This article goes behind the vague regulatory text and explains how the SBA decides whether a prime/subcontractor teaming relationship has crossed the line into impermissible affiliation.
Contractors reading the headlines might have missed the fine print about the heavy price GTSI had to pay to re-enter the federal marketplace. GTSI’s president and CEO resigned, as did its general counsel, and the company suspended several other employees. GTSI also agreed to forego any work on small business set-aside contracts, pay an SBA monitor to evaluate GTSI’s compliance, and make a number of other changes to its business practices.

GTSI’s suspension was just the highest-profile example of a renewed government focus on strict enforcement of its small business set-aside regulations, particularly those involving large subcontractors to small primes. In this “age of enforcement,” government contractors report surges in small business compliance audits and investigations, as well as size protests and eligibility challenges initiated both by the government and by competitors.

Even the federal courts have gotten into the act. In *Morris-Griffin Corporation v. C&L Service Corporation,*1 the court threw out a subcontractor’s lawsuit against a small prime for monies the subcontractor claimed were owed for its subcontract work. According to the court, the subcontract was “illegal” and “conceived in fraud” because it called for the subcontractor to perform more of the prime contract work than permitted under the Federal Acquisition Regulation (FAR). The court refused to enforce the subcontract.

However, the government’s stepped-up enforcement should not discourage small primes and large subcontractors from teaming up. There is nothing inherently wrong with a small business subcontracting part of the work on a set-aside contract to another company—even a large company. Indeed, small businesses have long relied upon subcontractors to help them obtain and perform government work.

The key is to do it right. Contractors should follow the FAR and SBA regulations, and be aware of a series of decisions issued by SBA’s Office of Hearings and Appeals (OHA), explaining when a legitimate prime/subcontractor teaming relationship crosses the line into so-called ostensible subcontractor affiliation, rendering the team ineligible for award. If you are considering a prime/subcontractor teaming relationship on a small business set-aside contract, consider this article your compliance cheat sheet.

Follow the Subcontracting Limits
When a small business primes a set-aside contract, the small business can only subcontract out so much of the work to other companies. Violating the subcontracting limits can cause big problems. In fact, GTSI’s suspension and the *Morris-Griffin* case centered on the companies’ alleged violations of the subcontracting limits.
FAR §2.219-14, “Limitations on Subcontracting,” and a corresponding SBA regulation, 13 C.F.R. §125.6, set forth the basic limitations on subcontracting. The regulations require the small business prime to perform a certain percentage of the work depending on the type of product or service the governing is acquiring:

- **Services**—The small business must perform at least 50 percent of the cost of the contract incurred for personnel with its own employees.

- **Supplies or products** (other than procurement from a non-manufacturer)—The small business must perform at least 50 percent of the cost of manufacturing (not including the costs of materials).

- **General construction**—The small business must perform at least 15 percent of the cost of the contract with its own employees (not including the costs of materials).

- **Specialty trade construction**—The small business must perform at least 25 percent of the cost of the contract with its own employees (not including the cost of materials).

You should consider making it clear in the proposal, teaming agreement, and subcontract agreement that the subcontractor will perform no more than the allowable percentage of work. In addition, consider including a mechanism for the prime contractor to reduce the subcontractor’s work share if it appears that the subcontractor will exceed the limits.

Finally, be aware that the subcontracting limits spelled out in FAR §2.219-14 apply to small business set-aside contracts. If you are setting up a team for a historically underutilized business zone, 8(a), women-owned, or service-disabled veteran-owned set-aside contract, different requirements may apply, so check the regulations.

**Avoid Ostensible Subcontractor Affiliation**

Contractors sometimes think that meeting the subcontracting limits is enough to make the team compliant. Not so. Under the doctrine of ostensible subcontractor affiliation, SBA may find a small prime affiliated with its subcontractor if: 1) the subcontractor will perform the “primary and vital” parts of the contract; and/or 2) the prime contractor is unusually reliant upon the subcontractor. Affiliation, in turn, will cause SBA to add the sizes of the prime and subcontractor together for size eligibility purposes—a deal-breaker whenever the subcontractor is a large company.

