

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, Subcommittee on Contracting and Workforce, Committee on Small Business
From: Committee Staff
Date: April 1, 2016
Re: Field Hearing: “Challenges for Small Defense Contractors”

On Tuesday, April 5, 2016, the Subcommittee on Contracting and Workforce will meet for a hearing titled “Challenges for Small Defense Contractors.” The hearing will be held at 2:00 P.M. at the Palmdale City Hall Chamber Room, 38300 Sierra Highway, Palmdale, CA 93550.

There are 451 small businesses in the 25th District of California seeking to do business with the federal government. Last year, the Department of Defense spent over \$881 million with businesses in the district, including nearly \$38 million with local small businesses. This means there are many opportunities for small companies to be federal prime and subcontractors, but there are also significant challenges and barriers to entry. This hearing will explore the opportunities and the challenges in doing business with the Department of Defense (DoD).

I. Introduction

The federal government routinely spends nearly half a trillion dollars through prime contracts each year. Given the sheer volume of dollars spent, this is a crucial market for small businesses as prime contractors and subcontractors. For example, in Fiscal Year 2015, the federal government obligated over \$437 billion in prime contracts, which in turn resulted in approximately \$225 billion in subcontracts.¹ Small businesses received over \$97 billion in prime contracts and over \$75 billion in subcontracts.²

DoD plays an incredibly important role in federal procurement, especially since it is responsible for over 62 percent of prime contract dollars spent last year.³ Likewise, DoD contractors awarded over 58 percent of subcontract dollars in Fiscal Year 2015.⁴ From a small business perspective, it is similarly striking: 55 percent of the prime contract dollars spent with small

¹ Prime contracting data retrieved from the Federal Procurement Data System *available at* www.fpds.gov; subcontracting data provided by SBA and on file with the Committee.

² *Id.*

³ *Id.*

⁴ *Id.*

business concerns, and 59 percent of the subcontract dollars awarded to small business concerns, originated at the DoD.⁵

The Small Business Act (the Act) iterates Congress's belief in the importance of small business participation in federal prime contracts and the resultant subcontracts, especially at DoD. Specifically, the Act directs that:

[t]o effectuate the purposes of this Act, small-business concerns within the meaning of this Act shall receive any award or contract or any part thereof, and be awarded any contract for the sale of Government property, as to which it is determined by the Administration and the contracting procurement or disposal agency (1) to be in the interest of maintaining or mobilizing the Nation's full productive capacity, (2) to be in the interest of war or national defense programs, (3) to be in the interest of assuring that a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with small-business concerns, or (4) to be in the interest of assuring that a fair proportion of the total sales of Government property be made to small-business concerns;

15 U.S.C. § 644(a).

To effectuate these objectives, Congress has enacted six different contract programs overseen by the Small Business Administration's (SBA's) Office of Government Contracting and Business Development. This memorandum will provide an overview of these programs, and the challenges faced by small defense contractors.

II. Programs

As previously mentioned, there are six federal procurement programs operating at the DoD that fall within the Act. Each of these programs has a statutory goal associated with it, relating to the percentage of prime contract dollars the government should award qualifying firms each year. These programs are the small business contracting program, Historically Underutilized Business Zone (HUBZone) small business program, Woman-Owned Small Business (WOSB) program, 8(a) Business Development (8(a)) program, Small Disadvantaged Business (SDB) programs, and the Service-Disabled Veteran-Owned Small Business (SDVOSB) programs. This document provides a brief overview of each of the programs.

A. The Small Business Prime Contracting Program and Subcontracting Program

According to the Act, a small business concern is one that is independently owned and operated, organized for profit, and which is not dominant in its field of operations.⁶ SBA creates specific

