January 6, 2012

VIA REGULATORY PORTAL AND U.S. MAIL

Mr. Dean Koppel
U.S. Small Business Administration
Office of Government Contracting
8th Floor
409 Third Street, SW
Washington, DC 20416


Dear Mr. Koppel:

On behalf of the Section of Public Contract Law of the American Bar Association (“the Section”), we are submitting the following comments to the proposed rule issued by the Small Business Administration (“SBA”) to implement the provisions of Small Business Jobs Act of 2010, Pub. L. 111-240, (Sept. 27, 2010), relating to small business subcontracting (“Proposed Rule”), 76 Fed. Reg. 61626 (Oct. 5, 2011). The Section consists of attorneys and associated professionals in private practice, industry and government service. The Section’s governing Council and substantive committees have members representing these three segments, to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.1

The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar

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1 The Honorable Thomas C. Wheeler, a member of the Section’s Council, did not participate in the Section’s consideration of these comments and abstained from the voting to approve and send this letter.
Association. The Section is submitting these comments under an approved Request for Blanket Authority.2

The Section commends SBA for its efforts to clarify the requirements applicable to small business subcontracting, and the Section concurs with SBA that additional guidance for industry in this area is necessary. The Proposed Rule offers a thoughtful approach to implementing the Small Business Jobs Act requirements. We submit these comments to offer suggestions to maximize the utility of the rule and to help ensure that SBA and industry have a clearer understanding of the requirements in this area.

I. DEFINITION OF A SUBCONTRACT

The Section appreciates SBA’s clarification of the definition of the term “subcontract” in proposed 13 C.F.R. § 125.3(a)(1). The Section believes that a few minor adjustments would strengthen the definition and provide additional guidance to industry in understanding the requirements.

“Subcontract” vs. “Indirect Costs”: The Section commends SBA for taking this opportunity to better define the types of agreements to be included in the subcontracting base, which is used in calculating the small business subcontracting percentages. We are concerned, however, that defining the term “subcontract” in this context could cause confusion with use of the term in other rules for other purposes, and in other parts of the Federal Acquisition Regulation (“FAR”). We believe that confusion could be reduced by establishing a distinct line in the Proposed Rule between two broad categories of agreements that manufacturers enter into for the purchases of goods and services necessary to run their businesses (and the payments made by manufacturers under these agreements known as “spend”): “subcontracts” – and the spend associated with them – and “vendor agreements” or indirect costs. This latter category of agreements and related spend would not otherwise be considered “subcontracts” but are discussed in the Proposed Rule because they are included in the subcontracting base for contractors that use indirect costs in establishing subcontracting goals in their small business subcontracting plans and in determining performance under their plans. We do not believe this change would have any impact on the policy goals of the Proposed Rule.

A potential way to clarify the distinction and to avoid confusion, particularly for commercial item contractors, would be to add text in the definition

2 This letter is available in .pdf format under the topic “Small Business and Socioeconomic Programs” at: http://www.americanbar.org/groups/public_contract_law/resources/prior_section_comments.html.
of “subcontract” under § 125.3 clarifying that the supplies or services provided under the agreement must be specific to the particular prime contract requirements in order for the agreement to be considered a subcontract. Specifically, we believe it would be useful to clarify that an agreement to obtain supplies or services that are in the nature of commercial items and are used to support both commercial and government contracts would not be considered a “subcontract.” (Such a vendor agreement could, however, be included in the subcontracting base for commercial plans because those plans are required to consider indirect costs.) This clarified definition will not only provide clear guidance in the context of a contractor’s small business subcontracting plan, it also will alleviate the confusion that has developed regarding perceived distinctions between the scope of the term “subcontract” in the context of the small business subcontracting plan requirements and the FAR requirement arising in the context of subcontract flowdowns. Put another way, clarifying the term “subcontract” in this rule will clarify that the term is meant to be defined consistently in both the small business subcontracting plan and subcontract flowdown contexts.

