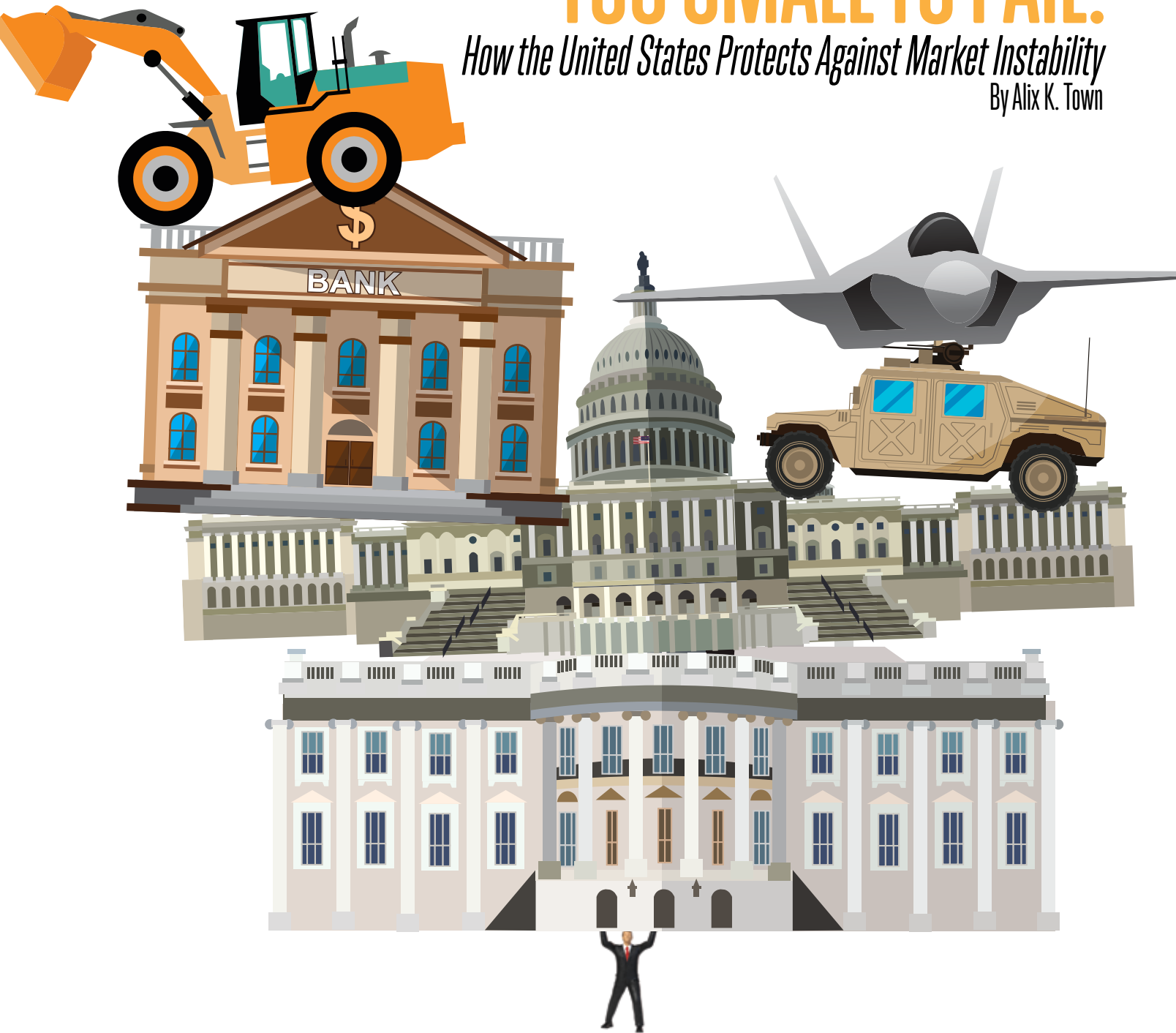


# TOO SMALL TO FAIL:

*How the United States Protects Against Market Instability*

By Alix K. Town



Globally, there has been a movement toward outsourcing functions that have been traditionally performed within governments—such as prison management or facilities maintenance. As a result, a symbiotic nature has formed between governments and their contractors. For many government contractors, they need the government to help sustain their business;

and conversely, the government needs these contractors in order to function.

## THE CONCERNING CASE OF CARILLION

In January, Carillion, one of the United Kingdom's largest government outsourcing and construction contractors, collapsed. At the time of its collapse, Carillion held contracts to maintain 50,000 homes for UK military

personnel, manage 50 prisons, provide 11,500 inpatient hospital beds, and provide 218 school meal services, among other contracts—including a £400 million contract for the Battersea Power Station redevelopment project and a massive £1.4 billion joint venture contract for HS2 (the UK's new high-speed rail network).<sup>1</sup> Due to the collapse, the UK government lost a major service

provider and faced tremendous setbacks in a number of significant government projects, and small- and medium-sized UK businesses were left with the financial consequences.

