PILIERO MAZZA PLLC
ATTORNEYS AT LAW

888 17TH STREET, NW, 11TH FLOOR
WASHINGTON D.C. 20006
PHONE 202 857-1000
FAX 202 857-0200
WWW.PILIEROMAZZA.COM

PilieroMazza Client Alert

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Analysis of SBA's Proposed Rule to Establish a Mentor-Protégé Program for All Small Businesses

On February 5, 2015, the U.S. Small Business Administration ("SBA") released its long-awaited proposed rule to establish a mentor-protégé program for all small businesses. See 80 Fed. Reg. 6618 (Feb. 5, 2015). Federal contractors have been eagerly anticipating this rulemaking since Congress directed SBA, first in the Small Business Jobs Act of 2010 and then in the 2013 National Defense Authorization Act, to expand its mentor-protégé program. Currently available only to participants in SBA's 8(a) Program, SBA is now proposing to create a second mentor-protégé program open to all small businesses.

The proposed expansion of SBA's mentor-protégé program heralds significant and beneficial changes for small and large businesses that work on set-aside projects. SBA is proposing to adopt a uniform approach to joint ventures between mentors and protégés for all of the small business programs, similar to the current rules for 8(a) joint ventures. SBA intends to impose more reporting and monitoring requirements to ensure joint ventures perform contracts consistent with SBA's rules and meet the small business performance requirements, and suspension and debarment would be a potential ramification of noncompliance. SBA is also proposing to make it easier to qualify as a protégé firm, opening the new mentoring programs up to more small businesses. The proposed rules may also hasten the end of many federal mentor-protégé programs offered through other agencies.

In addition to the proposed rules to implement the expanded mentor-protégé programs, this rulemaking also contains significant changes to other SBA programs. Most notably, SBA is proposing several changes to its 8(a) Program rules, in particular to heighten an applicant's burden to demonstrate its social disadvantage.

We will continue to analyze the proposed rule and talk with industry and government representatives about its potential positive and negative impacts. We would like to hear your views and we encourage all interested parties to submit comments (even if you agree with the proposals). Comments are due to SBA by **April 6, 2015**. If you would like our assistance preparing comments, or if you would like to share your views, please contact Jon Williams, Cy Alba, or Kimi Murakami at jwilliams@pilieromazza.com, ialba@pilieromazza.com, or kmurakami@pilieromazza.com.

Below is a summary of the key SBA proposals, along with our preliminary analysis.

NEW MENTOR-PROTÉGÉ PROGRAM FOR ALL SMALL BUSINESSES

Overview & Benefits

SBA is proposing to create one new mentor-protégé program available for all small businesses (i.e., service-disabled veteran-owned small businesses ("SDVOSBs"), HUBZone firms, women-owned and economically-disadvantaged women-owned small businesses ("WOSBs/EDWOSBs"), as well as small businesses without any other designation). This is welcome news for small and large businesses, as many more firms will be able to access the benefits of being a mentor and a protégé.

Patterned on the existing 8(a) mentor-protégé program, the proposed new mentor-protégé program for all small businesses will encourage mentors to provide various forms of assistance to protégés, including: technical and/or management assistance; financial assistance in the form of equity investments and/or loans; subcontracts; and/or assistance in performing Federal prime contracts through joint ventures. The program is designed to require approved mentors to assist protégés in competing for and performing set-aside contracts and more fully developing their capabilities. In terms of subcontracting, the program envisions the protégé would most often function as the prime contractor, but it would also encourage mentors to subcontract to protégés.

Notably, the new rule would allow small businesses of any type to form joint ventures with their SBA-approved mentors, even if the mentor is a large business. The joint venture would qualify for any type of set-aside contract for which the protégé is eligible.

SBA is also proposing to allow a mentor to take up to a 40% ownership interest in a protégé, just like in the 8(a) Program. However, SBA is seeking comments on whether that 40% ownership interest should be allowed only while the protégé is in the mentor-protégé program. SBA expressed concern that allowing the mentor's ownership stake to continue indefinitely would permit large businesses to reap the benefits from small business programs long after the assistance to the protégé has stopped. Nonetheless, SBA is overlooking that the equity investment is a form of assistance to the protégé that would continue as long as the ownership interest remains. Furthermore, the equity stake may not become a viable development tool if firms know they are forced to reverse an equity investment after only a few years.

