Congress of the United States
Washington, DC 20515

TO: **Members, Subcommittee on Contracting and Workforce, Committee on Small Business Members, Subcommittee on Oversight and Investigations, Committee on Veterans' Affairs**

FROM: **Committee Staff**

DATE: **Thursday, February 28, 2013**

The Small Business Committee's Subcommittee on Contracting and Workforce and the Veterans' Affairs Committee's Subcommittee on Oversight and Investigations will meet for a hearing titled, *Consistently Inconsistent: Challenges for Service-Disabled Veteran-Owned Small Businesses*. The hearing is scheduled to begin at **10:00 A.M., March 7, 2013, in Room 2360 of the Rayburn House Office Building**.

The Subcommittees will meet to examine challenges facing service-disabled veteran-owned small businesses (SDVOSBs) seeking federal contracts using both the Small Business Administration (SBA) and Department of Veterans Affairs (VA) contracting programs. Specifically, the Subcommittees will hear testimony regarding the statutory, regulatory and interpretive differences in the two programs and how these differences affect veterans. Additionally, the Subcommittees will look at how effectively the programs operate, and explore ways to improve the efficiencies of the programs.

The first panel of witnesses will include Mr. Richard Weidman, Executive Director, VET-Force, Washington, DC; Mr. Davy Leghorn, Assistant Director, National Economic Division of the American Legion, Washington, DC; and Mr. Marc Goldschmitt, PMP, CEO, Goldschmitt and Associates, LLC. Reston, VA. The second panel is composed of Mr. William Shear, Director, Financial Markets and Community Investment, Government Accountability Office (GAO), Washington, DC; Mr. A. John Shoraka, Associate Administrator, Office of Government Contracting and Business Development, SBA, Washington, DC; and Mr. Tom Leney, Executive Director, Veterans and Small Business Programs, VA, Washington, DC.

I. Introduction

Both the SBA and the VA operate procurement programs for SDVOSBs. The SBA program applies to procurements at all agencies other than VA, whereas the VA program applies only to VA contracts. While both programs apply nearly identical statutory definitions of a SDVOSB, both Committees have received complaints that the application of the statutory programs is resulting in disparate decisions. Therefore, this memorandum will discuss the statutory differences between the programs as well as the regulatory and interpretative differences between the programs. Finally, the memorandum will address the operation of the both programs.

II. Statutory Differences in the SDVOSB Contracting Programs

The Veterans Benefits Act of 2003 (VBA) amended the Small Business Act to create a governmentwide procurement program for small businesses,[1] while the Veterans Benefits, Health Care, and Information Technology Act of 2006 (VBHCITA) created the SDVOSB contracting program at VA.[2] The statutory

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[1] Pub. L. No. 108-183, Title III, §308, 117 STAT. 2662 (2003) (codified at 15 U.S.C. §657f).
[2] Pub. L. No. 109-461, 120 STAT. 3431 (2006) (codified at 38 U.S.C. §§8127-8128). The VBHCITA also create a set-aside program for Veteran-Owned Small Businesses (VOSBs). While there is only a subcontracting goal for VOSBs

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foundations of the two SDVOSB programs vary in three principal ways. First, the definition of a SDVOSB is slightly different. Second, the scope of the contracts to be awarded differs. Finally, the relationship between the SDVOSB program and other small business contracting programs is different.

With a few important exceptions, the VBA and the VBHCITA use the same definitions, relying on the VA's definitions of veteran or service-disabled veteran (SDV) to determine whether an individual qualifies for the program, and using the Small Business Act definitions of small business.[3] This is eminently sensible, as it entrusts to each agency that which the agency has the most experience defining. The only difference occurs when the two concepts are combined in an attempt to define SDVOSBs. Both statutes agree that the term means a small business concern that is at least 51 percent owned by one or more SDVs or, in the case of any publicly owned business, not less than 51 percent of the stock of which is owned by one or more SDVs.[4] However, there are three critical differences. First, the VBA, but not the VBHCITA, explicitly extends benefits to firms that, "in the case of a veteran with permanent and severe disability, the spouse or permanent caregiver of such veteran."[5] The discrepancy regarding permanent caregivers is addressed by VA in its regulations, which extends rights to these individuals.[6] Second, the VBHCITA but not the VBA allows the surviving spouse of a veteran to continue participating as a SDVOSB for up to ten years if, after the death of a veteran, the surviving spouse of such veteran acquires ownership rights.[7] Third, and perhaps most importantly for the scope of this hearing, the VBA permits self-certification by SDVOSBs, subject to protests, while the VBHCITA requires that VA maintain a database of SDVOSBs that are certified as such by the VA.[8]

