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SBA Rule Changes Benefit Contractors, But Pitfalls Remain

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After much anticipation, the Small Business Administration has issued a final rule implementing numerous small business contracting reforms from the 2013 National Defense Authorization Act aimed at relaxing burdensome requirements and eliminating duplicative reporting. Overall, the new regulations are favorable to contractors, increasing contracting opportunities for small business through clearly defining limitations on subcontracting and the application of the nonmanufacturer rule and eased affiliation rules, especially for joint ventures. The rule also clearly defines and limits the scope of familial affiliation. The harsh penalties for limitations on subcontracting violations that were required by the NDAA and included in the proposed rule, however, remain. The new rules go into effect June 30, 2016.

Limitations on Subcontracting: Clarifying Services v. Supply Contracts

A large portion of the SBA's final rule is dedicated to rewriting the often misunderstood and much-litigated rules regarding limitations on subcontracting. As a threshold matter, the final rule clarifies that limitations on subcontracting do not apply to contracts valued between $3,000 and $150,000.

The rule further clarifies how limitations on subcontracting are to be calculated, including how the rule's calculations apply to contracts containing both services and supply components. Under the SBA's prior regulations, a small business set-aside awardee generally had to perform 50 percent of the cost of the contract itself, with the goal to keep small business contract dollars in the hands of small businesses. 13 CFR § 125.6. The actual calculation method for the limitations depended on the type of contract, i.e. services or supplies: Under services contracts, the awardee had to perform no less than 50 percent of contract costs "incurred for personnel"; for supply contracts, the awardee had to incur no less than 50 percent of "the cost of manufacturing the supplies," excluding material costs. 13 CFR § 125.6.

The new rule simplifies these formulas and moves away from complicated cost calculations, adopting a more straight-forward "amount paid" calculation, in which contractors may not pay out more than 50 percent of the amount it receives from the government for supplies or services to nonsimilarly situated subcontractors:

> In order to be awarded a full or partial small business set-aside contract with a value greater than $150,000… a small business concern must agree that:

> (1) In the case of a contract for services (except construction), it will not pay more than 50% of the amount paid by the government to it to firms that are not similarly situated….
>
> (2)(i) In the case of a contract for supplies or products (other than from a nonmanufacturer of such supplies), it will not pay more than 50% of the amount paid by the government to it to firms that are not similarly situated… . Cost of materials are excluded and not considered to be subcontracted.

13 CFR § 125.6(a)(1)-(2) (new). The percentages for construction contracts remain unchanged.

Additionally, the prior regulations were not clear how subcontracting percentages limitations should be applied in "mixed" contracts that included both supply and services components. The SBA's final rule fills this gap by formalizing what had been a rule of thumb among contractors. Specifically, for mixed contracts, the contracting officer's chosen industry code for the procurement will control. The contracting officer is to assign one such code to the procurement based on which work category has the greatest percentage of the contract value: supplies or services. The corresponding limitation on subcontracting calculation method to that code then applies: "Therefore, where a procurement combines supplies and services, the limitations on subcontracting apply only to subcontracts that correspond to the principal purpose of the prime contract. For a contract principally for services, but which also requires supplies, this means that the prime contractor or its similarly situated subcontractors cannot subcontract more than 50 percent of the services to other than small concerns. However, the prime contractor can subcontract all of the supply components to any size business."

Limitation on Subcontracting: New Opportunities For Similarly Situated Subcontractors

The new rule also implements a limitation on subcontracting exemption for small businesses that partner with "similarly situated" firms — an exemption previously reserved for only a small subset of small business firms. See 13 CFR § 125.1. This change allows small business prime contractors to take credit for work performed by "similar situated" subcontractors without violating the limitations on subcontracting.

Under the prior regulations, a small business prime contractor was required to perform more than 50 percent of its contract, regardless of the size status of its subcontractors. See id. § 125.6. Thus, a woman-owned small business that subcontracted over 50 percent of its woman-owned set-aside contract to another woman-owned small business would be in violation of the limitation on subcontracting, despite the fact that all of the contract dollars were received by eligible firms. Under the new rule, this type of arrangement will be allowed. See id. § 125.6(c) (new). The key to applying this new provision is determining if the subcontractor is a "participant of the same small business program that the prime contractor is a certified participant and which qualifies the prime contractor to receive the award." See also, id. § 125.1 (new) (defining "similarly situated entity"). Notably, the "similarly situated" subcontractor does not have to be small for the industry code assigned to the prime contract, but instead must be small for the industry code assigned to the subcontract. Notably, the SBA rejected a proposal that "similarly situated" subcontractors sign the equivalent of a teaming agreement with the prime contractor, finding that this was unnecessary and may disincentive contractors from utilizing the new exemption.

To prevent additional subcontracting beyond the first tier, the new rule adds that lower tier subcontracts to concerns that are not "similarly situated" will still count against the limitation on subcontracting: "Any work that a similarly situated first tier subcontractor subcontracts, to any entity, will count as subcontracted to a non-similarly situated entity for purposes of determining whether the prime/sub team performed the required amount of work. In other words, work that is not performed by the employees of the prime contractor or employees of first tier similarly situated subcontractors will count as subcontracts performed by nonsimilarly situated concerns." See 13 CFR § 125.6(c) (new).

Limitations on Subcontracting: Penalties

In exchange for expanded flexibility in subcontracting, the new rule imposes strict penalties for limitation on subcontracting violations. These penalties include suspension, debarment, administrative remedies, and a minimum penalty of $500,000 or the dollar amount spent by the violating contractor in excess of the permitted levels of subcontracting, whichever is greater. Despite strong objection from the contracting community, the SBA declined to modify the rule or incorporate a "good faith" safe harbor. As written, the new rule may impose a $500,000 penalty for subcontracting beyond 50 percent, no matter the size of the overage.

