PRATT'S GOVERNMENT CONTRACTING LAW REPORT

VOLUME 10 **NUMBER 12** **December 2024**

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Library of Congress Card Number:

ISBN: 978-1-6328-2705-0 (print)
ISSN: 2688-7290

Cite this publication as:

[author name], [article title], [vol. no.] PRATT'S GOVERNMENT CONTRACTING LAW REPORT [page number] (LexisNexis A.S. Pratt)
Michelle E. Litteken, GAO Holds NASA Exceeded Its Discretion in Protest of FSS Task Order, 1 PRATT'S GOVERNMENT CONTRACTING LAW REPORT 30 (LexisNexis A.S. Pratt)

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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2024–Pub.4938)

Editor-in-Chief, Editor & Board of Editors

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Small Business Administration Proposed Rule Would Enact Material Changes and Promote Regulatory Uniformity Across Size and Status Programs—Part I

By Olivia Lynch, Michael E. Samuels and Zachary Schroeder*

In this two-part article, the authors discuss a proposed rule posted by the Small Business Administration (SBA) to update and clarify aspects of various SBA small business programs. In this first part, the authors review proposed changes related to minority shareholder negative control rights, size and status recertifications, and the ostensible subcontractor rule. In the next part, to be published in the January 2025 issue of Pratt's Government Contracting Law Report, *the authors will review proposed changes to the 8(A) BD program, the HUBZone program, miscellaneous proposed amendments to achieve uniformity across programs, and other miscellaneous proposed amendments.*

The Small Business Administration (SBA) has posted[1] a proposed rule to update and clarify aspects of various SBA small business programs, including but not limited to the HUBZone Program and 8(a) Business Development Program. This proposed rule followed SBA's July 22, 2024 notification of tribal consultation meeting and request for comments.

A major theme of the proposed rule is promoting uniformity across the size and status certification programs. SBA has apparently taken seriously feedback from small business that "improvements are needed to make its socioeconomic contracting programs more uniform, in order to relieve burdens associated with compliance with multiple programs."

CROSS-PROGRAM CHANGES RELATED TO MINORITY SHAREHOLDER NEGATIVE CONTROL RIGHTS

SBA proposes is to establish uniformity across the size, 8(a) Business Development (BD), Women-Owned Small Business (WOSB), and Service-Disabled Veteran Owned (SDVOSB) VetCert Programs as to the negative controls that minority investors can retain without giving rise to control and affiliation. As currently proposed, this change would be a notable change regarding minority blocking rights. SBA expects that by promoting uniformity and certainty as to the negative controls that would not give rise to affiliation

* The authors, attorneys with Crowell & Moring LLP, may be contacted at olynch@crowell.com, msamuels@crowell.com and zschroeder@crowell.com, respectively.

[1] https://www.federalregister.gov/documents/2024/08/23/2024-18325/hubzone-program-updates-and-clarifications-and-clarifications-to-other-small-business-programs?utm_campaign=subscription+mailing+list&utm_medium=email&utm_source=federalregister.gov.

or control that would be problematic for one or more statuses, investors may be more willing to invest in small businesses, thereby improving access to capital for these contractors.

State of the Current Regulations

Currently, SBA's affiliation regulation (13 C.F.R. 121.103(a)(3)) provides that control—giving rise to affiliation for size purposes—can be negative. While this regulation does not contain any exceptions, SBA's Office of Hearings and Appeals (OHA) developed a long line of caselaw distinguishing between ordinary and extraordinary actions: a minority investor's ability to block extraordinary actions that protect the minority shareholder's investment (e.g., adding new members, dissolution, bankruptcy, issuing additional capital stock, reclassifying interests, changing the size of the board, sale of all or substantially all of a concern's assets, etc.) would not give rise to control and, therefore, affiliation, while the ability to block an ordinary action (e.g., setting employee compensation, hiring and firing of employees, setting a budget, borrowing money, purchasing equipment, paying dividends, etc.) would give rise to control and, therefore, affiliation.