⁵ *Id.*

size standards for each industry, and assigns revenue- or employee-based size standards⁷ to each of the more than 1,100 North American Industrial Classification System (NAICS) codes.⁸ Prime contracts can be set aside for small businesses in two ways. First, all contracts below \$150,000 are reserved for small businesses unless the contracting officer (KO) determines there is not a reasonable expectation of obtaining offers from two or more firms.⁹ Second, any contract over \$150,000 should be set aside for small business if the KO determines that at least two small businesses will make offers, and the award can be made a fair price.¹⁰ The business certifies that it is small at the time of offer¹¹ through the System for Award Management (SAM).¹² If an offeror or the KO believes that the successful bidder is not actually a small business, SBA's size specialists and Office of Hearings and Appeals (OHA) will adjudicate the firm's size.¹³ There is a statutory goal of awarding at least 23 percent of all federal prime contract dollars to small businesses.¹⁴

For subcontracts, any other-than-small business receiving a prime contract worth more than \$700,000 (or \$1.5 million in the case of contracts for construction) must negotiate a subcontracting plan with the contracting agency as a material condition of the contract.¹⁵ Likewise, if the prime contractor is an other-than-small business that in turn subcontracts to an other-than-small business for an amount above the aforementioned dollar thresholds, the subcontractor must negotiate a subcontracting plan with the prime contractor. These subcontracting plans delineate subcontracting opportunities for each of the five categories of small businesses, usually as a percentage of the work that will be subcontracted.¹⁶ Some plans state the goals as a percentage of contract value.¹⁷ Failure to meet the subcontracting goals is reflected in past performance ratings on prime contractors, and if the failure is due to a lack of good faith it can be treated as a material breach of the contract.¹⁸ SBA creates both government-wide and agency goals for subcontracting with small businesses.¹⁹

⁶ 15 U.S.C. § 632(a). For further information, please see the Committee Memorandum, "What is a Small Business for Purposes of Federal Contracting?" (2013).

⁷ In a few instances, other factors are also considered, such as production or assets. *Id.*

⁸ 13 C.F.R. § 121. These regulations also provide SBA's affiliation standards, which address the independence of operations.

⁹ 48 C.F.R. § 19.502-2(a).

¹⁰ *Id.* at (b).

¹¹ 13 C.F.R. § 121.404.

¹² Available at www.sam.gov.

¹³ 13 C.F.R. § 121.1001.

¹⁴ 15 U.S.C. § 644(g)(1).

¹⁵ 15 U.S.C. § 637(d)(4); 48 C.F.R. § 19.702.

¹⁶ 48 C.F.R. § 19.704.

¹⁷ See, e.g., *FirstLine Transp. Sec., Inc., v. United States*, 12-601C, 2012 WL 5939228 (Fed. Cl. Nov. 19, 2012) (Court of Federal Claims denied a pre-award protest challenging a solicitation's small business subcontracting goal of 40% of the total contract value, holding that this goal was within the high level of discretion afforded to the agency.).

¹⁸ 48 C.F.R. § 19.705-4.

¹⁹ 15 U.S.C. § 644(g)(1).

B. The Historically Underutilized Business Zone (HUBZone) Program

A HUBZone is a geographic area with high poverty or high unemployment, as defined through a complicated statutory framework.²⁰ HUBZone small business concerns are small businesses whose principal office is located in a HUBZone, that are at least 51 percent owned by United States citizens, and which draw at least 35 percent of their employees from HUBZones.²¹ These firms can receive set-aside contracts if two or more HUBZone concerns are expected to make a fair and reasonable offer.²² Sole-source awards are permitted for contracts below \$4 million (\$6.5 million for manufacturing contracts).²³ A price evaluation adjustment of 10 percent is granted when bidding on contracts offered through full and open competition.²⁴ To certify as a HUBZone firm, a small business must apply on the SBA website, recertify every three years, certify through SAM, and qualify at the time of offer and the time of award.²⁵ SBA has the authority to conduct program examinations of firms to verify their continued eligibility²⁶ or to hear appeals regarding a firm's size²⁷ or eligibility for the program.²⁸ There is a statutory goal of awarding three percent of all prime contract dollars and three percent of all subcontract dollars to HUBZone firms.²⁹

C. The Small Disadvantaged Business (SDB) and the 8(a) Business Development (8(a)) Programs

SDBs are small businesses at least 51 percent unconditionally owned by one or more socially and economically disadvantaged individuals.³⁰ Social disadvantage is presumed for members of designated groups, or may be established by a preponderance of the evidence for any other individual.³¹ Economic disadvantage is defined as a net worth of less than \$750,000, after

