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Small Business

View From Protorae Law: Sequestration's Ripple Effect



BY DEVON HEWITT

In October of last year, I wrote a column in which I predicted that small businesses would be “first off the fiscal cliff.” The column detailed a number of impacts on small business likely to occur as a result of sequestration (98 FCR 448, 10/16/12).

It has been almost eight months since publication of that article, and now the question is: Was I right? Have small business government contractors suffered the brunt of sequestration? The answer, it appears, depends on who you ask.

According to the American Federation of Government Employees, government employees have suffered the brunt of sequestration because of mandatory furloughs and pay freezes, particularly within the Department of Defense.

The Pentagon disagrees. In a Senate Appropriations subcommittee hearing addressing DOD's budget, Undersecretary of Defense Robert Hale testified that civilian furloughs will only represent \$2 billion of the \$37 billion DOD has to cut in 2013, and that DOD's entire non-uniformed workforce will share the pain. The majority of the remaining cuts, Hale stated, will have to come from service contractors. The question still remains, therefore, whether these cuts are affecting small and large businesses equally.

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In early April of this year, Senator Mary Landrieu, Chair of the Senate Committee on Small Business and Entrepreneurship, tried to find out. She sent a letter to every federal agency asking them to inform the committee of sequestration's effects on their small business contracting efforts.

Nearly every agency responded, but few provided specific details. For the most part, agencies indicated that they were on track for meeting their small business contracting goals for fiscal year 2013 and that sequestration's impact on small business contractors would not be considerably different from its impact on large contractors. Some agencies, however, were more candid.

Department of Defense. Under Secretary of Defense Frank Kendall responded to Senator Landrieu's letter on behalf of the Secretary of Defense, the Secretaries of each of the military departments, and the directors of the various agencies. Kendall indicated that DOD was on track to meet its small business contracting goal for FY 2013, but acknowledged that the amount of *actual dollars* obligated to small businesses as of May 2013 was less than the amount obligated as of the same time the previous year.

However, he went on to state that “although sequestration potentially impacts every contract, it will not impact every contract equally.” Kendall explained that because of DOD's commitment to protecting war funding and other “emerging priority requirements,” the department's operation & maintenance accounts were ex-

periencing “significant funding challenges.” Confirming Undersecretary of Defense Hale’s testimony, Kendall said these “challenges” have had a disproportionate adverse effect on service contracting, an area in which small businesses regularly compete. (For those of you keeping track, I predicted just this result in my October column.)

Other sequestration impacts affecting small business and highlighted in Kendall’s letter included DOD’s suspension of its accelerated payment program. Launched as a pilot program last Fall, the accelerated payment program was intended to benefit small businesses because it facilitated prompt payment by prime contractors to their small business subcontractors. Kendall also stated that reduction in budgets has forced DOD to reduce spending on small business outreach, match-making, and workforce training.

Small Business Administration. In her letter to Sen. Landrieu, Administrator Karen Mills of the Small Business Administration stated that SBA also was on track to meet its small business contracting goals.

In a letter to Senate Appropriations Committee Chair Barbara Mikulski earlier this year, however, Mills predicted far more drastic repercussions for small businesses once sequestration started. Mills stated that sequestration would have the effect of cutting SBA’s loan subsidies by \$16.68 million, resulting in a reduction of nearly 2000 loans provided to small businesses. She also said that sequestration would affect SBA’s ability to identify and address fraud, waste, and abuse by reducing the number of agency audits of section 8(a) and HUBZone contractors.

The greatest impact, Mills claimed, would be on the funds SBA allocates to training and counseling programs. She estimated that budget shortfalls would mean that tens of thousands fewer small businesses would receive assistance from SBA.

Department of Education. James Ropelewski, Deputy Chief Financial Officer and Senior Procurement Executive for the Department of Education, did not pull any punches in his letter to Sen. Landrieu. Ropelewski said that DOE would be “challenged” to replicate the small business contracting volumes of the previous year. He admitted that total small business dollars likely would decline because of the need to obligate funds for certain “mission critical” operations at Federal Student Aid. Ropelewski explained that DOE was reducing expenditures primarily through declining to exercise options on existing contracts and cancelling planned projects.

The Ripple Effect. Reviewing the agency letters sent in response to Sen. Landrieu’s inquiry, testimony by Pentagon officials, news reports, and anecdotal evidence, it

appears that sequestration has affected contractors across the board, large and small. However, the big difference is in how large and small businesses are faring as a result of the planned budget cuts. Not surprisingly, small businesses are not doing as well as their larger counterparts.

Last week the Senate Committee on Small Business and Entrepreneurship held a roundtable on sequestration’s effect on small business. One of the principal effects was increased competition from large contractors for requirements that, historically, were not of interest to these companies. Large contractors also appear to be taking more aggressive positions in their subcontracting relationships with small businesses, including taking a number of subcontract positions in-house, failing to exercise options, and not paying in a timely way. The legal community, likewise, has seen an increase in demand letters and subcontract disputes and a dramatic increase in protests for smaller requirements.

In short, large contractors appear to have the resources and leverage to adapt to the changing fiscal environment whereas small businesses do not. Large contractors diversify, target certain areas or agencies, and bring work in house. Small businesses simply let employees go. The ripple effect of sequestration’s adverse impact, therefore, seems to fall primarily on small businesses.

What Should Small Firms Do? It might appear that there isn’t much small businesses can do in the face of all these obstacles created by sequestration. Not true. Small businesses should see large businesses’s interest in what was considered “small business territory” as an opportunity rather than a threat.

Although large businesses might be competing against small ones for some procurements, large businesses are even more interested in teaming with smaller firms for set-aside work. This interest is only going to increase as SBA extends its 8(a) Mentor-Protege Program to all its small business programs, including small businesses generally.

In addition to teaming with large businesses for set-aside work, small businesses should continue to pursue subcontracts because large businesses still have to fulfill their subcontracting plans. The difference for small businesses now is that they have to expend more resources to ensure their relationships with large businesses are well-documented and enforceable. A greater participation of large businesses in the market, whether in unrestricted or restricted procurements, also means more protests. So, while it is obviously in my interest to say so, small businesses now really need to have their government contracts attorney on speed dial.