Unfortunately, the regulations do not provide any additional guidance as to what constitutes “primary and vital” or when “unusual” reliance exists. However, over the years OHA has developed a body of case law interpreting the ostensible subcontractor regulation. The case law identifies a series of indicia of ostensible subcontractor affiliation, or, perhaps more accurately, *risk factors* for affiliation.
Below is a list of risk factors to avoid, if possible, whenever forming a prime/subcontractor team for a small business set-aside. Note that the presence of one or more risk factors does not necessarily mean that SBA will find the prime and subcontractor affiliated. Rather, SBA evaluates affiliation on a case-by-case basis. The more risk factors present, and the more severe the risk factors appear to be, the more likely it is that SBA will find that the team is actually a large joint venture masquerading as a prime/subcontractor team.

Division of Work
The larger the subcontractor’s share of work, the greater the risk of affiliation. In addition, if the small prime simply lacks the ability to perform the primary and vital portions of the contract, SBA is almost certain to find the prime affiliated with its subcontractor. As OHA stated in Size Appeal of Smart Data Solutions LLC, “a prime contractor must bring something to the table beyond its small business size status.”

Just because the subcontractor will perform less than the maximum allowed under the FAR’s subcontracting limits does not mean that an ostensible subcontractor relationship does not exist. As an extreme example, in one recent decision, Size Appeal of Alutiiq Education & Training, LLC, OHA held that an ostensible subcontractor relationship existed, even though the subcontractor would only perform 23 percent of the work—far below the 50-percent limit for the services contract in question. Despite the subcontractor’s relatively low work share, a number of other risk factors existed, including the subcontractor’s reliance on the prime for experience, the language of the proposal, and so on.

Incumbency
SBA is more likely to find an ostensible subcontractor relationship if the subcontractor was previously the incumbent for the contract work, but has since been rendered ineligible for the follow-on for size changes or other reasons (e.g., loss of 8(a) status). For instance, in Size Appeals of CWU, Inc. & U.S. Department of Homeland Security, the incumbent contractor grew out of the $7 million size standard, and subsequently entered into a subcontract with a small business for the follow-on contract. Writing that “incumbency can be probative of unusual reliance,” OHA held that the subcontractor’s incumbency, plus the presence of additional risk factors, created ostensible subcontractor affiliation.

Management
The larger the management role played by the subcontractor and its employees, the greater the likelihood of affiliation. As OHA wrote in Size Appeal of TKC Technology Solutions, LLC, “if a concern cannot manage a contract without the presence of a key subcontractor employee, this gives a large measure of control to that subcontractor.”

In TKC Technology Solutions, the prime proposed an employee of the subcontractor as its project manager. OHA held that this arrangement, by itself, created ostensible subcontractor affiliation, stating that using a subcontractor employee as the project manager “is an admission that [the small business] lacked the ability to perform the contract without him.”

Naming an employee of the small business as the project manager will almost certainly result in ostensible subcontractor affiliation, but other arrangements in which the subcontractor plays a large managerial role may also be indicative of affiliation. For example, in Size Appeal of Sectek, Inc., the parties’ teaming agreement called for the project manager to report to a committee comprised of the presidents of both the prime and the subcontractor. OHA determined that this arrangement was indicative of affiliation.

Proposal Terminology
It’s not surprising that when a small business—particularly a young, inexperienced small business—teams up with a large, experienced company, it wants to trumpet the teaming relationship in its proposal. After all, how better to reassure the procuring agency that the small business’ bid is backed by the resources and know-how of its subcontractor?

However, if the terminology and content of the proposal suggest that the subcontractor is an equal partner, or worse, the lead partner, repeated references to the subcontractor can backfire. In the CWU case discussed above, the small business and its large subcontractor referred to themselves as “Team CWU” throughout the proposal. OHA held that this choice of terminology suggested an ostensible subcontractor rela-
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tionship, writing that “persistent identification of the ‘team’ over the prime contractor is one factor that can be used to support a finding of undue reliance.”

You should be careful about repeatedly using the word “team,” but other words or graphics that blur the line between the prime contractor and subcontractor can be equally problematic. In Size Appeal of Access Systems, Inc., OHA pointed to the proposal’s “pervasive” use of the terms “we” and “our” to describe the prime contractor and subcontract as indicative of ostensible subcontract affiliation. And in Size Appeal of J.W. Mills Management, OHA identified the proposal’s repeated use of the subcontractor’s logo as evidence of affiliation.

