This material from The Government Contractor has been reproduced with the permission of the publisher, Thomson Reuters. Further use without the permission of the publisher is prohibited. For further information or to subscribe, call 1-800-328-9352 or visit *http://legal.thomsonreuters.com*.

THE GOVERNMENT CONTRACTOR®

Information and Analysis on Legal Aspects of Procurement

Vol. 63, No. 34 **September 15, 2021**

Focus

¶ 263

FEATURE COMMENT: Bueller ... Bueller ... Bueller: The FAR Council's Day(s) Off Come To An End With The Long-Awaited Implementation Of The SBA's 2016 Revisions To The Limitations On Subcontracting Rule

Although we have sadly said goodbye to summer, Government contractors have something to look forward to this fall as the Federal Acquisition Regulation Council returned from an extended vacation to publish a final rule amending FAR pts. 19 and 52 to align with similar regulations previously promulgated by the Small Business Administration more than a halfdecade ago. The regulatory changes, which became effective Sept. 10, 2021, include updates to the limitations on small business subcontracting rules that have long confused contractors, as well as other revisions mandated by prior National Defense Authorization Acts (NDAAs). As a result of implementing these changes, the patent discrepancies between the FAR and SBA regulations that have bedeviled contractors over the past five years have been largely laid to rest.

In contrast to the SBA's similar regulations at 13 CFR § 125.6, FAR pts. 19 and 52 have long included a haphazard and outdated amalgam of small business subcontracting rules that can easily render small businesses unsure as to how much of their prime contract they can subcontract, and to whom. Several provisions (e.g., FAR 19.505 and 52.219-14) impose limitations (from 50 percent for supply and service contracts up to 85 percent for general construction contracts) on how much work a small business prime contractor may issue to subcontractors. The limitation is intended to prevent the scenario in which a small business serves merely as a pass-through for a large business to perform a small business set-aside contract. Unfortunately, the threshold percentages are not easy to calculate and can vary dramatically depending on the type of contract at issue. Other related FAR regulations have been equally opaque. For example, under an exception to the limitations on subcontracting regulations that permits a small business subcontractor to supply products it did not manufacture if it sources those products from another small business—i.e., the "nonmanufacturer rule"—some small business programs dictated that the small business may supply a product from *any* small business, while others provided that the small business may only supply such products from another small business *in the same program*.

Congress attempted to rectify these nonconformances in the National Defense Authorization Act for Fiscal Year 2013, which mandated amendments to the Small Business Act to permit, among other solutions, (i) shifting the focus of subcontracting limitations from the percentage of work performed by a prime contractor to the percentage of the award amount spent on subcontractors, and (ii) no longer counting contract dollars spent by small business prime contractors for work performed by "similarly situated" first-tier subcontractors toward the threshold limitations. In May 2016 the SBA issued a final rule revising its regulations to codify, at 13 CFR § 125.6, Congress' overhaul of the limitations. In line with the 2013 NDAA, the SBA's new regulations jettisoned the disparate methodologies for calculating limitations on subcontracting compliance with a more user-friendly formula based on the amount paid by the Government to the prime contractor. In addition, the SBA clarified—in perhaps the most impactful change—that prime contractors subcontracting to "similarly situated entities" did *not* have to count such subcontracts towards the limitation on subcontracting threshold.

 © 2021 Thomson Reuters

The FAR, however, continued to include the prior small business subcontracting regulations (e.g., an outdated version of FAR 52.219-14, Limitations on Subcontracting) that could not be reconciled with the SBA's revised regulations, thus creating much unnecessary confusion for federal contractors. The Council remained silent on this untenable situation until Dec. 4, 2018, when it issued a proposed rule to implement the SBA's 2016 regulation. Now the Council has, at long last, promulgated the final rule to align the FAR limitations on subcontracting with the SBA's regulations. This Feature Comment discusses the final rule's revisions and their implications, along with suggested steps that all contractors can take to capitalize on these significant changes to the FAR.

How Could We Possibly Be Expected To Revise the FAR On a Day Like This?—Much like Ferris Bueller refusing to attend school on a beautiful day, the Council apparently had difficulty finding the motivation to implement these necessary changes. As an initial matter, the Council acknowledged, in response to public comments, the significant length of time between the opening of the FAR case and publication of the proposed rule. Although the Council cited "changes in the rulemaking process that occurred in 2017" as the reason for the delay, it also noted that, beginning in 2019, it has "taken steps to try to shorten the time required to implement SBA's rules in the FAR" by "start[ing] work[ ] on proposed FAR rules after [the] SBA publishes a proposed rule, instead of waiting for a final rule from SBA." 86 Fed. Reg. 44,234. While the Council asserts that its revised approach "should allow more timely publication of FAR rules implementing SBA rules," this commitment to a faster rulemaking process comes a little too late for small business contractors who have been struggling to harmonize the disparate SBA and FAR regulations since May 2016.

