that the other path could exist, then that society cannot consciously choose either to return to the branch point of the two paths (and then go down the other path) or to jump to the other path." Oona Hathaway, supra note 29 at 651.

\textsuperscript{260} Path dependence was applied in various areas of the law. See e.g. supra note 29.

\textsuperscript{261} Stephen J. Margolis and S.J. Leibowitz, Path Dependence, in 3 NEW PALGRAVE DICTIONARY OF LAW & ECONOMICS 17 (Peter Newman ed., 1998). Yet, scholars have clarified that "path dependence does not simply means that history matters, but rather that once an institution has taken a path, the costs of reversal may be very high, so that earlier plausible options (like the inquisitorial system) are now excluded." See also Page, supra note 25, at 87 (criticizing the over application of the idea of path dependence to almost any process, which caused this concept to dull in value. "In becoming a trendy way to say that history matters, path dependence no longer provides any analytic leverage.")
useful to look back to when Congress first reacted to the phenomenon of growing trusts and the formation of monopolies. Congress enacted antitrust laws, placing legal restrictions on their power to coordinate trade. This point in history marked a “critical juncture” in the development of small business culture and the beginning of a path dependence by which Congress acknowledged the need not only to protect small concerns from the concentration of economic power but indeed to promote small businesses.262

Small business culture developed from our nation’s philosophy of separation of powers, one of the bases of our democracy. Throughout history, suspicions about the concentration of power brought the government to favor small firms, viewing them as guardians of fair competition and free society. Natural disasters and economic shocks reinforced preconceived notions that small businesses had to be salvaged whenever events out of the government’s control harmed their well-being. This tendency brought government to expand its patronage over the years by providing small firms with special preferences through the legal system. Since most minority businesses are small businesses, their advancement was another form of affirmative action.263

Once a small business culture developed, corresponding small business political incumbents expanded path dependency of the SBIC program.264 Small business agencies and entities were established to promote another type of growing power – the power of the small business organizations. Congress formed congressional small business committees and the SBA to look at small businesses’ problems and reduce their equity gap. Consequently, the SBA provided direct loans and created a unique partnership between the private and the public sector to provide venture capital and long-term equity financing -- the SBIC program.265 Yet, the program soon turned out to be inefficient and cumbersome, and led to losses for the government and private investors.

Recently, scholars have been arguing that the case for small business favoritism is ambiguous when one looks at the transaction costs and the cumulative effects of regulation.266 The experience of the last half decade

264 Page, supra note 25.
shows the SBIC program did not provide benefits exceeding its costs. If one is to look at the performance of the SBIC program and consider alternative routes, one might discover a more efficient solution to the equity problem of small business. Yet, as this paper reveals, Congress's early funding policy became locked-in and resistant to change through self-reinforcement of organizations such as the SBA and congressional committees and expansion of positive feedbacks of growing small business culture.

The question of why our legal system maintained this inefficient program over a century has never been explored. Likewise, the intuitive concept that small is beautiful (when it comes to business) has not been examined through the prism of social history and the path dependence paradigm. Rhetoric and the desire of legislators to appeal to their constituents are over-simplistic explanations for the abundance of small business preferences. This article aimed at providing a more comprehensive framework to explain the long-time existence of a failed program. By utilizing path dependence theory in the political prism, the article proved that self-reinforcing small business organizations and the development of positive feedbacks through small business culture contributed to the persistence of SBICs.

The aftermath of path dependence theory is that our legal system is locked in an inefficient rut. Our legal system has invested resources in the SBIC rut, and created rules and regulations to encourage others to follow that rut. Although it may seem that the costs of diverging from the current program seem too high, breaking the inefficient SBIC path can only be achieved by radical reform. Another alternative to the SBIC program is to return to private local bank lending. Banks and institutional investors tend to have specialized knowledge about particular industries and are better equipped to monitor and assist small businesses. Since the SBIC experience of combined market capitalism and government intervention was unproductive, it is time to shift to private institutional lending, which thus far proved to be effective.

The purpose of this article was to spur a rethinking of the road we

---


have taken in the last century. Policymakers should be aware of the path dependencies in our legal system and consider whether alternative, different paths would be more efficient and effective.\textsuperscript{269} Our government is constantly considering proposals to simplify the legal system.\textsuperscript{270} The SBIC program has not fulfilled its purpose; the time is ripe to kill the goose for it has not laid the promised golden eggs.

\* \* \*

\textsuperscript{269} Pierce, supra note 48, at 563.

\textsuperscript{270} For example, in March 2009, the Obama Administration announced the formation of a task force led by former Federal Reserve Chairman Paul Volcker as part of the President’s Economic Recovery Advisory Board. The task force was charged with proposing ways to simplify the tax code, reduce evasion, close loopholes and reduce the tax gap. House Small Business Subcommittee on Finance and Tax Hearing; "How the Complexity of the Tax Code Hinders Small Businesses"; Testimony by Keith Hall, National Tax Advisor, NASE Grapevine, TX Congressional Documents and Publications, May 7, 2009. The task force received more than 500 submissions of serious tax reform ideas and decided to delay its report and hold various public meetings. Statement from PERAB Chairman Paul Volcker on Tax Task Force, President's Economic Recovery Advisory Board, White House, November 27, 2009, available at http://www.whitehouse.gov/blog/2009/11/27/perab-tax-task-force