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The Clause

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The President's Column
Susan Warshaw Ebner

Dear BCABA Members:

As 2010 comes to a close, so does my term as President. It has been a great pleasure to be President of this fine organization and, as you will see below, since my last report it has continued to be a great year for putting on educational and inspiring events at the BCABA, Inc.!

Trial Practicum

Approximately 50 people pre-registered to attend our September 16th Trial Practicum. Attendees obtained tips on practice at the Boards of Contract Appeals, and in particular learned about some of the more significant areas of practice at the ASBCA and CBCA, including case management, discovery, bifurcation, hearing and briefing matters, and ADR. Many thanks to program chairs **Shelley Ewald**, **Pete Pontzar** and **Don Yenovkian**, and our panelists **Judges Dickinson**, **Borwick**, **Goodman**, and practitioner **David Taylor**, for a really well done event.

BCABA-GWU LS Colloquium

On September 22nd, this year's Annual Colloquium, co-sponsored by the BCABA, Inc., and the George Washington Law School, addressed "Buying Federal Information Technology--Next Steps." The Colloquium, moderated by **Professor Chris Yukins**,

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President's Column (cont'd):

included such luminaries as **OFPP Administrator Dan Gordon, Dr. Steven Kelman**, **A.R. "Trey" Hodgkins, III**, and our own **Program Chair Michele Mintz Brown**. The Colloquium covered key legal issues relating to improving Federal Information Technology acquisitions, including negotiated procurements and organizational conflicts of interest (OCIs). OFPP Administrator Gordon gave us some insight into the status of currently proposed DFARS rules on OCI, and his thoughts on what is to come in this hot area of the law. Many thanks to Chris and Michelle for their hard work in putting this event together, and to our panelists for an excellent presentation.

Annual Conference
Approximately 125 people attended this year's all-day Annual Conference on October 7th. The Conference covered such wide-ranging topics as *Procurement Policy Developments in the Second Year of the Obama Administration* (moderator **Kristin Ittig**; panelists **Cathy Garman**, **Alan Chvotkin, Sr.**, and **Jeffrey Green**), *Implementation of the FERA Amendments to the False Claims Act* (moderator **David Nadler**; panelists **Stephen D. Altman**, **Richard O. Duvall**, and **Robert L. Vogel**), *Adventures in Accounting : Preparing Claims for Mathematically Challenged Lawyers* (moderator **Pete McDonald**; panelists **James W. Thomas**, **Michael Aumiller**, and **Greg S. Bingham**), *Interplay between Administrative Law and Procurement Law* (moderator **John Howell**; panelists **Robert A. Burton**, **Margaret K. Patterson**, and **Jeffrey S. Lubbers**), and our Annual Judges Panel focusing on key developments at the Boards of Contract Appeals (moderator **Chip Purcell**; panelists **Judges Paul Williams**, **Anthony Borwick**, **Jonathan Zischkau**, **Sharon L. Larkin**, and **Gary E. Shapiro**). Our program luncheon included our annual awards ceremony and a very candid speech by the new Chief Judge of the Federal Circuit Court of Appeals, **Judge Randall Rader**. Judge Rader's speech provided insight into what the Federal Circuit looks at in deciding appeals. Congratulations to this year's award recipients: **Jeremy Goldman** (Young Attorney's Writing Award, "*New FAR Rule on Compliance Programs and Ethics: A Hidden Assault on the Corporate Attorney-Client Privilege*" (March 2010)); **Raymond Saunders** and **Patrick Butler** (Writing Award, "*A Timely Reform: Impose Timeliness Rules for Filing Bid Protests at the Court of Federal Claims*" (September 2010)); **Thomas H. Gourlay, Jr.** (President's Award); and **Susan Warshaw Ebner** (Life Service Award)! Many thanks to our program chair, **David Black**, his assistant **Daniel Strouse**, our lunchtime speaker, panel moderators and panelists, and to those who participated in the award selection committees (Past Recipients of the Life Service Award and members of the BCABA, Inc. Board of Directors) for all of their hard work and for providing us with an absolutely fantastic day!

The Clause
Many, many thanks (and I mean many!) go to **Pete McDonald**, Editor of *The Clause*. Each quarter he tirelessly works to make sure our magazine includes timely, interesting and thought-provoking articles relevant to our practice, as evidenced by the two awards we handed out at our Annual Meeting in October (see above) and the really pertinent articles contained in this issue of *The Clause,* regarding predictions on where future litigation is likely to arise, questions

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President's Column (cont'd):

that remain in OHA size appeals, reasons for an exception to the Small Business affiliation rules for venture capital investment, strategies for enforcing teaming agreements, and last but certainly not least, the role accounting software may play in government contract compliance. The rules of government contracting keep changing and staying current with new developments is essential.

The BCABA, Inc.
In addition to successfully incorporating and being approved by the IRS as a Section 501(c)(6) nonprofit organization this year, we established a Membership Committee to help spread the word on our great organization and attract new and continuing members. Our incoming officers, **President David Black, Vice President Francis E. "Chip" Purcell, Secretary Gary Shapiro**, and **Treasurer Thomas Gourlay** are ready to take office on January 1st. We wish them well in their new positions. We also welcome our newest Board member, **Matthew Ponzar**, and bid thanks to our departing Board member **Anne Donahue**. A listing of the complete Board of Directors and Officers is contained in this issue.

January 2011
We are already gearing up for next year and planning our first Coffee Break Event, "The Good, The Bad, The Ugly -- Let's Talk About It Over Coffee." This first event will highlight career paths and anecdotal experiences in government contracts. Put a save-the-date on your calendar for January 26th and check our website in a few weeks for more information about this event.

One Last Set of Thanks
As this year winds down, I would be remiss if I did not acknowledge that it really takes a village to do the business of the BCABA, Inc., and to bring you all of these wonderful programs. Many thanks to the current BCABA Officers, Board of Directors, and Committee Chairs for all of their hard work in support of the BCABA initiatives I led this year to address Board matters, wrap things up at the BCABA, incorporate the new BCABA, Inc., plus handle all of our regular activities! And, last but certainly not least, thanks to **Pete McDonald, Rich Walters, Mike Littlejohn, Michelle Mintz Brown**, and **David Nadler,** past BCABA Presidents who got me started on the road to the Presidency and lent me their support when I needed it. It's been a pleasure to serve with you.

Wishing you fair winds and following seas as we sail into the new year!

Best regards,

Susan Warshaw Ebner
President, BCABA, Inc

Bored of Contract Appeals
(a.k.a. The Editor's Column)

by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

Leading this issue is a thought-provoking article by my former colleague, Ed Kinberg, who points out the likely causes for increased government contract litigation. Our second article, by Kathryn Swisher, presents a detailed case law analysis of developments at the SBA's Size Standards Appeals Board, a forum familiar to many government contract practitioners. The next article, by Robert Hanseman and Catherine Kidd, comprehensively addresses the numerous complex issues related to the enforceability of teaming agreements, which are used so extensively in the government contracting market. Also focusing on the small business market is an article by Jessica Tillipman and Damien Specht, who call for reform in the SBA affiliation rules. Then, if you REALLY have a lot of time on your hands, there's an article to expand your knowledge of accounting software (yawn . . .).

The Clause will reprint, with permission, previously published articles. We are also receptive to original articles that may be of interest to government contracts practitioners. But listen, everybody: Don't take all this government contract stuff too seriously. In that regard, we once again received some articles that were simply unsuitable for publication, such as: "Pete Action Figures Now on Sale— Easy Pay and Expedited Shipping Available!"; "BCABA Board Takes No Action on Ransom Note for Pete!!"; and "Pete Caught Texting During Testimony!!!"

The Upcoming Explosion in Government Contract Litigation

by
Edward J. Kinberg*

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We are entering a period of unprecedented oversight of federal government contractors. New laws, regulations, and policies are adding layers of complexity to an already overly complex system. There is a growing tendency to point to government contractors of all types as the source of widespread waste, fraud, and abuse. In addition, the government is substantially increasing not only the number of employees dedicated to contract oversight and enforcement but also the authority of investigators. The one "certainty" surrounding the many changes being made is that contractors will be increasingly forced to defend themselves in both administrative and judicial forums.

This article presents an overview of some reports issued by the Government Accountability Office (GAO), executive orders, and statutory changes that have emerged over the last two years and will result in a significant increase in government contract disputes and litigation.

The Defense Contract Audit Agency and the GAO

The GAO fired the first shot in the new war on waste, fraud, and abuse on July 22, 2008, when the agency issued a report[1] charging that the Defense Contract Audit Agency (DCAA) had failed to meet professional standards at several locations studied. In that report the GAO found that "DCAA managers took actions against staff at two locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment." GAO-08-857, cover page.

Even though the GAO study involved only a small number of locations, the report is a general indictment of the way DCAA conducts business. Overall, the report indicated that the DCAA had created a "culture" in which the agency put substantial pressure on its auditors to issue "clean" audit opinions. In another example, the GAO stated that there was "evidence that there was an up-front agreement between DCAA and Contractor A to limit the scope of work and basis for the audit opinion (a significant impairment of auditor independence)." GAO-08-857, p. 19.

These are just examples of more than three dozen "case details" in the report finding that the DCAA management took actions that resulted in contractors receiving favorable reports they did not deserve. The logical consequence of this finding is that, in a knee-jerk reaction, DCAA auditors will feel intense pressure to include unfavorable comments in the majority of its future audits, and supervisors will be increasingly reluctant to question or change an auditor's unfavorable comments. An unfavorable comment in an audit can result in reduced or (*continued on next page*)

The Upcoming Explosion (cont'd):

delayed payments, negative evaluations of past performance, and a suspension or debarment action against the contractor. As a result, contractors will be compelled to appeal adverse findings that are not supported by laws or regulations.

After the GAO report came out, the DCAA issued a policy memorandum on December 19, 2008, which stated:

> As further clarification, the contractor's failure to accomplish any control objective tested for in DCAA's internal control audits will or could ultimately result in unallowable costs charged to [g]overnment contracts, even when the control objective does not have a direct relationship to charging costs to [g]overnment contracts. For example, the control objective related to ethics and integrity is not directly related to charging costs to [g]overnment contracts.

DCAA Memorandum for Regional Directors, 08-PAS-043(R).

The memorandum specifically focuses on "ethics and integrity" as an example of internal control policy that "could ultimately result in mischarging to [g]overnment contracts" and notes that "[i]t is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness." The memorandum concludes by stating that auditors may no longer issue findings of "inadequate in part." Instead, the auditor may report the entire system as inadequate and recommend that the contracting officer should take corrective action.

The corrective actions available to the contracting officer include reducing or withholding progress payments and seeking reimbursement of costs. Such a finding could also result in the contracting officer initiating a suspension or debarment action against the contractor and initiation of an investigation under the federal False Claims Act (FCA), which is discussed in more detail below, as a failure to report an overpayment a contractor knew about or should have known about, can be considered a false claim.

In support of the new DCAA policy, the Department of Defense has proposed a new rule for the Defense Federal Acquisition Regulation Supplement (DFARS). This change will permit contracting officers to withhold payment for perceived deficiencies in any of the following business systems: accounting, estimating, purchasing, earned value management, material management, and property. Deficiencies in these systems will allow a contracting officer to withhold between 5 and 10 percent of payments for each system considered to be deficient; the total could reach 50 percent. 75 Fed. Reg. 2457 (Jan. 15, 2010). The deadline for comments on this rule was March 16, 2010. As this article goes to press, the Defense Department had not yet published a final rule.

On December 19, 2008, the DCAA issued a memorandum titled "Denial of Access to Records,"[2] which states that the data required by auditors should be (1) "readily available," (2) provided within a "reasonable time," and (3) available "upon request," unless there are

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The Upcoming Explosion (cont'd):

"extenuating circumstances." The memorandum and its instructions also state that support "includes access to personnel." Given the overall nature of the memorandum and instructions, the DCAA will require contractors to give the agency the documents, personnel, and other support needed to conduct an audit.

On March 13, 2009, the DCAA issued another memorandum,[3] which stated the following: "Certain unsatisfactory conditions related to actions of [g]overnment officials will be reported to the Department of Defense Inspector General in lieu of reporting the conditions to a higher level of management." DCAA Memorandum for Regional Directors, 09-PAS-004 (R), p. 1.

The primary purpose of this memorandum seems to be to intimidate contracting officers into accepting the findings of the DCAA's audit or risk an audit by the department's inspector general. Because a government agency's contracting officer is the only individual authorized by law to make decisions regarding contract requirements or a contractor's performance, this DCAA memorandum appears to be designed to reduce the independence of the contracting officer, regardless of whether, in the contracting officer's judgment, the findings are warranted. The danger to contracting officer's independence is shown by the following comment in the memorandum:

> An example might include a situation where the contracting officer purposely excludes DCAA from performing or completing an audit to avoid a negative report (e.g., audit report with an adverse opinion). Another example may be where a contracting officer ignores a DCAA audit report and takes an action that is grossly inconsistent with procurement law and regulation (e.g., awards a contractor unreasonable or excessive costs and/or profit)."

DCAA Memorandum for Regional Directors, 09-PAS-004 (R), p. 1.

By using this example, the DCAA is putting contracting officers on notice that, if the contracting officer does not support a DCAA finding, the DCAA will take action against the agency's contracting office. This outcome will have a chilling effect on the contracting officer's independence, because it will create a new burden on already overworked contracting officers, which, in turn, will require them to defend themselves against DCAA allegations that the contracting officer's action was improper.

The pressure on the DCAA to issue negative findings was further increased by the release of a 153-page GAO report on September 23, 2009, entitled "Widespread Problems with Audit Quality Require Significant Reform." GAO-09-468. The overall nature of this report is shown by the title of the first two appendixes to the report; Appendix I: Internal Control System Audits Did Not Meet Professional Standards, and Appendix II: DCAA Does Not Perform Sufficient Work to Identify and Collect Contractor Overpayments.

The message of the report is clear: The DCAA is not doing its job. In order to correct
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this impression, the DCAA will be compelled to implement policies and procedures that will result in substantially more adverse findings in its audits. Given the intense criticism of DCAA management for overriding or ignoring the work done by auditors and the possibility that contracting officers will be reported for failing to enforce the DCAA's findings, valuable checks and balances have been taken out the system. The only place left to serve as a check on an overly enthusiastic auditor will be in the courts and administrative boards.

