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PUBLIC CAPITALIZATION OF NEW BUSINESS*

S. PHILIP MALSPIES**

INTRODUCTION

Concept of New Business

New business is not susceptible of such exact definition that one may say unhesitatingly this certain business is or is not new business. Nevertheless, new businesses have characteristics in common which clearly delineate them as a segment of businesses in general. As used herein, New Business means that group of businesses which are established, are financially immature and unseasoned, and which are small. Explanation of these criteria will establish more clearly what is meant by New Business in this work.

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In this issue we are printing excerpts from the article as indicated (†) in the following table of contents. In the next regular issue of the Miami Law Quarterly (Vol. X, No. 4) we will print the sections designated (‡‡).

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An established business is one in which there has been actual operation of the physical part of the business, whether it be manufacturing, retailing, assembling or wholesaling. There must have been a going beyond the pale of ideas, schemes or plans.

Financial immaturity is the outstanding characteristic of New Business; such businesses are unbankable; i.e., they do not have access to long term credit. They are a poor credit risk in the eyes of private financial institutions such as commercial banks, savings and loan banks or trust companies. If a business has fixed assets available as collateral for a long term loan, or has the type of earnings record and business history which will satisfy strict credit requirements, it is bankable and not a financially immature and unseasoned business. A rule of thumb to determine bankability is whether the business has been in successful operation for five years. Businesses with successful operating records of five years or more are bankable, while those with successful operating records of less than five years are financially immature and unseasoned.

A new business, as the term is used herein, must be a small business. Smallness, however, is a term of rather vague meaning. Ask someone to define "small" and he will tell you it means little or not large, therefore, necessitating a knowledge of what large means. Whether or not a thing is small is a matter of degree or relationship. Considerable literature has been written with a view to drawing a line of demarcation between small business and large business. Many criteria have been proposed. Number of employees, amount of annual sales, net assets, gross assets, net

2. This is a rule of thumb used by financial specialists and bank examiners. (Personal interview with Bernard E. Boldin, financial specialist of the Small Business Administration.)
4. The Bureau of Foreign and Domestic Commerce has applied this criterion, including within the category of small business, manufacturing establishments with less than 100 employees, Schmidt, op. cit. supra note 3, at 206; the Bureau of Labor Statistics has also applied this test using 43 employees as the line of demarcation, Kaplan, op. cit. supra note 3, at 12; also used by Congress in the Small War Plants Act, the measuring point being 250 employees and in the Selective Service Act of 1948 in which the line was at 500 employees.
5. Criteria used by Bureau of Foreign and Domestic Commerce, under which wholesale establishments with less than $200,000 volume of annual net sales and service establishments with $50,000 annual net sale volume were considered small, Schmidt, op. cit. supra note 3, at 206.
6. This classification set up by the Bureau of Internal Revenue, Kaplan, op. cit. supra note 3, at 14.
7. Ibid. In applying this standard, the Securities and Exchange Commission, the Temporary National Economic Committee and the National Bureau of Economic Research have used the sum of $250,000 gross assets, to divide small and large business.
income,\(^8\) dominance in field of operation,\(^9\) independence of ownership,\(^10\) quantity of material consumed and amount of capital investments\(^11\) are the most notable.

For the purposes of this paper the definition of small business as "one which is independently owned and operated and which is not dominant in its field of operation" is accepted.\(^12\) This definition embraces approximately 4,000,000 firms, or percentage wise more than 90 per cent of all business in this nation.\(^13\) Large businesses, while they may be more or less financially unsound, are generally not financially immature and unseasoned by virtue of their lack of operative history. Should United States Steel create a subsidiary, it would not be a new business, although new in years, for it would lack that essential characteristic of smallness, which, combined with financial immaturity, conveys the picture of new business as contemplated herein. New business, then, is a type or category of small business. While all new businesses, for the purpose of this discussion, are small businesses, the converse is not true—for many small businesses are not new businesses.

