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Small Business

Renewed Focus on Small and Mid-Size Government Contractors Yields Series of Reforms



BY LES LEPOW, DAMIEN C. SPECHT, AND CYNTHIA J. ROBERTSON

With a slowly recovering economy and an increasing desire by Congress to encourage job growth, we have witnessed several developments that focus on small and mid-sized businesses. In the first week of October 2011, the Small Business Administration (SBA) proposed two rules implementing the Small Business Jobs Act of 2010 (Pub. Law 111-240) (the Act), which Congress passed to stimulate small business, protect small business subcontractors, and curb potential misrepresentation of size and status within small business set-aside programs. These proposed rules will impose several new obligations on large prime contractors that subcontract with small business entities, and on any entity submitting a bid or proposal under a small business set- aside program. Given the potential penalties, contractors should closely review these proposed rules and consider submitting comments prior to the deadlines in early November and December 2011. The proposed rules will become effective once released as interim or final rules, a process that typically takes several months following receipt of comments.

Les Lepow is a partner, Damien C. Specht is an associate, and Cynthia J. Robertson is a Government Contracts Emerging Issues attorney in Jenner & Block's Washington, D.C. office. They are all members of the firm's government contracts practice.

This flurry follows a separate May 2011 legislative proposal (H.R. 1812 – Small Business Growth Act) that has gained recent attention by virtue of its attempt to aid mid-sized businesses that outgrow their small business status and find difficulty competing with larger, more established companies. Below is a summary of the rules implementing the Small Business Jobs Act of 2010 and what they could mean for contractors – both large and small – as well as a brief discussion of the proposed Small Business Growth Act.

I. Small Business Subcontracting Proposed Rule. On October 5, 2011, SBA issued a proposed rule implementing small business subcontractor protections. ''Small Business Subcontracting,'' 76 Fed. Reg. 61626, imposes an obligation to maximize small business participation on any contract, though additional responsibilities apply to larger prime contractors that hold contracts exceeding $1.5 million (if construction-related), or $650,000 for all other contracts. Under the proposed rule, a prime contractor must ''make a good faith effort'' to obtain the products or services from the same small business subcontractor included in a bid or proposal. If a prime does not do so, or if payments to a subcontractor are reduced or 90 days or more past due, the prime must provide a written explanation to the contracting officer. Contracting officers are required to report prime contractors with a ''history'' of unjustified untimely or reduced payments to subcontractors in the

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Federal Awardee Performance and Integrity System (FAPIIS). SBA defines such ''history'' to mean three incidents of unjustified untimely or reduced payments in a 12-month period. The proposed rule further clarifies the contracting officer's role in monitoring and evaluating small business subcontracting plan performance, and defines the term ''subcontract'' to ensure accuracy in prime contractors' reporting obligations.

A. Definition of Subcontract. The FAR contains more than a half dozen definitions of subcontract. Now SBA has defined ''subcontract'' to assist in reducing inaccuracies in the prime's statement of small business subcontracting achievements. Subcontract means ''any agreement . . . entered into by a government prime contractor or subcontractor calling for supplies and/or services required for performance of the contract or subcontract (including modifications).'' 76 Fed. Reg. 61630-31. Purchases from affiliates of the prime contractor or subcontractor are not included. *Id.*

The rule clarifies that subcontract award data reported by prime contractors and subcontractors is limited to awards made to ''their immediate next-tier subcontractor.'' *Id.* It further specifies that credit cannot be taken for awards made beyond the immediate next tier, unless certain circumstances apply. Subcontracts performed outside the United States are likewise not included, though special rules apply for those awarded by the State Department and other agencies, and for foreign military sales contracts. The rule also lists items not to be included in reporting the subcontracting base, such as internally generated costs like salaries and wages, among other items.

B. The Good-Faith Effort to 'Use' Subcontractors. The proposed rule implements the Act verbatim in Section 125-3(c)(ix)(3), requiring offerors to represent ''a good faith effort to acquire [articles and services] . . . from the small business concerns that it used in preparing the bid or proposal, in the same amount and quality used in preparing and submitting the bid or proposal.'' 76 Fed. Reg. 61631.

