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### **Legal Issues that May Arise when Forming a Business Arrangement Between an SDVOSB Company and a Non-SDVOSB Company**

This memorandum identifies the potential legal issues when a SDV OSB and a non-SDV OSB, such as a large business, seek to join forces to participate on government set-aside procurements. To summarize, this memorandum provides the following primary observations:

- An SDV OSB company must be controlled by a service disabled veteran who actually manages the day-to-day operations of the company and possess the skills to do so. The service disabled veteran must hold the highest position in the company.
- A large business cannot be affiliated with the SDV OSB. If affiliation is found, small business size standards can not be met.
- The SBA looks to the totality of the circumstances when determining if affiliation exists between two companies. Specific regulations also address affiliation based on stock ownership, common management, economic dependence, identity of interests, and contractual relationships.
- Current officers, directors, managing members, or partners who control the management or board of directors of a large business cannot also control the management of the SDV OSB.
- Former officers, directors, principal stockholders, managing members or key employees of the large business cannot serve such a position in a newly created SDV OSB, while at the same time, the large business is providing financial or technical assistance to the SDV OSB.
- The SDV OSB cannot be economically dependent on the large business.

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- If an SDV OSB relies too heavily on its subcontractor to perform the prime contract, the SBA will treat them as a joint venture or affiliated. This is commonly referred to as the Ostensible Subcontractor rule, which asks whether the subcontractor is performing the vital and primary requirements of the prime contract. Accordingly, the SDV OSB cannot unusually rely on the large business for financial and technical support. Otherwise, a joint venture between the SDV OSB LLC and the large business will be presumed. This is true even if the SDV OSB will be performing the required percentage of subcontract work, i.e. 15% of the cost of performance for personnel for general construction.
- From an overall business perspective, the large business cannot be the only source of revenue and technical support for the SDV OSB. Otherwise, the SBA can deem the SDV OSB unusually reliant on the large business and deem them affiliated.
- The control and affiliation rules are inapplicable to the SBA's Mentor Protégé Program for 8(a) firms. The mentor-protégé agreement must be approved by the SBA and it is not subject to the control and affiliation requirements mentioned above.

Each of these points will be discussed next.

**I. A Joint Venture between the large business and an SDV OSB is Impermissible.**

To create a valid joint venture between an SDV OSB and another business concern, both members of the joint venture must be small businesses. A joint venture between a large business and an SDV OSB is improper.

**II. The SDV OSB Firm Must Be Controlled by a Service Disabled Veteran Who Actually Manages the Day-to-Day Operations of the LLC and Possess the Skills to Do So.**

An SDV OSB firm must be controlled by a service disabled veteran. He or she must manage the daily operations of the SDV OSB and cannot delegate this task to another entity. The regulations detail the following requirements regarding the service disabled veteran's required control over an SDV OSB:

- At least 51% of the SDV OSB must be unconditionally owned by one or more service disabled veterans.

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- The management and daily business operations must be controlled by the service disabled veteran.
- The service disabled veteran must make both the long term decisions and day-to-day business decisions.
- The service disabled veteran must hold the highest officer position in the firm (usually the President or CEO).
- The service disabled veteran must have the managerial experience of the extent and complexity necessary to operate the SDV OSB.
- Although the service disabled veteran does not have to have the technical expertise or possess the required licenses, he can demonstrate that he has ultimate managerial and supervisory control over those who possess the required technical expertise or licenses.

The protest decisions cited below provide insight into how the above factors are actually applied. In each decision, the SBA held that the service disabled veteran did not have the necessary control over the SDV OSB and therefore could not compete on the procurement:

**Singleton Enterprises-GMT Mechanical, SBA No. VET-130 (March 27, 2008).** Although the service disabled veteran held the highest officer position, he lacked the managerial experience and technical expertise to run the company. The SBA examined the veteran's resume and noted that it did not describe any experience with Government construction contracts of the size and complexity as the one at issue. The resume also did not depict the scope and type of experience the veteran had. The SBA also noted that the non-veteran member of the company had much more experience with Government contracts.

**IITS-Nabholz, LLC, VET-2007-02-02-01.** LLC not controlled by service disabled veteran because he lived in Maryland and the LLC's office was in Arkansas. The SBA held that "although some industries may allow for day-to-day management and business operations to be ably handle from a distant location, the inherent nature of construction mandates onsite supervision and direction. This is not met by the service disable veteran periodically traveling to Arkansas.

**First Capital Interiors, Inc., VET-2006-12-08.** LLC not controlled by service disabled veteran because he was 2,000 miles away from the LLC's headquarters. The LLC argued that it can hire local superintendents to

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manage the job. The SBA rejected this since the disabled vet does not have control if the local superintendent can direct subcontractors, negotiate with the Government, and make decisions when needed.

