New Defense Legislation a Mixed Bag for Small Business

ANALYSIS

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The 2013 National Defense Authorization Act included several provisions related to small businesses, which include expanded opportunities as well as potentially harsher penalties for failure to follow regulations.

Although other agencies have created similar programs, the Small Business Administration (SBA) mentor-protégé program provides firms of all sizes with a number of benefits. The new legislation helps small businesses that are part of this program and subcontractors to large firms.

The current arrangement is, however, limited to businesses that are accepted into the 8(a) program — a subset of small business set-asides that are limited to firms which are owned by economically or socially disadvantaged individuals who go through an SBA certification process.

The act provides the administration with new authority to create a mentor-protégé program for the thousands of other non-8(a) small businesses so that they can participate in programs modeled on the current structure.

If it chooses to exercise this authority, more small businesses will benefit from the experience, capabilities and, in some instances, capital of large business mentors while also gaining access to government prime contracts that previously may have been outside of their capabilities.

In addition, more large business mentors will be eligible to receive access to, with the protégé, set-aside contracts for which they would otherwise have been ineligible. They would also receive an exception from affiliation with protégés based on the mentor-protégé relationship, ownership of up to 40 percent of the smaller firm and, in certain circumstances, performance of up to 60 percent of the work and up to 60 percent of the profit for contracts performed by the joint venture.

Notably, this final provision, allowing a large company to perform the majority of a small business set-aside contract, seems inconsistent with the NDAA's focus on the limitation on small business subcontracting. As a result, there is no guarantee that SBA will exercise this new authority, and its actions in this regard should be of interest to firms both large and small.

The NDAA also reflects the government's increasing understanding that small businesses often gain a foothold in federal government as subcontractors. This understanding has led to increased emphasis on prompt payment of their plans.

The NDAA continues Congress' interest in this area by increasing transparency within subcontracting plans and further emphasizing compliance. Currently, firms are required to submit detailed subcontracting plans for negotiated or sealed bidding procurements above $500,000 or $1 million for construction contracts.

The plans must include, among other things, percentage goals for subcontracting with each type of small business and the efforts the larger companies will take to meet these goals.

Although the act does not impose new participation requirements for small business subcontracting, it uses an alternate strategy to increase their participation and monitor compliance. Specifically, it adds a requirement that any small business identified in a subcontracting plan as a potential participant must be notified prior to its inclusion. This prevents big firms from padding their plans with small companies they have no intention of using and later turning that work over to large subcontractors.

The NDAA also requires the Small Business Administration to establish a reporting mechanism to allow subcontractors to report fraud or bad faith by a prime contractor with respect to the subcontracting plan. It is still unclear how this system will be implemented and what penalties will be used to enforce compliance. Despite these lingering questions, these mechanisms may serve to increase the number of dollars that actually make it to small businesses and will call for greater prime contractor diligence in administering plans.

A contractor's failure to comply in good faith with its subcontracting plan is considered a material breach of the contract or subcontract, however, the government rarely pursues noncompliant firms on this basis. Federal acquisition regulations also provide a liquidated damages clause for failure to comply with subcontracting plans, but this clause is not required in all prime contracts and, in any event, is rarely enforced. In fact, the most powerful tool the government has to incentivize contractors to follow through with their subcontracting plans is through past performance evaluations, a method endorsed by the NDAA.

Although agencies have been including subcontracting plan compliance in performance evaluations for some time, the practice is now specifically authorized by the NDAA. Agencies can now use these evaluations to ensure that small business subcontracting commitments are kept and to reward contractors who follow through on their subcontracting plans.

Over the last several years, Congress has also shown increased interest in curtailing small business fraud. One of the key tools designed to limit fraud is the so-called presumed loss rule created by the Small Business Jobs Act. This provision created an "an irrefutable presumption of loss to the United States based on the total amount expended on the contract … whenever it is established that a business concern willfully sought and received the award by misrepresentation" of size status.

This rule could lead to millions of dollars in exposure for contractors that are found to have misrepresented their size status, even when all services required under a contract were performed to the government's satisfaction. The law slightly modifies the presumed loss rule by both expanding its reach and providing a potential safe harbor for contractors.