Limitations on Subcontracting: Nonmanufacturer Rule

The SBA's nonmanufacturer rule is an exception to the limitations on subcontracting that allows for a small business, which would normally be required to manufacture end items itself, to provide the products of other small business manufacturers. Alternatively, the small business can seek a waiver for items that are not manufactured by small businesses. The issue of how this rule applies to multiple-item procurements where a small business may manufacture some items, but not all, has been the topic of much litigation over the past several years. The SBA's final rule provides a clear rule.

Under the final rule, if 50 percent or more of the estimated contract value for a multiple-item procurement is composed of items manufactured by small businesses, a nonmanufacturer rule waiver is not required as "[t]here is no requirement that each and every item acquired in a multiple-item procurement be manufactured by a small business." 13 CFR § 121.406(e)(1) (new). However, if 50 percent or more of the estimated contract value is composed of items manufactured by other-than-small businesses, a nonmanufacturer rule waiver is required. Id. § 121.406(e)(2) (new). When a nonmanufacturer rule waiver is granted on a multiple-item procurement, the prime contractor must still meet the limitation on subcontracting for the nonwaived portion of the contract. Id. § 125.6(a)(2)(ii)(B) (new). For example, if a contract calls for $1 million worth of goods, but $600,000 of those items are granted a waiver, then the contractor must meet the limitation on subcontracting (by either manufacturing itself or providing the goods of a small business) for the remaining $400,000.

The new rule also addresses the issue of whether software is properly considered a service or supply, and thus, whether the nonmanufacturer rule is applicable. See 13 CFR § 121.1203(d) (new). Based on common practices, the Final Rule states that software is to be considered a supply unless the procurement is for creation, design, or customization of software and those services exceed the value of the software itself or the procurement is for cloud-based services. Id. As such, the nonmanufacturer rule applies to basic procurements of previously developed, unmodified software (although in many instances, these items will be eligible for a waiver). Id. The SBA also added (in response to litigation on the topic) that rentals are definitively considered services and are to be treated as such. Id. § 121.406(b)(4) (new).

Affiliation: Identity of Interest (Familial Relationships and Economic Dependence)

Although not a substantive change from current practice, the SBA's changes to the identity of interest affiliation rules codify long-standing Office of Hearings and Appeals precedent that certain familial relationships (married couples, civil unions, parents and children, and siblings) create a rebuttable presumption of identity of interest affiliation if those firms "conduct business with each other, such as subcontractor or joint ventures or share or provide loans, resources, equipment, locations or employees with one another." 13 CFR § 121.103(f)(1) (new). The new rule clarifies that only the enumerated family relationships may trigger the familial presumption, and the SBA expressly declined to expand the rule to any additional relationships. Id.

Similarly, the final rule codifies OHA precedent that a rebuttable presumption of affiliation based on economic dependence is found where a firm derives 70 percent or more of its revenue from another firm. 13 CFR § 121.103(f)(2) (new). Previously, the regulations did not specify a particular triggering percentage. Id. § 121.103(f). In response to several comments raising concerns that large contracts, especially for "startup" entities with very few total contracts, would unfairly face presumptions of affiliation under the 70 percent rule, the SBA modified the measuring period from one year to three years in the final rule. Id. § 121.103(f)(2) (new). The SBA also added clarifying language to demonstrate situations in which the affiliation presumption may be rebuttable, including where despite the contractual relations, the concern is not solely dependent on the other concern or where the firm has only been in business for a short time and has only been able to secure a limited number of contracts. Id. The bright line created by the final rule will add much-needed clarity for small businesses with strong ties to another entity, avoiding the uncertainty of litigation.

Affiliation: Joint Ventures

Under the SBA's current rules, joint ventures are deemed affiliated (and their revenues and employees are combined for size determination purposes) unless they fall within two exceptions. 13 CFR § 121.103(b). First, an 8(a) concern participating in the mentor-protégé firm is exempt from the joint venture affiliation rule when partnering with their SBA-approved mentor. 13 CFR § 121.103(b)(6). Second, a joint venture composed of two or more small businesses is exempt from the joint venture affiliation rules when bidding on large or bundled procurements. 13 CFR § 121.103(b)(9). The final rule greatly expands the second exception, removing the requirement that the procurement be large or bundled to trigger the exception. Under the new rule, all members of the joint venture must simply individually qualify as small under the NAICS code assigned to the procurement to be exempt from the joint venture affiliation rules, regardless of the size of the procurement. 13 CFR § 121.103(b)(9); (h)(3)-(4) (new). This is consistent with the new "similarly situated" subcontractor rule, which would allow for such a team to perform the work as subcontractors. Again, this rule opens the door for additional opportunities for small businesses to work together, especially on larger and more complex procurements.

Recertification: Mergers and Acquisitions Prior to Award

The SBA's rules currently require that an offeror recertify its size after a merger or an acquisition, but did not explain how pending bids were to be handled. Under the new rule, offerors must recertify their size prior to award if a merger or acquisition occurs for all pending small business bids. 13 CFR § 121.404(g)(2).

In conclusion, the SBA's final rule not only creates new contracting opportunities for small business through greatly expanded subcontracting and joint-venturing opportunities, but also provides much-needed clarity in several areas. Contractors, however, should be aware of the harsh penalties for failing to comply with the SBA's limitations on subcontracting.

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