Government Contracts
& Disputes

March 17, 2015

# Proposed Subcontracting and Affiliation Rules May Aid Small Business Prime Contractors

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*On December 29, 2014 the Small Business Administration ("SBA") issued proposed rules to implement provisions of the National Defense Authorization Act of 2013 ("NDAA"), and to make other clarifying changes to its regulations.* See *79 F.R. 77955. These changes are potentially significant and largely benefit small business prime contractors. Last week, the SBA extended the comment period to April 6, 2015 because of the scope of the proposed changes and the level of interest in the proposed changes. Both small and large businesses may be affected by the wide ranging proposed rule changes.*

## 2013 NDAA and Changes to Subcontracting Limits for Small Business Prime Contractors

The SBA's proposed rules implement two significant changes that the 2013 NDAA made to the limitations on subcontracting rule. While the current rule limits the amount of work a small business prime contractor can subcontract to a large business, it has been difficult to implement the current rule consistently, and the rule has been subject to varying interpretations. The new proposed rule also limits the amount of work that a small business prime contractor can subcontract to large businesses, but provides a much clearer standard. First, Section 1651 of the NDAA creates a shift in how the limitation on subcontracting is calculated by focusing on the percentage of the total award amount that can be spent on subcontractors, as opposed to focusing on a required percentage of work to be performed by the prime contractor. The SBA's proposed rule changes the existing formulas to reflect this shift. Additionally, under the current regulations, these formulas differ based on the type of contract (supply, services, etc.), and based on the type of set-aside (whether the contract is set aside for small businesses, SDVOSBs, etc.). Under the proposed rule there continue to be different formulas based on the type of contract, but the formulas generally do not differ based on the type of set-aside. The SBA hopes that this more streamlined approach will make compliance simpler for companies.

Section 1651 of the NDAA also provides that work performed by a small business that participates in the same SBA program as the small business prime contractor (e.g. 8(a), SDVOSB, HUBZone, EDWOSB) is exempt from the subcontracting limitation discussed above. In other words, work subcontracted to such a

small business (defined as a "similarly situated entity") does not count as subcontracted work for purposes of compliance with the limitation on subcontracting requirements. This change is significant because the current rule on subcontracting limitations covers all subcontracting with all small or large businesses.

## Clarification of Affiliation Rules Related to Substantially Similar or Identical Interests

The proposed rules amend 13 C.F.R. § 121.103(f), which defines affiliation based on an identity of interest. Currently under § 121.103(f), two or more individuals or firms may be found to be affiliated for purposes of an SBA size determination if it is determined that they have identical or substantially identical business or economic interests. As a result of these identical economic interests, the entities are treated as one, and their interests are aggregated. An entity may rebut such a presumption by the SBA with evidence showing that the interests deemed to be one are in fact separate. Examples of relationships listed under the old rule that may lead to an identity of interest determination include relationships between "family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships."

The proposed rules attempt to provide more guidance for determining when affiliation based on an identity of interest exists through a two-step process. First, the proposed rule provides more examples of relationships that create a rebuttable presumption of affiliation, adding that firms owned or controlled by married couples, parties to a civil union, parents and children, and siblings are presumed to be affiliated with each other if the firms conduct business with each other, including if they subcontract or joint venture, or if they share or provide loans, resources, equipment, locations or employees with one another. Second, the proposed rule states that if a firm derived 70% or more of its revenue from another firm over the previous fiscal year, SBA will presume that the one firm is economically dependent on the other and, therefore, that the two firms share an identity of interest, and are affiliated. This change is notable because there is currently no fixed percentage that creates this rebuttable presumption. This fixed percentage provides increased clarity for parties. Additionally, the proposed rule adds that this rebuttable presumption may be overcome by a new small business entity or start-up that has only received a few contracts, based on the recognition that such small businesses may initially be more dependent on one larger entity, but are expected to diversify as they grow.

## Joint Venture Affiliation Rule Changes

The proposed rules also amend 13 C.F.R. § 121.103(h)(4) to enable joint ventures formed by small businesses to bid on any contract as a small business, including small business set-aside contracts, as long as each company separately qualifies as a small business under the applicable size standard (and other procurement requirements are met). This proposed rule significantly broadens the ability of such otherwise qualifying small businesses to form joint ventures for purposes of bidding on any type or size contract by exempting such joint ventures from the affiliation rules. The current regulation is more restrictive because it limits the exemption from the affiliation rules to small business joint ventures bidding only for bundled or relatively large contracts as defined by the regulation (the value of contract contemplated by the procurement must exceed half of a revenue based size standard or $10 million when the applicable size standard is employee based). In such specific situations, the two firms are not deemed to be affiliated as a result of the joint venture, and the joint venture is entitled to certify that it is small. Under the proposed rule, the otherwise qualifying joint venture (e.g. for an 8(a) set aside both members must be 8(a) firms) may certify that it is small regardless of whether the contract it is bidding for is bundled, and regardless of the size of the contract contemplated by the procurement. In sum, the size of the joint venture will not be based upon the combined size of each joint venture member as long as each member would be qualified to bid as a small business under the applicable rules and size standards of the procurement.

## SBIR and SBTT Program Affiliation Rule Changes

The proposed rules also amend 13 C.F.R. § 121.702(a)(2), which relates to the size and eligibility requirements of the Small Business Innovation Research ("SBIR") and Small Business Technology Transfer ("STTR") Programs. Under 13 C.F.R. § 121.702(c), an SBIR or STTR awardee, together with its affiliates, must not have more than 500 employees. Concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party controls or has the power to control both.

13 C.F.R. § 121.702(a)(2), as it is currently written, states, "no single venture capital operating company ("VCOC"), hedge fund, or private equity firm may own more than 50% of the concern." This language has reasonably led some business concerns and government agencies to interpret the regulation as excluding from participation entities that are more than 50% owned by a single VCOC, hedge fund, or private equity firm *regardless* of the size of the VCOC, hedge fund, or private equity firm. This rule change clarifies that an entity may participate in the SBIR or STTR programs if it is more than 50% owned by a single VCOC, hedge fund, or private equity firm that is itself a small business. This means that the single VCOC, hedge fund or private equity firm, together with its affiliates, may not exceed the 500 employee size standard. This change may be significant because it may encourage greater qualifying investments in small businesses.

While the proposed rule on STTR and SBIR was not intended to change the substance of the current regulation, it clarifies the existing rule substantially, and it should encourage more small business entities to participate in the SBIR and STTR programs.

## Conclusion

We recommend that small businesses review the proposed rules to determine what opportunities may be affected by the proposed changes, and watch for the final regulatory changes that result from the proposed rules. All potentially affected businesses may wish to submit comments before April 6, 2015.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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