**Indirect Costs Included in the Subcontracting Base:** The Section supports SBA’s decision not to concur with the suggestion set forth in GAO Report No. 05-459 (May 2005) regarding the scope and nature of indirect costs for inclusion in the subcontracting base. Specifically, the Section agrees that costs such as electricity and other utilities do not belong in the subcontracting base in view of the fact that these services cannot be obtained from small businesses. The Section suggests, however, that the SBA provide additional clarity in the portion of the Proposed Rule that discusses the types of costs that are to be excluded from those considered “indirect costs” in the subcontracting base. This clarification will particularly benefit companies submitting commercial plans.

As proposed, § 125.3(a)(1) lists those items of cost that should not be contained within the subcontracting base. 76 Fed. Reg. 61631. There is no indication, however, as to whether this presents an exhaustive list of those types of arrangements that should be excluded from the subcontracting base as they are not to be considered vendor spend/indirect costs, or whether it is simply a list of examples.

Although the Section agrees that it is important to provide a representation of those types of agreements that contractors should exclude, we are concerned that contractors will be unsure whether the list presents the entire realm of agreements excluded from the subcontracting base or provides examples only. We recommend amending the language of § 125.3(a)(1) to read, in pertinent part, as follows:

*While indirect costs may be included in the subcontracting base (and must be included for commercial plans), the following are examples of indirect*
costs that should not be included in the subcontracting base: Internally generated costs such as salaries and wages, employee insurance; other employee benefits; payments for petty cash; depreciation; interest; income taxes; property taxes; lease payments; bank fees; fines, claims, and dues; Original Equipment Manufacturer relationships during warranty periods (negotiated up front with product); electricity; utilities such as water, sewer, and other services purchased from a municipality; and philanthropic contributions.

By clarifying the scope of the term “subcontract” and making clear that § 125.3 provides an illustrative, as opposed to exhaustive, list of indirect costs to be excluded from the subcontracting base, SBA can greatly increase the clarity of the Proposed Rule for prime contractors.

II. MULTIPLE AWARD SCHEDULES

Subcontracting Reports on Individual MAS Orders: The Section urges SBA to consider revising the Proposed Rule as it pertains to Multiple Award Schedule (“MAS”) contracts. As currently drafted, the Proposed Rule would require prime contractors that do not have commercial plans to submit annual small business subcontracting reports for each individual order as opposed to semi-annual or annual summary reports on all individual orders. 76 Fed. Reg. 61632 (proposed 13 C.F.R. § 125.3(h)(1)).

Although the Section understands that funding agencies are interested in receiving credit toward their own subcontracting goals, we believe that this requirement places an onerous burden on prime contractors to ensure that a report regarding small business subcontracting achievement is compiled for each individual schedule order rather than for the contract as a whole. For certain MAS contractors, this could mean tens, if not hundreds, of additional reports each year that must be compiled by the prime contractor and funneled to the appropriate funding agency. The cost impact of these additional reports will ultimately be borne by the Government, either through increased costs or increased prices for products and services. Furthermore, this reporting obligation would require the funding agencies to implement procedures for receiving, processing, and evaluating an influx of such reports, placing additional burdens on contracting officers that are already stretched too thin. Further this report requirement implies (as discussed further below) a level of subcontract management not generally feasible for schedule contract holders, whose choice of goods and services offered and basic pricing are set long in advance of individual agency orders, and much of which is not flexible enough to meet variable subcontracting obligations that would flow from individual agency and task order reporting.
We recommend that GSA and ordering agencies use the same measures and not create multiple levels of reporting for the same transactions – at the schedule contract level. Agencies can, either from their own data or in conjunction with the MAS contract lead agency, determine the percentage of sales under the contract during the particular period that were transacted with the agency and adjust their small business spend reports based upon the contractor’s overall reporting. We respectfully contend that a desire to achieve credit on the part of a purchasing agency should not cause additional reporting and compliance requirements to be placed on contractors. Moreover, to be effective, it would require that contracting officers compare the proposed pricing, technical and small business subcontracting goals in placing each order. This would place yet another burden on already strained contracting staff. We are concerned that this extra burden would not necessarily yield any greater use of small business in the end.