The monumental collapse of Carillion leads to the question, is the U.S. government vulnerable to a similar crisis? The answer is “probably not”—in part due to the United States’ Small Business Program.

## EU VS. U.S. PUBLIC PROCUREMENT MARKETS

The ways the public procurement markets in Europe and the United States treat small businesses are significantly different. The Treaty for the Functioning of the European Union prohibits state-aid to small- and medium-sized enterprises (SMEs) by setting aside contracts specifically for them. The EU’s main goal of this policy is to create an open market between multiple sovereign states. As a result, protectionist policies for particular segments of national economies are prohibited. The theory is that “[b]y not encouraging intra-[EU] competition—if not by deliberately rejecting it—the public sector pays more than it should for the goods it needs and, in so doing, supports sub-optimal enterprises in the [EU].”<sup>2</sup>

In creating an open market, there is the potential for several market effects to occur, which include:

- **The “static trade effect”**—Contracting authorities save money by purchasing from cheaper foreign sources<sup>3</sup>;
- **The “competition effect”**—Contracting authorities save money because domestic firms lower prices to compete against foreign firms<sup>4</sup>; and
- **The “restructuring effect”**—Contracting authorities save money because the industry reorganizes as a result of the change in the market.<sup>5</sup>

Setting aside contracts for small businesses would directly contradict these principles because it creates a barrier to free trade across borders. Even if the set-aside program was open to any SME across the EU, it would likely result in

protectionism. It is unlikely that a foreign SME would attempt to compete for that set-aside contract because the increased costs to perform from a distance and the transaction costs of working in a foreign state may make the contractor not competitive. Thus, contracts can be amalgamated within large professional contracting entities, which, should any such large entity collapse, leaves the market vulnerable from the resulting vacuum created—as is currently the case in the UK with Carillion’s collapse.

The U.S. federal procurement system is less concerned with creating an open market, as it has a single economy. Instead, the United States is more focused on achieving socioeconomic goals through its procurement system. In the United States, Congress has mandated that at least 23% of all federal government contracting dollars be awarded to small businesses. Purchases above the micro-purchase threshold and below the simplified acquisition threshold are automatically set aside for small businesses.<sup>6</sup> Purchases above the simplified acquisition threshold are set aside if market research suggests that offers can be obtained for two small businesses and award can be made at fair market prices.<sup>7</sup> These requirements mean that a substantial portion of the U.S. federal government’s spending must be spread out among multiple contractors.

Because of these policies, the United States’ procurement market is more segmented than the European market. Small businesses provide a variety of services to the U.S. federal government—such as janitorial services, laundry services, and facilities maintenance. While not the specific intent of the U.S. Small Business Program, the program serves to insulate the procurement market against market instability. The likelihood of many contractors failing all at once, barring a national catastrophe, is small. Instead, the failure of one or two contractors may impact the agencies with whom they contract, but there is a ready supply of other contractors available to come in and provide the same service without significantly impacting the marketplace.

## THE U.S. SMALL BUSINESS PROGRAM

The U.S. Small Business Program also protects against small businesses overreaching and ending up in bankruptcy. Small businesses must stay “small” in order to receive these set-aside contracts. The North American Industry Classification System (NAICS) codes determine a small business size standard based on the number of employees or average annual receipts for each industry. Exceeding this size standard would prevent the small business from qualifying for other contracts in the same industry in the future. Thus, small businesses are encouraged to stay within their capabilities rather than to over-extend themselves for larger contracts they may not have the financial or other resources to perform.

### *Facilitating Competition*

One of the critiques of the outsourcing model in general is that the contractor provides labor management, whereby the two ways a contractor can compete is through wages and overhead.<sup>8</sup> Competition based on wages is risky because in a firm-fixed-price contract, a contractor absorbs the risk for rising wages. The United States has decided that it does not want its contractors to compete based on wages; instead, for services and construction contracts, the wages are set by the wage determinations under either the Service Contract Labor Standards statute<sup>9</sup> or the Wage Rate Requirements (Construction) statute<sup>10</sup>—unless the contractor has a collective bargaining agreement. Each year, as the wage determinations or the collective bargaining agreement goes up, the U.S. government entity adjusts the contract price to reflect those adjustments. Thus, the contractor is incentivized to create the most competitive labor mix and to have the lowest overhead.

### *Risks for Small Businesses*

While the U.S. procurement market is protected, the risk to individual small businesses is greater. Because these businesses can only be awarded so many contracts and still remain “small,” and thus still eligible for award of these contracts, the potential impacts from the failure of

any one contract can have substantial consequences. This also makes small businesses more vulnerable to changes in U.S. government spending. For example, if the contracted work requires investment in a physical plant, but then the government closes a base, the contractor may not have sufficient business to cover its operating costs. Thus, small businesses have a significant operating risk if they are solely dependent on government contracts for their income.

