

Statement of

Edward T. DeLisle
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on behalf of

The Associated General Contractors of America

to the

U.S. House of Representatives

**Committee on Small Business' Subcommittee on Contracting
and Workforce**

For a hearing on

“Continuing Challenges for Small Contractors”

November 18, 2015

AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Quality People. Quality Projects.



The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 26,000 firms, including America's leading general contractors and specialty-contracting firms. Many of the nation's service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation/utilities installation for housing development, and more.

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Chairman Hanna, Ranking Member Takai and members of the committee, thank you for inviting me to testify on these important topics concerning federal small business contracting. My name is Ed DeLisle. I am a partner with the law firm of Cohen Seglias, where I co-chair our federal contracting group that is focused on federal construction. I regularly counsel federal contractors on a wide variety of small business issues, including advice on affiliation rules; mentor-protégé programs; small business and set-aside strategy and compliance (8(a) contracting, ANC, NAC, HUBZone, SDVOSB); small business subcontracting plan compliance; and small business size protests. Beginning next year, I will serve as Chair of the Federal Acquisition Regulation Committee for the Associated General Contractors of America (“AGC”).

In this testimony, I will discuss:

- The role the construction industry plays in the federal small business program;
- The steps Congress—through this committee—has taken to encourage small business program transparency, including counting of lower tier small business subcontractors, and the U.S. Small Business Administration’s (SBA) effort to include overseas contracts as part of the baseline used to rate agency performance against small business contracting goals; and
- The significant challenges small businesses face in the change order and claims processes when working for federal agencies.

I. The Role of the Construction Industry in the Federal Small Business Program

The construction industry has historically supported and provided opportunities for small businesses. Construction is usually accomplished under the leadership of a general, or prime, contractor. It is the job of the general contractor to integrate the work of the numerous trade and specialty contractors—acting as subcontractors—to complete the project. A significant construction project may have anywhere from 20 to 50—and in some instances more—trade and specialty contractors. These subcontractors are organized within the project delivery team in tiers so that each subcontractor can deliver its services in a highly integrated process. Small business subcontractors, operating at the appropriate tiers, are critical and essential to the success of construction projects and the construction industry as a whole. The industry cannot succeed without a large pool of qualified small business trade and specialty subcontractors.

This industry is proud of its efforts to include small businesses and allow small businesses to develop. However, instead of being rewarded for its efforts, agencies often over rely on the construction industry to shoulder the burden for other industries that have not encouraged small business involvement. Agencies try to meet substantial portions of their agency-wide goals by limiting competition to small businesses and their subsets in construction.

A consequence of this practice causes another disturbing trend: Massive growth in the percentage of small business subcontracting goals.¹ In some cases, we have seen the small business subcontracting goals exceed 50

¹ Before a federal agency sets aside a contract for only small business competition, the agency performs market research by conducting surveys and seeking responses from small businesses that would be interested in the contract. If two or more small businesses respond, the federal agency must set aside the contract for small businesses. When it comes to small business subcontracting, AGC is unaware of any market research conducted by federal agencies. AGC questions how federal agencies set their small business subcontracting goals when it appears

percent at the first tier of subcontracting on projects well in excess of the small business size standard.² Large prime contractors are usually able to meet the strict legal requirements to achieve these goals, but only through a combination of complicated project administration maneuvers and substantial use of lower-tier subcontracting to larger businesses. These techniques, while legally permissible, do not help most small business actually gain the experience necessary to grow and succeed as the federal small business program intends.

Rather than force unrealistic goals on construction projects, where an extremely high level of small business subcontracting is simply not feasible, the government should adapt its agency-wide subcontracting goals to be more consistent with what individual industry-wide markets can provide (i.e., construction, manufacturing and so forth). Counting lower tier small business subcontractors will help Congress and federal agencies make more informed decisions on how to do that, thereby ensuring that small businesses gain the experience they need to grow and succeed.

