Bloomberg BNA

Federal Contracts Report™

Small Business

Has the Court of Federal Claims Radically Expanded Small Business manufacturing Requirements?

BY DAMIEN C. SPECHT AND JAMES A. TUCKER

The Small Business Administration ("SBA") regulations pertaining to subcontracting work based on a small business set-aside prime contract are straightforward. If the prime contract is a supply contract, the contractor is required to manufacture the required supplies itself or it may supply the goods of another domestic small business through a limited exception known as the Non-Manufacturer Rule ("NMR").[1] If, on the other hand, the prime contract is a services contract, the contractor must "perform at least 50 percent of the cost of the contract incurred for personnel with its own employees."[2] Small businesses have relied on these regulations to balance their ability to fulfill the government's needs using subcontractors with the public's need to prevent set-aside awardees from being mere pass-through entities. A recent Court of Federal Claims decision, however, contradicts SBA's regulations and suggests that *both* of these rules apply to any set-aside contract requiring any amount of goods and services. Such a rule, which would deviate from years of established practice and SBA guidance, could pose significant compliance concerns for holders of set-aside contracts.

SBA's regulations related to small business manufacturing, last amended in 2011, create a bright-line rule for when service and manufacturing subcontracting limitations are applied:

(3) The nonmanufacturer rule applies only to procurements that have been assigned a manufacturing or supply NAICS code. The nonmanufacturer rule does not apply to contracts that have been assigned a service, construction, or specialty trade construction NAICS code.

(4) The nonmanufacturer rule applies only to the supply component of a requirement classified as a manufacturing or supply contract. If a requirement is classified as a service contract, but also has a supply component, the nonmanufacturer rule does not apply to the supply component of the requirement.[3]

Recently, however, the protester in *Rotech Healthcare, Inc. v. United States* (*Rotech II*),[4] argued that SBA's regulations were inconsistent with the underlying statute, and that small business manufacturing requirements *should* apply to a solicitation classified as one for services. Surprisingly, the court agreed – and it may have gone a step further.

The court started its analysis with the Small Business Act, which requires that small business manufacturing requirements apply to "any procurement contract for the supply of a product."[5] Essentially repeating this language, the court not surprisingly found that small business manufacturing requirements "appl[y] unambiguously, to all supply contracts."[6] Presented, as it was, with a contract for equipment rental, classified under a services North American Industry Classification System ("NAICS") code, the court could have concluded that, consistent with SBA's bright-line regulations, manufacturing requirements do not apply to a services contracts.

[1] 13 C.F.R. § 121.406.15; *see also* U.S.C. § 637(a)(17). Although the requirement that a small business manufacture the products delivered on a set-aside contract often is colloquially referred to as the Non-Manufacturer Rule, that rule is an *exception* to the manufacturing requirement and not the requirement itself.

[2] 13 C.F.R. § 125.6(a)(1). Other percentages apply to construction contracts.

Damien C. Specht is Special Counsel and James. A. Tucker is an Associate in Jenner and Block LLP's Government Contracts Group.

[3] 13 C.F.R. § 121.406(b)(3)-(4). Additional exceptions apply to kit assemblers, as well as low-value FAR Part 13 acquisitions and orders placed under unrestricted multiple-award contracts. See 13 C.F.R. § 121.406(c)-(d).

[4] No. 14-502C (Fed. Cl. Sep. 9, 2014).

[5] 15 U.S.C. § 637(a)(17)(A).

[6] *Rotech II*, slip op. at 7.

 ISSN 0014-9063

Practice Tips

1. Firms should not assume that SBA's regulations regarding small business manufacturing will remain static.

2. If a procuring agency is not requiring small business manufacturing compliance for the supply components of a mixed procurement, consider raising the issue with the agency or filing a pre-award protest.

3. Offerors should understand whether they must comply with small business manufacturing rules before submitting proposals.

Instead, despite finding that the rental NAICS code was correct, the court proceeded to weigh the value of the contract on a line item by line item basis to determine if services or supplies were predominant. Concluding that the cost of supplies constituted the majority of contract value, the court found that all supplies provided under the contract were required to comply with the NMR—by which the court meant that the offerors must manufacture the goods themselves or obtain them from another domestic small business under the NMR exception.

