



The Inapplicability of Limitations on Subcontracting to “Preference Contracts” for Small Businesses: *Washington-Harris Group*

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Summary

This report discusses *Washington-Harris Group*, a protest filed with the Government Accountability Office (GAO) alleging, among other things, that an agency improperly awarded a "preference contract" to a service-disabled veteran-owned small business that proposed to subcontract a greater percentage of work on the contract than allowed under the Small Business Administration's limitations on subcontracting. GAO denied the protest, in part, because it found that limitations on subcontracting apply only to contracts "set aside" for small business, not to preference contracts. A preference contract is one awarded in an unrestricted competition in which firms' small-business status is an evaluation factor, while a set-aside is a procurement in which only small businesses may compete. Limitations on subcontracting are statutory and regulatory provisions that require small businesses to perform certain percentages of the work on federal prime contracts themselves, rather than subcontract it to other firms. GAO's decision appears to be a case of first impression and can arguably be construed to mean that existing limitations on subcontracting are inapplicable to non-disaster and non-emergency contracts awarded to any type of small business under the general contracting authorities. Commentators have suggested that the decision may result in increased use of preference contracts by federal agencies.

The federal government awarded \$96.8 billion in prime contracts and subcontracts to small businesses in FY2009 through set-asides and other contracting vehicles.

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Background

General and Special Contracting Authorities

Federal agencies rely on both their general contracting authorities and the special authorities of the Small Business Act when contracting with small businesses. The general contracting authorities—the Armed Services Procurement Act (ASPA) of 1947 and the Federal Property and Administrative Services Act (FPASA) of 1949—grant defense and civilian agencies, respectively, broad authority to contract with any responsible firm, including small businesses.¹ However, ASPA and FPASA do not authorize agencies to set aside contracts for small businesses, or conduct procurements in which only small businesses, or specific types of small businesses, may compete. Only the Small Business Act does this,² authorizing³ agencies to set aside part or all⁴ of certain procurements for

1. small businesses;⁵
2. women-owned small businesses;⁶

¹ ASPA, P.L. 80-413, 62 Stat. 21 (Feb. 19, 1948) (codified at 10 U.S.C. § 2302 et seq.); FPASA, P.L. 81-152, 63 Stat. 377 (June 30, 1949) (codified at 40 U.S.C. § 471 et seq. and 41 U.S.C. § 251 et seq.).

² Small Business Act of 1958, P.L. 85-536, 72 Stat. 384 (July 18, 1958) (codified at 15 U.S.C. § 631 et seq.).

³ Between December 2, 1997, and September 27, 2010, the Small Business Act contained certain language that the GAO and the federal courts construed as *requiring* agencies to use HUBZone set-asides in certain circumstances. *See generally* CRS Report R40591, *Set-Asides for Small Businesses: Recent Developments in the Law Regarding Precedence Among the Set-Aside Programs and Set-Asides Under Indefinite-Delivery/Indefinite-Quantity Contracts*, by (name redacted). However, the Small Business Jobs and Credit Act of 2010 removed this language. *See* P.L. 111-240, § 1347, 124 Stat. 2546-47 (Sept. 27, 2010).

⁴ When a total set-aside is not appropriate, a procurement can generally be partially set aside for small businesses if (1) agency requirements can be severed into two or more economic production runs or reasonable lots; (2) one or more small businesses are expected to have the technical competence and productive capacity to satisfy the set-aside portion of the requirement at a fair market price; and (3) the procurement is not subject to simplified acquisition procedures. 48 C.F.R. § 19.502-3(a)(1)-(4). Partial set-asides cannot be made when procuring construction. 48 C.F.R. § 19.502-3(a).

⁵ 15 U.S.C. § 644(a); 48 C.F.R. § 19.502-2 & § 19.502-3. A small business is a for-profit entity that is “independently owned and operated”; is “not dominant in its field of operation”; and meets any definitions or standards established by the head of the SBA. 15 U.S.C. § 632(a)(1)-(2)(A). These standards focus primarily upon the size of the business, as measured by the number of employees, its annual average gross income, and the size of other businesses within the same industry. 13 C.F.R. §§ 121.101-121.108.