II. Transparency in the Federal Small Business Program

AGC believes that many within the federal contracting agencies focus on meeting statistical goals, rather than achieving the intent of the Small Business Act itself: encouragement and development of small business in an effort to preserve and expand upon the nation's security and economic well-being.³ Every administration—under either political party—trumpets the high grades of agency small business scorecards for meeting, or coming close to, their small business contracting goals. However, those grades are often based on unclear and incomplete data. Congress, through the leadership of this committee, has adopted, and is working on a number of reforms, to increase transparency within small business programs to help generate more accurate data to encourage federal agencies to meet the intent of the law, rather than to generate press.

This committee has undertaken a number of legislative initiatives to address small business transparency issues, including the agency scorecards. AGC thanks you for those efforts. For the purpose of my testimony

as though they do not conduct market research. The association fears that federal agencies arbitrarily set these subcontracting goals based on the edicts from senior bureaucrats in an effort to meet small business scorecard grade requirements, rather than the intent of the Small Business Act. In at least some instances, AGC finds that federal contracting officers simply copy and paste small business subcontracting goals from one contract to the next, regardless of the difference in the scope, value, or location of a project. The availability of qualified small business subcontractors significantly varies by location. The availability of small business subcontractors in Philadelphia, Pennsylvania is likely significantly different than that of those in Minot, North Dakota.

² As previously noted, some construction projects may involve 50 or more subcontractors. A number of those firms will likely be small business subcontractors. From that, one may reasonably question: why would it be difficult for prime contractors to achieve high small business subcontracting goals? The issue—as described in more detail in Section II.A. of this testimony—is that the government only counts subcontractors at the first tier of subcontracting towards small business goals. Generally speaking, when you have a construction project that requires 50 subcontractors or more, there could be three, four or more total tiers of subcontractors. In such an arrangement, the first tier of subcontracting may involve subcontracts well above \$15 million. The \$15 million dollar threshold is significant because that is the annual gross revenue threshold below which a subcontractor must be in order to be considered a small business. Usually, it is very difficult for a qualified small business subcontractor to preform work on one subcontract that may be greater than its entire annual gross revenue. Such a subcontract can put the small business subcontractor in a precarious position based on their limited internal capabilities and the availability of resources—staff and financial—that can also be committed to other ongoing subcontracts. As a result, meeting a high percentage subcontracting goal is can lead prime contractors to award subcontracts to small businesses that: (1) could default; or (2) more likely subcontract the lion's share of the work to a large business subcontractor that can perform the work, creating a pass-through situation.

³ See 15 U.S.C. § 631 (2015). See also PUBLIC CITIZEN, SLIGHTED: ACCOUNTING TRICKS CREATE FALSE IMPRESSION THAT SMALL BUSINESSES ARE GETTING THEIR SHARE OF FEDERAL PROCUREMENT MONEY, AND THE POLITICAL FACTORS THAT MIGHT BE AT PLAY (Taylor Lincoln ed. 2014) available at <http://www.citizen.org/documents/Small-business-contracting-report.pdf>

today, I would like to first discuss AGC's support for allowing non-small business prime contractors to count lower tier small business subcontractors toward small business subcontracting goals. Then, I would like to address AGC's concerns with the SBA's effort to include overseas contracts as part of the baseline used to rate agency performance against small business contracting goals.

