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OPINION ON THE LOOPHOLE
IN SBA SIZE STANDARD REGULATIONS

Thank you for the opportunity to express my opinion on the subject of the loophole in SBA size standard regulations promulgated in mid-November 2006. I am Professor of Government Contracts at the University of Baltimore Law School and the co-author of *GOVERNMENT CONTRACT LAW: CASES AND MATERIALS* (Carolina Academic Press 2d edition 2004). My opinion is my own and not an opinion of my school or any other entity.

The Small Business Administration's (SBA's) latest size standard regulations issued in mid-November¹ will still result in the federal government reporting many of its prime contracts performed by large businesses, as small business contract awards, for at least five years to come. I have reviewed the new regulations. Also, I have reviewed the many independent inquiries about the government's enormous loopholes for large businesses to enjoy contracts purportedly awarded to small businesses. It is clear that,

¹ 71 Fed. Reg. 66434 (Nov. 15, 2006).

after three years of hesitation about doing something, the SBA simply ducked action for even partially closing those loopholes.

The SBA sets small business size standards and regulations that determine eligibility for federal small business contract programs, the most important of which is reserving contracts for exclusive participation by small business concerns. It is a given that with the dynamic nature of businesses constantly changing the volume of activity they do in different lines of work, the size regulations, without regular recertification and/or serious penalties, have an Achilles heel. Namely, contracts intended only for small businesses end up being performed by large ones, with the rewards of the contracts accruing wrongly to big rather than small business. Moreover, federal agencies are required by statute to maximize the percentage of their contracts reported as going to small businesses in order to be in compliance with federal law, policy, and the public will. These agencies find it, however, convenient to turn a blind eye to the illusions by which their large business contractors can enjoy small business contracts without commensurately adjusting downward that publicly reported percentage of small business participation.

In 2003, the (then) General Accounting Office released a striking report blowing the lid off of how high volumes of contract work enjoyed by large companies were reported as small business contract awards.² In April 2003, the SBA proposed rules --

² GAO, *Reporting of Small Business Contract Awards Does Not Reflect Current Business Size*, GAO-03-704T (2003).

the opening of the process leading to the November 2006 action -- to address the problem by requiring annual certification by businesses of their size status.³

As the government contracting press reported at that start in 2003, “current rules contain [a] loophole” and this was “a proposed rule that would close a current loophole” which “has led to skewed, and, in SBA’s view, ‘misleading’ results.”⁴ Yet, the final rule in November 2006 has simply dropped the cynosure of the April 2003 draft. It totally dropped the new requirement of annual size recertification. In its November 2006 announcement, SBA offhandedly noted that in 2003 “SBA proposed requiring recertification on an annual basis,” but gave a series of apologetic rationalizations for having discarded this effort. SBA explained that a recertification requirement would have been “contrary to the general rule, which allows a concern to retain its size status for the life of the contract, which is typically five years”⁵ However, the whole point of the rulemaking was to close a loophole, not venerate it. And, the SBA’s comment virtually conceded that large businesses would be able to enjoy small business contract awards for 5 years.

The other main SBA November 2006 rationalization was that, from agencies such as a “GSA and DoD, SBA has been told that the agencies do not have the resources to request, receive, and process the expected influx of size certifications every year.” Again, to paraphrase an old joke, the point of the rulemaking was to change the old busted light bulb, not just to count the agencies that like it much better in the dark. And,

³ 68 Fed. Reg. 20350 (2003).

⁴ *SBA to Require Annual Recertification of Size Status for Multiple Award Contracts*, 79 BNA Fed. Cont. Rep. 504 (2003).

⁵ 71 Fed. Reg. at 66435. This statement also ignores the fact that most contracts are single year awards with up to four independent option years and ignores the fact that the regulations allow but do not require an agency to award option years to a small business concern that has become a large business during the period of contract performance.

SBA's admission that it has succumbed to the agency whining virtually conceded that it would let large businesses enjoy small business awards for 5 years.

I have reviewed the past inquiries to ascertain the nature and scale of the loopholes in the SBA size standard certification requirements, in general, and to see whether there is any chance that the SBA's very limited November 2006 action will meaningfully reduce the scale, or shorten the duration, of the problem. After all, in November 2006 the SBA did take a couple of small steps – it formalized that contractors must recertify after a merger or acquisition,⁶ and that those with contracts of more than five years must recertify around the end of the fifth year.⁷ That latter aspect virtually accepts that long-term contractors can enjoy small business contracts for the next five years despite actually turning out to be large businesses. But one may still ask whether the SBA has eliminated loopholes leading to this. After all, as just noted, the SBA did purport to end one of the ways this happens, the acquisition by a large business of a small business, by requiring recertification after mergers or acquisitions.