**Variable Subcontracting Goals on MAS Orders:** Additionally, the Proposed Rule would allow each funding agency to set its own subcontracting goals in connection with individual orders. 76 Fed. Reg. 61632 (proposed 13 C.F.R. § 125.3(h)(3)). This requirement would substantially increase the administrative work associated with each individual order, and it is not clear that this additional administrative burden will achieve the desired goal. If divergent goals were associated with individual MAS contract orders, some funding agencies could require minimal small business subcontracting participation while others could implement much higher goals. Contractors, in turn, would be limited by its GSA-negotiated prices and products and would have little flexibility to be responsive to differing subcontracting demands on the same products. Because the goods and services listed on the schedules are essentially fixed, there is little room for adjustment to accommodate different goals for particular orders. In order for a MAS contractor to maintain compliance with pricing, domestic sourcing and other related compliance requirements, the Section is concerned that a situation in which contractors would have to change sources so as to meet additional goals for certain orders could be unduly burdensome.

Indeed, although the objectives that these provisions target are laudable, as a practical matter, it is not clear that they would have an impact on the outcome of a contractor’s performance against the stated goals. A manufacturer that purchases supplies and allocates them against its product in a proportionate amount is unlikely (and may be unable in an economical fashion) to change its source of supply for what would likely be a limited number of units under an individual order in order to achieve a single agency’s differing subcontracting goals.

We also note that MAS contracts by nature are commercial item vehicles that are meant to simplify acquisition procedures for the funding agencies by placing the burden of administering these contracts on the General Services
Administration and the Department of Veteran Affairs. See FAR 8.402(a). Requiring each funding agency to review and evaluate a contractor’s compliance with an individual subcontracting plan on an order-by-order basis will also considerably increase the burden on these funding agencies, and detract from the stated benefits of the MAS program.

Finally, the Section is concerned that the Regulatory Impact Analysis accompanying the Proposed Rule may not reflect the additional burdens, discussed herein, that would fall on contractors and government contracting staff. Although the Analysis states that “[l]arge business prime contractors will have to submit subcontracting reports more frequently,” 76 Fed. Reg. 61629, the Analysis does not address the extent of the burden that we believe prime contractors and individual funding agencies will face with plans and reports for individual schedule contract orders. The Regulatory Impact Analysis also does not quantify the monetary implications of the additional MAS requirements, as required “to the extent feasible” by Executive Order No. 12866. Accordingly, before determining that additional reports will be required, the Section recommends that the SBA reevaluate its Regulatory Impact Analysis with regard to how the Proposed Rule impacts MAS prime contractors and funding agencies.

The Section recommends that SBA remove this new requirement with regard to MAS contracts and urges that SBA (1) not require reporting of subcontracting results on an order-by-order basis, and (2) not provide funding agencies the discretion to set their own subcontracting goals for individual orders under MAS contracts. In the alternative, should SBA decide not to remove these two requirements for MAS contracts, the Section recommends that SBA implement a monetary threshold that triggers these obligations. The Section recommends that the threshold be set at the level at which the individual ordering agency could seek to negotiate its own goals if the order would independently meet the threshold for imposing a small business subcontracting plan on the contractor: $650,000 generally, and $1.5 million for construction contracts.

III. RESPONSIBILITIES OF PRIME CONTRACTORS

The Proposed Rule would create certain responsibilities for prime contractors that help to ensure that small business concerns have maximum opportunities to participate in the performance of contracts. Although these responsibilities are important to implementing the provisions of the Small Business Jobs Act, the Section believes that further clarification of these responsibilities would improve the final rule.

**Late and Reduced Payments to Subcontractors:** Section 1334 of the Small Business Jobs Act established a requirement that a prime contractor notify
the contracting officer in writing whenever a payment to a subcontractor is reduced or is 90 days or more past due for goods and services provided for the contract and for which the Federal agency has paid the contractor. The Section believes this requirement will provide needed protections to small businesses that have reported that their contractor customers do not always pay them in accordance with the terms of their contracts. The Section fears, however, that the manner in which the Proposed Rule addresses this requirement will result in prime and higher tier contractors unnecessarily reporting matters related to routine financial transactions such as contract payment adjustments that do not indicate a failure to abide by contract terms.

For example, it is not uncommon for a contractor to pay its suppliers upon receipt of goods, and prior to inspection of the goods. If, after inspection, a shortage is discovered (such as where the supplier furnished fewer goods than the contract required or delivered defective goods), the contractor will debit the supplier’s account and make a setoff against future payments on other contracts. If transactions like this are treated as “reduced” payments, contracting officers will be inundated with thousands of notices, far more than can be reasonably investigated to determine whether a contractor’s actions were justified.

