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FEATURE COMMENT: New Year, New Rules—Changes Are Coming To The FAR's Small Business Subcontracting Limits And Nonmanufacturer Rule

Introduction—On Dec. 4, 2018, the Federal Acquisition Regulatory Council finally released a proposed rule to implement changes to certain small business subcontracting regulations required by the 2013 National Defense Authorization Act (NDAA). 83 Fed. Reg. 62540 (Dec. 4, 2018). This is a welcome, if not long-overdue sign of progress. Over the last half-decade since the passage of the 2013 NDAA, contractors and Government personnel alike have struggled to comply with an amalgam of inconsistent rules regarding the extent to which a small business may subcontract work under a federal small business set-aside contract.

Currently, the FAR contains several provisions that limit how much work a small business prime contractor may give to subcontractors. Unfortunately, these limitations have not been applied consistently across small business programs. For example, some small business programs require that a small business prime contractor perform a guaranteed percentage of the work itself.

Under others, the prime contractor may subcontract any percentage of the work it receives if the work is given to a "similarly situated entity." Application of the nonmanufacturer rule—an exception to the limitations on subcontracting that allows a small business subcontractor to supply products it did not manufacture if it sources those products from another small business—is similarly confounding for contractors. Some small business programs dictate that the small business may supply a product from *any* small business, while others provide that the small business may only supply such products from another small business *in the same program*.

As a result of this haphazard collection of rules, small businesses have been forced to walk through dizzying regulatory mazes, often unsure as to how much of their prime contract they can subcontract, and to whom. With the passage of the 2013 NDAA, Congress began the process of rectifying these issues. In particular, § 1651 of that NDAA amended the Small Business Act in a manner that shifted the focus of the subcontracting limits from the percentage of work performed by a prime contractor to the percentage of the award amount spent on subcontractors.

Section 1651 also provided small businesses with greater flexibility to choose their subcontracting partners. In this respect, the law states that contract dollars expended by a covered small business concern on a subcontractor that is a "similarly situated entity" are no longer considered subcontracted for purposes of complying with the subcontracting limitations.

The Small Business Administration implemented the changes required by the 2013 NDAA via a final rule on May 31, 2016. 81 Fed. Reg. 34243 (May 31, 2016). The SBA's final rule included two important clarifications: (1) similarly situated entities must themselves comply with the limitations on subcontracting; and (2) subcontracting limitations and the nonmanufacturer rule "do not apply to small business set-aside contracts valued at or below $150,000, but do apply to set-aside and sole-source awards under the other small business programs regardless of dollar value." 83 Fed. Reg. 62540, 62541 (Dec. 4, 2018).

The revisions to the SBA regulations caused much confusion in the federal procurement community because they did not comport with FAR requirements. For example, under the SBA regulations, a small business prime contractor cannot spend more than 50 percent of the amount paid to

it by the Government on firms that are not similarly situated entities, but it can subcontract an unlimited amount of the work to a similarly situated entity if that entity performs the work with its own employees. 13 CFR § 125.6.

By contrast, FAR 52.219-14, Limitations on Subcontracting, requires that a small business set-aside recipient—with few exceptions—(a) expend at least 50 percent of the cost of contract performance on its own personnel, and (b) incur at least 50 percent of the cost of manufacturing supplies. As currently written, the SBA regulations and the FAR are irreconcilable, creating an impossible situation for contractors attempting to comply with both.

The proposed rule attempts to break the logjam by modifying FAR pts. 19 and 52 to align with SBA requirements. While not perfect, the changes are designed to provide much-needed clarity to small business prime contractors performing under set-aside contracts, and to any-size Government contractors who work as subcontractors to a small business on a set-aside procurement. This Feature Comment discusses these changes and their implications, while also offering some tips for compliance for contractors of all sizes.

Changes to the FAR's Small Business Limits on Subcontracting—The proposed rule would modify the FAR's small business subcontracting limitation provisions in two critical ways: (1) the basis for calculating compliance would be changed to require that a small business prime contractor limit its subcontract spending to a percentage of the overall award amount instead of ensuring that it performs a certain percentage of the work itself, and (2) the limitations will be standardized across all small business programs.