It increases the scope of the presumed loss rule by applying a modified version of it to subcontracting limitations. With the exception of awards to an 8(a) mentor-protégé joint venture, small businesses are required to provide either:

- At least 50 percent of the cost of contract performance incurred for personnel under a services contract.
- At least 50 percent of the cost of manufacturing supplies, not including the cost of materials, in a supply contract.
- Or at least 15 percent of the cost of construction contract, not including the cost of materials, with its own employees under a set aside contract.

Under previous law, a small business could be penalized with suspension, debarment, fines and myriad other penalties for misrepresenting its size status. But it was not clear that failure to abide by these subcontracting limitations would trigger any of these penalties. The act corrects this ambiguity by providing for fines equaling "the amount expended, in excess of permitted levels, on subcontractors" against small

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business prime contractors that violate the subcontracting limitations. This "presumed loss" for all expenditures above the permitted subcontracting percentages could result in penalties in the millions of dollars against small business prime contractors, far beyond the original $500,000 cap now.

This change is significant for two reasons. First, it shows that the Congress is convinced that imposing huge penalties on contractors, no matter the value these contractors provide the government, will help deter size fraud at both the prime and subcontracting level. Second, this steep penalty will likely influence conduct and practices as small firms will more closely monitor their subcontracting.

At the same time as it expanded the rule, Congress also recognized that it is not without its faults. Specifically, the NDAA adds a "safe harbor" from the presumed loss rule related to small business size status. In the House version of the bill, this safe harbor was broad, exempting contractors from penalties if they "acted in reliance on a written advisory opinion from a licensed attorney who is not an employee of the defendant" when they certified that they were a small business. This provision is consistent with requests made by a number of outside groups, many of which pointed out that the SBA's size regulations are subject to a number of good-faith interpretations surrounding affiliation and small business size determinations. These groups argued that penalizing small businesses for failing to predict what interpretation the administration would adopt based on a given set of facts was not justified.

The final version of the bill tightens this safe harbor, which limits it to "good-faith reliance on a written advisory opinion from a small business development center … or an entity participating in the Procurement Technical Assistance Cooperative Agreement Program." But this safe harbor may not be helpful, as the NDAA states that "nothing in this act shall obligate either entity to provide such a letter."

This new presumed safe harbor loss raises more questions. Aside from stating that contractors have no right to receive an advisory opinion and, thus, no right to the safe harbor, the legislation also sets out no prescribed process for issuing size determination letters. In fact, given the apparently voluntary nature of letter issuance, it is not clear whether any mandatory process can be prescribed.

The Small Business Administration currently has a process well suited to these determinations in the area office certification of competency process, but, for reasons that are not articulated, the act is clear that the development centers — and not the area offices — are responsible for these determinations and therefore that the certification of competency process is inapplicable.

Without an established process, contractors will be unable to rely on the issuance of size determination letters in time for proposal submission and size certification, which severely limits the usefulness of this safe harbor. Further, the NDAA does not provide an avenue to appeal an adverse advisory opinion, as is otherwise permitted in the regulations. If a small business cannot appeal a development center's incorrect size determination to the area office or office of hearings and appeals, it may choose not to risk using this safe harbor at all. Without clarity in these areas, this safe harbor provides little comfort.

The act also broadens the ability of an agency to disbar or suspend a contractor if it misrepresents itself as a small business concern. Before the NDAA, the Small Business Act specified that a suspension or debarment for size misrepresentation could only be "on the basis that such misrepresentation indicates a lack of business integrity that seriously and directly affects the present responsibility to perform any contract awarded by the federal government or a subcontract under such a contract."

This language made it more difficult to suspend or disbar contractors for misrepresentations that did not directly impact present responsibility. That language has been removed and, without the present responsibility language in the statute, agencies are now free to use any one of the bases for suspension and debarment in Federal Acquisition Regulation 9.4, including those related to fraud.

Overall, the NDAA provides a mixed bag of small business reforms. In the area of increased opportunities, the expansion of the mentor-protégé program is not mandatory, hence its implementation is less than certain.

Copying the 8(a) program regulations may undercut the current small business subcontracting limitations. Although the act does provide increased small business subcontracting transparency, it does not include significant incentives for contractors to meet those goals.

Moreover, the expansion of the presumed loss rule to subcontracting limitations and the ill-defined safe harbor may create more administrative burdens for small businesses doing work for the government. ND

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