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Focus

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FEATURE COMMENT: Joint Adventures—Mentor-Protégé Joint Ventures Offer Significant Advantages And Potential Pitfalls For Federal Contractors

Each year, the Federal Government reserves a significant amount of its spending for small business contracts. The small business set-aside market is lucrative, accounting for over $145 billion in federal spending last year. However, even as spending on small business contracts rises, the pool of small business contractors is drastically decreasing. According to a recent U.S. Women's Chamber of Commerce report, 21,500 small business suppliers were lost between fiscal years 2017–2020. The same report also found that small businesses have borne the brunt of the contract consolidation driven by the category management initiative, as a staggering 53 percent of the contracts lost were small business contracts.

In this environment, it is difficult for many small businesses to compete on their own for the larger and "best-in-class" contract vehicles that are now the necessary hunting licenses for federal contractors. Many large businesses, particularly those in the dreaded "mid-tier," face a similar predicament: too large to pursue small business contracts, but not large enough to compete against the truly large contractors.

As a result, small and larger contractors are increasingly turning to the U.S. Small Business Administration's Mentor-Protégé Program (MPP) for assistance in joining forces to pursue set-aside contracts. SBA has administered a mentor-protégé program for some time, but it has really taken off over the last several years. In 2013, Congress directed SBA to expand its mentor-protégé program to allow any type of small business to be a protégé. In 2016, SBA opened the doors to its All Small Mentor-Protégé Program (ASMPP), which has since been consolidated with its former 8(a) mentor-protégé program into what is now referred to as the MPP. According to the list SBA publishes on its website, there are currently over 1,200 SBA-approved MP relationships.

The MPP relationship can provide many potential benefits to the mentor and protégé, ranging from business development to technical and financial assistance. In our experience, the most common usage of the MPP is the formation of a joint venture (JV) between the mentor and protégé. The MP JV is the "killer app" of the MPP because, if established correctly, the MP JV takes on all of the protégé's small business status(es) and may pursue any type of set-aside contract for which the protégé is eligible. The protégé, therefore, does not have to pursue the contract on its own. The prime contractor is the JV, a separate legal entity in which the mentor owns a minority interest. Significantly, the mentor can provide invaluable resources, capabilities, past performance, and other assistance to the protégé, as well as perform and profit from a greater share of the work than it would otherwise be entitled to, all in a joint effort to win set-aside contracts through the MP JV.

The use of MP JVs has dramatically increased since the start of the ASMPP. According to an SBA inspector general report, in 2012, there were 122 MP JVs through SBA's 8(a) mentor-protégé program. As of September 2018, a couple of years into the ASMPP, the Government Accountability Office found that the number of MP JVs had more than doubled, to 277. With over 1,200 approved MP relationships today, there are surely many more MP JVs that have been formed and are pursuing federal contracts.

As the popularity of MP JVs has skyrocketed, the regulatory and competitive requirements for JVs have evolved. MP JVs are tightly regulated by SBA through rules that require the parties' JV Agreement (JVA) to satisfy numerous governance requirements for the JV to be eligible to pursue the different types of small business contracts. JVs must also satisfy the

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competitive requirements in the contract solicitations they pursue. Further emphasizing the importance of compliance for JVs are recent indications that the Department of Justice is taking greater interest in JVs (with False Claims Act settlements in February 2021, *www.justice.gov/usao-sdil/pr/ofallon-building-co-settles-fraud-claims*, and June 2021, *www.justice.gov/usao-edwa/pr/ch2m-hill-plateau-remediation-company-agrees-pay-more-3-million-settle-hanford*, as two examples). It is therefore critical to ensure the MP JV relationship is formed and used carefully, both to maximize the potential benefits of the arrangement and to stay off the enforcement radar.

Against this backdrop, recent regulatory changes and case law highlight advantages and potential pitfalls for MP JVs pertaining to their internal governance structure and in how agencies should evaluate proposals from MP JVs.