The Question Isn't 'What Are We Going To Do?' The Question Is 'What Aren't We Going To Do?'—Ferris, along with his best friend Cameron and girlfriend Sloane, used his "day off" to cover as broad an array of experiences as possible. Similarly, the Council has taken the opportunity to promulgate a broad swath of revisions in the final rule. Consistent with the proposed rule issued in December 2018, the final rule modifies the FAR's small business limitations on subcontracting provisions in two specific ways: (1) it changes the basis for calculating compliance 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) it standardizes subcontracting limitations across all small business programs.

Calculating Compliance: The changes to the calculation of the limitations on subcontracting requirement will be welcome relief for the headache that the FAR has caused small business contractors over the past several years. Previously, under the existing FAR regulations, small business prime contractors were required to track the total cost of contract performance, as well as the percentage of that cost incurred for its personnel, in order to determine the amount that the contractor was permitted to subcontract. See FAR 52.219-14(c). As most contractors know all too well, tracking total contract costs can be an onerous undertaking, as it requires the adoption of precise internal accounting and recordkeeping practices to ensure that subcontracting expenditures do not exceed the "cost of contract performance."

The final rule changes this burdensome method of calculating subcontract expenditures by revising it to focus on the contract price itself—i.e., the percentage of the overall award amount spent on subcontracting in relation to the total amount paid to the prime contractor. 86 Fed. Reg. 44,245 (revising FAR 52.219-14(e)(1)-(2) to state that a small business concern performing set-aside service or supply contracts (excluding construction contracts) "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."). For contracts assigned a North American Industry Classification System (NAICS) code for either general construction or construction by special trade contractors, a small business concern may not pay more than 85 or 75 percent (excluding the cost of materials), respectively, of the amount paid by the Government for contract performance to subcontractors that are not similarly situated entities. Id. Notably, in a significant change from the proposed rule, the final rule provides welcome clarity on calculating the 50 percent subcontracting limitation for "mixed" contracts involving the provision of both services and supplies. Id. at 44,236. Specifically, the revised FAR 52.219-14(e)(1) now instructs that, when a contract is assigned a NAICS code for services, the 50 percent subcontracting limitation shall only apply to the *services* portion

© 2021 Thomson Reuters

of the contract. Id. Similarly, a contract assigned a NAICS code for supplies requires that the 50 percent limitation apply only to the supply portion of the contract. Id.

Another benefit for contractors hoping to make sense of the small business subcontract limitations is the final rule's clarification of the applicable compliance period. In short, for a set-aside contract, compliance with the limitations on subcontracting rule is required "by the end of the base term and then by the end of each subsequent option period, or by the end of the performance period for each order issued under the contract, at the contracting officer's discretion." 86 Fed. Reg. 44,242. For task orders set aside under an indefinite-delivery, indefinite-quantity contract or a partial set-aside contract, compliance is required "by the end of the performance period for the order." Id.

Similarly Situated Entities: The final rule also emphasizes that subcontract work performed by "similarly situated entities"—i.e., first-tier subcontractors with the same small business program status as the small-business status of the prime contractor—is exempt from the subcontracting limitations. See, e.g., 86 Fed. Reg. 44,235 ("A prime contractor may subcontract more than 50 percent of the work to a similarly situated entity and still comply with the limitations on subcontracting."). The Council also makes clear that only work subcontracted to similarly situated first-tier subcontractors will not count toward the applicable subcontracting limitation. Thus, any lower-tier subcontracting, even if to another "similarly situated" entity, *will* count toward the applicable limitation. Id. ("[A]ny work that the similarly situated entity further subcontracts will be counted toward the 50 percent subcontract limit."). In another change from the proposed rule, in response to public comments requesting clarification, the final rule includes a revised definition of "similarly situated entity" in FAR 19.001 and 52.219-14 to now (1) provide an example of when entities have the same small business program status, and (2) specify that the similarly situated entity must qualify as small under the NAICS code the prime contractor assigned to the subcontract. Id. at 44,233.