A. Counting Lower Tier Small Business Subcontractors

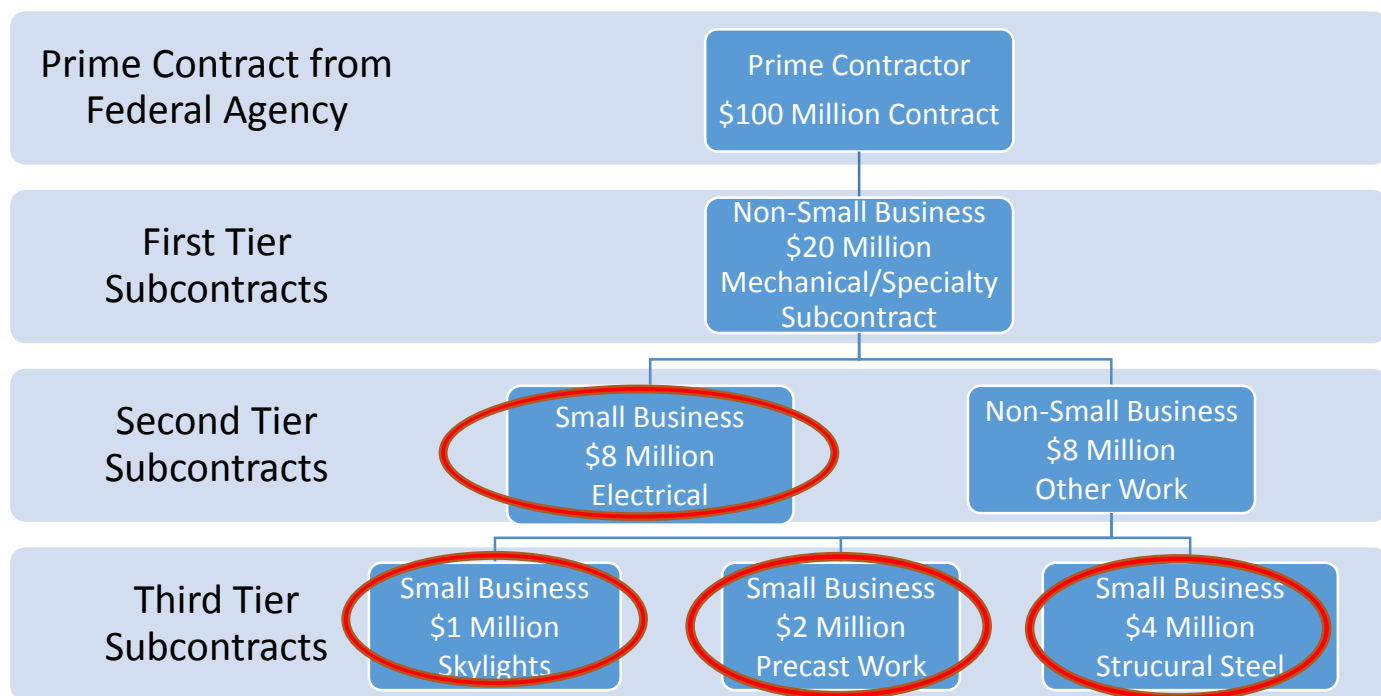
On December 26, 2013, the president signed the National Defense Authorization Act for Fiscal Year 2014 into law. Section 1614 of that law allows for the counting of lower tier small business subcontractors and is a provision that stems from a bipartisan bill—HR 2232 in the 113th Congress—introduced by former House Small Business Committee Chairman Sam Graves and cosponsored by Reps. Richard Hanna, Derek Kilmer and Gerald Connolly, among others.

The law can only take effect after the SBA and Federal Acquisition Regulation Council issue regulations to implement it. That rulemaking process was supposed to be completed 18 months after the legislation became law. Today, we are 23 months removed from when the law was enacted, and the SBA has only recently issued a proposed rule. Additionally, AGC has heard reports that the General Services Administration is not acting on addressing the electronic reporting systems changes necessary to implement such a reform. As a result, the current system of counting small business subcontractors remains in place. That system continues to fail to account for true small business participation.

i. How the Current System Fails to Account for True Small Business Participation

Current rules require set-asides for small business subcontractors, but prohibit prime contractors from truly accounting for the total amount of dollars flowing to small businesses. As it stands, if a business deemed large by SBA standards is included as a first tier subcontractor, a prime contractor is disqualified from reporting further dollars going to small businesses at lower tiers. As a result, and quite unfortunately, these current counting rules provide an incomplete picture of true small business participation. Putting the necessary reforms in place would help bring greater transparency to small business subcontracting goals as shown through the following example:

- An agency procures the construction of a \$100 million building. One of the first tier subcontracts is for all necessary mechanical and other specialty work, including electrical. The prime contractor awards that first tier subcontract, valued at approximately \$20 million, to a non-small business, as no qualified mechanical/specialty small businesses are available to manage that contract. That first tier small business contractor, in turn, subcontracts \$8 million in electrical work to a second tier small business.
- The current law prevents the prime contractor from counting the \$8 million second tier small business work, as that work is beyond the first tier. If the first tier subcontractors are non-small business contractors, as is the case here, the counting and reporting stops. That is true even though the electrical subcontractor is a small business. The counting problem is compounded if the first tier non-small business subcontractor then subcontracts another \$8 million to other non-small business that, in turn, subcontracts to small business specialty tradesmen that provide work such as skylights (\$1 million), precast (\$2 million) and structural steel fabrication (\$4 million). As a result, another \$7 million subcontracted is not counted under the current rules.
- The diagram below depicts the example discussed above. Under the current rules, the small business contracts circled below are *not* counted towards a prime contractor's small business subcontracting goals. In this example, \$15 million in small business subcontracts would not be counted toward the subcontracting goal and the government would likely have no record of this degree of small business participation.