The long-term credit and equity—capital problems of new businesses have been sorely neglected. The past score of years saw national recognition of the capital problems of small businesses.\(^14\) The laborious task of securing aid to small businesses has generally overshadowed the problem of the most needy segment of the small business population, the new business. Thus, while writings on the problems of small businesses have been prolific,\(^15\) little has been written regarding the capital problems of new businesses. Nevertheless, the capital problems of small and new businesses are identical, except that with regard to new businesses, the problem is more acute. It is safe to conclude that insofar as access to capital is concerned, new businesses are under the greatest disability since financial immaturity is their major characteristic. For these reasons, an analysis of the capital problems of small business generally will bring into sharp focus the capital problems

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8. *Ibid.* The TNEC distinguished small business as having net income of less than $25,000.
9. In *Does Small Business Get a Fair Shake*, Fortune, Vol. 48 pp. 162-5, Oct. 1953 the following example is given: Crucible Steel Co. is a relatively small entity in its industry (about 1 per cent of U.S. Steel capacity). It has $157 million in assets and approximately 16,400 employees. Studebaker Corp. produces 4 per cent of automobiles made in the United States; has $195 million in assets and approximately 26,700 employees. Both are considered small under the criteria proposed.
11. Id., at 20.
of new business. The reader must constantly keep in mind the proposition that all that is said of small business is applicable to new business, only more so.

Capital Problems of New Business

The capital problems of new businesses can be described aptly in a single phrase, lack of access. There is no shortage of financial institutions to which a business may apply for satisfaction of its capital requirements. The investment funds of these institutions, however, are for the most part unavailable to new businesses. For the purposes of this discussion, financial institutions may be divided into two groups. One group consists of institutions of a public or quasi-public nature. These are, respectively, administrative agencies created by statute, and non-profit institutions with governmental condonation and support. In the other group are private profit-making organizations operating to serve individual interests.

There are many such private financial institutions. Commercial banks, trust companies, bank trust departments, industrial banking companies, commercial paper houses, small loan companies, insurance companies, equipment manufacturers, private venture capital, capital markets and private industrial development groups are the most common. All but the last of these have been analyzed, scrutinized, criticized, evaluated and appraised by various writers. Each of these has come to the conclusion that the funds of these institutions are generally not available for the capitalization of small businesses. They are, therefore, unavailable to new small businesses. Burdening the reader with a reinvestigation and a reexamination of the data upon which these conclusions are based will add nothing of value. For the purposes of this paper, it is sufficient to state the findings of this mass of writings and to proceed to examine the public and quasi-public institutions, about which little has been written.

Commercial banks and trust companies are providers of both short-term and long-term credit. Long term loans are usually not available to small businesses because of collateral requirements. Collateral for such loans must be fixed assets, such as equipment, machinery or realty. These banks normally require five year earning records and other evidence that the borrower is a good credit risk. Interest rates to small businesses are sometimes three times higher than those to large businesses. Since new businesses generally have little in the way of collateral and since they have short earning records, long-term funds from banks are almost unavailable.

16. Studies of individual community industrial foundations have been made. See Hopkins, The Louisville Industrial Foundation, Atlanta, Georgia, Federal Reserve Bank of Atlanta, 1945.

17. Wilhelm, Jr., How Small Business Competes for Funds, 11 Law and Contemporary Problems 235 (1946). Mr. Wilhelm has made a thorough and systematic survey of private capital sources, based upon adequate data. His conclusions are stated here.
As to short-term loans, collateral is almost always required of small businesses, whereas large businesses may borrow without collateral. While short-term loans are usually unavailable to small businesses and also to new businesses, the practice of requiring interest payments in advance and insisting upon a minimum balance makes the use of short-term loans inexpedient for capitalization.18

Industrial banking companies are providers of short-term credit. They are limited by statute in many states to loans for one or two year maturity periods. The impracticality of using short-term credit for long term capitalization rules these organizations out as a source of capital for new businesses.19

Small loan companies have diversified activities in the supplying of capital. They provide funds to finance wholesale purchases from manufacturers and distributors; commercial financing under which they purchase current open accounts receivable from manufacturers, wholesalers, and distributors; factoring, wherein they purchase current open accounts receivable and assume the risk thereon; in addition to the familiar service of providing installment financing for the purchase of retail products.20 Although these institutions claim competitive rates with other institutions, their rates are generally higher, varying from 15 per cent to 30 per cent per annum.21 Furthermore, the cost of such financing to small or new businesses is not readily apparent. The hidden costs of loss of discounts for cash cannot be calculated. This is also true of credit available from equipment manufacturers.22 In addition, the impracticality of short-term renewals renders the small loan company an unsatisfactory source of capital.