At the same time, the regulations regarding SDVOSB status currently include five extraordinary actions over which a minority investor may have blocking rights. Specifically, 13 C.F.R. 128.208(j) provides:

> SBA will not find that a lack of control exists where a qualifying veteran does not have the unilateral power and authority to make decisions regarding the following extraordinary circumstances:
>
> (1) Adding a new equity stakeholder;
> (2) Dissolution of the company;
> (3) Sale of the company or all assets of the company;
> (4) The merger of the company; and
> (5) Company declaring bankruptcy.

The regulations governing the 8(a) and WOSB Programs do not currently specify the types of blocking power a minority shareholder may have, if any.

SBA'S Proposed Changes to the Regulation

In order to establish uniformity, SBA is proposing to add one additional "extraordinary circumstance" to the VetCert regulations (at 13 C.F.R. 128.203(j)), namely that a minority investor may be able to block amendments of the company's corporate governance documents that would remove the shareholder's authority to block any of the other extraordinary actions.

SBA is also proposing to amend the affiliation test on negative control (at 13 C.F.R. 121.103(a)(3)) and to add the same language to the regulations governing the 8(a) BD Program (at 13 C.F.R. 124.106(h)) and WOSB Program (13 C.F.R. 127.202(h)):

> SBA will not find that a minority shareholder has negative control where such minority shareholder has the authority to block action by the board of directors or shareholders regarding the following extraordinary circumstances:
>
> (i) Adding a new equity stakeholder;
>
> (ii) Dissolution of the company;
>
> (iii) Sale of the company or all assets of the company;
>
> (iv) The merger of the company;
>
> (v) The company declaring bankruptcy; and
>
> (vi) Amendment of the company's corporate governance documents to remove the shareholder's authority to block any of (1) through (5).

The proposed regulation would allow minority shareholders fewer control rights with respect to their investments in small businesses (that are not eligible for any status) than are currently available under OHA caselaw while at the same time providing for greater control rights for minority shareholders in 8(a) BD Participants and WOSBs that are akin to those currently available in SDVOSBs.

Request for Comments

SBA specifically requested comments, which were due by October 7, 2024, as to whether the six identified exceptions are sufficient or whether one or more additional exceptions should be included in the regulations.

CROSS-PROGRAM CHANGES TO SIZE AND STATUS RECERTIFICATIONS

Another significant change is SBA's proposal to delete the recertification requirements regarding size and status from the program-specific rules and add a new section (13 C.F.R. 125.12) that would impose uniformity around the impact of recertification. As is discussed below, SBA is proposing to write-out of its rules the longstanding exception regarding the impact of recertifications under GSA FSS contracts, overturn recent caselaw about the impact (or lack

therefore) on eligibility for set-aside task orders after a recertification following merger, sale, or acquisition, and allow additional opportunities for protests related to orders.

State of the Current Regulations

The current regulations regarding the impact of recertification are contained in different places for size (13 C.F.R. 121.104), HUBZone (13 C.F.R. 126.619), WOSB (at 13 CFR 127.504(h)), and VetCert (at 13 C.F.R. 128.401(e)) Programs. While there are obvious differences between these regulations, SBA has indicated in its commentary that such differences are unintentional.

SBA'S Proposed Changes to 13 C.F.R. 121.404

SBA is proposing to clarify, in a significantly revised 13 C.F.R. 121.104, that there are "three, narrow exceptions to the general rule that the date on which size is determined for an order or agreement against a [multiple award contract (MAC)] is dependent on whether the underlying MAC was set aside for small business or unrestricted."

First, when size recertification is triggered pursuant to any scenario outlined in the new proposed regulation 125.12, the date to determine size will either be the date of the triggering event or, if the CO has requested recertification with the offer, the date of initial offer for a particular order or agreement (per 13 C.F.R. 121.404(b)(4)(iii)).