In addition to the differences in the applicable definitions, the scope of contracting authority between the two programs is slightly different. The VBA allows any federal agency to restrict competition to SDVOSB companies "if the contracting officer has a reasonable expectation that not less than 2 small business concerns owned and controlled by [SDVs] will submit offers and that the award can be made at a fair market price."[9] If the contracting officer does not have a reasonable expectation that at least two SDVOSBs will submit offers, but the contracting officer believes that the award may be made to a responsible SDVOSB for a fair and reasonable price that does not exceed $6.5 million in the case of a manufacturing contract or $4 million for all other contracts, the contracting officer may award a sole source contract.[10] Any company receiving a contract pursuant to this authority is limited in the amount that they can subcontract, so that a SDVOSB does not win the contract only to subcontract all of the work to a non-SDVOSB company.[11] The VBHCITA allows set-aside contracts under the same circumstances as the VBA, but does not restrict subcontracting and only allows sole source contract up to $5 million.[12]

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under the Small Business Act, the certification issues described herein are generally applicable to VOSBs except for the lack of a prime contracting certification process at SBA.

[3] Section 3(q) of the Small Business Act defines "veteran" in accordance with 38 U.S.C. § 101(2) and service-disabled veteran is defined per 38 U.S.C. § 101(16). VBHCITA adds the definition of small business found in Section 3(a) of the Small Business Act to 38 U.S.C. § 8127(k)(1).

[4] Small Business Act, § 3(q)(2)(A); 38 U.S.C. § 8127(k)(2). *c.f.,* The VBHCITA actually requires that the service disabled veterans "are unable to manage the daily business operations of such concern," but in regulation this has been interpreted to require the management of the daily business operations. 38 C.F.R.§74.1.

[5] Small Business Act, § 3(q)(2)(B).

[6] 38 C.F.R.§74.1.

[7] 37 U.S.C. § 8127(h).

[8] Small Business Act, § 36(q)(2)(B). 38 U.S.C. § 8127(f).

[9] 15 U.S.C. § 657f(b).

[10] 15 U.S.C. § 657f(b). The statute provides dollar thresholds of $5 million and $3 million, respectively, but these have been adjusted for inflation pursuant to 41 U.S.C. § 1908.

[11] Small Business Act, § 46.

[12] 38 U.S.C. § 8127(c)-(d).

Finally, the relationship between the SDVOSB contracting program and other contracting authorities differ between the governmentwide program created by the VBA and the VA program created by the VBHCITA. The governmentwide program treats each of the small business contracting programs as equal, and allows the contracting officer to choose the most appropriate program for any given contract.[13] However, VBHCITA gives preference to SDVOSBs before awarding contracts pursuant to the other contracting programs.[14]

While these three types of differences may seem minor, the result is that a firm may qualify as a SDVOSB at VA but not for a contract at another agency, or vice versa. As will now be discussed, this statutory divergence is only magnified through regulatory differences.

III. Regulatory and Interpretative Differences

SBA and VA have both received criticism alleging that the regulatory differences between the two SDVOSB programs exceed those differences that would be expected given the statutory discrepancies. Thus, SBA and VA have undertaken joint review of the regulations governing each program and produced a chart that provides a section-by-section comparison of the existing regulations each believes are relevant (VA Chart).[15] VA has stated that this analysis demonstrates that there are only three differences between the regulations: (1) VA allows surviving spouses to inherit limited benefits; (2) VA requires change of ownership notification; and (3) VA has a program for veteran-owned small businesses (VOSB).[16] Furthermore, VA stated that they were aware of only one interpretive difference in the application of the regulations, and that concerned a question of whether SDVs control a company with a three-person board if one SDV and one non-SDV could align against a second SDV.[17] Based on this, the conflict would appear minimal at best. However, SBA has stated "while it is true that the wording of the regulations pertaining to the VA's and SBA's eligibly [sic] requirements is similar, there are some key differences in interpretations."[18] This memorandum will now briefly discuss the foundation of these differences.

