

MEMORANDUM

To: Clients and Friends

From: Pamela J. Mazza *PJM*

Date: January 7, 2015

RE: Analysis of SBA's Proposed Rule Regarding Limitations on Subcontracting

On December 29, 2014, the Small Business Administration (SBA) published its proposed rule to implement provisions of the National Defense Authorization Act of 2013 (NDAA) that change the way firms calculate compliance with the limitation on subcontracting rule on small business set-asides. SBA's proposed rule also proposes changes dealing with the nonmanufacturing rule, affiliation and joint ventures.

This memorandum summarizes the key provisions of the proposed rule. Comments are due to SBA on, or before, February 27, 2015. We are continuing to analyze this proposal and the potential impact on small businesses and their large business subcontractors. We would appreciate your thoughts. Please email them to me at pmazza@pilieromazza.com. Any thoughts will be helpful to us as we develop our comments to SBA. We encourage everyone to submit comments on this important rule as SBA carefully considers comments from the community before issuing its final rule.

I. LIMITATION ON SUBCONTRACTING

Under current regulations primarily codified in 13 C.F.R. Section 125.6, whether a firm is in compliance with the limitation on subcontracting rule is determined based upon the percentage of the cost of the contract performance incurred for the small business prime contractor's personnel. Small businesses performing service and manufacturing contracts must incur 50% of labor costs (loaded with fringe and general and administrative expenses) with their own employees. For general construction, the percentage is 15%; for specialty trade construction, the percentage is 25%.

Section 1651 of the NDAA changes this requirement. Under the new law, compliance is determined not by an analysis of how much work the small business prime contractor performs with its own employees, but rather by limiting a percentage of the award amount that may be subcontracted. SBA's proposed rule utilizes the same percentages, i.e., 50%; 15% and 25%, but those percentages are now based on total contract value. So, for example, a small business with a \$10 million service contract can only subcontract \$5 million—regardless of whether the subcontract is for services or supplies.

The SBA is proposing procedures for industry groups or interested small businesses to request that the SBA Administrator change the above subcontracting percentage requirements by six digit NAICS codes. The request must demonstrate that the change is necessary to reflect industry practices among small businesses in that NAICS code. The proposed rule cites examples of information that should be submitted. In order for SBA to grant such a request, it must go through a rulemaking process, i.e. public notice and opportunity for comment.

The NDAA and the proposed rule carve out one exception to this rule for “similarly situated” firms. This means that if a contract is set-aside for small businesses, then the small business prime contractor and any small business teaming partner together can satisfy the requirement. The same holds true for contracts set-aside under the socio-economic programs for HUBZone companies, Service-Disabled, Veteran Owned Small Businesses, Section 8(a) firms and Women-Owned or Economically Disadvantaged Women-Owned small businesses.

Therefore, in the example mentioned above, if a small business with a \$10 million service contract self-performs \$3.5 million and its small business teaming partner performs \$1.5 million, then the remaining \$5 million can be subcontracted out to any subcontractor regardless of its designation. The small business prime contractor and its small business teaming partner's revenues combined satisfy the limitation on subcontracting rule. The same would be true if the contract was set aside for one of the socio-economic classes and the teaming partner were a member of that group. So, the limitation on subcontracting requirement would be satisfied for a \$10 million HUBZone set-aside if the HUBZone prime contractor and its HUBZone teaming partner combined performed \$5 million of the \$10 million contract. SBA refers to these arrangements as Small Business Teaming Arrangements (SBTAs).

Importantly, the proposed rule asks for comments on how best to guard against a “similarly situated subcontractor” subcontracting to a lower tier subcontractor that is not qualified to be included for purposes of the prime contractor's compliance with the limitation on subcontracting. SBA is concerned that if the monitoring is limited to the first-tier “similarly situated” prime contractor, then the intent of the new law will not be satisfied if that first-tier subcontractor in turn subcontracts to a non-qualifying contractor. SBA is proposing that any work subcontracted by a “similarly situated” subcontractor to a non-qualifying lower-tier

subcontractor will not count toward the required percentage of performance by the prime contractor.

In addition, the rule addresses the fines and penalties for violations of the limitations on subcontracting. Specifically, the law dealing with material misrepresentations applies except that the penalty is not the value of the contract, but the greater of either \$500,000 or the dollar amount spent in excess of the permitted levels for subcontracting.