Ensuring Uniformity Across Small Business Programs: The final rule also aims to eliminate confusion caused by different FAR rules that have applied to small business prime contractors depending on the type of small business program at issue. Previously, under Historically Underutilized Business Zone (HUBZone) and Service-Disabled Veteran-Owned Small Business (SDVOSB) programs, for example, a prime contractor could choose to subcontract to other HUBZone or SDVOSB concerns, and would 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 was required to 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 was no requirement that the SDVOSB prime contractor perform a percentage of the work. Rather, SDVOSB prime contractors were permitted to 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 would be required to perform a certain percentage of the work itself, and would receive 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, this meant that small businesses qualified under these inexplicably disfavored programs would—if they wanted to work together—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 the obvious inefficiencies associated with such undertakings, these rules were self-defeating as a matter of policy because they functioned to limit the number of small businesses willing or able to become Government contractors.

Following the changes in the proposed rule, the final rule revises and standardizes limits on subcontracting using a single FAR contract clause (FAR 52.219-14) applicable to every small business program:

> (1) Contracts that have been set aside for any of the small business concerns identified in 19.000(a)(3);

© 2021 Thomson Reuters

> (2) Part or parts of a multiple-award contract that have been set aside for any of the small business concerns identified in 19.000(a)(3);
> (3) Contracts that have been awarded on a sole-source basis in accordance with subparts 19.8, 19.13, 19.14, and 19.15;
> (4) Orders expected to exceed the simplified acquisition threshold and that are—
> (i) Set aside for small business concerns under multiple-award contracts, as described in 8.405–5 and 16.505(b)(2)(i)(F); or
> (ii) Issued directly to small business concerns under multiple-award contracts as described in 19.504(c)(1)(ii);
> (5) Orders, regardless of dollar value, that are—
> (i) Set aside in accordance with subparts 19.8, 19.13, 19.14, or 19.15 under multiple-award contracts, as described in 8.405–5 and 16.505(b)(2)(i)(F); or
> (ii) Issued directly to concerns that qualify for the programs described in subparts 19.8, 19.13, 19.14, or 19.15 under multiple-award contracts, as described in 19.504(c)(1)(ii); and
> (6) Contracts using the HUBZone price evaluation preference to award to a HUBZone small business concern unless the concern waived the evaluation preference.

86 Fed. Reg. 44,245. Indeed, the final rule clarifies that the limitations on subcontracting (as well as the nonmanufacturer rule) apply to set-asides and sole-source awards made pursuant to FAR subpts. 19.8, 19.13, 19.14, and 19.15, as well as to awards using the HUBZone price evaluation preference pursuant to FAR subpt. 19.13, regardless of dollar value. Id. at 44,233.

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 final 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. See 86 Fed. Reg. 44,236 ("[T]he ... rule provides small businesses with greater flexibility in how they choose to comply with the limitations on subcontracting. Moreover, the new rules make it easier for small business prime contractors to do business with Federal agencies by giving them more choices that are less burdensome and less costly for pursuing and winning larger contracts than before.").

Nonmanufacturer Rule—The final rule also implements the newly revised and standardized nonmanufacturer rule set forth in the proposed rule. Under the nonmanufacturer rule, to qualify as a small-business concern for a set-aside or sole-source supply contract, a small business must either manufacture the product it will supply to the Government, or provide an end item that a small business has manufactured. The small business may also provide an end item of a large business if the SBA grants an individual or class waiver. Previously, the nonmanufacturer rule was applied inconsistently across small businesses, causing confusion and limiting the utility of the rule. For instance, the FAR previously provided that HUBZone small businesses may only provide products manufactured by another HUBZone small business, thereby nonsensically limiting the categories of small businesses from which a HUBZone small business concern may source products it does not manufacture. FAR 19.1308(e)(1).

The final rule makes several significant changes to the regulations implementing the nonmanufacturer rule, including consolidating nonmanfacturer rule coverage across small business programs. Prior to March 30, 2020, the FAR did not include coverage of the limitations on subcontracting and nonmanufacturer rule in subpts. 19.8, 19.13, 19.14 and 19.15 (addressing the 8(a) program, the HUBZone program, the SDVOSB program and the WOSB program, respectively). Federal Acquisition Circular (FAC) 2020-05 added coverage tailored to each of those subparts. The final rule, however, removes the coverage from those subpts. and consolidates the coverage in subpt. 19.5. The final rule also makes an important revision to the dollar threshold at which the nonmanufacturer rule applies. Under the final rule, the nonmanufacturer rule applies to small business set-asides above the simplified acquisition threshold, which is currently $250,000 for most acquisitions. 86 Fed. Reg. 44,234; FAR 2.101 (establishing the "simplified acquisition threshold" at $250,000 for most procurements). However, like the limitations on subcontracting, the nonmanufacturer rule applies to small business socioeconomic category procurements (e.g., a set-aside or sole source contract for 8(a) participants, WOSBs, HUBZone small businesses, or SDVOSBs) regardless of contract value.

