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New, Steep Penalty In Proposed SBA Subcontracting Rule

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On Dec. 29, 2014, the U.S. Small Business Administration issued a proposed rule to enact changes to the limitations on subcontracting rules mandated in the National Defense Authorization Act of 2013. See 79 FR 77955. The rule proposes important amendments to the SBA's rules for affiliation, joint ventures, calculation of annual receipts, size protests, North American Industry Classification System appeals, the nonmanufacturer rule, and the limitations on subcontracting. This article will focus only on the changes to the limitations on subcontracting rules, including the mandatory fine of at least $500,000 for noncompliance with the limitation on subcontracting.

The Changed Rules

The current/old rule requires a prime contractor to perform "at least 50 percent of the cost of contract performance incurred for personnel" on services contracts, and "at least 50 percent of the cost of manufacturing the supplies (not including the cost of materials)" on supply contracts. 13 C.F.R. § 125.6(b), (c)(2014). Prior decisions from the U.S. Government Accountability Office and the SBA Office of Hearings and Appeals held that these calculations excluded overhead, general and administrative expense and profit from the computation of total contract cost for services contracts, and material and subcontracting costs from the computation of total contract cost for supply contracts. See, e.g., Mech. Equip. Co. Inc., et al., B-292789.2 et al., Dec. 15, 2003, 2004 CPD ¶ 192.

The 2013 NDAA changed this rule to prohibit the prime contractor from spending "more than 50 percent of the amount paid to the [prime] under the contract" on service subcontracts. For supply contracts, the prime contractor "may not expend on subcontractors more than 50 percent of the amount, less the cost of materials, paid to the [prime] under the contract." See Pub. L. 112-239 § 1651. The SBA's newly proposed rules reflect this change.[1] See 79 FR 77967, § 125.6(a).

Additionally, the proposed rule exempts small business set-aside contracts below $150,000 in value from application of the rule, although the preamble to the rule makes clear that the limitations on subcontracting will still apply to "all 8(a), HUBZone, SDVO, and WOSB/EDWOSB set aside contract awards regardless of value," consistent with the requirements of Section 46 of the Small Business Act. Id at 77 FR 77957. The SBA is considering whether for policy reasons and consistency it should apply the limitation to

small business set-aside contracts between $3,000 and $150,000. Id.

Calculating Compliance

To ease the burden on small business primes, the proposed rule also allows primes to exclude the amounts paid to "similarly situated" entities at any tier from the compliance calculations. See 79 FR 77967, § 125.6(a). However, if any similarly situated subcontractor further subcontracts to a nonsimilarly situated entity, this amount will be counted toward the 50 percent compliance threshold. Id.

The proposed rule defines "similarly situated entity" as "a subcontractor that has the same small business program status as the prime contractor." Id. at 77966, § 125.1 (x). It goes on to explain that it is the requirement being contracted for and the assigned NAICS code that control. Thus, an entity which qualifies under multiple set aside categories does not get to pick among multiple similarities, but rather the category under which it received the award.

In other words, an 8(a), SDVO SBC prime can now subcontract any amount to another service-disabled veteran-owned small business subcontractor under an SDVO set-aside without violating the limitations on subcontracting rule. A subcontract to an 8(a) that was not an SDVO SBC, however, would not qualify as similarly situated. Caution is in order because if the SDVO SBC subcontractor further subcontracts part of this amount to a non-SDVO SBC entity, e.g. even to an 8(a) contractor, the amount subcontracted will count towards the calculation of compliance with the limitation on subcontracting rule.

Moreover, the timeline for calculating compliance has not changed from the old rule. For total or partial set-aside contracts, the period of time is the "base term and then each subsequent option period." Id. at 77969, § 125.6(h). Also, "for an order set aside under a full and open contract or a full and open contract with reserve, the agency will use the period of performance for each order to determine compliance." Id.[2] Thus, compliance with the limitations on subcontracting rule is determined at the end of the period. As explained below, the current constrained and incremental funding of federal contracts complicates contractors' good faith compliance efforts.

Penalties

Significantly, the 2013 NDAA imposed new and steep penalties for noncompliance with the limitations on subcontracting rules. See Pub. L. 112-239 § 1652. Previously, the law did not penalize violations of the limitations on subcontracting. See 15 U.S.C. § 645 (2011). The 2013 NDAA, however, mandates that an entity that exceeds a limitation on subcontracting "shall" be penalized in an amount "the greater of- (A) $500,000; or (B) the dollar amount expended, in excess of permitted levels, by the entity on subcontractors." 15 U.S.C. § 645(g) (2014). This penalty also appears in the newly proposed rule at § 125.6(k), and just like the statute, the rule mandates that "[w]hoever violates the requirements set forth in [the limitations on subcontracting rule] shall be subject to the penalties." 79 FR 77969, § 125.6(k).

In other words, there is a mandatory minimum penalty of $500,000 for violations of the limitations on subcontracting rule, and the proposed rule does not appear to create any safe harbors that would exempt contractors from the penalty for honest mistakes that result in violations.

Additionally, the proposed rules allow the SBA to consider debarment for any entity that violates a subcontracting agreement designed to achieve compliance with the limitations on subcontracting rules. See 79 FR 77968, § 125.6(b)(3).

