Diversity: Success in Small Business Contracting: How to Maximize the Opportunities and Avoid the Pitfalls

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The uncertainty of the current construction market has left many contractors looking for opportunities in new markets. Over the past several years, the federal government, and specifically their small business contracting programs, has been a valuable source of opportunity for construction contractors. Although many of these opportunities are specifically set aside for small businesses, small businesses and large businesses alike can benefit from these opportunities.

Although set-aside programs provide a tremendous opportunity for small businesses to develop their expertise, this opportunity must be pursued with a strong understanding of the regulations governing the programs. A failure to understand and comply with these regulations will foreclose opportunities to do business with the federal government and may even result in civil or criminal liability.

This article addresses the various contracting programs established by the federal government that are intended to increase participation by minority and women contractors in the construction industry. This article also addresses the common pitfalls related to affiliation that can turn an exciting opportunity into a nightmare.

Federal Programs for Disadvantaged and Women-Owned Small Businesses:

Under Construction

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The federal government seeks to award close to a quarter of all federal prime contract dollars to small business groups, with subcontracting goals for certain small business groups as well. The U.S. Small Business Administration (SBA) implements and administers multiple programs to assist small businesses contracting with federal agencies. Among these programs are the 8(a) Business Development Program and the Women-Owned Small Business (WOSB) Program.

The 8(a) Business Development Program

The 8(a) Business Development (BD) Program was established to assist small disadvantaged businesses compete for federal contracts. In order to qualify for the 8(a) BD Program, a small business must be unconditionally owned and controlled by one or more “socially and economically disadvantaged individuals” who are of good character, citizens of the United States, and demonstrate a potential for success.

The regulations governing the 8(a) provide that socially disadvantaged individuals include: Black Americans, Hispanic Americans, Native Americans, and Asian Pacific Americans. However, minority status is not required to demonstrate social disadvantage.

Economic disadvantage is characterized by an impaired ability to compete in the free enterprise system due to diminished capital and credit opportunities.

In addition, 8(a) participants must fall within the size standards applicable to their industry NAICS codes. These standards govern threshold to be considered “small” and are calculated based on a company’s average annual receipts for the prior three years.

To qualify as “economically disadvantaged”, an individual cannot exceed any one of the thresholds set forth for personal income, personal net worth, or total assets. The threshold for personal net worth is $250,000. An applicant’s personal residence, as well as funds invested in an IRA or other “official retirement account that [is] unavailable to an individual until retirement age without a significant penalty,” are specifically excluded from the personal net worth determination.

The regulations further provide that income received from an applicant that is a S Corp., LLC or partnership will be excluded from an individual’s net worth where the applicant can demonstrate that the income was reinvested in the firm or used to pay taxes arising in the normal course of operations of the firm. Losses from the business entity, however, are losses to the company only, not losses to the individual, and cannot be used to reduce an individual’s net worth.
The SBA 8(a) Mentor-Protégé Program

Businesses that are eligible for the 8(a) BD Program also have the opportunity to participate in SBA’s 8(a) Mentor-Protégé Program. Under the Program, the Mentor provides its expertise and resources to the Protégé. The regulations provide that any concern or non-profit entity that demonstrates a commitment and the ability to assist developing 8(a) Participants may act as a mentor. In order to qualify as a mentor, an entity must (1) demonstrate favorable financial health, (2) possess good character, (3) cannot appear on the federal list of debarred or suspended contractors, and (4) must be able to impart value to the Protégé due to lessons learned and practical experience.

In order to initially qualify as a Protégé, an 8(a) Participant must (1) be in the developmental stage of participation, (2) have never received an 8(a) contract, or (3) have a size that is half the size standard corresponding to its primary NAICS code.

Women-Owned Small Business Program

The Women-Owned Small Business (WOSB) Program facilitates federal contracting with WOSBs and economically disadvantaged women-owned small business (EDWOSBs). This Program authorizes federal agencies to set aside certain contracts for competition solely among WOSBs and EDWOSBs, in an effort to meet the federal government’s goal of awarding a certain percentage of both prime and subcontract dollars to these groups.

In order to qualify as a WOSB, the business concern must be at least 51% directly and unconditionally owned and controlled by one or more women who are citizens of the United States. An EDWOSB includes the additional requirement that the women are economically disadvantaged.

Although no program has been established yet, the SBA intends to create a Mentor-Protégé program for WOSBs that is similar to the 8(a) program. This program is likely to provide similar contracting benefits to WOSBs as the current program provides to 8(a) participants. These benefits are discussed below.

State-Level Programs

Programs supporting minority or women-owned small businesses are not limited to the federal government. Many states have also implemented similar programs.

For instance, the State of Maryland established the Minority Business Enterprise (MBE) Program to assist minority- and women-owned businesses gain access to state government contracting opportunities. The MBE Program requires that approximately 70 state agencies and departments strive to spend a quarter of their contracting dollars on certified MBEs. In FY
2012, the State of Maryland achieved this goal, with a total MBE participation of 25.2%.

For contracts that are fully-funded by the State of Maryland, or a combination of state and local government funds, an MBE is defined as: "Any legal entity, other than a joint venture, organized to engage in commercial transactions which is at least 51 percent owned and controlled by one or more minority persons, or a non-profit entity organized to promote the interests of the physically or mentally disabled."