Had the court stopped there, the decision would only have been a slight expansion of the court's precedent in a 2006 case (''*Rotech I*'') in which it held that the small business manufacturing requirements apply to set-aside procurements ''for the supply of manufactured items which *also* require the provision of *some* services.''[7] But additional language in the decision raises real concerns about whether services contracts, with only a small amount of supplies, may be required to comply with small business manufacturing requirements. Specifically, the court characterizes *Rotech I* as holding that small business manufacturing rules apply to ''contracts for the procurement of *any* supplies.''[8] The Court further explained that ''[t]he significance of the service component [in a mixed procurement] is, however, irrelevant to the application of the NMR under the holding in *Rotech* as long as there is a supply component.''[9]

Taking the *Rotech II* dicta at face value would represent a dramatic expansion of small business manufacturing requirements to *all contracts* that contain even a negligible amount of supplies. Undoubtedly, such a rule would create real compliance risk for small businesses that, relying on SBA guidance and regulations, have operated on the NAICS code standard (where manufacturing rules do not apply to procurements that are classified under services codes and vice versa) for years.

In an ironic twist, the expansion of this statute intended to protect small businesses could result in *fewer* small business set-aside contracts. This is the case because any contract requiring *any* products that are manufactured only by large businesses could no longer be set aside for small businesses without a waiver of manufacturing requirements. Further, the usefulness of the NMR exception would be diminished because the NMR applies only to businesses that are ''primarily engaged in the wholesale or retail trade'' and ''a regular dealer . . . in the product to be offered the Government.''[10] If a non-manufacturer is primarily a provider of services and competing for a contract assigned a services NAICS code, it may be impossible for it to comply with the NMR, even if it finds a domestic small business that can supply the required items. This problem becomes more acute if the more expansive dicta in *Rotech II* prevail and the manufacturing requirements are applied to any supplies provided under any set-aside contract. Because the facts of the *Rotech* cases do not directly address this issue, the applicability of small business manufacturing rules may remain unclear until later cases.

The *Rotech* decisions also create confusion regarding applicable size standards. As a general rule, size is determined under services contracts using revenue, while employee counts are relevant for manufacturing contracts. Because it is designed for supply contracts with manufacturing NAICS codes, the regulatory NMR allows non-manufacturers to supply another domestic small concern's items if the non-manufacturer has fewer than 500 employees. How, then, should this standard be applied to services contracts where size is based on a revenue? In theory, a small business would be required to meet both employee and revenue codes to take advantage of this exception to small business manufacturing rules. This mix of size standards, however, runs counter to the normal rule that size is determined either by revenue or by employee count, but not by both.

Take-Aways. Large and small businesses can take several lessons away from these decisions. First, the overarching message of both decisions is that firms should not assume that SBA's regulations regarding small business manufacturing will remain static. There may be significant change in the coming years, and the current way of doing business may have to change.

Second, a broader interpretation of small business manufacturing may benefit some contractors. If a procuring agency is not requiring small business manufacturing compliance for the supply components of a mixed procurement (and a firm believes that its competitors may be unable to comply), a firm should consider raising the issue with the agency or filing a pre-award protest. This tactic may benefit a small business manufacturer by eliminating some of its competitors. Alternatively, such a protest may benefit excluded large businesses by eliminating small businesses that would otherwise have been able to supply a large business product.

Third, if a set-aside award is announced in a procurement where supplies will be delivered, and the intended awardee has more than 500 employees, an interested party may wish to protest the intended awardee's size to the appropriate SBA area office. Similarly, if the intended awardee is unlikely to manufacture the supplies and appears not to be ''primarily engaged in the wholesale or retail trade'' and ''a regular dealer . . . in the product to be offered the Government,'' interested parties may wish to file a size protest. If small business manufacturing rules applies to all contracts, as the *Ro-*

[7] *Rotech Healthcare, Inc. v. United States*, 71 Fed. Cl. 393, 424 (2006). The earlier case involved the same protester, the same agency, and a similar procurement.

[8] *Rotech II*, slip op. at 8 (emphasis in original).

[9] *Id.* at 10.

[10] 15 U.S.C. § 637(a)(17)(B)(i) & (iii).

  FCR ISSN 0014-9063

tech decisions insist they do in set-aside procurements that predominantly (or, perhaps, even negligibly) involve supplies and manufactured items, a services NAICS code should no longer be an obstacle to that kind of protest.

Finally, small business manufacturing rules continue as a compliance obligation after contract award. Offerors should understand whether they must comply with these rules before submitting proposals. If manufacturing requirements will apply to an acquisition—even an acquisition of services—an offeror that intends to supply noncompliant manufactured items not only runs the risk of a protest if it wins the contract, it also will be vulnerable to accusations of default, fraud, and violation of the False Claims Act once performance begins. Under existing contracts that neither the contracting agency nor the SBA intended to be covered by the manufacturing requirements, post-award disputes over compliance with those rules may be unlikely. For contracts not yet awarded, however, offerors should consider potential manufacturing compliance obligations if goods must be supplied under the contract.