Compliance Risk

The proposed rule appears to expand subcontracting opportunities, both by expanding how much can be subcontracted by the prime, and to whom the subcontracts can be given. But caution is in order. The imposition of the statutory penalty for violations of the limitations on subcontracting rule creates serious compliance risks for contractors.

Although the new rules exclude subcontracts to similarly situated entities at any tier from the compliance calculation, they also include subcontracts at any tier that are not made to similarly situated entities. For practical purposes, this means that a SDVO SBC prime could subcontract 60 percent of the amount paid to itself under a services contract to another SDVO SBC without violating the limitations on subcontracting rules. If the SDVO SBC performs all of the subcontracted work, the prime will be in compliance with the limitations on subcontracting because the amount contracted to this similarly situated entity will not be counted toward the compliance threshold for the limitations on subcontracting rule. If, however, the subcontractor SDVO SBC in turn subcontracts 95 percent of its work to an other-than-small entity (perhaps one that has falsely certified) or to a non-SDVO SBC without the prime's knowledge, then the prime will have violated the limitations on subcontracting rule because 57 percent[3] of the amount paid to the prime will have been subcontracted to a non-SDVO SBC concern. This will subject the prime to the statutory penalties.

The regulations do not specify that the prime (as opposed to the subcontractor) will be subject to the penalty in such situations, however, such a result seems logical for several reasons. First, the prime must agree to the limitations on subcontracting. See 79 FR 77967, § 125.6(a) ("In order to be awarded a full or partial small business set-aside contract ... a small business concern must agree "). Second, the proposed rules require the offeror to submit a certification of compliance with the limitations on subcontracting, and treat compliance as an element of responsibility, both of which indicate that the prime is the target of the rules. Id. at 77968-69, §§ 125.6(c), (h)(2). Finally, the government does not have privity of contract with subcontractors, which means that the government will likely seek to enforce the rule against the prime.

Additional risk exists because compliance determinations are made at the end of the contract term under the rules. In other words, it is only once the contractor reaches the end of the contract term that it will know whether or not it has violated the rules. Thus, businesses that subcontract larger amounts of work are exposed to greater risk.

For example, a woman-owned small business prime could subcontract 49 percent of the amount it has been paid to an other-than-small business without violating the limitations on subcontracting rule. But if a 10 percent portion of the WOSB prime's work was subsequently descoped by the contracting agency, the prime could find itself in violation of the rule at the end of the period of performance.[4] Moreover, the current fiscal environment leads to the incremental funding of federal work. Often contractors are asked to work "at risk," or may find that work planned for the year is "reprogrammed" to other Agency priorities. Work may be meted out in short 30-day or three-month options. This uncertainty may derail small business prime contractors' plans to allocate work within any year.

Penalties under the statute and the proposed rules will be a minimum of $500,000 for any violation. Given that the limitations on subcontracting apply to contracts over $150,000, this means that on contract valued at $150,001, the penalty for a violation of the limitations on subcontracting could result in a minimum violation over two and one half times the total contract value. Under an indefinite delivery/indefinite quantity contract, a contractor may be exposed to the liability for an even smaller task

order of just a few thousand dollars. Thus, it is crucial that small business prime contractors account for and monitor these risks.

Mitigation Measures

In light of the above risks, contractors may wish to submit comments on these subjects to the SBA for consideration prior to the final rulemaking. Comments are currently due by Feb. 27, 2015. See 79 FR 77955. It may be beneficial for the SBA to consider a safe harbor provision for contractors who find themselves in violation of the limitations on subcontracting rules through no fault of their own.

Because there is no guarantee, however, that SBA will adopt any revisions proposed in comments, there are other prudent measures that small business prime contractors can and should take to protect themselves from violations.

First, prime contractors should ensure that any subcontracts contain reporting and approval requirements for lower-tier subcontracts. Such provisions give the prime better visibility into the subcontracting activity at lower tiers, and allow the prime to refuse approval of lower tier subcontracts which could result in violations of the limitations on subcontracting rules. Additionally, primes should ensure that any subcontracts mandate that such reporting and approval clauses flow down and must be included in all subcontracts at any lower tier.

Second, prime contractors should consider drafting a savings clause in their first-tier subcontracts. Such a clause could specify that if, at the end of the compliance term, it is determined that the prime is in violation of the limitations on subcontracting rules, then the payment due to the subcontractor is limited to an amount which would not violate the limitations on subcontracting rules.

Conclusion

The proposed rule seeks to simplify compliance with the limitations on subcontracting rules. However, continuing compliance challenges create hidden risk for the unwary. Any small business prime that intends to subcontract portions of the work awarded under a set-aside contract should be careful to ensure that it understands the performance requirements, and has adequate measures in place to safeguard against compliance violations.

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[1] The proposed rule also contains compliance thresholds for construction contracts and special trade contracts that will not be discussed in depth in this article.

[2] The limitations on subcontracting rule does not apply to orders that are competed amongst small and other-than-small businesses. 79 FR 77969 § 125.6(h).

[3] Computed as .95 x 60 = 57.

[4] Section 125.6(e) requires the prime to notify the contracting officer if it modifies a subcontractor's award amount in a way that would affect the prime's compliance with the limitations on subcontracting. See 79 FR 77968, § 125.6(e). But this provision does not create a safe harbor for violations, and the penalties for violations of the limitations on subcontracting are phrased in mandatory language.
