SBA Overhaul of 8(a) Rules Provides Additional Flexibility for Joint Ventures, But May Increase Risk for Large Contractors Partnering with 8(a) Firms

By John R. Prairie

The Small Business Administration (SBA) recently completed its first comprehensive revision to the 8(a) Business Development (BD) Program in more than 10 years.[1] The changes will affect many small businesses applying for and participating in the 8(a) BD Program, but will have a significant impact on many large businesses as well. The federal government purchased nearly $20 billion in goods and services through 8(a) contracts in FY2009.[2] With shrinking agency budgets and a sluggish economic recovery in the commercial sector, large companies are increasingly looking to get a piece of these 8(a) contracting dollars by partnering with 8(a) firms. By participating in the SBA's Mentor/Protégé Program, for example, a large business mentor can compete for 8(a) contracts as part of a joint venture with its small business protégé.

The SBA's overhaul of the 8(a) Business Development Program made several significant changes to the rules governing joint ventures and the Mentor/Protégé Program. Several of these changes—including allowing joint ventures to be awarded three contracts in two years and streamlining the SBA's approval of new opportunities—will increase flexibility and efficiency, and decrease administrative costs, for joint venture partners. Other changes, however, may increase risks for large businesses partnering with 8(a) firms. In light of recent high-profile matters focusing on the percentage of work performed by small businesses under set-aside contracts, the new requirement that 8(a) joint venture partners perform at least 40 percent of the work done by the joint venture could lead to increased scrutiny and enforcement in this area. In addition, the 8(a) rules now permit the SBA to take certain actions, including debarment, against a mentor that fails to provide the agreed-upon business development assistance to its protégé.

This article discusses the changes to the SBA's rules governing joint ventures and the Mentor/Protégé Program, as well as the impact these changes may have on large businesses that partner with 8(a) firms.

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Joint Ventures

The "Three in Two" Rule. Under the SBA's rules, a joint venture is an entity of limited duration. Specifically, the prior regulation limited a joint venture to submitting no more than three offers over a two-year period.[3] The SBA made two significant changes to this requirement. First, the revised regulation allows a specific joint venture to be awarded three contracts within a two-year period.[4] Second, the SBA clarified that the partners to a joint venture could form a second joint venture that could be awarded three additional contracts, and a third joint venture that could be awarded three more.[5] The revised rule notes, however, that at some point such a longstanding relationship could lead to a finding of general affiliation among the joint venture partners.[6]

The SBA also clarified when it will determine whether the three contract awards in two years requirement has been met. Once a joint venture is awarded its first contract, the SBA will measure compliance with the "three award in two years" rule as of the date a concern submits a written self-certification that it is small as part of its initial offer, including price.[7] As such, a joint venture could ultimately be awarded more than three contracts without the SBA finding affiliation between the joint venture partners if the joint venture received two or fewer contracts as of the date it submitted one or more additional offers, which thereafter resulted in one or more additional contract awards.[8]

The new "three in two" rule is a welcome change for contractors participating in joint ventures with small businesses. Under the prior rule, joint venture partners were forced to be very strategic about which opportunities they chose to pursue because they were limited to submitting three proposals in two years. While it was common for joint venture partners to enter into additional joint ventures after reaching the three proposal limit, creating additional joint ventures was an unnecessary administrative burden, particularly for 8(a) joint ventures, which must be approved by the SBA.[9] The ability to submit multiple proposals (and potentially receive multiple awards) once a joint venture has already been awarded two contracts will provide joint ventures additional flexibility in selecting opportunities to pursue.

While the new rule expressly permits contractors to enter into multiple successive joint ventures, it cautions that "[a]t some point . . . such a longstanding inter-relationship or contractual dependence between the same joint venture partners will lead to a finding of general affiliation between and among them."[10] Notably, the SBA stated

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that concerns could be found affiliated with each other on this basis "even in the 8(a) mentor/protégé joint venture context."[11] This is significant because joint venture partners that also participate in the Mentor/Protégé Program generally operate under the assumption that they cannot be found affiliated based on assistance received under an SBA-approved mentor/protégé agreement.[12] It is uncertain whether a finding of affiliation between a mentor and protégé on this basis would be upheld, however, because the SBA's statement was in the explanatory text only, and was not included in the final regulatory text.

Ostensible Subcontractors. The final rule also clarifies that the "ostensible subcontractor" rule applies not only at the time of size certification, but also during contract performance.[13] Thus, if a subcontractor performs "primary and vital requirements of a contract," the prime contractor and the subcontractor will be treated as affiliates for size purposes.[14] If the two firms exceed the applicable size standard in the aggregate, the contractor cannot continue to certify as small for that contract or for any task order under that contract.[15] This change will require small and large businesses that team together outside of the joint venture context to be more diligent about the assignment of work during contract performance to ensure that the large business subcontractor does not perform "primary and vital requirements" of the contract. It is uncertain what impact this change will ultimately have, however. While the SBA can generally rely on a firm's competitors to protest the award of a small business set-aside contract where it appears that a small business is unusually reliant on a large business subcontractor, procuring agencies have historically not closely tracked which firm performs the work after award.