SBA would continue its separate mentor-protégé program for the 8(a) Program, though participants in that program would have the option of applying to either mentor-protégé program. SBA is seeking comment on whether it should instead create five mentor-protégé programs, one for each of the small business types. The current proposal of only one additional program seems more efficient and it should be easier for small businesses to understand one program. The potential downside is the extent to which one program with one reviewing office might overwhelm SBA with applications.

Applications & Approval

Firms would need to apply and be approved into the new mentor-protégé program by SBA's Office of Government Contracting. 8(a) mentor-protégé applications will continue to be

approved by the Associate Administrator for Business Development, but SBA is considering (and seeking comments on) whether to consolidate the application and review process in one place.

SBA is also considering open and closed application periods, so firms would only be able to apply during certain "open" periods, in case the agency receives a high volume of applications. This seems like a reasonable proposal, but the concern is how often there will be open periods, and for how long. The Department of Veterans Affairs tried a similar approach a few years ago and many firms were unable to apply because there were only a few relatively brief open periods before the VA shut down its program.

The primary application document will be the mentor-protégé agreement. Under the proposed rule, all small business mentor-protégé agreements must be in writing. The agreement must clearly articulate how the mentor will provide real and substantive developmental assistance to the protégé. If the protégé already has a mentor through any other mentor-protégé program (8(a) or other agencies), SBA must be provided with a copy of those mentor-protégé agreements and the protégé must identify how the assistance under the new mentor-protégé agreement differs from that already being provided under the prior agreements.

SBA is proposing to limit the length of agreements under the new mentor-protégé program to no more than three years. Similarly, SBA is proposing that no one protégé can have more than two three-year mentor protégé agreements (whether sequential or concurrent with the same or a different mentor). This proposal seems inconsistent with SBA's recognition, elsewhere in the proposed rule, that small businesses may need and benefit from mentoring even as they approach large business status. Rather than impose a six-year cap, SBA should consider allowing small businesses to remain in the mentor-protégé program as long as they remain a small business and are able to demonstrate a need for mentoring.

Eligibility Criteria

SBA is proposing to require all small businesses to undergo a formal size determination before they will be eligible for the mentor-protégé program. If a firm has already undergone a formal size determination or size appeal, and been found small, such a firm may simply certify there have been no changed circumstances since SBA's prior determination. If a firm has not previously undergone such a review, the proposed rule provides a mechanism for the firm to request a size determination from SBA. We assume a size determination issued as a result of a request from a prospective protégé would be appealable to SBA's Office of Hearings and Appeals ("OHA"), but SBA should clarify in the final rule.

Additionally, SBA is proposing to allow only for-profit entities to qualify as a mentor. Although SBA's 8(a) Program currently allows a non-profit to qualify as a mentor, and Congress directed SBA to make its new mentor-protégé programs identical to the 8(a) Program, there is a conflict in Congress' definition of "mentor." As a result, SBA is also proposing to drop non-profit eligibility from the 8(a) Program, meaning only for-profit entities would be able to qualify as a mentor in both mentor-protégé programs. Rather than limit the pool of mentors in this fashion, SBA should read Congress' direction to fashion a new mentoring program that is

"identical" to the 8(a) Program as trumping any conflict in the definition of "mentor." This approach would allow the new mentoring program to match the existing 8(a) Program so both programs would permit non-profits to act as mentors.

Conversely, SBA is proposing to relax the criteria for becoming a protégé. Currently, an 8(a) firm must be less than one-half the size standard for its primary industry, or it must be in the developmental stage of the 8(a) Program or have never received an 8(a) contract. SBA is now proposing that any firm may qualify as a protégé, for 8(a) and all other programs, as long as it qualifies as a small business. For 8(a), the protégé would also have to demonstrate how the mentoring will aid its business plan. SBA is seeking comments on this proposal. We are in favor of this proposal because it will allow more small firms to benefit from the mentor-protégé program. Many maturing small businesses can still benefit from mentoring, particularly as they approach the transition from small to large business in their industry.