Executive Orders and Memorandums

Shortly after taking office, President Obama issued a number of executive orders that will have a substantial impact on government contractors. Although all these orders are focused on increasing government efficiency and strongly emphasize fighting waste, fraud, and abuse, the executive orders tend to shift the burden to contractors to prove they are in compliance, to put pressure on agencies to find wrongdoing on the part of the contractors, and to reduce barriers to bringing claims and actions against government contractors.

On January 21, 2009, the President issued a memorandum stating that, when agencies review requests under the Freedom of Information Act (FOIA), "[a]ll agencies should adopt a presumption in favor of disclosure, in order to renew their commitment to the principles embodied in FOIA, and to usher in a new era of open [g]overnment. The presumption of disclosure should be applied to all decisions involving FOIA." It is interesting to note that this memorandum is focused on restoring trust in the government by specifically stating that information should not be kept confidential because of the possibility that public officials will be "embarrassed" or because of "speculative or abstract fears."

Nonetheless, because the agencies have been directed to resolve doubts in favor of disclosure, this memorandum is likely to increase the number of FOIA requests for sensitive and/or confidential contract information. As a result, contractors will test the new policies in an effort to obtain information that will assist them in understanding how their competitors build and price proposals. Consequently, the targets of those requests will be compelled to file suit under FOIA to stop the release of information that may give companies insight into their competitors' bidding practices and procedures.

On January 30, 2009, the President issued an executive order prohibiting contractors from including costs related to collective bargaining. The order stated that these costs are not allowable if they are incurred by a contractor to encourage an employee "to exercise or not to exercise, or concerning the manner of exercising, the right to organize and bargain collectively through representatives of the employees' own choosing. Such unallowable costs shall be excluded from any billing, claim, proposal, or disbursement applicable to any such federal [g]overnment contract." It is likely that this order will result in many disputes over the allowability of costs in virtually all contracts with companies that have collective bargaining

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The Upcoming Explosion (cont'd):

agreements or are involved in efforts to establish such agreements. Given the recent criticism of the DCAA as found in the GAO report discussed above, auditors will be pressured to disallow costs that may be related to a collective bargaining agreement in order to avoid the appearance that the auditor is favoring the contractor. This outcome will result in a substantial increase in litigation, because the courts will be used to clarify rules that agencies are unable to clarify themselves.

A memorandum issued by President Obama on March 4, 2009, noted that a 2008 GAO study of 95 major defense acquisition programs "found cost overruns of 26 percent, totaling $295 billion over the life of the projects." Therefore, the President ordered the development of

> [g]overnment-wide guidance to assist agencies in reviewing, and creating processes for ongoing review of, existing contracts in order to identify contracts that are wasteful, inefficient, or not otherwise likely to meet the agency's needs, and to formulate appropriate corrective action in a timely manner. Such corrective action may include modifying or canceling such contracts in a manner and to the extent consistent with applicable laws, regulations, and policy.

When read in its entirety, this order seems to imply that all overruns are the result of contractors' inefficiency or fraud. Consequently, this policy is likely to result in a substantial number of contract terminations for which the courts will be required to determine if "overruns" were caused by the contractor or the government and whether the government or the contractor must bear the burden of the disputed costs.

In a memorandum issued on January 20, 2010, the President directed the IRS to conduct a review of all "certifications of non-delinquency" that were submitted by government contractors since the requirement was implemented in 2008. The IRS was directed to provide the President a report on the overall accuracy of contractor certifications within 90 days of the memorandum. This order is likely to increase litigation as disputes arise over the accuracy of the data collected by the IRS.

Finally, on March 10, 2010, the President issued an executive order titled "Finding and Recapturing Improper Payments." In this memorandum, the President announced his administration's plan to expand the use of "payment recapture audits," which he defined as "a process of identifying improper payments paid to contractors or other entities whereby highly skilled accounting specialists and fraud examiners use state-of-the-art tools and technology to examine payment records and uncover such problems as duplicate payments, payments for services not rendered, overpayments, and fictitious vendors." These audits are likely to result in significant disputes about the propriety of various payments, and these disputes will have to be resolved in court.

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The Upcoming Explosion (cont'd):

Statutes and Regulations

On May 20, 2009, the President signed the Fraud Enforcement and Recovery Act (FERA),[4] which substantially modified the False Claims Act, making it easier for private citizens to bring suit against contractors in the name of the government and to recover a portion of the damages as well as attorneys' fees. The revised FCA, in combination with the changes discussed above, are likely to result in a significant increase in lawsuits related to the FCA.

In addition to making it easier for a private citizen to bring an action under the FCA, FERA added $165 million to the federal budget for investigating false claims and also established a federal task force aimed at increasing the government's ability to investigate false claims. A false claims suit can arise from a false statement in any of the dozens of certifications a contractor is required to execute—from failure to strictly comply with the terms and conditions of an individual contract to submitting an improper pay request.

Prior to the passage of the FERA, a false claim had to be made with the intent to get money from the government. The FERA deletes that FCA provision and replaces it with the explanation that false claim involves making a false record or statement that is "material to a false or fraudulent claim."[5] This new standard introduces substantial flexibility, which increases the likelihood that a false claims suit will be successful. Because FCA actions can be brought by a disgruntled employee, the slightest deviation from the strict requirements of a contract could result in litigation being brought against a contractor.

Perhaps the most significant impact of the FERA is the provision that gives the U.S. attorney general the right to delegate the authority to issue a Civil Investigative Demand (commonly known as a CID) and the Justice Department the right to share information it obtains from a CID with the individual who brought the suit. On March 24, 2010, the attorney general delegated the authority to issue CIDs to the U.S. attorney for cases that are delegated to that office. 75 Fed. Reg. 56, p. 14072. This will make it substantially easier for the government to investigate FCA claims.

Coming Soon to Contractor Near You

The U.S. Department of Labor is considering implementing a new program, referred to as the High Road Contracting Plan, which would make a contractor's labor policy a key element in evaluating bids and proposals. An article written by Robert Brodsky that appeared on GovernmentExecutive.com on April 1, 2010, discussed the reasons this program is under consideration. In his article, Brodsky noted that two congressional representatives had asked the GAO "to quantify the taxpayer burden associated with a certain company if they pay so little that workers and their families qualify for federal safety-net benefits."[6] Even though, on the surface, conducting such a study makes sense, if the results lead to implementation of the High Road Contracting Plan, government contractors can expect a significant increase in bid protests, contract disputes, suspensions and debarments, and false claims acts suits. Under this

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The Upcoming Explosion (cont'd):

initiative, each negotiated procurement would include an evaluation factor that rates the following items:[7]

- Whether the contractor pays a "livable wage,"
- Whether the contractor provides "quality, affordable health insurance,"
- Whether the contractor has "an employer-funded retirement plan and paid sick leave," and
- Whether the contractor is in compliance with federal and state tax and labor laws.

If this policy is implemented, there is a strong likelihood that there will be disputes over the interpretation of these terms and application of the criteria to the contract award. Because these issues will become another factor that must be considered in selecting a contractor, they will be subject to review by the GAO and the courts. In addition, the application of these standards could be considered a constructive suspension or debarment giving rise to numerous lawsuits challenging these rules.

Finally, in the area of labor, it is important to note that the Office of Federal Contract Compliance Programs has received funding to increase its oversight of various affirmative action regulations and policies. One of the areas on which the office will be focusing will be the state and local contracts that have been funded by the American Recovery and Reinvestment Act. Because the act not only requires compliance with numerous federal laws that may not traditionally apply to state and local government contracts but also contains complicated reporting requirements, it is likely that many contractors will face adverse action by the U.S. Department of Labor.

Conclusion

We are entering an era of unprecedented government control over government contractors and the public employees that oversee contracting; it is an era during which suspicion of wrongdoing attaches to virtually all contractors. The public assumption that the system is rife with fraud, corruption, and waste puts intense pressure on our political leadership to develop policies and procedures that appear to guarantee that taxpayers are protected from the slightest possibility of misuse or abuse of public funds. There is also intense pressure to ensure that public funds are spent in a socially responsible manner without regard to the additional costs contractors are forced to incur in order to correct agency actions that may be unreasonable.

The various reports, executive orders, memorandums, and statutes discussed in this article are just the tip of the iceberg. Over the next few years, we will see many more regulations aimed at creating the appearance that government contractors are providing the best pay and benefits packages to their employees while ensuring that the government consistently

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The Upcoming Explosion (cont'd):

gets the best possible products for the goods and services it pays for. Even though, on the surface, this goal sounds promising, when the policy is implemented in a way that unduly shifts the burden (and cost) to contractors to prove that they are in full compliance with everything, contractors will be forced to rely on the court to protect them from unfair and unreasonable government actions.

* - Edward Kinberg, of Kinberg & Associates LLC in Melbourne, Florida, practices in the areas of government contracts, commercial and construction law. Prior to opening his practice in 1996, Mr. Kinberg served in the U.S. Army Judge Advocate General (JAG) Corps. His assignments included the Office of the Chief Trial Attorney for the Army, in which he represented the Army in complex disputes and bid protests. He also served as the deputy chief of contract law and procurement fraud coordinator for the U.S. Army in Europe, and as a senior attorney with the U.S. Army Aviation and Troop Command.

Endnotes

1. U.S. Government Accountability Office, *Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards were Substantiated*, GAO-08-857 (July 22, 2008).
2. Defense Contract Audit Agency, Memorandum for Regional Directors, 08-PAS-042 (R), along with an instruction letter, DCAA Instruction No. 7640.17 (Dec. 19, 2008).
3. Defense Contract Audit Agency, Memorandum for Regional Directors, 09-PAS-004 (R) (March 13, 2009).
4. Pub. L. No 111-21, 123 Stat. 1617 (codified at 31 U.S.C.).
5. 31 U.S.C.A. §3729(a) (1)(b).
6. Robert Brodsky, "*Watchdog Asked to Study Contractor Salaries, Benefits*," www.governmentexecutive.com (April 1, 2010).
7. Robert Brodsky, *High Road Contracting Policy Comes into Focus*, www.Nextgov.com (April 2, 2010).

Third Time's a Charm? Size Determination Appeal Decisions Provide Necessary Guidance, But Unresolved Issues Remain

by

*Kathryn E. Swisher**

On November 18, 2009, the Small Business Administration (SBA) Office of Hearings and Appeals (OHA) issued its decision in the *Size Appeal of Social Impact, Inc.*[1] This decision culminated three size appeals by Social Impact, Inc. (Social Impact), the first of which was filed on June 26, 2008, more than 18 months earlier.[2]

In each appeal, Social Impact claimed that the SBA's Area Office had incorrectly applied 13 C.F.R. §121.104(a), which allows firms in certain industries to exclude from the calculation of their average annual receipts "amounts collected for another."

The final decision was significant, not only because OHA granted the size appeal and reversed the Area Office's size determination, but also because the three *Social Impact* decisions represent the only recent OHA case law specifically addressing the exception as it applies to conference management service providers.[3]

While the *Social Impact* decisions collectively provide much needed guidance from OHA on the application of the exception to "amounts collected for another by conference management service providers," some issues have yet to be definitively resolved. This article will first discuss the regulation and the *Social Impact* decisions, and then address how the decisions may be applied by practitioners.

The Regulation

SBA's size regulations provide an exception from the calculation of average annual receipts for amounts collected for another by conference management service providers, as follows:

> Receipts do not include . . . amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker.[4]

The exception for conference management service providers was added in 1996.[5] Discussing the proposed rule, SBA explained that in its view conference management service providers shared certain characteristics with the other industries to which the exception already applied.[6] These characteristics had been identified by SBA as follows:

(1) A broker or agent-like relationship between a firm and its third-party provider exists that represents a dominant or crucial activity of firms in these industries.

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Third Time's a Charm? (cont'd):

(2) The pass-through funds associated with the broker or agent-like relationship are a significant proportion of total receipts.

(3) As the normal business practice of firms in the industry, a firm's income remaining after the pass-through funds are remitted to a third party is typically derived from a standard commission or fee.

(4) Firms do not usually consider billings that are reimbursed to other firms as their own income, preferring instead to count only those receipts that are retained for their own use.

(5) Federal government agencies that engage in the collection of statistics and other industry analysts usually represent receipts of the firms on an adjusted receipts basis.[7]

SBA explained that conference management service providers shared these characteristics as follows:

> Conference management services firms provide a range of services in support of organizing and facilitating conferences, such as travel, lodging, honoraria and other administrative support services. The sponsoring organization is responsible for developing the conference and its contents and for all conference expenses. The conference management service provider principally acts as an agent on behalf of the sponsoring organization by arranging for various support services in connection with the conference and provides few, if any, of the support services itself. The arrangements made through the conference management services provider to a third-party provider are paid for using the sponsoring organization's funds or by the conference management services provider and later reimbursed by the sponsoring organization. The pass-through monies paid to third-party providers generally account for a majority of the total expenses incurred by the conference management services provider. The conference management services provider's earnings are based on fees or commissions from these activities.[8]

SBA sought comments and information regarding the practices of firms in the conference management services industry, in particular, regarding the typical relationship between conference management service providers and their clients.[9] The final rule was issued on January 31, 1996, with no change to section 121.104 as proposed.[10]

The *Social Impact* Decisions

In May 2008, following award of a contract to The QED Group, LLC (QED) by the United States Agency for International Development (USAID), Social Impact, a disappointed offeror, filed a protest with the Area Office, asserting QED was other than small for purposes of the procurement.

The Area Office issued its size determination one month later, concluding that QED had

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Third Time's a Charm? (cont'd):

properly excluded from its revenue calculations amounts directly attributed to conference management services, and that QED was an eligible small business for the procurement.[11]

Social Impact filed an appeal with OHA, asserting that the Area Office had allowed QED to exclude all of the costs QED claimed were related to its provision of conference management services, and that the Area Office had failed to determine whether these amounts were collected as an agent for another, as required by the regulation.

