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Five Recent Developments in Small Business Contracting Small and Large Government Contractors Should Know

By David T. Hickey, William Jack, Elizabeth C. Johnson, and Amba M. Datta*

This article highlights five recent developments that every government contractor should know.

While acquisition reform has garnered a great deal of attention in Congress and the Federal Executive Branch, small business contracting statutes and implementing regulations are significantly altering the federal acquisition environment in 2016. Many of these changes are significant for large businesses, small businesses, and those participating in Service-Disabled Veteran-Owned Small Business ("SDVOSB") contracts, Veteran-Owned Small Business ("VOSB") contracts, HUBZone contracts, 8(a) Business Development contracts, and Women Owned Small Business ("WOSB") and Economically Disadvantaged Women Owned Small Business ("EDWOSB") contracts. This article highlights five recent developments that every government contractor should know:

1. VA GUIDANCE TO IMPLEMENT *KINGDOMWARE*

The first development will significantly and specifically impact Department of Veterans Affairs ("VA") contracting for SDVOSBs and VOSBs. In a June 2016 decision in *Kingdomware Technologies, Inc. v. United States*, the U.S. Supreme Court held that the VA has an affirmative obligation to apply the "Rule of Two" in every procurement—*i.e.*, the VA must set aside a contract for SDVOSBs and/or VOSBs if there are two or more capable SDVOSB or VOSB offerors who are likely to submit offers at fair and reasonable prices. The Court held that this mandatory obligation applies regardless of whether the VA has met its annual statutory SDVOSB or VOSB contracting goals. The Court also

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held that the Rule of Two applies to all contracts, including orders placed under Federal Supply Schedules ("FSS").

In response to the Supreme Court's ruling, the VA recently issued a Procurement Policy Memorandum to instruct Contracting Officers on the ruling's impact on the VA Acquisition Regulation ("VAAR") provisions governing the SDVOSB and VOSB Acquisition Program. The guidance instructs Contracting Officers to examine requirements in the pre-solicitation phase, the solicitation/evaluation phase, the proposal evaluation phase where offers have been submitted, in awarded contracts where a notice to proceed has not been issued, and all new competitive requirements. Therefore, the ruling has an immediate impact on the VA contracting environment.

For requirements in the pre-solicitation phase, Rule of Two market research must be conducted to determine whether there are two or more qualified, capable, and verified VOSBs or SDVOSBs who are likely to submit a proposal at a fair and reasonable price. In all such cases, the procurement must be set aside for VOSBs and SDVOSBs. For requirements currently in the solicitation/evaluation phase, Contracting Officers must examine those procurements that were not set aside for SDVOSBs and VOSBs and initiate a review of the original market research to confirm whether or not the Rule of Two was appropriately considered. If the VA finds that there are two or more qualified SDVOSBs or VOSBs, the Policy Memorandum states that an amendment "shall be issued that cancels the solicitation." The re-solicitation would then be issued as an SDVOSB/VOSB set-aside unless urgent and compelling circumstances exist to continue with the original acquisition strategy. In that case, a justification and approval must be issued. With regard to contracts that have been awarded to other than verified SDVOSBs or VOSBs, but where a notice to proceed has not been issued, the guidance requires Contracting Officers to coordinate with the Head of the Contracting Authority, the Office of the General Counsel and the Office of Small Business Utilization to determine whether to issue a notice to proceed. All new competitive procurements, including FSS orders, must comply with the Rule of Two.

Contractors that do business with the VA should be aware of the VA's Rule of Two obligations, and should understand that even ongoing solicitations may be subject to cancelation and re-solicitation as set asides for VOSBs and SDVOSBs. Contractors should expect to see more solicitations from the VA, including orders placed under FSS, set-aside for small businesses in the future.

2. SIGNIFICANT CHANGES TO THE LIMITATION ON SUBCONTRACTING RULE

A second significant development impacts calculations for the Limitation on

Subcontracting Rule. Effective June 30th, the U.S. Small Business Administration ("SBA") implemented provisions of the National Defense Authorization Act of 2013 ("NDAA") that amended that Rule. The amendment should result in more flexibility and a greater percentage of work for small business subcontractors. The Limitation on Subcontracting Rule pertains to the required percentage of contract performance that a prime must perform under full or partial small business set-aside contracts, HUBZone contracts, 8(a) BD contracts, SDVOSB contracts, WOSB, and EDWOSB contracts. The new regulations reflect a shift in measuring the limitation on subcontracting as a required percentage of cost of work to be performed by a prime contractor, to one measured as a percentage of the award amount to be spent on subcontractors.

In addition to this significant change in the base measurement for subcontracting limits, the new rules exclude from the calculation the percentage of the award amount that the prime contractor spends on "similarly situated entity subcontractors." Similarly situated entities are small business subcontractors that are participants of the same small business program as the prime contractor, under which the prime contractor is a certified participant and which qualifies the prime contractor to receive the award. In short, other "similarly situated entity subcontractors" are not counted towards the limitation at the first-tier subcontractor level.