8(a) Joint Ventures. The final rule made four amendments to the requirements for joint ventures performing 8(a) contracts. Several of these changes have the potential to significantly alter the relationship between 8(a) and non-8(a) joint venture partners.

Profit Received by the 8(a) Firm. The revised rule provides that the 8(a) participant(s) in an 8(a) joint venture must receive profits from the joint venture "commensurate with the work performed by the 8(a) Participant(s)."[16] Under the prior rule, the 8(a) participant(s) were required to receive at least 51 percent of the profits, regardless of the amount of work they performed.[17] This is a welcome change for large businesses that joint venture with 8(a) firms. The prior rule made little sense in light of the fact that the 8(a) firm(s) were not required to perform 51 percent of the work. The rule often discouraged legitimate non-8(a) firms from participating as joint venture partners in the 8(a) program because they often performed 60 percent or more of the contract, but only received 49 percent of the profits. It is worth noting, however, that the rule may not have much of an impact where the joint venture is established as a separate legal entity. In that case, the final rule requires that the 8(a) participant own at least 51 percent of the entity and receive profits from the joint venture "commensurate with ownership interests in the joint venture."[18]

Performance of Work Requirement. The final rule requires that the 8(a) participant(s) in a joint venture for an 8(a) contract perform at least 40 percent of the work done by the joint venture.[19] The 40 percent requirement applies to unpopulated joint ventures and joint ventures populated only with one or more administrative personnel.[20] The work performed by the 8(a) firm(s) under these types of joint ventures must be "more than administrative or ministerial functions so that they gain substantive experience."[21] For joint ventures populated with individuals intended to perform contracts awarded to the joint venture, each 8(a) participant in the joint venture "must demonstrate what it will gain from performance of the contract and how such performance will assist in its business development."[22]

This marks a significant departure from the prior rule. Previously, the 8(a) participant in an 8(a) joint venture was required to perform "a significant portion of the contract," rather than a specific percentage of the work.[23] While this standard was somewhat ambiguous, it provided flexibility to joint venture partners in allocating the work under 8(a) contracts. By adopting a bright-line 40 percent rule, the SBA has arguably provided better guidance to contractors and contracting officers as to what should be expected of the 8(a) firms. But the rule may prove difficult to administer in practice.

The new 40 percent standard could prove particularly difficult to meet under construction contracts where, outside of a joint venture, an 8(a) prime contractor would be required to perform only 15 percent of the work under the contract.

To begin, the new rule requires that in addition to performing 40 percent of the work performed by the joint venture, the 8(a) participant must perform "more than administrative or ministerial functions."[24] This standard is just as ambiguous as the "significant portion" test. The revised rule may also have the effect of significantly increasing the amount of work that must be performed by the 8(a) joint venture partner. Under the prior rule, the 8(a) firm may have been able to perform only 25 percent of the work while still complying with the "significant portion" rule. The new 40 percent standard could also prove particularly difficult to meet under construction contracts where, outside of a joint venture, an 8(a) prime contractor would be required to perform only 15 percent of the work under the contract.[25] In light of the increased scrutiny of this issue by

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the SBA and procuring agencies, a bright-line percentage of work test may also make it easier to take enforcement actions against joint venture partners that are not in strict compliance with the 40 percent rule.

The new rule will also require each 8(a) firm that performs an 8(a) contract through a joint venture to report to the SBA how the performance of work requirements were met on the contract.[26] While this new reporting requirement appears relatively innocuous on its face, it could be significant in light of the increased focus by the SBA and procuring agencies on the percentage of work performed by small businesses under set-aside contracts.

SBA Approval of Joint Venture Agreements. The final rule provides that once the SBA approves an 8(a) joint venture agreement for one 8(a) contract, it only has to approve addendums to that agreement setting forth the performance requirements for a second or third 8(a) contract award.[27] This is a positive change that will lead to increased efficiency and decreased administrative burden for 8(a) joint ventures. Under the new rule, joint venture partners will be able to respond quickly to opportunities with short turnaround times without waiting for the SBA to reapprove an entire joint venture agreement.