⁶ 15 U.S.C. § 637(m). Set-asides for women-owned firms may be made only in industries in which the SBA has determined that such businesses are underrepresented. 15 U.S.C. § 637(m)(2)(A)-(F) & (m)(4). Set-asides for women-owned small businesses have not yet been implemented, in part, because of concerns over the number and nature of the industries in which the SBA found that women-owned small businesses are underrepresented. *See* Small Business Administration, Proposed Rule: Women-Owned Small Business Federal Contract Assistance Procedures, 72 Fed. Reg. 73285 (Dec. 27, 2007) (identifying only four industries in which women-owned small businesses are underrepresented); Robert Brodsky, SBA Issues New Proposal on Small Business Program, But Same Questions Remain, *Gov’t Exec.*, Sept. 30, 2008, available at <http://www.govexec.com/dailyfed/0908/093008rb1.htm> (reporting an SBA proposal to increase the number of industries in which women are underrepresented from 4 to 31); Omnibus Appropriations Act, 2009, P.L. 111-8, Administrative Provisions—Small Business Administration, § 522, 123 Stat. 673 (Mar. 11, 2009) (prohibiting SBA from using funds appropriated under the act to implement the set-aside program with the previously identified industries). However, on October 7, 2010, the SBA issued final regulations for the women-owned small business set-aside program that are scheduled to take effect on February 4, 2011. *See* Small Business Administration, Women-Owned Small Business Federal Contract Program; Final Rule, 75 Fed. Reg. 62258 (Oct. 7, 2010). Among other things, these regulations identify 83 industries in which women are underrepresented or (continued...)

3. service-disabled veteran-owned small businesses (SDVOSBs);⁷
4. small businesses located in Historically Underutilized Business Zones (HUBZones) (HUBZone small businesses);⁸ and
5. small businesses owned and controlled by socially and economically disadvantaged individuals participating in the Small Business Administration's (SBA's) Minority Small Business and Capital Ownership Development Program (commonly known as the 8(a) Program) (8(a) firms).⁹

Although ASPA and FPASA do not authorize set-asides for small businesses, agencies may still "favor" small businesses in certain procurements conducted under their authority by using small-business status as an evaluation factor in negotiated procurements. A negotiated procurement is one in which the government awards the contract to the contractor whose offer represents the "best value" for the government in light of various factors established by the government and incorporated into the solicitation for the contract.¹⁰ Cost or price must be among these factors, but it need not be the primary factor or carry any specific weight in the overall award.¹¹ Other factors may include contractors' past performance, compliance with the solicitation requirements, technical excellence, management capability, personnel qualifications, prior experience, and small-business status.¹² Commentators sometimes call contracts that are awarded using firms' size as an evaluation factor "preference contracts" because they allow agencies to prefer various types of small businesses without setting aside a procurement for them.

Not all contracts awarded to small businesses under ASPA and FPASA are preference contracts, however. Some contracts are awarded to small businesses using sealed bidding, with awards made solely on the basis of price and without consideration of firms' size.¹³ In other cases, agencies use negotiated procurements without evaluation factors focusing on firms' size.

(...continued)

substantially underrepresented. *Id.* at 62259-60.

⁷ 15 U.S.C. § 657f; 48 C.F.R. § 19.1405. When used in reference to SDVOSBs, both "service" and "veteran" carry the meanings they have under the statutes governing veterans affairs. 15 U.S.C. § 632(q)(1) & (4). A veteran is a person who served "in the active military, naval, or air service, and who was discharged or released therefrom under conditions other than dishonorable." 38 U.S.C. § 101(2). A disability is service-related when it "was incurred or aggravated ... in [the] line of duty in the active military, naval, or air service." 38 U.S.C. § 101(16).

⁸ 15 U.S.C. § 657a; 48 C.F.R. § 19.1305. HUBZones include census tracts or non-metropolitan counties with higher than average unemployment, or lower than average median household incomes; lands within Indian reservations; and base closure areas, among others. 15 U.S.C. § 632(p)(1) & (4). At least 35% of the employees of a HUBZone small business generally must live in the HUBZone. 13 C.F.R. § 126.200(b)(4).