OHA agreed, and explained as follows:

> *The key phrase in the regulation is "amounts collected for another*." The regulation does not permit the exclusion from receipts amounts attributable to whole categories of business.[12]

OHA remanded the case to the Area Office for a determination of exactly what proportion of QED's conference management revenues constituted amounts collected as an agent for another.[13]

The Area Office issued a second size determination five months later, again finding QED to be small. QED sought to exclude conference management expenses in connection with two contracts, one with USAID, and one with the United States Department of Housing and Urban Development (HUD). QED asserted that it had collected the excluded amounts for others, and provided the Area Office with copies of the contracts, task orders, and final invoices.[14]

The Area Office reviewed the documents, and determined that there were "conference management costs" associated with the two contracts that could properly be excluded from the calculation of QED's receipts.[15]

Social Impact filed a second appeal, arguing that the Area Office had exclusively reviewed QED's contract and task order statements of work to determine which of the identified business activities constituted "conference management services," as defined by NAICS 561920, without regard to whether the costs QED sought to exclude had been collected by QED as an agent for another.[16] In other words, the Area Office had, for the second time, incorrectly applied the exclusion to all amounts attributable to conference management services, despite OHA's direction on remand that such amounts must also have been collected as an agent for another.

OHA found that the Area Office had not distinguished between excludable costs and QED's own expenses.[17] OHA again remanded the case to the Area Office for a determination of exactly what proportion of QED's conference management revenues were amounts that had been collected as an agent for another.[18]

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Third Time's a Charm? (cont'd):

The Area Office issued its third size determination on July 20, 2009. The Area Office concluded that QED had acted as an agent on behalf of its government customers.

Social Impact appealed to OHA for the third time.

OHA found that the record did not support the Area Office's conclusion that QED had acted as an agent for its government customers.[19] Specifically, while QED had repeatedly provided documentation indicating that it had performed conference management services in connection with the two contracts, QED had not provided evidence of how the revenues from the performance of those contract management services constituted amounts collected as an agent for USAID and HUD.[20] OHA granted the size appeal, and reversed the Area Office's size determination.

Applying the *Social Impact* Decisions

The *Social Impact* decisions, as well as OHA precedent and SBA's regulations, suggest the following analytical framework for determining whether revenues may be excluded by a conference management service provider as amounts collected for another:

1. Are the revenues associated with services provided by the concern in its capacity as a conference management service provider?
2. If so, are the revenues "amounts collected for another"?
   a. Is there an agency relationship with an unaffiliated third party; or
   b. Do the amounts in question constitute the concern's ordinary business expenses, for which it was reimbursed under a claim of right?

The *Social Impact* decisions do not, however, resolve some potentially conflicting nuances in the regulations and case law, and thus the application of this two-part test remains problematic.

1. *Are the revenues at issue associated with services provided by the concern in its capacity as a conference management service provider?*

It is well-settled that the exclusion of pass-through receipts is limited to those industries specified in the regulation.[21] What has not been clear, however, is whether the application of the exclusion is predicated on the firm itself, i.e., the specific industry to which the concern belongs (as determined by the concern's primary NAICS code, for example),[22] or whether the exclusion applies to the nature of the amounts the concern is seeking to exclude, i.e., whether the allegedly excludable costs were incurred while the concern was acting in the capacity of a firm in one of the enumerated industries.[23]

Applying the exclusion in the latter manner makes the most practical sense, because most small businesses perform work under multiple NAICS codes. For example, a firm whose primary industry is conference management services (e.g., NAICS code 561920, Convention

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Third Time's a Charm? (cont'd):

and Trade Show Organizers) may perform work under an IT services contract. The firm's pass-through amounts for those IT services should not be excludable simply because the firm's primary industry is one of those enumerated in section 121.104(a). Conversely, as is clear from the *Social Impact* decisions, a firm whose primary industry is not listed in the regulation may nevertheless provide conference management services in connection with a contract that has a much broader scope of work. The revenues earned by the firm in its capacity as a conference management services provider should be excludable, provided the amounts were also collected as an agent for another, regardless of whether the firm's entire business is based on providing contract management services.

In the Social Impact decisions, OHA implied that a firm's revenues are excludable under the regulation if those amounts were incurred by the firm while it was performing in the capacity of a firm in one of the identified industries, that is, the firm's "primary industry" is irrelevant. OHA found that the Area Office correctly analyzed whether QED's allegedly excludable revenues were earned in connection with QED's provision of conference management services, but concluded that the Area Office had failed to determine which of those revenues were collected as an agent for another, and thus neglected to perform the second part of the two-part analysis.[24]

Thus, although OHA has never specifically elucidated this point, the first step in analyzing whether the exception applies must be to determine whether the amounts the firm seeks to exclude were associated with the firm's provision of conference management services.[25]

2. If so, are the revenues "amounts collected for another"?

In *Social Impact*, OHA reiterated that the "key phrase" in the regulation is "amounts collected for another."[26] It is not enough to determine that allegedly excludable costs were incurred by a firm in connection with its provision of conference management services. Those amounts must also have been collected as an agent for another. The nature of the agency relationship is, however, unclear—for whom is the firm acting as an agent?

a. Is there an agency relationship with an unaffiliated third party?

SBA's 1995 discussion of the proposed rule indicated that the agency relationship contemplated is between the firm and an *unaffiliated* third party, rather than between the firm and the firm's customer.[27] Thus, in SBA's estimation, the normal business practices of conference management service providers are akin to those of a travel agency. There is, for example, an agency relationship between a travel agency and its transportation and lodging vendors, because the travel agency receives money from its customers on behalf of those vendors, and is compensated largely by commissions earned from those vendors, rather than by payments for services by customers.[28]

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In *Social Impact*, however, OHA characterized the agency relationship as follows:

> I turn again to the preeminent example of the travel agent—the agent buys a plane ticket on behalf of a customer, and the customer pays the agent, who transfers the money directly to the airline. We know the travel agent formed an agency relationship **with the customer** because the customer asked the travel agent to act on its behalf, the customer paid money to the travel agent, and the travel agent transferred the money to the airline. The tickets are not items the travel agent keeps in inventory to sell. Rather, the agent only acts upon direction from each specific customer, the transaction is entered into under the customer's name, and the customer is ultimately responsible for the fees. The travel agent thus acts "as" the customer or "in the customer's shoes" when it engages in the transaction.[29]

This characterization is analogous to SBA's statement in the discussion of the proposed rule that a "conference management service provider principally acts as an agent *on behalf of the sponsoring organization*,"[30] an illustration suggesting that this concept has been unclear from its inception.

In most cases, including *Social Impact*, OHA analyzes the alleged agency relationship without regard to whether such relationship is between a firm and its customer, or between a firm and an unaffiliated third party.

For example, in *Size Appeal of Cannon & Cannon, Inc*., OHA disagreed with the appellant's assertion that money appellant held "as an agent for its customers" constituted pass-through funds.[31] The appellant was primarily engaged in leasing crane equipment, and, as a service to its customers, regularly entered into leases to provide them with other heavy equipment. Appellant asserted that it did so as an agent, acting on behalf of its customers, and that amounts appellant received in this capacity constituted pass-through money it held as an agent for its customers. OHA, however, concluded that "such arrangements are tantamount to subcontracting and, being virtually indistinguishable, cannot be excluded from Cannon's average annual receipt calculations."[32]

In *Size Appeal of Courtesy Associates, Inc*., the appellant was not allowed to exclude from its receipts revenues the appellant had identified as reimbursements for expenses that the appellant had incurred on behalf of, and passed through to, clients of its conference and management services.[33] OHA found that the reimbursed costs were treated as the appellant's ordinary business expenses, and thus were not pass-through amounts.

The appellant in *Size Appeal of Mid-Columbia Engineering, Inc*. claimed to be a "payroll agent."[34] The appellant provided temporary employees to its clients, and billed its clients at an hourly rate for the employees' work. The appellant was compensated based upon a predetermined percentage of the compensation paid to the employees. The appellant sought to

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exclude from its receipts the amounts the appellant paid to the temporary employees the appellant furnished to its client firms. OHA determined that because the employees looked to the appellant for their pay, and not to the firms for which they performed work, and because the firms paid the appellant, and not the employees, the appellant thus conducted the transactions in its own name, rather than acting as an agent for another.[35]

The nature of the agency relationship at issue in *Social Impact* was further complicated by the fact that QED claimed that it had an agency relationship with its government customers. The Area Office accepted QED's contention, concluding that in performing the contracts, QED had acted on behalf of the two federal agencies.

Under *United States v. Johnson Controls, Inc*., 713 F.2d 1541 (Fed. Cir. 1983), an agency relationship between the government and a government contractor is established as follows:

> To establish an agency relationship between the government and a government contractor, the record must show that the contractor was: (1) acting as a purchasing agent for the government; (2) the agency relationship was established by clear contractual consent; and (3) the contract between the contractor and the government specifically stated that the government would be directly liable to subcontractors for goods or services provided to the prime contractor.[36]

In *Social Impact*, nothing in the record evidenced a clear contractual agency relationship between QED and either USAID or HUD, nor was there a specific statement indicating that either agency would be directly liable to subcontractors.

OHA has "relied upon the law of agency" when determining whether certain amounts may be excluded, considering the following criteria:

> Is the challenged firm merely acting as an agent for another in the transactions it seeks to exclude? Does the firm enter into the transactions in its own name? If so, is the challenged firm liable for the transactions it enters into which produce the revenues in question? Do these transactions not constitute an integral part of the challenged firm's business?[37]

OHA precedent, however, does not appear to distinguish between government and nongovernment customers. For example, in Courtesy Associates, the appellant identified reimbursable costs it had incurred under both government and commercial contracts. In *Size Appeal of D.K. Shifflet & Associates, Ltd.*, the protested concern argued that it was acting as a "purchasing agent" or "distributing agent" for the National Institutes of Health.[38]

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Third Time's a Charm? (cont'd):

OHA's conclusion in Social Impact did not address which analysis to apply when determining whether an agency relationship exists between a firm and its government customer.[39] Rather, OHA emphasized the lack of evidence in the record to support the Area Office's conclusion. OHA explained as follows:

> Under either . . . agency test . . . QED failed to meet its burden of proving it acted as an agent for USAID or HUD. To prove an agency relationship, QED needed to explain precisely its role in each transaction as well as the government's role in each transaction. This required clarification as to how the transactions proceeded logistically—i.e., How did the money flow between the entities? Did USAID and HUD reimburse QED for these expenses? Did USAID and HUD advance money for these expenses to QED? What entity contracted for these expenses? Did QED enter into the transactions in its own name? Could the recipients of the funds for each transaction hold QED responsible for payment? Could the recipients of the funds hold the government responsible for payment? Were these expenses included in QED's revenue as reported on its IRS Form 1040? Instead of offering this sort of precise information, QED has merely generally and conclusorily asserted throughout these proceedings that it acted as an agent in providing conference management services. This is insufficient.[40]

Arguably, OHA should not have analyzed this issue at all, and should have instead simply concluded that the Area Office's determination that QED had an agency relationship with its customers was irrelevant because such an agency relationship is not contemplated by the regulation.

b. Do the amounts in question constitute the concern's ordinary business expenses, for which it was reimbursed under a claim of right?

If there is no agency relationship between the concern and its third-party vendors, then the amounts are simply the concern's ordinary business expenses, for which it was reimbursed by its customer under a claim of right, and, as such, may not be excluded.[41]

Conclusion

The *Social Impact* decisions provide necessary guidance on the exclusion of amounts collected for another by conference management service providers. OHA clearly explained that the exclusion does not apply to whole categories of business; rather, "[i]t is a simple legal question of what role the conference management service provider played in the transaction," i.e., were the amounts in question collected as an agent for another?

What is not clear is whether the exclusion may only be applied to a firm whose primary

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industry is one of those enumerated in the regulation, or whether a firm acting in the capacity of a concern in an identified industry may exclude amounts it collects as an agent for another. OHA's decision in *Social Impact* suggests that the latter application is acceptable.

In addition, the nature of the required agency relationship is debatable. SBA's discussion of the rule, as proposed, suggests that the agency relationship contemplated is between a firm and its unaffiliated third party vendors. Such an interpretation is consistent with the business practices of firms in the industries to which the exclusion applies, e.g., travel agents or real estate agents.

OHA precedent does not, however, appear to distinguish between an agency relationship with an unaffiliated third party, and an agency relationship between a firm and its government or commercial customer.[43] Ultimately, it would be most helpful for OHA to analyze the nature of the agency relationship contemplated by the regulation. Such an analysis, however, will have to wait for another appeal.

* - Kathryn E. Swisher recently relocated to San Francisco, California from Washington, D.C., where she was an associate with Oldaker Belair & Wittie LLP.

Endnotes

1. *Size Appeal of Social Impact, Inc.*, SBA No. SIZ-5090, 2009 WL 4838341 (Nov. 18, 2009).
2. The author represented Social Impact in all three appeals before OHA.
3. There is one other OHA decision addressing "conference and management services," which was issued before "conference management service providers" were added to the regulation in 1996. *See Size Appeal of Courtesy Associates, Inc.*, SBA No. SIZ-2941, 1988 WL 219851 (Aug. 23, 1988). *See also* discussion *infra* and note 34.
4. 13 C.F.R. §121.104(a).
5. 61 Fed. Reg. 3,280, -81, -88 (Jan. 31, 1996). For a helpful overview of the regulatory history, *see Size Appeal of Reiner, Reiner & Bendett, P.C.*, SBA No. SIZ-4587, 2003 WL 22815888, at *5 (Oct. 27, 2003).
6. SBA added an exception for travel agents in 1988, and for real estate agents in 1989. 53 Fed. Reg. 18,820 (May 25, 1988); 54 Fed. Reg. 6,267 (Feb. 9, 1989). In 1992, SBA proposed that amounts collected for another by advertising agencies also be excluded from the calculation of average annual receipts. 57 Fed. Reg. 38,452-56 (Aug. 25, 1992). This proposed rule was also made final in 1996. *See* 61 Fed. Reg. 3,280-88 (Jan. 31, 1996).
7. 60 Fed, Reg. 57,985 (Nov. 24, 1995. *See also* 57 Fed. Reg. 38,452 (Aug. 25, 1992).
8. 60 Fed. Reg. at 57,986.
9. *Id.*
10. 61 Fed. Reg. at3281.
11. *Size Appeal of Social Impact, Inc.*, SBA No. SIZ-4990, 2008 WL 4295992, at *2 (Aug. 27, 2008) (hereinafter, "First Size Appeal").
12. First Size Appeal at 3 (emphasis in original).
13. First Size Appeal at 4.

