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Small Business

View From Wiley Rein: SBA Opens Its Arms to More Large Businesses to Help Foster Its Small Business Mission

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The Small Business Administration (“SBA”) is expected to soon issue two final rules that have the potential to dramatically expand the federal contracting opportunities available to businesses both large and small. These two rules—an expansion of the mentor/protege program and a change in the self-performance requirements for small business prime contractors—will enhance the business development of small businesses and incentivize broader participation in small business programs by large businesses. Although some minor tweaks to the proposed rules are inevitable, their basic frameworks are expected to remain intact in the final rules.

Changes to the Mentor/Protege Program. In February 2015, the SBA issued a proposed rule that will throw open the gates of its mentor/protege program to all businesses designated small. Most significantly, the program will no longer be limited to 8(a) program participants. All small businesses—women-owned small businesses (WOSB), service-disabled, veteran-owned small businesses (SDVOSB), HUBZones, and even “regular” small businesses not part of a designated SBA program—will now be eligible for the many benefits of this critical business development tool.

The purpose of the mentor/protege program is to encourage approved mentors to provide various forms of business development assistance to protege firms. The primary incentive for large businesses to participate as mentors is their ability to form a joint venture with their protege to pursue small business set-aside contracts. Significantly, the joint venture arrangement also allows

the large business to perform up to 60 percent of the work. Under a traditional prime contractor-subcontractor relationship, the large business would be limited to performing no more than 49 percent of the work. Once the rule is finalized, all types of small businesses will be eligible to participate in the mentor/protege program and pursue small business set-aside contracts with their large business mentors.

It is apparent from the proposed rule that the SBA wants consistency across all small business programs. The new mentor/protege rule is designed accordingly. The proposed rule retains essentially the same qualification requirements for becoming a mentor that currently apply for the 8(a) mentor/protege program: a mentor must be a for-profit business that demonstrates a commitment and the ability to assist small business concerns. To meet these requirements, the mentor must possess favorable financial health and good character, may not be currently suspended or debarred, and, most importantly, can impart value to a protege firm due to lessons learned and practical experience.

Also consistent with the current framework, under the proposed rule a mentor could have no more than one protege at a time, unless authorized by the SBA. Obtaining SBA approval for an additional protege requires the mentor to demonstrate that the additional mentor/protege relationship will not adversely affect the development of either protege firm.

The proposed rule would make significant changes to the qualification requirements for proteges, however, by opening the mentor-protege program up to “larger” and more established small businesses. The proposed rule would eliminate the current the 8(a) program protege qualifications, and would allow firms participating in all SBA programs to qualify as proteges as long as they qualify as small under their primary NAICS code. Prospective protege firms would have to obtain SBA verification of their small business size status before receiving approval to participate in a mentor-protege relationship.

The proposed rule also makes a number of changes to the rules governing the formation and approval of joint ventures. The rule will clarify that the joint venture

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must be created through a formal written document setting forth all of the responsibilities of the parties as a partnership, regardless of whether a new legal entity, such as a limited liability company, is formed or not. The proposed rule would eliminate the option to create a joint venture entity populated with employees who will be performing the contract. Instead, the joint venture entity must be unpopulated or populated only with administrative personnel. The SBA's concern is that the large business mentor will populate the joint venture with its own employees, and it will be too difficult to determine what benefits the protegee is receiving from the relationship.

Other changes to the joint venture rules also signify SBA's concern that this expansion of the program could create opportunities for abuse. The rule would require all joint venture partners participating in a small business set-aside contract to certify to the contracting officer and to the SBA prior to performing the contract that they will perform the contract in compliance with the joint venture regulations. The joint venture must also submit annual reports to the contracting officer and SBA certifying compliance with joint venture requirements and explaining how the performance of work requirements are met.

In anticipation of the flood of mentor-protege applications the SBA will receive once the rule is finalized, the SBA cautions in the proposed rule that if the number of mentor-protege applications becomes "unwieldy," the SBA may institute "open" and "closed" periods for the receipt of mentor-protege applications. The SBA would then accept applications only during "open" periods.

Changes to the Small Business Performance Requirements. In December 2014, the SBA released a proposed rule that would make major changes to the current methodology for calculating the amount of work that must be performed by a small business under a set-aside contract. The proposed rule would also relax the current performance requirements for small business prime contractors by effectively allowing them to count work performed by small business subcontractors as their own.

Most significantly, the proposed rule changes the calculation of the work performed by a small business prime contractor from a "cost-based" to "percentage of total payments" methodology. The current method for determining compliance requires a calculation of the percentage of contract costs incurred by the prime contractor. It is often referred to as the "50 percent rule" because for service and supply contracts, the rule requires that the small business prime contractor must incur at least 50 percent of the total contract costs (construction contracts only require 15 percent). That calculation can be difficult to perform in practice and has never been consistently applied by Government agencies or industry, in part because prime contractors typically do not have insight into their subcontractor's actual costs.

The new approach would change from this "cost-based" methodology to a "percentage of total payments" approach. This would require a much simpler calculation by placing a limit on the percentage of the amount paid by the Government to the prime contrac-

tor that the prime can pay to its subcontractors. The percentage would remain at 50 percent for service and supply contracts. It would be 85 percent for general construction (i.e., a general contractor could not expend on subcontractors more than 85 percent of the amount it receives from the government).

A key feature of the proposed rule would make it easier for small businesses to comply with the "50 percent rule" by forming teaming arrangements and other partnerships with each other. Specifically, the new rule would not count work performed by "similarly situated entities" as subcontracted work for purposes of determining compliance with the limitation on subcontracting requirements. A similarly situated entity is a small business subcontractor that is a participant of the same small business program as the prime contractor. For instance, work subcontracted by a WOSB to another WOSB would not count against the percentage limits on subcontracting. Only payments to other-than-small subcontractors would be used to determine whether the prime contractor exceeded the limitation on subcontracting requirement.

As with the mentor/protege rule, the SBA recognized that these new provisions may invite abuse. Specifically, the SBA raised concerns about a scenario in which a similarly situated first-tier subcontractor would subcontract excessive portions of the work to a large business at the second-tier subcontract level. To mitigate this concern, the proposed rule would amend the review process to include lower-tier similarly situated subcontractors, rather than focus solely on the prime contractor and its direct subcontractors, for compliance with the 50 percent rule. The new rule would also require the small business prime contractor to enter into a written agreement with every similarly situated entity detailing the percentage of work forecasted to be performed by each entity. The small business prime contractor must also identify these similarly situated entities in all proposals for small business set-aside contracts.

Although these changes will largely benefit small business prime contractors, they could also benefit large businesses as well. In particular, the rule would exclude similarly-situated entities from the purview of the ostensible subcontractor rule, which could reduce scrutiny of multi-contractor teams that win small business set-aside contracts. Additionally, large businesses will be able to seek more lower-tier subcontracting opportunities, with less risk that their small business prime and first-tier contractors will run afoul of their self-performance obligations.

Conclusion. Collectively, these new rules will have a dramatic effect on the small business set-aside contract landscape by increasing the participation of large businesses and, consequently, competition for that work. Indeed, now that all small business types will be able to participate in the mentor/protege program, a mentor/protege joint venture will be a virtually "must have" in order to compete for small business set-aside contracts. Contractors both large and small should begin familiarizing themselves with the key requirements of these rules so they are prepared to hit the ground running when the final rules are released.