The old SBA Rule—and the current FAR, which has not yet been amended—set forth performance of work requirements based on the type of small business program set-aside at issue, whether the acquisition was for services, supplies, general construction, or specialty trade construction. For example, the performance of work requirements for a contract for services was measured by the percentage of the cost of the contract performance incurred for the prime contractor's personnel.

Now—once the rule is fully implemented and the resulting clauses are incorporated into solicitations and contracts—for both service and supply contracts, the prime must agree that it will not pay more than 50 percent of the amount paid by the government to firms that are not similarly situated. Any work that a similarly situated subcontractor further subcontracts to a lower tier subcontractor will count towards the 50 percent subcontract amount that cannot be exceeded. 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 non-similarly situated concerns.

A question remains on the impact of the new rule on current solicitations and contracts. While Congress and the SBA have formally addressed the Limitation on Subcontracting issue, the FAR Council which implements

changes to the FAR and its contract clauses has not yet amended the FAR. On August 17, 2016, the FAR Council opened a FAR Case to implement the NDAA's statutory changes and SBA's implementing regulations through an interim rule. Small business prime contractors and large business subcontractors should study any Request for Proposal and carefully consider their teaming options. Solicitations and contracts could contain the "old" clause that is inconsistent with the NDAA and the SBA regulations. Dialog with Contracting Officers and close monitoring of this FAR case is recommended until the FAR is amended and the new clauses find their way into solicitations and contracts.

3. CHANGES TO REQUIREMENTS FOR SUBCONTRACTING PLANS

The third issue—Subcontracting Plans—was also part of the June 30 SBA Rule implementing sections of the NDAA of 2013. The changes to the SBA's subcontracting plan regulations will result in greater scrutiny of subcontracting plans and may result in serious consequences should a prime contractor fail to meet the goals and objectives set out in their small business subcontracting plans. Negative consequences could include material breach of contract claims, liquidated damages, negative past performance, referral to the SBA's Area Director, or referral to the SBA Office of the Inspector General ("OIG") for further investigation.

SBA's final rule provides that the head of a contracting agency shall ensure that contractors meet the goals set forth in their subcontract plans. In satisfying this mandate, a prime contractor that identifies a small business by name as a subcontractor in a proposal or subcontracting plan must notify those subcontractors in writing prior to submitting that proposal or plan. The rule also provides that anyone who has a reasonable basis to believe that a prime contractor or subcontractor may have made a false statement to the government with respect to subcontracting plans must report the matter to the SBA OIG. SBA OIG referrals are also required where firms that are found to have acted fraudulently or in bad faith. The SBA is required to establish a reporting mechanism to allow potential subcontractors to report fraudulent activity or bad faith behavior by a prime contractor with respect to a subcontracting plan.

A second mechanism to ensure that contractors are meeting their subcontracting goals is through on-site compliance reviews by the SBA and follow-up reviews that supplement evaluations performed by the contracting agencies. A contractor that fails to provide a written corrective action plan after receiving a marginal or unsatisfactory rating for its subcontracting plan performance, or that fails to make a good faith effort to comply with its subcontracting plan, would be considered to be in material breach of the contract and the failure

must be considered in any past performance evaluation of the contractor. Liquidated damages may also be applied. The FAR Council also issued a final rule implementing regulatory changes made by the SBA concerning small business subcontracting, which will become effective on November 1, 2016. These changes flow from regulations issued by the SBA in 2013 and originate in the Small Business Jobs Act of 2010, which required the issuance of new regulations addressing small business subcontracting compliance.

The final rule contains the following significant changes with respect to subcontracting plans: First, under revised FAR 19.704, prime contractors are required to make good faith efforts to utilize proposed small business subcontractors during performance of a contract to the same or greater degree the prime contractor relied on the small business in preparing and submitting its bid or proposal. If a prime contractor does not do so, it must prepare a written statement for the Contracting Officer within 30 days of contract completion explaining why it is unable to do so. If a prime contractor fails to make a good faith effort to comply with its subcontracting plan, in addition to forming the basis for a material breach of contract, noncompliance may be considered in a contractor's past performance evaluation.[1] In addition, subcontractors may now have access to the Contracting Officer to complain about the lack of utilization, and prime contractors are restricted from prohibiting subcontractors to discuss payment or utilization with the Contracting Officer.[2]

Second, Contracting Officers now have the discretion to require a subcontracting plan from a prime contractor in two situations: (1) where a prime contractor that was small at the time of contract award recertifies as other than small, pursuant to FAR 19.301-2(e); and (2) a contract modification causes the total dollar value of the contract to exceed the subcontracting plan threshold specified in FAR 19.702(a)(3).

Third, FAR 19.704 now permits Contracting Officers to require prime contractors to establish subcontracting goals in terms of total subcontract dollars and total contract dollars. Although some commenters were strongly opposed to this approach, the Councils stated that this change is discretionary, not mandatory, and noted that many Contracting Officers have already established subcontracting goals in terms of total contract dollars as a means of obtaining additional insight into the contractor's subcontracting performance.