© 2021 Thomson Reuters

These important changes are set forth in the newly revised FAR 19.505, Limitations on subcontracting and nonmanufacturer rule, which provides at subparagraph (a):

> (a) *Applicability.* (1) This section applies to small business set-asides above the simplified acquisition threshold and orders issued directly to a small business in accordance with 19.504(c)(1)(ii) above the simplified acquisition threshold.
>
> (2) This section applies, regardless of dollar value, to the following awards under subparts 19.8, 19.13, 19.14, and 19.15:
>
> (i) Contracts that are set aside.
>
> (ii) Contracts that are awarded on a sole-source basis.
>
> (iii) Orders that are set-aside as described in 8.405–5 and 16.505(b)(2)(i)(F).
>
> (iv) Orders that are issued directly in accordance with 19.504(c)(1)(ii).
>
> (v) Contracts that use the HUBZone price evaluation preference to award to a HUBZone small business concern unless the concern waived the evaluation preference.

86 Fed. Reg. 44,241.

The final rule also preserves the proposed rule's change to the application of SBA waivers to the nonmanufacturer rule granted before award. If the SBA grants a nonmanufacturer rule waiver after the issuance of a solicitation, but before award, contracting officers must amend that solicitation to notify potential offerors of the waiver and to give them more time to submit proposals. 86 Fed. Reg. at 44,240. This significant 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.

The proposed rule set forth a variety of revisions designed to resolve inconsistencies in how this rule was applied across small business programs; however, in the intervening years since the proposed rule was published, many revisions to the FAR were made as a result of FAC 2020-05 (published Feb. 27, 2020, and effective March 30, 2020). Therefore, some revisions in the proposed rule were no longer necessary as FAC 2020-05 already made the revisions to the FAR—including implementation of new contract clause FAR 52.219-33, Nonmanufacturer Rule. Importantly, however, the final rule significantly revises FAR 52.219-33 to (i) add key definitions of "manufacturer" and "nonmanufacturer," (ii) provide detail concerning when the clause applies, and (iii) clarify that the clause applies to contracts using the HUBZone price evaluation preference to award to a HUBZone small business concern (unless the concern waived the evaluation preference). FAR 52.219-33(c)(2) was also revised to remove text concerning an item for a kit that is not produced by small business concerns in the U.S. or outlying areas. As revised, FAR 52.219-33 now reads:

> Nonmanufacturer Rule (SEP 2021)
>
> (a) *Definitions.* As used in this clause—
>
> *Manufacturer* means the concern that transforms raw materials, miscellaneous parts, or components into the end item. Concerns that only minimally alter the item being procured do not qualify as manufacturers of the end item. Concerns that add substances, parts, or components to an existing end item to modify its performance will not be considered the end item manufacturer, where those identical modifications can be performed by and are available from the manufacturer of the existing end item.
>
> *Nonmanufacturer* means a concern, including a supplier, that provides an end item it did not manufacture, process, or produce.
>
> (b) *Applicability.*
>
> (1) This clause does not apply to contracts awarded pursuant to the unrestricted portion of a partial set-aside or to a contractor that is the manufacturer of the product or end item.
>
> (2) This clause applies to—
>
> (i) Contracts that have been awarded pursuant to a set-aside, in total or in part, for any of the small business concerns identified in 19.000(a)(3);
>
> (ii) Contracts that have been awarded on a sole-source basis in accordance with subparts 19.8, 19.13, 19.14, and 19.15;
>
> (iii) Orders expected to exceed the simplified acquisition threshold and that are—
>
> (A) Set aside for small business under multiple-award contracts, as described in 8.405–5 and 16.505(b)(2)(i)(F); or
>
> (B) Issued directly to a small business concern under multiple-award contracts as described in 19.504(c)(1)(ii);
>
> (iv) Orders, regardless of dollar value, that are—
>
> (A) Set aside in accordance with subparts 19.8, 19.13, 19.14, and 19.15 under multiple-