²⁰ HUBZone are defined as any area located in a qualified census tract, qualified nonmetropolitan county, within the external boundaries of an Indian reservation or an area subject to the Base Realignment and Closure Act (BRAC). 15 U.S.C. § 632(p). Qualified census tracts are tracts designated by the Department of Housing and Urban Development (HUD) in which either 50 percent or more of the households have an income which is less than 60 percent of the area median gross income for such year or which has a poverty rate of at least 25 percent, but no more than 20 percent of a metropolitan statistical area may qualify. 26 U.S.C. § 42(d)(5)(B)(ii). Qualified nonmetropolitan counties are those in which median household income is at less than 80 percent of the nonmetropolitan State median household income, the unemployment rate at least 140 percent of the average unemployment rate for the United States or for the State in which such county is located, whichever is less, or which is located in a difficult development area, as designated by HUD. 15 U.S.C. § 632(p).

²¹ 15 U.S.C. § 632(p)(5).

²² 48 C.F.R. § 19.1305-1307.

²³ *Id.*

²⁴ *Id.*

²⁵ 13 C.F.R. § 126.300.

²⁶ *Id.* at § 126.401.

²⁷ *Id.* at § 121.1001.

²⁸ SBA, the KO, or any other interested party may protest the apparent successful offeror's qualified HUBZone SBC status. 13 C.F.R. § 126.801.

²⁹ 15 U.S.C. § 644(g)(1).

³⁰ 13 C.F.R. § 124.1002.

³¹ There is a rebuttable presumption that "Black Americans; Hispanic Americans; Native Americans (American Indians, Eskimos, Aleuts, or Native Hawaiians); Asian Pacific Americans (persons with origins from Burma, Thailand, Malaysia, Indonesia, Singapore, Brunei, Japan, China (including Hong Kong), Taiwan, Laos, Cambodia (Kampuchea), Vietnam, Korea, The Philippines, U.S. Trust Territory of the Pacific Islands (Republic of Palau), Republic of the Marshall Islands, Federated States of Micronesia, the Commonwealth of the Northern Mariana

excluding the value of the individual's ownership interest in the small business and the value of the individual's equity in a primary personal residence.³² A firm certifies as an SDB to either the procuring agency or to a third-party certifier, although all 8(a) firms are automatically considered SDBs.³³ There is a statutory goal of awarding five percent of all prime contract and five percent of all subcontract dollars to SDBs.³⁴

The 8(a) program is an important subset of the SDB program. 8(a) firms are small businesses owned and controlled by socially and economically disadvantaged individuals who have applied for and been accepted into a nine-year business development program at SBA.³⁵ While the definition of social disadvantage is the same in the 8(a) program as it is in the SDB program, the definition of economic disadvantage is much stricter, with a \$250,000 cap on assets outside of the business and primary residence, and a requirement that the individual demonstrate a limited access to capital.³⁶ Participation in the 8(a) program provides important contracting preferences – sole-source contracts up to \$4 million (\$7 million for manufacturing contracts) are the preferred contracting method, although competitive 8(a) awards are allowed with the permission of the SBA.³⁷

In the 8(a) program, SBA is considered the prime contractor, and the 8(a) firm is its subcontractor, which requires agencies to negotiate awards with SBA.³⁸ However, since the 1990s, SBA has been entering into Memorandums of Understanding (MOUs) with agencies, allowing agencies to bypass SBA and award contracts directly to the 8(a) firms.³⁹ The 8(a) certification is processed by SBA, and annual reviews are required throughout the nine years of program participation to ensure a firm's continued eligibility.⁴⁰

Small business concerns owned by Indian Tribes (ITs) and Alaska Native Corporations (ANCs) may qualify for a modified version of the 8(a) program. ITs and ANCs are not required to be involved in the day-to-day management of the participant.⁴¹ ANCs are presumed economically disadvantaged, whereas ITs look at the economic status of the tribe as a whole is considered and different thresholds apply.⁴² In neither case is the size of other concerns owned by the ANC or IT considered when determining if the firm is small, and ANCs and ITs may have multiple subsidiaries participating in the 8(a) program at the same time. Perhaps the most important distinction is that ANCs and ITs are not subject to any caps on the size of sole-source contracts,

Islands, Guam, Samoa, Macao, Fiji, Tonga, Kiribati, Tuvalu, or Nauru); Subcontinent Asian Americans (persons with origins from India, Pakistan, Bangladesh, Sri Lanka, Bhutan, the Maldives Islands or Nepal)” are socially disadvantaged. 13 C.F.R. § 124.103.