⁹ 15 U.S.C. § 637(a); 48 C.F.R. §§ 19.800-19.812. For more on the 8(a) Program, see CRS Report R40744, *The "8(a) Program" for Small Businesses Owned and Controlled by the Socially and Economically Disadvantaged: Legal Requirements and Issues*, by (name redacted) and (name redacted).

¹⁰ 48 C.F.R. § 15.101 (best value); 48 C.F.R. § 15.304 (evaluation factors). For more on negotiated procurements, see 48 C.F.R. §§ 15.000-15.609.

¹¹ 48 C.F.R. § 15.304(c)(1).

¹² 48 C.F.R. § 15.304(c)(2).

¹³ See 48 C.F.R. §§ 14.100-14.503-2.

Goals for Contracting and Subcontracting with Small Businesses

Contracts awarded under any authority—ASPA, FPASA, or the Small Business Act—count toward the government-wide and agency-specific goals for contracting with small businesses. The Business Opportunity Development Reform Act (BODRA) of 1988 requires the President to set government-wide goals for the percentage of federal contract and/or subcontract dollars awarded to various categories of small businesses.¹⁴ These goals must be equal to or exceed certain percentages specified in statute, as illustrated in **Table 1**. A 1978 amendment to the Small Business Act similarly requires that agency heads, in consultation with the SBA, set agency-specific goals for the percentage of contract dollars awarded to the same categories of small businesses.¹⁵ These goals are to “realistically reflect the potential” of small businesses to perform federal prime contracts and subcontracts and thus vary among agencies.¹⁶ Commentators frequently note the government’s failure to meet either government-wide or agency-specific goals,¹⁷ and some Members of Congress have suggested that the current government-wide goals are too low.¹⁸

Table 1. Government-Wide Goals for Contracting and Subcontracting with Small Businesses

| Category | Minimum Goals for Contracting and/or Subcontracting |
|---|--|
| HUBZone small businesses | 3% of the total value of all prime contracts and subcontracts ^a per fiscal year |
| SDVOSBs | 3% of the total value of all prime contracts and subcontracts per fiscal year |
| Small businesses | 23% of the total value of all prime contracts awarded per fiscal year |
| Small disadvantaged businesses ^b | 5% of the total value of all prime contracts and subcontracts per fiscal year |
| Women-owned small businesses | 5% of the total value of all prime contracts and subcontracts per fiscal year |

Source: Congressional Research Service, based on 15 U.S.C. § 644(g)(1).

- a. The government-wide goal for HUBZone small businesses did not include subcontracts until Congress enacted the Small Business Jobs and Credit Act of 2010. See P.L. 111-240, § 1347, 124 Stat. 2546-47 (Sept. 27, 2010).
- b. Small disadvantaged businesses (SDBs) include, but are not limited to, 8(a) firms. There is no separate goal for contracting with 8(a) firms, nor are there set-asides for SDBs that are not also 8(a) firms.

¹⁴ P.L. 100-656, § 502, 102 Stat. 3853, 3881 (Nov. 15, 1988) (codified at 15 U.S.C. § 644(g)(1)).

¹⁵ P.L. 95-507, § 221, 92 Stat. 1757, 1771 (Oct. 24, 1978) (codified at 15 U.S.C. § 644(g)(2)).

¹⁶ *Id.* (requirements for agency-specific goals).

¹⁷ See, e.g., Kent Hoover, Federal Government Misses Small Business Contracting Goal, *Wash. Bus. J.*, Oct. 22, 2008, available at <http://washington.bizjournals.com/washington/stories/2008/10/20/daily54.html>.

¹⁸ See, e.g., H.R. 2299, 111th Cong., § 5 (proposing to increase the government-wide goals for contracting with small businesses and small disadvantaged businesses to 25% and 10%, respectively).

Limitations on Subcontracting

Limitations on subcontracting have applied to contracts set aside for small businesses under the authority of the Small Business Act since 1986.¹⁹ These limitations result from statutory and regulatory provisions prohibiting agencies from awarding prime contracts to small businesses unless the small business performs a certain percentage of the contract work itself, instead of subcontracting it. The percentage that must be performed by the small business varies depending on the nature of the contract, as **Table 2** illustrates. Prior to GAO's decision, no judicial or administrative tribunal appears to have addressed whether these limitations apply to preference contracts as well as set-asides.