ii. The Benefit of Counting Small Business Subcontractor Participation at All Tiers

Allowing prime contractors to report small business subcontracting at all tiers would demonstrate true small business participation on a federal contract. Consequently, Congress and federal agencies could determine where small businesses are underrepresented and make informed improvements to the small business program.

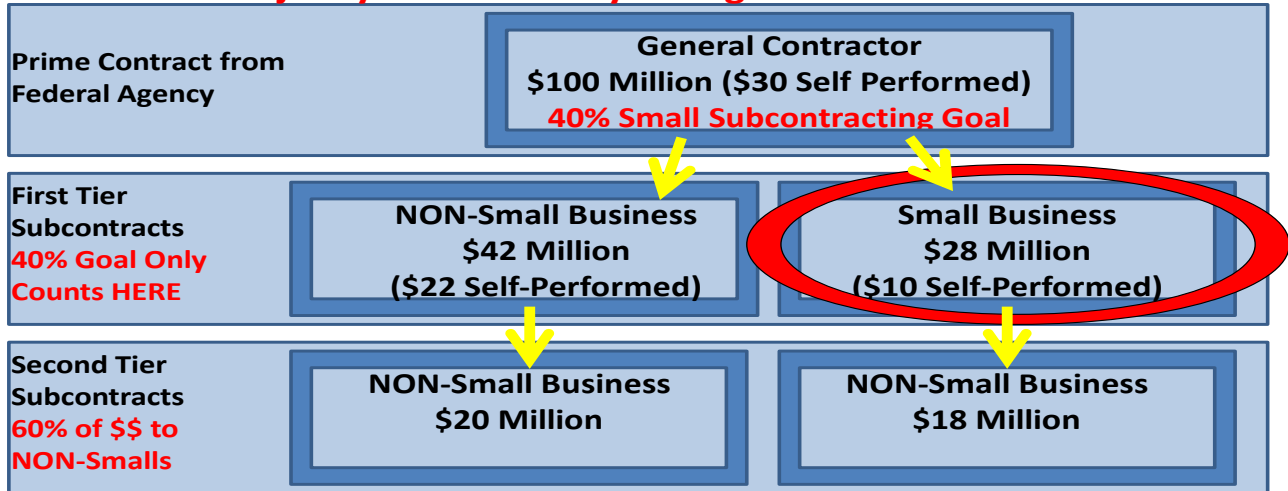
In addition, this reform would help ensure that small businesses actually gain the experience the program intends for them to gain through the enactment of these goals. However, as it stands, many prime contractors raise small business subcontractors that usually work at lower tiers to the first tier to help meet current small business subcontractor goals. Oftentimes, those small business subcontractors then join with non-small businesses, which actually perform a significant amount of the work and have the bonding capacity to guarantee it. As a result, much of the work experience the small business program intends for a small business subcontractor to gain is actually passed through to contractors that are other than small. Prime contractors are incentivized to do this because agency small business participation plans and subcontracting plans are an important element in the contract award process.

Small business participation at the subcontractor level is something agencies consider in their determination to make an award and the prime contractor's ability to meet those goals are included in past performance evaluations used in consideration for future federal work. By enabling prime contractors to count lower tier small business contractors toward small business goals, prime contractors can encourage qualified small business subcontractors to participate at a level they are most capable to perform and succeed by gaining the experience the federal small business program intended them to gain. The charts below further illustrate the benefits of this reform.