³² 13 C.F.R. § 124.1002(c).

³³ *Id.* at § 124.1003.

³⁴ 15 U.S.C. § 644(g)(1).

³⁵ 13 C.F.R. § 124.

³⁶ *Id.* at § 124.104.

³⁷ *Id.* at § 124.506.

³⁸ 15 U.S.C. § 637(a).

³⁹ 13 C.F.R. § 124.508.

⁴⁰ *Id.* at § 124.201, 124.601.

⁴¹ *Id.* at § 124.109.

⁴² *Id.*

although there is a proposed regulation to require that KOs justify sole-source awards above \$20 million.⁴³

Unlike the HUBZone or small business programs, the eligibility of an 8(a) participant cannot be challenged by another 8(a) firm or any other party.⁴⁴ Instead, all OHA protests must focus on whether the firm is indeed a small business, and the protest may only be brought when the contract in question is a set-aside contract rather than a sole source award.⁴⁵

D. The Women-Owned Small Business (WOSB) and Economically Disadvantaged Women-Owned Small Business (EDWOSB) Programs

WOSB are small businesses that are at least 51 percent owned and controlled by women who are United States citizens.⁴⁶ EDWOSBs must meet the same eligibility requirements, and demonstrate that they have a personal net worth of less than \$750,000, exclusive of a primary residence, the ownership share in the business, and any retirement accounts that have penalties for early withdrawal.⁴⁷

Currently, SBA allows firm to certify as a WOSB or EDWOSB by registering and certifying as such in SAM, and by providing the KO with supporting documents.⁴⁸ Additionally, the firm must either be certified by an SBA-approved third party certifier or provide supporting documentation to the Program Repository.⁴⁹ However, recent legislative changes require that a firm be certified as a WOSB or EDWOSB by a federal agency, a state government, SBA, or a national certifying entity approved by SBA.⁵⁰ SBA has not yet implemented these changes, so the prior certification methods are still being used.⁵¹

Contracts may be set aside for EDWOSBs if: (1) the contract requirement is in an industry designated by SBA as one where WOSBs are underrepresented; (2) two or more EDWOSBs will submit offers for the contract; and (3) award of the contract may be made at a fair and reasonable price.⁵² Contracts may be set aside for WOSBs in the same manner, except that the contract requirement must be for an industry designated by SBA as one where WOSBs are substantially

⁴³ Federal Acquisition Regulation; Justification and Approval of Sole-Source 8(a) Contracts, 76 Fed. Reg. 14,559 (Mar. 16, 2011) (to be codified at 48 C.F.R. § 6, § 8, and § 19).

⁴⁴ 13 C.F.R. § 124.517.

⁴⁵ *Id.*

⁴⁶ *Id.* at § 127.200.

⁴⁷ *Id.* at § 127.203.

⁴⁸ *Id.* at § 127.300. The supporting documents include (1) proof of citizenship; (2) joint venture agreements; (3) Articles of Organization and operating agreements for Limited Liability Companies; (4) Articles of Incorporation, By-Laws, stock certificates, stock ledger and voting agreements for corporations; (5) for partnerships, the partnership agreement and any amendments; (6) any assumed/fictitious name certificate(s); (7) a signed copy WOSB/EDWOSB program certification; and (8) for EDWOSBs, personal financial statements.

⁴⁹ *Id.*

⁵⁰ Section 825 of the National Defense Authorization Act for Fiscal Year 2015, Pub. L. No. 113-291, 128 Stat. 3292 (2014).

⁵¹ 80 Fed. Reg. 55019 (2015).