MP JV Governance: Who's Running the Ship—To be eligible to pursue small business contracts, MP JVs must comply with SBA regulations. For example, the JVA between the mentor and protégé must contain several required provisions for the MP JV to qualify as a small business. See 13 CFR § 125.8(b)(2). The JVA must include similar provisions when the MP JV desires to qualify for an 8(a), woman-owned small business, Historically Underutilized Business Zone, or service-disabled veteran-owned small business (SDVOSB) contract. Id. at §§ 124.513(c), 127.506(c), 126.616(c), 125.18(b)(2).

Key among the requirements for the MP JVA is a provision "[d]esignating a small business as the managing venturer of the joint venture." 13 CFR § 125.8(b)(2)(ii). While it may be simple enough to include a provision in the JVA naming the protégé as the managing venturer of the JV, there is more complexity beneath the surface of the managing venturer designation. There are many decisions that an MP JV will need to take, ranging from extraordinary actions like dissolving the JV or deciding to pursue a new federal contract, to more mundane actions such as paying subcontractors and maintaining records. SBA's regulations do not explain what it means to be the "managing venturer" of the JV or specify the types of decisions the protégé must control to qualify as the managing venturer. As a result, when putting together the JVA, it can be difficult to determine how much control the protégé firm is required to have over the MP JV.

When SBA's regulations do not squarely address a topic, practitioners look to case law from SBA's Office of Hearings and Appeals (OHA) to determine the best approach to compliance. However, on the question of what is required of the protégé to be considered the managing venturer of the MP JV, there are relatively few OHA cases upon which to draw.

In 2012, OHA analyzed whether the JVA of Hana JV—a JV between Merit Contracting Inc. (the SDVOSB) and Omni Corp.—provided the SDVOSB with "the autonomy and authority necessary to be considered the 'managing venturer.' " *Hana-JV*, SBA no. VET-227 (2012). The JVA provided that (i) both members must agree on all hiring; (ii) one member could not write a check without approval of the other member; and (iii) all decisions must be made by the two members mutual agreement, including execution of contract documents and approving expenditures above the line item budgets. Id. at *5. Relying on these provisions in the JVA, OHA found that the SDVOSB could not be considered the managing venturer because both members were required to "consent to all significant actions taken by the joint venture" and, thus, the SDVOSB "did not fully control [the joint venture's] decision-making, because Omni enjoys veto power over all significant decisions." Id.

In 2013, OHA analyzed whether the JVA of SOF Associates provided the SDVOSB member with control over the daily operations of the JV. *SOF Associates—JV*, SBA no. VET-234 (2013). OHA found that the SDVOSB was "not really the managing venturer" because the JVA required a supermajority vote "to approve 'tactical and strategic business issues' without defining just what those issues are." Id. at *7. Ultimately, OHA found that SBA's regulations required the managing venturer to have unequivocal control over the JV. Id.

Interestingly, other OHA cases that deal with the governance of the small business party to the JV are more permissive regarding the veto rights that a minority owner is permitted to have. See, e.g., *S. Contracting Sols. III, LLC,* SBA no. SIZ-5956 (2018); *Carntribe-Clement 8AJV # 1, LLC*, SBA no. SIZ-5357 (2012). In our view, these cases reflect the appropriate recognition that without affording reasonable protections to minority owners over extraordinary company decisions, small business owners would find it much more difficult to bring on minority owners and grow their businesses. Id.

Yet, the case law on governance of an MP JV seems to be heading in the opposite direction based on a significant OHA decision issued last year in *Seventh*

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Dimension, LLC, SBA no. VET-6057 (2020). In *Seventh Dimension*, the MP JV utilized a "Members' Committee" that had "complete and exclusive control over the management of the Company's business, including controlling the performance of [the JV's] Contracts." Id. The Members' Committee included two representatives from the protégé and one representative from the mentor. Id. The JVA specified many actions requiring unanimous consent by the Members' Committee, including "the final approval and submission of any proposal; entry into any contract with a customer, and any modification of a contract; entry into any subcontract of work in excess of $500,000; approval of the annual budget; hiring an individual to serve as an employee of the company." Id.

