

## Outstanding Questions For Limitations On Subcontracting

By **Scott Freling, Tyler Evans and Brooke Stanley** (January 8, 2019, 3:10 PM EST)

A recently proposed rule would update the Federal Acquisition Regulation, or FAR, to incorporate statutory changes to limitations on subcontracting that have been in effect since 2013.[1] The U.S. Small Business Administration has long since revised its own regulations to implement these changes, but some contracting officers have been reluctant to follow these changes in the SBA regulations because the FAR contains contradictory provisions.[2]

The proposed rule is a sign of progress. In particular, it should add significant clarity to the current disconnect between the FAR and SBA regulations. However, the proposed rule is not perfect, and a number of recent developments highlight that outstanding questions remain.

### FAR Changes to Limitations on Subcontracting

For the majority of contractors, the proposed rule is most relevant for its change to the way that limitations on subcontracting are calculated.

Specifically, the proposed rule would amend the FAR to recognize a simplified regime for contractor compliance and to expressly permit set aside recipients to subcontract any amount of performance to one or more “similarly situated” small businesses.[3] These changes would significantly benefit small businesses that engage in teaming with other small businesses. In addition, these changes are important for contractors that do not qualify as small businesses — such as large businesses, nonprofit organizations and certain non-U.S. entities — in that more subcontract spending under set asides can be made available to these types of entities when subcontracts to similarly situated small businesses do not count against limitations on subcontracting.

The FAR currently contains an outdated limitations on subcontracting framework, under which a small business that received a set aside was expected to track performance costs for either personnel or manufacturing, depending on whether a set aside was for services or supplies. A recipient was required to ensure that it performed work amounting to at least 50 percent of such costs, with an exclusion for materials under set asides for supplies. Similar frameworks with different percentages also applied to construction contracts.[4]



Scott Freling



Tyler Evans



Brooke Stanley

Now, under the updated framework that has been in effect by statute since 2013 — and in SBA regulations since 2016 — a small business that receives a set aside is only expected to ensure that no more than 50 percent of the amount paid under its prime award is paid to subcontractors that are not similarly situated. Corresponding updates have been made for construction contracts, and material costs continue to be excluded from limitations on subcontracting under set asides for supplies.[5]

Under the updated framework, a similarly situated small businesses is defined as:

- Being able to participate in the small business program under which a set aside was issued; and
- Qualifying as a small business under the size standard associated with the North American Industry Classification System, or NAICS, code that a prime contractor assigns to a subcontract.[6]

For example, a women-owned small business could be similarly situated for a subcontract under a women-owned small business set aside, which would allow the subcontract to be exempt from limitations on subcontracting. However, to benefit from this exemption, similarly situated small businesses cannot engage in further subcontracting.[7]

### **Outstanding Questions**

The proposed rule is expected to be received favorably by many contractors. However, a number of outstanding questions likely will remain as comments are received through Feb. 4, 2019, and the rule is subsequently finalized.

### ***Effective Date***

First, some contracting officers may continue to take the position that the updated framework cannot be applied to new or existing contracts until the proposed rule is finalized. Yet, the validity of this position is questionable. The statute that establishes the updated framework for limitations on subcontracting does not state that implementing regulations are required, nor does it suggest that the FAR can be modified in a way that deviates from SBA requirements.[8] Contracting officers are obligated to abide by applicable statutes and regulations when entering into contracts,[9] and the updated framework has been in effect by statute and through SBA regulations for some time.

A decision by the U.S. Court of Federal Claims at one point raised questions about whether the updated framework could be applied without revisions to the FAR.[10] However, before the SBA even proposed changes to its regulations, the U.S. Government Accountability Office issued a decision assuming that the updated framework had immediately gone into effect through statutory revisions.[11] Some agencies have also taken the initiative to immediately apply the updated framework in their own implementing regulations to the FAR, with the U.S. Department of Veterans Affairs issuing a class deviation in 2018 and the U.S. Department of Defense issuing a similar deviation in parallel with issuance of the proposed rule.[12]

It is not clear why the Federal Acquisition Regulatory Council took so long to move forward with a rulemaking that will bring the FAR's limitations on subcontracting up to date with current law. It is also not clear why the council elected to issue a proposed rule in lieu of an interim rule with immediate effect, which would have helped put to rest any lingering confusion about the effective date of changes that Congress enacted over five years ago. Thus, although there is ample evidence that the updated

framework is already in effect, some contracting officers may continue to interpret the current situation as necessitating compliance with old requirements while we wait for the updates to the FAR to be finalized.