Proposal Preparation

If the subcontractor drafts the proposal or otherwise plays a large role in determining the content of the proposal, it is indicative of ostensible subcontractor affiliation. For example, in Size Appeal of Eperience, Inc., OHA concluded that the large business’ “substantial input” into the proposal was a “strong indicia” of affiliation.

Terms of the Teaming Agreement

Whenever SBA reviews an ostensible subcontractor size protest, it will ask to see any written teaming agreement between the parties. To avoid affiliation, you should ensure your teaming agreement demonstrates that the small business will control the relationship. The teaming agreement in the Access Systems case did not pass muster. In that case, parties put the teaming agreement on the subcontractor’s letterhead—an immediate indication of the subcontractor’s control of the relationship. And the substance of the teaming agreement was also troublesome, leading OHA to question whether the prime would perform the primary and vital portions of the contract. OHA found the companies affiliated.

Relative Experience and Expertise

When an inexperienced small prime teams with a large, experienced subcontractor, SBA may decide that the prime could never have been awarded the contract without the subcontractor’s experience—in other words, impermissible undue reliance. For instance, in Size Appeal of Osirus, Inc., the small prime had no experience in refuse collection and transportation services. OHA held that the small business was unduly reliant upon its large subcontractor, which had substantial experience in the industry.

Location of the Parties

Managing the project from the subcontractor’s offices may also be a sign of affiliation. In Leonardo Technologies, Inc., the proposal stated that the large subcontractor would provide the prime contractor with office space for the project manager and staff. OHA determined that this arrangement was indicative of affiliation.

In addition, the parties’ relative distance from the jobsite may be an important consideration, especially when the work requires onsite supervision (such as construction). In Size Appeal of C.E. Garbutt Construction Co., a small prime contractor won a construction contract to be performed in Grand Rapids, Michigan. The prime was located in Georgia, had no office in Michigan, and had done most of its construction work in Georgia. The subcontractor, on the other hand, was located in Grand Rapids. OHA considered the parties’ relative locations—vis-à-vis the jobsite—as evidence of affiliation.
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**Transferred Personnel**

Affiliation may exist when the small prime hires, or plans to hire, employees from its subcontractor, especially if those employees will perform key roles on the contract. For instance, in *Size Appeal of Video Masters, Inc.*, the proposal stated that the prime would hire 11 key employees from the subcontractor prior to beginning performance, including an important managerial employee. OHA held that transferring personnel in this manner was indicative of undue reliance on the subcontractor.

It remains to be seen how SBA will interpret the “transferred personnel” factor in light of Executive Order 13495, which requires service contractors to offer a right of first refusal to incumbent service contract personnel in some cases. If the subcontractor is the incumbent, it seems reasonable to assume that SBA will not penalize the prime for complying with its first refusal obligations. It is important to note, however, that Executive Order 13495 does not apply to managerial or supervisory employees.

**Bonding, Financing, and Equipment**

SBA may find affiliation if the subcontractor supplies critical bonding, financing, or equipment, particularly if the prime could not obtain these things from other sources. In *Size Appeal of Emergency Beacon Corp.*, the prime contractor was required to produce and test certain emergency beacons. OHA found the prime affiliated with its subcontractor in part because the subcontractor owned the testing equipment and software, making it impossible for the prime to perform the required testing without its subcontractor.

**Profit Sharing**

In SBA’s eyes, joint ventures share profits and losses; prime contractors and their subcontractors do not. For this reason, if a prime and its subcontractor agree to a profit-sharing arrangement, SBA will deem it indicative of a joint venture relationship—i.e., ostensible subcontractor affiliation. In *Size Appeal of American Guard Services*, the prime and subcontractor agreed to split profits on a 60 percent/40 percent basis. OHA found the companies affiliated, based in large part upon the profit-sharing arrangement.

**A Few Parting Words**

In this age of enforcement within the government’s small business programs, small primes and large subcontractors alike should be mindful of the special regulations and SBA case law governing the small business programs. So, go ahead and team up—but follow the subcontracting limits, and do your best to avoid as many indicia of ostensible subcontractor affiliation as you can. If SBA comes knocking on your door, or a size protest lands on your lap, you’ll be very glad that you did. CM

**About the Author**

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**Endnotes**

4. *See note 12.*