Calculating Compliance: As currently written, the FAR imposes a significant burden on small business prime contractors performing under set-aside contracts because it requires them to track the total cost of contract performance, as well as the percentage of that cost incurred for its personnel. FAR 52.219-14(c). In practice, this means that small business contractors often must adopt complex internal accounting methods and ensure meticulous recordkeeping to demonstrate compliance. For example, a contractor performing services for the Government must track not only its direct labor dollars and other allowable costs under FAR pt. 31, but also fringe benefits and general and administrative expenses that are allocated indirectly to the specific contract at issue. This is a time-consuming process that typically results in a significant expenditure of resources.

The proposed rule would relieve these costly administrative headaches by establishing the contract price—i.e., the amount paid by the Government to the small business prime contractor—as the basis for calculating limitations on subcontracting:

> (e) By submission of an offer and execution of a contract, the Offeror/Contractor agrees that, in the case of a contract for—
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> (1) Services (except construction), it will not pay more than 50 percent of the amount paid by the Government for contract performance to subcontractors that are not similarly situated entities. Any work that a similarly situated entity further subcontracts will count towards the 50 percent subcontract amount that cannot be exceeded;
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> (2) Supplies (other than procurement from a nonmanufacturer of such supplies), it will not pay more than 50 percent of the amount paid by the Government for contract performance, excluding the cost of materials, to subcontractors that are not similarly situated entities. Any work that a similarly situated entity further subcontracts will count towards the 50 percent subcontract amount that cannot be exceeded;
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> (3) General construction, it will not pay more than 85 percent of the amount paid by the Government for contract performance, excluding the cost of materials, to subcontractors that are not similarly situated entities. Any work that a similarly situated entity further subcontracts will count towards the 85 percent subcontract amount that cannot be exceeded; or
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> (4) Construction by special trade contractors, it will not pay more than 75 percent of the amount paid by the Government for contract performance, excluding the cost of materials, to subcontractors that are not similarly situated entities. Any work that a similarly situated entity further subcontracts will count towards the 75 percent subcontract amount that cannot be exceeded.

83 Fed. Reg. at 62549. As the FAR Council recognizes, these changes will "make it easier for prime contractors to do business with Federal agencies by giving them more, and less burdensome, options for pursuing and winning larger contracts than before." 83 Fed. Reg. at 62541.

In particular, small business prime contractors would no longer need to employ complex cost-tracking mechanisms to comply with subcontracting limitations. In addition to dramatically reducing compliance

costs, the changes would provide small business contractors with a bigger menu of subcontracting options.

For example, under the current FAR rules, a small business receiving a set-aside valued at $1,000 that costs $800 to perform must ensure that it performs $400 of the work in-house, using its personnel, and that it subcontracts no more than $400 worth to other companies. However, under the proposed rule, the small business may subcontract to any combination of similarly situated and non-similarly situated entities and remain in compliance with the new limits on subcontracting as long as the amount spent on non-similarly situated entities does not exceed $500. 83 Fed. Reg. at 62544. Also, as discussed below, the proposed rule would permit a small business prime contractor to subcontract all of the work to a "similarly situated entity" without exceeding subcontracting limitations.

Ensuring Uniformity Across Small Business Programs: The current FAR rules differ depending on the type of small business program at issue, creating inconsistencies without any clear purpose.

Under Historically Underutilized Business Zone (HUBZone) and Service-Disabled Veteran-Owned Small Business (SDVOSB) programs, for example, a prime contractor can choose to subcontract to other HUBZone or SDVOSB concerns, and will receive credit for that subcontract as part of the percentage of the work it performed without running afoul of the subcontracting limitations. See FAR 52.219-3(d)(1)–(2); FAR 52.219-27(d).