The VA Chart compares three sources of regulations – VA's SDVOSB regulations, SBA's SDVOSB regulations, and SBA's 8(a) business development (8(a)) program regulations.[19] This framing of the discussion itself presents two problems. First, looking at the regulations regarding the 8(a) program may be informative, but should not be controlling since the programs have different statutory purposes. The 8(a) program is a time-limited program intended to assist socially and economically disadvantaged individuals trying to establish successful small businesses, and contracting is used as a tool in the development process.[20] In contrast, both SDVOSB programs are contracting programs intended to help the federal government meet its statutory goals of awarding at least 3 percent of all prime contract and subcontract dollars to SDVOSBs.[21] When VA patterned its rules off of the 8(a) program regulations, it failed to recognize this dichotomy. This has led to situations such as that where VA requires SDVOSB living in community property states to have their spouses

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[13] 15 U.S.C. § 637 note; *see* Committee on Small Business, "Small Business Act Programs for Small Federal Contractors" (2013) *available at* http://smallbusiness.house.gov/uploadedfiles/small_business_act_programs_for_small_federal_contractors.pdf (hereinafter "Small Business Act Programs") for information on the other federal contracting programs.
[14] 38 U.S.C. § 8127(i).
[15] On file with the Committee.
[16] Comments of Tom Leney, Executive Director of the Veterans and Small Business Programs for VA, to VET-Force (Feb. 12, 2013).
[17] *Id.*
[18] GAO, VETERAN-OWNED SMALL BUSINESSES: PLANNING AND DATA SYSTEM FOR VA'S VERIFICATION PROGRAM NEED IMPROVEMENT 56 (2013) (GAO-13-95) (hereinafter PLANNING AND DATA).
[19] 38 C.F.R. § 74; 13 C.F.R. §§ 125.8-125.29; 13 C.F.R. § 124. *See* Small Business Act Programs at 4-5 for additional information on this program.
[20] 13 C.F.R. § 124.1.
[21] Small Business Act, § 15(g); 38 U.S.C. § 8127(c).

preemptively relinquish any interest in the firm lest the spouse be considered an owner, even though VBHCITA will allow the same spouse to qualify for the program after the SDV's death – a requirement not found in SBA's SDVOSB program.[22] Additionally, like the 8(a) program, VA requires that SDVs receive the majority of the pay or profits of the firm.[23] SBA has not included this requirement in the SDVOSB regulations, although distribution of profits would be considered in analyzing control, because pay itself is not always determinative of control.

Perhaps more egregiously though, the VA Chart excludes the relevant SBA's regulations that address issues fundamental to whether a SDV owns and controls a firm and whether the firm is itself small, which are found at 13 C.F.R. § 121. These regulations provide the underpinnings for the ownership and control provisions found in SBA's SDVOSB and 8(a) programs. For example, it is this additional section of regulation that tells firms how stock ownership will be used to determine control of a company, and how board composition affects this calculus[24] – the very situation VA admitted caused interpretive differences.[25] However, these regulations go far beyond that one example – they address when agreements to act in the future will be given present effect, how to treat companies with common management, companies with substantially identical business or economic interests, companies spun off from other companies, joint ventures, companies that are unduly reliant on an ostensible subcontractor, companies with franchise and license agreements, or companies where the totality of the circumstances indicate that the business is not independently owned and controlled.[26] To attempt to determine if a firm is a SDVOSB without examining it in light of these regulations belies VBHCITA's direction to use SBA's definition of a small business, because these are the regulations that define whether a firm is small.[27]

This had led to bright line rules at VA that do not exist at SBA. For example, VA will deny SDVOSB status if ownership in the entity carries with it the requirement that a right of first refusal to purchase the SDV's ownership interest will be offered to another owner or third party.[28] While SBA does consider agreements regarding transfer of ownership, it looks at each agreement to determine whether its terms mean that the SDV does not unconditionally control the company. Similarly, VA requires that that at least one SDV who "manage[s] the applicant or participant must devote full-time to the business during the normal working hours of firms in the same or similar line of business."[29] SBA does not require this, as long as SDVs can prove actual ownership and control over day-to-day decisions.

Indeed, the regulatory and interpretive differences are being borne out by case law. Within SBA, any appeal regarding a firm's size or status is heard by the Office of Hearings and Appeals (OHA), a body of administrative judges that provides final agency action through published decisions. Recently, OHA identified fourteen cases:

> in connection with SDVO set-asides where (1) OHA determined the subject business concern was not small and thus was ineligible for the contract at issue, and (2) had the [VA regulations] been the sole governing rules, the business concern would have been eligible for the contract. In each of these 14 cases, the different outcome is owed to

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[22] 13 C.F.R. § 121.105(k); 38 C.F.R. § 74.3(f); *supra* note 7.
[23] 38 C.F.R. § 74.3(d)
[24] 13 C.F.R. § 121.103(c). For an in depth discussion of affiliation and control issues, see Committee on Small Business, "What is a Small Business for Purpose of Federal Contracting?"6-16 (2013) *available at* http://smallbusiness.house.gov/resources/committee-publications.htm.
[25] *Supra* note 17.
[26] 13 C.F.R. §§ 121.103(a)(5); 121.103 (d)-(i).
[27] *Supra* note 3.
[28] VA, Verification Assistance Brief – Transfer Restrictions *available at* http://www.va.gov/osdbu/veteran/transferRestrictionsBrief.asp.
[29] 38 C.F.R. § 74.4(c)(4).