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Endnotes (cont'd)

14. *Size Appeal of Social Impact, Inc.*, SBA No. SIZ-5028, 2009 WL 1030588, at *3 (Mar. 6, 2009) (hereinafter, "Second Size Appeal").
15. *Id.*
16. Second Size Appeal at 3-4.
17. Second Size Appeal at 6.
18. Second Size Appeal at 7.
19. *Size Appeal of Social Impact, Inc*., SBA No. SIZ-5090, 2009 WL 4838341, at *8 (Nov. 18, 2009) (hereinafter, "Third Size Appeal").
20. Third Size Appeal at 9.
21. *See* Second Size Appeal at 6. *See also, e.g.*, Reiner, Reiner & Bendett, 2003 WL 22815888, at *5; *Size Appeal of Recycling Res*., LLC, SBA No. SIZ-4324, 1998 WL 644767, at *4 (Sept. 4, 1998); *Size Appeal of Aliron Int'l, Inc*., SBA No. SIZ-4317, 1998 WL 531866, at *3 (Aug. 3, 1998). *See also* 13 C.F.R. § 121.104(a) ("For size determination purposes, the only exclusions from receipts are those specifically provided for in this paragraph. All other items, such as subcontractor costs, reimbursements for purchases a contractor makes at a customer's request, and employee-based costs such as payroll taxes, may not be excluded from receipts.").
22. *See, e.g.*, *Size Appeal of Communicar, Inc*., SBA No. SIZ-4551, 2003 WL 23205062, at *4 ("Pass-through receipts may not be excluded from a concern's size unless its primary industry is one for which the SBA's size regulations authorize such exclusion."); *Recycling Res.*, 1998 WL 644767, at *4 ("The . . . regulation does not include Appellant's industry or its [NAICS] code."). Interestingly, if OHA had applied the exclusion in this way, QED would arguably not have met this first criterion. According to QED's profile on SBA's Dynamic Small Business Search database, QED's primary NAICS code is 541611, Administrative Management and General Management Consulting Services, not 561920, Convention and Trade Show Organizers. *See generally* http://dsbs.sba.gov, and QED profile on file with author.
23. *See, e.g.*, *Aliron Int'l*, 1998 WL 531866, at *3 ("Neither the items Appellant claims for exclusion nor the specific industry to which Appellant belongs, falls within the exclusion.").
24. *See, e.g.*, Third Size Appeal at 4 ("Although [in its second size determination] the Area Office properly asked QED to define the business activities included in the revenues it seeks to exclude, QED's explanations for the exclusions were overly broad. Therefore . . . I again remanded the case to the Area Office for a determination of exactly what amount of QED's total conference management revenues are amounts collected as an agent for another."). *See also* Third Size Appeal at 9 ("[The] excerpted [SOW] pages indicate that QED did provide conference management services under the . . . contracts. However, these documents do not indicate how QED acted as an agent . . . in performing or paying for those services.").
25. Further, the more specific the firm can be when making this assertion the better. *See, e.g.*, Second Size Appeal at 5 (noting Social Impact's argument that QED failed to identify for the Area Office which portions of its invoiced costs related to conference management services).
26. *See, e.g.,* Second Size Appeal at 3.
27. *See, e.g.*, 60 Fed. Reg. at 57,985 (noting characteristics under which it might be appropriate to exclude from a concern's revenues certain funds received from a client firm to be transmitted to an unaffiliated third party, including a "broker or agent-like relationship between a firm and its third party provider"). *See also* 13 C.F.R. §121.201 n.10 (noting that "funds received in trust for an unaffiliated third party, such as bookings or sales subject to commissions" are excludable).
28. *See* 60 Fed. Reg. at 57,985 ("As the normal business practice of firms in the industry, a firm's income remaining after the pass-through funds are remitted to a third party is typically derived from a standard commission or fee.").

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29. Third Size Appeal at 9-10 (emphasis added). There are additional examples of OHA's interpretation. For example, in the second size appeal, OHA stated that "The crux of the matter is whether an agency relationship exists with respect to the costs in question, *i.e*., they are not ordinary business expenses of the challenged business, but are costs incurred *on behalf of the client*." Second Size Appeal at 7 (emphasis added). Similarly, the Area Office, in its third size determination, concluded that QED had sought to exclude "only pass-through amounts *paid by QED as an agent for another*," which suggests that QED was acting as an agent by making payments on behalf of its customer, rather than holding funds in trust for an unaffiliated third party. Third Size Appeal at 5 (emphasis added).
30. 60 Fed. Reg. at 57,986 (emphasis added).
31. *Size Appeal of Cannon & Cannon, Inc*., SBA No. SIZ-3737, 1993 WL 50690 (Feb. 11, 1993).
32. *Cannon & Cannon*, 1993 WL 50690, at *4.
33. *Courtesy Associates*, 1988 WL 219851, at *8. *Courtesy Associates* appears to be the only decision prior to *Social Impact* that deals with the exclusion of amounts collected for another by a "conference and management services" provider. This case has not been specifically overruled by the 1996 addition of conference management service providers to the regulation, and, indeed, the analysis is arguably the same, *i.e.*, whether the allegedly excludable amounts were collected by a business concern acting as an agent for another.
34. *Size Appeal of Mid-Columbia Eng'g, Inc*., SBA No. SIZ-3703, 1996 WL 33703, at *2 (Jan. 16, 1996).
35. *Mid-Columbia Eng'g*, 1996 WL 33703, at *5.
36. Third Size Appeal at 5.
37. *Mid-Columbia Eng'g*, 1996 WL 33703, at *4-5 (citing *Size Appeal of D.K. Shifflet & Associates, Ltd*., SBA No. SIZ-3081, 1989 WL 229434 (Apr. 4, 1989); *Courtesy Associates*, 1988 WL 219851).
38. *D.K. Shifflet*, 1989 WL 229434, at *2.
39. Indeed, these analyses are not incompatible. The critical question is whether the customer will be directly liable to third-party vendors with which the firm contracts. The government, however, will not enter into an agency relationship without giving clear contractual consent to such liability.
40. Third Size Appeal at 9-10.
41. *See, e.g.*, *Courtesy Associates*, 1988 WL 219851, at *8. *See also Mid-Columbia Eng'g*, 1996 WL 33703, at *5.
42. Third Size Appeal at 11.
43. Indeed, *Social Impact* may have generated some of this confusion in its appeal, by arguing that the agency relationship contemplated by the regulation is the firm's relationship with unaffiliated third parties, while at the same time attempting to refute QED's claim that it had an agency relationship with its government customers.

Enforceability of Teaming Agreements

by
Robert G. Hanseman
And
*Catherine Kidd**

Teaming agreements have become increasingly common in government contracting.[1] These agreements enable companies to compete for contracts that could not be efficiently performed by a single company, such as consolidated contracts that require a wide-ranging variety of skills.[2] But what happens when team members no longer have the same priorities, or have a falling out due to one member's recognition that it could more profitably obtain its teammate's services elsewhere? Even worse, what happens if one team member uses the other's name and reputation only as a part of a premeditated "bait and switch"? This article will examine the options available to a jilted team member.

FAR 9.602 and 9.603

In the context of government contracting, teaming agreements may take one of two forms: (1) "[t]wo or more companies form a partnership or joint venture to act as a potential prime contractor," or (2) "[a] potential prime contractor agrees with one or more other companies to have them act as its subcontractors under a specified Government contract or acquisition program."[3] Federal Acquisition Regulation (FAR) 9.603 articulates a general policy of recognition of "the integrity and validity of contractor team arrangements." The reasons underlying this policy are pragmatic, and are set forth in FAR 9.602 as follows: "Contractor team arrangements may be desirable from both a Government and industry standpoint in order to enable the companies involved to [c]omplement each other's unique capabilities[,] and [o]ffer the Government the best combination of performance, cost, and delivery for the system or product being acquired."

Despite the utility of entering into teaming arrangements, they are not readily enforceable by a disappointed team member. Accordingly, disappointed parties have sought redress for breaches of teaming agreements under a variety of legal theories, including: (1) breach of contract; (2) breach of preliminary agreement and duty of good faith and fair dealing; (3) promissory estoppel; and (4) unjust enrichment. As will be explained below, cases advancing the latter three causes of action have met with limited success, particularly with respect to the remedies available to the disappointed contractor.

Breach of Contract

Although breach of contract has proved to be the theory most likely to bring success to a disappointed team member, the nature of teaming agreements renders it difficult to prove the

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essential elements of an enforceable contract. Generally speaking, these essential elements are: (1) intent to be bound; (2) consideration; and (3) definite terms, including price, quantity and duration.[4] Because teaming agreements involve numerous contingencies, the existence of the first and third elements are often in doubt in cases in which a disappointed party asserts a breach of contract claim.[5]

Despite doubt regarding the parties' intent to be bound and the definiteness of terms, a teaming agreement may constitute an enforceable contract. For example, in *ATACS v. Trans World Communications*, the United States Court of Appeals for the Third Circuit held that the teaming agreement, which provided that ATACS would assist Trans World in preparing its bid and that Trans World would work exclusively with ATACS on the project, was enforceable.[6] In that case, the government of Greece sought bids to manufacture communications shelters for its army.[7] Both ATACS and Trans World considered bidding independently on the project as the prime contractor; each, however, concluded that it would be unsuccessful in going it alone.[8] Accordingly, the parties agreed that Trans World would bid as the prime contractor, with ATACS as the main subcontractor.[9] The parties' agreement resulted in a winning bid, but the arrangement fell apart when Trans World revealed that it had been soliciting other proposals for the subcontractor and requested that ATACS lower its price.[10]

When Trans World later chose another company as its main subcontractor, ATACS responded by bringing an action asserting, among other things, breach of contract.[11] With respect to the first element — intent to be bound — the court noted that "[t]he record contains numerous correspondences by both parties clearly indicating their 'intent to team' and work exclusively with each other in preparation for the [project]."[12] In addition, Trans World represented in its proposal to the government that ATACS "constituted part of the 'team' that would undertake the project."[13] With respect to the third element — definiteness of terms — the court found that ATACS' promise to assist in bid preparation and to work exclusively with Trans World in exchange for good-faith negotiation of the subcontract was sufficiently definite.[14] In so finding, the court emphasized that the teaming agreement did not contain a provision "indicat[ing] that the terms of their teaming agreement were subject to final execution of the subcontract."[15]

Similarly, in *EG&G v. The Cube Corporation*, a Virginia state court held that the teaming agreement, which provided that EG&G would substantially assist in preparing Cube's bid in exchange for being named the key subcontractor, was enforceable.[16] In that case, NASA and the Navy sought bids for "the procurement of operations and maintenance support services" at one of NASA's flight facilities.[17] The procurement was a small business set-aside. Independently, neither EG&G nor Cube could successfully bid on the procurement because EG&G did not qualify as a small business, while Cube lacked the necessary experience.[18] Accordingly, the parties entered into a teaming agreement, under which EG&G would assist Cube in preparing its bid and Cube would award EG&G the subcontract.[19] As promised, EG&G expended significant resources assisting in the preparation of the winning bid.[20] After

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Cube won the contract, however, the parties were unable to reach agreement regarding the terms of the subcontract.[21] Specifically, EG&G and Cube were unable to agree on the rate at which EG&G's compensation would be capped.[22]

When Cube sent EG&G a letter stating that because the parties had reached an impasse, the temporary letter subcontract under which EG&G had been performing would be allowed to expire, EG&G brought an action for specific performance of the teaming agreement.[23] With respect to the first element of EG&G's claim, the court held that the agreement evidenced an intent to require more than good-faith negotiations toward a final subcontract, emphasizing that the agreement provided that EG&G "would" be awarded the subcontract in exchange for EG&G's bid preparation services.[24] In addition, the language of the teaming agreement and the statements in proposals submitted to the government indicated that the parties would work as a team on the project.[25] With respect to the third element, the court held that the teaming agreement was sufficiently definite. The agreement specified the terms of the work to be performed by EG&G to the extent that they were known to the parties at the time the agreement was executed.[26] In addition, the proposals submitted to the government "clearly stated the scope and nature of the work that EG&G was to perform as subcontractor."[27] Finally, the teaming agreement provided the general method by which EG&G was to be compensated for its work under the subcontract.[28]

Even when a teaming agreement is found to be enforceable, however, as in *ATACS* and *EG&G* , it may be difficult for a disappointed party to prove a breach of the agreement. For example, in *Ulliman Schutte Construction v. Emerson Process Management Power & Water Solutions*, the United States District Court for the District of Columbia granted summary judgment in favor of Emerson with respect to Ulliman Schutte's breach of contract claim.[29] The parties had agreed to join forces to bid on a contract to upgrade the District's Blue Plains wastewater Treatment Plant.[30] The teaming agreement provided Ulliman Schutte "would perform the [subcontract] based on: (1) the requirements of the [prime contract]; (2) [Emerson's] Standard Terms; and (3) any modifications to the requirements and terms of the [prime contract] or the Standard Terms 'as negotiated and mutually agreed upon' by [Emerson] and [Ulliman Schutte]."[31] Significantly — and fatally for Ulliman Schutte — the agreement also provided that the parties would be released from their obligations in the event of failure to negotiate any terms of the subcontract.[32]

When the parties failed to agree on the payment terms of the potential subcontract, Ulliman Schutte brought several contractual and quasi-contractual claims against Emerson.[33] The court implicitly found that the teaming agreement was enforceable, and explicitly found that it authorized Emerson's insistence on a payment schedule that was consistent with the primary contract and its standard terms, and that the parties' failure to reach agreement released Emerson from its obligation to award the subcontract to Ulliman Schutte.[34] The court rejected Ulliman Schutte's contention that the teaming agreement was only partially integrated and thus susceptible of proof by parol evidence that Emerson had previously agreed to the payment terms advanced by Ulliman Schutte.[35] Specifically, the court observed:

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Enforceability of Teaming Agreements (cont'd):

> [Ulliman Schutte's] argument that the [teaming agreement] is only partially integrated, and thus is susceptible of parol evidence, appears at first blush to have some force. It is, after all, undisputed that the [agreement] expressly contemplated further negotiation on certain topics — most critically, the scope of work to be subcontracted to [Ulliman Schutte] — thus, the argument goes, the [agreement] could not have constituted the parties' entire agreement. However, this argument conflates the parties' intent in entering the [agreement] with their intent in drafting a subcontract; these documents have related but distinct purposes. In signing the [teaming agreement], the parties did not intend to enumerate the work details — those details were left for later negotiations and would be memorialized in the eventual subcontract. Their purpose in securing the [teaming agreement] was more limited: They sought to set forth the conditions under which they would work together to bid on the [prime contract], and — as evidenced by the title of the document itself — under which their mutual promises of exclusivity would remain binding.[36]

Finally, even assuming the existence of an enforceable agreement and breach has been found, it may be difficult for a disappointed party to prove damages resulting from the breach. Although such difficulty may result in an award of specific performance of the teaming agreement,[37] it may also result in an award that merely compensates the disappointed party for the value of the services rendered in bid preparation. For example, in *ATACS*, the court concluded that lost profits were not the appropriate measure of damages because "significant obstacles' stood in the way of an agreement on the subcontract's price, and . . . [ATACS] had not presented sufficient evidence that further negotiations would prove fruitful."[38] Thus, the court remanded with directions to determine and award ATACS the value of its services in assisting in the preparation of the bid.[39]

ATACS, *EG&G*, and *Ulliman Schutte* suggest that a *written* teaming agreement is a practical prerequisite to a finding of enforceability. Assuming the existence of an enforceable agreement, language that the prospective contractor "will" be awarded a subcontract, without condition, appears to be required in order to successfully advance an action for breach of contract. This language, however, is not typical of teaming agreements; rather, such agreements tend to condition award of the subcontract on successful negotiation of its terms. Assuming such definite language is not included in the agreement, it is far more difficult for a disappointed party to prevail on a breach of preliminary agreement and duty of good faith and fair dealing claim than on a breach of contract claim. Therefore, although breach of contract remains the most attractive theory available to a disappointed party, its success is by no means guaranteed.

