# No Company is an Island - Part 1: Subcontractor Affiliation

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Government Contractors often determine that going it alone is not the best business decision. Whether a small business trying to break into a new industry or a large business seeking niche expertise to support a particular opportunity, every contractor can use help from time to time. However, choosing the correct teaming methodology can be a challenge. Indeed, each teaming opportunity must be analyzed individually to determine the relationship that makes the most sense for the teaming partners to accomplish their goal—developing a solution that will win business and provide value to the ultimate customer.

The FAR appreciates the value that teaming arrangements can bring to both the companies teaming and the Government. Specifically, FAR 9.602 states that teaming arrangements may be desirable to "complement [the teaming companies'] unique capabilities" and "offer the Government the best combination of performance, cost, and delivery for the system or product being acquired." With that in mind, the FAR envisions two main forms of teaming arrangement: the typical prime-subcontractor relationship and the joint venture. FAR 9.601.

There are myriad potential factors that may affect the choice of the proper teaming arrangement, but some of the most common questions to ask to help sort out the issue are:

- What skills does each party bring to the team, and what are their envisioned roles?
- What is it about the combination that differentiates the team from the competition and makes the whole greater than the sum of its parts?
- What are the teammates chasing—a particular opportunity or a longer-term strategy?
- How should the various risks (performance or financial) be allocated amongst the teammates?

Ultimately, all of the above questions point to the single overarching goal of developing a strategy that maximizes the potential to receive work and places the team in the best possible position to be successful in performing that work.

This is the first in a series of blog posts entitled "No Company is an Island," which will delve into the various issues that arise in teaming arrangements. The first issue to be addressed arises often in teaming arrangements that are designed to pursue and perform contracts set-aside for entities that qualify for one or more of the Small Business Administration's (SBA's) various socio-economic programs. That issue is affiliation.

**How are entities determined to be affiliated?**

For small businesses that use teammates to perform set-aside contracts, affiliation can be lurking quietly around every corner waiting to steal an awarded contract. To qualify as a "small business" to receive a small business set-aside contract or participate in the SBA's various socio-economic programs, the business must qualify as small for the North American Industry Classification System (NAICS) code assigned to the procurement. The NAICS code sets either a revenue-based or employee-based threshold that the business must be under to qualify for the award. For instance, NAICS code 541512 is the code for Computer Systems Design Services and has a $27.5 million revenue size standard.

In determining a business's size, the SBA aggregates the annual revenues or number of employees of the business and all of its affiliates and compares it to the size standard applicable to the relevant NAICS code. As a result, a contractor that would otherwise be considered a small business for a particular procurement could be found affiliated with its teaming partner and, thus, other than small based on its relationship with that teammate. Affiliation's ability to sneak up on contractors undetected is based, in part, on the various and sometimes unclear routes that can lead to two or more entities being considered affiliated. It is important to take the potential for affiliation into account when determining the appropriate teaming approach.

The general rule for affiliation is fairly straightforward. Concerns are affiliates of each other when one controls or has the power to control the other or a third party controls or has the power to control both. 13 C.F.R. 121.103. The reason the SBA analyzes affiliation is also fairly straightforward. The SBA's support of small businesses through its contracting programs would be undermined if large businesses could receive the benefits of set-aside contracts indirectly by simply asserting control over the small businesses that receive them. In other words, the affiliation concept is intended to ensure that the recipients of set-aside awards are truly small businesses.

There are certain instances where affiliation is easy to detect. For instance, if entities have common majority ownership and/or common controlling management, determining whether they are affiliated should be easy. Further, these issues are less germane to this blog post because, if entities have the same majority ownership and controlling management, they are likely to be considered affiliated regardless of the teaming approach they might take.

However, after certain bright-line rules for ownership and management, the existence of affiliation between entities can become murky. Specifically, in determining affiliation, "SBA will consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation." 13 C.F.R. 121.103(a)(5). Although prior SBA findings provide some guidance, this is not far from a "we know it when we see it" standard and requires an extremely fact-intensive analysis. Common minority ownership, common current or former employees, common back-office support, common facilities, loans between entities and familial ties are some of the factors that can contribute to a finding of affiliation. More important to this blog post, a teaming arrangement can also create or contribute to a finding of affiliation.