To address this issue (in part), the U.S. *Federal Acquisition Regulation (FAR)* recognizes “idle facilities” and “idle capacity” costs as allowable costs.<sup>11</sup> This means a contractor can recover from a change in a contract for facilities that “[a]re necessary to meet fluctuations in workload,” or that “[w]ere necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen.”<sup>12</sup> Thus, a contractor has a potential avenue to recover some of those costs for mid-contract changes in requirements. A shift in contract requirements this substantial likely will lead to at least a partial termination for convenience; thus, the contractor can recover for its facilities costs that it anticipated recovering over the life of the contract—even if they are not being used. However, there’s a catch: The idle facilities/capacities costs are generally considered “reasonable” for a period of one year, depending on the contractor’s initiative to find a productive use for the facilities or capacities.<sup>13</sup> A contractor then needs to find other business to fill its capacity or to use, sell, lease, or dispose of the excess facilities. This does not, however, solve the problem of a permanent reduction in government needs, which may force the contractor out of business entirely.

### *Critiquing the U.S. Small Business Program*

There are several (perhaps valid) criticisms of the U.S. Small Business Program. For one, it is a highly complex system; it requires a small business to be determined and thorough to fully understand and participate in the process. Further, there is em-

pirical evidence that the U.S. government pays more for these services when they are purchased from a small business than they would otherwise spend from medium- and large-sized businesses. However, the Small Business Program’s inadvertent yet beneficial effect of protecting the marketplace for at least these basic services—which are crucial to the day-to-day functioning of the government—may be worth the additional administrative burden and expense.

### CONCLUSION

While the United States is less at risk from the impacts of a Carillion-like collapse, such as those impacts the UK government is currently experiencing,<sup>14</sup> there are lessons to be learned. Around the world, the drive to outsource as many governmental functions as possible is not slowing down, and, within the United States at least, this will likely result in more labor management contracts rather than fewer. Success within the market is difficult for businesses that pursue these types of contracts because these contract types require competing on margins.<sup>15</sup>

For U.S. contracting officers, it is important to pay attention to a contractor’s financial position. If a contractor is experiencing financial difficulties, for example, there is a performance risk to the government entity under the contract. In such a case, it may be worth it for the contracting agency to ask for a clarification or conduct discussions in order to discover the true extent of the financial difficulty and the contractor’s plan for resolving the problem.

For contractors, it is critically important to evaluate the realistic costs of performing the contract, as well as to have a contingency plan in place in case something does go wrong. It is also important to have a long-term strategy for the inevitable rise and fall of procurement budgets.

And yet, for the U.S. public procurement system as a whole, we are challenged to construct contracts in a way that establishes a stable business model both for contractors and for the government. **CM**

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### ENDNOTES

1. BBC News, “Carillion Collapse: UK Puts Up £100M to Back Carillion Contractor Loans” (February 3, 2018), [www.bbc.com/news/business-42925155](http://www.bbc.com/news/business-42925155).
2. Paolo Cecchini, *The European Challenge: The Benefits of a Single Market* (1988): section 3, pg. 16.
3. *Ibid.*
4. *Ibid.*
5. *Ibid.*
6. *As per Federal Acquisition Regulation (FAR)* 19.502-2(a).
7. *Ibid.*, at (b).
8. “Carillion Collapse Shakes UK Outsourcing Industry Model,” *Financial Times* (March 18, 2018), available at [www.ft.com/content/9668f25e-2901-11e8-b27e-cc62a39d57a0](http://www.ft.com/content/9668f25e-2901-11e8-b27e-cc62a39d57a0).
9. 41 USC Chapter 67 (formerly known as the Service Contract Act of 1965).
10. 40 USC Chapter 31, Subchapter IV (formerly known as the Davis-Bacon Act).
11. *As per FAR* 31.205-17(a). (“Costs of idle facilities or idle capacity” means costs such as maintenance, repair, housing, rent, and other related costs; e.g., property taxes, insurance, and depreciation.”)
12. *FAR* 31.205-17(b).
13. *As per FAR* 31.205-17(b)(2) (*but see FAR* 31.205-42).
14. See, e.g., “Carillion Collapse,” note 1; and Hallie Detrick, “What You Need to Know About the Collapse of Carillion, a UK Construction Giant,” *Fortune* (January 15, 2018), available at <http://fortune.com/2018/01/15/what-you-need-to-know-about-the-collapse-of-carillion-a-u-k-construction-giant/>.
15. See “Carillion Collapse Shakes UK Outsourcing Industry Model,” note 8.

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