Reprinted from The Government Contractor, with permission of Thomson Reuters. Copyright © 2016. Further use without the permission of West is prohibited. For further information about this publication, please visit *http://legalsolutions.thomsonreuters.com*, or call 800.328.9352.

The Government Contractor®

THOMSON REUTERS

Information and Analysis on Legal Aspects of Procurement

Vol. 58, No. 26 **July 13, 2016**

Focus

¶ 239

FEATURE COMMENT: *Kingdomware*: Broader Than SCOTUS Intended?

In a unanimous opinion overturning the U.S. Court of Appeals for the Federal Circuit, the U.S. Supreme Court held that the Department of Veterans Affairs (VA) must consider whether two veteran-owned small businesses (VOSBs) can perform a proposed contract before issuing a solicitation. If this "rule of two" analysis leads to a reasonable expectation that two such businesses would submit offers and that the award can be made at a fair and reasonable price, the acquisition must be reserved for VOSBs. Although this finding is consistent with prior Government Accountability Office (GAO) decisions, courts had unanimously accepted the VA's view that such set-asides were not required if the VA had met its statutory VOSB contracting goals. This decision will undoubtedly result in an increase in VOSB set-asides by the VA, but it may also have broad implications for small business set-aside requirements for the General Services Administration's Federal Supply Schedules (FSS).

***Kingdomware Techs. Inc. v. U.S.*, 136 S. Ct. 1969 (June 16, 2016)**—The controversy in *Kingdomware* arose from a 2012 solicitation for emergency notification services for VA medical centers. The VA sought prices from, and eventually contracted with, a non-veteran-owned company through the FSS, a collection of long-term, multiple-award contracts for commercial goods and services administered by GSA, but available for use Government-wide. Through the FSS, agencies simply review the catalog of available products or services, and place orders against previously negotiated contracts.

Kingdomware, a service-disabled VOSB, protested, arguing that the department violated federal law by failing to evaluate whether two VOSBs could perform the work. Kingdomware's claim was based on the Veterans Benefits, Health Care, and Information Technology Act of 2006 (Veterans Act), 38 USCA § 8127, which states that the VA "shall" restrict competition to VOSBs when the rule of two is met, i.e., when, based on market research, the contracting officer reasonably expects that at least two eligible small businesses will submit offers and that the award can be made at a fair and reasonable price. The VA rebutted Kingdomware's contention, arguing that these set-asides were just a tool to meet contracting goals, and because the department had been meeting its VOSB goals, it was not required to continue to reserve contracts under the Veterans Act.

GAO agreed with Kingdomware, finding that the VA's failure to conduct a rule-of-two analysis was unlawful. GAO recommended that the VA conduct the appropriate market research to determine if a set-aside was required. In a rare move, the VA declined to follow GAO's recommendation, and Kingdomware sought judicial review. Both the U.S. Court of Federal Claims and the Federal Circuit sided with the VA, finding that the rule-of-two set-aside requirement under the Veterans Act was intended only to ensure that the VA complied with its statutorily set VOSB contracting goals. Thus, if the VA met those goals, the set-aside requirements would no longer be mandatory.

The Supreme Court disagreed with the lower courts, finding that the rule-of-two set-aside requirement in § 8127 is mandatory and that the statute

> requires the Department to apply the Rule of Two to all contracting determinations and to award contracts to veteran-owned small businesses. The [Veterans Act] does not allow the Department to evade the Rule of Two on the ground that it has already met its contracting goals or on the ground that the Department has placed an order through the FSS.

Not surprisingly, given that the opinion was authored by Justice Thomas, the Court based its opinion on the

 © 2016 Thomson Reuters

precise words of the statute, which utilizes the mandatory clause "shall," rather than the discretionary clause "may," in requiring that contracts be reserved under the rule of two and provides no exceptions for FSS orders. The Court held that "[w]hen a statute distinguishes between 'may' and 'shall,' it is generally clear that 'shall' imposes a mandatory duty …. We see no reason to depart from the usual inference here."

The Court also rejected the department's argument that a prefatory clause, stating that the statute was passed "for purposes of" meeting the department's annual contracting goals, nullified the operative clause requiring the set-asides. Notably, this argument, which formed the basis for the Federal Circuit's decision, was abandoned by the Government in its briefing before the Court. Instead, the Government argued on appeal that the statute identified "contracts" and not "orders" for set-side treatment, so FSS orders were per se exempt. However, as Justice Thomas explained, "the prefatory clause has no bearing on whether § 8127(d)'s requirement is mandatory or discretionary." The prefatory language, the Court held, "does not change the plain meaning of the operative clause," i.e., meeting the statute's stated purpose does not render its requirements inoperable.