After reviewing the JVA, OHA found that the protégé did not qualify as the managing venturer because the mentor was required to approve several actions of the Members' Committee that OHA found were "essential actions of the day-to-day running of the business," rather than "extraordinary actions which are meant to protect a minority shareholder's interest." Id. at *15. OHA explained its determination as follows:

> It is true that, in reviewing size cases, OHA has held that provisions requiring a supermajority for certain extraordinary actions which are meant to protect a minority shareholder's interest do not create negative control on behalf of that minority shareholder. *Size Appeal of EA Engineering, Science and Technology, Inc.*, SBA No. SIZ-4973 (2008). However, the actions for which Aquila's JVA requires unanimous consent are not merely extraordinary actions such as the issuance of additional stock and filing bankruptcy, but essential actions of the day-to-day running of the business. *The very purpose of the Aquila joint venture was to compete for and perform contracts. The requirement of unanimous consent gives GDIT veto power, and thus negative control over all decisions concerning the competition for and performance of contracts, the essential functions of any business*. Further, GDIT has veto power, and thus negative control, over the approval of the budget and the incurrence of any indebtedness, which have been held to be actions vital to ordinary daily business operations. *Size Appeal of Team Waste Gulf Coast*, SBA No. SIZ-5864 (2017); *Size Appeal of BR Construction, LLC*, SBA No. SIZ-5303 (2011).

Id. at *15 (emphasis added). Ultimately, OHA affirmed its prior holding in *SOF Associates* that the "managing venturer" must have "unequivocal" control over the JV. Id. at *14.

On the one hand, *Seventh Dimension* appears to agree with the notion that a protégé may permit its mentor to have negative control over extraordinary JV decisions and still qualify as the managing venturer of an MP JV. This is helpful, as the basic protections of minority owners that have been accepted in size and SDVOSB cases should, for the same reasons, also be permitted for mentors in MP JVs.

However, *Seventh Dimension* also highlights the downside of the lack of clarity in SBA's managing venturer rule. Without clear guideposts about what it takes to be considered the managing venturer, OHA found that giving the mentor approval over the JV's submission of new proposals (including the required JVA addendum), entering into contracts, and modifications to such contracts are not extraordinary decisions and, therefore, the protégé alone must control these actions. *Seventh Dimension*, therefore, seemingly requires protégés to have unfettered control over the contracts the MP JV pursues. In our view, this cannot be what SBA intended in its MP JV regulations. SBA's rules have long recognized that JVs are limited-purpose entities existing only to pursue and perform a discrete number of federal contracts. Given the purpose of the MP JV is limited to pursuing contracts over a two-year period (and until recently was limited to as few as three contract awards in that period), the parties' decision to pursue a new contract is inherently an extraordinary decision in the limited existence of the MP JV.

When OHA issued *Seventh Dimension* last summer, SBA was in the midst of finalizing MP and JV rule changes that it had proposed toward the end of 2019. See 84 Fed. Reg. 60846 (Nov. 8, 2019). Interestingly, SBA had not proposed any changes to the managing venturer rule. However, when SBA finalized the proposed rules in October 2020—a few months after OHA issued *Seventh Dimension*—SBA made changes to the managing venturer rule that it had not previously proposed. See 85 Fed. Reg. 66146 (Oct. 16, 2020) (effective Nov. 16, 2020). While the prior rule merely required the JVA to include a provision "[d]esignating a small business as the managing venturer of the joint venture," the rule now includes the following additional explanation: "[t]he managing venturer is responsible for controlling the day-to-day management and administration of the contractual performance of the joint venture, but other partners to the joint venture

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may participate in all corporate governance activities and decisions of the joint venture as is commercially customary." 13 CFR § 125.8(b)(2)(ii)(A).