### ***Incomplete Guidance***

Second, the proposed rule does not include all guidance reflected in SBA regulations, which may lead to continued confusion once the proposed rule is finalized. Instead of merely cross-referencing SBA regulations like the class deviation issued by the U.S. Department of Veterans Affairs, the proposed rule attempts to characterize some — but not all — of the principles established by the SBA in 2016.[13]

For example, SBA regulations expressly state that for most prime contractors limitations on subcontracting only apply to the services or supply component of a set aside that involves both types of performance — so-called “mixed” contracts — depending on the type of NAICS code assigned to the set aside.[14] This principle generally allows the recipient of a services set aside to subcontract for supplies without restriction and vice versa under set asides for supplies.[15] The proposed updates to the FAR do not expressly recognize this distinction.[16]

Moreover, the proposed updates to the FAR do not address the time period for measuring compliance with limitations on subcontracting.[17] SBA regulations currently require compliance to be measured separately for each base and option period and provide contracting officers with discretion to require compliance on an order-by-order basis under indefinite-delivery, indefinite-quantity contracts.[18]

Admittedly, contracting officers may ultimately view additional guidance in SBA regulations as supplemental to the FAR. However, differences between the two create the potential for confusion and inconsistent treatment, as has already been demonstrated by some contracting officers in connection with the FAR’s outdated framework. At a minimum, the proposed rule would benefit from an explicit cross-reference to the SBA regulation.

### ***Other Pending Changes***

Third, the proposed rule’s failure to merely cross-reference SBA regulations has the potential to become even more significant if and when other pending changes to the SBA regulations are finalized.

On the same day that the Federal Acquisition Regulatory Council issued its proposed rule, the SBA proposed new regulatory changes that would further reform the limitations on subcontracting.[19] In particular, the SBA may recognize a number new exclusions for certain types of subcontracting under service-based set asides — including a potentially significant exclusion for cloud-based computing — yet these exclusions are not referenced in the proposed revisions to the FAR.

In addition, the SBA proposed modifying how the nonmanufacturer exception to supply-based set asides is implemented, including by removing special rules applicable to “kit assemblers.”[20] In contrast, the proposed revisions to the FAR include contradictory language.[21]

Separately, the SBA proposed to permit an arguably unauthorized — but widespread — practice of setting aside orders for socioeconomic subcategories of small businesses under multiple-award contracts that were previously set aside for small businesses generally.[22] Yet, neither of the recently proposed rules explains how limitations on subcontracting are expected to be applied to new scenarios involving tiered set asides.[23] Importantly, additional revisions to the SBA regulation addressing the

limitations on subcontracting, 13 C.F.R. Section 125.6(e), likely would be necessary to implement the most obvious approach of requiring standard and socioeconomic-based limitations to be satisfied in parallel respectively at the contract and order level.

Moreover, it is not clear how another set of proposed changes to the FAR that have been pending for over two years will be reconciled with the more recently proposed revisions to the FAR.[24] The FAR revisions previously proposed in 2016 addressed updated SBA guidance on set-asides under multiple-award contracts, and were more comprehensive than the FAR revisions proposed in December.[25] As a result, the 2016 revisions may address some of the outstanding issues identified above once finalized. However, the currently separate FAR regulatory proceedings from 2016 and 2018 may not be immediately reconciled.

### ***Compliance Risks***

Fourth, the SBA's recently proposed 2018 revisions, and discrepancies with the proposed rule for the FAR that was issued on the same day, highlight outstanding questions regarding compliance risks associated with limitations on subcontracting. Although a number of contractors likely will benefit from the flexibility afforded by being able to freely subcontract with similarly situated small businesses, this flexibility could make monitoring compliance with limitations on subcontracting more difficult in some respects.

The SBA's proposed revisions indicate that subcontractors will no longer qualify as similarly situated when they lose their applicable small business status, potentially even in the middle of performance of a long-term subcontract.[26] When considered with the lack of clarity about this issue in the proposed revisions to the FAR, and the prohibition on further subcontracting by similarly situated small businesses generally, the SBA's guidance suggests that a failure to properly monitor the size status and second-tier subcontracting of similarly situated small businesses could be a potential source of liability for set aside recipients. Even other non-small subcontractors could be impacted by this guidance if they knowingly perform a large amount of work based on a questionable assumption that other subcontractors continue to be exempt from limitations on subcontracting.