A carefully drawn business plan should satisfy the control issue so long as the service disabled veteran is a legitimate owner/officer, has the necessary management powers, and has the requisite skill-set to administer the government contract.

**III. To Meet Applicable Small Business Size Standards, the Large Business and the SDV OSB Cannot Be Affiliated with Each Other.**

The SDV OSB must be small under applicable size standards. Problems arise when a protestor asserts that the SDV OSB is affiliated with a large business concern. If affiliation is found, the receipts of the large business are counted towards the size determination. This would disqualify the SDV OSB from competing on set-aside procurements. A SDV OSB company therefore cannot be affiliated with the large business.

Business concerns are affiliates of each other if one has the potential to control the other. Potential control does not mean actual control. 13 C.F.R. §121.103(a). The SBA has the discretion to look at “the totality of the circumstances” when determining if affiliation exists. 13 C.F.R. 121.103(a)(5) Specific factors considered are:

- (1) Stock Ownership. A person that owns 50% or more of a concern’s voting stock controls that concern. Affiliation can also be found if less than 50% of voting stock is owned, but when compared to other blocks of ownership, it has power to control that concern.
- (2) Common Management. Affiliation exists if an officer, director, managing member, or partner who controls the management of the SDV OSB also controls the other business concern.
- (3) Identity of Interests. Firms that have identical economic and business interests are affiliated with each other. This includes firms that are economically dependent on each other through contractual or other relationships. This creates

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a presumption of affiliation that can be rebutted only by a showing that the interests are in fact separate.

- (4) Newly Organized Concern Rule. Affiliation may arise if (a) former officers, directors, principal stockholders, managing members, or key employees hold positions in the a new SDV OSB operating in the same industry and (b) the business concern will be providing technical or financial support to the new SDV OSB. This presumption can be rebutted by showing that a clear fracture exists between the SDV OSB and the other business concern.

**IV. To Maintain Non-affiliation, the large business Cannot Be the Only Source of Revenue and Technical Support for the SDV OSB.**

Affiliation can be found if the large business and the SDV OSB maintain critical contract relationships between each other. For example, in Pointe Precision, LLC, SIZ-2001-09-07-35, the SBA held that affiliation existed based on contractual relationships.

There the SDV OSB relied on the large business concern for the bulk of its business:

The contractual relationships rule centers on the challenged firm's dependence on the alleged affiliate for contracts and business. Thus, it may be found when the alleged affiliate's business accounts for a large part of a challenged firm's receipts. See Size Appeal of J&R Logging, SBA No. SiZ-4426 at pgs. 3-4 (2001). Although the absence of a normal arm's length relationship between the firms strengthens the case for applying the contractual relationships factor, the presence of a arm's length transaction is not sufficient, by itself, to preclude a finding of contractual relationships. Thus, a firm may be found to be economically dependent on one customer for business, even absent evidence that their dealings are not at arm's length.

To avoid affiliation based on the contractual relationship rule, the SDV OSB should not rely on the large business for all of its business. The more business it receives from other sources, the better able the SDV OSB is to show no affiliation with the large business.

**V. Former Principals and Key Employees of the large business Cannot Hold Positions in the SDV OSB, When At the Same Time, the large business Is Providing the SDV OSB Financial or Technical Support.**

There is a regulation that addresses an SDV OSB that is created by individuals of a former business concern. Specifically, 13 C.F.R. 121.103(g), states:

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Affiliation based on the newly organized concern rule. Affiliation may arise where former officers, directors, principal stockholders, managing members, or key employees of one concern organize a new concern in the same or related industry or field of operation, and serve as the new concern's officers, directors, principal stockholders, managing members, or key employees, and the one concern is furnishing or will furnish the new concern with contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities, whether for a fee or otherwise. A concern may rebut such an affiliation determination by demonstrating a clear line of fracture between the two concerns. A "key employee" is an employee who, because of his/her position in the concern, has a critical influence in or substantive control over the operations or management of the concern.

The regulation quote above can be dissected into four parts:

- (1) Former officers, directors, principal stockholders, or key employees of one firm organize a new firm; and
- (2) These individuals serve as the new firm's officers, directors, principal stockholders or key employees; and
- (3) The new firm is in the same or a related industry or field of operation; and
- (4) The one concern is furnishing or will furnish the other concern with subcontracts, financial or technical assistance, bid or performance bond indemnification, or other facilities, whether for a fee or otherwise.

The purpose of the newly organized business concern rule is to prevent circumvention of the size standards by the creation of spin-off firms which appear to be small, independent firms, but are really affiliates or extensions of large firms. The factors considered look to whether the large business is providing the newly created concern technical or financial support. If yes, the newly formed concern can rebut the presumption of affiliation only by proving a "clear line of fracture" between the newly formed concern and the large business concern.