Mentor/Protégé Program

The final rule also contains several notable changes to the regulations governing the SBA's Mentor/Protégé Program, including:

- Requiring that assistance that is to be provided through a mentor/protégé relationship be consistent with the protégé firm's SBA-approved business plan;[28]
- Placing an absolute limit of three protégés per mentor;[29]
- Allowing a firm seeking to be a mentor to submit federal income tax returns, audited financial statements, or Securities and Exchange Commission filings in order to demonstrate the firm's favorable financial health;[30]
- Allowing nonprofit business entities to be mentors;[31]
- Clarifying that the benefits derived from the mentor/protégé relationship end once the protégé firm graduates from or otherwise leaves the 8(a) BD Program;[32]
- Allowing a protégé to have a second mentor where it demonstrates that the second relationship pertains to an unrelated secondary NAICS code, the first mentor does not possess the specific expertise that is the subject of the mentor/protégé agreement with the second mentor, and the two relationships will not compete or otherwise conflict with each other;[33]
- Excluding a protégé from becoming a mentor while retaining its protégé status;[34]
- Precluding the approval of a mentor/protégé relationship where the 8(a) participant has less than six months remaining in its program term;[35]
- Allowing a joint venture between a mentor and protégé to be treated as small for federal subcontracts;[36]
- Clarifying that a mentor/protégé agreement must be approved by the SBA before the two firms can submit an offer as a joint venture to take advantage of the special exception to the six requirements for that procurement;[37]
- Requiring that in order to receive the exclusion from affiliation for non-8(a) procurements, a joint venture between a mentor and protégé must comply with the performance of work requirements for 8(a) joint ventures, including the requirement that the 8(a) concern perform 40 percent of the work performed by the joint venture;[38] and
- Clarifying the procedures for requesting reconsideration of the SBA's decision to deny a proposed mentor/protégé agreement.[39]

The majority of these changes make sense and simply clarify the SBA's existing practices. Although the three-protégé rule is couched as a "limit," it may actually have the effect of *increasing* the pool of available mentors, as most large business mentors currently have only one protégé. Department of Energy (DoE) contractors figure to be the greatest beneficiaries of the change allowing joint ventures between a mentor and protégé to be treated as small for federal government subcontracts. DoE has a significant amount of contracting activity go through government-owned, contractor-operated (GOCO) facilities, and the contracts between the GOCO and a contractor technically are subcontracts. Finally, while requiring joint ventures between a mentor and protégé for non-8(a) procurements to comply with the performance of work requirements for 8(a) joint ventures makes sense, it will impose additional burdens on these entities that did not exist under the prior rule.

Consequences for "Bad" Mentors. By far the most significant change to the regulations governing the SBA's Mentor/Protégé Program is the addition of consequences for a mentor that fails to provide the assistance it agreed to provide in its mentor/protégé agreement.[40] Under the final rule, where the SBA determines that a mentor has not provided to the protégé firm the business development assistance set forth in its mentor/protégé agreement, the SBA will notify the mentor of such determination and afford the mentor an opportunity to respond.[41] The mentor must respond within 30 days of the notification, explaining why it has not provided the agreed upon assistance and setting forth a definitive plan as to when it will provide such assistance.[42]

If the mentor fails to respond, does not supply adequate reasons for its failure to provide the agreed upon assistance, or does not set forth a definitive plan to provide the assistance:

- The SBA will terminate the mentor/protégé agreement;
- The mentor will be ineligible to again act as a mentor for a period of two years from the date SBA terminates the mentor/protégé agreement; and
- The SBA may recommend to the relevant procuring agency to issue a stop work order for each federal contract for which the mentor and protégé are performing as a small business joint venture in order to encourage the mentor to comply with the mentor/protégé agreement. Where a protégé firm is able to independently complete performance of any such contract, SBA may also authorize a substitution of the protégé firm for the joint venture.[43]

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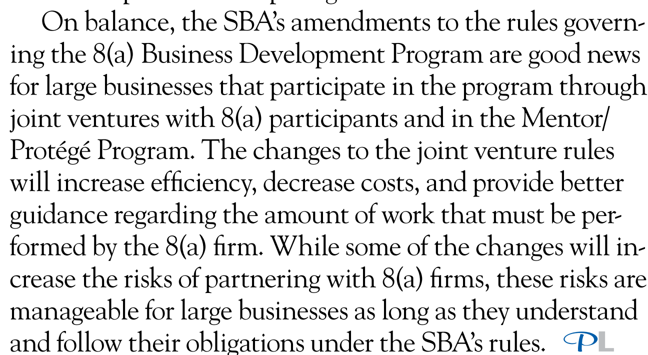
Finally, the new rule provides that the "SBA may consider a mentor's failure to comply with the terms and conditions of an SBA-approved mentor/protégé agreement as a basis for debarment on the grounds . . . that the mentor has not complied with the terms of a public agreement under 2 C.F.R. § 180.800(b)."[44]

The addition of penalties, including potential debarment actions, for a mentor that fails to provide the agreed-upon assistance to its protégé increases the risk for large businesses partnering with 8(a) firms. While the SBA likely already had the ability to take some, if not all, of these actions against "bad" mentors, expressly providing for them in the regulations may signal the SBA's intent to subject mentors to increased scrutiny in the future. In order to protect themselves, mentors must be sure to make good faith efforts to provide the assistance called for in their mentor/protégé agreements and to carefully document all assistance provided to a protégé.