Insurance companies supply mortgage loans and occasionally long-term loans on industrial property. They invest in bonds and securities of large companies and therefore provide capital to those companies. Collateral requirements prevent small or new borrowers from using these companies. Direct loans have been made only to companies with more than $1,000,000 in assets.23

Commercial paper houses operate by purchasing commercial paper at a discount on the open market and by selling such paper to investment houses. Since they are in fact brokers, and are compensated by commission, they will not handle paper of small companies. The margin of commission is too narrow and such paper is difficult to dispose of.24

18. Ibid.
19. Id. at 226.
21. Id. at 80.
22. Wilhelm, Jr., op. cit. supra note 17, at 232.
23. Id. at 228.
24. Id. at 230.
Private venture capital is usually deemed a last resort for businesses of all types. For the new business, it is prohibitive as a source of capital. Private, individual investors demand exhorbitant rates of interest, they demand bonuses, and they usually assume control of the business. The relinquishment of a controlling share of a business, for capital with which to operate it, is not the capitalization of a business, but rather an outright sale thereof.26

Capital markets provide funds for business by the sale of securities, whether on the national exchanges or over-the-counter markets. A new business, because of its smallness, would not be listed on a national exchange. New businesses, furthermore, frequently have weak or inexpert management. Their bookkeeping, record keeping and general accounting methods are, in most cases poor.27 They have little collateral and little earnings potential. These facts, rather than the high cost of flotation, prevent the sale of securities by new businesses on the over-the-counter market.27

From these findings, the following general conclusions may be drawn. There is no lack of short-term credit available to new business. It is, however, available only at high cost. The use of short-term credit for capitalization is impractical. Long-term or equity capital is unavailable to new business from private financial institutions. This is directly due to the financial immaturity of these businesses. They have little collateral and virtually no earning records. The cost of servicing new business loans is disproportionately high in relation to the return to the investor. Inefficient management, poor accounting systems and the high rate of mortality make new businesses an undesirable credit risk.28

Public sources of capital purport to make long-term capital available to small and new businesses. Do they do so? If not, there is no satisfactory source of such capital available to the attorney who seeks capital for a new business client. Response to this question must be delayed until the public source of capital, i.e., the Small Business Administration, is examined in detail.

**CAPITALIZATION OF NEW BUSINESS ON THE FEDERAL LEVEL—THE SMALL BUSINESS ADMINISTRATION**

**Administrative Machinery of SBA**

The Small Business Administration (hereinafter referred to as the SBA) was created by the Reconstruction Finance Corporation Liquidation Act. It is more commonly called by its popular title, the "Small Business Act

25. Id. at 233.
of 1953.”

The agency is under the “general direction and supervision of the President,” and its principal office is in Washington, D.C., in the Lafayette Building. In order to function properly, the agency, of course, has branch offices; thirteen regional offices and some thirty-two field offices strategically located throughout the United States make up its physical plan. In addition, quasi-official bodies called the National Council of Consultants and the Regional Board of Advisors have been established. These are, respectively, national and local advisory groups composed of business men, bankers, economists and financial specialists whose function is to provide SBA with a cross-index of small business needs and opinions, and, by no means incidentally, to promote SBA goodwill. Almost all contact with the applicant is through the field office. These offices are staffed by men and women with wide experience in small business capital problems. They are ready and willing to advise, negotiate among institutions for private loans, or offer solutions to non-financial small business problems, even though the inquirer does not seek an SBA loan. The attorney for a small business is well advised to make the acquaintance of the field office staff and to take advantage of their specialized knowledge and experience, whether or not he seeks SBA assistance.

Management of the agency is vested in an administrator appointed by the President with the advice and consent of the Senate, and three deputy-commissioners appointed by the Administrator. The act provides that the Administrator “shall be a person of outstanding qualifications known to be familiar and sympathetic to small business problems.” This requirement is an answer to the age-old cry that the directors of the Reconstruction Finance Corporation were not sympathetic to small business. There are no qualification requirements for deputy commissioners.