Fourth, revised FAR 19.705-1 provides that the Contracting Officer shall require a subcontracting plan each indefinite-delivery, indefinite-quantity

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[1] *See* FAR 52.219-9.

[2] FAR 19.704.

contract where the estimated value of the contract meets the subcontracting plan thresholds and small business subcontracting opportunities exist. In addition, Contracting Officers placing orders may establish small business subcontracting goals for each order. Finally, prime contractors with subcontracting plans on task and delivery order contracts will be required to report order-level subcontracting information after November 2017. Subcontracting data will be required for each order, regardless of value. Prime contractors should be aware of these new regulatory changes, which impose additional compliance obligations with regard to the proposed utilization of small business concerns described in contractor subcontracting plans. The SBA's activities as well as the Contracting Agency's activities will be critical in this area.

4. EXPANSION OF THE MENTOR-PROTÉGÉ PROGRAM

The fourth issue to emerge this year is the expansion of the SBA's mentor-protégé program. On July 22, 2016, the SBA published a final rule significantly expanding the scope of its mentor-protégé program and will now include all businesses designated as small, not only 8(a) Business Development Program participants. Thus, large businesses will be able to form joint venture agreements with protégé firms, including WOSBs, SDVOSBs, and HUBZone firms, to bid on small business set-aside contracts.

The mentor-protégé program provides a benefit for both large and small businesses: A large business mentor may form a joint venture with its small business protégé to compete for any government prime contract or subcontract set aside for small businesses, provided certain requirements are met. No determination of affiliation or control may be found between a protégé firm and its mentor based on the mentor/protégé agreement or any assistance provided pursuant to the agreement. The small business protégé benefits from its mentor's assistance, including through technical and/or management assistance, loans, and equity investments.

The mentor-protégé program is an exception to the SBA's affiliation rule, and contractors must ensure that they are operating within the limits that exception. The rules require that a joint venture agreement must be in writing and identified in the System for Award Management ("SAM"). The legal form of the relationship may be as an informal partnership or as a separate legal entity or limited liability company. The SBA must approve the mentor-protégé agreement and, if approved, the firms may form a joint venture for a small business contract provided the protégé qualifies as small for the size standard corresponding to the procurement. The SBA's new mentor-protégé rule went into effect on August 24, 2016.

5. REVISIONS TO THE NONMANUFACTURER RULE

Fifth, and finally, in its June 30, 2016 final rule the SBA made some significant changes to the Nonmanufacturer Rule, which allows a small business to offer a product that it did not manufacture under a small business set-aside if SBA has granted a waiver. The Nonmanufacturer Rule is an exception to the percentage of work requirements (limitation on subcontracting) for manufacturing of supplies. Generally, under the Nonmanufacturer Rule, a firm can qualify as a small business concern under a small business set-aside procurement for products or supplies if it:

- Does not exceed 500 employees;
- Is primarily engaged in the retail or wholesale trade and normally sells the type of item being supplied;
- Takes ownership or possession of the item(s) with its personnel, equipment or facilities in a manner consistent with industry practice; and
- Will supply the end item of a small business manufacturer, processor or producer made in the United States, or obtains a waiver of this requirement.

The SBA's new rule introduces some important changes to the Nonmanufacturer Rule.

The SBA provided two important clarifications as to what constitutes a "supply" contract subject to the Nonmanufacturer Rule: Rental services are classified as "services" rather than supplies; thus, contracts for rental services are not subject to the Nonmanufacturer Rule. On the other hand, SBA's new rules classify software as a supply item; thus, contracts for the provision of software generally are now subject to the Nonmanufacturer Rule.

Next, the SBA has clarified how the Nonmanufacturer Rule applies on a multiple item supply contract. On contracts that include some items that are subject to an individual or class waiver, and other items that are not, the value of the waived item(s) are subtracted from the total, and the prime contractor is responsible for meeting the requirements on the remainder under the Nonmanufacturer Rule. In other words, at least 50 percent of the value of the items not subject to a waiver in a multiple item supply contract must be supplied by one or more domestic small business manufacturers, and the prime small business nonmanufacturer may act as a manufacturer for one or more items.

Further, the new rules state that Contracting Officers must provide written notification of a class or individual waiver to the Non-Manufacturer Rule to

potential offerors at the time a solicitation is issued. If a solicitation has already been issued, the Contracting Officer can grant an individual waiver only after providing all potential offerors additional time to respond. SBA can also grant a waiver *after* contract award, if the Contracting Officer has determined that the modification is within the scope of the contract and the agency followed the regulations prior to issuance of the solicitation and properly and timely requested a waiver for any other items under the contract. The rules also provide specific waiver provisions for commercially-available software.

The SBA's new rule helps clarify some aspects of the Nonmanufacturer Rule, but there are still some potential pitfalls for prime contractors that supply goods manufactured by a subcontractor. Contractors subject to the Limitation on Subcontracting and Nonmanufacturer Rules should consult with counsel to ensure compliance with these complex rules.