Current Law

GROWTH: PROVIDING FOR MORE SMALL BUSINESS PARTICIPATION

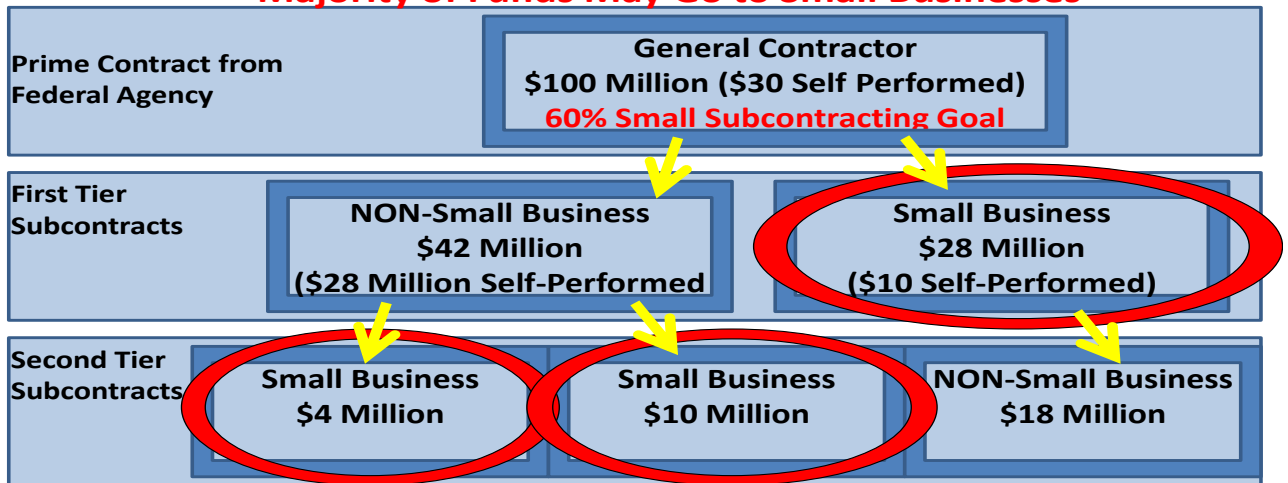
- General Contractor Goaled on Maximum Practicable Utilization of Small Business at ONLY 1st Tier
- NO Incentive to Drive Small Business \$\$ Below 1st Tier
- Majority of Funds May NOT go to Small Businesses



REFORM

GROWTH: PROVIDING FOR MORE SMALL BUSINESS PARTICIPATION

- General Contractor Goaled on Maximum Practicable Utilization of Small Business at ALL Tiers
- Incentive to Drive Small Business \$\$ at ALL Tiers
- Majority of Funds May Go to Small Businesses



B. Concerns with Overseas Contracts as part of the Baseline Used to Rate Agency Small Business Performance

AGC is very concerned with the SBA's effort to include overseas contracts as part of the baseline used to rate agency performance against small business contracting goals. As it stands about \$100 billion a year in federal contracts—including those contracts that support overseas projects—are not considered when an agency calculates small businesses' share of procurement dollars annually.⁴

When it comes to small business contracting, AGC firmly holds that government data used to measure an agency's small business "score" should be as accurate as reasonably possible. Nevertheless, AGC is aware of the unintended consequences of placing increased pressure on these agencies to meet their goals and receive a high score. Here, I would like to warn this committee of the potential impact of those unintended consequences when it comes to the inclusion of overseas contracts.

As previously noted, federal agencies often place significant reliance on construction contracts to meet their small business goals. By including overseas contracts in the baseline figure against which federal agencies measure their small business contracting participation, federal agency small business participation percentages will likely decrease, as American small construction businesses generally do not compete for prime contracts or subcontracts overseas.⁵ With an inherent inability to significantly raise small business contracting figures on overseas contracts, federal agencies will likely turn their attention to raising small business goals on domestic contracts. As a result, and in accordance with past trends, AGC believes that those goals will rise most precipitously on construction contracts. This could lead to unrealistic small business goals, allowing unqualified businesses to perform work on which they may default, pass through to non-small businesses, or require uncompetitive and higher payment. Such a situation would neither benefit small businesses, nor the taxpayers.