Impact on Other Federal Mentor-Protégé Programs

The proposed rule signals the end for many mentor-protégé programs offered through other federal agencies. While SBA has not prohibited such programs, it questions the utility of other mentor-protégé programs when SBA's newly-expanded program will apply to all small businesses and all federal agencies. SBA is also specifically seeking comment on whether the VA's mentor-protégé programs for SDVOSBs and VOSBs should continue. SBA has a good point. The potential for confusion, duplication, and adverse consequences such as affiliation will limit (if not eliminate) the usefulness of the other federal mentor-protégé programs. Anticipating that other federal agencies will discontinue their programs, SBA should look to include in its own program the subcontracting and evaluation incentives that are the primary benefits of the other programs.

JOINT VENTURES

SBA is proposing to eliminate populated joint ventures when a joint venture is formed as a separate legal entity. SBA believes it is difficult to determine how the small business benefits from a populated joint venture. This concern is understandable, and the vast majority of the joint ventures we see are unpopulated, so this appears to be a reasonable proposal.

That said, it is unclear why SBA has emphasized separate legal entity here – does SBA intend to permit populated joint ventures when the joint venture is an informal partnership (i.e., not a separate legal entity)? Also, SBA has attempted to clarify confusion through its use of the term "informal" joint venture, but the proposed rule is still confusing regarding this point.

SBA is seeking comment on whether it should require all joint ventures to be formed as a separate legal entity. The agency seems to lean in this direction, as it believes a separate legal entity is easier for SBA to monitor. Because a formal legal entity structure such as a limited liability company affords the joint venture partners liability protection, this appears to be a good proposal. The downside is that requiring a formal legal entity adds additional time and cost to forming a joint venture.

SBA hopes to implement uniform joint venture rules for each of the small business programs. For example, SBA is proposing similar requirements for each program regarding the content of the joint venture agreement,[1] such as the need for the SDVOSB, HUBZone, or WOSB/EDWOSB managing joint venture partner to perform at least 40% of the joint venture's work. However, in a departure from the current 8(a) rules, SBA is proposing that joint venture partners must receive profits commensurate with their ownership interests in a joint venture that is a separate legal entity; profits could be split commensurate with work performed for an "informal" joint venture. It is unclear why SBA decided to depart from the current 8(a) rules, which permit profit to be split commensurate with the work performed except in a populated separate entity joint venture. Allowing a mentor to perform up to 60% of the work in a joint venture, but limiting its share of the profit to no more than 49% when a separate legal entity is created, does not make sense.

SBA's proposed rule is inconsistent with another recently-released SBA rulemaking regarding how the agency will determine the size of a joint venture. In the proposed rule addressing the limitations on subcontracting, released at the end of December, SBA proposed to allow small businesses to joint venture for any project, regardless of the size of the project, as long as each small business meets the project's small business standard. However, the mentor-protégé rulemaking retains language SBA sought to change, which provides that, absent an exception, small businesses must be small in the aggregate to form a joint venture. SBA should change this in the final rule to be consistent with the proposal in the limitations on subcontracting rulemaking, as that proposal would allow more small businesses to use joint ventures.

SBA is also proposing new certification and reporting requirements for all joint ventures. All joint venture partners would be required to submit a certification to SBA and the contracting officer stating that they will comply with the joint venture agreement and applicable regulations in performance of the contract. Such certification and reporting would have to be submitted before performance begins and then on an annual basis until completion of the contract. Failure to submit or adhere to the certification could lead to suspension or debarment.

SBA wants to better track awards to joint ventures, but it is not sure how to accomplish this goal. The agency indicated it is considering several options, including requiring all joint ventures to include "Small Business Joint Venture" or "Mentor-Protégé Small Business Joint Venture" in the name of the entity. Other options, such as requiring a disclosure within SAM.gov, would better balance SBA's goal and contractors' concerns about the confidentiality of their business arrangements.

Currently, SBA typically will not receive an 8(a) joint venture agreement, let alone review and approve it, until the contract award is imminent. SBA is now proposing to approve 8(a) joint ventures at any time, whether or not in connection with a specific 8(a) contract. This will benefit 8(a) joint venture partners, as well as contracting agencies, by allowing for greater certainty about the eligibility of a joint venture before a proposal is submitted.

[1] However, for small business joint ventures, the proposed rule states that such a joint venture need not be in any specific form or contain any specific conditions to qualify as small.