⁵² 13 C.F.R. § 127.503(a).

underrepresented.⁵³ Status as an EDVOSB or a WOSB may be protested by another EDVOSB or WOSB bidding on a specific requirement, by the KO, or by SBA.⁵⁴

EDWOSB and WOSB may also receive sole source contracts if the award will not exceed will not exceed \$700,000 in the case of a contract assigned a NAICS code for manufacturing, or \$4,000,000 in the case of any other contract opportunity.⁵⁵ Additionally, in case of an EDWOSBs, the KO must determines that: (1) the EDWOSB is a responsible contractor with respect to performance of the requirement; (2) the contract meets the requirements for to be set aside for an EDWOSB, but the KO does not have a reasonable expectation that 2 or more EDWOSBs will submit offers; and (3) the award can be made at a fair and reasonable price.⁵⁶ Likewise, for a sole source award to a WOSB, the contract must be one that could have been set aside for a WOSB, except that the KO must not have a reasonable expectation that 2 or more WOSBs will submit offers, the WOSB must be a responsible contractor, and the award must be made at a fair and reasonable price.⁵⁷ There is a statutory goal of awarding five percent of all prime contract dollars and five percent of all subcontract dollars to WOSBs.⁵⁸

E. The Service-Disabled Veteran-Owned Small Business (SDVOSB) Program

SDVOSBs are small businesses that are at least 51 percent owned and controlled by service-disabled veterans, or the spouse or caregiver of a service-disabled veteran with a permanent and severe disability.⁵⁹ Contracts may be set aside for SDVOSB if there are two or more SDVOSBs who will submit offers and the award can be made at a fair and reasonable price.⁶⁰ SDVOSB may receive sole-source contracts if there is only one SDBVOSB who can meet the requirements at a fair and reasonable price, and the contract will not exceed \$7 million for a manufacturing contract or \$4 million for any other contract.⁶¹ For purposes of contracting with any agency other than the Department of Veterans Affairs (VA), a concern must self-certify its status in SAM, and is subject to protest by other interested parties, the KO, or the SBA.⁶² If the firm wishes to contract with VA, it must have its eligibility verified by VA.⁶³ There is a statutory goal of awarding three percent of all prime contract dollars and three percent of all subcontract dollars to SDVOSBs.⁶⁴

⁵³ *Id.* at § 127.503(b).

⁵⁴ *Id.* at § 121.1001(a)(9).

⁵⁵ 13 C.F.R. § 127.503(c)-(d).

⁵⁶ *Id.* at § 127.503(c).

⁵⁷ *Id.* at § 127.503(d).

⁵⁸ 15 U.S.C. § 644(g)(1).

⁵⁹ 13 C.F.R. § 1215.8.

⁶⁰ 48 C.F.R. § 19.1405(b).

⁶¹ *Id.* at § 19.1406(a).

⁶² 13 C.F.R. § 125.25.

⁶³ 38 C.F.R. § 74. Interestingly, this has led to cases where VA and SBA have conflicting determinations regarding who controls the business.

⁶⁴ 15 U.S.C. § 644(g)(1).

III. Issues for Small Defense Contractors

In 2012, the Committee on Armed Services issued a report titled “Challenges to Doing Business with the Department of Defense.”⁶⁵ That report identified numerous challenges facing small contractors, and made ten small business specific recommendations. Some of these have been enacted into law, and so will not be discussed at this time. However, the Subcommittee welcomes testimony from the witnesses on the outstanding recommendations. These are as follows:

A. Increase the Small Business Goals

Recommendation 2.1. stated that “Congress should consider increasing the DoD’s small business prime contract and subcontract procurement goals, and increase accountability in the achievement of the procurement goals.”⁶⁶ The Subcommittee is curious as to whether small businesses are better served by higher goals, or by less consolidation of contracts.

