

**ALERT**

# SBA Provides Important Guidance on "Non-Manufacturer Rule," Validates Practice of "Drop Shipment" by Small Business Resellers

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A recent decision by the U.S. Small Business Administration (SBA) Office of Hearings and Appeals (OHA) provides some much-needed clarification for small business resellers and dealers concerned about complying with the SBA's "nonmanufacturer" rule, which was amended in February 2011 to require small business nonmanufacturers to take "ownership or possession" of supply items they sell to the Federal Government. OHA confirmed that a small business reseller meets this new requirement so long as title to the supplies passes to the reseller prior to delivery to the end customer, even where the goods are "drop shipped" by the manufacturer and the small business reseller never takes physical possession of the goods being resold.

By way of background, the SBA's nonmanufacturer rule permits a firm to qualify as a small business concern for a requirement to provide manufactured products or other supply items even if the firm does not actually manufacture the end item itself. Until February 2011, the rule allowed a firm to qualify as a "nonmanufacturer" if it: (1) does not exceed 500 employees; (2) is primarily engaged in the retail or wholesale trade and normally sells the type of item being supplied; and (3) will supply the end item of a small business manufacturer, processor or producer in the United States, unless a waiver of that requirement is obtained. 13 C.F.R. § 121.406(b)(1).

The nonmanufacturer rule was amended in February 2011 to include an additional requirement that the firm "[t]akes ownership or possession of the item(s) with its personnel, equipment or facilities in a manner consistent with industry practice." 76 Fed. Reg. 8222 (Feb.

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2011). The SBA emphasized in the regulatory background to the rule change that the new requirement obligates small business nonmanufacturers to take ownership or possession, but not both, and was not intended to impair "legitimate small business dealers":

SBA first notes that the proposed rule did not require a small business nonmanufacturer to take possession of the supply items in every case. It required that the nonmanufacturer take ownership or possession. If the nonmanufacturer arranged for transportation of the supply items (e.g., it uses trucks it owns or leases to transport the items to the final destination), then it need not take ownership of the supply items. If it does not arrange for the transportation, then it must at least take ownership of the supply items. SBA recognizes the validity of small business dealers and does not seek to harm legitimate small business dealers. SBA continues to believe, however, that the ownership or possession requirement provides a necessary safeguard to abuse. A multi-million dollar supply contract in which a large business manufacturer provides the supply items directly to the Government procuring agency and the small business nonmanufacturer provides nothing more than its status as a small business does not foster small business development.

*Id.* at 8226. Although this explanation made clear that small business nonmanufacturers were not required to take possession of the end items in every case, the SBA did not provide guidance on what firms needed to do in order to satisfy the "ownership" requirement. As a result, it was uncertain following the change whether the use of drop shipments from the manufacturer would comply with the amended rule.

In a recent size protest decision, *Wear Mark, Inc. d/b/a All Seasons Apparel*, SBA No. SIZ-5397 (2012), OHA confirmed that the rule change was not intended to prohibit the standard industry practice of "drop shipping" by small business resellers, and that the "ownership" requirement is met so long as the reseller takes legal title to the products. The case involved a small business set-aside contract with the Department of Veterans Affairs for the purchase of flags. The small business reseller proposed to purchase the flags from a large business, which would manufacture and package the completed end items for delivery and transport them to the manufacturer's loading dock. The small business reseller was then obligated to arrange for product pick up at the manufacturer's loading dock, at which point title and risk of loss would pass to the reseller.

Two disappointed offerors protested the award, alleging among other things that the small business reseller did not satisfy the "ownership or possession" requirement of the nonmanufacturer rule. Specifically, the protesters argued that the reseller (1) does not take free and clear ownership of the flags because they are encumbered by a carrier lien and (2) does not take ownership with its own personnel, equipment and facilities, as the regulation requires. The SBA intervened in the appeal, and urged OHA to find that the small business reseller was eligible under the nonmanufacturer rule. SBA explained that the "ownership and possession" requirement was not intended to disturb the "long history of drop shipping" under the nonmanufacturer rule, a practice under which "a small business nonmanufacturer could qualify for a small business set-aside never having touched or owned the item being procured." SBA further explained that it "did not intend for the recent revision to the nonmanufacturer rule to prohibit drop shipping by nonmanufacturers, only that nonmanufacturers would be required to handle items 'in a manner consistent with industry practice,'"

whether that be through ownership or control."

OHA agreed with the SBA and denied the appeal. OHA first rejected the protester's argument that the reseller did not have "ownership" as a result of the carrier lien, reasoning that "the regulation only requires ownership, not unencumbered ownership. The fact that a lien may arise against the items sold to the Government does not mean that they are not owned by the seller. To hold otherwise would call into question the ownership of any item shipped by a common carrier, and this cannot have been the intent of the regulation." OHA also rejected the protesters' argument that the small business reseller was required to take ownership of the items with its personnel, equipment or facilities, finding that this interpretation "contravenes SBA's intent in amending the regulation." Reciting the regulatory history of the February 2011 change, OHA agreed with the reseller and SBA that the requirement is disjunctive and requires the nonmanufacturer to take ownership or possession, not both:

This language demonstrates SBA contemplated a nonmanufacturer would take possession and use its facilities and equipment to do so. Alternatively, the nonmanufacturer could take ownership of the items. There is no requirement that the nonmanufacturer take ownership with its personnel, facilities, and equipment. Those requirements modify only the possession prong of the regulation. This interpretation is consistent with common sense and experience. It is difficult to imagine an instance in which a nonmanufacturer would take ownership using its personnel, facilities, and equipment without taking possession.

I agree that [the] regulation is disjunctive, and requires the nonmanufacturer to either take ownership of the items, or take possession of them with its own personnel, equipment or facilities. Possession is a physical act, and thus requires the use of personnel, equipment or facilities. It is therefore appropriate that the regulation should enumerate these methods of taking possession. Ownership is a question of law, and one need not take physical possession to take ownership of an item, if title to the item has passed under a contract. Here, [the small business reseller] has satisfied § 121.406(b)(1)(iii) because [the reseller] will take ownership of the flags. The evidence shows the risk of loss shifts to [reseller] at the loading docks, . . . .

As SBA argues, a policy that required nonmanufacturers to take ownership using its personnel, equipment, and facilities would prohibit drop shipping. As [the small business reseller] points out, there is ample precedent that title shifts by drop shipments as part of the normal course of business. . . . The preamble to the published regulations makes clear SBA never intended to prohibit drop shipping. I therefore find that SBA made no error in concluding that [the reseller] had taken ownership of the flags through its contract with Allied. Accordingly, I conclude a nonmanufacturer may take ownership of supplies if title to the supplies passes to the nonmanufacturer under a contract, even if they do not physically take possession of the supplies.

It is important to note that the decision does not address the scenario where the manufacturer is also providing financing or other assistance to the small business reseller; although this issue was raised by the protesters, OHA declined to address it because it was raised for the first time on appeal. In addition, it is not clear to what extent OHA's decision might have been influenced by the fact that the reseller provided more than just its status as a small business, but was also responsible for "marketing, selling, and interfacing with customers" and "curing" defects after delivery. Nevertheless, this decision confirms the "validity" of small business dealer arrangements and the common practice of drop shipment, and clarifies that the "ownership and possession" prong of the nonmanufacturer rule does not require a small business reseller to take physical possession of the goods, so long as title and risk of loss transfers to them under their contract with the manufacturer, consistent with industry practice.