The SBA did not find a clear line of fracture in Frontier Applied Sciences, Inc., Docket No. SIZ-98-02-27-11, because there were still ties between the two entities:

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Finally, Appellant cannot demonstrate a clear fracture between itself and FESC. The Promissory Note guarantees Mr. Shreve a percentage of Appellant's revenues (which obviously increases if Appellant does well) and further revenues if Appellant's shareholders sell the firm for a profit. Appellant itself characterizes Mr. Shreve's position as that of a nonvoting stockholder. Appeal at 10. While the Promissory Note alone is not evidence of control, it does establish that Mr. Shreve, and by extension, his wife, FESC's majority shareholder, continue to have a financial interest in Appellant. The absence of clear fracture is further shown by Appellant's lease of office space Mr. Shreve owns, even though this transaction may not constitute financial assistance. The subcontracts continue in effect.

Thus, if an SDVOSB company were to be managed by former key employees or officers of the large business, the SDVOSB company could not receive financial or technical support from the large business. If this occurs, the large business bears the arduous task of showing that a clear fracture exists between the large business and the SDVOSB company.

**VI. Under the Ostensible Subcontractor Rule, the SDV OSB Cannot Rely Too Heavily on the Large Business for Financial and Technical Support.**

A potential SDV OSB/large business subcontract would have to pass scrutiny under the ostensible subcontractor rule: an SDV OSB and its subcontractor are treated as a joint venture if the SDV OSB "is unusually reliant" on its subcontractor. This occurs if the subcontractor performs the primary and vital requirements of the prime contract. This is significant since, as previously discussed, the large business and an SDV OSB cannot qualify as a small business as a joint venture.

More specifically, the Ostensible Subcontractor regulation provides:

A contractor and its ostensible subcontractor are treated as joint venturers, and therefore affiliates, for size determination purposes. An ostensible subcontractor is a subcontractor that performs primary and vital requirements of a contract, or of an order under a multiple award schedule contract, or a subcontractor upon which the prime contractor is unusually reliant. All aspects of the relationship between the prime and subcontractor are

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considered, including, but not limited to, the terms of the proposal (such as contract management, technical responsibilities, and the percentage of subcontracted work), agreements between the prime and subcontractor (such as bonding assistance or the teaming agreement), and whether the subcontractor is the incumbent contractor and is ineligible to submit a proposal because it exceeds the applicable size standard for that solicitation. 13 C.F.R. § 121.103(h)(4).

A business arrangement between an SDV OSB company and a large business may therefore be treated as a joint venture if the large business supplies the vital/primary requirements of the prime contract, even if the limitations on subcontracting requirements are met. The following protest decisions illustrate this point:

RTL Networks, Inc., SBA No. SIZ-4923. Mantech subcontracted with an SDVO SBC for technical security support services. The SDVO SBC represented that it would be performing at least 51% of the work. Even so, the SBA held that Mantech was an ostensible subcontractor because of the (1) unusual reliance on the wholesale hiring of Mantech's incumbent staff, and (2) the unusual reliance on Mantech's past performance history in the past performance submittals.

CardioMetrix, Inc., Docket No. SIZ-95-1-11-4. CardioMetrix, the small business, subcontracted with National, a the large business, to provide medical laboratory testing services. CardioMetrix would perform 55% of the work and National 45%. Even though CardioMetrix would be performing more than 50% of the work, the SBA held that this was improper because National would be performing the vital and primary requirements of the solicitation, i.e. medical laboratory testing. The SBA held that a review of the records, including CardioMetrix's tax returns, indicated that it was not in the medical laboratory business and that it would be relying on National to perform that work. Because the average annual receipts of the two firms must be therefore be combined, the SBA held that CardioMetrix was an other-than-small business and did not qualify to compete in the set-aside procurement.

Hamre Associates, Inc. Docket No. SIZ-94-06-28-084, Prime contractor/small business concern was financed by subcontractor/the large business concern. Large business/subcontractor was responsible for performing most of construction activities, such as site preparation and installation of modular buildings. Small concern was held to act merely as an intermediary between the contracting agency and its subcontractor.

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The ostensible subcontractor regulation and related protest decisions make it clear that, if asked, the SBA has the discretion to look at a variety of factors. This includes, but is not limited to:

- Examination of whether the large business is performing the vital component(s) of the prime contract rather than the SDV OSB.
- Determining if the SDV OSB has the requisite experience to perform the work as opposed to unduly relying on the large business to do so.
- Inquiring into tax records, bonding, and other financial documentation to determine if the SDV OSB will be relying on the financial support of the large business.
- Review of SDV OSB's qualifications to verify if the service disabled veteran has the necessary qualifications to perform the work, i.e. not unusually reliant on the large business.