Breach of Preliminary Agreement

To date, the theories of "breach of preliminary agreement" and breach of the duty of

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Enforceability of Teaming Agreements (cont'd):

good faith and fair dealing have not proved to be viable alternatives to disappointed parties who are unable to prove breach of contract. As an initial matter, some states do not recognize a separate cause of action for breach of the duty of good faith and fair dealing.[40] Accordingly, in disputes governed by the law of these states, that theory does not permit recovery for damages in the absence of an enforceable teaming agreement.[41] Moreover, as discussed in the preceding section, it may be difficult to prove that the teaming agreement satisfies the traditional elements of a contract.

In disputes governed by state law that *does* recognize preliminary agreements, however, it appears that a typical teaming agreement likely will be found to constitute an enforceable preliminary agreement. New York law, for example, provides that an "agreement to agree" may be enforceable as a "Type II" preliminary agreement that binds the parties to "make a good faith effort to negotiate toward the ultimate objective."[42] In determining whether an agreement constitutes a Type II preliminary agreement, New York courts analyze "(1) whether the intent to be bound is revealed by the language in the agreement; (2) the context of the negotiations; (3) the existence of open terms; (4) partial performance; and (5) the necessity of putting the agreement in final form, as indicated by the customary form of such transactions."[43]

In *Trianco v. IBM*, the United States District Court for the Eastern District of Pennsylvania held that the parties' teaming agreement, which provided that Trianco would assist IBM in preparing the bid and that the parties thereafter would in good faith negotiate the terms of the subcontract, was an enforceable Type II preliminary agreement.[44] Analyzing the relevant five factors, the court found that the teaming agreement evidenced an intent to be bound,[45] was subject to numerous contingencies,[46] did not contain too many open terms,[47] was partially performed,[48] and was "in keeping with the customary nature of teaming agreements."[49] The court further found that the preliminary agreement was supported by adequate consideration: the promise of good-faith negotiations[50] and the right of first refusal to perform the subcontract.[51]

Given that the teaming agreement was an enforceable preliminary agreement, both parties were bound to negotiate the terms of the subcontract in good faith.[52] Trianco, however, did not assert breach of the duty of good faith and fair dealing as a cause of action, presumably because the parties extensively, albeit unsuccessfully, negotiated the terms of the subcontract. Accordingly, Trianco sought relief under several quasi-contractual theories. The court's finding of an enforceable preliminary agreement barred those claims, and left Trianco without a remedy. *Trianco* demonstrates that in the absence of a failure to negotiate, a finding of an enforceable preliminary contract often will bar, rather than provide a basis for, a disappointed party's claims.

Finally, even when breach of preliminary agreement and breach of the duty of good faith and fair dealing are available and are asserted by a disappointed party, those theories may be difficult to prove. For example, in *Ulliman Schutte*, the court held that, even assuming that

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Enforceability of Teaming Agreements (cont'd):

state law imposed a duty to negotiate in good faith, Ulliman Schutte failed to demonstrate a breach of that duty.[53] Specifically, Emerson's insistence on payment terms that were authorized by the primary contract and its Standard Terms did not constitute a failure to negotiate in good faith, and the teaming agreement's provision releasing the parties from their obligations in the event of unsuccessful negotiations was "a far cry from [an] unequivocal promise . . . to negotiate the proposed transaction to completion."[54]

Promissory Estoppel

Disappointed team members that have advanced the theory of promissory estoppel have also been unsuccessful in obtaining relief. As a preliminary matter, some states do not recognize promissory estoppel as a cause of action.[55] Accordingly, in disputes covered by the law of such states, promissory would clearly not permit recovery of damages or costs incurred in reliance on unfulfilled promises made in the context of negotiating a teaming agreement.[56]

Even where promissory estoppel is recognized, however, it is unlikely to afford relief to the disappointed party. Generally speaking, states that recognize promissory estoppel as a cause of action require a showing of the following: "(1) a clear and definite promise; (2) a reasonable expectation by the defendant that the offer will induce action or forbearance on the part of the plaintiff; (3) actual and reasonable action or forbearance by the plaintiff; and (4) detriment to the plaintiff which can only be avoided by the enforcement of the promise."[57]

The first element — a clear and definite promise — may prove difficult to demonstrate in the absence of an enforceable written teaming agreement. For example, in the appellate decision in Trianco, the Third Circuit held that Trainco's failure to prove the existence of a binding agreement that IBM would award the subcontract to Trianco also doomed its promissory estoppel claim.[58] Specifically, the court found:

> The District Court dismissed [the promissory estoppel] claim because Trianco did not allege that IBM made an express promise to award it a subcontract at the prices Trianco proposed. We agree with this conclusion. . . . Here, Trianco's claim that IBM clearly and unambiguously promised Trianco a subcontract at a certain price is contradicted by the terms of the Teaming Agreement, which states in no uncertain terms that Trianco's receipt of a subcontract was subject to future negotiations on price.[59]

The fourth element — detriment to the plaintiff that can be avoided only by enforcement of the promise — may also be an insurmountable obstacle. For example, in *Abt Associates v. JHPIEGO Corp.*, the United States District Court for the District of Maryland granted summary judgment in favor of JHPIEGO with respect to Abt's claim for promissory estoppel.[60] As an initial matter, the court held that the claim was barred because the plaintiff failed to request specific performance of JHPIEGO's promise to enter into a formal teaming agreement.[61] The court further found that even if Abt had requested this relief, the claim still would have failed.[62]

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Enforceability of Teaming Agreements (cont'd):

The court reasoned:

> [Abt Associates] has not produced evidence showing any demonstrable detriment suffered by it. [Abt] contends that its reliance on [JHPIEGO's] alleged promise to enter into a formal contract forced it to forego joining a competing team . . . . However, as noted hereinabove, competent evidence does not exist in this record that these factors resulted in actual detriment to [Abt]. [Abt's] claim is therefore speculative at best. Had [Abt] joined a competing team, there is no guarantee that this other team would have received the Award.[63]

The reasoning applied in *Trianco* and *Abt Asso*ciates suggests that it is extremely difficult for a disappointed team member to successfully bring a claim for promissory estoppel. Under the reasoning of *Trianco*, to the extent that a claim for breach of contract fails because the teaming agreement provides for future negotiations regarding award of the subcontract, a claim for promissory estoppel will likewise fail absent the demonstration of a clear and unambiguous promise.

Moreover, under the reasoning of *Abt Associates*, damages for promissory estoppel are rendered speculative by award of the contract to the former teammate, rather than to the competing company with which the disappointed party would have teamed in the absence of the former teammate's promises. As a practical matter, however, a disappointed party is far more likely to commence litigation if it has been deprived of a concrete, rather than hypothetical, opportunity to perform a subcontract. That is, it is more likely that a disappointed party will bring suit when the former teammate is the successful bidder. One reason is that in such situations, damages for breach of contract are more readily ascertainable. Thus, it appears that a claim for promissory estoppel is likely to be successful in factual circumstances in which a claim for breach of contract is not, and vice versa.

Unjust Enrichment

Although a disappointed party's claim for unjust enrichment was unsuccessful in a decisive majority of the cases surveyed,[64] in at least two cases a disappointed party received limited relief via such a claim. Generally speaking, unjust enrichment requires a showing of the following: "(1) a benefit conferred upon the defendant by the plaintiff; (2) an appreciation or knowledge by the defendant of the benefit; and (3) the acceptance or retention by the defendant under such circumstances as to make it inequitable for the defendant to retain the benefit without the payment of its value."[65]

Unjust enrichment appears to be a viable alternative to a breach of contract claim only when award of the contract to the former teammate clearly would not have occurred absent the disappointed party's services. For example, in *International Cargo Management Specialists v. EG&G Dynatrend*, the United States District Court for the District of Columbia found that

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Enforceability of Teaming Agreements (cont'd):

although the plaintiff (ICMS) failed to demonstrate the existence of an enforceable contract with Dynatrend, it could recover the reasonable value of its services under a theory of unjust enrichment.[66] The court found that ICMS provided the following valuable services to Dynatrend: (1) identification of the contract opportunity; (2) development of significant portions of the technical proposal; and (3) expertise in dealing with the government agency.[67] The court also accepted plaintiff's valuation of the benefits conferred, which focused on "comparable transactions, namely a joint venture agreement between [Dynatrend] and [another company] to submit a proposal on the [contract] when it [was] rebid."[68]

Under the reasoning of *International Cargo*, and in light of the wealth of cases dismissing unjust enrichment claims in the context of failed teaming agreements, it appears that a claim of unjust enrichment is likely to be successful only when the former teammate is awarded the contract, and such award clearly would not have been made in the absence of the disappointed party's services. As a practical matter, proving these circumstances likely would require seeking the cooperation of the contracting officer, who may be reluctant to testify against the party that is currently performing the contract. Moreover, to the extent that any enforceable agreement governs the disappointed party's provision of services, a claim for unjust enrichment will be barred. Finally, even assuming that the claim is available to the disappointed party, it is important to note that the measure of damages will be limited to the value of services provided.

Conclusion

A written contract is essential to ensure the enforceability of a teaming agreement and to provide a disappointed party with the full range of remedies necessary to fully redress damages arising from breach of the agreement. If your client is a subcontractor or junior partner in a teaming agreement, you should ensure that:

- The teaming agreement is embodied in a signed writing;
- The teaming agreement contains a favorable choice of law provision;
- The teaming agreement relates to one particular project;[69]
- The teaming agreement specifically delineates each team members functions in creating the proposal and performing under the contract;
- The teaming agreement provides that your client *will* be awarded the subcontract, rather than that the parties will negotiate the subcontract; and
- Your client is named as a teammate, and its role is specifically delineated, in bid proposals and communications with the government.

In the event that a written teaming agreement was not executed or is somehow defective, however, a range of alternative theories, such as breach of preliminary agreement, breach of the duty of good faith and fair dealing, and unjust enrichment, may provide limited relief to a disappointed party.

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Enforceability of Teaming Agreements (cont'd):

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Endnotes

1. Michael W. Mutek, Contractor Team Arrangements—Competitive Solution or Legal Liability: The Deskbook for Drafting Teaming Agreements 1 (2006).
2. *Id.* at 3–4.
3. FAR 9.601.
4. *See ATACS Corp. v. Trans World Communications, Inc.*, 155 F.3d 659, 665–66 (3d Cir. 1998).
5. *Id.* at 666. *See also, e.g., Quandry Solutions Inc. v. Verifone Inc.*, No. 07-097, 2009 U.S. Dist. LEXIS 31459, at *45–46 (E.D. Pa. Apr. 13, 2009); *Glynn Interactive, Inc. v. iTelehealth, Inc.*, No. 2003-0449, 2004 U.S. Dist. LEXIS 3651, at *10 (D. Md. Mar. 9, 2004); *Abt Assocs., Inc. v. JHPIEGO Corp.*, 104 F. Supp. 2d 523, 532–33 (D. Md. 2000); *Int'l Cargo Mgmt. Specialists, Inc. v. EG&G Dynatrend, Inc.*, No. 91-1360, 1995 U.S. Dist. LEXIS 9577 at *43–44 (D.D.C. Mar. 31, 1995).
6. *ATACS*, 155 F.3d at 668.
7. *Id.* at 662.
8. *Id.*
9. *Id.*
10. *Id.* at 663–64.
11. *Id.* at 664.
12. *Id.* at 668.
13. *Id.*
14. *Id.*
15. *Id.*
16. *EG&G, Inc. v. The Cube Corp.*, 63 Va. Cir. 634, 648 (Cir. Ct. 2002).
17. *Id.* at 635.
18. *Id.*
19. *Id.* at 636.
20. *Id.* at 637–38.
21. *Id.* at 641–43.
22. *Id.*
23. *Id.* at 643.
24. *Id.* at 649.
25. *Id.*
26. *Id.* at 652.
27. *Id*.
28. *Id.* at 652–53.
29. *Ulliman Schutte Constr., LLC v. Emerson Process Mgmt. Power & Water Solutions*, No. 02-1987, 2006 U.S. Dist. LEXIS 14987, at *29 (D.D.C. Mar. 31, 2006).
30. *Id.* at *2.
31. *Id.* at *28.
32. *Id.* at *4–5.
33. *Id.* at *12–13.