The Section believes SBA should clarify that a reduced payment does not include cases where payment is reduced based on routine contract administration grounds, such as circumstances in which a supplier delivered less than the contract required or the contractor rejected delivered goods as nonconforming. With respect to late payments, the Section believes that SBA should clarify that payment will not be considered late if the delay in payment is due to the supplier’s failure to complete performance in time. In addition, to further reduce reporting for matters related to routine contract administration and to focus on cases where a contractor may be improperly paying its small business late or reduced amounts, the Section believes that reduced or late payments should be reported to the contracting officer only when the small business subcontractor has indicated to the contractor that it disagrees with the contractor’s reduced or delayed payment.

Similarly, the Section recommends that SBA clarify what constitutes an “unjustified” late or reduced payment. A contractor should not, for example, be considered as “unjustified” in its action if it believes in good faith that its action is consistent with the terms of its contract and has provided an explanation for its position to the contracting officer.

Lastly, consistent with the Small Business Jobs Act, the Proposed Rule would require contracting officers to identify prime contractors with a history of unjustified, untimely, or reduced payments to subcontractors in the Federal Awardee Performance and Integrity System (“FAPIIS”). The Proposed Rule would define a history of unjustified payments as 3 incidents within a 12-month period.
The Section respectfully suggests this is not an appropriate means for implementing the statutory requirement. In particular, the Section is concerned that establishing an across-the-board standard may not be appropriate because the size of contractors, and the number of payments they make to small businesses, varies considerably. Large contractors, for example, may make hundreds of thousands of payments to suppliers annually. To factor in the difference in contractor size, the Section recommends that SBA consider establishing a percentage standard based on the number of payments made to subcontractors or set a standard that includes a materiality requirement based upon the volume of transactions.

Using Small Business Concerns in Proposals: Section 1322 of the Small Business Jobs requires that a prime contractor on a covered contract must notify the contracting officer in writing if the prime contractor fails to utilize a small business concern it had relied upon in the prime contract proposal. As the preamble to the Proposed Rule notes, defining when a prime contractor used a subcontractor in preparing a bid or proposal can be very difficult. The Section agrees that providing a quote, or discussing availability, does not rise to the level of collaboration that would require notice to the Government. The Section commends SBA for attempting to clarify the circumstances under which a contractor would be required to provide the required notice. Nevertheless, as discussed below, the Section believes that additional clarification is required.

The Proposed Rule would provide that an offeror will be considered to have used a small business concern in preparing the bid or proposal if:

(i) The offeror references the small business concern as a subcontractor in the bid or proposal;

(ii) The offeror has a subcontract or agreement in principle to subcontract with the small business concern to perform a portion of the specific contract; or

(iii) The small business concern drafted any portion of the bid or proposal or the offeror used the small business concern's pricing or cost information or technical expertise in preparing the bid or proposal, where there is an intent or understanding that the small business concern will be awarded a subcontract for the related work if the offeror is awarded the contract.

The Section believes that paragraph (i) is unclear and recommends that SBA revise this provision as follows: “[T]he offeror indicates it has awarded or selected the small business concern as a subcontractor to perform a portion of the specific contract; or”.

With respect to paragraph (ii), the Section believes that conditioning the requirement on the existence of an “agreement in principle” could prove unworkable in practice because establishing the existence or non-existence of an “agreement in principle” will be fact-specific and difficult to determine. Accordingly, the Section recommends replacing “or agreement in principle” with “has made a written commitment to.”

Paragraph (iii), in its use of “intent or understanding” presents the same challenges as paragraph (ii). The Section recommends basing this provision on a written commitment by the offeror to the small business concern. The Section is not suggesting that there must be a formal contractual document such as a teaming agreement, to document an offeror’s commitment to a small business concern; we believe written correspondence between the parties could satisfy the requirement. At bottom, the Section believes the rule will be clearer and easier to implement if it is based on tangible evidence of the offeror’s intention to use a small business concern in a resultant contract.

