Updates
January 23, 2019

Proposed Changes to Small Business Rules That All Government Contractors Need to Know

The Small Business Administration (SBA) issued a proposed rule on December 4, 2018, to implement, among other things, certain provisions of the National Defense Authorization Acts (NDAA) of 2016 and 2017. The proposed rule, if adopted without change, would increase risk in areas of small business government contracting that have tended to fly under the enforcement radar. Such changes would:

- Raise the stakes for complying with small business subcontracting plans;
- Empower contracting officers to request information from contractors to verify their compliance with limitation on subcontracting requirements; and
- Provide a mechanism for reviewing allegations that an 8(a), SDVOSB, HUBZone or WOSB set-aside prime contractor is unduly reliant on a small business subcontractor that is not "similarly situated"—i.e., that would not qualify for the award of the prime contract.

The proposed rule also would implement procedural changes that could affect how contractors think about certain small business set-aside opportunities, and how contractors enforce their rights in connection with such opportunities.

In this update, we highlight some of the significant aspects of the SBA's proposed rule. Comments on the proposed rule are due by February 4, 2019. Although the government shutdown may delay finalization of this and other proposed rules, the SBA has not announced an extension to this comment deadline.

What Constitutes a Good Faith Effort to Comply With a Small Business Subcontracting Plan?

Section 1821 of the 2017 NDAA provides that it shall be a material breach of a contract when a contractor fails to comply in good faith with the requirements of its subcontracting plan, including requirements related to reporting and cooperating in studies and surveys to determine compliance with the plan. Section 1821 also directs the SBA to provide examples of activities that would be considered a failure to make a good faith effort to comply.

In response to that direction, SBA proposes, consistent with past practice, that an analysis of "good faith" will consider the totality of the contractor's actions to promote subcontracting opportunities for small businesses to the extent agreed upon in the subcontracting plan. What's new, however, is the list of nine specific "activities reflective of a failure to make a good faith effort" to comply, including activities that could have operational consequences for some large businesses. For example, under the proposed rule, a large business prime contractor that fails to: (1) submit individual or summary subcontracting reports in eSRS by the required deadlines; (2) pay small business subcontractors in accordance with the terms of the contract with the prime; or (3) designate and maintain a company official to administer the subcontracting program and monitor and enforce compliance with the plan, can be found to have materially breached its contract for failing to make a good faith effort to comply with its small business subcontracting plan. Such a breach may be considered in future past performance evaluations as well as in the administration of the breached contract.

Changes to the Limitation on Subcontracting Requirements

Monitoring and Enforcement

Limitations on subcontracting (LOS), which appear in solicitations and contracts that are set aside for award to small business, are intended to ensure that small business prime contractors perform sufficient amounts of the work that government customers set aside for them. In practice, however, LOS have suffered from inadequate monitoring and enforcement—in part because of uncertainty about who has that responsibility.

To address this issue, SBA's proposed rule would clarify that contracting officers may request information from contractors to demonstrate their compliance with LOS clauses. From a prime contractor, such information may include copies of subcontracts or an email that lists the amount the prime contractor has paid its subcontractors for a particular procurement.

Further, SBA is requesting comment on whether all small business prime contractors performing set-aside or sole source contracts should be required to demonstrate compliance with LOS and, if so, what information can be effectively requested by and produced to the contracting officer.

Treatment of Independent Contractors

SBA has long provided guidance on the circumstances in which a company should treat independent contractors as employees for purposes of determining that company's size under an employee-based size standard. Currently, SBA's size regulations provide that "all individuals employed on a full-time, part-time, or other basis" are considered employees of the firm whose size is at issue. To determine when an individual contractor is employed on an "other basis" and, therefore, should be counted as an employee, SBA uses 11 criteria first set forth in a 1986 Size Policy Statement. Underlying this guidance is SBA's desire to prevent firms from firing employees to maintain small business status, then rehiring those same individuals as independent contractors to evade application of SBA's size regulations.

When the applicable size standard is receipts-based, however, a contractor's number of employees isn't relevant to its size status, so an independent contractor need not be evaluated as a potential employee. Instead, an independent contractor is appropriately treated as a subcontractor, per 13 C.F.R. § 125.6(e)(3), and the work performed by that independent contractor "may count toward meeting the applicable LOS where the independent contractor qualifies as a similarly situated entity."

