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Small Business Savvy? Senate Bill Would Undercut New SBA Regulations

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On February 11, 2011, the Small Business Administration issued final regulations addressing an array of issues relating to the agency's programs, including the size standards applicable to nonmanufacturers or dealers, the elimination of the vexing use of both SIC and NAICS codes for size standards and adoption of the latter as the sole criteria for use in the standards, and the 8(a) mentor-protégé program. 76 Fed. Reg. 8222 (Feb. 11, 2011).

On September 22, 2011, Senator Claire McCaskill (D-Mo.), acting as though the new SBA regulations had never been promulgated, introduced the "Fairness for Small Businesses in Federal Contracting Act of 2011," which, if enacted, would require substantial changes to the current system for contracting under the Small Business Regulations. The Senator believes that her Subcommittee on Contracting Oversight's investigation of SBA size standards has established, among other things, that because the size standard for "nonmanufacturers", *i.e.*, distributors of or dealers in products manufactured by others, allows the entity to have up to 500 employees, it allows large distributors or dealers to be awarded contracts which should go to small ones. 13 C.F.R. § 121.406(b)(1)(i). The Senator also takes issue with so-called loopholes she contends allow large businesses to perform contracts intended for small businesses – *e.g.*, the size status of a small business is determined as of the date of contract award, but the determination remains valid for the life of the contract – thus, formerly small businesses continue to perform contracts even though they have grown into large ones.

Senator McCaskill, who is a former Missouri State Auditor, is proposing steps that include: (i) elimination of the "non-manufacturer rule," and (ii) elimination of the Census

Bureau's widely accepted North American Industrial Classification System ("NAICS"),[1] with a direction to the Small Business Administration to come up with an entirely new system for classifying industries. The first step is unnecessary and irrelevant; the second would be both irrelevant and profoundly disruptive of small business programs specficially and the procurement system as a whole.

First, Senator McCaskill has missed the boat as to the actual source of potential abuse of the so-called nonmanufacturer rule, which is not the intrusion of large business dealers into the space of small ones but the misuse of the rule by some small dealers themselves, who Congress has directed "shall not be denied the opportunity to submit and have considered . . . [their] offer[s] for any procurement contract for the supply of a product" under small business programs simply because they are not manufacturers or processors of the product in question. 15 U.S.C. § 637(a)(2)(17)(A). The SBA, perhaps yielding too much in its implementation of this direction, simply copied the criteria in the statute, 15 U.S.C. § 637(a)(2)(17)(B), when drafting the size standard so that it allowed a situation where, for example, "[a] multi-million dollar supply contract in which a large business manufacturer [or large distributor or dealer] 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 . . . ." 76 Fed. Reg. 8226 (Feb. 11, 2011). The new rules address this loophole by requiring that, to take advantage of Congress's guarantee of participation, the small business dealer must not only meet the size criteria but must take ". . . ownership or possession of the item(s) with its personnel, equipment of facilities . . . ." 13 C.F.R. §121.406(b)(1)(iii).

Second, the notion that small business contractors who have matured into large ones should forego all contracts awarded while they were small is contrary to the policy underlying the small business programs. Allowing a small business to grow as a result of a Federal contract or subcontract award is the very purpose of small business contracting programs – without the ability to grow and benefit from contracts, there is no incentive for small businesses to participate in the program at all. To the extent there are real issues with the listing of contractors as small who are clearly large, the problem is one of enforcement, not to be solved with a wholesale rewriting of the rules. The Senator's proposed solution, which entails basing the size standards on an undefined "new" classification system and eliminating the use of NAICS would place a huge burden on both the SBA – whose competence to design and implement such a system

is, as the SBA would itself likely agree, questionable – and the Federal contracting system as a whole because it would require small businesses, contracting officers, prime contractors and a number of other affected parties to understand and implement a classification system that does not clearly correspond to a particular type of contract. The effect could be to create a disincentive to enter into small business contracting programs.

Moreover, Senator McCaskill's proposed legislation ignores the SBA's 8(a) Mentor-Protégé program, an area where, prior to the issuance of the new regulations, the potential for abuse by large businesses was high, in part because the rules imposed no specific requirement as to the amount of work to be performed by the small business participants in joint ventures formed under the program. The new rules expand opportunities while tightening the criteria for access, providing that 8(a) participants (or protégés) in a Mentor-Protégé Joint Venture ("JV") no longer merely can perform a "significant portion" of the JV's work but must perform 40% of the JV's work and receive profits commensurate with the work it performs. Further, a mentor who fails to provide sufficient assistance to its protégé, or who violates the performance requirements, is now subject to the threat of more severe penalties, including suspension and debarment from Government contracting. These changes cured two flaws in the joint venture regulations that allowed both the small and large business members of the joint venture to engage in behavior contrary to the purposes of the program. Thus, the uncertainty of the "significant portion" standard permitted, in some cases, an 8(a) firm to have a minor role in contract performance, perhaps only assigned ancillary or administrative tasks, while receiving 51% of the profit. On the other hand, the non-8(a) large firm or mentor could benefit from access to sales via competitive advantage of 8(a) contracts, while providing no real developmental benefit for the protégé.

Senator McCaskill's effort to make substantial changes to the small business contracting programs only months after the responsible agency has issued comprehensive new rules addressing relevant problems makes no sense. Federal agencies and contractors barely have had enough time to understand the new rules, much less conform their practices to them. The "Fairness" legislation should be allowed to die without further discussion. That said, the proposed legislation does serve to highlight increasing Congressional interest in the efficiency and transparency of small business contracting which means that these issues are now "hot-buttons" for SBA

officials who now have evidenced a new enthusiasm for eliminating exploitation of small business contracting programs by large and small businesses alike. Clearly, large businesses desiring to partner with small businesses must take special care to examine any risk factors particular to relationships with small businesses under SBA programs.

Authored By:

W. Bruce Shirk
(202) 741-8426
bshirk@sheppardmullin.com

Kerry O'Neill
(202) 469-4968
koneill@sheppardmullin.com

[1] "NAICS is a system for classifying establishments (individual business locations) by type of economic activity . . . . NAICS is used by Federal statistical agencies that collect or publish data by industry. It is also widely used by State agencies, trade associations, private businesses, and other organizations." 74 Fed. Reg. 724 (Jan. 7, 2009).