PATTON BOGGS LLP

September 25, 2012

What is a "Small Business" Under the Army's $7 Billion Renewable Energy RFP?

Government Contracts Law Alert

This Alert provides only general information and should not be relied upon as legal advice. This Alert may be considered attorney advertising under court and bar rules in certain jurisdictions.

For more information, contact your Patton Boggs LLP attorney or the author listed below.

Robert K. Tompkins
rtompkins@pattonboggs.com

WWW.PATTONBOGGS.COM

As the October 5, 2012 deadline looms for interested parties to submit proposals in response to the Army's RFP for Renewable and Alternative Energy there remains a great deal of confusion as to the details of the "small business" eligibility requirements. As interested parties know, this is a vital issue in the context of this RFP. The Army intends to reserve substantial numbers of task orders for small businesses, including through a variation on the "Rule of Two" in the task order process. Large businesses are required to develop not only Small Business Subcontracting Plans, but also Small Business Participation Plans including detailed information documenting their teaming agreements with small businesses. Utilization of small business is one of the enumerated evaluation criteria set forth in the RFP.

Understanding whether your small business or small business teaming partner meets the SBA definition of a "small business" is vital, not only as a matter of eligibility for award, but because of significant new anti-fraud provisions that apply to companies holding themselves out as small businesses. Among other things, these new small business integrity provisions establish that a company that submits an offer in response to a small business set-aside procurement or that represents that it is small on government databases and websites, is making a deemed "certification" that the company is in fact a small business. In addition, by law the presumed loss to the government associated with a mis-certification of size status is deemed to be the total value of any small business contract awarded, meaning that damages for violating these provisions could escalate to three times the total value of the contract if a violation of the False Claims Act is established. These new laws apply to both prime and subcontracts. The stakes are undeniably high.

NAICS Code 221119

The SBA size standards and size regulations are complex and nuanced. The size standard applicable to the Army's RFP, set forth under NAICS Code 221119, has its own special provisions attached to it. From our extensive work in SBA matters in government contracting, and our experience in working with this NAICS code in particular, we offer the following brief overview of some of the key characteristics of this size standard and how it applies in the context of this RFP.

The size standard is found in 13 CFR § 121.201 and is explained in more detail in footnote 1, which reads, with our annotations, as follows:

A firm is small if, including its affiliates, it is primarily engaged in the generation, transmission, and/or distribution of electric energy for sale and its total electric output for the preceding fiscal year did not exceed 4 million megawatt hours.

This size standard differs significantly from nearly all of SBA's other size standards which are generally defined by total receipts (in the case of services industries) or number of employees (in the case of manufacturing industries). Here the size standard is based on "total electric output."

This size standard also differs from most others because it requires that a company be "primarily engaged in" the designated type of business. The SBA size regulations do not define "primarily engaged in." While SBA's regulations do address determining a concern's "primary industry" (13 CFR § 121.107), SBA's Office of Hearings and Appeals ("OHA") has expressly refused to consider this provision as also defining "primarily engaged in." Rather, OHA has stated that this definition is merely "illustrative of factors SBA should consider" in determining the business a firm is primarily engaged in.

With OHA's limitations in mind, we do believe 13 CFR § 121.107 provides some useful guidance. Specifically, that regulation states that SBA will consider "the distribution of receipts, employees and costs of doing business among the different industries in which business operations occurred for the most recently completed fiscal year. SBA may also consider other factors, such as the distribution of patents, contract awards, and assets." We believe that if a firm can demonstrate that it derives at least 50% of its total receipts from the relevant type of business that it will meet the primarily-engaged-in requirement. That said these other enumerated factors give companies that do not derive at least half their revenues from the designated businesses some room for arguing that they should qualify.

It is also important to appreciate the limitations of the types of business that qualify here. As stated in the footnote, only the "generation, transmission and/or distribution" of electric energy count. SBA and OHA have construed this requirement literally and very narrowly. In a case we handled several years ago, SBA and OHA rejected our client's position that a company that is exclusively in the business of construction, maintenance and repair of powerhouses should qualify under the standard. SBA and OHA disagreed. In their view, the company must be directly engaged in one or more of the three enumerated activities. Work that is outside these specific categories does not count, even if it is vital to the generation, transmission and/or distribution of electric energy.

Interested parties should also be cautious of the "for sale" requirement. Even where a company has been engaged in the requisite activities, if it has not provided the electric energy for a price, the company may not qualify under this requirement. For example, a concern that generates electric power for use in its own facilities, but does not sell that power, may not qualify.

