On February 11, 2011, the Small Business Administration (“SBA”) issued what has been described as the most comprehensive set of changes to its 8(a) Small Business Development program in over a decade. Although these new rules also address various aspects of 8(a) eligibility, the most significant changes are in the Mentor Protégé program. The revised rules create new opportunities, but also codify limitations on subcontracting that may introduce troubling new uncertainties.

The Mentor Protégé program teams disadvantaged firms in SBA’s 8(a) program with large businesses in joint ventures. The small business protégé benefits from the business experience and capabilities of the large business mentor while also gaining access to Government prime contracts that previously may have been outside of its capabilities. The large business mentor benefits from the program because it gains access to participation, with the protégé, in 8(a) set aside contracts for which it would otherwise have been ineligible. While the work must be split between the mentor and protégé, the large business mentor may also own up to 40% of the ownership interest in the protégé, thus providing the protégé with operating capital and the mentor with additional value from the relationship.

A steady stream of recent reports and investigations, including the unusual suspension of both mentor GTSI Corp. and its mentor protégé joint venture EG Solutions from federal contracting, have built momentum for new regulations governing the Mentor Protégé program. In March 2010, the Government Accountability Office discovered significant fraud in the 8(a) program, identifying several ineligible firms who received set-aside contracts and engaged in other forms of abuse, primarily due to inadequate oversight and monitoring. Other recent investigations also found insufficient oversight in various SBA programs.

While the regulations do address program abuses, they provide significant new opportunities for potential mentors and protégés:

Mentor protégé joint ventures can chase more business. In the past, an SBA approved mentor protégé joint venture could only bid on three contracts in two years without risking a finding of affiliation. Under the new regulations, instead of being limited to three offers over a two year period, a mentor protégé joint venture is limited to three contract awards. This rule makes sense, as there was little benefit in limiting the ability of a joint venture to bid on work before it had received a single contract award. In fact, under the new rules, successful joint venturers do not need to stop at three awards. A single joint venture could receive more than three awards because the total number of awards received is calculated at the time the offer is submitted and not at the time of award. Moreover, the new regulations make clear that successful partners could, with SBA approval,
form a second and a third JV each with the potential for an additional three awards. viii In another positive development that can only help expand the Mentor Protégé program, joint ventures can now represent that they are small businesses in pursuing subcontract work. ix

Protégés can have more than one mentor. In the past, a mentor could have multiple protégés, but a protégé was limited to a single mentor. Under the new regulations, a mentor may have up to three protégés. x In a significant policy shift, SBA has taken the common sense position that a protégé with multiple lines of business should have access to multiple mentors. A protégé may now take on a second mentor as long as it demonstrates that the second mentor protégé relationship pertains to a secondary NAICS code that is unrelated to its first mentor protégé relationship, that the second mentor has expertise that the first does not possess, and that the two relationships will not compete or conflict with one another. xi This new rule should provide small businesses with additional opportunities to gain experience and will increase the number of mentors available.

Workshare requirements are clarified. Before these regulations, a small business protégé was required to perform a “significant portion” of the work performed by the joint venture. This amorphous term led to widespread confusion and, in some circumstances, questions of abuse of the Mentor Protégé program. Most firms assumed that, because the protégé was required to receive at least 51% of the profits of the joint venture no matter how much work it performed, a “significant portion” meant 51% of the work. That is no longer the case. SBA’s new regulations do away with the flexible but undefined “significant portion” test in favor of a requirement for a protégé to perform 40% of the work performed by the joint venture partners in an “unpopulated” joint venture (i.e., where all work other than administration is subcontracted). xii The joint venture typically must perform at least 51% of the work under the contract, and the protégé must perform 40% of that 51%. As discussed further below, while this rule may reduce the minimum amount of work that must be performed by the protégé, it also aims to close one potential loophole by aggregating all work done by the mentor and any of its affiliates at any subcontracting tier. In a “populated” joint venture (i.e., where the staff of the joint venture performs the substantive contract work), a rigid workshare would be difficult to calculate, and the protégé therefore must simply “demonstrate what it will gain” from the relationship. xiii Given these new rules, both mentors and protégés will have to plan joint venture structures carefully, as these early decisions can have significant impacts on workshare and profit.

Profit distribution is tied to workshare. In a related shift, the protégé is no longer required to receive 51% of the profits of the joint venture. Instead, the protégé must receive profit commensurate with its workshare, i.e. at least 40%, where the joint venture is not a separate legal entity. xiv However, where the joint venture is a separate legal entity, the protégé still must own at least 51% of that entity and must receive profits commensurate with its ownership interest. Once again, partners to a joint venture will have to assess structure given these new clarifications from SBA.