© 2021 Thomson Reuters

> award contracts as described in 8.405–5 and 16.505(b)(2)(i)(F); or
>
> (B) Issued directly to concerns that qualify for the programs described in subparts 19.8, 19.13, 19.14, and 19.15 under multiple-award contracts as described in 19.504(c)(1)(ii); and
>
> (v) Contracts using the HUBZone price evaluation preference to award to a HUBZone concern unless the Contractor waived the evaluation preference.
>
> (c) *Requirements*.
>
> (1) The Contractor shall—
>
> (i) Provide an end item that a small business has manufactured, processed, or produced in the United States or its outlying areas; for kit assemblers who are nonmanufacturers, see paragraph (c)(2) of this clause instead;
>
> (ii) Be primarily engaged in the retail or wholesale trade and normally sell the type of item being supplied; and
>
> (iii) Take ownership or possession of the item(s) with its personnel, equipment, or facilities in a manner consistent with industry practice; for example, providing storage, transportation, or delivery.
>
> (2) When the end item being acquired is a kit of supplies, at least 50 percent of the total cost of the components of the kit shall be manufactured, processed, or produced in the United States or its outlying areas by small business concerns.

86 Fed. Reg. 44,246.

Once implemented, these changes should provide significant relief to small business contractors, particularly HUBZone contractors, that have struggled to reconcile the conflicting regulations applicable to small business nonmanufacturers.

They Think He's a Righteous Dude—Err, Rule—As one might expect with a rule of this significance, several commentators had robust responses to the proposed rule. Many expressed support for the rule, largely mirroring the public discourse surrounding the changes. Others voiced frustration that the forthcoming changes do not account for additional needed modifications to the FAR, which will only necessitate further revisions in the near future. For example, some respondents pointed out that the proposed text of FAR 52.219-4(e) did not account for joint venture options afforded to HUBZone small business concerns under SBA's regulations, requiring further revisions to the FAR to bring the regulations in line with the SBA. The Council responded that a separate FAR case, 2017-019, Policy on Joint Ventures, will address this concern. Unfortunately, as much as contractors universally adore the changes to these rules (much like the diverse student groups that adore our hero Ferris Bueller), there is still work to be done to align the FAR with the SBA regulations.

If I'm Gonna Get Busted, It Is Not Gonna Be By A Guy Like That—Unlike Ferris Bueller disguised as Abe Froman—i.e., the Sausage King of Chicago—the Council apparently determined that one can go "too far" in making revisions to the FAR to align with the SBA regulations, and declined to address proactively certain changes made in the SBA's final rule published in the *Federal Register* on Nov. 29, 2019 (84 Fed. Reg. 65,647). These changes included (1) exclusions from the limitations on subcontracting for the hazardous waste industry, (2) clarifications regarding "independent contractors," and (3) exclusion of materials and other direct costs from the limitations on subcontracting for services. Although the Council acknowledged these changes to the SBA regulations, the final rule does not implement these changes. Instead, the Council noted that "[a] new FAR case would have to be opened to implement the additional changes," including notice and public comment prior to implementation. Thus, although the belated implementation of these changes to the FAR are welcome to contractors of all sizes, contractors will need to once again steel themselves to wait for the rulemaking process to run its course to bring the FAR in line with the SBA regulations.

Life Moves Pretty Fast ... If You Don't Stop and Look Around Once In A While ...You Could Miss It—Despite the ups and downs of the *prolonged* rulemaking process, the forthcoming FAR changes to the limitations on subcontracting rules will be welcome news to contractors of all sizes. Contractors should plan to capitalize on these changes by taking a number of steps that will enable them to benefit now from these changes:

1. Establish and deepen relationships with similarly situated entities with whom you may want to subcontract in order to profit from broader access to set-aside procurements.
2. Review existing and contemplated teaming and subcontracting arrangements to identify strategies to take advantage of the new regulations.
3. Ensure that existing accounting practices allow

© 2021 Thomson Reuters

for accurate monitoring of subcontracting effort such that the contract value is tracked rather than cost of contract performance.

4. Conduct market research to identify new sources of supply for contracts anticipated to be below the simplified acquisition threshold.
5. Monitor SBA waivers of the nonmanufacturer rule and act quickly to submit proposals where the waiver affects a given procurement.

This Feature Comment was written for The Government Contractor by* Franklin Turner, Alex Major, Cara Wulf *and* Ethan Brown.** ***Mr. Turner and Mr. Major are Partners in the Washington, D.C. office of McCarter & English, LLP, where they serve as Co-Leaders of the Government Contracts and Global Trade Practice Group. Ms. Wulf and Mr. Brown are Senior Associates in the Government Contracts and Global Trade Practice Group and are also based in the Washington D.C. office of McCarter & English. The authors routinely teach courses on a variety of Government contracts issues and can be reached at fturner@mccarter.com, amajor@mccarter.com, cwulf@mccarter.com, and ebrown@mccarter.com.

© 2021 Thomson Reuters