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Enforceability of Teaming Agreements (cont'd):

Endnotes (cont'd)

34. *Id.* at *28–29.
35. *Id.* at *35.
36. *Id.* at *34.
37. *EG&G,* 63 Va. Cir. at 657.
38. *ATACS*, 155 F.3d at 670.
39. *Id.* at 671.
40. *See, e.g.*, *Quandry Solutions Inc. v. Verifone Inc*., No. 07-097, 2009 U.S. Dist. LEXIS 31459, at *47–48 (E.D. Pa. Apr. 13, 2009) (Pennsylvania does not recognize cause of action for breach of duty of good faith and fair dealing in the absence of an enforceable contract); *Abt Assocs.,* 104 F. Supp. 2d at 534 (Maryland does not recognize separate cause of action for breach of implied duty of good faith and fair dealing).
41. *Quandry Solutions*, 2009 U.S. Dist. LEXIS, at *47–48; *Abt Assocs.*, 104 F. Supp. 2d at 534.
42. *Trianco LLC v. Internatl. Bus. Machs. Corp*., 583 F. Supp. 2d 649, 657 (E.D. Pa. Oct. 15, 2008), *aff'd by* No. 08-4318, 2009 U.S. App. LEXIS 22213, at *8 (3d Cir. Oct. 6, 2009).
43. 583 F. Supp. 2d. at 657 (quotation marks and citation omitted).
44. *Id.* at *8.
45. *Id.* at 659–60 (noting that the teaming agreement expressly provided that the parties were bound to negotiate the subcontract in good faith, and the agreement would terminate if such negotiations were unsuccessful).
46. *Id.* at 660 ("[T]he potential award of the subcontract to Trianco was conditioned on IBM winning the contract. The contingency of the relationship, including factors that could not be determined at the time of the initial negotiations . . . reinforces [the] argument that this is a binding Type II agreement requiring further negotiations.").
47. *Id.* at 662.
48. *Id.* at 662–63 (finding that Trianco partially performed the teaming agreement by assisting in preparation of the bid).
49. *Id.* at 663.
50. *Id.* at 664.
51. *Id.* at 665.
52. *Id.* at 657 ("parties cannot demand performance of the ultimate objective in a Type II preliminary agreement, but they can demand good faith negotiation toward a final contract").
53. *Ulliman Schutte*, 2006 U.S. Dist. LEXIS 14987, at *67.
54. *Id.* at *66–67 (quotation marks and citation omitted).
55. *See, e.g.*, *W.J. Schafer Assocs., Inc. v. Cordant, Inc*., 493 S.E.2d 512, 521 (Va. 1997) ("Today, however, we hold that promissory estoppel is not a cognizable cause of action in the Commonwealth, and we decline to create such a cause of action.").
56. *W.J. Schafer*, 493 S.E.2d at 521.
57. *See, e.g.*, *Abt Assocs.*, 104 F. Supp. 2d at 536 (Maryland law adopting four-part test set forth in Restatement (Second) of Contracts §90(1)).
58. *Trianco, LLC v. Internatl. Bus. Machs. Corp*., 271 Fed Appx. 198, 205 (3d Cir. 2008).
59. *Id.*
60. *Abt Assocs.*, 104 F. Supp. 2d at 536.
61. *Id.*
62. *Id.*
63. *Id.*
64. *See, e.g.*, *Trianco,* 2009 U.S. App. LEXIS 22213, at *9 (unjust enrichment claim dismissed because there was an enforceable preliminary agreement between the parties); *Saber Solutions, Inc. v. Protech Solutions, Inc*., No. 06-4922, 2009 U.S. Dist. LEXIS 88705, at *34 (D.N.J. Sept. 25, 2009) (unjust enrichment claim dismissed because there was no dispute that a written contract existed); *Quandry Solutions,* 2009 U.S. Dist. LEXIS 31459 at *54 ("Several courts have ruled that parties to failed contract negotiations may not rely on unjust enrichment to recover

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Enforceability of Teaming Agreements (cont'd):

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negotiation-related expenses. In such cases, each party seeks to advance its own interest in obtaining a valuable contract and any benefit conferred on the other party is incidental to that goal."); *Abt Assocs.,* 104 F. Supp. 2d at 535 (unjust enrichment claim dismissed because plaintiff's decision not to join a competing team was not a benefit conferred on defendant, and any damages would be speculative).

65. *Abt Assocs.*, 104 F. Supp. 2d at 535.
66. *International Cargo*, 1995 U.S. Dist. LEXIS 9577.
67. *Id.* at *34–35.
68. *Id.* at *36.
69. In the event that your client is eligible for small business set-asides, this step will ensure that the client does not inadvertently become affiliated with the other team member and thus become ineligible for set-asides.

Venture Capital Investment & Small Business Affiliation Rules: Why a Limited Exception is Crucial to Economic Recovery Efforts

by
*Jessica Tillipman & Damien Specht**

I. Venture Capital Companies & Small Business Concerns

Small businesses and venture capital are a natural pair. While many small businesses are born of technical expertise and innovation, few are well financed. One of the reasons for this lack of financing is that small concerns are often viewed as risky investments. Small businesses are rarely led by experienced business people and, as many statistics demonstrate, are more likely than not to fail.[1] Unlike their under financed counterparts, venture capital companies ("VCCs") are well financed and what they lack in technical capability, they make up for in business acumen and financial wherewithal. Moreover, risky investments with large upsides are exactly the type of opportunities that can produce significant returns for venture capital funds

In the commercial marketplace, many small businesses receive venture capital infusions to transform their ideas and research into viable products.[2] This same principle should apply to federal procurement, where Government procurement policies favor small business contracting, but early stage research and development funding is difficult to come by. VCC investment would be utilized to fill the gap between Government policy and economic reality. This type of investment would increase the pool of potential small businesses for federal procurement and help to diversify the government's contractor portfolio. Overall, this would have a positive impact on competition, a fundamental tenet of government procurement. There are also technological benefits: with the assistance of venture capital investments, small companies would have the freedom to develop cutting-edge technologies that larger, more established corporations are either unwilling or unable to develop.[3]

The mutually beneficial relationship between small business contractors and VCCs has been frustrated due to a complicated web of government regulations that, while well intended, have the effect of holding back promising small businesses in the federal marketplace. In this harsh economic climate, venture capital is crucial to small, innovative businesses. Although VCCs have felt the impact of the recession, they remain well equipped to aid small concerns[4] and their assistance is imperative.[5] As a result, now is the time to advance a compromise position that protects small business programs while encouraging venture capital investment in federal contractors.

II. Affiliation

Federal agencies are encouraged to set aside contracts for small businesses. These set asides limit competition to small businesses based on employee or revenue based metrics.[6]
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Small Business Affiliation Rules (cont'd):

Standing alone, the small businesses that receive venture capital investment are, in fact, small as measured by employees or revenue. Similarly, venture capital firms are often, at least by number of employees, thinly staffed small businesses. However, many small businesses that receive investments from similarly small VC companies are deemed to be large, and, as a result, ineligible for set aside awards by the Small Business Administration ("SBA"). If both VC firms and their investment targets are small, why is there a barrier to investing in small businesses that perform set aside contracts? The answer is "affiliation."

Affiliation, a concept developed to prevent small firms that are closely related to large firms from being awarded small business contracts, requires the SBA to analyze a company's size status by adding together the employees and revenue of related firms. More often than not, this analysis results in a determination that changes a company's size status from small to "other than small" without any actual change in that firm's employee count or revenues.

Affiliation is particularly relevant to the small business/venture capital relationship because the SBA frequently finds VCCs to be affiliated with not only a single small business, but also with the other portfolio businesses in which they invest.[7] This concept is vital for small businesses and venture capital investors to understand because once a small firm is deemed affiliated with a VCC, it will often exceed the SBA's size standards, will lose its small business size status and can no longer compete for set-aside work. This is likely to make the business a less profitable enterprise and a less attractive investment.

How does the SBA calculate affiliation? The answer is not entirely clear and is generally very fact specific. In cases where the small business is not majority owned by a single investor, SBA regulations note merely that it will examine the "totality of the circumstances" to determine if two (or more) businesses should be considered affiliated, and thus a single entity.[8] The regulations do however list some factors that, when present, increase the risk of two businesses being found to be affiliated including control, ownership, management, and contractual relationships.[9]

When VCCs invest in small businesses, the "control" factor often results in a finding of affiliation. Most VCCs require some level of control as a condition of their investment in a particular company. However, because small business set-asides minimize competition these same investors would prefer that the target small business retain its status. There is, therefore, a constant struggle to strike an appropriate balance between protecting an investment without triggering the "control" factor and jeopardizing the small business's size status.[10] Complicating this issue further is the fact that, for the purposes of affiliation, it does not matter whether control is exercised, as long as the power to control exists.[11]

Typically, a VCC will be found to control, and thus be affiliated with, a platform business through stock ownership.[12] Stock ownership may lead to affiliation under a variety of circumstances including when an entity owns a block of stock which is larger than other outstanding blocks of voting stock.[13] That said, ownership, of less than 50% of the voting stock

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Small Business Affiliation Rules (cont'd):

of an entity is not a safe haven from affiliation.[14] Rather, if two or more individuals or entities owns, controls, or has the power to control less than 50 percent of a business's voting stock, the SBA may make the counterfactual presumption that both individuals or entities either control or have the power to control a small business.[15] One caveat: if a business's voting stock is widely held and no single block of stock is large when compared with all other holdings, the business's board of directors and CEO or President will, in the absence of evidence to the contrary, be deemed to have the power to control the business.[16]

Control and affiliation may also be attributed to individuals who do not own stock in a particular concern.[17] For example, VCC investors will often require that employees of a particularly fund serve on the board of portfolio companies. This is risky because the SBA will find two concerns to be affiliated when one or more officers, directors or general partners of one concern control the board of directors and/or the management of one or more other concerns.[18] A further twist on this concept is that interests may be combined based on "identity of interests."[19] Individuals with an "identity of interest" affiliation may be found when individuals or firms that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships) are treated as one party because such interests are aggregated.[20] This determination may be rebutted with evidence that demonstrates the interests are separate.[21]

Another complication: control can be either affirmative or negative.[22] Affirmative control is a straightforward and will be found by the SBA if, for example, the VCC owns the majority of voting stock; or, controls the board of directors, or VCC approval is necessary before the company can make certain business decisions.[23]

Negative control, on the other hand, involves more subtle factors and may be challenging for VCC investors that rely on indirect methods to protect investments in portfolio companies. SBA's regulations provide that a concern has negative control and is affiliated with another when, "though lacking affirmative ability to approve actions, it can block corporate action by the other concern."[24] In determining whether a concern has negative control over another concern, the SBA considers whether: the affiliate has veto power, can block or deadlock the board's actions or can prevent a quorum at the shareholder or board of directors meetings. The SBA will also address the size of the other blocks of stock, whether there are any agreements that limit the amount of control the affiliate has over the concern[25] and the number of directors the alleged affiliate has on the board.[26]

While many venture capital firms have raised creative arguments to avoid findings of affiliation, most have failed. For example, many VCCs have argued that they are exempt from affiliation based on the exception found at 13 C.F.R. §121.103(b)(5)(i) for venture capital operating companies ("VCOCs") that provide financial, management or technical assistance under the Small Business Investment Act of 1958. This argument has repeatedly failed because

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Small Business Affiliation Rules (cont'd):

SBA's regulations explicitly limit the exception to *VCOC*s as defined by the Department of Labor regulations.[27]

VCC's have also argued that their passive "control" in a small business does not constitute affiliation, but this claim has been repeatedly rejected by the SBA.[28] According to the SBA it is not relevant that venture capital companies are passive investors if they have the potential to control a small business.[29] For example, in *Size Appeal of TSP TWO, Incorporated*, the contractor argued that it was not affiliated with two different companies--one of which was a holding company.[30] The holding company owned 74% of the contractor's stock and characterized itself as an "investment entity" without an active role in the management or operation of the contractor's business.[31] The SBA determined that the holding company was an affiliate for purposes of SBA size determinations basing its finding, in part, on the fact that the regulations consider an entity affiliated if it controls or has power to control 50% or more the contractor's voting stock.[32]

The affiliation rules place venture capital companies in a difficult position. By their nature, VCCs not only invest but want to participate (in varying degrees) in the management of their portfolio of businesses.[33] A VCC cannot own a majority of the small concern's stock or assume a majority position on the board of a small government contractor, however, because of the risk that a target small business will be found affiliated with the company and each of its portfolio businesses. Moreover, under SBA's current interpretation of its regulations, VCCs cannot safely install market standard negative covenants without risking a negative control finding. This regulatory strait jacket is a significant impediment to investment, which limits the growth of small businesses involved in government contracting.[34]

III. Current Legislative & Executive Initiatives in Support of Venture Capital

Recent legislative changes proposed by Congress and statements made by the Obama Administration suggest a more favorable view towards the small business-venture capital relationship. On the legislative front, Congress has proposed amendments to the Small Business Act that would permit VCCs to invest in small businesses without triggering affiliation.[35] The proposed amendments apply to small businesses that participate in the Small Business Innovation Research (SBIR) program. The SBIR program ensures that small, high-technology, innovative businesses receive a significant portion of the federal government's research and development funds.[36] Current SBIR regulations require participating small businesses be at least 51 percent owned and controlled by "natural persons" who are either U.S. citizens or permanent resident aliens of the United States; or, at least 51 percent owned and controlled by another business concern that is at least 51 percent owned and controlled by "natural persons[37] who are either U.S. citizens or permanent resident aliens of the United States.[38]

The SBIR/STTR Reauthorization Act of 2009 included proposed amendments to affiliation designed to encourage venture capital investment in small businesses.[39] Specifically,

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Small Business Affiliation Rules (cont'd):

the legislation provided that a business concern would not be considered affiliated with a VCOC if the VCOC owns less than 50 percent of the business and employees of the VCOC do not constitute a majority of the concern's board of directors.[40] Unlike the current affiliation principles, this legislation indicates that affiliation in some circumstances may be narrowly tied to stock ownership and seats on the board of directors. The other factors of affiliation, including negative covenants and management control, are notably absent from the language of the bill. Although this legislation does not apply to all small businesses, it does indicate Congressional intent that, for SBIR participants receiving specific types of venture capital funding, many of the affiliation factors may soon no longer apply.

The Obama Administration has also made statements that signal its support of venture capital. The Administration has stated it plans to improve the procurement system to attract venture capital-backed companies[41] and increase minority-owned business access to venture capital.[42] In addition, the President has appointed individuals with venture-capital backgrounds to several key positions; two such examples include SBA appointees Karen Mills and Winslow Sargeant.[43] These appointments indicate the Administration's support for venture capital. Indeed, Sargeant has specifically voiced his support for the inclusion of venture capital investments in SBIR participants.[44] These factors, while not dispositive, imply the Administration holds a favorable view towards of the role of venture capital in the procurement system.