Table 2. Percentages of Various Types of Contracts that Must Be Performed by Employees of a Small Business Prime Contractor

| Contract Type | Performance Requirements |
|------------------------------|--|
| Service Contract | At least 50% of the personnel costs of the contract must be performed by employees of the prime contractor |
| Supply Contracts | At least 50% of the costs of manufacturing the supplies (excluding the costs of materials) must be performed by employees of the prime contractor if the contractor is not a regular dealer in such supplies |
| General Construction | At least 15% of the costs of construction (excluding materials) must be performed by employees of the prime contractor |
| "Special Trade" Construction | At least 25% of the costs of construction (excluding materials) must be performed by employees of the prime contractor |

Source: Congressional Research Service, based on 15 U.S.C. § 637(a)(14)(A)(i)-(ii) (limitations on subcontracting for 8(a) firms; 15 U.S.C. § 644(o)(1)(A)-(B) (limitations on subcontracting for other firms); 13 C.F.R. § 125.6(a)(3)-(4).

Certain contracts set-aside for "local firms," of any size, in disaster or emergency areas under the authority of the Stafford Act are also subject to limitations on subcontracting.²⁰ These limitations require that similar percentages of work be performed by the "local firm," as opposed to subcontracted, on the types of contracts listed in **Table 2**.²¹ However, these limitations are arguably unaffected by the GAO decision discussed here because they are not related to firm size.

GAO's Decision in *Washington-Harris Group*

In its November 16, 2009, decision, GAO denied Washington-Harris Group's protest alleging that the Army National Guard Bureau improperly awarded a contract for case management and administrative services to Skyline Ultd Inc.²² The procurement had not been set aside for

¹⁹ See National Defense Authorization Act for FY1987, P.L. 99-661, § 921(c), 100 Stat. 3927-28 (Nov. 14, 1986) (codified at 15 U.S.C. § 637(a) and 15 U.S.C. § 644(o)). There are separate provisions applicable to contracts awarded under the authority of Section 8(a) of the Small Business Act and to contracts awarded under the authority of Section 15 of the Small Business Act. The text of these provisions is identical, however.

²⁰ See, e.g., Department of Defense, General Services Administration, and National Aeronautics and Space Administration, FAR Case 2006-014: Local Community Recovery Act of 2006, 71 Fed. Reg. 44546 (Aug. 4, 2006).

²¹ 48 C.F.R. § 52.226-5.

²² Comp. Gen. Dec. No. B-401794; B-401794.2, 2009 U.S. Comp. Gen. LEXIS 226, at *1 (Nov. 16, 2009).

SDVOSBs.²³ However, the solicitation had included an evaluation factor focusing on firms' SDVOSB status, as well as a statement that the source selection authority would "favorably view an offeror's Small Business status."²⁴ Under the solicitation, firms' SDVOSB status and understanding of the requirements carried equal weight, and each was more important than any other evaluation factor.²⁵ Price was the least important factor.²⁶ For purposes of the solicitation, offers were considered to come from SDVOSBs if either (1) the prime contractor was an SDVOSB or (2) the offeror was a joint venture involving an SDVOSB firm that would perform more than 50% of the work.²⁷ There was no dispute that Skyline proposed to perform less than 50% of the contract requirements.²⁸

Washington-Harris Group argued that the solicitation and the Federal Acquisition Regulation (FAR) required SDVOSB contractors to perform at least 50% of the contract requirements in order to be evaluated favorably as an SDVOSB.²⁹ Washington-Harris Group's reference to the FAR appears to have been to Part 19.14, which requires, among other things, that a clause containing the limitations on subcontracting discussed in **Table 2** (Clause 52.219-27) be incorporated in all solicitations.³⁰

GAO rejected Washington-Harris Group's arguments regarding the solicitation because the solicitation distinguished between SDVOSB prime contractors and SDVOSB joint venturers and required only the latter to perform more than 50% of the work.³¹ It also rejected the argument that the FAR clause containing the limitations on subcontracting applied to this procurement.³² GAO reached this conclusion because the FAR states that Clause 52.219-27 is required only when "[o]ffers are solicited only from service-disabled veteran-owned small business concerns [and] [o]ffers received from concerns that are not service-disabled veteran-owned small business concerns shall not be considered."³³ Given this language, GAO concluded that the clause did not apply to this procurement because the procurement was not set aside for SDVOSBs.³⁴ Because

²³ *Id.* at *3.