The footnote also designates that the period of measurement is the "preceding fiscal year." Again, this differs from the typical calculation of receipts used in other size standards which are based on the average of receipts for the contractor's three most recently completed fiscal years. While the footnote does not expressly state this, consistent with SBA's other receipts-based requirements, we believe "fiscal year" refers to the contractor's fiscal year (not the government's fiscal year) and that it refers to the most recently completed fiscal year, not merely the most recent 12 month period.

We have also been asked whether companies need to be formally certified to hold themselves out as a small business. The answer is "no." A self-certification is all that is required. That said, particularly given the new anti-fraud laws, companies should document the basis for their certification. In the case of this size standard, this means identifying data to support each of the requirements outlined above:

* that it's engaged in the requisite activity;
* that on the basis of receipts this accounts for at least half of the company's business – and in the most recent "fiscal" year;
* that it has actually sold electric power in the required amount; and
* that its total output did not exceed 4 million megawatt hours.

Prudent large contractors should request similar data and certifications from their prospective small business teaming partners. In limited circumstances, concerns may seek a formal size determination from SBA. Obtaining a formal size determination would provide certainty to a concern's status. However, prior to seeking a size determination concerns would be wise to undertake a thorough self-assessment of their status in light of the eligibility requirements.

Affiliation

We also highlighted the term "affiliation" in the text of the footnote. The Small Business Act generally requires that small businesses must be "independently" owned and operated. 15 USC 632(a). SBA, through its regulations and case law of OHA, has implemented this statutory requirement through a concept called "affiliation." In determining a concern's size, the size of the concern along with the size of all affiliates (and affiliates of affiliates) is counted together.

Generally, concerns are affiliated with one another if one has the power to control the other, or if the concerns are subject to common control. Control can be positive (i.e. through affirmative voting or management rights) or negative (i.e. through rights that allow a party to block a concern from operating independently such as supermajority voting rights, quorum requirements, etc.). The ability to control need not be actually exercised to create a finding of affiliation, but rather need only exist as a potential right.

Affiliation can arise through various means including through ownership, management, or contractual arrangements (including loans). It can also arise through familial or business relationships ("identity of interest") or prior relationships (the "newly organized concern rule"). SBA has also established a catch-all test – the "totality of the circumstances," through which it can make a finding of affiliation based on several factors taken together even where no single factor meets a specific regulatory definition of affiliation. *See Diverse Construction Group, LLC*, SBA No. SIZ-5112, 2010 WL 1052449, Feb. 2, 2010; 13 C.F.R. § 121.103(a)(5).

Generally, joint venture partners are considered to be affiliates of one another. 13 CFR § 121.103(h). Even where parties do not explicitly form a "joint venture" SBA might find a joint venture to exist if the prime contract is unusually reliant on the subcontractor or the subcontract will perform "primary and vital" portions of the work. This is known as the "ostensible subcontractor" rule. In the context of

government contracting to qualify as a small business offeror, this generally dictates that teaming arrangements take the form of a prime-sub relationship, with the small business as the prime and charged with the primary and vital functions, to avoid a finding of affiliation.

In response to questions, the Army has confirmed that subcontractors' past performance of subcontractors can be offered provided there is an appropriate teaming agreement or other commitment between the prime contractor and that entity. However, relying in whole or substantial part on a subcontractor's past performance may suggest affiliation under the ostensible subcontractor rule. It also begs the question of how a concern with little or no relevant past performance can demonstrate that it is "primarily engaged" in the requisite business activity as required under NAICS Code 221119.

SBA does provide for some narrow exceptions to affiliation, which include joint ventures between two or more small businesses for large procurements (like this one), and joint ventures between parties approved for SBA's 8(a) mentor-protégé program. NOTE: The affiliation exception for mentor-protégé joint ventures only applies to participants in SBA's 8(a) mentor-protégé program. Parties operating under mentor-protégé programs run by other agencies cannot avail themselves of this exception.

Numerous questions related to affiliation are likely to arise in the context of this procurement, particularly because of the capital that will be required to develop the projects involved. SBA and OHA have generally held that concerns that are owned in whole or substantial part by private equity or venture capital firms are affiliated with those investors and their other portfolio companies, which often destroys small business status. This risk holds where there are multiple such investors and no one investor has a controlling stake. NOTE: there's an important affiliation exception for concerns owned in whole or substantial part by SBA-licensed Small Business Investment Companies (SBICs).