Finally, and perhaps most importantly, the Court also addressed the department's newfound argument that the rule-of-two provision does not apply to "orders" under "preexisting FSS contracts." The VA argued that FSS orders are not contracts and thus are not covered by the statute's requirement to "award *contracts*" to VOSBs. After noting that the argument would normally be considered forfeited because it was not raised in any of the lower courts, the Court opined that the argument would fail in any event, as FSS orders are " 'contracts' within the normal meaning of that term," and, in accordance with the definition of a contract in Federal Acquisition Regulation 2.101,

> [a]n FSS order creates mutually binding obligations: for the contractor, to supply certain goods or services, and for the Government, to pay. The placement of the order creates a new contract; the underlying FSS contract gives the Government the option to buy, but it does not require the Government to make a purchase or expend funds.

It is this holding—one that is arguably dicta—that may have broader implications than the Supreme Court intended, especially with regard to the FSS.

Impact of *Kingdomware*: Mandatory FSS Set-Asides?—The Court's holding is significant in several ways. First, and most obviously, the Court's opinion obliges the VA to perform a veterans rule-of-two analysis, and set aside any contract meeting the rule of two, for VOSBs. This applies to *all* acquisitions, including those made under the FSS. This holding will inevitably lead to increased contracting opportunities for VOSBs with the VA, and is a big win for these businesses. To this end, the VA recently issued interim guidance on *Kingdomware*, instructing contracting officers to conduct appropriate market research for rule-of-two purposes and to cancel pending solicitations that could have been set aside under the rule but were not.

Despite this guidance, it is not clear how the VA will proceed. For years it has denied that it was required to do a rule-of-two analysis for veterans, and it has awarded millions of dollars in contracts on that basis. Further, there are undoubtedly procurements in process for which the VA fell short of its statutory mandate. Contractors can expect some growing pains, and likely more litigation, before those issues are resolved.

Second, the Court's holding suggests that GSA's long-standing position that FSS orders are exempt from set-aside requirements may be incorrect due to the Court's holding that set-aside requirements for *contracts* apply equally to FSS orders. Aside from the Veterans Act, the Small Business Act, codified at 15 USCA § 644, more generally requires that certain contracts (not limited to specific agencies) be reserved for small businesses based on the rule-of-two analysis:

> (1) Each *contract* for the purchase of goods and services that has an anticipated value greater than $2,500 but not greater than $100,000 *shall* be reserved exclusively for small business concerns unless the contracting officer is unable to obtain offers from two or more small business concerns that are competitive with market prices and are competitive with regard to the quality and delivery of the goods or services being purchased.

15 USCA § 644(j) (emphasis added).

GSA has long argued (so far successfully) that § 644(j)'s general mandate to set aside contracts under the rule of two does not apply to its FSS orders. GSA explained its reasoning for this belief shortly after GAO's 2008 decision in *Delex Sys., Inc.*, Comp. Gen. Dec. B-400403, 2008 CPD ¶ 181. In *Delex*, GAO

© 2016 Thomson Reuters

held that the rule-of-two set-aside requirement, implemented in the regulations at FAR pt. 19.502-2(b), applies to multiple-award contracts, such as indefinite-delivery, indefinite-quantity vehicles. Several commenters suggested that GAO's reasoning also applied to GSA's FSS, which comprises several multiple-award contracts.

GSA responded just days after GAO's opinion, stating that despite speculation to the contrary, the ruling in *Delex* did not apply to GSA's Schedule contracts. GSA based its reasoning on FAR pt. 19, Small Business Programs, which expressly exempts FSS procurements from small business regulations, including those implementing § 644(j).

In response to the *Delex* debate and before the FSS issue could be litigated, Congress amended § 644, adding a provision at § 644(r) to address multiple-award contracts. Section 644(r) provides that agencies "may, at their discretion" set aside multiple-award contracts or orders thereunder:

> Not later than 1 year after September 27, 2010, the Administrator for Federal Procurement Policy and the Administrator, in consultation with the Administrator of General Services, shall, by regulation, establish guidance under which Federal agencies *may, at their discretion*—
>
> (1) set aside part or parts of a multiple award contract for small business concerns, including the subcategories of small business concerns identified in subsection (g)(2);
>
> (2) notwithstanding the fair opportunity requirements under section 2304c(b) of title 10 and section 4106(c) of title 41, set aside orders placed against multiple award contracts for small business concerns, including the subcategories of small business concerns identified in subsection (g)(2); and
>
> (3) reserve 1 or more contract awards for small business concerns under full and open multiple award procurements, including the subcategories of small business concerns identified in subsection (g)(2).

15 USCA § 644(r).

This provision may not completely settle the FSS set-aside debate. Section 644(r) provides only that agencies have the discretion to set aside parts of multiple-award contracts. It does not, however, expressly create any additional exemptions to § 644(j), which mandates that *all* procurements between $2,500 and $100,000 be set aside if the rule of two is met. Thus, if it were found that § 644(j) applies to orders under the FSS, § 644(r) is no savior. As explained below, the Supreme Court's holding may give litigants exactly that argument.