For construction contracts awarded to HUBZone prime contractors, however, some percentage of the cost of contract performance incurred for personnel must be performed by the HUBZone prime contractor's employees, thus re-imposing a limit on the amount a HUBZone prime contractor may subcontract to other HUBZone small businesses. See FAR 52.219-3(d)(3)–(4). For construction contracts with SDVOSB prime contractors, on the other hand, there is no requirement that the SDVOSB prime contractor perform a percentage of the work. Rather, SDVOSB prime contractors may continue to utilize either their employees or the employees of other SDVOSBs without limitation. FAR 52.219-27(d)(3)–(4).

Under the 8(a) and Women-Owned Small Business (WOSB) programs for services, supply and construction contracts, a small business prime contractor currently must perform a certain percentage of the work itself and receives no credit for subcontracting that work to other 8(a) and WOSB small business concerns. See FAR 52.219-14(c); FAR 52.219-29(d); FAR 52.219-30(d). In practice, to work together, this means that businesses under these disfavored programs could be forced to undertake the cost, paperwork and general hassle to form a new joint venture or a new legal entity so as not to run afoul of FAR requirements. In addition to obvious inefficiencies associated with such undertakings, these rules are self-defeating as a matter of policy because they limit the number of small businesses willing or able to become Government contractors.

The proposed rule would revise and standardize limits on subcontracting using a single FAR clause applicable to every small business program. In this respect, the proposed rule would remove "outdated limitations on subcontracting guidance" in FAR 52.219-3, FAR 52.219-27, FAR 52.219-29 and FAR 52.219-30, and revise FAR 52.219-14. 83 Fed. Reg. at 62542. In particular, the proposed rule would add an inclusive definition of "similarly situated entity" to FAR 52.219-14 for purposes of determining compliance with the subcontracting limits:

> "Similarly situated entity," as used in this clause, means a first-tier subcontractor, including an independent contractor, that has the same small business program status as that which qualified the prime contractor for the award; and is considered small for the [North American Industry Classification System] code the prime contractor assigned to the subcontract the subcontractor will perform. An example of a similarly situated entity is a first-tier subcontractor that is a HUBZone small business concern for a HUBZone set-aside or sole-source award under the HUBZone Program.

83 Fed. Reg. at 62548. The proposed rule would also widen the applicability of the clause. The current version of FAR 52.219-14 specifies that the clause applies to contracts and parts of contracts set aside "for small business concerns or 8(a) participants." FAR 52.219-14(b)(1). The modified clause, on the other hand, would extend applicability to all small businesses identified in FAR 19.000(a)(3)—i.e., small businesses, 8(a) participants, HUBZone small businesses, SDVOSBs, economically disadvantaged WOSBs (EDWOSBs) and WOSBs eligible under the WOSB program. 83 Fed. Reg. at 62549. In addition, the clause would apply to (a) part(s) of a multiple-award contract that have been set aside for any small business concerns identified in 19.000(a)(3); (b) contracts awarded on a sole-source basis in accordance with

subpts. 19.8, 19.13, 19.14 and 19.15; and (c) orders set aside for any of the small businesses identified in 19.000(a)(3) under multiple-award contracts as described in 8.405-5 and 16.505(b)(2)(i)(F). Id.

These changes will allow small business contractors to compete for larger contracts because they can leverage the expertise of their peers in their respective small business programs and subcontract to those peers without limitation. As a result, the proposed rule will encourage small business contractors to award more and larger subcontracts to similarly situated entities, which should, in turn, result in greater small business involvement in the federal marketplace.

Changes to the Nonmanufacturer Rule—The proposed rule also would implement a newly revised and standardized nonmanufacturer rule, along with a new implementing contract clause. The nonmanufacturer rule, as currently defined in FAR 19.001, provides that "a contractor under a small business set-aside or 8(a) contract shall be a small business under the applicable size standard and shall provide either its own produce or that of another domestic small business manufacturing or processing concern."

Once again, however, this rule has been applied inconsistently across small business programs. For example, the FAR provides that HUBZone small businesses may only provide products manufactured by another HUBZone small business, thereby inexplicably limiting the categories of small businesses from which a HUBZone small business concern may source products it does not manufacture. FAR 19.1303(e). This has led to constant confusion among businesses of all sizes.