The proposed rule provides that a small business prime contractor relying on subcontracting to similarly situated entities to satisfy the limitation on subcontracting rule must certify compliance in its offer. If it is not apparent in the offer that the prime contractor will comply, then the contracting officer may seek a Certificate of Competency from SBA. The contracting officer must be satisfied that the small business will comply at the time of award. This language would appear to give GAO jurisdiction to hear such grounds for a bid protest.

A small business prime contractor must identify any similarly situated teaming partners in its proposal and set forth the amount of the prime contract award to be spent on each similarly situated teaming partner. A written agreement with each such entity is required.

A prime contractor must notify the contracting officer in writing of any change in its subcontracting if it falls out of compliance with the limitations on subcontracting.

The period for compliance for a total or partial set-aside contract is the base period and then each option period. For orders set-aside under a full and open contract or a full and open contract with reserve, compliance will be determined using the period of performance for each task order. However, if the order is competed among small and other than small businesses, no limitation on subcontracting is applicable.

Finally, SBA is proposing to exempt only small business set-asides valued between \$3000 and \$150,000 from this rule based upon its interpretation of the Small Business Act. However, this exemption would not apply to the other socio-economic programs.

II. AFFILIATION

SBA is adding additional guidance on how to analyze affiliation based upon an identity of interest between two firms.

SBA is proposing new language to add a presumption of affiliation due to an identity of interest where firms that conduct business with each other are owned and controlled by married

couples, parties to a civil union, parents and children and siblings. The presumption is rebuttable.

SBA is also adopting a rebuttable presumption of affiliation due to economic dependence where one firm derives 70% or more of its revenue from another firm during the previous fiscal year. The presumption is rebuttable for start-ups that have only received a few contracts or subcontracts.

III. JOINT VENTURES

Current SBA regulations provide an exemption from the rule that the combined receipts/employees of joint venture partners are used for determining whether a joint venture is small and therefore eligible to compete on a small business set-aside. SBA provides an exemption to this rule for larger contracts and bundled or consolidated contracts.

SBA is proposing to eliminate the general rule and allow small businesses to compete on any size contract so long as each business is small under the NAICS code assigned to the contract. This proposed change seems consistent with the new NDAA provision and SBA's proposal to allow similarly situated firms to team to satisfy the limitation on subcontracting rule.

IV. CALCULATION OF ANNUAL RECEIPTS

SBA is proposing to amend its definition of annual receipts to clarify that passive income is included in the calculation of annual receipts.

V. RECERTIFICATION

Currently, there is a gap in SBA regulations regarding when a concern must recertify its size in connection with a merger or acquisition. The proposed rule would require firms to recertify size to the contracting officer on pending proposals where the merger or acquisition occurs prior to award.

VI. NONMANUFACTURER RULE

The nonmanufacturer rule essentially provides that for small business set-aside contracts for manufactured items, either the prime contractor must manufacture the items or the prime contractor must supply the items of another small business unless the SBA has granted a class waiver for the item or the contracting officer has requested that SBA grant an individual waiver for purposes the particular solicitation.

SBA is also proposing to allow contracting officers to request a waiver:

- i. After a solicitation has been issued so long as offerors have additional time to respond, and
- ii. When modifying existing contracts to add additional items.

SBA also proposes to amend its regulations to require contracting officers to notify potential offerors whether a class waiver or an individual waiver is applicable to a particular procurement. SBA is proposing to add this notification to the solicitation itself so that potential offerors can evaluate whether or not they will be able to comply prior to submitting a proposal.

In addition, SBA is proposing a new provision dealing with waivers to the nonmanufacturer rule for the purchase of software. This proposal would treat certain types of software as a product or item of supply where it is readily available, meaning that compliance with the nonmanufacturer rule is not required and the item may be eligible for a waiver. The proposal does not apply to solicitations seeking modified or customized software as those should be classified as service contracts.

VII. CONCLUSION

As noted above, these rules, if enacted, will significantly change how small businesses must analyze whether or not they can comply with the limitation on subcontracting rule. It may be very difficult in some industries such as IT, remediation or construction where large dollar amounts are expended for purchase of supplies and products. While SBA was required by the NDAA to change the method by which to calculate compliance with the subcontract limitation rule, Congress authorized the SBA to change the percentages specified in the law through the rulemaking process. SBA is offering, through further rulemaking to consider whether these percentages are inappropriate. However, rulemakings take many months, if not years. The public has until February 27, 2015 to submit comments on this proposed rule. This may afford an opportunity to comment on the percentages now rather than waiting.

SBA is making clear that compliance will be monitored and companies can face serious fines and penalties for noncompliance.

Again, we are encouraging you to review this memorandum and the proposed rule and send us your thoughts and submit your comments to SBA.