B. Conduct an Independent Assessment

Recommendation 2.4. stated that “Congress should require an independent assessment of the DoD’s federal procurement contracting performance. The assessment should examine DoD’s contracting procedures with the goal of making recommendations for increasing small business contracting with the DOD. The assessment should also examine the industrial make up of companies receiving subcontracts pursuant to the DOD Comprehensive Subcontracting Plan Test Program, with the goal of understanding how division or corporate subcontracting plans affect the subcontracting base. Additionally, the Comptroller General should be required include Small Business numbers and participation in their annual Assessment of Selected Weapons Programs report.”⁶⁷ Unfortunately, although section 1613 of the National Defense Authorization Act (NDAA) for Fiscal Year 2013 required the Secretary of Defense to submit to the congressional defense committees by January 1, 2014, a report on an independent assessment of the procurement performance of the Department of Defense related to small business concerns, the report has never been delivered.⁶⁸ In the absence of this assessment, the Subcommittee encourages witnesses to provide recommendations on ways to increase small business opportunities within DoD.

C. Develop the Preferred Supplier Program

Recommendation 2.5. stated that “[i]n developing the preferred supplier program, the Secretary of Defense should consider creating a mechanism for rewarding small businesses that have exhibited a history of superior contract performance. One approach could be to allow small businesses with a superior past performance record to sign multi-year contracts with DOD. Such a program could incentivize small companies to compete for and perform on government contracts by holding out the opportunity for locking in long-term contracts based on

⁶⁵ House Armed Services Committee (2012).

⁶⁶ *Id.* at 30.

⁶⁷ *Id.*

⁶⁸ Pub. L. No. 112-239 (2013).

performance. Such a program could also incentivize small businesses to commit more of their limited resources to government projects or government related internal R&D funds because of the long-term payoff of a multiyear contract.”⁶⁹ The Subcommittee wishes to hear whether this remains a challenge.

D. Track Subcontractor Work

Recommendation 2.6. stated that “[t]he Secretary of Defense should develop business processes and establish a single Department-wide information technology solution to comprehensively track subcontractor work down to appropriate levels and to track past performance of individual subcontractors at such level. Such an effort should develop methodology to optimize tracking so as to add value to the small business subcontracting process and accountability. This effort should not only capitalize on the OSD defense industrial databases that currently exist, but should also provide the information needed to conduct market research and identify critical component and/or service [defense industrial base] issues.”⁷⁰ While section 1614 of the NDAA for Fiscal Year 2014 provided for lower tier subcontracting, the necessary regulations and systems have not yet been put in place.⁷¹ Additionally, H.R. 4341, which the Committee passed on January 13, 2016 provided for some past performance credit for subcontractors. The Subcommittee welcomes comments on how to better track and credit subcontractors.

E. Incentivize Subcontracting

Recommendation 2.8. stated that “[t]he Secretary of Defense should examine the potential benefit of using contract incentives in prime contracts to increase small business subcontracting.”⁷² The Subcommittee wishes to hear whether any small businesses have encounter such incentives, and how they have affected subcontracting opportunities.

F. Reduce Fraud

Recommendation 2.9. stated that “Congress should ensure that work being reserved for small business performance is actually performed by small businesses. Therefore, the FAR and DFARS should be reviewed, and clarified if required, to eliminate ambiguity regarding responsibility for ensuring compliance.”⁷³ Despite this recommendation, the Subcommittee continues to hear allegations of fraud in small business contracting, and seeks recommendations on how to combat this issue.

G. Eliminate Unjustified Bundling

Recommendation 2.10. stated that “[t]he Secretary of Defense should clarify and improve contract bundling decision processes to identify work likely to be suitable for small businesses,

⁶⁹ Challenges to Doing Business with the Department of Defense at 30-31.

⁷⁰ *Id.* at 31.

⁷¹ Pub. L. No. 113-66 (2014).

⁷² Challenges to Doing Business with the Department of Defense at 31.

⁷³ *Id.*

capture construction contracting, and improve transparency.”⁷⁴ Despite this recommendation, bundling and consolidation remain the top complaints from small contractors. The Subcommittee seeks advice on how to improve compliance with bundling and consolidation rules.

IV. Conclusion

The number of small businesses seeking federal contracts has fallen drastically since 2013. While this harms the industrial base as a whole, it particularly affects the defense industrial base. This Subcommittee wishes to hear from small contractors about their continued challenges, and whether those documented in 2012 remain key, or if instead increased regulations are a greater challenge.

⁷⁴ *Id.*