²⁴ *Id.* at *3-4. The source selection authority is person to whom the agency head delegates authority to select a contractor. It is generally the contracting officer. *See* 48 C.F.R. § 15.303(a).

²⁵ 2009 U.S. Comp. Gen. LEXIS 226, at *3.

²⁶ *Id.*

²⁷ *Id.* at *4.

²⁸ *Id.* at *8.

²⁹ *Id.* at *8-9.

³⁰ *See* 48 C.F.R. § 52.219-27(b)(2)(1)-(4) ("A service-disabled veteran-owned small business concern agrees that in the performance of the contract, in the case of a contract for—(1) [s]ervices (except construction), at least 50 percent of the cost of personnel for contract performance will be spent for employees of the concern or employees of other service-disabled veteran-owned small business concerns; (2) [s]upplies (other than acquisition from a nonmanufacturer of the supplies), at least 50 percent of the cost of manufacturing, excluding the cost of materials, will be performed by the concern or other service-disabled veteran-owned small business concerns; (3) [g]eneral construction, at least 15 percent of the cost of the contract performance incurred for personnel will be spent on the concern's employees or the employees of other service-disabled veteran-owned small business concerns; or (4) [c]onstruction by special trade contractors, at least 25 percent of the cost of the contract performance incurred for personnel will be spent on the concern's employees or the employees of other service-disabled veteran-owned small business concerns.").

³¹ 2009 U.S. Comp. Gen. LEXIS 226, at *10-11.

³² *Id.* at *10 ("[T]he Army contends, and we agree, that the SDVOSB set-aside clause at FAR § 52.219-27 was not included in this solicitation, was not required to be included here, and has no application to this procurement.").

³³ *See* 48 C.F.R. § 52.219-27(b)(1).

³⁴ 2009 U.S. Comp. Gen. LEXIS 226, at *10-11. Washington-Harris Group's argument that Skyline should not have been considered the prime contractor because a teaming agreement between it and its subcontractor on the contract (continued...)

Clause 52.219-27 did not apply to the procurement, it found that the agency did not improperly evaluate Skyline favorably as an SDVOSB when awarding the contract even though Skyline proposed to subcontract over 50% of the work on the contract.

GAO did not directly address the differences between the general contracting authorities and the Small Business Act in its decision. It also did not address contracting with small businesses that are not SDVOSBs. However, because contracts awarded under the general contracting authorities cannot be set aside for SDVOSBs while those awarded under the authority of the Small Business Act can be, and because the same limitations on subcontracting apply to other types of small businesses as apply to SDVOSBs,³⁵ GAO's decision can arguably be construed to mean that limitations on subcontracting do not apply to any non-disaster and non-emergency "preference contract" awarded to any type of small business under the general contracting authorities.

Effects of GAO's Decision

Some commentators have suggested that GAO's decision could result in agencies using more preference contracts and fewer set-asides.³⁶ Such a shift from set-asides to preference contracts would not necessarily result in the government paying higher prices. While greater subcontracting generally tends to increase costs because each tier of subcontractors imposes additional overhead costs, recent legislation may help ensure that the government is aware of and does not compensate certain costs. For example, Section 866 of the Duncan Hunter National Defense Authorization Act for FY2009 imposed "limitations on tiering of subcontractors" by requiring that the FAR be amended to "minimize the excessive use ... of subcontractors, or of tiers of subcontractors, that add no or negligible value" by non-defense agencies.³⁷ The amendments to the FAR required by Section 866 took effect on October 14, 2009, and require contractors to "provide information on indirect costs and profit/fee and value added with regard to the subcontract work" when over 70% of the total cost of the work to be performed under the contract will be subcontracted.³⁸ The amendments also bar contractors from receiving indirect costs or profits/fees on work performed by subcontractors when the contractor "add[ed] no, or negligible value."³⁹ Similar requirements already applied to defense agencies under Section 852 of the John Warner National Defense Authorization Act for FY2007,⁴⁰ and in a memorandum dated December 23, 2009, the Director of Defense Procurement and Acquisition Policy

(...continued)

allowed the subcontractor to use Skyline as a subcontractor on its own Federal Supply Schedule contract was also rejected because this agreement was not part of the agency's source selection decision.