Although SBA did not explain why it revised the managing venturer rule in November 2020, it appears to have been in response to *Seventh Dimension*. As of yet, OHA has not issued a decision on whether a protégé firm is considered to be the managing venturer under 13 CFR § 125.8(b)(2)(ii)(A). Therefore, it remains to be seen if SBA's November 2020 rule change will adequately address the noted downside of *Seventh Dimension*. We believe the rule change did not go far enough because "participating" in all corporate governance activities and decisions of the JV is not the same as having the ability to veto certain key decisions. It is also unclear what would be considered "commercially customary" in this regard. Unless SBA further revises its rules, these vagaries will have to be sorted out in future OHA cases. Given that "participate" is not the same as "control," MP JVs should not be too optimistic that OHA will view the November 2020 rule change as altering its interpretation that the protégé must have "unequivocal" control over the MP JV, including the MP JV's decision to pursue new contracts.

Evaluating MP JVs: How It Started and How It's Going—In the past, it was not uncommon for agencies to struggle with how to evaluate proposals from MP JVs. Often, agencies included solicitation terms that limited the ability of MP JVs to compete, especially for past performance. As noted, MP JVs are limited-purpose entities and consequently, often have no past performance. The purpose of the arrangement is to join two firms that together are stronger than they would be on their own. Thus, the MP JV should be able to utilize the past performance of the protégé and mentor and it should not matter if the MP JV itself lacks past performance.

Over the years, how agencies plan to evaluate JVs has been the subject of bid protests. One such case, GAO's decision in *Ekagra Partners, LLC*, Comp. Gen. Dec. B-408685.18, 2019 CPD ¶ 83, illustrates the challenges that JVs have faced and the need to resort to the protest process to address unduly restrictive solicitation terms. Ekagra challenged the solicitation for a multiple-award contract issued by the General Services Administration, arguing it was unduly restrictive because, in relevant part, the solicitation prevented JVs from forming contractor teaming arrangements where the JV could rely on the experience of subcontractors. Id. at *2. GAO sustained the protest on this basis, finding it was unreasonable to prevent JVs from using subcontractors outside of their JV structure because no regulation barred it and GSA could not explain why it increased their administrative burden.

To assist MP JVs in pursuing contracts, Congress and SBA have sought to minimize, if not eliminate, the potential that agencies will place JVs at a competitive disadvantage when pursuing set-aside solicitations. For example, in July 2016, SBA implemented a new rule requiring that, when procuring agencies evaluate a proposal from an MP JV, they must "consider work done individually by each partner to the joint venture as well as work done by the joint venture itself previously." See 13 CFR § 125.8(e) (2016). While this was a welcome addition to the MP JV rules, GAO's decision in *Yang Enters., Inc.*, Comp. Gen. Dec. B-418922.4, 2021 CPD ¶ 209; 63 GC ¶ 200, demonstrates its limitations. In *Yang*, the solicitation provided that the agency would evaluate the past performance of JV partners by "focusing on performance that is relevant to the [t]echnical subfactors and [c]ost/[p]rice factor for those requirements that they are proposed to perform." The protester argued that the agency credited the awardee JV partner with past performance in areas it was not proposed to perform on the contract. Id. at *4. GAO sustained the protest, concluding the agency incorrectly evaluated the JV partners' past performance in the aggregate, rather than individually as required by the solicitation and 13 CFR § 125.8(e) (2016). Id. at *12.

Fortunately, the outcome in *Yang* will be short-lived because SBA had already enhanced the relevant regulation to provide for more expansive and favorable treatment of MP JVs in evaluations for set-aside contracts. The strengthened rule, 13 CFR § 125.8(e) (2020), took effect in November 2020 and states as follows:

> *Capabilities, past performance and experience.* When evaluating the capabilities, past performance, experience, business systems and certifications of an entity submitting an offer for a contract set aside or reserved for small business as a joint venture established pursuant to this section, a procuring activity must consider work done and qualifications held individually by each partner to the joint venture as well as any work done by the joint venture itself previously.