The new rule changes recent OHA case law which held that disappointed offerors could not protest the size of an SBA-approved 8(a) joint venture. Because SBA does not determine the size of the 8(a) concern or the size of a joint venture, in approving an 8(a) joint venture, SBA has concluded that 8(a) joint ventures should not be immune from size protests.

HUBZONE PROGRAM

In welcome news for the HUBZone Program, SBA is proposing to allow HUBZone firms to joint venture with any other small business. Currently, HUBZone firms may only joint venture with another HUBZone firm. We are strongly in favor of this change, as it should make joint ventures a much more viable option for HUBZone firms. SBA is seeking comment on whether allowing mentor-protégé relationships and joint ventures with non-HUBZone firms makes sense in light of the purpose of the HUBZone program. We believe it does, for the mentoring and joint venture assistance will only strengthen the HUBZone firms' ability to benefit historically-underutilized areas.

CHANGES TO THE 8(A) PROGRAM RULES

Establishing Social Disadvantage

SBA is proposing to amend its regulations to abrogate multiple lines of case law from OHA relating to the level of proof required to show social disadvantage for admission into the 8(a) program. The effect of these rules, if adopted, will be to make it easier for SBA to reject what the applicant has offered to show social disadvantage, even if the information is uncontroverted.

Specifically, prior OHA cases have allowed 8(a) applicants to prove social disadvantage with affidavits and sworn statements attesting to events in their lives that, the applicants believe, were motivated by bias or discrimination. SBA would like the rules to permit the agency to disregard a claim of social disadvantage "where a legitimate alternative ground for an adverse action exists and the individual has not presented evidence that would render his/her claim any more likely than the alternative ground." As such, the proposed rule would seek additional evidence from applicants showing that such negative events (e.g., being passed-over for a promotion or not being hired) were more likely than not due to bias or discrimination and not simply due to other benign factors (e.g., another candidate had some tangible or intangible qualities – aside from race or social status – that made him more attractive for the job). The evidence necessary to corroborate an applicant's claim of social disadvantage would include: (1) when and where the discrimination occurred; (2) who committed the discrimination; (3) how the discrimination took place; and (4) how the individual was adversely affected by such acts. SBA believes there can be no qualifying discrimination or bias without evidence of a negative impact on the applicant which can be clearly articulated.

Substantial Unfair Competitive Advantage Within an Industry – Tribal and ANC 8(a)'s

The new rule attempts to more clearly define when a concern owned or controlled by an Indian Tribe or an Alaska Native Corporation ("ANC") has gained a substantial unfair

competitive advantage, thus making that entity lose its exemption from affiliation with other concerns owned or controlled by the same Tribe or ANC. First, SBA proposes to define "Industry" as being the six-digit NAICS code under which the concern does business. Thus, when determining whether an entity owned or controlled by a Tribe or ANC has obtained an unfair competitive advantage, SBA will review whether that entity has an unfair advantage as compared to firms in the same six-digit NAICS code. Where a firm works under multiple NAICS codes, each line of business will be reviewed separately per the applicable code.

Further, the unfair competitive advantage would not be determined at a local level. Instead, for a concern owned or controlled by a Tribe or ANC to lose its exemption from affiliation, SBA will review whether, on a national level, the concern has an unfair competitive advantage. Thus, firms may have an unfair advantage locally, or in multiple localities, but if there is no such advantage at the national level, the concern will not lose its exempted status.

Other Proposed 8(a) Rule Changes

The new rule would provide that no one individual can be responsible for the management or daily operations of more than two Tribally-owned 8(a) firms at the same time. The proposed rule would allow 8(a) firms to elect to be suspended from the 8(a) Program when its principal office is located in a geographical area where a major disaster has occurred or there has been a lapse in Federal appropriations. In addition, benefit reporting would no longer be part of the annual review submission, but instead would be done at the time of the 8(a) firm's annual submission of financial statements.

SBA also proposed a rule that would give it discretion to change an 8(a) firm's primary NAICS code when the greatest portion of total revenues during a three-year period have changed from one NAICS code to another. This does not mean that more than 50% of a firm's revenue must come from the primary NAICS code. Rather, revenue from a firm's primary NAICS code must exceed revenues generated from any other NAICS code.