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Understanding the Limitations on Subcontracting: *Where They Are Now, and Where They Are Headed*

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The "limitations on subcontracting" clause of the Federal Acquisition Regulation, FAR § 52.219-14, is an important component of all set-aside contracts. The clause ensures that small businesses benefit from set-aside contracts by restricting the amount of work that may be subcontracted. Though the reasoning for the limitations may be clear, it can be difficult to interpret how they apply to the various types of small businesses and contract vehicles. Given that we have recently seen an increase in the amount of audits and enforcement actions related to compliance with the limitations on subcontracting (also referred to as the performance of work requirements), it is critical for all firms that perform set-aside contracts to understand the current requirements and changes that are on the horizon.

Currently, the FAR clause[1] states that small business prime contractors must perform a specific percentage of the labor costs incurred under their set-aside contracts with their own employees. The percentage varies depending on the type of contract. For example, the required percentage of work for a prime contractor on a set-aside contract for services is 50 percent. In this context, "labor costs" means direct labor costs, as well as general and administrative (G&A) and overhead expenses attributable to those costs. Tracking compliance based on costs is often difficult for small businesses.

Generally, the small business prime contractor is required to satisfy the applicable percentage of work on its own. However, there are exceptions for HUBZone firms and service-disabled veteran-owned small businesses (SDVOSBs), which are permitted to satisfy the requirement through their own employees or through subcontracts to other HUBZone firms and SDVOSBs, respectively.

According to the Small Business Administration's rules, "[t]he period of time used to determine compliance [with the limitations on subcontracting] will be the period of performance which the evaluating agency uses to evaluate the proposal or bid."[2] If the agency does not specify a period of performance for evaluation of proposals, SBA's rules state that the contract's base year, excluding options, will be used to determine compliance.

Contractors are also often confused about how to apply the current performance of work requirements to task order

continued on page 24

[1] FAR § 52.219-14
[2] 13 C.F.R. § 125.6(g)
[3] 13 C.F.R. § 124.510(c)

from page 23

contracts. SBA's regulations indicate that, on 8(a) task order contracts, compliance is assessed every six months for all orders issued during that period, although different requirements apply during the first six months of the contract.[3] For other task order contracts, however, there are no specific regulatory guidelines. The prevailing view is reflected in a 1997 bid protest decision in which the GAO held that the FAR limitations on subcontracting clause applies to the contract as a whole, not each task order issued there under.

To address some of the confusion and to make the requirements easier to enforce, Congress included several important changes to the limitations on subcontracting requirements in the National Defense Authorization Act of 2013 (NDAA). Notably, the NDAA modified the measurement of compliance from labor costs to total contract price. For contracts that are a mix of services and supplies, the subcontracting limitation is based on the amount awarded under the contract for services or supplies (whichever, in the contractor's view, accounts for the greatest percentage of the contract). These changes should make it easier for contractors to meet the requirements and for the government to track compliance.

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The NDAA also provides more flexibility for small businesses to comply with the performance of work requirements through subcontracts to "similarly situated entities." Whereas the current rules only provide such flexibility to HUBZone firms and SDVOSBs, the NDAA permits all small businesses to meet the applicable percentage of work through their own employees as well as subcontracts to similarly situated small businesses (i.e., 8(a) to 8(a), SDVOSB to SDVOSB, etc.). However, there is no regulation yet that defines the term "similarly situated small businesses."

In addition to these carrots, the NDAA includes a stick: the penalty for noncompliance with the limitations on subcontracting will be a fine of $500,000, or the amount expended on subcontractors in excess of the permitted level under the FAR clause, whichever is greater. Prior to the NDAA, there were no clear penalties or methods for enforcing the limitations on subcontracting.

The new provisions in the NDAA should not be effective for a particular contract until the contract is modified to include a new version of the limitations

on subcontracting FAR clause, which will need to be revised based on the NDAA. While the NDAA did not deal directly with the application of the limitations on subcontracting to multiple award contracts, there is a pending SBA rule that would do just that. In May 2012, SBA proposed that compliance with the performance of work requirements on multiple award contracts would be assessed per task order. SBA considered looking to the aggregate of work performed at any point in time during the contract, but concluded that judging performance on an order-by-order basis would be easier to monitor. SBA's proposed rule regarding multiple award contracts may be finalized this year.

With these changes on the horizon, and given the government's increased efforts to enforce the performance of work requirements, as well as the overall emphasis on ensuring small business contracts truly benefit small businesses, the evolution of the limitations on subcontracting bears watching for all firms that perform on set-aside contracts. ■

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Neil Albert *continued from pg. 7*

To ensure these goals are achieved, the PSC Commission on Driving Efficient and Innovative Service Outcomes Efficiency Subcommittee's findings and recommendations can be summarized in the following manner.

Government and industry can improve efficiency and effectiveness by applying contract type and evaluation techniques in a more consistent and objective manner.

Whether it is implementing a Lowest Price Technically Acceptable contract, evaluating past performance, or determining what is technically acceptable, the right contract type needs to be applied, the marketplace needs to sufficiently understand the evaluation criteria, and the resulting contract needs to be managed as the contract is written. By redefining these terms and conditions, the government sets up industry for failure; and with industry failures comes government's ineffectiveness.

The greatest opportunity for achieving efficiency and effectiveness requires that government and industry increase communication with each other and collaborate on how they can work together to improve results.

By improving communication with each other, government and industry can focus on what each other brings to the table to shape opportunities, to understand the requirements, to achieve savings, to define the best solutions for the mission, and to understand what may go wrong and how it can be corrected. The current lack of communication has created a level of distrust and has reduced actions to be reactive rather than proactive in improving results.

Government also needs to carefully focus on the balance between oversight and efficiency/effectiveness.

Government has become the prescriber of how industry should bid, of what process they should use, of how to report it, and of what market value is to be ascribed to individual functional expertise. In other words, government is limiting industry's ability to be innovative, provide the kind of expertise their experience suggests is needed, or effectively and efficiently execute the program or contract to the best of their capabilities. Too often the government has pursued a "check the box" approach to execution and focused on procedural perfection rather than excellent outcomes.

Both government and industry need to look internally to improve efficiency and effectiveness.

For government, this means sharing best practices across agencies, reducing duplication of audits (e.g., DCAA vs. DCMA), eliminating multiple contracts that attempt to accomplish the same or similar mission, cross functionally training acquisition professionals, and strategically determining how dollars are spent particularly if spending more upfront will result in lower life-cycle costs. For industry, it's about improving processes, ensuring costs are fair and reasonable, incentivizing outstanding performance, being held accountable for poor business judgment, and avoiding grade creep. In either case, focusing on the mission and the end result must be a priority.

The biggest surprise in assessing and evaluating the issues that potentially affect our ability to be more efficient and effective was the change we have seen over the last four or more years in industry's and government's interaction. Having a strong and honest relationship between government and industry is all but gone. The best results have always been in times was when industry and government freely and openly communicated. Issues were discussed and constructive discussion followed. Based on conversations with both government and industry practitioners, it is increasingly clear that today's environment is dominated by a "we vs. them" mentality where distrust, over-specification of process requirements, and an excessive focus on non-value added compliance requirements have soured what used to be a cooperative and collaborative environment.

This focus on efficiency, effectiveness, and productivity can be seen in the Department of Defense's Better Buying Power (BBP) 2.0 initiatives and similar initiatives that OMB and other agencies have established across government. Together industry and government must help each other to succeed in this new and challenging environment so they can best achieve the outcomes and missions they are required to meet. ■