The proposed rule does not address how determinations of this good faith effort will be made, or how the ''amount and quality'' of a subcontractor's effort will be assessed when comparing its bid and proposal work with its contract performance. Unless additional clarification is added, such a provision may cause additional negotiation, and perhaps tension, as prime contractors and subcontractors negotiate their roles for various phases of contract performance.

The SBA defined the level of bid and proposal ''use'' of a small business subcontractor that would trigger the proposed rule's requirements. 76 Fed. Reg. 61628. If the offeror references a small business in a bid or proposal or has a written agreement with the small business to perform as a subcontractor, then the prime must use that subcontractor during contract performance (or supply an explanation to the contracting officer). Likewise, if the small business drafted portions of the prime's proposal or submitted pricing or technical information appearing in the bid or proposal, with the intent or understanding that the small business would perform that work, the offeror would again be subject to the same obligations.

The rule thus provides added incentive for prime contractors to clarify the relationship and proposed work anticipated for a subcontractor. Large primes may feel unduly burdened by the new requirement, and less freedom to remove or replace subcontractors even for a good reason. The contractor's past performance in previous subcontracting plans, which includes an evaluation of whether the contractor has ''used'' its subcontractor as intended in its bid and proposal, may be a factor in source selection and in evaluating contractor performance. 76 Fed. Reg. 61632.

C. Reporting Reduced or Late Subcontractor Payments. The prime contractor must provide a written explanation of reduced subcontractor payment once the subcontractor's work is complete, or of payments 90 days past due, for which the prime contractor was paid by the government. Proposed Rule at 125.3(c)(1)(b)(ix)(5), 76 Fed. Reg. 61631. The proposed rule does not contemplate subcontractor participation in the prime's written submission, but states that a prime contractor may not prohibit a subcontractor from discussing payment issues with the contracting officer. Proposed Rule at 125.3(c)(1)(b)(iii), 76 Fed. Reg. 61631. The contracting officer is required to consider any unjustified, untimely or reduced payments to subcontractors when evaluating the prime contractor's performance, and in the context of source selection. Proposed Rule at 125.3(g), 76 Fed. Reg. 61632.

Contracting officers are also being asked to consider requiring primes to enter into a ''funds control agreement'' with a neutral third party if the prime is unjustified in withholding or reducing payments to its subcontractors. Proposed Rule at 125.3(d)(6), 76 Fed. Reg. 61632. SBA is specifically requesting comments on such arrangements.

Congress and SBA are clearly seeking ways to encourage prompt and full payment to subcontractors in the absence of an enforcement action, a right generally held only by parties to a contract. Because a prime contractor's history of subcontractor dealings (including promptness of payments) may be a factor in performance ratings and even source selection, this regulation can impact prime contractors who neglect subcontractor payments without justification. Determining whether a delayed or late payment is justified may prove difficult to resolve in some situations and may cause problems for contractors, who must now outline their positions to not only their subcontractors, but their contracting officers as well. Contracting officers will no doubt find themselves in the middle of competing views of the prime versus subcontractor — a potentially burdensome distraction in achieving overall contract performance.

D. Additional Prime Contractor Responsibilities. The numerous prime contractor responsibilities addressed by the proposed rule in section 125.3(c) also include: (1) determining whether to include indirect costs in subcontracting goals; (2) assigning each subcontract the correct NAICS code and corresponding size standard; and (3) submitting timely and accurate Individual Subcontract Reports (ISRs). The prime must also notify unsuccessful small business offerors of the successful offeror's identity on all subcontracts over $150,000 for which a small business concern received a preference. The proposed rule also recommends as a best practice conducting the same procedure for subcontracts at or below $150,000.

SBA also proposed that the contracting officer for IDIQ contracts establish subcontracting plans for con-

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tractors without commercial plans. The contractor will report small business subcontracting achievement on an order-by-order basis to the contracting officer for the contracting agency, allowing the funding agency to receive credit toward its small business subcontracting goals. This stands in contrast to current practice, in which contractors report information on all orders collectively or on a semiannual or annual basis. SBA is seeking comments on whether the reporting requirement should apply to all orders, or only those above a certain threshold.

The numerous responsibilities for prime contractors proposed in the rule should be given attention by industry leaders prior to the public comment deadline of December 5, 2011, given the burdens and consequences the new rules will create.

