

Government Contracts Update

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Why the 50 Percent Rule Deserves 100 Percent Attention

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Small business prime contractors and their team members should pay careful attention to how the "50 Percent Rule" applies to their proposals and contracts. Some recent GAO bid protest decisions reveal that the 50 Percent Rule is being interpreted differently after the Small Business Act was amended by the 2013 National Defense Authorization Act (NDAA). As a result, small businesses must clarify with their agency customers how the 50 Percent Rule will be applied to the cost of labor and materials under their contracts. Failure to do so could expose small businesses to serious consequences, including proposal rejection, contract termination, fines, penalties, or worse.

In a recent GAO case, *MindPoint Group, LLC*, B-409562 (May 8, 2014), protester MindPoint challenged the DOJ's award of a contract set aside for economically disadvantaged, woman-owned small business (EDWOSB) concerns. The DOJ successfully argued that MindPoint was not an interested party to the protest because MindPoint, on the face of its proposal, took exception to the requirement that its employees perform at least 50 percent of the cost of contract performance incurred for personnel – also known as the "50 Percent Rule." The GAO agreed and dismissed the protest on those grounds.

The 2013 NDAA included several important changes to the small business contracting programs. One such change is an expansion of small business contracting opportunities through an augmentation to the 50 Percent Rule, which currently requires at least 50 percent of the cost of contract performance incurred for personnel to be expended for employees of the prime contractor. Despite the changes in the law, the Small Business Administration (SBA) regulations and the FAR have not yet been amended to incorporate these changes. As a result, many contractors have inquired whether they can take advantage of the expanded subcontracting opportunities contained in the NDAA.

Similarly Situated Entities

With limited exceptions, the current rule is strictly applied, even if the small business prime contractor is subcontracting work to other small businesses. The 2013 NDAA significantly expands subcontracting opportunities by extending exceptions currently allowed for HUBZone and service-disabled veteran-owned (SDVO) set-asides to small business subcontractors across the board. Subcontracts to other small businesses falling under the same small business category ("*similarly situated entity*," see Section 1651) will not count as subcontracts for purposes of the 50 percent calculation. For example, a woman-owned small business (WOSB) will be able to subcontract more than 50 percent of its work to another WOSB without running afoul of the 50 percent rule.

The legal status of the "similarly situated entity" exception remains uncertain, as neither the SBA regulations nor the FAR has been updated to include the language from the NDAA. Adding to the uncertainty is language in the GAO's decision in *Sealift, Inc.*, B-409001 (Jan. 6, 2014), indicating that the "similarly situated entity" rule might properly be held by an agency to apply in non-HUBZone or SDVO procurements. In *Sealift*, a small business set-aside award was upheld, where the awardee indicated its small business subcontractor would furnish what appeared to be personnel in excess of 50 percent of the costs of the awarded contract. The GAO held that the navy did enough during discussions to confirm that the prime contractor would comply with the 50 Percent Rule, but the decision did not clearly indicate how compliance would be achieved. Further, the GAO stated in a footnote that under the new NDAA framework, costs incurred on "similarly situated" small business subcontractors are not considered subcontractor costs.

Consequences of Noncompliance

Notwithstanding the recent vintage of the NDAA's changes to the Small Business Act and the footnoted language in the *Sealift* decision, contractors should remember that the NDAA is not self-executing and did not set a deadline for implementation by the SBA. Until the SBA and FAR Council amend the relevant provisions, contractors who rely on Section 1651 run the risk of facing strict consequences of noncompliance:

- **Negative impact on past performance ratings;**
- **Rejection of proposal** and lack of standing to protest, as evidenced by the recent MindPoint decision;
- **Small business size and status integrity issues.** A small business that willfully violates the 50 Percent Rule may be deemed affiliated with a large business subcontractor. As Venable previously reported, the SBA regulations state that the consequences of such wilful misrepresentation could include liability for the cost of the entire contract;
- **Termination for default.** An agency may terminate the set-aside contract for default in light of noncompliance with the 50 Percent Rule requirements;
- **False Claims Act liability** for certification of contract compliance upon invoice submission; and
- **Possible referral to agency suspension and debarment official.**

Tips for Compliance

Given the potentially harsh consequences of noncompliance with subcontracting limitations, contractors should carefully review their team arrangements and confirm whether any new NDAA requirements apply to their proposals or contracts. With that in mind, contractors should:

- Carefully review the language of the 50 Percent Rule as it is applied to your prime contract under FAR 52.219-14 or similar clauses;
- Review any and all contract modifications to determine if the agency is altering the application of the 50 Percent Rule; and
- When responding to a solicitation, if possible during the Question and Answer process, ask whether the agency considers "similarly situated entities" for purposes of compliance with the 50 Percent Rule. Keep a careful record of the agency's response in case there are compliance-related questions later during contract performance.

For more information on how compliance with the 50 Percent Rule might affect your business, or to better understand the requirements regarding small businesses, please contact [Keir Bancroft](#) at , [Christina Kube](#) at , [Anna Pulliam](#) at , or any of the other attorneys in Venable's [Government Contracts Practice Group](#).