Compliance risks also may increase as a result of a new emphasis on enforcement. The SBA's proposed revisions from December include express audit rights relating to compliance with limitations on subcontracting, which presumably will make documentation of compliance even more important going forward.[27] Importantly, under existing regulations, a failure to comply with limitations on subcontracting can result in liability based on impermissibly subcontracted amounts, and debarment is possible as a result of a failure to comply with the "spirit and intent" of subcontracts with similarly situated small businesses.[28]

The SBA's revisions suggest that demonstrating compliance could be as simple as presenting subcontract lists or invoices showing amounts paid to subcontractors.[29] However, the SBA does not appear to have taken into account practical difficulties in continually monitoring subcontractor size status and ensuring that similarly situated small businesses do not engage in further subcontracting.

### **Expectations**

Overall, the proposed updates to the FAR are a welcome clarification to the long-standing confusion resulting from a disconnect with SBA regulations. However, a number of outstanding issues need to be

resolved going forward, and hopefully many will be addressed during the pending comment period for the recently proposed FAR rule.

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*Scott Freling is a partner and Tyler Evans and Brooke Stanley are associates with Covington & Burling LLP.*

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[1] Federal Acquisition Regulation: Revision of Limitations on Subcontracting, 83 Fed. Reg. 62,540 (Dec. 4, 2018).

[2] Small Business Government Contracting and National Defense Authorization Act of 2013 Amendments, 81 Fed. Reg. 34,243 (May 31, 2016).

[3] 83 Fed. Reg. at 62,541.

[4] See, e.g., FAR 52.219-14.

[5] See 15 U.S.C. Section 657s; 13 C.F.R. Section 125.6.

[6] See 13 C.F.R. Section 125.1.

[7] See *id.* Section 125.6(c).

[8] See 15 U.S.C. Section 657s.

[9] FAR 1.602-1.

[10] See *Hyperion, Inc. v. United States*, 115 Fed. Cl. 541, 551–53 (2014) (identifying the statutory change in limitations on subcontracting while requiring compliance with the old framework under the FAR); see also *Analytical Graphics, Inc. v. United States*, 135 Fed. Cl. 378, 419 n.33 (2017) (describing an argument that emphasized the prominence of the FAR).

[11] *Sealift, Inc.*, B-409001, Jan. 6, 2014, 2014 CPD ¶ 22 at \*4 n.4.

[12] See U.S. Dep't of Veterans Affairs, *Class Deviation to VA Acquisition Regulation (VAAR) 819.72, 852.219-74, 852.219-75, and 852.219-76* (Jun. 27, 2018), available at <https://www.va.gov/oal/docs/business/pps/deviationVaar20180627.pdf>; U.S. Dep't of Def., *Class Deviation—Limitations on Subcontracting for Small Business* (Dec. 3, 2018), available at <https://www.acq.osd.mil/dpap/policy/policyvault/USA003103-18-DPC.pdf>.

[13] Compare 83 Fed. Reg. 62,545–50, with 81 Fed. Reg. at 34,259–64.

[14] 13 C.F.R. Section 125.6(b).

[15] *Id.*; see also 81 Fed. Reg. at 34,245.

[16] See 83 Fed. Reg. 62,545–50.

[17] *Id.*

[18] 13 C.F.R. Section 125.6(e).

[19] National Defense Authorization Acts of 2016 and 2017, Recovery Improvements for Small Entities After Disaster Act of 2015, and Other Small Business Government Contracting, 83 Fed. Reg. 62,516 (Dec. 4, 2018).

[20] See 83 Fed. Reg. at 62,521.

[21] See *id.* at 62,546.

[22] See *id.* at 62,518; see also Acquisition Process: Task and Delivery Order Contracts, Bundling, Consolidation, 78 Fed. Reg. 61,114, 61,124 (Oct. 2, 2013).

[23] See 83 Fed. Reg. 62,527–32, 62,545–50.

[24] Federal Acquisition Regulation: Set-Asides Under Multiple Award Contracts, 81 Fed. Reg. 88,072 (Dec. 6, 2016).

[25] Compare *id.* at 88,072–77, 88,079–95, with 83 Fed. Reg. 62,545–50.

[26] See 83 Fed. Reg. at 62,518, 62,530.

[27] See *id.* at 62,519–20, 62,523–24, 62,530.

[28] See 13 C.F.R. Section 125.6(h).

[29] See 83 Fed. Reg. at 62,520, 62,524, 62,530.