the operation of SBA's affiliation rule at 13 C.F.R. § 121.103. The affiliation rule, an integral part of small business size analysis, is not a part of the DVA's SDVO status regulations.[30]

These cases should not be seen as an exhaustive list, since OHA does not have the ability to review cases that VA denies, nor does OHA see each case that VA approves. However, it does illustrate how different applications of regulations by even the most well-intentioned parties can lead to regulatory and interpretive discrepancies.

IV. Operational Issues

Both SBA and VA processes for certifying SDVOSBs are imperfect. As previously mentioned, SBA relies upon a process of self-certification. If a contracting officer, SBA, or an interested party believes that the firm does not qualify, they may raise a protest to the SBA Director of the Office of Government Contracting (DGC).[31] The DGC then has 15 days to investigate and issue a decision.[32] Appeals of the DGC's decision are heard by OHA and decided in 15 days, at which time a published decision is made publicly available.[33] While this process has the advantage of allowing nearly 13,000 SDVOSBs to quickly begin competing for contracts, it also leaves open the door for fraud.[34] Indeed, GAO previously recommended that the relevant parties expand "the use of the VA VetBiz 'verified' database governmentwide for purposes of validating all SDVOSB eligible firms for contracting."[35] However, VA has previously stated that such a program would cost nearly $100 million in annually, and GAO more recently tempered the recommendation, stating that "an expansion of VA's authority to address government-wide program problems should not be undertaken until VA demonstrates that its process is successful in reducing its own SDVOSB program's vulnerability to fraud and abuse."[36]

In contrast, VA's SDVOSB program has 4,102 SDVOSB currently certified in its database, each of which must be certified yearly.[37] Additionally, in fiscal year 2012, VA received 4,900 new initial applications for both the SDVOSB and VOSB program.[38] VA uses over 200 full time equivalents and spends $33 million a year running a four step certification process after an application is submitted:

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[30] Email from SBA to Committee Staff, "OHA decisions on Service-Disabled Veteran-Owned Status and Size Cases," (Feb. 12, 2013). The cases are: Size Appeal of Chu & Gassman, Inc., SBA No. SIZ-5394 (2012); Size Appeal of Chu & Gassman, Inc., SBA No. SIZ-5344 (2012); Size Appeal of EarthCare Solutions, Inc., SBA No. SIZ-5183 (2011); Size Appeal of Specialized Veterans, LLC, SBA No. SIZ-5138 (2010); Size Appeal of A1 Procurement, LLC, SBA No. SIZ-5121 (2010); Size Appeal of J.M. Waller Associates, Inc., SBA No. SIZ-5108 (2010); Size Appeal of DooleyMack Government Contracting, LLC, SBA No. SIZ-5086 (2009); Size Appeal of DooleyMack Government Contracting, LLC, SBA No. SIZ-5085 (2009); Size Appeal of Blue Cord Construction, Inc., SBA No. SIZ-5077 (2009); Size Appeal of Taylor Consultants, Inc., SBA No. SIZ-5049 (2009); Size Appeal of Heritage of America, LLC, SBA No. SIZ-5017 (2008); Size Appeal of Mission Solutions, Inc., SBA No. SIZ-4828 (2006); Size Appeal of B & M Construction, Inc., SBA No. SIZ-4805 (2006) Size Appeal of Catapult Technology, Ltd., SBA No. SIZ-4795 (2006).

[31] 13 C.F.R. § 125.24-25.

[32] 13 C.F.R. § 125. 25-27.

[33] 13 C.F.R. § 134-514.

34 SDVOSB numbers are taken from the SBA's Dynamic Small Business Search tool, *available at* www.dsbs.sba.gov; for information on fraud, see, e.g. GAO, CASE STUDIES SHOW FRAUD AND ABUSE ALLOWED INELIGIBLE FIRMS TO OBTAIN MILLIONS OF DOLLARS IN CONTRACTS (2009)(GAO-10-108) (hereinafter CASE STUDIES).

[35] CASE STUDIES at 21.

36 GAO, SDVOSB PROGRAM: VULNERABILITY TO FRAUD AND ABUSE REMAINS 2(2012) (GAO-12-697).

[37] www.vip.vetbiz.gov; 38 C.F.R. § 74.15; *c.f.* http://www.va.gov/osdbu/faqs/verification.asp (recertification is required every two years).