Each deputy commissioner is in charge of a key function. These consist of the Washington Office, Field Operations and Loan Approval. Also composing the internal structure of the SBA are three main offices, under

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34. SBA, 1st Semi-Annual Report, 61, examples cited.
36. Ibid.
which there are many staff offices; the former are the office of Procurement Assistance, the office of Financial Assistance and that of Production and Distribution Assistance. The more important staff offices are Information and Managerial Assistance, General Council, Controller, Economic Advisor, Office Management and Compliance and Security.\textsuperscript{38}

The most important internal office in the agency is the Loan Policy Board. This is composed of the administrator as chairman, the Secretary of the Treasury and the Secretary of Commerce.\textsuperscript{39} The Act provides that the Cabinet Members may appoint any member in their department to act in their stead on the Board, so long as such member was appointed to that department by the President with the advice and consent of the Senate.\textsuperscript{40} Since the Loan Policy Board sets the rules which control the agency's most important function, it is readily apparent that SBA Loan Policy will closely follow presidential domestic policy.

\textit{Loan Policy of the Small Business Administration}

The 83rd Congress created the SBA for the express purpose of preserving and expanding the growth of free competition, free markets and opportunity for personal initiative.\textsuperscript{41} The realization that these objectives of economic security were correlative with the success of small business led to the adoption of the following loan policy by the SBA:

It is the policy of the Small Business Administration to assist reliable, capable businessmen operating small firms to secure necessary credit for constructive purposes on terms that will meet the borrower's particular requirements.\textsuperscript{42}

The sweep of this policy statement is indicative of the wide latitude given to the SBA's Administrator in the formulation of loan policy, conditions and procedure. The power to make loans, as prescribed by the act, is similarly so broad that meaningful analysis can be achieved by examination of restriction.\textsuperscript{43} Under a basic premise that the SBA may do anything and everything under its loan powers, that which it is prohibited from doing becomes of vital importance. It is interesting to note that many such prohibitions are not positively stated but rather are quite clearly omitted. The act gives the SBA the power to make loans to small businesses for the purpose of financing plant construction, conversion, expansion or

\begin{itemize}
\item \textsuperscript{38} SBA, \textit{What It Is: What It Does}, Washington, Office of Managerial Assistance and Information 2-4 (1953).
\item \textsuperscript{40} Act of July 30, 1953, c. 282, Title II § 204, 67 Stat. 233, 15 U.S.C. 633(d) (1946).
\item \textsuperscript{42} SBA, \textit{Public Statement of Loan Policy}, Feb. 1954, mimeographed.
\end{itemize}
acquisition. Also, the SBA may finance the acquisition of equipment, facilities, machinery and supplies and materials. Therefore, loans must be made for fixed or working capital. No provision is made for providing equity or risk capital. Loans for working or fixed capital may be granted only to concerns engaged in the manufacture or assembly of articles, equipment, supplies and materials for war, defense or essential civilian production. However, funds which are necessary to insure a balanced national economy may be loaned to small businesses of any kind. The Loan Policy Board, under the very elastic "essential civilian production" and "balanced national economy" clauses, has considerably enlarged the prospective scope of the SBA loan customers.

The act sets forth the following express limitations, within the confines of which the Administrator is to formulate loan terms and conditions. Financial aid may not be granted unless it is otherwise unavailable at reasonable terms. Loans must be secure or of such sound value as reasonably to assure repayment. The different types of loans must be applied for in a particular order. First, a deferred participation loan must be sought. If such be not available, the applicant must then seek an immediate participation loan. If no participation loan is possible, then, and only then, may a direct loan be made to the applying concern. These conditions, imposed by the Administrator, are considered in detail at a later stage of this article.

As already indicated, the act defines small business as "one which is independently owned and operated and which is not dominant in its field of operation." Authority is given to the Administrator, in making a
detailed definition, to use other criteria such as dollar volume and number of employees. The SBA has found that a single size is unrealistic. The definition in present use is based upon differences in various segments of industry. The SBA has wisely refrained from making this categorization inflexible. This criterion is to operate temporarily until such time as it proves itself adequate or inadequate.