Let's come full circle and return to the issue I noted at the beginning of this discussion concerning statistics outweighing the Small Business Act's intent. No one likes to receive a bad grade, including a federal agency.⁶ And, as noted, AGC believes that the construction industry is likely to bear an unreasonable increase in small business goal requirements on its contracts through federal agencies. As such, AGC hopes that this committee will work with AGC to establish reasonable, industry-specific small business goals based on accurate, reliable data. Additionally, AGC hopes this committee will investigate sectors of the economy in which small business awards may be less than reasonably expected to help agencies more equitably meet their goals.

III. Challenges Small Businesses Face in the Change Order and Claims Processes

⁴ Jill R. Aitoro, *SBA to include Overseas Contracts in Rating Agencies*, WASH. BUS. J., May 15, 2015 available at http://www.bizjournals.com/washington/blog/fedbiz_daily/2015/05/sba-to-include-overseas-contracts-in-rating.html

⁵ Overseas construction contracts require significant financial and professional resources that often go beyond the realistic capability of a general contractor with annual gross revenues of \$36.5 million or subcontractor with annual gross revenues of \$15 million. AGC is unaware of any small construction contracting businesses competing for federal contracts abroad.

⁶ The exclusion of overseas contracts as part of the baseline used to rate federal agency small business contracting performance provides for fair competition between agencies. Remember, some agencies may have a significant number of overseas contracts, while others may have very few or none at all. For example, the Departments of Defense and State likely have a large number of overseas contracts, while the Department of the Interior may not. Including overseas contracts into the baseline will place agencies with many overseas contracts at a distinct disadvantage to those that do not have many or any of such contracts. The result would be an uneven playing field that would likely create a more confusing and less transparent grading system. That stated, in the event that SBA continues in its effort to include overseas contracts, AGC would urge members of this committee to allow for the reporting of two figures for purposes of the small business scorecards: (1) one figure that includes overseas contracts in the baseline; and (2) another figure that does not. Such a compromise would still allow for transparency, while also maintaining a level playing field between agencies.

The practicalities of working in the construction business and for the federal government are most challenging for small construction contracting businesses. The greatest challenge for such small businesses is dealing with their smaller economies of scale. Small businesses have fewer resources than larger businesses, and, consequently, may be ill-equipped to handle long downturns in the economy, the costs of complying with burdensome and endless federal regulation, and the expense of wading through bureaucratic federal agency processes. In this section, I would like to address the bureaucratic process known as contract modification—commonly referred to as the change order process—and the procedure when agreement on contract modifications during construction cannot be reached: the claims process.

A. Issues with Federal Agency Change Order Processes

A general contractor on a construction project is charged with managing subcontractors—whose numbers could range from anywhere from 2 to more than 50—based on a tight and detailed schedule. The general contractor must ensure that it and its subcontractors adhere to the requirements and specifications in the contract with a federal agency. However, sometimes the contract specifications or designs do not meet the practical needs of the project or the federal agency's project needs may change during construction. Such can happen when a contractor relies on a federal agency's account of the site conditions and the conditions on the ground are not as stated in the contract—i.e., contractor prepares to build a foundation, but during excavation, finds a previously unknown water well, or when a federal agency decides it needs more or fewer offices for an administrative building.

The problem for many small construction businesses is not that they cannot adjust to meet the changes required to complete the project as the federal agency desires. Rather, the issue is that many federal agencies take months and sometimes a year or more to issue a formal change order notice that a contractor should perform work to address the change—making the agency liable for payment for the work performed. Even after the decision to issue a change order is made, a small business contractor may not actually receive payment for that change order work for a considerable period of time. Because of schedule requirements under the contract, many small business construction contractors perform this change order work without waiting for the formal change order notice from the federal agency. Instead they may rely upon verbal promises from federal representatives that they will eventually get paid for the work. This is an incredibly risky proposition that, sometimes, leaves the small business unpaid for work it performed at the instruction of a federal representative without official notice. These problems were most recently publicized on the Department of Veterans Affairs' Aurora Hospital project outside Denver, Colorado.