Second, for set-aside orders or agreements placed against General Services Administration's Federal Supply Schedule (FSS) contracts, an exception currently exists so that, broadly speaking, size status is determined as of the date of offer for the underlying FSS contract. Under the proposed rule, however, if a trigger for size recertification occurs under 13 C.F.R. 125.12 (including a contracting officer (CO) recertification request associated with a specific set-aside order or agreement against the FSS contract) size status would be determined either as of the date of the trigger or as of the offer date for a particular order, depending on the trigger involved. In its commentary, SBA states that it is clarifying that (1) when a CO requests recertification of size with respect to an order or agreement, the FSS exception does not apply, and (2) if there is a disqualifying size recertification in response to any event in 125.12 (including a merger, sale, or acquisition), the concern must notify the CO for the underlying contract, notify the CO for each existing order, and update its SAM.gov profile to reflect its current size status—which renders the concern no longer eligible for set-aside orders or agreements against the FSS contract.

Third, for 8(a) sole-source awards issued against MACs, regardless of whether the underlying MAC (1) is unrestricted, (2) set-aside (even if the underlying

MAC itself was set-aside for 8(a) Participants), or (3) under the GSA's FSS contracts, the concern must qualify as small for the size standard corresponding to the NAICS code assigned to the order or agreement as of the date of initial offer for and award of the order or agreement (per 13 C.F.R. 121.404(b)(4)(ii)).

SBA'S Proposed Roll-Out of New 13 C.F.R. 125.12

Per SBA, "[s]ize and status recertification is a complex area of SBA's regulations that requires simplification and clarity, especially in the context of exceptions to recertification and the impact of recertification" and as such SBA is proposing to simplify and place all relevant regulations in a newly created 13 C.F.R. 125.12. SBA also takes issue with recent decisions from the Government Accountability Office (GAO) and SBA's OHA regarding recertifications and intends to correct (what SBA perceives as) the misinterpretation of its regulations arising out of those decisions—with the impact that recertification as other than small or other than a particular required status is, by and large, disqualifying for future awards.

The rule will continue to be that a concern recertifying as other than the size or status required under an award it is already performing may continue to perform for the existing period of performance. The issue of whether such a concern "can continue to receive future orders under an underlying contract or agreement after it submitted a disqualifying recertification depends upon whether the underlying contract or agreement is a single award or a multiple award vehicle." To that end, SBA's commentary and proposed new 13 C.F.R. 125.12(e) provide the following:

- For a single award small business contract or any unrestricted contract, a concern that recertified as other than small or other than the required small business program status:
- Remains eligible to receive options and
- May receive orders or agreements issued.
- Under both of these circumstances, the procuring agency cannot count the options or orders as an award to a small business or small business program participant for goaling purposes.
- For any multiple-award small business set-aside or reserve, a concern that recertified as other than small or other than the required small business program would:
- Be ineligible to receive options and
- Be ineligible for orders set aside for small businesses or set aside for a specific type of small business.

- If a disqualifying recertification event occurs "after an offer is submitted but prior to award," recertification will be required for an award set aside or reserved for small business—a concern must recertify its size and, where appropriate, status, if a merger, sale or acquisition occurs after an offer is submitted but prior to award. Continued eligibility to receive the award will depend on when the sale, merger or acquisition occurred. If it was within 180 days of offer submission and before award, the concern is ineligible for the award. If it occurred after 180 days of its offer and before award, the concern would continue to be eligible for the award.

As noted above, SBA specifically takes issue with several recent decisions from GAO and OHA—both of which SBA believes adopted incorrect interpretations of SBA's size recertification regulations. These cases include:

- OHA's 2021 decision in *Size Appeal of Odyssey Systems Consulting Group, Ltd.*,[2] where OHA ruled that, under a MAC (in this case OASIS) set aside for small businesses, even if a contract novation (or a merger or acquisition not requiring novation) renders the contractor other than small, the contractor remains eligible for award. In that decision, the only impact of the change in status was that the agency could not count any new orders toward its small business contracting goals. SBA had filed comments in the case, seeking to distinguish between size recertifications requested by a contracting officer and recertifications following a merger, sale, or acquisition—but only as that distinction relates to timeliness for size protests. SBA seemingly feels like too much weight was placed on its comments.
- OHA's 2024 decision in *Size Appeal of Saalex Corp. d/b/a Saalex Solutions, Inc.*,[3] in which OHA ruled that if a concern recertifies as other than small following a merger, sale, or acquisition, the concern may remain eligible for future set-aside orders under an unrestricted MAC, but not provide goaling credit.
- The 2023 GAO decision in *Washington Business Dynamics, LLC*,[4] in which GAO extended the FSS exception to apply to size recertifications for orders placed under other MACs.

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[2] Size Appeal of Odyssey Systems Consulting Group, Ltd., SBA No. SIZ-6135 (2021).

[3] Size Appeal of Saalex Corp. d/b/a Saalex Solutions, Inc., SBA No. SIZ-6274 (2024).

[4] Washington Business Dynamics, LLC, B-421953, B-421953.2 (Dec. 18, 2023).

SBA'S Proposed Change to Size Protest Triggers in 13 C.F.R. 121.1001

SBA is also proposing to allow requests for size determinations following any size recertification made under 125.12(a) and (b) as well as those requested by a CO as set forth in 125.12(c). SBA is proposing to specifically authorize the contracting officer, the relevant SBA program manager, or the Associate General Counsel for Procurement Law to request a formal size determination. Additionally, the proposed rule would specify that, in connection with a size recertification relating to a MAC, any contract holder on that MAC could request a formal size determination concerning a recertifying concern's status as a small business.

Request for Comments

Of all the proposed changes discussed above, SBA only specifically requested comments (which were due October 7, 2024) on whether to allow size protests in connection with the award of an order issued under a multi-agency MAC where the protest relates to the ostensible subcontractor rule. As many disappointed offerors have discovered, unless a CO requested a size recertification for a particular order, the disappointed offeror is not currently able to challenge a prime's undue reliance on a subcontractor for an order—even though that information would not have been available for use in a size protest at the time of the underlying contract award.

CHANGE TO THE OSTENSIBLE SUBCONTRACTOR RULE—WHICH MATERIALLY CHANGES USE OF MPJVS

State of the Current Regulations

In a May 2023 rulemaking, SBA had written what appeared to be exemptions to the ostensible subcontractor rule into its affiliation rule (13 C.F.R. 121.103(h)(3)). Specifically, the newly revised regulation provided:

> A contractor and its ostensible subcontractor are treated as joint venturers for size determination purposes. An ostensible subcontractor is a subcontractor that is not a similarly situated entity, as that term is defined in § 125.1 of this chapter, and performs primary and vital requirements of a contract, or of an order, or is a subcontractor upon which the prime contractor is unusually reliant. As long as each concern is small under the size standard corresponding to the NAICS code assigned to the contract (or the prime contractor is small if the subcontractor is the SBA approved mentor to the prime contractor), the arrangement will qualify as a small business.

In this new rulemaking, SBA recognizes that the language specifying that a teaming arrangement will not render the prime to be deemed other than small so long as the subcontractor is the prime's SBA-approved mentor has "caused some confusion." SBA states that "[i]n the context of a subcontractor that is an SBA-approved mentor of the prime contractor, in treating the relationship 'as a joint venture,' SBA intended to allow the relationship to qualify as a small business only if all the joint venture requirements were met." In other words, that the protégé and mentor have an underlying joint venture agreement that meets the requirements of 125.8(b), the protégé will direct and have ultimate responsibility for the contract, and the performance of work requirements set forth in 125.8(c) will be met.

SBA'S Proposed Changes to the Regulations

SBA indicated that in light of the confusion it is proposing to remove the above-quoted language related to the impact of SBA-approved mentor and protégé relationships on the ostensible subcontractor rule.