The present standards according to size, have been adopted from those used by government procurement agencies. As to the SBA Procurement Assistance Program, firms employing 500 employees or fewer are classified as small. This same classification applies to the issuance of Certificates of Competency in connection with SBA assistance. For all other purposes, manufacturing concerns are said to be small if they contain fewer than 100 employees and large if they employ more than 1,000 persons. Firms with employment forces between 100 and 1,000 are listed as small or large depending upon the size standards of the particular industry. Firms are also categorized as large or small according to dollar volume of annual sales. This standard is employed with regard to businesses which may be large despite small employment forces. The SBA has announced its intention to apply, in the near future, a standardization system using the number of units produced or net worth as the norm, where this would be more suitable. Assuming that the applicant is within one of the above categories of small business, he may nevertheless be ineligible for SBA assistance by application of any of the following exclusionary rules.

Where the result or purpose of the loan, directly or indirectly, is to pay creditors who do not have adequate security or who may sustain losses,

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51. Ibid.
52. SBA, 1st Semi-Annual Report, op. cit. supra note 34, at 10.
53. Id. at 9.
54. Ibid. In this connection 95.2 per cent of American businesses have fewer than 20 employees while only one per cent have more than 100 employees. SBA Release, (Speech by William D. Mitchell at Portsmouth, New Hampshire), Sept. 8, 1953, mimeographed.
56. Any wholesale concern whose annual sales are $2,000,000 or less shall be classified as small. In addition, any of the following types of wholesale concerns whose annual sales are $5,000,000 or less shall be classified as small: Coal and coke (in yards); coffee, tea, spices; cotton, drugs (general line); dry goods (general line); electrical appliances and equipment; electrical goods (general line); hardware (general line) with industrial departments; meat, meat products; nonferrous metals and metal work; piece goods, converters, refrigerator equipment (household); lines and tubes; tobacco (leaf); wool (mohair). Any wholesale concern also engaged in manufacturing shall not be designated as a small business concern unless it so qualifies under both manufacturing and wholesaling standards. Any retail or service trades concern whose annual sales are $300,000 or less shall be classified as small. In addition any of the following types of retail concerns whose annual sales are $500,000 or less shall be classified as small: Farm equipment dealers, lumber yards and building material dealers. In the case of new and used motor vehicle dealers and department stores the standard shall be $1,000,000 or less.
57. Ibid.
the SBA will not grant the loan. Such loans, if made, would benefit the creditors and not the business to which the aid has been afforded. Furthermore, the assistance might do little more than to stave off the inevitable. This would be an unwise lending policy for the government or private business.

The SBA will not provide funds for distribution in the form of salaries or dividends to owners, partners or shareholders, nor will it provide working capital to free other capital for such purposes. This rule clearly demonstrates that the SBA will not and does not intend to provide risk or equity capital. Funds obtained from the SBA must be secured by first mortgages and may be used only for working or fixed capital purposes. This is not unwise. It protects taxpayers' funds by removing temptation from the path of an unscrupulous businessman, who might disburse such funds in the form of salaries, without possibility of repayment.

Where the result or purpose of the loan directly or indirectly would be to cause a change of ownership in the business, the SBA will not lend a financial hand. Nor will money be loaned to provide free funds for speculation of any kind; or to applicants who derive, or whose principal owners derive, some part of their gross income from gambling. These exclusions are based upon public policy. It is not the function of the federal government to provide capital with which to gain control of a business or to encourage or assist gambling or speculation.

Similarly, for policy reasons, where a substantial portion of the gross income of the applicant or its principal owners is derived from the sale of alcoholic beverages they are not eligible for SBA assistance. This is true, also, if the effect of extending financial aid is to encourage or create monopolies, or is not consistent with American free, competitive enterprise. The latter precept is in accord with well-established federal policy. The former emanates from policy purportedly long abandoned.

Other specifically exempted businesses are recreational and amusement firms, investment and lending houses, newspapers, magazines, radio broad-
casting companies, television companies and similar enterprises. Eleemosynary institutions also are barred from the scope of SBA lending activities.\^67

Stated positively, it is the policy of the SBA to make loans only where they will actually help a borrower to operate a successful business, into which he has put a sufficient amount of his own capital, and if the making of the loan will benefit his community, the economy and the taxpayer.