IV. Affiliation Regime & the Negative Impact on Venture Capital

There is no doubt that the current economic climate has made it difficult for small businesses to raise capital from banks and other lenders.[45] In the Federal marketplace, this tightening has been exacerbated by the fact that the small businesses contractors who are able to locate VC financing are penalized for that support. Despite recent initiatives that support VC investments in small concerns, the current legislative regime limits the ability of small businesses to obtain capital without impacting their size status. This means companies must forgo VC-financing or risk losing eligibility to compete for small business set aside contracts and subcontracting opportunities with prime contractors who seek to meet small business subcontracting goals. As a result, some of the most innovative small businesses are disqualified from participating in federal programs simply because they receive no VCC funding.

A close read of the Small Business Investment Act of 1958 makes it difficult to understand why the SBA has failed to exempt VCCs from affiliation. Specifically, Section 103 of the statute states: "an investment by a venture capital firm . . (i) shall not cause a business concern to be deemed not independently owned and operated regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment; (ii) shall be disregarded in determining whether a business concern satisfies size standards established pursuant to section 3(a)(2) of the Small

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Small Business Affiliation Rules (cont'd):

Business Act; and (iii) shall be disregarded in determining whether a small business concern is a smaller enterprise. . .".[46] The plain language of this provision appears to expressly exempt VCC owned concerns from affiliation rules.

Created by Congress in 1953, the SBA is tasked primarily with the role of aiding, counseling, assisting and protecting the interests of small business concerns.[47] In other words, the "SBA helps Americans start, build and grow businesses."[48] Contrary to its founding principles, however, SBA's affiliation rules impair the ability of small businesses to obtain capital.[49] Specifically, when small government contractors obtain capital infusions from VCCs, the investment is likely to change the business's size status, to "other than small" under SBA size standards.[50] This new size status may result in the loss of government contracts that have been set aside for small businesses or those in which the agency requires performance by a small business in order to satisfy its small business goals.[51] Moreover, the loss of size status makes the business less attractive to prime contractors interested in the concern only to satisfy their small business subcontracting goals. This not only eliminates the small business's prime contracting opportunities, but also their subcontracting opportunities.

Although SBA claims the affiliation rules are designed to protect the interests of small businesses, when VCC investments are involved, the result is to the contrary. The small business loses its attraction when its size status and its size-dependent contracts are lost. This result is in direct contravention of the SBA's policy goals: it harms rather than protects small business interests.

V. A Proposal For Change

The government currently excludes most VCC-backed small businesses from competing for small business contracting opportunities, regardless of their potential to provide high quality products, services and solutions. It is at best illogical that small businesses be penalized because they have demonstrated significant market potential and received VCC funding. Well-meaning but misapplied small business regulations have the practical effect of eliminating small businesses that receive VCC backing from competing for small business contracts, and forces the small businesses to compete against large corporations for contracting opportunities. Given that small businesses cannot compete on the same level as their larger corporate counterparts, such as Lockheed Martin Corporation or General Dynamics, the small concerns are likely to lose these procurement opportunities and the government will lose out on new and advantageous business partnerships.

Despite their shortcomings, SBA's affiliation rules should not be eliminated entirely because they serve an important purpose. The government has an interest in ensuring that the small businesses, which receive set-aside contracts, are in fact small businesses. Moreover, the government must ensure that legitimate small businesses are not forced out of the federal marketplace by large businesses using small business fronts. The affiliation rules, while clearly

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Small Business Affiliation Rules (cont'd):

over inclusive, are effective in preventing this type of activity. At the same time, the current affiliation rules are holding many small businesses back from their potential and are limiting the types of innovate goods and services that are offered to the federal government.

To remedy this problem, the government must revise existing legislation and regulations to eliminate unreasonable restrictions on VCC-backed small business concerns while maintaining a regulatory regime that protects all small businesses. While encouraging VCC investment, an effective proposal cannot have the effect of squeezing out small businesses that lack such financing.[52] Rather, the solution that we propose attempts to strike a balance between these opposing positions. While there may be no perfect balance, regulatory reform focused on updating the concept of affiliation may provide venture capital access while maintaining the independence of small businesses. This balance, particularly during the current economic downturn, will provide much needed capital and spur small business growth.

One way to optimize venture capital involvement in small business government contracts is to provide VCC companies with a blanket exception to affiliation. This solution would permit the participation of a VCC-backed small business, regardless of the percentage of the business controlled by a VCC. This type of waiver would, however, allow VCCs the unfettered ability to create a series of business fronts to compete for small business set-asides. Large businesses could also create private equity funds and use these funds to access set-aside work. Neither of these scenarios, however, does anything to inspire entrepreneurs to start small businesses, encourage innovation or promote small business growth. Rather, an unlimited VCC affiliation waiver would squeeze independent small businesses out of government contracts, and consume available venture capital.

A more nuanced approach, modeled after waivers of the "non-manufacture rule," would have a more salutary effect on the type of venture capitol activity small businesses so desperately need while not foreclosing federal contracting opportunities. Under the "non-manufacture rule," in order to qualify as a small concern for a small business set- aside or an 8(a) contract to provide manufactured products, an offeror must be the manufacturer of the end item.[53] The SBA may waive non-manufacture rule requirements where it "determines that no small business manufacturer or processor of the product or class of products is available to participate in the Federal procurement market."[54] These waivers are specifically tailored to select North American Industry Classification Systems ("NAICS") codes where the SBA has determined that there are no small business manufacturers. This waiver process takes place largely in public, with notices required to be published in Commerce Business Daily and the Federal Register before they are granted.[55] Further, these waivers are not granted and forgotten. Rather, "non-manufacture rule" waivers are subject to challenge by private individuals and are periodically reviewed by SBA.[56]

A similar public process could be created with regard to waiver of the affiliation rules for VCCs. This system would have clear benefits over both current affiliation rules and an overall affiliation waiver. Affiliation waivers would be limited to NAICS codes in which SBA

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Small Business Affiliation Rules (cont'd):

determines that the class of product or service requires significant capital investments that would not be possible without venture capital involvement. For example, the VC community often argues that there should be a blanket affiliation waiver for all VCCs because some industries, such as biotechnology, require significant startup capital that is unlikely to be available from traditional sources. While a blanket affiliation waiver would be over-inclusive, a specific waiver for biotechnology related NAICS codes would increase access to VC funding while limiting crowding out of small businesses in other less capital intensive industries. In addition, these waivers have the benefit of being the result of public notice and comment, which will allow small businesses to directly impact the waiver process. The waivers, once granted, would be subject to periodic review to determine if significant VC involvement is still required. Independent small businesses working under specific NAICS codes could also challenge existing waivers as traditional funding becomes available.

With a NAICS code based affiliation waiver, VCCs would have the freedom to take a majority stock position in small businesses. VCCs could also impose affirmative and negative controls, which are central to protection of their investment in risky small businesses. These incentives, coupled with the ability to compete for small business set asides, have the potential to increase VC involvement in areas where capital is key—especially during this time of economic downturn.

VI. Conclusion

In this harsh economic climate, small businesses need assistance to weather the rough financial storm and VC firms bring managerial, technical and financial expertise to their portfolio companies without managing the day-to-day operations of small concerns. The beneficial nature of this relationship should not be hampered by a flawed regime based on absolutes that exclude VCC-backed small businesses from small business contracting opportunities. Nydia Velazquez, co-chair of the House Small Business Committee says it best when she states, "small firms must not be penalized for accepting investment they need to advance their R&D efforts."[57]

An exception to the affiliation rules must be made for VCC-backed firms if small businesses are to succeed in the current market. While a blanket exemption is not necessary, limited exemptions based on a firm's particular service or product is more than warranted. This solution will allow small businesses to obtain much-needed capital, while still remaining eligible to compete for small business contracts.

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Small Business Affiliation Rules (cont'd):

Endnotes

1. *See* U.S. Small Business Administration, Get Ready, http://www.sba.gov/smallbusinessplanner/plan/getready/SERV_SBPLANNER_ISENTFORU.html (explaining that "Starting a small business is always risky, and the chance of success is slim. According to the U.S. Small Business Administration, roughly 50% of small businesses fail within the first five years.").
2. National Venture Capital Association, *The U.S. Small Business Administration's Impact on the Future of Government Funded Innovation*, *available at http://www.nvca.org/index.phpoption=com_docman&task=doc_download&gid=226&Itemid=93.*
3. *See id.*
4. "With less money available at the source, professional venture capitalists are hanging on to what they've got. And their priorities are changing. Rather than take risky bets on promising new technologies, VCs are hunkering down, trying to make the most of what's already in their coffers." Peter Schnitzler, *The Recession's Domino Effect*, INDIANAPOLIS BUSINESS JOURNAL, May 11 2009, http://www.allbusiness.com/economy-economic-indicators/economic-conditions-recession/12347516-1.html. Still, although VCCs may be less likely to invest in risky projects, they have a unique ability to adapt to circumstances and will be a much relied-upon source of revenue for small businesses.
5. Pankaj Patel and Rodney D'Souza, Uncovering Knowledge Structures of Venture Capital Investment Decision Making, Office of Advocacy Working Paper, http://www.sba.gov/advo/research/rs315.pdf.
6. *See* 13 C.F.R. §121.201 (listing size standards).
7. *See e.g., Size Appeal of: Novalar Pharmaceuticals, Inc*., SBA No. SIZ-4977 (2008).
8. 13 C.F.R. §121.103(a)(5); 13 C.F.R. §121.103(a)(5) (2010); *Size Appeal of: Lance Bailey & Associates, Inc*., SBA No. SIZ-4817 (2006) ("Affiliation through the totality of the circumstances means that if the evidence is insufficient to show affiliation for a single independent factor (13 C.F.R. §121.103(c), (d), (e), (f), or (g)), the SBA may still find the businesses affiliated under the totality of the circumstances where the interactions between the businesses are so suggestive of reliance as to render the businesses affiliates."), In *Lance Bailey* the court made clear, however, that "totality of the circumstances is not an independent basis of affiliation" and that the "independent bases of affiliation . . . are the nucleus of a finding of affiliation through the totality of the circumstances." *Id.*
9. *See* 13 C.F.R. §121.103.
10. VENTURE IMPACT, THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY 5 (HIS Global Insight 5th ed.) ("Typically, VCs take seats on the boards of their portfolio companies and participate actively in firm management.")
11. 13 CFR §121.103(a)(1); *see also* Pine Products Corp. v. U.S., 19 Cl.Ct. 691, 695–96(1990)(discussing how the control factor is applied to joint ventures).
12. 13 C.F.R. §121.103(c).
13. For example, when a person, business or entity owns, or has the power to control, 50 percent or more of a small business's voting stock the two concerns will be found to be affiliated. 13 C.F.R. §121.103(c)(1).
14. *See Size Appeal of: Forterra Systems, Inc*., SBA No. SIZ-5029 (2009).
15. If these minority holdings are equal or approximately equal in size, and the aggregate of these holdings is large as compared with other stock holdings the SBA will find control. *See Size Appeal of: Forterra Systems, Inc*., SBA No. SIZ-5029 (2009).
16. 13 C.F.R. §121.103(c)(3); *see also Size Appeal of: Eagle Pharm., Inc*., SBA No. SIZ-5023 (2009). The three largest blocks of stock are: Investor 1-35.7%; Investor 2- Block which aggregated totals 34.5% and Investor 3-7.2%. Appellant's ownership structure would quickly run afoul of the multiple-largest minority shareholder rule, because the [Investor-1] and [Investor-2] Block holdings would be "equal or approximately equal in size" and their aggregate would be "large as compared with any other stock holding." Company tries to argue widely held rule applies. Court dismisses the argument: though the Investor 2 block consists over 20+ shareholders, this is not the definition of widely held.

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Small Business Affiliation Rules (cont'd):

Endnotes (cont'd)

17. 13 C.F.R. §121.103(e).
18. *Id.*
19. Identity of interest exists when individuals or firms that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships). 13 C.F.R. §121.103(f); *Size Appeal of: Taylor Consultants Inc*., SBA No. SIZ-5049 (2009).
20. 13 C.F.R. §121.103(f).
21. *Size Appeal of: Taylor Consultants Inc*., SBA No. SIZ-5049 (2009).
22. 13 CFR 121.103(a)(3); *see also Pine Products Corp. v. United States*., 19 Cl.Ct. 691, 695–96 (Cl.Ct.,1990 (explaining how control and affiliation apply to joint ventures).
23. *But see Size Appeal of: Cytel Software, Inc*., SBA No. SIZ-4837 (2007) (The SBA Board determined that though VC had role in appointing 3 people on the Board, that alone did not result in negative control.)
24. Though a concern does not possess a specific talisman of control, like the majority of voting stock, it controls the alleged affiliate because the business "is not entirely free to conduct its business as it chooses." *Size Appeal of: Regent Mfg.*, SBA No. SIZ-4533 (2003).
25. 13 CFR §121.103(a)(3); *see Size Appeal of: Eagle Pharm,, Inc*., SBA No. SIZ-5023 (2009) (finding negative control when a stockholder investor could block payment of dividends and creation of debt); *see also Size Appeal of: Regent, Mfg, Inc*. SBA No. SIZ-4533 (20030. (although not a VCC case, the SBA found negative control when a board required the concurrence of all board members in order to appoint an independent member). *But see Size Appeal of: EA Eng'g, Sci., & Tech., Inc*., SBA No. SIZ-4973 (2008) (finding where supermajority approval requirements for certain fundamental corporate actions not required for decisions regarding daily operations of the business did not constitute negative control).
26. *See Size Appeal of: Dell-Star Corp*., SBA No. -2663 (1987) (finding that although the affiliate VC had a minority interest of stock , through agreement, it had a majority position on the Board.).
27. *See Size Appeal of: Dell-Star Corp*., SBA No. -2663 (1987) (finding that although the affiliate VC had a minority interest of stock , through agreement, it had a majority position on the Board.).
28. *See*, *e.g., Size Appeal of: TSP TWO, Inc*., SBA No. 3009, (November 29, 1988) (explaining that the definition of "affiliates" in 13 CFR §121.103 (previously § 121.3) contains no exemption for venture capital firms). *Size Appeal of: Union Metal Corporation*, SBA No.-2578 (December 22, 1986) ("We have consistently held that investment companies, or holding companies, and the firms they own are subject to the affiliation rules because of the power of one to control the other or others.").
29. *See Size Appeal of: International Laser Machines Corp.*, SBA No.-2541 (November 7, 1986) (rejecting the argument that because a venture capital sponsor was merely a passive investor, it did not have the power to control the contractor and finding that investment/holding companies are not "within the terms of the specific exemptions in the size regulations . . . subject to affiliation rules.").
30. *Id.*
31. No. SBA No. 3009, (November 29, 1988),
32. *Id.*
33. The SBA also noted that the definition of affiliates found in the size regulations do not provide an exemption for venture capital firms and explained that there was no evidence to suggest that the investment company was exempt under the Small Business Investment Act of 1958 or the Investment Company Act of 1940. *Id*.
34. VENTURE IMPACT, THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY 5 (HIS Global Insight 5th ed.) ("Typically, VCs take seats on the boards of their portfolio companies and participate actively in firm management.").
35. Keric B. Chin and Richard J. Vacura, *Small Business: SBA Rules to Continue to Impact Ability of Small Businesses to Raise Capital*, BNA's Federal Contracts Report Analysis & Perspective, Aug. 25, 2009, *available at* Westlaw, 92 FCR 152(discussing factors investors should consider when making investment including: percent of ownership; the implications of shareholder voting agreements, corporate charters and bylaws, common management, and mutual business or economic interests. There are no bright lines or clearly delineated safe harbors to guide small businesses and investors).

