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Limitation on Subcontracting

In creating this new Limitation on Subcontracting rule, the Small Business Administration specifically extended the definition of “similarly situated entity” *only to first-tier subcontractors*. Even if a second-tier (or lower) contractor is similarly situated, work performed by the lower-tier subcontractor will count the same as if subcontracted to a large business.

Similarly Situated Subcontractors



BY BRYAN KING

This year, the Small Business Administration (SBA) has made several changes to its regulations designed to improve the various small-business contracting programs. We have previously covered the minor change to the certification process for the woman-owned small business (WOSB) program, and the big changes to the mentor-protégé program. As we discussed in those articles, one of the benefits of the new mentor-protégé rules is the expansion of opportunities for small businesses in the pursuit of contract awards, through mentoring and joint venture relationships, that were not previously available to most categories of small businesses.

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This summer, the SBA finalized another new rule that aims to assist small-business contractors on the other end of the spectrum — meeting performance requirements after a small-business set-aside contract has been awarded.

Historically, the SBA has required a small-business contractor to perform a minimum percentage of work on every prime contract it is awarded. This is known as the Limitation on Subcontracting rule.¹ For example, the Limitation on Subcontracting rule generally required a small-business contractor receiving an award of a nonconstruction contract to perform at least 50 percent of the work with its own employees.² While the intention of this rule is laudable — it is meant to ensure

¹ 13 CFR § 125.6.

² For general construction contracts, no more than 85 percent of the work can be subcontracted to nonsimilarly situated entities. For special trade construction contracts, no more than 75 percent of the work can be subcontracted to nonsimilarly situated entities.

small-business set-asides are actually performed by small businesses — it has also created challenges for some small-business prime contractors. Solicitation requirements seem to become more complex each year, and many small businesses must rely on subcontractors as part of a team to meet the required level of knowledge and technical expertise necessary to win the contract. For some small-business contractors, this has resulted in a precarious post-award balancing act between using the expertise of their subcontractors — which was needed to win the award — and meeting the Limitation on Subcontracting requirement.

A new rule effective June 30, 2016,³ is intended to make it easier for small-business prime contractors to use the expertise of subcontractors and still meet the Limitation on Subcontracting requirement. The previous version of the Limitation on Subcontracting rule made a special allowance for service-disabled, veteran-owned small businesses (SDVOSBs) and HUBZone small businesses. For SDVOSB set-aside contracts, amounts spent by the SDVOSB prime contractor on either its own employees or the employees of another SDVOSB were all counted toward the percentage of performance requirement. Thus, SDVOSB prime contractors were allowed to use the services of its SDVOSB subcontractors, at any tier, to meet its own Limitation on Subcontracting obligations. The same applied to HUBZone small businesses on HUBZone set-asides. However, there was no such rule for 8(a) or WOSB set-asides, or for general small-business set-asides.

The new rule introduces a uniform system applicable to each small-business program, as well as to general small-business set-asides. Under the new rule, small-business prime contractors are still required to perform a certain minimum percentage of the work, but the SBA has changed the way that minimum percentage is calculated. Under the new rule, small-business prime contractors now get credit for work subcontracted to certain subcontractors, *i.e.*, “similarly situated entities.”

According to the SBA, a “similarly situated entity” is a subcontractor that has the same small-business status as the prime contractor. Under this new rule, any first-tier subcontracts to a similarly situated entity count as though the small-business prime contractor performed the work itself.⁴ For example, a WOSB awarded a service contract set aside for WOSBs would still meet the new Limitation on Subcontracting rule under the following performance breakdown:

20 percent: Performed by the WOSB prime contractor

30 percent: Performed by a first-tier WOSB subcontractor

50 percent: Performed by a large business

This breakdown meets the Limitation on Subcontracting rule because the WOSB prime contractor and its similarly situated WOSB subcontractor are together performing 50 percent of the work. This would be the

³ 81 FR 34243.

⁴ The previous rule applicable to SDVOSBs and HUBZone small businesses used the amount spent on personnel to determine the prime contractor’s percentage of work. The new rule employs a different calculation method to determine the prime contractor percentage of work, using instead the amount paid to subcontractors.

case under any of the small-business programs, *e.g.*, a HUBZone small business subcontracting to a similarly situated HUBZone small business on a HUBZone set-aside contract, etc.

This new rule is a positive move for the SBA, as it will surely help small-business prime contractors meet their percentage of performance requirements. However, there are certain features and limitations of this new rule that deserve special attention.