However, my review of previous studies has shown that large businesses will still enjoy small business contract awards. A key survey, of the top 1,000 contractors receiving small business awards, was conducted for the SBA's Office of Advocacy in 2004.⁸ It found 44 large companies,⁹ receiving \$2 billion in small business contracts, by some computer file cross-matching that basically comes down to looking up the company names.

⁶ New 13 CFR 121.404(g)(2), in 71 Fed. Reg. at 66444.

⁷ New 13 CFR 121.404(g)(3), in 71 Fed. Reg. at 66444.

⁸ Eagle Eye Publishers, Inc., *Analysis of Type of Business Coding for the Top 1,000 Contractors Receiving Small Business Awards in FY 2002* (Dec. 2004), available at www.sba.gov/advo/research/rs246tot.pdf.

⁹ To be precise, 39 of these were companies, and 5 more were "other" such as the State of Texas – which apparently has done well obtaining small business contracts.

That SBA survey listed, as receiving extensive small business contracts, large companies including Titan, Raytheon, BAE, Northrop Grumman, CACI, L-3 Communications, the Carlyle Group, General Dynamics, EDS and SAIC.¹⁰ If anyone thinks these are truly small businesses, I have a few thousand dollars on hand ready for buying me five or ten percent of any of them from you – surely a fair price for me to buy a piece of these from you if they really are “small businesses.” The study found the loophole by which such megafirms, and other large firms, gathered up small business awards was created by six distinct factors, of which the one factor addressed in November 2006, the acquisitions of small businesses by large ones, was only one of two parts of one of those six distinct factors. Many companies appeared to be exploiting such opportunities as “reduction in procurement reporting requirements [that] has led to fewer award challenges on the basis of company size.”¹¹ In plainer words, the increasing level of loopholes in competition requirements that allow companies to obtain contracts without full and open competition also seems to be allowing them to evade size protests too. Just requiring recertification after acquisitions addresses only part of only one of the six factors in the SBA Office of Advocacy study, and will thus have minimal effect.

The leading article in the legal literature about this issue identified many ways in which large companies “take advantage of the apparent ‘loopholes’ in size regulations.”¹² Its author, Al Krachman, suggested a series of serious steps, namely, allowing suspension and debarment, and, application of the False Claims Act, for size miscertifications.

Needless to say, what the SBA has done will accomplish virtually nothing compared to

¹⁰ *Id.* at 9-10.

¹¹ *Id.*

¹² Al Krachman, *Due to a Confluence of Factors, There is Compelling Evidence of Widespread Miscertification with the SBA When Firms Report Their Small Business Status*, Contract Mgmt., June 1, 2005, at 30.

those serious steps, so that large companies will go undeterred from enjoying their undeserved small business contract awards for five years.

There is an annual “scorecard” report by staff of the House Small Business Committee. This past summer, it found the awarding to large businesses of small business contracts had mushroomed to \$12 billion in FY 2005. Of this, barely a sixth “were due to acquisitions of small businesses by large.”¹³ The other five-sixths were from other loopholes. So, the overwhelming majority of small business contract awards enjoyed by large firms may be for reasons that are undisturbed, up through their five years, by the November 2006 rules.

Another place to look is the reporting by the SBA’s Office of Inspector General. In its recent annual report (in October 2006, for FY 2007) of SBA serious management challenges, it states “Challenge 1” as: “Procurement flaws allow large firms to obtain small business awards and agencies to count contracts performed by large firms towards their small business goals.”¹⁴ The SBA OIG noted that “SBA also needs to work to close regulatory loopholes that allow agencies to take credit for meeting their small business procurement goals even though contracts are performed by large firms.” It recalled that “In 2003, SBA proposed a regulation requiring companies to certify as to their size on an annual basis, *but now it appears that a rule with a one-year certification requirement will not be issued.*”¹⁵ The OIG mentioned several other loopholes in this context that need closing. That is a stark self-recognition within the SBA itself that its November 2006 rule

¹³ House Small Business Committee Democratic Staff, *Faulty Accounting by Administration Results in Missed Opportunities for Small Businesses* (July 26, 2006).

¹⁴ U.S. Small Business Administration Office of Inspector General, *FY 2007 Report on the Most Serious Management Challenges Facing the Small Business Administration*, Report No. 7-01 (Oct. 16, 2006).

¹⁵ *Id.* at 1 (italics added).

was not going to prevent large firms from enjoying their small business contracts for five years to come.

Conclusion:

Preferring, or setting aside, federal contract opportunities for participation by small business concerns is one of the most firmly established and important policy decisions enacted by Congress with regard to federal contracts. One would think that the Small Business Administration would be in the business of helping small businesses against the tendency of agencies to let large businesses hog those contracts. But, this most recently published rule shows the SBA will let small business be squeezed out.