In addition, the FAR does not apply the nonmanufacturer rule to small business set-asides below $25,000. See, e.g., FAR 52.219-6(d). The SBA regulations set a significantly higher ceiling and exempt set-asides below $150,000 from the application of the rule. When the SBA established the threshold in 2016, it provided the following justification in its final rule implementing the 2013 NDAA requirements:

> [N]ot applying the nonmanufacturer rule to small businesses set-asides valued between $3,500 and $150,000 will spur small business competition by making it more likely that a contracting officer will set aside an acquisition for small business concerns because the agency will not have to request a waiver from SBA where there are no small business manufacturers available.

81 Fed. Reg. at 34254. The SBA's reasoning is sound. The process of requesting a waiver is onerous and can discourage small business suppliers with limited resources from competing for contracts in the first place. Many small business set-asides are valued below $150,000—the effective simplified acquisition threshold at the time this final rule was published.

Adopting the SBA's logic, the proposed rule would remove the $25,000 threshold and revise the FAR to raise the dollar threshold for application of the nonmanufacturer rule to acquisitions exceeding $150,000. 83 Fed. Reg. at 62545. The proposed rule also would create a new FAR provision dedicated to the nonmanufacturer rule, which incorporates these changes and specifies that it applies to all 8(a), HUBZone, SDVOSB, EDWOSB and WOSB set-aside and sole-source acquisitions regardless of dollar value:

> 19.103 Nonmanufacturer Rule.
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> (a) Application. (1) The nonmanufacturer rule applies to small business set-asides above $150,000; it does not apply to small business set-asides at or below $150,000. The nonmanufacturer rule applies to all set-aside and sole-source awards under the 8(a), HUBZone, Service-Disabled Veteran-Owned Small Business, Women-Owned Small Business programs regardless of dollar value.
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> (2) The nonmanufacturer rule applies to nonmanufacturers in accordance with paragraph (b) and to kit assemblers who are nonmanufacturers in accordance with paragraph (c).

83 Fed. Reg. at 62545.

In addition, the proposed rule would correct the FAR's inconsistent application of the nonmanufacturer rule to the HUBZone program to align with the SBA's requirements. Currently, the FAR provides that a HUBZone small business recipient of a set-aside or sole-source award must provide products manufactured by another HUBZone small business, but for awards under the other small business programs, the prime contractor must provide products manufactured by any small business. 83 Fed. Reg. at 62544. This nonsensical exclusion of HUBZone small businesses is corrected by the proposed rule, which seeks to amend FAR 19.1303 to provide that "a HUBZone small business concern may submit an offer for supplies as a nonmanufacturer if it meets the requirements of the nonmanufacturer rule set forth at 13 CFR § 121.406." 83 Fed. Reg. at 62547.

The proposed rule also would significantly change the waiver process. In particular, it would allow

contractors to take advantage of an SBA waiver before award—even if the solicitation under which the waiver is sought has already been issued. If the SBA grants a nonmanufacturer rule waiver after the issuance of a solicitation, but before award, COs must amend that solicitation to notify potential offerors of the waiver and to give them more time to submit proposals. 83 Fed. Reg. at 62544. This important change will give small business contractors an opportunity to take advantage of these waivers in "real time" and to compete for contracts for which they might otherwise be ineligible.

Eventually, contractors will see these changes in their contracts through a newly proposed clause, 52.219-XX, Nonmanufacturer Rule. 83 Fed. Reg. at 62550. Once implemented, these changes should bring welcome relief to small contractors, and HUBZone prime contractors in particular, that have struggled to comply with the nonmanufacturer rule.

Existing DOD Class Deviation—On Dec. 3, 2018—the day before the proposed rule was published in the *Federal Register*—the Department of Defense issued Class Deviation No. 2019-O0003, which addresses the preceding limits on small business subcontracting. The class deviation generally tracks the requirements of the proposed rule and functions to harmonize the 2016 revisions made by the SBA pursuant to the 2013 NDAA. Effective immediately, DOD COs are to use the procedures in the class deviation when issuing solicitations and awarding contracts or task or delivery orders under FAR pt. 19 to small businesses, 8(a) program participants, HUBZone small businesses, SDVOSBs, EDWOSBs and WOSBs eligible under the WOSB program. Class Deviation No. 2019-O0003 at 1.