**VII. The SDV OSB Must Perform At Least 15% of the Cost of Performance for Personnel for General Construction, At Least 25% for Construction By Special Trades.**

Special limitation-on-subcontracting rules apply to SDV OSBs. Specifically, 13 C.F.R. 125.6(b) provides the following limitation-on-subcontracting for an SDV OSB:

- In the case of a contract for services (except construction), the SDVO SBC spends at least 50% of the cost of the contract performance incurred for personnel on the concern's employees or on the employees of other SDV OSBs;
- In the case of a contract for general construction, the SDVO SBC spends at least 15% of the cost of contract performance incurred for personnel on the concern's employees or the employees of other SDV OSBs;
- In the case of a contract for construction by special trade contractors, the SDV OSB spends at least 25% of the cost of contract performance incurred for personnel on the concern's employees or the employees of other SDV OSBs; and
- In the case of a contract for procurement of supplies or products (other than procurement from a non-manufacturer in such supplies or products), at least 50% of the cost of manufacturing the supplies or products (not including the costs of materials), will be performed by the SDV OSB prime contractor or other SDV OSBs.

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- In the case of a joint venture, the SDV OSB joint venture must perform the applicable percentage of work. At 13 C.F.R. §125.15(b)(3).

**VIII. If a Protest is Lodged Against an SDV OSB, if Must Respond to the SBA's Request for Information Within Five (5) Business Days.**

An actual SBA request for information following a protest against an SDV OSB is attached hereto. It has been redacted to protect the name of the SDV OSB. The SBA only gives five (5) business days to respond.

The SBA Checklist is an informative source of anticipated areas of inquiry if an SDV OSB is challenged. The SBA's Protest Checklist demands the following information: <sup>1</sup>

<u>Description</u>	<u>Control</u>	<u>Affiliation</u>	<u>Ost. Sub. Rule</u>
Proof that majority owner(s) are service disabled veterans	X		
Names of all owners, partners, members and principal shareholders	X	X	
Percentage of stock owned by service disabled veterans	X		
List of stock options	X		
Stock held by others as pledged collateral	X	X	
Buy/sell agreements	X	X	
Shareholder agreements	X	X	
Promissory Notes and proof of payment	X	X	
SDV OSB's two most recent Federal tax returns	X	X	X
Bylaws, partnership agreement or operating agreement	X	X	
Latest corporate minutes	X	X	

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<sup>1</sup> The areas of control, affiliation, and ostensible subcontractor rule have been added. Note that the SBA may request additional information pursuant to its authority to look at the totality of the circumstances.

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<u>Description</u>	<u>Control</u>	<u>Affiliation</u>	<u>Ost. Sub. Rule</u>
Articles of incorporation	X	X	
Agreements required for operation of business (franchise, license and similar agreements with other concerns)	X	X	X
List of Affiliates	X	X	
List of all owners, officers, directors, officers or principal shareholders that have ever been employed by or performed work for any affiliate of the firm		X	
List of all facilities, equipment, and/or personnel shared with other firms at the time of bid opening		X	X
Copy of lease agreements		X	
List of the firm's current financial obligations to other individuals or entities (e.g. loan, security agreements, guarantees, indemnification, etc.)		X	
Percentage and description of work under this contract that will be performed by affiliate(s)		X	
Breakdown of firms sources of revenue indicating total percentage of revenues attributable to individual source		X	X
List of individuals who have signed documents to allow the SDV OSCB obtain credit guarantees or indemnification who are no owners, officers, directors, employees, partners, or principal stockholders of the business concern		X	

**IX. The Control and Affiliation Rules Are Inapplicable to the SBA's Mentor Protégé Program for 8(a) Firms.**

The SBA Mentor-Protégé Program allows a large business to mentor an 8(a) firm. An SDV OSB may also be an 8(a) firm. This permits the two to compete on government contracts as a joint venture. The beauty of this program is that it precludes application of the control and affiliation rules:

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No determination of affiliation or control may be found between a protégé firm and its mentor based on the mentor/protégé agreement or any assistance provided pursuant to the agreement. 13 C.F.R. §121.103(h)(3)(iii)

Thus, if the large business can find an 8(a) firm it can trust, it can become a mentor and benefit in contracts that are awarded to the 8(a) firm. There are reporting requirements that accompany this program, limits on the number of procurements that can be bid on, and possible risks dealing with an 8(a) firm.

**X. Conclusion**

The SBA will closely examine the work to be performed by the SDV OSB and tasks to be subcontracted to the large business. The SBA will also review all financial ties between the large business and the SDV OSB as a further barometer of affiliation. If a protest is lodged, this information must be immediately disclosed. Penalties for improper small business certifications, even if inadvertent, could be significant.