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> A procuring activity may not require the protégé firm to individually meet the same evaluation or responsibility criteria as that required of other offerors generally. The partners to the joint venture in the aggregate must demonstrate the past performance, experience, business systems and certifications necessary to perform the contract.

By requiring procuring agencies to evaluate the MP JV partners in the aggregate, the current rule gives fuller effect to the spirit and intent of MP JVs. Indeed, as SBA explained in implementing the rule, "[t]he reason that any small business joint ventures with another business entity, whether a mentor-protégé joint venture or a joint venture with another small business concern, is because it cannot meet all performance requirements by itself and seeks to gain experience through the help of its joint venture partner." See 85 Fed. Reg. 66146, 66167 (Oct. 16, 2020). Continuing, SBA noted that "a solicitation provision that requires both a protégé firm and a mentor to each have the same level of past performance (e.g., each partner to have individually previously performed 5 contracts of at least $10 million) is unreasonable, and should not be permitted." Id. at 66168. Agencies should recognize that the protégé sought an MP JV relationship because it could not win the work on its own, and the new SBA rule appropriately requires that agencies consider the contributions of both JV partners when evaluating proposals from MP JVs.

The early returns on SBA's enhanced rule are favorable. A few months ago, GAO relied on the new rule to sustain a protest against an Air Force small business set-aside solicitation in *Innovate Now, LLC*, Comp. Gen. Dec. B-419546, 2021 CPD ¶ 178; 63 GC ¶ 139. The solicitation in *Innovate* required offerors to submit at least one past performance example demonstrating the firm was a prime contractor on a cost-reimbursement contract for at least six months and achieved at least satisfactory ratings under certain areas of consideration. The solicitation imposed the same requirement on the protégé in an MP JV, rather than allowing the mentor to fulfill the requirement on behalf of the MP JV. SBA agreed with the protester and argued that the relevant regulation contains an "understanding that proteges must be held to a different experience standard from mentors and other offerors." Id. at *3. GAO agreed with SBA and sustained this aspect of the protest, holding that even though it was permissible for the agency to require experience from each JV member, the solicitation improperly required the protégé to meet the same evaluation requirements as other non-JV offerors, contrary to 13 CFR § 125.8(e) (2020). Id.

The November 2020 change to 13 CFR § 125.8(e) and GAO's recent decision in *Innovate* are positive steps to enhance the competitive posture of MP JVs. However, there are still some competitive challenges that MP JVs need to overcome. For one, procurements such as NITAAC's debacle with CIO-SP4 demonstrate that, despite clear regulations and case law, some agencies may still issue solicitations that are contrary to the MP JV rules, forcing industry to advocate and file protests. The CIO-SP4 solicitation has been plagued by a number of issues, including improperly restricting the amount of experience that could come from the mentor in an MP JV and a laundry list of requirements for the JVA well beyond what is required under SBA's regulations. Mentors and protégés will have to remain diligent and be willing to push back when agencies issue solicitations that contradict the MP JV rules, as did CIO-SP4.

Another ongoing challenge for MP JVs pertains to facility security clearances (FCLs). SBA's regulations state that "[a] joint venture may be awarded a contract requiring a facility security clearance where either the joint venture itself or the individual partner(s) to the joint venture that will perform the necessary security work has (have) a facility security clearance." 13 CFR § 121.103(h)(4). This makes sense, again because the JV is a limited-purpose, unpopulated entity that relies on the capabilities, past performance, experience, certifications, and business systems of the JV partners. SBA's rules appropriately recognize that the protégé should only be required to have the FCL if having the FCL is necessary for the protégé to perform the primary and vital requirements of the contract. Id. at § 121.103(h)(4)(i). Otherwise, the MP JV should qualify for the contract based on the mentor having the FCL to cover the work it will do that requires an FCL. Id. at § 121.103(h)(4)(ii).