Just as *Delex* opened the door for questions surrounding FSS set-asides, another GAO decision, *Aldevra*, coupled with *Kingdomware* may provide a new avenue for small business litigants. In *Aldevra*, Comp. Gen. Dec. B-411752, 2015 CPD ¶ 339, GAO found that the set-aside requirement in § 644(j) was inapplicable to the FSS based on the language implementing § 644(j) and § 644(r) in the FAR and the Small Business Administration's *regulations*, rather than the underlying *statutory* language. GAO's decision focused on the language in FAR 8.504-4(a)(1)(i), which excepts FSS procurements from the small business provisions at FAR pt. 19, including the small business set-aside requirement. This reasoning mirrors the SBA's post-*Delex* defense of the FSS. These regulations adopt the interpretation that only the discretionary provision at § 644(r), and not the mandatory provision at § 644(j), applies to the FSS. The *Aldevra* opinion notes the SBA's disagreement with GAO's reasoning, based on the argument that both § 644(j) *and* § 644(r) should apply to the FSS:

> SBA argued that the most reasonable manner in which to harmonize sections 644(j) and (r) is to read section (j) as requiring that all FSS orders with values in the specified range be set aside unless market research shows that competitive offers from two or more small businesses cannot be expected, and to read section (r) as merely creating an exception to the requirement in 10 U.S.C. § 2304c(b) (and 41 U.S.C. § 4106) that all multiple-award contract holders be given a fair opportunity to compete for orders. According to SBA, a contrary interpretation would effectively repeal section 644(j) by implication.

Comp. Gen. Dec. B-411752 at 6.

Importantly, GAO's decision in *Aldevra*, through the underlying regulations on which it rests, is premised in part on the alleged legal distinction between *contracts* and *orders*. The FAR pt. 19 exemption for FSS orders on which GAO relied in *Aldevra* is found in FAR pt. 8.4. Part 8.4 applies only to "*[i]ndividual orders* for supplies or services placed against Federal Supply Schedule contracts." In contrast, the set-aside requirements both in § 644(j) and the implementing regulations in FAR pt. 19 apply not to "orders," but to "*contracts*." It is this distinction which formed the basis for GAO's decision and GSA's post-*Delex*

© 2016 Thomson Reuters

arguments that the FSS is exempt from the § 644(j) statutory set-aside requirements.

The Supreme Court's decision in *Kingdomware* draws into question GAO's reasoning in *Aldevra*. As discussed above, according to the Court's ruling there is no distinction between a "contract" and an FSS "order." Thus, the Veterans Act's requirements to "award *contracts*" to VOSBs apply to task orders because they are properly considered contracts. This reasoning arguably applies equally to the requirement at § 644(j) that "each *contract*" between $2,500 and $100,000 *shall* be reserved for small business.

With FSS task orders encompassed under the term "contract," the statutory § 644(j) set-aside requirement would apply equally to FSS task orders, trumping the regulatory exemptions relied on by GAO. Under this regime, all FSS task orders valued between $2,500 and $100,000 would be subject to the small business rule-of-two set-aside requirement, and any FSS task order exceeding that amount could be set aside at the agency's discretion under § 644(r)—the very interpretation that the SBA argued for in GAO's *Aldevra* litigation. Although it is not certain this is how the issue would play out in the courts, especially as the Supreme Court's reasoning may be categorized as dicta, the topic will likely be litigated in the very near future.

Conclusion—The concept of requiring set-asides for the FSS has been highly controversial. Small businesses argue that the schedules are the perfect place for set-asides because the Government issues hundreds of thousands of small orders through the schedules every year. These are precisely the type of efforts that can be performed by a wide variety of small businesses, giving them needed revenue and growth opportunities. On the other hand, the schedules were designed to mirror the commercial marketplace and reduce procurement timelines. Expanded set-aside usage may frustrate that design. Further, it is not clear what expanding the § 644(j) set-aside requirements to FSS orders would mean for GSA's Federal Strategic Sourcing Initiative, which consolidates FSS orders into a few contract holders. If all FSS orders under $100,000 must be set aside under § 644(j), there would be significant leakage from strategic sourcing contracts, making those contracts less useful for the Government and less desirable for contractors.

The Supreme Court's decision in *Kingdomware* will have immediate positive impacts for VOSBs looking to contract with the VA. Whether the decision will lead to expansion of small business set-asides under GSA's FSS is yet to be seen, but it has already been the topic of congressional hearings, and may soon be the topic of litigation.

This Feature Comment was written for The Government Contractor by* Damien C. Specht *and* Rachael K. Plymale. *Damien C. Specht is a partner in Morrison & Foerster's Government Contracts Group and the Co-Chair of the American Bar Association Small Business & Other Socio-economic Programs Committee. He co-authored an amicus brief in Kingdomware on behalf of more than 40 members of Congress. Rachael K. Plymale is an Associate in Morrison & Foerster's Government Contracts Group.

© 2016 Thomson Reuters