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New DoD Pilot Program Could Boost Opportunities for Employee-Owned Businesses

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On May 30, 2024, the Department of Defense ("DoD") published a Proposed Rule to establish a Pilot Program to Incentivize Contracting with Employee-Owned Businesses.

The Proposed Rule would benefit contractors that are owned through an Employee Stock Ownership Plan ("ESOP") – a type of qualified retirement plan that provides a company's workforce with an ownership interest in the company. These plans can improve employee motivation and retention, foster a sense of ownership, and offer potential tax benefits for the company.

ESOPs have become prevalent among federal contractors for several reasons. ESOPs provide a viable exit strategy for owners who want to retire or sell their stake in the business while preserving the company's independence and continuity. Federal contracts often require a stable and committed workforce, and ESOPs can serve as a powerful tool to attract, retain, and motivate talented employees, which is critical in performing government contracts effectively. ESOPs are designed so that employees' motivations and interests are aligned with those of the company's shareholders. They incentivize employees to focus on company performance. Moreover, from a management perspective, ESOPs also offer significant tax benefits, which can be particularly attractive to government contractors. Overall, ESOPs are a strategic choice for many companies, helping them address ownership transition, improve employee commitment, and leverage financial benefits.

The Proposed Rule, if adopted, would implement Congressional directives from the FY22 and FY24 National Defense Authorization Acts. In particular, the Proposed Rule would amend the Defense Acquisition Regulation Supplement ("DFARS") to allow contracting officers to award one sole-source, follow-on contract for the continued development, production, or provision of products or services that are the same or substantially similar to those procured under previous contracts awarded by or for DoD to a "qualified business." A "qualified business" is defined as an S-corporation for which 100 percent of the outstanding stock is held through an ESOP.

Under the Proposed Rule:

- Only a contracting officer may submit an application to participate in the pilot program.

- Contracting officers may only award contracts to contractors that meet the definition of a qualified business.
- Contracting officers may only award one sole-source, follow-on contract to a qualified business for each predecessor contract, unless a waiver is obtained.
- Unless waived, a qualified business may not pay more than 50 percent of the amount paid by the Government for contract performance to subcontractors that are not qualified businesses, except when the contract is for a product and subcontracts for materials are not available from another qualified business.
- DoD does not intend to apply the Proposed Rule to smaller contracts at or below the Simplified Acquisition Threshold, nor does DoD intend to apply the Proposed Rule to contracts for the acquisition of commercial products, excluding COTS items, and commercial services.

The Proposed Rule, if adopted, would be beneficial to employee-owned defense contractors that have an established a record of high performance on their existing contracts. The rule would essentially provide a mechanism by which a contracting officer could elect to continue forward with the existing contractor on a sole-source basis in a situation where he or she would otherwise be required to offer the contract to other companies for competition under the usual competition-in-contracting requirements.

The Proposed Rule is open for comments through July 29, 2024.

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