Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Reporting Alone Won't Stop Short-Changing Of Subcontractors

By **Dietrich Knauth**

Law360, New York (July 17, 2013, 9:00 PM ET) -- A new U.S. Small Business Administration rule requires contractors to report deviations from their small business subcontracting proposals, but attorneys say that transparency alone may not prevent big companies from leaving smaller partners out in the cold after they win a contract.

The rule, finalized Tuesday, implements a part of the Small Business Jobs Act of 2010 that seeks to prevent larger contractors from getting credit for including small business subcontractors in their bids and then backing out of tentative work-share agreements once the contract is signed. Under federal contracts that require a small business subcontracting plan, prime contractors are now required to notify the government whenever they don't use a small business subcontractor that was proposed in the company's bid, and must report any reduced or delayed payments to such a subcontractor.

Courts have held that preaward subcontracting agreements are unenforceable "agreements to agree," which can make it difficult to win relief even for small business subcontractors that can make a good case that their participation helped a larger partner win. Experts say the rule is a good effort to prevent companies from using a bait-and-switch approach to their subcontracting proposals, but cautioned that reporting will not be a cure-all for small businesses that fear that they'll be short-changed.

"I think these regulations are really the government's reaction to small business contractors that feel like they've been getting the short end of the stick for a long time," said Gunjan Talati, an associate in Reed Smith LLP's government contracts group. "This regulation is a step in the right direction, but I'm not sure it goes far enough in protecting small business subcontractors. The primes have to disclose this, but there's no real punishment."

And the reporting itself may be less than helpful, according to Amy Laderberg O'Sullivan, a partner with Crowell & Moring LLP, because it must be reviewed by already overworked contracting officers before anyone can hold large contractors to account for failing to live up to their proposals.

The rule applies to large businesses that hold contracts offering subcontracting opportunities worth more than $1.5 million for public building construction and more than $650,000 for all other contracts, according to the SBA. It requires companies to explain circumstances in which they didn't utilize the small business they had proposed, which can include a host of legal and reasonable explanations, such as changes to the contract work, the deterioration of a partnership between companies that didn't fit together as well as they initially thought and other business reasons, O'Sullivan said.

"There are certainly a lot more commonplace reasons why a sub may not perform the work that had been originally proposed," O'Sullivan said. “At the end of the day, I think contracting officers are going to be so inundated with paper [that] I don't think you'll actually see a lot of contractors being called on for failing to follow through on their subcontracting proposals.”

The rule also expands the reporting obligations to include subcontracts for individual task orders under large, flexible contracts like indefinite-delivery/indefinite-quantity contracts. The SBA said that the change would enable agencies to more closely monitor small business subcontracting on an order-by-order basis, and allow the agencies to count that subcontract work toward their small business contracting goals.

But O'Sullivan said that the task order reporting was a bit odd, because it makes reporting mandatory for contractors while leaving it to the discretion of agencies whether they include small business goals in task orders or not.

"It's a disconnect, from my perspective, as well as an overly burdensome obligation," O'Sullivan said.

For Talati, though, the reporting requirements aren't anything out of the norm for government contractors, who are already subject to a lot of regulation and reporting.

"I don't necessarily view it as all that burdensome, especially when you consider all the records that you already have to keep under the [Federal Acquisition Regulation]," Talati said.

In its effort to ensure that prime contractors pay their subcontractors on time and at the promised rates, the SBA rule says contractors may not prevent their subcontractors from discussing payment or subcontract participation with the contracting officer. Some companies that commented on the rule said the change conflicts with the principle of privity of contract, which holds that only the government and the prime contractor have a contractual relationship, but the SBA disagreed.

That change may cause prime contractors to alter the legal language in their agreements with subcontractors, O'Sullivan said. Prime contractors are used to controlling all communications with their government customers, and future agreements and subcontracts might require the subcontractor to keep its prime contractor in the loop on discussions between the government and the subcontractor, without prohibiting that communication, she said.

And as a more general matter, the new rule may make companies think twice before signing preaward teaming agreements with potential subcontractors, she added.

“We'll have to wait and see on what impact this might have on teaming agreements,” O'Sullivan said. “Once you get to this level, you're locking yourself into this reporting obligation, so companies will think more closely before signing this kind of teaming agreement."

--Editing by Elizabeth Bowen and Melissa Tinklepaugh.