³⁵ See 48 C.F.R. § 52.219-3 (clause containing limitations on subcontracting for HUBZone set-asides); 48 C.F.R. § 52.219-14 (limitations on subcontracting for other set-asides).

³⁶ See, e.g., Matthew Weigelt, GAO Ruling Draws Line on Small-Biz Set-Asides: Ruling Eases the Burden on Certain Types of Small Firms Awarded Work Under Contracts in Which They Were Given "Preference," *Washington Tech.*, Dec. 3, 2009, available at <http://washingtontechnology.com/articles/2009/12/03/gsa-ruling-contracts-perferences-set-asides.aspx> (quoting Robert Burton, former deputy administrator at the Office of Federal Procurement Policy).

³⁷ P.L. 110-417, § 866, 122 Stat. 4551 (Oct. 14, 2008).

³⁸ See Department of Defense, General Services Administration, and National Aeronautics and Space Administration, FAR Case 2008-031: Limitations on Pass-Through Charges, 74 Fed. Reg. 52853 (Oct. 14, 2009) (adding Sections 52.215-22 and 52.215-23 to the FAR, among other things).

³⁹ *Id.*

⁴⁰ See P.L. 109-364, § 852, 120 Stat. 2340-41 (Oct. 17, 2006).

announced that the Department of Defense would delete its agency-specific regulations implementing Section 852 and comply with the government-wide regulations implementing Section 866.⁴¹

Ignoring costs, any shift that might occur could potentially have both benefits and drawbacks. On the one hand, increased use of preference contracts could result in increased contracting with small businesses because agencies could award contracts to firms that would have lacked the capacity to perform the required percentage of the work on a set-aside contract.⁴² Increased contracting, in turn, could result in the government, as a whole, and individual agencies performing better on their goals for contracting with small businesses.⁴³ On the other hand, increased use of preference contracts could limit small businesses' development because they would no longer be effectively required by the limitations on subcontracting to develop the in-house resources to perform certain set-aside contracts. This may be a particular concern with 8(a) firms because the 8(a) Program is, in part, intended to help small businesses owned and controlled by socially and economically disadvantaged individuals develop.⁴⁴ Agencies could also potentially use preference contracts to steer work to preferred subcontractors, who are not competitively selected.⁴⁵

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⁴¹ Office of the Under Secretary of Defense for Acquisition, Technology & Logistics, Class Deviation: Limitations on Pass-through Charges, Dec. 23, 2009, *available at* <http://www.acq.osd.mil/dpap/policy/policyvault/USA007457-09-DPAP.pdf>.

⁴² *See* Weigelt, *supra* note 36.

⁴³ *See supra* notes 14 and 17 and accompanying text.

⁴⁴ *See* 13 C.F.R. § 124.1 ("The purpose of the 8(a) BD program is to assist eligible small disadvantaged business concerns compete in the American economy through business development."). 8(a) firms are assured of receiving only management and technical assistance, including training in financing, management, accounting, bookkeeping, marketing, the operation of small businesses, and the identification and development of new business opportunities, from the government. 13 C.F.R. § 124.404(a)-(c); 13 C.F.R. § 124.405; 13 C.F.R. §§ 124.701-704. They are not guaranteed federal contracts, and in FY2008, only 44% of 8(a) firms that were not owned by Alaska Native Corporations received contracts. *See* Office of the Inspector General, U.S. Small Business Administration, Participation in the 8(a) Program by Firms Owned by Alaska Native Corporations, at 5 (July 10, 2009), *available at* http://www.sba.gov/idc/groups/public/documents/sba_homepage/oig_reptbydate_july9-15.pdf.

⁴⁵ *See, e.g.,* Robert O'Harrow, Jr., FDA Takes End Run to Award Contract to PR Firm, *Wash. Post*, Oct. 2, 2008, *available at* <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/01/AR2008100103061.html> (reporting that the Food and Drug Administration (FDA) awarded a sole-source contract to an Alaska Native Corporation (ANC) with the intent that the ANC would subcontract the work to the FDA's preferred vendor).

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