The purpose of the SBA being to foster competition between private enterprises, it would be incongruous for it to compete with regular financial institutions. The SBA would accomplish very little if it offered financial aid to concerns which could obtain aid elsewhere. Therefore the SBA requires the applicant to demonstrate that the desired credit is not available elsewhere on reasonable terms.\^68

The applicant must show that his bank or any local bank has refused to make the loan.\^69 Refusal must be evidenced by a letter from the institution setting forth the facts of the application and the refusal.\^70 If the amount of the desired credit is in excess of the legal lending limit or policy lending limit of the bank, and this is the reason the loan was refused, correlative refusal from corresponding banks or other lending institutions with capacity and authority to make such a loan must be shown. It is permissible to establish this by a statement made in the local bank letter of refusal.\^71 Letters from other financial institutions, such as industrial banking companies, commercial paper houses, equipment manufacturers or factors' insurance companies may also be required.\^72

Funds required must not be obtainable by the sale of securities publicly or privately.\^73 This does not mean that the availability of a "barber-turned-investment banker," who will attempt to dispose of securities purely on a best effort basis, will preclude the concern from applying for SBA credit.\^74 In most cases, no question arises as to the sale of securities. Where, however, it appears that securities of the applicant might be

\^69. ... a small firm must have exhausted the possibilities of obtaining the needed loan from a bank or other private source of capital or credit.
\^70. SBA, Release No. 23, Sept. 25, 1953, mimeographed.
\^71. Ibid.
\^72. Ibid.
\^73. Id.
\^74. Sowards, Cash and Materials on Corporate Finance, 293-295 (1st ed. 1950).
marketed by a reliable investment banker, it will be necessary to show a letter by such an investment banker stating that in his opinion the concern is not acceptable for a public marketing of securities.\footnote{This is so, if the securities of the applicant can be sold by a reliable investment banker, whether under standby agreement, firm agreement or best effort agreement. Personal interview, Bernard E. Boldin.}

Similarly, if the corporation’s business history and operating circumstances indicate that it would be feasible to effect a private sale of securities, funds will not be made available from the SBA. Unfortunately, what is meant by “private sale of securities” is not made clear by the loan policy statement. Construed in the light of other loan policy requirements, it seems to mean that funds must not be reasonably available to the applicant through the sale of securities to friends and relatives without the intercession of an underwriter. Whether such a sale of securities is feasible would be determined by the SBA examiner through his investigation of the applicant.

If the applicant has assets not required in the conduct of his present business, nor reasonably necessary to the firm’s potential health or growth, which can be mortgaged to obtain funds, or if he can utilize his personal credit and that of his officers, partners, managers or principal shareholders to obtain funds without undue hardship, he is ineligible for an SBA loan.\footnote{Prior to Jan. 7, 1954, the policy of the Small Business Administration was to refuse loan assistance if desired for “the direct or indirect purpose of refinancing indebtedness due to a Government instrumentality.” The policy was reversed on the above date to permit application for SBA loans to refinance RFC indebtedness. SBA Release No. 65, Jan. 7, 1954, mimeographed.}

Similarly, other government financing must be unavailable.\footnote{SBA, \textit{Common Sense, Credit Requirements of the Small Business Administration}, Dec. 7, 1953, mimeographed. SBA Release No. 49, Dec. 7, 1953, mimeographed.} It is generally unnecessary to establish compliance with these conditions other than by filling in the application forms.

Having established that funds are not reasonably available elsewhere, it is then necessary to qualify under the following “common sense” requirements. First, the applicant must be of good character.\footnote{SBA, 1st Semi-Annual Report, op. cit. supra note 34, at 3.} This refers particularly to his reputation in the community in which he operates his business. All elements of character are considered and weighed; no single fact will determine the applicant’s good or bad character. Typical facts tending to show bad character are habitual drunkenness, indulgence in narcotics, or conviction for a criminal offense—especially one arising out of business—such as fraud or concealment of assets in bankruptcy. Bankruptcy itself may be considered. Voluntary bankruptcy is viewed more harshly than involuntary bankruptcy. Also, of course, of weight are the usual factors of character similar to those used by any bank in considering loan applications. It is the sum total of all factors, or a composite picture, which yields the final determination as to character, and despite the
existence of some minor fact evidencing bad character, the ultimate finding
may well be otherwise.79