SBA is now proposing instead to add a section (v) to the ostensible subcontractor portion of the joint venture affiliation test (at 13 C.F.R. 121.103(h)(3)) that would, in essence, impose two new requirements on small business joint ventures—that the managing venturer perform the primary and vital requirements of the contract and not be unusually reliant on its joint venture partner:

> A joint venture offeror is ineligible as a small business concern, an 8(a) small business concern, a certified HUBZone small business concern, a WOSB/EDWOSB concern, or a VO/SDVO small business concern where SBA determines that the managing joint venture partner will not perform 40% of the work to be performed by the joint venture, where a joint venture partner that is not similarly situated to the managing venturer performs primary and vital requirements of a contract, or of an order, or where the managing venturer is unusually reliant on such a joint venture partner.

For those contractors in joint ventures formed pursuant to mentor and protégé relationships (hereinafter referred to as an MPJV), this would be a significant departure with respect to MPJV eligibility. The proposed language essentially imposes two new requirements on an MPJV (as well as providing two new bases for size or status protests of MPJVs): first, that the managing venturer perform the primary and vital requirements of the contract or order, and, second, that the managing venturer not be unusually reliant on its JV

partner. (Note, this rule change is not limited to MPJVs but would also impact joint ventures formed by all small businesses—although one can imagine that challenges around unusual reliance on a JV partner will be most easily targeted at MPJVs.)

Other Changes to the SBA's Mentor-Protégé Program and Small Business Joint Venture Regulations

In addition to the two most consequential changes to the use of MPJVs discussed above, SBA proposes the following—with some of these revisions clarifying changes that were made in SBA's May 2023 rulemaking:

- *Clarifying Evaluation Criteria for Small Business Joint Ventures Following COFC's Decision in SH Synergy, LLC v. United States*.[5] Currently, SBA's regulations on joint ventures provide that a procuring activity may not require a protégé firm to individually meet the same evaluation or responsibility criteria as that required of other offerors generally. But SBA recognizes that, in light of the requirement that a protégé perform 40% of the work to be performed by the joint venture, COs have been trying to find ways to require protégé joint venture partners to demonstrate some level of past performance as part of a joint venture's offer (see the *SH Synergy* decision). SBA is now proposing to provide guidance for such situations, allowing a procuring activity to require some past performance at a dollar level below what would be required of joint venture mentor partners or of individual offerors.
- *Clarifying Ability of Joint Ventures to Recertify*. SBA is proposing to clarify (at 13 C.F.R. 125.12(f)) that, where a joint venture must provide a recertification, the joint venture can recertify as small where (1) all parties to the joint venture qualify as small at the time of recertification, or (2) the protégé small business in a *still active* mentor-protégé joint venture qualifies as small at the time of recertification. SBA is further clarifying that such recertification as small does not implicate the two-year cap on joint ventures (at 13 C.F.R. 121.103(h)).
- *Clarifying Name in Which JV Awards Must be Made*. SBA is proposing to amend the current small business joint venture regulation that allows a procuring activity to execute a contract in the name of the joint venture entity or a small business partner to the joint venture (at 13 C.F.R. 125.8(f)) to clarify that if there is a separate legal entity, the award to the JV must be made in the name of the JV. SBA had only intended to allow JV awards to be made in the name of the small

[5] SH Synergy, LLC v. United States, 165 Fed. Cl. 745 (2023).

business partner where the JV was not a separate legal entity.