On the VA Aurora Hospital project, the inability of the VA to process contract modifications left the general contractor and its subcontractors without payment for extended periods of time with severe consequences. For example, between September 2011 and September 2012, the VA stopped processing change orders tied to the southern clinic building then under construction.⁷ Small companies rely on prompt payments to meet payroll and expenses, often unable to cover those costs for very long.⁸ Many rely on bank loans and lines of credit to bridge the gap, but on the Aurora project some banks balked at letting small business clients rely on its money to continue work.⁹ According to the Colorado SBA, at least 33 small businesses were not paid for work in a timely fashion, and some were waiting more than a year after work was completed for payment.¹⁰ Of those 33

⁷ David Migoya & Mark Matthews, *Aurora VA Hospital Project Spooked Subcontractors, Causing Cost Hikes*, DENV. POST, May 15, 2015 available at http://www.denverpost.com/news/ci_28125325/aurora-va-hospital-project-spooked-subcontractors-causing-cost

⁸ *Id.*

⁹ *Id.*

¹⁰ Cathy Proctor, *SBA: Progress being made on Helping Unpaid VA Hospital Subcontractors*, DENV. BUS. J., April 4, 2013 available at <http://www.bizjournals.com/denver/news/2013/04/04/sba-urges-va-to-speed-payments-for.html>

companies, at least two filed for bankruptcy.¹¹ The prime contractor even paid subcontractors several million dollars out of its own pockets while waiting for payment from the VA, which was highly unusual.¹²

While the project in Aurora is a recent and, unfortunately, well-known example, problems with processing change orders happen in every federal construction agency on a regular basis. The problem is that those change order delays are happening on projects worth \$5 million, \$10 million and \$100 million, on which Congress does not ordinarily conduct oversight. The issue is that when the dollar amount is not high, and media attention is not existent, meaning that there's a lack of public outrage, the problems persist but go unnoticed by everyone except the small business that may have to close its doors.

As such, AGC strongly encourages this committee to conduct oversight on federal agency delays with issuing change orders on small business contracts. Through such oversight, we hope reform can be implemented that will help small businesses grow through federal contract work, not die.

B. Issues Facing Small Businesses with Claims against Federal Agencies

When small business contractors and federal agencies disagree as to when work is, or is not, covered under the construction contract, a contractor may file a claim for equitable adjustment, or a certified claim, against the government for payment. The claims process is often long, expensive and risky. Small businesses neither have the luxury of deep pockets to bear long periods of time without payment, nor can they generally handle such risk. The claims process generally takes years—sometimes 5 or more years—to conclude. During that time, small businesses may have to pay thousands of dollars in legal fees for the potential benefit of being paid pennies on the dollars they are owed.

There will always be legitimate discrepancies between a small business contractor and the government based on the terms of the contract. However, our concern is when the claims process is used unfairly—where the government fails to act in good faith—to the detriment of small businesses. Generally speaking, project funds come from a different budget account than the funds used to litigate and pay claims. Consequently, with project budgets tight, some federal contracting officers may tell contractors that there will be no change orders issued on a project. If there is an issue, the contractor will have to do the work and file a claim. The expense of litigating the claim, in the long run, may be more to the government and taxpayer than paying for the change order work. But, this situation is not something that will impact the contracting officer on the project or that project's budget. Additionally, some agencies will use the unlimited time and financial resources of the federal government to wait the small business out until it can no longer afford to continue with litigation and settles.

To provide further insight into this problem, AGC would like to work with this committee to investigate the trends in small construction business claims filed against federal agencies.

IV. Conclusion

Thank you again for inviting AGC to testify on these important topics to America's small businesses. We look forward to following up with you on several items, including:

- Implementing the lower tier small business counting reform in a timely fashion and in a practical and reasonable manner that will generate reliable data without being overly burdensome to contractors;
- Establishing reasonable, industry-specific small business goals based on accurate, reliable data;
- Investigating sectors of the economy in which small business awards may be less than reasonably expected to help agencies more equitably meet their goals;
- Reviewing the market research efforts, if any, that federal agencies use to set small business subcontractor goals;

¹¹ *Id.*

¹² *Id.*

- Conducting oversight on federal agency delays with issuing change orders on small business construction contracts; and
- Examining the trends in small construction business claims filed against federal agencies

Thank you for your time and consideration.