



SBA Regulation Invalidated By Court of Federal Claims: Nonmanufacturer Rule Applies to Supply Portions of Service Contracts By Cy Alba, Partner, PilieroMazza PLLC

It has been the common understanding within the Small Business Administration (“SBA”), and the small business government contracting community as a whole, that the nonmanufacturer rule applies only to contracts for the provision of supplies (i.e., goods) and not to service contracts, regardless of whether or not such service contracts have a supply component. This understanding was even memorialized in a regulatory change that SBA made in 2011 whereby the agency stated that the nonmanufacturer rule did not apply to mixed contracts that had both services and supply components where the primary purpose was for services. See 13 C.F.R. § 121.406. However, the U.S. Court of Federal Claims (“COFC”), in *Rotech v. United States*, COFC No. 14-502C (2014), issued a ruling on September 19, 2014, which invalidated that SBA regulation. This means that all small businesses now have to comply with all requirements of the nonmanufacturer rule for any and all supplies provided under a service contract. It is unclear how broad the reach of the decision could be but, in theory, it could have a massive impact on how small businesses perform federal contracts and how contracting officers solicit such contracts.

The nonmanufacturer rule requires small businesses to meet certain specific requirements, different from the standard limitation on subcontract rules, to be considered eligible small businesses for supply contracts. Specifically, to comply with the nonmanufacturer rule, a small business must (1) have 500 employees or less; (2) be primarily engaged in the retail or wholesale trade and normally sell the items being supplied under the contract; (3) take ownership or possession of the items being supplied with its own personnel or facilities; and (4) supply the end item of a small business manufacturer unless the contracting officer obtains a waiver or a class waiver exists for the items being supplied. Thus, under this new court precedent, small businesses entering into service contracts where supplies are also being provided must apply this four-part test to the supply portion of the contract before they can be considered

small businesses for that procurement. This means that, in addition to having to qualify as small under the NAICS code and meet the limitation on subcontracting/performance of work requirements, small businesses must now also meet the nonmanufacturer requirements for the supply portions of the contracts.

Further, contracting officers must now make a determination, prior to the issuance of any service contract where supplies are a component, as to whether or not a small business exists that can manufacture the supplies required by the contract. If there is a small business, then the supplies being used under the service contract must come from a small business manufacturer. This means that, by way of example, an IT company providing certain computer components must provide components manufactured by a small business or it would be in violation of the rule and not qualify as “small” for the procurement. If there is no small business manufacturer for the supplies being used (i.e., say you need Cisco routers and no small business supplies the same or similar routers) then the contracting officer would have to check and see if SBA has already issued a class waiver to the nonmanufacturer rule for those items or whether a contract-specific waiver is required. If there is no class waiver, then the contracting officer will either have to issue the contract as a full-and-open procurement, likely excluding most or all small businesses, or he/she will have to prepare a written justification for the nonmanufacturer, contract-specific waiver and request said waiver from SBA. SBA will then review the issue, investigate whether any small businesses exist who manufacture the supplies requested, and then, if and only if, no small business exists, issue the requested contract specific waiver – thereby allowing small businesses to compete for the procurement. Thus, before even soliciting a service contract where supplies are required, the contracting officer will have to do substantial additional due diligence.

Another major concern for small businesses, due to the COFC’s ruling, is whether small business service contractors would

ever be able to qualify as small under the nonmanufacturer rule at all because they are service providers, not companies “primarily engaged in the retail or wholesale trade” or “normally sell the type of item being supplied” as the rule requires. Thus, if an IT service provider is not “primarily engaged in the retail or wholesale trade” of routers, they just install them and service them, but then a procurement hits the street where routers are required to be supplied (regardless of how small a portion of the contract that supply actual is) the IT service provider would not be an eligible small business under the nonmanufacturer rule and would, thus, no longer qualify as “small” for the service component. This is clearly not what was intended by Congress when drafting the Small Business Act, but due to imprecise drafting, it is now how the COFC is forced to interpret the Act. This is extremely unfortunate and, unless and until the recent decision is limited through future litigation, it is unclear what the scope or impact of the case will be to the large community of small business service contractors. At its worst, it could have a major negative impact.

Given the COFC’s ruling in *Rotech*, it is possible that many current small business set-asides will change to full-and-open procurements in the future or small business service companies will have to find small business manufacturers for the supplies they are currently using to perform contracts. Otherwise, the small business service contractors will not be in compliance with the nonmanufacturer rule, and would no longer be eligible for award of service contracts that for years have been performed by the small business community. Clearly, Congress needs to act quickly to amend the Small Business Act so I would urge all of our clients to reach out to their representatives to discuss these issues and seek a correction to the law.

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