The SBA 8(a) “70 Percent Rule”

You are interested in obtaining 8(a) status for your company, but you have heard something about a nebulous “70 Percent Rule” that might be a disqualifying factor for your 8(a) application.

What is this mysterious 70 Percent Rule, and where did it come from?

This brief overview from Government Certification Specialists Inc. (GCS) provides you with a layperson’s understanding of the SBA 8(a) 70 Percent Rule so you can make a go/no-go decision about pursuing 8(a) certification for your company.

Where did the 70 Percent Rule come from?

In the simplest terms, the 70 Percent Rule originated from a series of court decisions at the federal level that were administered by the US Small Business Administration’s Office of Hearings and Appeals (OHA), a quasi-judicial entity.

The term “70 Percent Rule” is a colloquialism, meaning you will not find this specific term used inside the US Code of Federal Regulations (CFR).

This colloquial term is used in 8(a) discussions because it is easier to understand and remember than quoting the names of specific court cases.

What does the 70 Percent Rule address?

The 70 Percent Rule addresses alleged economic dependence between a business and its customer(s).

Generally speaking, the SBA will not let a business into the 8(a) program if the SBA has reason to suspect the applicant business is too economically dependent upon its client to survive the loss of that client.

The 70 Percent Rule pertains to gross revenue, not net income, and the percentage of gross revenue that comes from each client.

For example, your company might have four (4) clients with a distribution of gross revenue like this:

Example distribution of gross revenue at Company X:
Client A constitutes 10% of gross revenue +
Client B constitutes 30% of gross revenue +
Client C constitutes 15% of gross revenue +
Client D constitutes 45% of gross revenue +

__________________________________
100% of gross revenue

In the above example, the biggest client of Company X is Client D at 45% of gross revenue.

The 70 Percent Rule posits that if 70 percent or more of gross revenue comes from only one client, there is de facto economic dependence between the 8(a) applicant firm and that client.

Here is an example of a company in violation of the 70 Percent Rule:

*Example distribution of gross revenue at Company Y:*
Client A constitutes 75% of gross revenue +
Client B constitutes 25% of gross revenue +

__________________________________
100% of gross revenue

In the above example, the biggest client of Company Y is Client A at 75% of gross revenue, which is above the 70% threshold. Therefore Company Y is too economically dependent upon Client A, so at this time Company Y is not eligible to get 8(a) certified.

**What time period does the 70 Percent Rule cover?**

The 70 Percent Rule addresses the “totality of the circumstances,” meaning the SBA will hunt for patterns of possible economic dependence in the current year as well as going back in time up to three full years.

**Why does the SBA care that I am economically dependent on my client?**

The SBA does not admit companies that are economically dependent upon other companies into the 8(a) program because it is too risky.

In the SBA’s view, if the number one client of the applicant business disappears or ends the contract, then the applicant business will likely fold.

The SBA does not want to let unstable companies that are statistically susceptible to failure into the 8(a) program because the program lasts nine (9) years, plus the applicant screening process uses a tremendous amount of SBA resources. The SBA does not want to waste precious resources on application review work for a company that has a strong likelihood of collapsing when their big client ends their contract. The SBA does not want a company to enter the 8(a)
program and suddenly go bankrupt and shut down midstream during the 9 years of program participation, leaving government agencies in the lurch.

Like most federal agencies, the SBA is **risk averse**. Federal agencies and their employees dislike risk, do not like to take risks and will do anything possible to avoid risk. Economic dependence on your client represents risk to the SBA, whether you personally view it as risk or not.

There are other negative consequences to the 70 Percent Rule that factor into the SBA’s decision-making.

**Other Negative Consequences of a 70 Percent Rule Violation**

Economic dependence on your client has other negative consequences on your 8(a) eligibility:

1. **Affiliation.** Economic dependence (violation of the 70 Percent Rule) creates a bond of “affiliation” that legally (meaning under federal law) links the applicant firm together with its top customer. Affiliation is negative because when two businesses are affiliated, the SBA treats them as one entity, one business. You do not want to be affiliated with your client, or with any other company for that matter. Affiliation is almost always a negative for an 8(a) application.

2. **Negative Control.** The SBA **automatically** assumes when an applicant firm is economically dependent upon its client that the client has the potential ability to negatively control the applicant firm by exerting financial leverage over the applicant firm. Because an 8(a) business must be 100% unconditionally controlled only by one or more socially and economically disadvantaged individuals, negative control exerted over the applicant firm by one of its clients violates this secondary 8(a) rule about 100% unconditional control by the disadvantaged. (Technically speaking, the negative control—meaning the financial leverage created through economic dependence—is a condition that prevents 100% unconditional control by disadvantaged individuals.) An SBA finding of negative control by a customer renders a business ineligible for 8(a) certification.

3. **Size Determination.** The size of your business is computed by the SBA by analyzing your 3-year-average gross revenue amount or employee headcount **added to** the 3-year-average gross revenue amount or employee headcount of each affiliated business. This means if your primary customer (constituting 70 percent or more of your gross revenue) is a large corporation, their size affects your size, and your firm might be determined to be “other than small” and thus ineligible for 8(a) status (because affiliation with a large corporation effectively renders your business medium or large sized, and 8[a] is a small business program.)