Second, there must be evidence that the applicant has the ability
to operate his business successfully.80 Books, reports, and records are
examined; on-the-spot checks of business operations are made. Investiga-
tions are made to determine the personal expenses of principal owners or
managers and their past business experience in other businesses. If the
business is new and has little to show by way of past experience, its market
product and present equipment will be closely scrutinized to determine
soundness. Preference is given to businesses which have been in operation
at least five years. Those in operation less than two years are considered
too unseasoned and immature, save in exceptional cases.81

Third, past records and future prospects must be such, and the
business must show a sufficient probable income, so it can logically be
assumed the applicant will be able to pay the loan out of the future income
of the business.82 The SBA examiner requires a five year earning record
to be shown, except in exceptional cases. Not only must the applicant
show that the business has sufficient earnings to meet current obligations,
but in addition must show sufficient earnings to pay income tax and the
salaries of officers. Furthermore, there must be sufficient income to provide
a living in terms of food, clothing, medical bills, rent, etc., for the principal
owners, with enough surplus remaining to meet the payments of the SBA
loan.83

Fourth, the applicant must have sufficient capital in the business so
that it, together with funds provided by the SBA, will permit the business
to operate on a sound financial basis.84 In this connection, when a business
is new, that is, having operated less than five years, it must be able to
match dollar-for-dollar each dollar of SBA assistance. In the case of businesses
in operation more than five years it is possible to borrow more than the
business’s net worth. In no event, however, may a business borrow from
the SBA more than twice its net worth.85

Fifth, the SBA Act requires the loan to be of sound value or so
secured by first mortgages or fixed assets, as reasonably to assure repay-
ment.86 Some SBA loans are secured by accounts receivable, especially in
those cases in which there is bank participation, since the bank is able
to service the loan. Where accounts receivable are used as collateral,

79. Boldin, op. cit. supra note 75.
80. SBA, COMMON SENSE, CREDIT REQUIREMENTS, op. cit. supra note 78.
81. Boldin, op. cit. supra note 75.
82. SBA, COMMON SENSE, CREDIT REQUIREMENTS, op. cit. supra note 78; SBA,
Release No. 49, op. cit. supra note 78.
83. Boldin, op. cit. supra note 75.
84. SBA, COMMON SENSE, CREDIT REQUIREMENTS, op. cit. supra note 78; SBA,
Release No. 49, op. cit. supra note 78.
85. Boldin, op. cit. supra note 75.
86. SBA, COMMON SENSE, CREDIT REQUIREMENTS, op. cit. supra note 78.
the system of release and substitution of accounts is employed. Since SBA loans must be secured dollar-for-dollar in most instances, it is necessary for the SBA examiner to determine the value of fixed assets or other collateral. This is done not by book replacement value, but by liquidation value. The examiner considers whether the business could be sold as a going concern or whether it would have to be sold piecemeal. The liquidation value is the most important factor used to determine the amount of loan which the SBA will make\textsuperscript{87} within its $150,000 scope.\textsuperscript{88}

Sixth and most important, the loan must aid the defense program or be necessary to the maintenance of a well-balanced national economy.\textsuperscript{89} Aid to the defense program is self-explanatory.\textsuperscript{90} The requirement relating to a balanced national economy, however, affords the agency a wide measure of discretion which apparently is utilized to encompass the broadest field possible. In the phrase “well-balanced national economy,” the word “national” is employed to mean anywhere in the nation, and not in the sense of national as distinguished from local. Under this interpretation, small business anywhere, is within the scope of the SBA’s activities. For example, if a small town factory employs many people, that factory is essential to a well-balanced economy. The extreme to which this principle can be carried is indicated by the following illustration. John Doe owns a grocery store in Miami, Florida. There are no other grocery stores for eight or ten blocks and it is a hardship for residents in the area to walk to another store. John Doe needs financial aid to operate his store. Since persons in that area depend upon the store to provide them with groceries, the store is essential to a well-balanced national economy.\textsuperscript{91}

