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MEMORANDUM

To: Clients and Friends

From: Pamela J. Mazza
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Date: November 10, 2008

Re: *Rothe Development Corp. v. Department of Defense* (Fed Cir. 2008)

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I. EXECUTIVE SUMMARY AND ANALYSIS

On November 4, 2008, the United States Court of Appeals for the Federal Circuit issued a decision holding that preferences given to small disadvantaged businesses ("SDBs") by the Department of Defense ("DOD") under 10 U.S.C. § 2323 ("Section 1207") are unconstitutional as a race-based violation of the right to equal protection. The Court declared the statute unconstitutional and enjoined application of the current version of the law. The Court found that the statute was unconstitutional because it afforded preferential treatment on the basis of race and there was no strong basis in evidence for Congress to conclude that the DOD had engaged in pervasive, nationwide racial discrimination.

The ramifications of the Federal Circuit's decision on Rothe are unclear at this time. At first blush, the Court's findings would appear to not have any significant ramification on SDBs (and 8(a) firms) because of the current status of the SDB program. Section 1207 established a 5% goal for the award of contracts to SDBs, which, by definition, includes 8(a) firms. To achieve that goal, Section 1207 authorized the DOD to provide a price evaluation adjustment for bids from SDBs. However, because the DOD has met the 5% goal for a number of years, the authority to provide the price evaluation adjustment has been suspended, substantially limiting the value of the SDB program.

Although the benefits of the SDB program have been eroded over the years, the decision raises one disturbing issue: If the statute is unconstitutional, does the DOD have the authority to set aside contracts for the 8(a) Program? Should the Rothe decision be broadly interpreted, DOD officials may question whether 8(a) set-asides are permissible if there are no statutory goals for awards to SDBs. Such an interpretation would directly impact 8(a) firms as the 5% goal was being met through 8(a) set-asides. It may also lead procuring agencies to question whether other statutory goals for awards to disadvantaged businesses are constitutional.

The decision also has potential ramifications for the 8(a) Program. While the decision does not specifically address the 8(a) Program, more challenges to such race-based programs likely can be expected, particularly given the similarities between the SDB program and the 8(a) Program as they pertain to presumptions of social disadvantage. Critics of race-based programs may rely upon the Rothe case to challenge the constitutionality of the 8(a) Program. To survive such challenges, Congress will need to assemble strong evidence that there is racial discrimination in federal contracting. Thus, potentially-affected businesses would be well-served to lobby for more thorough and methodologically sound studies of widespread discrimination.

II. DISCUSSION

A. The Relevant Statute

Section 1207 was originally enacted in 1986 and, while it has been reenacted and amended several times since then, the most relevant portions of the statute have remained the same. Section 1207 sets a goal that (5%) of DOD contracts for each fiscal year be awarded to SDBs and provides that DOD shall give assistance to SDBs and, in order to achieve the

percentage goal, may make advance payments to SDBs and award contracts to them at prices up to (10%) above fair market costs. Additionally, Section 1207 incorporates the Small Business Act's presumption that certain classes of people are socially disadvantaged.

Originally, DOD implemented Section 1207 by, among other methods, applying a price evaluation adjustment to bids submitted by non-SDB bidders in an attempt to level the playing field between disadvantaged companies and non-disadvantaged companies. Thus, DOD would increase bids from non-disadvantaged companies by 10% prior to comparing them to bids from SDBs. Congress later suspended this practice and it has not been used by DOD since 1998. Most recently, Congress reenacted Section 1207 in 2006.

B. Background Information

In the late 1980's, Rothe Development Corporation ("Rothe") contracted with the Department of the Air Force (the "Air Force") to maintain, operate and repair computer systems at Columbus Air Force Base in Mississippi. In the late 1990's, the Air Force decided to consolidate that contract with a separate contract for communications services. The Air Force issued a new solicitation. Rothe, a non-disadvantaged company, bid $5.57 million, and International Computer and Telecommunications ("ICT"), a certified SDB and a competitor of Rothe, bid $5.75 million. ICT was awarded the contract because, once the 10% price adjustment was added to Rothe's bid, ICT was considered the low bidder.

Rothe originally filed suit against DOD in November 1998 in U.S. District Court in Texas. Rothe sought both an injunction against the award to ICT as well as a declaratory judgment that Section 1207 is facially unconstitutional. Since then, there have been several decisions and appeals, leading up to the Federal Circuit's most recent decision on November 4, 2008.

C. The Circuit Court's Decision

The Federal Circuit agreed with Rothe's claims, holding that Section 1207, as reenacted in 2006, on its face violates the right to equal protection.

Because Section 1207 incorporates an explicit racial classification—the presumption that members of certain minority groups are "socially disadvantaged" for purposes of obtaining SDB status and the benefits that flow from that status under the statute—the Federal Circuit applied the strict scrutiny test to the statute.

Statutes that include explicit racial classifications are reviewed with "strict scrutiny." Such provisions are only valid if they serve a compelling governmental interest, and are narrowly tailored to further that interest. The Federal Circuit stated that, while the Government may have a compelling interest in "remedying the effects of past discrimination or present racial discrimination,…an effort to alleviate the effects of societal discrimination is not a compelling interest." Thus, the Federal Circuit found that, prior to resorting to race-conscious measures, the Government must specifically identify the discrimination to be remedied and have a strong evidential basis upon which to conclude that remedial action is necessary. Additionally, because Congress reauthorized Section 1207 in 2006, the Federal Circuit noted that, to be constitutional, the evidence of a compelling governmental interest must exist *at that time*.

The Federal Circuit found that the evidence before Congress at the time it reenacted Section 1207 in 2006 failed to provide a strong evidential basis that could lead to the conclusion that DOD was a participant in racial discrimination. The Federal Circuit states that the older Congressional evidence that existed at the time of original enactment was stale by 2006 and, thus, not reliable. The Federal Circuit then turned to the newer disparity studies.

The Federal Circuit determined that the state and local studies relied upon by Congress were unreliable due to their limited geographic coverage and methodological defects. As a result, the Federal Circuit held that Congress did not have a sufficiently "compelling interest" to support the race-based preferences in Section 1207, thereby rendering the statute unconstitutional and invalid.

III. CONCLUSION

In sum, while the Federal Circuit has stated that preferences given to SDBs by DOD under Section 1207 are unconstitutional as a race-based violation of the right to equal protection, the full implications of the decision are unclear. The Federal Circuit *explicitly* left open the possibility that Congress could, in the future, establish a strong basis in evidence for the SDB preferences. Notably, the Federal Circuit specifically stressed that its "holding is grounded in the particular terms of evidence offered by DOD and relied on by the district court in this case, and should not be construed as stating blanket rules, for example about the reliability of disparity studies." The Federal Circuit's statements clearly leave open the door for a future finding of constitutionality based upon better statistical and anecdotal evidence.

Please feel free to call us if you have any questions regarding this memorandum or require any additional information.