**Can a simple prime-subcontractor relationship create affiliation?**

Most companies do not consider the potential for affiliation when entering into a simple subcontract. Indeed, the typical subcontract to perform specified services under a government contract will not, by itself, result in the prime and subcontractor being characterized as affiliates. However, there are instances where a single subcontract can result in a finding of

affiliation for the purposes of that specific procurement. Specifically, one method the SBA uses to consider affiliation is the "ostensible subcontractor rule." 13 C.F.R. 121.103(h)(4). SBA will find that a subcontract violates the ostensible subcontractor rule and that the entities are affiliated when the prime contractor is: (1) "unusually reliant" upon the subcontractor or (2) the subcontractor will perform the "primary and vital requirements of a contract." With regard to "unusual reliance," SBA has cited "four key factors" in evaluating whether it exists: "(1) the proposed subcontractor is the incumbent contractor and is ineligible to compete for the procurement; (2) the prime contractor plans to hire the large majority of its workforce from the subcontractor; (3) the prime contractor's proposed management previously served with the subcontractor on the incumbent contract; and (4) the prime contractor lacks relevant experience and must rely upon its more experienced subcontractor to win the contract." *Charitar Realty*, No. SIZ-5806, Jan. 25, 2017. As these factors demonstrate, determining whether a prime contractor is unusually reliant on its subcontractor and in violation of the ostensible subcontractor rule requires an exhaustive evaluation of the teaming partners' approach to performing the work in their proposal and the actual teaming arrangements. As the SBA has stated, "An ostensible subcontractor analysis is extremely fact-specific and is undertaken on the basis of the solicitation and the proposal at issue." *Brown & Pipkins LLC*, No. SIZ-5621, Dec. 8, 2014.

An equally exhaustive analysis is performed in considering whether the subcontractor will perform the primary and vital functions of the contract. Specifically, one must analyze the solicitation to determine the primary and vital functions of the work, as well as the proposed approach and work allocation between the teammates, to determine which entity will perform those primary and vital functions.

Moreover, in addition to resulting in a finding of affiliation under a particular procurement, subcontracts can be a consideration in finding general affiliation between a prime and a subcontractor. For instance, subcontract relationships are factors in the aforementioned "totality of the circumstances" test. Although a single subcontract may not create affiliation, when compiled with a series of other ties between companies, the subcontract can contribute to the ultimate finding of affiliation.

Finally, a subcontractor's financial interest can be so tied to subcontract(s) with a particular prime that the SBA may find the subcontractor is economically dependent on that prime. In such a circumstance, the prime may assert control over that subcontractor, and the entities will be considered affiliates. 13 C.F.R. 121.103(f). This rule can create a factual scenario that may appear at odds with the SBA's ultimate goals. For instance, assume a small business's first several contracts as it becomes a going concern are subcontracts with the same large business prime contractor, amounting to $1 million annually. The small business then receives its first prime federal contract, which is a small business set-aside assigned a NAICS code with a $27.5 million size standard and valued at $100,000. Although the small businesses' annual revenues may fit comfortably under the $27.5 million size standard, the small business and the large business could be considered affiliated and the small business not eligible for the set-aside award, based on an assertion that the small business is economically dependent on the large business. One would hope that the SBA would understand that the set-aside award is the first step in the small business's independence and not block the small business from receiving the award, but the SBA must weigh that potential against the concern that a large business may be wheedling its way into a set-aside contract. Again, a review of the facts associated with the two businesses' relationship would likely guide the analysis.

The above scenario shows just how closely a contractor must monitor its relationships to avoid affiliation and how fact-specific an analysis of affiliation tends to be. What start as innocent teaming arrangements may evolve and grow, and a contractor must remain vigilant to ensure that it does not fall prey to a colorable argument that it is affiliated with a teammate either for a

specific procurement or generally.

Needless to say, subcontracts are not the only teaming arrangement with complex affiliation issues.  Next time on “No Contractor is an Island,” we will address affiliation and joint ventures.

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