[38] PLANNING AND DATA at 44.

- VA employees screen it to ensure that it meets the minimum eligibility requirements;
- VA contractors conduct an initial evaluation and make a preliminary recommendation for approval, denial or additional review;
- VA contractors and employees review the initial recommendation, and if necessary, conduct site visits; and
- VA supervisors make a formal determination and issue a letter decision to the applicant.[39]

This process takes approximately 85 days, and 61 percent of applicants are accepted.[40] Those that are rejected may appeal the decision through a Request for Consideration, which is conducted by the VA's Office of General Counsel.[41] Requests for reconsideration are granted on 48 percent of appeals, but generally take an additional 147 days. In contrast with SBA's process where appeals are decided by independent judges "where the standard of review is whether the determination of eligibility was based on a clear error of fact or law or whether the decision was arbitrary, capricious or contrary to law[, VA] has no such appellate procedure."[42] VA's decisions are not published, and do not represent legal precedent.

GAO and the federal courts have taken issue with VA's process. GAO recently found that while "VA has made progress toward reducing its vulnerability to fraud and abuse," the agency's strategic planning and data capabilities necessary to prevent that fraud remain inadequate.[43] The Court of Federal Claims (COFC), when examining transfer restrictions and appeals under the VA process, found that VA's appeals process does not allow "basic procedural due process" and that the examination "contravened the minimal requirements for informal adjudication set forth in Section 555 of the [Administrative Procedures Act (APA)]."[44] While the GAO finding highlighted the lack of long term planning and data systems that allow VA to monitor applications and processes to ensure consistence, the COFC holdings go to a more crucial question – whether the verification system is able to address the tension between providing due process to SDVs firms and preventing fraudulent contracting.

V. Issues Before the Subcommittees

a. Statutory, Regulatory, and Interpretive Discrepancies

The Subcommittees have long heard SDVOSBs complain of discrepancies between the SBA and VA SDVOSB contracting programs. These discrepancies usually focus on the treatment of spouses, requirements related to full time employment, organization matters such as operating agreements and by-laws, definitions of unconditional ownership, and restrictions on the sale of ownership interests. The Subcommittees will explore to what extent these and other discrepancies are statutory, regulatory, or interpretive. To the extent that the differences are statutory, input is sought on whether legislative changes are necessary to ensure consistent eligibility determinations. If the discrepancies are regulatory, then the Subcommittees wish to examine whether there is a statutory basis for the regulatory differences, whether 8(a) program regulations provide a suitable counterpart for the VA regulations, and how regulations could be further harmonized. The Subcommittees recognize that even the clearest regulations will leave open questions for agency interpretation. Therefore, the Subcommittees also wish to explore how the SBA and VA can reconcile interpretive differences in the implementation of the programs.

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[39] PLANNING AND DATA at 8.
[40] *Id.* at 14, 44.
[41] *Id.* at 44; *supra* note 16. VA's regulations require a decision in 60 days. 38 C.F.R. §74.11.
[42] PLANNING AND DATA at 56.
[43] *Id.* at 33-34.
[44] Miles Construction, LLC v. United States, No. 12-597C 13, 25 (Fed. Cl. 2013); *see also* KWV, Inc. v. United States, No. 12-882C (Fed. Cl. 2013).

b. Fraud Prevention

The two programs offer a stark contrast in their approach to balance fraud prevention against cost and procedural efficiencies. The Subcommittees will explore ways to decrease the risk of fraudulent firms receiving contracts, while remaining mindful that the legitimate beneficiaries of these programs are small businesses with limited resources. The Subcommittees wish to examine both pre-award and post-award preventative measures, as well as whether contractual terms such as the limitation subcontracting clause may prevent some of the more egregious behavior.

c. Appellate Processes

Mindful that clear standards, binding precedents, and transparency are among the keys to a successful program, the Subcommittees will examine whether APA protections need reinforcement in the VA process.

d. GAO Findings

Given GAO's recommendations for the improvement of the VA program, and GAO's criticisms of the SBA self-certification program, the Subcommittees wish to explore ways each agency can address these findings.

VI. Conclusion

SDVOSBs received $12.2 billion in federal prime contracts in fiscal year 2012, and 27.5 percent of those contracts were awarded by the VA.[45] Therefore, the government needs to ensure that these dollars are spent with eligible firms, and that the benefit of the SDVOSB contracting programs is enjoyed by SDVs. This goal will only be met if the two primary programs for awarding contracts to SDVOSBs operate in an efficient, transparent, and compatible manner.

[45] Federal Procurement Data System, *available at* www.fpds.gov.