Prime Contractor Monitoring of Subcontractor Subcontracting Plans:
The Proposed Rule would require that a small business compliance review include consideration of whether the contractor is monitoring its subcontractors with regard to their subcontracting plans, achievement of their proposed subcontracting goals, and reviewing their subcontractors’ ISRs (or SF-294s, if applicable). The Section believes that SBA should clarify what is meant by “monitoring.” Unlike the Government, contractors typically do not have audit rights in subcontractor financial and other proprietary information, and do not have the ability to monitor a subcontractor’s performance in the same manner and extent that the Government can monitor a prime contractor’s performance. Prime contractors can flowdown appropriate clauses and require basic reporting on compliance to ensure subcontractors continue to acknowledge their obligations, but do not have as a general rule the rights or the resources to take on more. Accordingly, the Section believes that the term “monitoring” should be defined consistently with the limited oversight abilities that prime contractors possess.

Furthermore, the Section recommends that SBA clarify that requirements such as the provisions implementing Sections 1332 and 1334 of the Small Business Jobs Act apply at the prime contracting level only and are not appropriate as a part of subcontract monitoring. The Section respectfully maintains that monitoring, to the extent it is required, should be limited to what prime contractors can perform within the constraints of their commercial relationships with subcontractors.

Issues Associated with the eSRS Small Business Subcontract Reporting System: The Proposed Rule would require contractors to correct eSRS reports when they are rejected by the contracting officer. The Section concurs with this requirement, but believes that contracting officers should be required to provide the
contractor with the reason for rejecting a report. This will facilitate the prompt correction of errors in reports and help prevent future errors.

IV. CONTRACTING OFFICER RESPONSIBILITIES

The Proposed Rule also would require contracting officers to take certain actions to ensure a prime contractor complies with its subcontracting plan. Although the Section agrees that it is important for contracting officers to evaluate prime contractor compliance, certain of these responsibilities could be altered to better reflect the Government’s interests and avoid confusion.

Options: The Proposed Rule would require contracting officers to obtain updated subcontracting plans from the prime contractor when an option is exercised. The Section believes options should be addressed in the initial contract award, as the FAR presently requires. When options are properly addressed as part of the initial subcontracting plan, future updates should not be needed.

Small Business Subcontracting Plans and Change Orders: The Proposed Rule would require contracting officers to obtain from prime contractors a subcontracting plan if the value of a contract modification causes the value of a contract to exceed the subcontracting plan threshold. The Section believes this requirement should apply only where (1) the modification together with the yet-to-be-performed portion of the prime contract exceeds the threshold for a small business plan, and (2) the modification offers subcontracting opportunities. Many modifications to contracts take place late in performance and may be low in value and limited in scope. If substantially all of the subcontracting is completed by the time a contract is modified to exceed the threshold, it will not serve the Government’s interests to require the contractor to negotiate a subcontracting plan.

Subcontracting Plans for Contracts with Small Businesses that Become Large Businesses after Award: The Proposed Rule would require contracting officers to obtain a subcontracting plan if a firm’s size status changes from small to other than small as a result of a size recertification. The Section urges SBA to delete this provision from the Proposed Rule. This aspect of the Proposed Rule appears to be a significant departure from the traditional approach of allowing contracts won while small to remain under the same rules, while applying large business standards to new business. Adding new compliance requirements in the

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3 FAR 19.704(c) currently provides as follows: “For multiyear contracts or contracts containing options, the cumulative value of the basic contract and all options is considered in determining whether a subcontracting plan is necessary (see 19.705–2(a)). If a plan is necessary and the offeror is submitting an individual contract plan, the plan shall contain all the elements required by paragraph (a) of this section and shall contain separate statements and goals for the basic contract and for each option.”
middle of contract performance will expose the Government to claims by contractors for adjustment to the contract price and substantially increase the administrative burden on growing businesses.

V. CONCLUSION

The Section supports SBA’s proposal to implement the Small Business Jobs Act through amendments to its regulations regarding small business subcontracting. The Section believes that SBA’s objectives would be furthered and administrative burdens on contractors and Government alike would be reduced by clarifying and revising the Proposed Rule, as set forth above.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

Carol N. Park-Conroy
Chair, Section of Public Contract Law

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