

ALERT

SBA Proposes Major Changes to Small Business Performance Requirements

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On December 29, 2014, the Small Business Administration (SBA) released a proposed rule that would make sweeping changes to the current methodology for calculating the amount of work that must be performed by a small business under a set-aside contract. The changes are being made pursuant to Section 1651 of the National Defense Authorization Act of 2013 (NDAA), which requires that the limitations on subcontracting for set-aside contracts be evaluated based on the percentage of the overall award amount that a prime contractor spends on its subcontractors. Significantly, the NDAA excludes from the limitations on subcontracting calculation the percentage of the award amount spent on "similarly situated entity" subcontractors.

If adopted, the new methodology would do away with the current version of the "50 percent rule," which requires a calculation of the percentage of contract costs incurred by the prime contractor and its subcontractors. That calculation can be difficult to perform in practice and has never been consistently applied by government agencies or industry. The new methodology would be much a simpler calculation based on total payments by the government to the prime contractor. It would also relax the current performance requirements for small business prime contractors by effectively allowing them to count work performed by other small businesses as their own.

Below is a summary of some of the key aspects of the proposed rule:

- **Change from a "cost-based" to "percentage of total payments" methodology.** The current method for determining whether a firm is in compliance with the limitation on subcontracting requires a calculation of the percentage of

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contract costs incurred by the prime contractor. It is often referred to as the “50 percent rule” because for service and supply contracts the rule requires that the small business prime contractor must incur at least 50% of the total contract costs. The new approach would change from this “cost-based” methodology to a “percentage of total payments” approach that limits the percentage of the amount paid by the government to the prime contractor that the prime can pay to its subcontractors. The percentage would remain at 50% for service and supply contracts. It would be 85% for general construction (*i.e.*, a general contractor could not expend on subcontractors more than 85% of the amount it receives from the government).

- **Exclude work performed by “similarly situated entities.”** The new rule would not count work performed by “similarly situated entities” as subcontracted work for purposes of determining compliance with the limitation on subcontracting requirements. A similarly situated entity is a small business subcontractor that is a participant of the same small business program as the prime contractor. Thus, only payments to other-than-small subcontractors would be used to determine whether the prime contractor exceeded the limitation on subcontracting requirement. The new rule would require the small business prime contractor to enter into a written agreement with every similarly situated entity detailing the percentage of work forecasted to be performed by each entity. It would also require the small business prime to identify these similarly situated entities in its proposal.
- **Review of percentage of work performed by “similar situated entity” subcontractors.** The SBA expressed concern in the proposed rule about a situation in which the prime contractor could subcontract a significant amount of a contract to another small business, only to have that small business turn around and subcontract all of that work to a large business. The new rule would thus require “similar situated entity” subcontractors to also perform the requisite percentage of work on the contract themselves.
- **Time period for determining compliance.** The period of time used to determine compliance with the limitations on subcontracting requirement for a total or partial set-aside contract would be the base term and then each subsequent option period. For a task or delivery order set aside under a full and open contract, the period of performance for each order would be used to determine compliance.
- **New penalties for noncompliance.** Companies that violate the limitations on subcontracting will be subject to, among other criminal, civil and administrative remedies, a fine equal to the greater of \$500,000 or the dollar amount spent in excess of the permitted levels for subcontracting.
- **Exemption for small contracts.** The proposed rule would exempt small business set aside contracts valued at less than \$150,000 from the limitations on subcontracting requirements.

Comments on the proposed rule are due by February 27, 2015. Wiley Rein will continue to monitor any developments in connection with the proposed rule.