4. **Allegations of being a “front” company.** In the past, large unethical corporations created new 8(a) companies in order to take advantage of 8(a) benefits for themselves, which is illegal. The SBA figured out how these illegal schemes typically worked and in turn enacted a set of 8(a) rules to behave as countermeasures to block fronts from joining the 8(a) program. The 70 Percent Rule is one of these countermeasures designed to defeat fronts. If a client provides
your business with 70 percent or more of its gross revenue, it looks like your client set you up as a front in order to get 8(a) benefits for itself. The SBA will not let any fronts or any businesses that appear to be fronts into the 8(a) program. In other words, under this rule your business does not have to be proven to be a front—it just has to look like a front to get disqualified.

Is this unfair of the SBA to do? Sometimes yes, sometimes no. The 70 Percent Rule has successfully stopped many fronts from entering the 8(a) program and it has also stopped many large corporations from trying to game the system by setting up fronts.

Do legitimate businesses sometimes get stung by this fraud prevention mechanism? Unfortunately, yes.

The 8(a) program is supposed to be for disadvantaged businesses—so why am I being punished for having one client, or one client who gives me 70% or more of my gross revenue?

Although the 8(a) program is designed for disadvantaged individuals, companies admitted into the 8(a) program must be stable, low risk or entirely risk-free when admitted into the 8(a) program so that they will last for 9 or more years.

A company in shaky financial condition is unstable and very high risk, so the SBA is not going to let such a company into the 8(a) program.

Economic dependence on a client equals risk.

A company that is too dependent upon one client for its survival is considered to be unstable and high risk, and is therefore inadmissible into the 8(a) program.

This situation might be unfortunate, but it is the reality of the 8(a) application process, so it is critical to understand how the SBA operates when it assesses and reviews your application. You don’t want to waste your precious time, effort and labor submitting an 8(a) application that will be disqualified.

What Can I Do to Overcome a 70 Percent Rule Violation?

The only thing you can do to overcome a 70 Percent Rule violation is to market your business and diversify your client base—obtain more customers and more projects to change the proportion of gross revenue coming from each customer so that no single customer equals 70 percent (or more) of your gross.

Where Do I Get New Clients?

The question of “where to find new clients” plagues every business, whether they want to get 8(a) certified or not. Here are some ideas to try to generate some more sales:
1. Network with friends (but not relatives) to see if their companies can give you one or more new projects. Be sure these projects are legitimate and real tasks that can be documented. Issue a business-to-business (B2B) agreement of some kind, even if it is only a 1-page document. Do not let the other company issue you a W-2 form or a 1099 form. This is a contract between two companies, not between two individuals.

2. Attend some federal government (or state or local government) small business events that include “matchmaking” appointments, and set up a matchmaking reservation well in advance. This will guarantee you a time slot to speak face-to-face with a government representative to ask how to conduct business with the agency, to ask about current opportunities at the agency, etc.

3. Hunt for possible projects on freelancer websites. Some of these websites let you sign up as a representative of your company (so the work is conducted through a business-to-business agreement). No matter what you do, there is likely a freelancer website available for your industry. Here are a few general ones to try:
   - Freelancer.com
   - Elance.com
   - Odesk.com
   - Textbroker.com
   - Guru.com

Are there any exceptions to the 70 Percent Rule?

An 8(a) applicant firm cannot be affiliated with or negatively controlled by an agency of the federal government. If your only client (or your 70%+ client) is the federal government, and you have a direct business-to-government (B2G) contract, the 70% rule will not apply.

We repeat: This only applies to you if you have a direct federal contract.

If you have a prime contractor, and you are a subcontractor, you do not qualify for this exception.

The following article from reputable federal contracting attorney Steven Koprince highlights another exception (where there is no longstanding pattern of economic dependence, only a single isolated instance of economic dependence):


Please bear in mind the exception discussed in the article cited above by Steven Koprince is an extreme rarity, meaning it likely will not apply to your particular situation, especially if you have been the owner in control of your business for multiple consecutive years.
I know of an 8(a) company that is in violation of the 70 Percent Rule—how come they are allowed to get away with it?

First, the 70 Percent Rule applies to 8(a) applications only—there are different rules for companies that are already 8(a) certified.

If you think another business is trying to defraud the SBA, or if you think another business is breaking federal laws or violating 8(a) rules, report that business to the government for investigation.

Just bear in mind that your allegation might be incorrect, so do not lodge complaints lightly.

Here is where you can report fraud, waste and abuse to the SBA:

1. File a complaint online: http://web.sba.gov/oigcss/client/dsp_welcome.cfm

2. Call the OIG Hotline toll-free at (800) 767-0385.

All is Not Lost—Apply for 8(a) Later

It can be very disappointing to discover that your business is not currently eligible for 8(a) certification due to a violation of the 70 Percent Rule; however, all is not lost! Do not give up hope. Just because your business is not eligible now does not mean it is ineligible forever.

In a few short weeks, you might have several new projects or clients and be in better financial shape to get certified. Work aggressively starting now to diversify your client base and attract new customers and projects. You might render yourself eligible for 8(a) status a lot faster than you expect.

In the end, this temporary disappointment might turn out to be a good thing for your business, because when you diversify your revenue base and take on additional projects and clients, you in turn make your business stronger and more stable. Banks and lenders like to see a diverse mix of clients, too—you will better position your company to obtain loans and credit lines to fund growth and expansion. Having a wide mix of customers, none of which exerts any financial leverage over you, is a positive thing, both for 8(a) certification and for your business in general.

More Questions?

Government Certification Specialists Inc. (GCS) is available via email and telephone to provide further detail:

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