‘Similarly Situated Entities’ Only Includes First-Tier Subcontractors

In creating this new Limitation on Subcontracting rule, the SBA specifically extended the definition of “similarly situated entity” *only to first-tier subcontractors*. Thus, small-business prime contractors will only get performance credit for work subcontracted to similarly situated first-tier subcontractors. Even if a second-tier (or lower) contractor is similarly situated, for Limitations on Subcontracting purposes, work performed by the lower-tier subcontractor will count the same as if subcontracted to a large business.

In the example above, the WOSB prime contractor still meets the new Limitation on Subcontracting even though it only performs 20 percent of the work on its WOSB set-aside prime contract, because it subcontracted 30 percent of the work to a similarly situated WOSB. However, if that first-tier WOSB subcontractor then subcontracted all of its work to another WOSB under a second-tier subcontract, this would violate the Limitations on Subcontracting rule. In that case, even though 50 percent of the work was being performed by the three WOSBs, the prime contractor and its similarly situated first-tier subcontractor would only be performing 20 percent of the work.

As a practical matter, to ensure compliance with this requirement, it would be prudent for small-business prime contractors to obtain assurances from its similarly situated first-tier subcontractors that they will not subcontract any of the work without the prime contractor’s approval. The SBA does not require a specific certification from a small-business prime contractor related to the use of similarly situated entities. However, there is a general requirement for small-business prime contractors to agree to comply with the Limitation on Subcontracting requirements (with or without the use of similarly situated entities). Thus, as a best practice, small-business prime contractors should consider inserting language in subcontracts with similarly situated first-tier subcontractors prohibiting the subcontractor from entering into lower-tier subcontracts without the prime contractor’s express written consent.

‘Similarly Situated Entities’ Does Not Extend Across Small-Business Programs

It is also important to note that the definition of a “similarly situated entity” applies equally to general small-business set-aside contracts and to each of the SBA contracting programs (WOSB, HUBZone, etc.). For general small-business set-asides, any other qualified small business will count as a similarly situated entity, regardless of any other certifications the subcontractor may have. However, for program specific set-aside contracts, the “similarly situated entity”

definition does not extend from one program to another.

Using the example above, if, instead of subcontracting that 30 percent to a WOSB, the prime contractor subcontracted to a non-woman-owned SDVOSB, the prime contractor would fail to meet the Limitation on Subcontracting rule. Even though the SDVOSB is a small business, it would not qualify as a similarly situated entity for a contract set aside for WOSBs. Thus, any small-business prime contractor seeking to take advantage of the similarly situated entity exception to the Limitation on Subcontracting rule should confirm its potential subcontractors actually have the small-business status required by the prime contract. A simple way to verify their potential subcontractor's status is to consult the SAM.gov system to ensure the subcontractor certified as to its proper status. The prime contractor should also consider obtaining a certification from the potential subcontractor that it is eligible under the applicable small-business program as of the date it submitted its proposal.

A 'Similarly Situated Entity' Only Needs to Be Small for the Subcontract

Finally, the SBA clarified that the new Limitation on Subcontracting rule does not require subcontractors to meet the same size threshold that is applicable to the prime contract. Under the new rule, the SBA permits small-business prime contractors to designate a North American Industry Classification System (NAICS) code specific to the work required by a specific contract. This subcontract-specific NAICS code can be the same as the prime contract NAICS code, but it does not have to be. The SBA will allow a subcontractor to qualify as a "similarly situated entity" as long as it is small for the

NAICS code that is specifically assigned to the subcontract.

This aspect of the rule may allow small-business prime contractors to get creative with subcontracting partners. Many contracts have a wide range of products and services as part of the requirements. In cases where the work can be broken up into various NAICS codes, a small-business prime contractor can subcontract with a larger company that may not have been small enough to compete for the overall work, but remains small under a portion of the work and a specific NAICS code. As long as this subcontractor still meets whatever status is called for by the set-aside contract (e.g., WOSB, etc.), the new Limitation on Subcontracting rule would count this work as though it was performed by the prime contractor itself under the exception for similarly situated entities.

Conclusion

This new rule signifies that the SBA has recognized that there are myriad ways to ensure that work under small-business set-asides is being performed by the intended beneficiaries of the various SBA programs. By permitting small-business prime contractors with set-aside contracts to count work awarded to similarly situated first-tier subcontractors, the SBA has created additional opportunities for small-business contractors. With the option to team with other similarly situated entities, working essentially as one for the purposes of the Limitation on Subcontracting rule, small businesses now are in a much better position to meet the increasingly complex requirements of government solicitations. The next step in this process is for agencies to recognize these increased capabilities of the small-business contracting community, and to set aside more procurements exclusively for small businesses.