Management responsibilities are defined. The new rules provide that, in an unpopulated joint venture, the protégé must designate one of its employees as the project manager. xv In a populated joint venture, the joint venture must demonstrate that “the performance of the contract is controlled” by the protégé. xvi

The new regulations are not without their flaws. In order to limit fraud within the program, SBA has enacted new rules limiting subcontracting from 8(a) mentor protégé joint ventures. In previous years, a mentor could increase its workshare under the Mentor Protégé program by subcontracting work from a populated joint venture to itself or its affiliates. SBA’s new rules will limit this practice, but the breadth of the new rule does lead to some significant uncertainty.
SBA's new rules treat the three different forms of mentor protégé joint ventures separately. As discussed above, for an unpopulated joint venture where all of the work will be subcontracted, the protégé must perform at least 40% of the work. SBA's new rules explain that “in determining the amount of work done by a non-8(a) partner, all work done by the non-8(a) partner and any of its affiliates at any subcontracting tier will be counted.” xvii Similarly, in a joint venture populated only by administrative personnel, “the joint venture may subcontract performance to a non-8(a) joint venture partner provided it also subcontracts work to the 8(a) partner(s) in an amount sufficient to meet the 40% requirements. The amount of work done by the partners will be aggregated and the work done by the 8(a) partner(s) must be at least 40% of the total done by all partners. In determining the amount of work done by a non-8(a) partner, all work done by the non-8(a) partner and any of its affiliated at any subcontracting tier will be counted.” xviii For populated joint ventures, SBA has enacted a new prohibition against subcontracting to the mentor: “a non-8(a) joint venture partner, or any of its affiliates, may not act as a subcontractor to the joint venture awardee, or to any other subcontractor of the joint venture, unless the AA/BD determines that other potential subcontractors are not available.” xix

While SBA’s goal in limiting subcontracting to the mentor is understandable, the inclusion of all affiliates and all subcontractors at any tier is an unwieldy solution. This is the case for at least two reasons.

First, the Mentor Protégé regulations do not provide a new definition of the term “affiliate.” As a result, the current affiliation definition found at 13 C.F.R. 121.103 appears to apply. This definition, which is based on the application of a series of factors, is flexible and much broader than traditional corporate affiliation (parent, subsidiary, etc.). In fact, based on Office of Hearings and Appeals case law, a company may be affiliated with companies in which it has as little as a 20% stake or shares a handful of board members. xx The uncertainties surrounding whether or not two distantly related companies are affiliated and, as a result, whether an unpopulated mentor protégé joint venture can subcontract to them, may add new and unnecessary complications to the program. This may also lead to an increase in litigation as offerors may challenge whether or not a proposed subcontractor of a mentor protégé joint venture is, in some manner, affiliated with the mentor.

Second, the limitation on subcontracting to subcontractors at any tier will be difficult to implement. As discussed above, even the most tangential relationship with another firm may lead to an argument that work has been subcontracted to an affiliate. By expanding this rule to all subcontract tiers, SBA has effectively required 8(a) mentors to identify and pre-screen all subcontractors at all tiers for all parties for possible affiliation issues. Without this advance screening, a mentor protégé joint venture risks loss of contract awards, time consuming litigation and potentially even investigations and bad publicity based on third tier subcontractors in which it has a minority interest. This risk may well prevent firms with diverse ownership from participating in the program at all.

Overall, there is little doubt that SBA’s new Mentor Protégé regulations will have a positive effect on the program. While there is still room for reform on subcontracting issues, increased certainty in workshare and expanded mentoring opportunities will both attract large businesses and provide significant benefits for 8(a) program participants.
END NOTES


ii. This advisory focuses only on the Mentor Protégé program aspect of the new rules. We do not address significant changes to 8(a) eligibility and Alaska Native Corporations.

iii. See 13 C.F.R. § 124.520(d)(2).


vi. 13 C.F.R. § 121.103(h).

vii. Id.

viii. Id.

ix. 13 C.F.R. § 121.103(h)(3)(iii). The mentor protégé program provides an exception to affiliation for SBA approved joint ventures. The new regulations also make clear that joint ventures created through other agencies, such as the Department of Defense, may provide an exclusion from affiliation if specifically authorized by statute or where the agency receives SBA approval. It remains to be seen whether this will lead to an increase in the number of mentor protégé programs available.

x. 13 C.F.R. § 124.520(b)(2).

xi. 13 C.F.R. § 124.520(c)(3).

xii. 13 C.F.R § 124.513(d)(2)(i).

xiii. 13 C.F.R § 124.513(d)(1).

xiv. 13 C.F.R § 124.513(c)(4).

xv. 13 C.F.R § 124.513(c)(2).

xvi. Id.


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