

ALERT

DOD Launches Pilot Program for Sole Source Follow-on Awards to ESOPs

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On October 10, 2024, the U.S. Department of Defense (DOD) issued a final rule amending the Defense Federal Acquisition Regulation Supplement (DFARS) to establish a pilot program allowing for sole source follow-on contract awards to S corporations owned by an employee stock ownership plan (ESOP).

The Pilot Program was initially introduced in Sections 874 and 872 of National Defense Authorization Acts for Fiscal Years 2022 and 2024 and published as a proposed rule on May 30, 2024. The Pilot Program is memorialized in DFARS 212.301(f)(xxii), 212.371(b)-(d), 252.270-7000, 252.270-7001, and 252.270-7002, and DFARS Part 270. The effective date for the final rule is November 25, 2024. The Pilot Program is discussed in more detail below.

Qualifications for Pilot Program

Under the Pilot Program, the Contracting Officer (CO) may award a sole-source follow-on contract to the incumbent contractor if the contractor meets the following conditions:

1. Must certify as a “qualified business,” which is defined as an S corporation for which 100% of the outstanding stock is held through an ESOP;
2. Must have a minimum “Satisfactory” CPARS rating for the incumbent contract;
3. Must meet limitations on subcontracting certification that it will not pay more than 50% of the contract price to subcontractors unless

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1. those subcontractors are also “qualified businesses,”
2. subcontract materials are not available from another “qualified business,” or
3. the subcontractor receives a waiver from the head of the contracting activity;
4. Follow-on contract must be for the continued development, production, or provision of products or services that are the same as or substantially similar to those under the incumbent contract; and
5. The contract is not for commercially available off-the-shelf (COTS) items.

The CO can award only one follow-on contract per predecessor contractor through the Pilot Program unless the CO receives a waiver from the head of the contracting activity. Additionally, the CO must prepare a sole source justification citing FAR 6.302-5, *Authorized or Required by Statute*, as the exception to full and open competition.

Reporting Requirement

Contractors participating in the Pilot Program must submit reports related to their ESOP program. Not later than 30 days after the end of the period of performance of the incumbent covered contract, the contractor must submit to the contracting officer the following information:

1. the number of years the contractor has been wholly-owned by its employee stock ownership plan;
2. the contractor's challenges, if any, in attracting and retaining a talented workforce due to its corporate ownership structure;
3. the contractor's challenges, if any, that hinder its ability to contract with DOD in order to scale its technologies and capabilities due to its corporate ownership structure; and
4. the contractor's challenges, if any, due to its corporate ownership structure, in obtaining capital necessary to bridge funding gaps, for example, between prototype demonstration and full-scale development.

The Pilot Program is the latest effort by DOD to expand the defense industrial base and promote the utilization of small businesses (many of which are owned in whole or in part by ESOPs). Specifically, the Pilot Program is “expected to incentivize and expedite the award of follow-on contracts to qualified businesses for the continued development, production, or provision of products or services previously procured by or for DOD. As a result, employee-owned businesses may benefit from additional opportunities to contract with DOD.” It is unclear how many contractors may be considered qualified businesses for purposes of the final rule (only eight businesses have participated in the pilot program’s initial phase). Only COs, not contractors themselves, may submit applications for participation in the Pilot Program, which are subject to approval from the Under Secretary of Defense (Acquisition and Sustainment), Office of the Principal Director, Defense Pricing, Contracting, and Acquisition Policy (Contract Policy). Given the high level of approval required, interested contractors should broach the topic of participating in the Pilot Program with their COs well in advance of the end of contract performance.