II. Small Business Size and Status Integrity Proposed Rule. On October 7, 2011, SBA issued a proposed rule entitled ''Small Business Size and Status Integrity,'' (76 Fed. Reg. 62,313) to implement provisions of the Act designed to prevent and deter firms from misrepresenting their size[1] or socioeconomic status, and to enable easier prosecutions of such misrepresentations.

A. Irrefutable Presumption of Total Loss Upon Willful Misrepresentation of Size or Status. The proposed rule amends section 121.108 to establish that in every contract or grant that is reserved for small business, ''there shall be *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.'' 76 Fed. Reg. 62316 (emphasis added). ''[A]ffirmative, willful and intentional certifications of small business size and status'' are deemed to occur upon submission of a bid or proposal for small business set-asides. Proposed rule at 121.108 (b)(1)-(3), 76 Fed. Reg. 62317. Certification may also occur by registration on any Federal electronic database for the purpose of being considered for small business awards. *Id*. Finally, the rule requires an ''authorized official'' to sign the certification on the same page containing the size status claimed. *Id*. at 212.108(c).

B. Limitation of Liability. The proposed rule provides a limited exception to liability for cases involving ''unintentional errors or technical malfunctions that demonstrate that a misrepresentation of size was not affirmative, intentional, or willful.'' *Id*. at 212.108(d). In making such a determination, consideration will be given to the firm's internal management procedures governing size, the clarity or ambiguity of the representation, and the efforts made to correct a mistaken certification in a timely manner. The proposed regulations, which adopt a strict liability standard with ill-defined exceptions for ''unintentional errors,'' can be read to conflict with the False Claims Act, 31 U.S.C. section 3729 (b)(1)(A), which requires proof of deliberate ignorance or reckless disregard. This conflict, as well as one posed by the proposed rule's measure of damages, likely will be the subject of industry comments and future litigation.

C. Damages, Fines and Other Penalties. The proposed rule requires contractors to be extraordinarily careful in evaluating size and status before submitting a bid or proposal for small business set asides. If a misrepresentation is found, a company could be exposed to potential liability or criminal conviction under the False Claims Act, 31 U.S.C. 3729-3733, and liability under the Program Fraud Civil Remedies Act, 331 U.S.C. 3801-3812, among other laws specific to the Small Business Act, as well as suspension and debarment. Companies will be forced to take great care in completing certifications. Protests regarding size or status could subject contractors to an increasing number of investigations by DOJ or other investigative authorities. In situations where determining size is not entirely clear cut, companies will likely err on the side of caution given the proposed rule's strict liability approach originally promulgated by the Act.

The Act and the proposed regulations can be seen as Congress' attempt to resolve the question of damages in False Claims Act cases involving small business set-asides — a still evolving subject among the circuit courts. In *Longhi v. Lithium Power Technologies, Inc.*, 575 F.3d 458, 473 (5th Cir. 2009), the defendant received a Small Business Innovation Research Program grant to develop batteries. The defendant was found to have made false statements in its proposal that were material to the government's award. In determining damages, the Fifth Circuit highlighted that the benefit of the bargain to the government was the intangible benefit of providing an ''eligible deserving'' small business with the award money, rather than a tangible benefit obtained by standard procurement where the government orders products or services. The court distinguished a grant from a contract when calculating damages by finding that in grant cases, where there is no tangible benefit to the government and the intangible benefit is impossible to calculate, damages should be valued as the total amount the government paid to the defendant.

In cases involving contracts rather than grants, False Claims Act precedent holds that calculation of loss must be reduced by the value received by the government. See *United States v. Bornstein*, 423 U.S. 303, 317 (1976). At issue will be whether Congress' new mandate for a presumption of total loss to the government for both contracts and grants in the proposed SBA regulation will be upheld when the government receives a tangible benefit in the form of contracted goods or services received, which normally reduces the amount of damages owed by the contractor.

We anticipate that Congress' attempt to extend the Longhi damages decision to cover not just grants, but also contracts issued under small business set asides — where the government does receive some tangible benefit — will be a likely subject of forthcoming litigation.