The problem here is that SBA does not manage the FCL process for the Federal Government—this is done by the Defense Counterintelligence and Security Agency (DCSA). And, DCSA has indicated it will not follow SBA's rule and will continue to require MP JVs to obtain their own FCL. See Def. Counterintelligence Sec. Agency, Facility Clearance Orientation Handbook, 21 (Mar. 2021). DCSA believes that requiring the MP JV itself to have an FCL does not conflict with 13 CFR § 121.103(h)(4).

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Until there is a resolution of this disconnect between SBA's rules and DCSA's approach, perhaps in a future rule change or GAO decision, MP JVs face a quandary in determining how to compete for set-aside contracts that require FCLs.

Finally, we note that the Department of Defense's upcoming Cybersecurity Maturity Model Certification (CMMC) is expected to be required for JVs. See CMMC-AB FAQs, *cmmcab.org/faq/*. Such a requirement, if implemented, would be contrary to 13 CFR § 125.8(e). Moreover, requiring an MP JV to have its own CMMC is both impractical and unnecessary, given the MP JV (which must be unpopulated without its own employees) would not have its own information technology system that could be assessed for CMMC.

Conclusion and Recommendations—As discussed, MP JVs are a very popular and increasingly necessary tool for small and larger contractors to compete for set-aside contracts. When set up and evaluated correctly, the MP JV provides significant advantages to the protégé, the mentor, and the procuring agency. However, while progress has been made to provide more insight into how MP JVs should establish their internal governance structure and to allow MP JVs to bid with greater confidence and clarity, more needs to be done for MP JVs to realize their full potential. To that end, we have the following recommendations:

- SBA should further revise its MP JV regulations to list specific extraordinary decisions for which the mentor is permitted to have a veto right without jeopardizing the protégé's status as the managing venturer. This list should include the MP JV's decision to pursue a new contract (including the corresponding JVA addendum) and enter into such contract, including any modifications thereto. New contract pursuits entail significant financial exposure and require contributions from both parties. The protégé did not have the unilateral ability to force the mentor into the MP JV relationship in the first instance—rather, the protégé had to reach an agreement with the mentor on the first contract they desired to pursue through the MP JV. There is no reason the parties should not be expected to reach agreement for each subsequent contract they want to pursue, and requiring such agreement in the JVA should not mean that the protégé lacks the control necessary to be the managing venturer of the JV.
- Procuring agencies should ensure that their set-aside solicitations adhere to the current version of 13 CFR § 125.8(e) and corresponding socioeconomic JV regulations. Ideally, small businesses and their mentors should not be forced to protest solicitation terms that contradict the clear regulatory requirements. But, recognizing that will likely remain necessary in some cases, protégés and mentors should be prepared to utilize the protest process when necessary, like the protester in *Innovate*.
- DCSA and procuring agencies should follow SBA's regulations and should not require MP JVs to have their own FCL. Rather, the MP JV should qualify for contracts that require an FCL based on the FCL(s) of the protégé and/or mentor, depending on the nature of the work and the roles each party will play in contract performance. It is unnecessarily burdensome to require one of the JV partners to issue a subcontract to the MP JV, to establish the need for the MP JV to then obtain its own FCL, particularly when the MP JV itself very rarely has its own facilities because it is an unpopulated entity that relies on the facilities, people, and resources from the JV partners.
- When the CMMC initiative is finalized and the certification process begins, DOD should not require MP JVs to obtain CMMC. Again, the MP JV is an unpopulated entity without its own employees or business systems. Given that the CMMC is designed to assess the cybersecurity hygiene of the contractor's IT system, it does not make sense that the MP JV would need CMMC because the MP JV would not have its own IT system. As with FCLs, DOD should permit the MP JV to qualify for the CMMC requirement applicable to a given contract based on the roles the JV partners will play in performing the contract and their respective CMMCs.

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