- *Clarifying that Non-Profits May Not Be Mentors*. While SBA's commentary on the roll-out of the All-Small Mentor-Protégé Program in 2016 made clear that only for-profit entities could be mentors, SBA is now proposing to make this clear in its regulations (at 13 C.F.R. 125.9).
- *Clarifying an Entity May Only Be a Protégé for 12 Years*. In May 2023, SBA revised[6] the mentor-protégé program regulations to allow a protégé to elect to maintain its mentor-protégé relationship with the same mentor as opposed to having two separate mentors for 6 years each. Out of an abundance of caution, SBA is proposing to clarify its regulations (at 13 C.F.R. 125.9) to specify that a firm can only be a protégé for up to 12 years, regardless of whether the concern has a mentor-protégé relationship with two different mentors or the same mentor for a second six-year period.
- *JV Purchase—Right of First Refusal to the Protégé*. SBA is proposing to add a provision to its mentor-protégé program regulations (at 13 C.F.R. 125.9(d)) to specify that where a mentor seeks to sell its interest in a mentor-protégé joint venture, the protégé firm shall have a right of first refusal to purchase that interest.
- *Providing Protégé Rights with Respect to the Mentor-Protégé Agreement (MPA) Where the Mentor Is Acquired*. Currently, SBA's regulations allow for the continuation of a mentor-protégé relationship when a mentor is acquired by another firm, so long as the purchasing firm commits to honoring the obligations under the seller's MPA. SBA recognizes that, as drafted, the protégé does not have any rights where a sale of its mentor occurs, and there are certainly situations where the purchasing concern "may not be the best business concern to carry out the previous mentor's commitments." Per SBA, "[w]here the purchasing concern is not able to fulfill the requirements of the existing mentor-protégé agreements as written," the protégé should be able to either negotiate a revised MPA with the purchasing concern or terminate the MPA if the protégé believes the new entity is not a good fit. As always, SBA would need to approve any revisions to an MPA. But should the protégé terminate the MPA post-acquisition, SBA is proposing that the protégé could seek another business concern to enter an MPA for a duration not to exceed six years minus the length of the mentor-protégé

[6] https://www.federalregister.gov/documents/2023/04/27/2023-07855/ownership-and-control-and-contractual-assistance-requirements-for-the-8a-business-development.

relationship with the former mentor.

- *Clarifying the Impact of Pre-Mentor-Protégé Relationship Affiliation Between the Mentor and Protégé*. The longstanding rule has been that SBA will not approve a mentor-protégé relationship between two firms that are already affiliated. While SBA did not address this proposed change in its commentary, SBA nonetheless is proposing to clarify (at 13 C.F.R. 125.9(b)(2)) that SBA will decline an application not only if the proposed mentor is otherwise affiliated with the proposed protégé but also if the mentor "employs or otherwise controls the managers or key employees of the protégé." In the same vein, SBA is also proposing to update its regulations to provide for SBA termination of an MPA not only if the entities were affiliated at the time of application or become affiliated during the relationship for reasons other than assistance provided pursuant to the MPA but also if "[k]ey managers or personnel become employees of both the mentor and protégé firms at the same time." It is not clear how key employees will be defined here—for example, whether we should be looking to the definition of key employee from the newly organized concern affiliation test (of 13 C.F.R. 121.103).

Then, coming out of SBA's rule change in May 2023 authorizing a mentor to purchase another business entity that is also an SBA-approved mentor if the purchasing mentor commits to honoring the obligations under the seller's mentor-protégé agreement, SBA is now proposing the following material change to the regulations:

- *Competition Amongst Joint Ventures Would Require Mentor Exit from a JV.* SBA's current regulations prohibit a mentor that has more than one protégé from submitting competing offers in response to a solicitation for a specific procurement through separate joint ventures with different protégés. SBA is now proposing that where a mentor purchases another business entity that is an SBA-approved mentor and a MAC holder as a joint venture with a protégé small business, and the purchasing mentor is a contract holder with a protégé small business on that same MAC, the mentor must exit one of those joint venture relationships. In light of the potential adverse impacts to one of the protégés, SBA is proposing to allow the protégé firm connected to the joint venture from which the mentor exits to seek to either acquire the new mentor's interest in the underlying MAC or reserve and work with the CO to determine whether novation of such contract or reserve to itself only may be appropriate, or to allow the protégé to seek to replace the new mentor with another business in the joint venture such that the

revised joint venture continues to qualify as small.

* * *

Editor's note: The conclusion of this article will appear in the next issue of *Pratt's Government Contracting Law Report.*