After all obstacles have been overcome and the applicant has qualified for a loan, what type of financial assistance is available to him and under what terms and conditions? As indicated earlier, SBA loan assistance is of three types and must be applied for in proper order. The small business man must, in the first instance, seek a deferred participation loan.\textsuperscript{92}

In the case of a deferred participation loan, serviced entirely by the bank, the funds borrowed by the business are furnished solely by the bank. These funds are advanced by the bank as an assurance, by virtue of a

\begin{itemize}
  \item \textsuperscript{87} Act of July 30, 1953, c. 282, Title II § 207, 67 Stat. 235, 15 U.S.C., 636 (a) (2) (1946).
  \item \textsuperscript{88} Boldin, op. cit. supra note 75.
  \item \textsuperscript{89} SBA, \textit{COMMON SENSE, CREDIT REQUIREMENTS}, op. cit. supra note 79.
  \item \textsuperscript{90} Aid to the defense program includes in addition to defense loans, loans for essential civilian production. Examples of loans for defense are for manufacture of oxy-acetylene equipment; equipment for welding of aircraft; tractors for marine camps, etc. Examples of loans for essential civilian production are loans for smelting aluminum scrap; manufacture of commercial fertilizer; manufacture of livestock feed; machine shop specializing in designing industrial machinery, etc. SBA, \textit{1ST SEMI-ANNUAL REPORT}, op. cit. supra note 35, at 69, 70.
  \item \textsuperscript{91} Boldin, op. cit. supra note 75.
\end{itemize}
participation agreement with the SBA, that on demand by the bank the SBA will purchase an agreed portion of the loan. In order to do this, and in compliance with the agreement entered into, it is necessary that the SBA set apart from its revolving fund the agreed amount of deferred participation. The SBA must be able to supply these funds to the bank on demand. An interest charge is made to the local bank to compensate the SBA for the loss of income resulting from the setting aside of these monies. The charges are fixed in accordance with a sliding scale, the per annum increasing as the participation percentage increases. Where the participation percentage is in the one per cent to fifty per cent range, the charge is one per cent per annum. The maximum charge of two per cent is made when the SBA is obligated to purchase between seventy-five per cent and ninety per cent of the loan made. In this type of loan, the bank or other lending institution fixes the rate of interest to the borrower, passing on to him the cost of the SBA participation. Under the SBA requirement, the rate of interest on the amount of the loan to which the SBA is committed may never be less than five per cent.

Immediate participation loans are made under the same terms and conditions as deferred participation loans. The mode of operation differs. In this type of loan the bank and the SBA enter into a participation agreement, each immediately supplying a portion of the funds directly to the borrower. Since the interest on the monies advanced by the SBA is paid directly by the borrower, no charge is made to the bank. The bank, however, services the loan. The borrower makes a single monthly payment to the bank; the bank then accounts to the SBA under the terms of the participation agreement. In both the deferred and immediate participation loans, the SBA participation is limited to ninety per cent of the total outstanding loan. Applicable to all SBA loans is the rule that no loan may remove from the revolving fund an amount in excess of $150,000. The maximum maturity period of any SBA loan is ten years including renewals and extensions. An exception is made in the case of loans to construct industrial facilities, in which case the loan must mature within ten years plus the period necessary to complete construction.

The direct SBA loan requires little explanation. It is a typical mortgage loan serviced entirely by the SBA. The complexities of bank participation are not present. A loan agreement, typical of those used by banks in private dealings, is entered into between the SBA and the borrower.

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95. *Ibid*.
96. *Ibid*.
98. *Ibid*.
Typical of government loan transactions is the great number of forms to be submitted. The borrower is required to execute a note; interest is charged at the flat rate of six per cent per annum. It should be remembered that direct loans, as well as the two types of participation loans, require first mortgages or accounts receivable as collateral. Where there is outstanding indebtedness, subordination agreements from other creditors will be required. By requirement of loan policy and as a matter of preferential choice on the part of the SBA's Administrator and Examiners, the amount of direct loans made is small in comparison with participation loans. This is in accordance with the policy of encouraging private financial institutions to lend to small business.

100. SBA, Release No. 24, op. cit. supra note 94.