Although the class deviation is broadly consistent with the language of the proposed rule, it appears that DOD has been paying closer attention to the SBA regulations than the FAR Council has. In this regard, the class deviation draws attention to a critical flaw in the proposed rule. As written, the proposed rule applies the nonmanufacturer rule to small business set-asides above $150,000, and specifies that it does not apply to small business set-asides at or below $150,000. 83 Fed. Reg. at 62545.

However, the proposed rule fails to acknowledge that, in a final rule published on March 26, 2018, the SBA amended 13 CFR § 121.406(d) to specify that the subcontracting limits and the nonmanufacturer rule do not apply to small business set-aside acquisitions with an estimated value "between the micro-purchase threshold and the simplified acquisition threshold (as both terms are defined in the FAR 2.101)." This change was made to conform with the changes made to the Small Business Act by the 2018 NDAA, which modified the Small Business Act "by removing the $2,500 and $100,000 thresholds found in the Small Business Act and replacing them with references to the micro-purchase threshold and the simplified acquisition threshold, respectively." 83 Fed. Reg. 12849 (March 26, 2018).

Thus, a critical difference between the proposed rule and the class deviation is the threshold for application of the nonmanufacturer rule. As noted above, the proposed revisions to the FAR remove FAR 52.219-6(d) and FAR 52.219-7(c), both of which currently set the nonmanufacturer rule threshold at $25,000. 83 Fed. Reg. at 62547. The proposed rule also mirrors the 2016 SBA final rule by specifying that the nonmanufacturer rule "applies to small business set-asides above $150,000." 83 Fed. Reg. at 62545.

The class deviation, on the other hand, rewrites 52.219-6(d) and FAR 52.291-7(c) to specify that for a contract exceeding the *simplified acquisition threshold*, the rule applies. Class Deviation 2019-O0003, Attachment 1–2 (emphasis added). Thus forms a cloud in an otherwise sunny sky. As we know, the current simplified acquisition threshold for DOD procurements is $250,000. Class Deviation 2018-O0013 at 2. Given that Class Deviation No. 2019-O0003 has been in effect for almost two months now, we would not be surprised to see a collection of DOD contracts between $150,000 and $250,000 that afford contractors an opportunity to be freed from the confines of the nonmanufacturer rule. This creates an obvious conflict with the proposed rule. If the proposed rule remains unchanged, civilian agency contracts awarded after the implementation of the final rule may be held to a lower threshold of $150,000.

Practical Guidance—Comments on the proposed rule are due February 4. Although the changes discussed above are not yet final, DOD's general adoption of the 2016 SBA regulations upon which the proposed rule is predicated serves as a clear indication that the changes in the proposed rule will likely be implemented in substantially the same form in which they now appear in the *Federal Register*. In light of the class deviation, and because we anticipate the aforementioned broad FAR changes vis-à-vis the issuance of a final rule at some point this year, we recommend that contractors consider taking the following steps:

1. Ensure that all solicitations issued by DOD on or after Dec. 3, 2018, contain the versions of the operative clauses in the class deviation. Many DOD agencies will not timely update forms and templates to reflect the deviation, and mistakes will certainly be made. If you encounter a solicitation without the appropriate clause(s), notify the CO in writing in accordance with solicitation procedures.
2. Seek out and establish relationships with similarly situated entities with whom you may want to subcontract under the new rules.
3. Approach current subcontractors—large and small—to discuss potential reformation of existing relationships to take advantage of the new rules.
4. Consider conducting market research to identify new sources of supply for contracts anticipated to be below the simplified acquisition threshold.
5. Be prepared to modify existing accounting policies and procedures to accurately monitor the percentage of subcontracting expenditures compared against the total value of the contract.

Of course, to the extent you have any questions, do not hesitate to contact appropriate legal counsel.

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