III. H.R. 1812: Small Business Growth Act. In yet another new development related to small and mid-sized government contractors, Rep. Gerry Connolly (D-Va.), introduced H.R. 1812, the Small Business Growth Act in May 2011. This legislative proposal aims to assist mid-sized government contractors who have grown out of their small business status. Once contractors ''graduate'' from their applicable size standard, they are often unable to compete with larger companies. The bill would create a new five-year set aside pilot program within the General Services Administration's (GSA's) mentor-protege program that is designed to target mid-sized firms.[2]

To be eligible to participate, the mentor would have to exceed small business standards, but have fewer

than 1,500 employees, and have at least one protege that was a small business. At the request of GSA, contracting officers would be required to report why contracts were or were not awarded under this new program. In sum, this legislation would remove GSA contracts from full and open competition in order to benefit a select subset of mid-sized government contractors who participate in the GSA mentor-protege program. It is not clear why this program is only applicable to GSA mentors and not midsize contractors generally. H.R. 1812, which has no cosponsors, has been referred to a House subcommittee and there is no legislative companion in the Senate.

On September 14, 2011, H.R. 1812 was considered during a House Small Business Committee hearing that examined proposals for medium-sized businesses.[3] While some of the panelists favored the bill, others feared its impact on the government's obligation to fulfill small business programs goals, despite its intent to preserve existing opportunities for small business. *Id*. At least one witness advocated a reduction of bundling contract requirements as the preferred means to provide acquisition opportunities for mid-sized business. *Id*. In his hearing testimony, Rep. Connolly noted a similar piece of legislation proposed for DoD by Rep. Mike Rogers as an amendment to the 2012 National Defense Authorization Act.[4] This amendment was not considered by the House for inclusion in the 2012 NDAA because it failed to meet House rules' requirements.

Even if H.R. 1812 were to obtain the political support needed, the pilot program offered by H.R. 1812 may be less effective than intended given its placement in the GSA mentor-protege program, as compared to that of the Small Business Administration (SBA), which offers more flexibility and advantages in terms of the business partnering relationships between mentor and protege. Though narrower in scope, the SBA's mentor-protege program allows large or mid-sized businesses to team with small businesses in joint ventures to pursue already existing small business set aside opportunities without being considered affiliated businesses. This is a significant advantage over GSA's program that provides a significantly more limited affiliation exemption and discourages joint ventures.

We will continue to monitor the development of this bill and any others intended to assist mid-sized businesses as they proceed through legislative consideration.

IV. Conclusion. The impact of the proposed SBA rules — especially regarding the measure of damages of false size standard certification and the attendant liability standards — should not be underestimated and deserve close analysis. SBA may be willing to consider changes to the limitation of liability provision. As proposed, the provision protects contractors that misrepresent their size status as a result of ''unintentional errors or technical malfunctions'' or ''erroneous representations or certifications made by government personnel.'' 76 Fed. Reg. 62,317. The proposed rule could be improved by also including a safe harbor for contractors attempting in good faith to comply with the regulations. We anticipate that this issue will be addressed by associations or industry groups that submit comments. We also anticipate some scrutiny by Congressional committees regarding how the certification and presumption of loss provisions in the Act are likely to impact small business.

ENDNOTES. 1. NAICS code size standards are regularly reviewed and changed by SBA. SBA is currently conducting an ongoing analysis of its size standards across various industries. The SBA published two proposed rules on October 12, 2011 that would raise size standards for 15 information industries, such as software publishers, radio networks, and television broadcasters, as well as 37 individual administrative/support and waste management/remediation service entities, including telemarketers, credit bureaus and waste collectors. 76 Fed. Reg. 63510 and 63216.

2. GSA's mentor-protege program regulations are found at 48 C.F.R. 519.70. The primary benefits of this program to large and midsize mentors are evaluation preferences during the source selection process for subcontracts awarded under their subcontracting plans pursuant to their mentor-protege agreements. 48 C.F.R. 519.7004(c).

3. Chairman Graves Questions Proposals for a Medium-Sized Business Program, House Committee for Small Business, Press Release, Sept.14, 2011; available at http://smallbusiness.house.gov/News/DocumentSingle.aspx?DocumentID=260051.

4. Testimony of Rep. Connolly, House Committee for Small Business, Sept. 14, 2011, available at: http://smbiz.house.gov/UploadedFiles/Connolly_Testimony.pdf.

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