Other financial and contractual arrangements, short of ownership, can give rise to affiliation. For example, debt financing can create affiliation issues particularly if the lender is given control rights in the company or a government project. Relying on a partner for bonding capacity and indemnification on bonding can also create affiliation issues. The bottom line is, we see potential for significant affiliation issues to arise in this procurement and offerors should carefully consider how their relationships with other parties might impact their size status.

Finally, we see some potential for confusion as to the extent to which affiliates factor into the overall analysis under NAICS 221119. The placement of the term "affiliates" in the language of the footnote arguably calls for a concern's affiliates to be considered in all aspects of the footnote, including in determining whether a concern is primarily engaged in the requisite activity. One could argue that if affiliation were only relevant for determining the maximum size (4 million MW hours), it would have been placed next to that phrase in the definition. This might allow firms to aggregate the experience of their affiliates to meet the primarily-engaged-in requirement. It might also present would-be protesters with a means to attack an otherwise small business' assertion that it is primarily engaged in the requisite activity if one or more of its affiliates have substantial business in other areas. Section L of the RFP provides some useful discussion on this point.

When does size matter?

Generally, SBA determines an offeror's size at the time the offeror submits its initial offer, including price, in response to the Government solicitation in question. Generally, the company's size status remains as "small" for the life of the contract even if the company itself outgrows the size standard. That said, for long-term contracts (more than five years) contractors generally must re-certify their size at the end of the five year term. In addition, contractors must also re-certify their size within 30 days of finalizing a merger or acquisition. Finally, contracting officers may ask companies to re-certify their size with respect to task orders issued under multiple award contracts. The bottom line is: offerors generally will have to be able to show that they were small as of October 5, 2012 (the date initial offers including price are due) in order to qualify as a small business for this procurement. Based on the language the Army added to Section H, they will likely be called upon to do so when bidding for specific task orders as well.

What about size protests?

The contracting officer and the SBA can raise size protests of a small business contractor at any time. In addition, other offerors can raise challenges to an awardee's size, but there are strict time limits for doing so (generally within three days of receiving the notice of intent to award). However, given the IDIQ/MATOC nature of this contract we expect size challenges to arise throughout the course of the contract, in particular with respect to specific task orders. In addition, the contract calls for certain task orders to be set aside for small business where the Agency has an expectation of receiving bids from at least small businesses – applying the so-called "Rule of Two." We expect large contractors will take an interest in whether small businesses upon who the set-aside determination is made are in fact small, as a potential means to move those task orders to the unrestricted side of the contract.

What about post-award small business issues like percentage of work requirements?

We can foresee significant small business issues that will be open to interpretation once awards are made. For example, determining the appropriate percentage of work is always a complex process. In the context of services contracts, the small business generally must perform at least 50% of the cost of the contract for personnel with its own employees. Interested parties should note that "cost of the contract for personnel" is not the same as total contract cost. In addition, "cost" and "price" are fundamentally different concepts – it is cost, not price, which is the focus of this inquiry. There are also important differences between the percentage of work requirements and calculations for SBA's HUBZone, 8(a) and other programs.

We also see some incongruous aspects of the solicitation, notably in that it purports to apply the Davis Bacon Act – a law which applies to federally funded construction. This seems to leave open the possibility that task orders could be construed as for construction services as opposed to services. There are separate and less stringent percentage of work requirements that apply to construction contracts (generally only a 15-percent self-performance requirement).

Finally, the Army has provided for on and off ramps to add or subtract contractors. We expect this will be used to refill small business slots as small business awardees grow too large, are acquired, or perhaps don't participate in bidding for task orders. This may create the opportunity for new small business entrants, but we note that the RFP states that the agency intends to use this process infrequently.

These are but a few issues we can foresee arising in the post-award environment with respect to small business issues – so more on that another day.

If we can be of assistance to you in these matters, please do not hesitate to contact us.

Robert K. Tompkins
Patton Boggs LLP
2550 M Street, NW
Washington, DC 20037
(202) 457-6168 (direct dial)
(202) 457-6315 (fax)
rtompkins@pattonboggs.com
http://www.pattonboggs.com/rtompkins/

To learn more about our Government Contracts practice, go to:

http://www.pattonboggs.com/govcontracts/

And our Renewable Energy practice:

http://www.pattonboggs.com/services/ServiceDetail.aspx?firmService=433

This Alert provides only general information and should not be relied upon as legal advice. This Alert may also be considered attorney advertising under court and bar rules in certain jurisdictions.

WASHINGTON DC | NEW JERSEY | NEW YORK | DALLAS | DENVER | ANCHORAGE | DOHA, QATAR | ABU DHABI, UAE | RIYADH, SAUDI ARABIA

PATTON BOGGS LLP