Minority persons generally include a member of the following groups: African American, American Indian/Native American, Asian, Hispanic, Women, and Physically or Mentally Disabled. The MBE Program also has a Personal Net Worth (PNW) eligibility requirement. An individual’s PNW is the net value of assets held by that individual. In 2013, the PNW cap for the MBE Program is $1,615,663.00.

**Teaming Arrangements on Set-Aside Contracts**

Although these programs are intended to assist minority and women-owned businesses to grow and develop, they also provide a tremendous business opportunity to large businesses that are willing to provide a guidance and assistance to these entities on set-aside contracts.

The most common methods of collaboration are small Prime Contractor/ large Subcontractor teams or Joint Ventures. Traditionally, a joint venture is considered affiliated, and the partners’ combined annual receipts will be considered to determine size eligibility for small business set-aside contracts. A Joint Venture between an SBA-approved Mentor and its 8(a)Protégé, however, is exempt from this general affiliation rule. Prime/Sub teams offer an opportunity for large firms to work with small firms on set aside contracts even if they are not in a formal Mentor-Protégé relationship.

The FAR encourages these teaming arrangements because they allow the participating businesses to “complement each other’s unique capabilities” while “offer[ing] the Government the best combination of performance, cost, and delivery.” But these arrangements must be properly structured in order to avoid an affiliation determination by the SBA.

**Common Pitfalls Related to Affiliation**

There is a great deal of opportunity for disadvantaged and women-owned small businesses to contract with the federal government as well as state and local governments. But it is particularly important for small businesses, as well as the businesses they team with, to be aware of the relevant regulations and common pitfalls.
The most common issue businesses are likely to face is affiliation. A finding of affiliation will affect whether a business qualifies as small for any given contract. Businesses are affiliated if one controls or has the power to control the other, or a third party or parties controls or has the power to control both. To determine whether two firms are affiliated, the SBA generally considers ownership, management, previous relationships between the two businesses, and contractual relationships.

The practical consequence of two firms being affiliated is that their annual receipts of both business and all of their affiliates will be aggregated. In most instances, this will render the small business ineligible for set-aside contracts because it no longer meets its applicable size standard.

**Affiliation Can Arise In the 8(a) Mentor-Protégé Program**

Although the 8(a) Mentor-Protégé Program provides a valuable protection from a finding of affiliation, this protection is not absolute. Instead, the exemption applies only to assistance provided by the Mentor under the Parties’ Mentor-Protégé Agreement. Accordingly, it is important to structure the work performed by each Joint Venture partner to be consistent with the terms of the Mentor-Protégé Agreement.

For example, Mentor-Protégé joint ventures may be deemed affiliated if they have an extensive relationship outside the 8(a) BD Program. The SBA Office of Hearings and Appeals issued a decision in Size Appeal of Patriot Construction, Inc., SBA No. SIZ-5439 (2013) where it suggested that “extensive sharing of employees between the two concerns, outside of the contracts the approved joint ventures performed, was beyond the scope of the assistance provided under the mentor/protégé agreement, and thus constituted a basis for finding affiliation between [the two participating businesses] for other reasons.”

**2. Ostensible Subcontractor Rule**

In a Prime/Sub teaming arrangement on a set-aside contract, the small business prime contractor retains control over the contract management and is solely responsible for performance. If, however, the government determines that a subcontractor is “perform[ing] the primary and vital requirements of a contract” or the prime contractor is “unusually reliant” on the subcontractor, the prime and its “ostensible subcontractor” will be treated as affiliates.

In order to avoid a finding of affiliation under the ostensible subcontractor rule, it is critical that the small business, prime contractor retain control over the project. This may be difficult to achieve, particularly when the prime contractor is a small
business that has subcontracted with a larger business that has more resources and experience.

A carefully drafted subcontract agreement can protect Prime/Sub teams from a finding of affiliation under the Ostensible Subcontractor Rule. In drafting the agreement, the parties should give extra consideration to the following terms:

- undue restrictions on the prime's right to select another subcontractor;
- excessively favorable provisions for the subcontractor;
- sharing of program management responsibility with the subcontractor

3. Bonding Assistance

Small businesses competing for federal construction and infrastructure projects may have a difficult time securing the necessary bonds. One solution to this problem is for the large business to provide bonding assistance on the project.

However, businesses must be careful upon entering into these agreements because they might indicate affiliation. Although the SBA Office of Hearings and Appeals has repeatedly held that bonding assistance is not dispositive of affiliation, it can form the basis for an affiliation determination when considered with other factors.

For example, in Appeal of David Boland, Inc., SBA No. SIZ-4965 (2008), the SBA OHA found two businesses to be affiliated where they entered into a bonding assistance agreement and had a long-term relationship in which each business was dependent on the other for a large portion of its revenue.

It is critical that businesses contemplating a bonding assistance agreement are careful craft the agreement to mitigate affiliation concerns. Specifically, the two businesses should ensure that they reduce, to the extent feasible, other business relationships to avoid affiliation pitfalls that may ultimately prevent the small business from obtaining construction set-asides.

Conclusion

As noted herein and as detailed in the regulations and case law, when pursuing opportunities under these contracting programs, contractors should be mindful of issues related to affiliation and take proactive steps to avoid such a determination. This careful approach to contracting under these programs will yield tremendous business opportunities and opportunities for growth and development of small and large businesses alike and avoid sanctions.

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