

Reproduced with permission from Federal Contracts Report, 98 FCR 448, 10/16/2012. Copyright © 2012 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Small Business

Sequestration and Small Business: First Off The Fiscal Cliff



BY DEVON E. HEWITT, PROTORAE LAW

It may seem obvious, but it bears repeating: small firms typically are more vulnerable to changes in the economy than large ones. They have fewer financial resources, smaller business backlogs, and narrower profit margins. As a result, they are less able to sustain unprofitable operations and to reposition themselves in a struggling economy by developing new products or markets.

The situation is no different for small government contractors. For a number of reasons, sequestration could snuff out their participation in the federal marketplace.

Services Contracts Will be Hit Hardest. Because sequestration targets agencies' discretionary spending, it will have the biggest impact on their operational budgets. Services contracts are a big part of those budgets. The majority of small contractors provide the government with services rather than products because there are fewer barriers to entry in the services market than the market for manufactured items or supplies. For supplies, a company needs personnel, equipment, facilities, distribution channels, etc. For services, it just needs people. But when funds are cut, it is far easier for an agency to eliminate two data processors from a contract than to eliminate the production of a wing of a fighter jet. It follows that by cutting services in a greater pro-

Devon E. Hewitt is a partner at Protora Law.

portion than products, sequestration will affect many more small contractors than large ones.

Smaller Contracts are a Bigger Target. In an environment of fiscal austerity, agencies find it easier to terminate or eliminate smaller contracts than larger multimillion-dollar programs. Large programs are generally multi-year efforts and require considerable investment by the agency in research and planning before production or performance begins. Agencies reasonably will try to ensure that resources already invested do not go to waste. By contrast, smaller contractors have smaller contracts that often do not reflect a tremendous investment by an agency and therefore are easier to eliminate. Agencies also find it easier to terminate or insource less complicated or less sophisticated projects such as administrative services, mail room operations, facilities management, etc. Contracts that depend on more sophisticated or trained personnel or rely on proprietary processes or technology cannot easily be replaced. Because most small businesses do not have the operating capital starting out to perform complex contracts, they tend to chase smaller, less sophisticated requirements. Agencies will target these smaller, simple contracts first in a funding crisis.

The Pie is Dwindling. A smaller federal contract pie after sequestration naturally means greater competition for the pie that remains. Larger companies might chase requirements that they would have considered too small only a year ago, or they might take reduced profit or "buy in" to contracts. Small businesses, as a result, probably will not have the win rates they had before. Moreover, a greater percentage of small businesses are subcontractors rather than primes. As the federal pie gets smaller, large prime contractors likely will keep a greater share of the prime contract work in order to minimize the impact on their businesses. In so doing, large contractors will be tempted to back away from their teaming and subcontracting commitments.

Protests and Claims are Costly. A smaller federal pie will make government contractors fight harder to get and keep federal work. Accordingly, many anticipate an increase in protests and claims, which require spending

considerable funds that cannot be charged to a contract. However, small businesses have fewer financial and administrative resources to bring or defend protests. In the case of claims, a contractor must continue to perform notwithstanding a claim that the agency changed the terms of a contract to its financial detriment. It may be several months before an agency resolves a claim; with funding issues, the time frame may be even longer or the resolution of the claim more hotly negotiated. Many small businesses cannot afford to continue performance indefinitely without receiving the additional funds needed for the additional or changed work.

Uncertainty is Paralyzing. One of the most devastating effects of sequestration or the threat of sequestration is uncertainty. Uncertainty paralyzes small businesses in particular because most do not have a robust or diversified contract portfolio. Without reasonable assurances of future business, small contractors cannot plan for the future and are not likely to invest in their growth by acquiring additional equipment, facilities, or personnel. However, small businesses that fail to invest or grow will find themselves less competitive for the opportunities that remain.

Proportionate Losses, Disproportionate Impacts. Small businesses usually have, on average, no more than 10 federal contracts at one time. A small business with 10 contracts will feel the effects of losing one of them more than a company with a 100 contracts that loses 10. Larger companies have a greater ability to reallocate idle personnel and resources to their many remaining federal contracts. Larger contractors, moreover, are more likely to have commercial and/or international contracts that can offset the effects of a stymied federal market, while small firms rarely are able to diversify in this manner.

Suggestions to Cope. In light of all this, what can small government contractors do to prepare for sequestration? Here are some suggestions:

- Communicate often and widely with your government customers. The more information at your disposal, the better-informed your decision will be.
- Make a concerted effort to be visible to your government customers because relationships matter; sales is a contact sport.
- Focus on your competitive advantages. In a tougher business environment, you have to work harder to distinguish yourself. Focus on being more strategic in your planning, whether it's deciding to concentrate on a particular government customer or specializing in a certain type of service/product. If you cast a wide net, you are not likely to be as competitive as a "niche" player.
- Address any negatives that could cause your firm to be eliminated from consideration for a contract award. Be vigilant in monitoring your past performance reports and attempting to correct or explain any less than favorable government comments.
- Educate yourself on the rights you and the government have under your contracts and contracts law. Understanding limitations on the government's ability to terminate work or increase performance demands will make a small government contractor more prepared when that time comes.
- Follow best practices to ensure that your house is in order, including having contract administration procedures and financial accounting systems in place. If you decide to pursue a claim, good documentation will be essential.