On balance, the SBA's amendments to the rules governing the 8(a) Business Development Program are good news for large businesses that participate in the program through joint ventures with 8(a) participants and in the Mentor/Protégé Program. The changes to the joint venture rules will increase efficiency, decrease costs, and provide better guidance regarding the amount of work that must be performed by the 8(a) firm. While some of the changes will increase the risks of partnering with 8(a) firms, these risks are manageable for large businesses as long as they understand and follow their obligations under the SBA's rules. PL



Endnotes

1. 76 Fed. Reg. 8222 (Feb. 11, 2011).
2. *See* U.S. Small Business Administration, *at* http://www.sba.gov/content/final-regulations-will-strengthen-8a-business-development-program-small-businesses (last visited Apr. 17, 2011).
3. 13 C.F.R. § 121.103(h) (2011).
4. 76 Fed. Reg. 8251 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 121.103(h)).
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* The final rule also contains three examples in the regulatory text demonstrating the application of the new "three in two" rule. 76 Fed. Reg. 8251-52 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 121.103(h)).
9. 13 C.F.R. § 124.514(e) (2011).
10. 76 Fed. Reg. 8251 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 121.103(h)).
11. 76 Fed. Reg. 8223 (Feb. 11, 2011).
12. 13 C.F.R. § 121.103(b)(6) (2011).
13. 76 Fed. Reg. 8252 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 121.404(g)(4)). An ostensible subcontractor is a subcontractor that performs primary and vital requirements of a contractor, or of an order under a multiple award schedule contract, or a subcontractor upon which the prime contractor is unusually reliant. 13 C.F.R. § 121.103(h)(4) (2011). A contractor and its ostensible subcontractor are treated as joint venturers, and therefore affiliates, for size determination purposes. *Id.*
14. 76 Fed. Reg. 8252 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 121.404(g)(4)).
15. *Id.*
16. 76 Fed. Reg. 8261 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(c)(4)).
17. 13 C.F.R. § 124.513(c)(3) (2011).
18. 76 Fed. Reg. 8261 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(c)(3),(4)).
19. 76 Fed. Reg. 8261 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(d)). The final rule does not change the requirement that the joint venture (not the 8(a) participant(s) alone) is responsible for meeting the applicable percentage of work required by 13 C.F.R. §§ 124.510 & 125.6 (2011). *Id.*
20. 76 Fed. Reg. 8261 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(d)(1) (2011)).
21. *Id.*
22. *Id.*
23. 13 C.F.R. § 124.513(d) (2004).
24. 76 Fed. Reg. 8261 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(d)(1))
25. 13 C.F.R. §§ 124.510(a), 125.6(a)(3) (2011).
26. 76 Fed. Reg. 8262 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(i)).
27. 76 Fed. Reg. 8262 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.513(e)(2)).
28. 76 Fed. Reg. 8262-63 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(a), (e)(1)(i)).
29. 76 Fed. Reg. 8262 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(b)(2)). The final rule provides, however, that "[g]enerally a mentor will not have more than one protégé at a time." *Id.*
30. 76 Fed. Reg. 8262 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(b)(3)). Previously, a firm seeking to become a mentor was required to submit its federal tax returns for the last two years. 13 C.F.R. § 124.520(b)(3) (2011).
31. 76 Fed. Reg. 8262 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(b)).
32. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(d)(1)(iii)). The final rule makes clear, however, that the parties remain obligated to complete performance of the contract: "Leaving the 8(a) BD program, or terminating the mentor/protégé relationship while a protégé firm is still in the program, does not, however, affect contracts previously awarded to a joint venture between the protégé and its mentor. In such a case, the joint venture continues to qualify as small for previously awarded contracts and is obligated to continue performance on those contracts." *Id.*
33. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(c)(3)).
34. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(c)(4)). To become a mentor, a protégé must first terminate its mentor/protégé agreement with its mentor. *Id.*
35. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(c)(5).
36. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(d)(1)).
37. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(d)(1)(i)).
38. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(d)(1)(ii)).
39. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(f)).
40. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(h)).
41. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(h)(1)).
42. *Id.*
43. *Id.*
44. 76 Fed. Reg. 8263 (Feb. 11, 2011) (to be codified at 13 C.F.R. § 124.520(h)(2)).

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