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Small Business Affiliation Rules (cont'd):

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36. *See* SBIR/STTR Reauthorization Act of 2009, H.R. 2965, 111th Cong. (as passed by the House on July 8, 2009 and Senate on July 13, 2009).
37. Small Business Administration Website: http://www.sba.gov/aboutsba/sbaprograms/sbir/sbirstir/SBIR_SBIR_DESCRIPTION.html
38. United States citizens or permanent resident aliens of the United States. 13 C.F.R. §121.702(a).
39. *See* 13 C.F.R. §121.702(a).
40. *See* SBIR/STTR Reauthorization Act of 2009, H.R. 2965, 111th Cong. (as passed by the House on July 8, 2009 and Senate on July 13, 2009).
41. *Id.* The bill also states that a "VCOC controlled by a business with more than 500 employees has an ownership interest in a small business owned in majority by VCOCs, that small business is eligible to receive an SBIR or STTR award only if: (1) not more than two of such VCOCs have an ownership interest in the small business; and (2) such VCOCs do not collectively own more than 20% of the small business." *Id*.
42. http://www.nextgov.com/nextgov/ng_20090526_1094.php
43. *See also www.barackobama.com/pdf/SmallBusinessFINAL.pdf.*
44. Karen Gordon Mills, the current Administrator of the United States Small Business Administration, is a former private equity investor and adviser and the former founding partner and managing director of Solera Capital, a New York based venture capital firm. http://www.washingtonpost.com/wp-dyn/content/article/2008/12/19/AR2008121902112.html. Winslow Sargeant, the former managing director at the venture firm Venture Investors LLC, was appointed by the President as SBA chief counsel for advocacy .
45. http://blogs.wsj.com/venturecapital/2009/05/22/obamas-sba-nomination-nods-in-favor-of-vc-industry (citing a 2006 interview with the Wisconsin Technology Network in which Sargeant stated: "The majority of SBIR/STTR grants will still go to small business . . . [and the] rule limiting the size of a company to 500 employees or fewer would still be in effect. Early-stage research would not change significantly. I could see more partnerships with corporations."). U.S. Small Business Administration; Office of Advocacy, About Advocacy, http://www.sba.gov/advo/about.html. "The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Economic research, policy analyses, and small business outreach help identify issues of concern. Regional Advocates and an office in Washington, DC, support the Chief Counsel's efforts."
46. SBA Office of Advocacy: "Impact of Tight Money and/or Recessions on Small Business," (June 2003) *available at http://www.sba.gov/advo/research/rs230tot.pdf* ("Smaller businesses rely more on bank lending as a source of credit than do larger firms. As a consequence, smaller businesses may be more adversely affected when tighter monetary policies or adverse conditions in banking reduce the overall supply of bank loans."). *See also* Keric B. Chin and Richard J. Vacura, *Small Business: SBA Rules to Continue to Impact Ability of Small Businesses to Raise Capital*, BNA's Federal Contracts Report Analysis & Perspective, Aug. 25, 2009, *available at* Westlaw, 92 FCR 152 (hereafter "Chin & Vacura").
47. "About the Small Business Administration (SBA)," http://www.sba.gov/aboutsba/index.html (last visited November 30, 2010).
48. SBA: Overview & History, http://www.small business.gov/aboutsmallbusiness/history/index.html.
49. *See infra, fn.* 35 (Chin & Vacura, p. 1).
50. *Id.*
51. *Id.*
52. *See, e.g.,* Chapman, *Obama Appoints Venture Capital Executive to Head Small Business Administration*, HuffingtonPost.com (December 23, 2008) (arguing that by allowing VCC-backed small businesses to participate in the small business contracting regime, "billions of dollars [will be diverted] away from the middle class economy and into the hands of wealthy investors.").
53. 13 C.F.R. §121.406(a)(1).
54. 13 C.F.R. §121.406(b)(3)(ii).

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Small Business Affiliation Rules (cont'd):

Endnotes (cont'd)

55. 13 C.F.R. §121.1204(a)(4)(i).
56. 13 C.F.R. §121.1204(a)(7).
57. http://yourbiz.msnbc.msn.com/archive/2008/04/25/941211.aspx .

You Can't Get There from Here:
The Limitations of Accounting Software

by
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I. Background

It is said that accounting is the language of business. That being so, the financial information accountant's gather is the data on which business decisions are made. Today, accounting software is the tool that maintains every organization's financial information, and this is just as true for government agencies as it is for contractors, non-profits, universities, hospitals, and even small businesses. Like any software package, however, accounting software only does what it is programmed to do. The reality is, though, that accounting software is programmed only to do what the customer has paid for. Because of the Federal Government's dominant role in the economy, what software a government contractor uses is important as that software provides the information on which contractual, regulatory, and even judicial decisions are made.

II. The Accounting Software Market

The accounting software market today offers literally hundreds of packages. In general, a software product's features and capabilities (generically referred to as its "bells and whistles") are commensurate with their price. Inexpensive programs have limited capacity and features, while more costly programs are more versatile and have considerably greater capabilities. For example, some accounting software permits its data to be exported to word processing programs. Some do not. Some packages have foreign exchange conversion features. Some do not. (You get the idea.) However, no one software program offers everything, largely because there is no market for such a product. Instead, different software packages have different attributes to meet the needs of different user communities.

Consider the circumstances of a supply contractor with an inventory of products to be managed. Tracking that inventory is crucial to the contractor's profitability, which means being able to have the right products for the right customers at the right time and at the right price. Accordingly, the software used by this supply contractor must have the capacity to effectively handle the data for all products. There is certain minimum (or core) information that the company must have, but then there is also additional information the company might like to have. Of course, the software package must be able to handle the core information, such as product number, price, quantities, shipment date, customer, and so on. For additional

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capabilities, however, software manufacturers typically create modules that are separately priced. As an example, this supply contractor might want the module that integrates the inventory controls with the billing system – but that module costs more, and that usually presents a problem.

The acquisition of accounting software usually generates differences of opinion between management, the Information Technology (IT) group, and the accounting department. Management typically prefers the cheapest possible solution, which means acquiring only the basic software package. The accounting system then would only have core information, which greatly limits what the accounting department can do. On the other hand, accounting departments always want the accounting system to possess more than a minimum capability (i.e., more "bells and whistles"), but those additional features make the accounting package more expensive. For their part, IT groups are not generally cost conscious and lean toward the latest offerings.

The American Institute of Certified Public Accountants (AICPA) provides a great deal of information about accounting software to its members. In fact, the AICPA's *The CPA Technology Advisor* (formerly the *CPA Software News*) is one of the few publications that specializes in this area, and thank goodness as this is a field in a constant state of flux. New software products are always being brought to market, with better features and ever more sophisticated capabilities. As but one of many examples, user-friendly graphics used to be sold as separate modules, but are now standard with accounting software products. This is very helpful when financial presentations need to be made to non-accountants, as people who have difficulty understanding spreadsheet data can grasp a pie chart or trend line.

In addition to deciding on the accounting software to use, numerous related decisions must be made about how the organization will operate: Whether the company will operate via the Internet; whether it will do online banking; what kind of timekeeping system will the employees use; and on and on. While government contractors and grant recipients should choose the software package that best accommodates their organization, this unfortunately does not always happen. Management's decision, about how much to spend and what to get, are not always in accord with the accounting department's recommendations.

Regarding accounting software itself, there are three accounting functions that are critical to those having contracts or grants with the government. These essential functions are (1) audit trails, (2) internal controls, and (3) report modules. While these features are widely available, they are not always included in basic software packages, which is why organizations need to carefully evaluate any prospective accounting system with a careful definition of requirements and comprehensive, methodological assessment. Even where these three functions are offered, they are not always performed the same way by different accounting systems. Moreover, some software packages require users to take training classes even for core functions, offered at additional cost by the manufacturer (of course).

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III. Defense Contract Audit Agency

Whatever software products are chosen, the system will, at some point, be reviewed by a government auditor, usually from the Defense Contract Audit Agency (DCAA). This "systems review" is to determine the accounting system's capability to properly track costs under a government contract or grant. The Federal Acquisition Regulation (FAR) does not contain a listing of the attributes for an acceptable accounting system. For this reason, what will be deemed allowable is largely a matter of auditor judgment. However, the government auditor's discretion is not unbounded as the DCAA has issued guidance in this area. In deciding whether organizations have an accounting system that meets the government's minimum requirements, government auditors perform a review to determine the following (DCAA Audit Guidance, "Pre-Award Survey of Prospective Contractor Accounting System," April 2004):

1. Verify that the accounting system is working in accordance with generally accepted accounting principles (GAAP).
2. Determine whether the system will be able to identify and segregate direct costs from indirect costs.
3. Verify that the system can track direct costs by contract.
4. Test whether indirect costs are accumulated into logical groupings and that allocations are done on a causal/beneficial basis.
5. Ensure that the timekeeping and labor distribution systems appropriately identify direct and indirect labor charges to intermediate and final cost objectives.
6. Verify that the system is able to determine the cost of work performed at interim points (at least monthly) due to routine posting of costs to the books of account.
7. Verify that the system can identify and segregate unallowable costs as defined by FAR Part 31 and any applicable contract terms.
8. If required by the contract, ensure that the accounting system will be able to identify costs by contract line item number (CLIN) or by unit.
9. Determine whether the system will be able to segregate pre-contract costs from contract costs.
10. Verify that the accounting system can provide the minimum necessary cost information required by FAR 52.232-20 (Limitation of Cost) clause and applicable progress payment clause.
11. Determine whether the financial records are maintained in such a manner that adequate, reliable data is developed for use in pricing follow-on contracts.
12. Verify that the accounting system and its modules are currently in full operation.

Although an accounting software product might meet all of the above minimum requirements, particular capabilities may also be needed for the recordkeeping and/or reporting requirements of a certain project or contract. To that extent, the government auditor's review may be supplemented by additional tests.

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IV. Compliance

Once an organization's accounting software system is approved and in use, it becomes an integral element of that organization's compliance regime. Experience has shown that an organization's compliance program is the product of many variables: the size and types of contracts and/or grants being performed; the diversity of agency customers, each with their own FAR Supplement; the size and geographical distribution of the organization; recordkeeping and reporting requirements (legal, contractual, self-imposed, or otherwise); the proficiency of the organization's contract administrators; the amount of training employees receive; the activity of an internal audit or contract compliance department (if any); and numerous other minor factors. While the parameters of contract/grant compliance lie beyond the scope of this article, the underlying support for any organization's compliance program, whatever its size or scope, is its accounting system.

Recall earlier where it was pointed out how accounting software only performs functions the user has paid for. Consider an organization that has carefully assessed its compliance requirements, and has designed a compliance program to fully meet those requirements. Assume the organization acquired a software accounting package that met the needs of that compliance program. Significant problems may well arise, however, when *new* compliance requirements are imposed. This may occur via statutory or regulatory developments, or in some instances through merger and acquisition (M&A) activity. In any event, as a result of new developments the compliance program, and the accounting system of which it is a part, now no longer meets the needs of the organization because the accounting software is unable to provide the data needed for the new recordkeeping or reporting constraints.

The phrase widely used by accounting departments to describe these circumstances to management is that "you can't get there from here." In other words, the accounting system the organization is then using can no longer meet the needs of the compliance program without manual, time-consuming "work around" solutions. Management may be understandably unhappy with this news, particularly where the current accounting system has not been in use very long, or where the accounting department's recommendations for a more expensive software package were accepted, only to find that the additional features (or modules) are not capable of responding to the new requirements.

Over the years the compliance costs of government contracts/grants has grown, and continues to do so. This is a simply a cost of doing business with the government, which is why the government pays more for its goods and services. Over and above the costs of routine compliance, though, are the additional periodic costs of new accounting software. Because accounting software is the foundation for most other compliance activities, replacing the accounting system significantly roils related administrative processes and is a highly unsettling event for any organization. Training will frequently be a concomitant requirement of the new accounting system, and training takes more time and adds to the costs of system

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You Can't Get There from Here (cont'd):

implementation. Also, during the transition period many organizations find it necessary to create extensive, complex tables (called "cross walks") that seek to match the code numbers from the old legacy accounting system with those of the new accounting system. Regrettably, the carefully prepared cross walks do not always work well. Organizations belatedly discover that software accounting packages sometimes define specific accounts differently, and this causes problems when users find they cannot classify costs using the cross walks. Even more problems are encountered when customers (government agencies) begin receiving unfamiliar compliance reports from the organization that don't tie in with, and don't look the same as, the previously furnished reports.

V. Conclusion

Government contractors and grant recipients operate in a heavily regulated environment, and one susceptible to capricious political currents. Financial reporting is a critical component of any organization's compliance regimen, and one that is invariably integrated into other compliance systems. Organizations doing business with the government are forced to incur ever more expensive compliance programs, and this includes accounting software. Having the appropriate accounting software, however, does not always mean that the government's compliance requirements can be met. This is especially true when new compliance requirements are established, and organizations can get caught short.

In these situations, management discovers that they cannot achieve compliance with the accounting software they have. They are told, "You can't get there from here." Management knows that installing new accounting software will be expensive, time-consuming, and disruptive. Even worse, management also knows that new accounting software will only adequately support their compliance program until a new round of compliance requirements is imposed.

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