The effect of the applicable size standard—whether employee-based or receipts-based—on the treatment of independent contractors is insufficiently clear in the current regulations, and SBA now recognizes the inequity that can result from that lack of clarity. As SBA puts it, "It would not be equitable to say that a given individual counts against a firm in determining size (because he/she is considered an 'employee' of the firm), and then to say that [the] same individual also counts against the firm for the LOS requirements (because he/she is not considered an 'employee' of the firm)."

To address this inequity and clear up related confusion, SBA proposes to treat independent contractors differently under employee-based size standards and receipts-based size standards. The new rule would provide that, for a contract assigned a NAICS code with an employee-based size standard, an independent contractor may be considered an employee. For a contract with a NAICS code with a receipts-based size standard, an independent contractor *could not* be considered an employee and, instead, would always be deemed a subcontractor. Such subcontractors, if they are "similarly situated entities," would not count against the prime contractor's LOS under 13 CFR § 125.6(a).

Exclusions From LOS Requirements

SBA's proposed rule also provides exclusions from compliance with LOS requirements for: (1) certain contracts performed outside of the United States; (2) transportation and disposal of waste in the environmental remediation industry; (3) media purchases; and (4) remote hosting on servers or networks (i.e., cloud computing, which SBA previously determined should be considered a service and, therefore, exempt from the Non-Manufacturer Rule). As an alternative to such treatment of cloud computing, SBA is requesting comments on whether cloud computing should be treated as a supply such that SBA can issue waivers of the Non-Manufacture Rule. The SBA also wants comments on a definition of cloud computing that would prevent other-than-small businesses from providing an excessive portion of services on small business set-aside contracts.

These proposed changes to LOS compliance requirements, if implemented without modification, would clarify some historical sources of confusion—always a good thing for contractors—but simultaneously emphasize and encourage increased oversight of this issue by contracting officers.

Undue Reliance on a Small Business Subcontractor Not "Similarly Situated" to the Prime Contractor

The ostensible subcontractor rule applies when a small business is unduly reliant on a large business subcontractor, or when that subcontractor will perform vital or primary parts of the contract. In such cases, SBA will typically treat the small business prime contractor and its subcontractor as joint venturers and, therefore, as affiliates (absent an exception to joint venture affiliation). If the subcontractor is not small, the prime contractor is ineligible for award due to that affiliation.

Under SBA's recent joint venture regulations, however, a joint venture receives an exception from affiliation if both joint venturers are small under the applicable NAICS code. Thus, current regulations prevent SBA from performing an analysis under the ostensible subcontractor rule when, for example, a prime contractor performing an 8(a) set-aside subcontracts with a non-8(a) small business. In such a situation, because the prime contractor and subcontractor are small, both benefit from the exception from affiliation for small joint venture partners—despite the subcontractor's ineligibility for award of the prime contract.

To change this result, SBA proposes language allowing it to make a determination regarding a small business program participant's overreliance on a non-similarly situated subcontractor as part of an eligibility or status protest decision. If SBA finds that the subcontractor is an ostensible subcontractor, it will treat the relationship as a joint venture and analyze whether the concern meets SBA's new joint venture requirements. If the proposed rule is implemented as-is, this change will apply only to service contracts, but will make more set-aside awards subject to size and status protests.

Allowing a Set-Aside Within a Set-Aside

The proposed rule also would allow agencies to set-aside orders for a particular socioeconomic small business program (for example, 8(a), HUBZone, SDVOSB or WOSB) under multiple award contracts (MACs) originally awarded as general small business set-asides. SBA notes that agencies may implement such set-asides in different ways, including: (1) establishing set-asides to socioeconomic programs at the order solicitation level; and (2) establishing socioeconomic set-aside pools at the master contract solicitation level.

If implemented, this change could make small business set-aside MACs even more valuable for 8(a) participants, HUBZones, SDVOSBs and WOSBs, given the potential for further restrictions on competition at the task order level. The flip side is that small business awardees that lack such socioeconomic status might find themselves shut out of task order opportunities for which they otherwise would have competed. Likely because of these potential conflicts between SBA procurement programs, SBA is requesting comments on whether this approach will impact the ability of all types of small businesses to compete for and receive orders.

Additional Changes to Small Business Contracting Expected

The changes described by SBA in the proposed rule could have significant repercussions for large and small government contractors—and more changes to small business contracting programs are on the way. We will provide a separate update on the Small Business Runway Extension Act, which President Trump signed into law on December 17, 2018, and we will continue to monitor other developments on these topics. Subscribe here for future updates.

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