

Doing Business with DOD: Contracting and Regulatory Issues

Joel L. Johnson, February 6, 2012

The next few years are likely to be extremely challenging for DoD and the companies that are its traditional suppliers. This will be particularly true for the smaller companies in the defense industry food chain. As procurement and R&D budgets shrink, primes will almost certainly pull some work in-house that is currently subcontracted out, so as to reduce the numbers of their own employees that must be terminated. This means smaller companies currently doing defense business are likely to be squeezed even more than the large suppliers. Not only will they see direct contracting with DoD shrink, but the same will be true of business with defense prime contractors.

What's more, for the smaller the companies, it is harder to accept the same percentage reduction than it is for the large companies. If a company has several thousand or hundred employees, a small percentage reduction in work forces still allows it to maintain the variety of overhead employees needed to meet the various DoD accounting and procurement requirements. If you have a few dozen employees, similar percentage reductions can be more problematic. To paraphrase Secretary Panetta with respect to the sequestration formula, you cannot employ 80% of an accountant.

This environment will make it difficult for small firms currently doing business directly or indirectly with DoD to continue to do so. Even more to the point, smaller companies currently not doing defense work will be skeptical that this is an area to pursue, particularly if the civil economy is beginning to show signs of life. This makes it all the more important that the government is not seen by potential innovators in the private sector as being an unattractive customer, partner, or investor.

In an ideal world doing business with DoD would be comparable to doing business with the private sector. DoD and service procurement officials would know what kind of technology or hardware would be useful to their respective institutions, and would be empowered to bargain with companies that possessed such technology or hardware to negotiate a contract that was acceptable to both parties. In some circumstances DoD or the service might even play the role of venture capitalist, providing seed money to help develop a promising technology, in exchange for some consideration (presumably not part ownership, but rather return of the investment plus some amount, and/or certain rights to technology) if the project were successful.

Alas, this is not an ideal world, so it is necessary to find ways to reduce impediments and improve inducements within the constraints of the Federal Acquisition Regulation (FAR),

Defense Federal Acquisition Regulation Supplement (DFARS), and as will be noted later, the International Traffic in Arms Regulations (ITAR). First and foremost in dealing with small companies is to remember that small means small. Thus such companies do not have the personnel to understand or comply with the plethora of federal and DoD regulations, and cannot wait for months for decisions or audits to be completed.

Conversely, because they are small, DoD and Service procurement officials find the unit cost for dealing with the small companies is an uneconomic use of their time. They may be unfamiliar with the bona fides of the company, uncertain as to the merits of the proposed technology, and unwilling to make the investment in assisting the company to understand the contracting complexities of the DoD. As a result, such officials will often urge a small business to work with a prime, or even to find a prime with enough task orders from DoD that the DoD can funnel money through a current prime contract, with, of course, the prime taking a percentage, and perhaps making demands for certain data rights. FFRDCs can also serve as such conduits between DoD and small companies. The bottom line is there should be means to facilitate direct DoD and service relationships with small business without intermediaries.

There are several ways to accomplish this objective. Where possible contracting should reflect FAR Part 12 commercial contracting and require submission of “other than cost or pricing data” for commercially based technology and products. The Truth in Negotiations Act (TINA) threshold of \$700,000 might be raised to \$1 million or \$2 million. Reauthorizing the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs for six years will also help. Now it is important that these programs should be appropriately funded and administered.

Small business has several other concerns with doing business with DoD. They may feel the deck is so stacked against them that there is no use trying. They know the large companies have extensive marketing operations that constantly “work” the services, DoD, and indeed, the Congress. They have large advertising budgets that blanket the trade publications, trade and professional society shows, and even the Metro entrances to the Pentagon. They have the personnel to understand the arcane contracting and auditing requirements of federal procurement. Thus it is important that DoD find ways to reach out to such companies to assure them that DoD is truly interested in their innovations and technology. This means DoD may have to develop appropriate outreach programs, perhaps through state and local business associations, to convince small business that it is worth the effort to explore potential business with DoD.

Small companies also worry about maintaining a hold on their intellectual property if they become involved with the defense world. DoD may demand full data disclosure in its contracts, which then may be made available to competitors in future competitions. They may face the

same risk indirectly, if they work through primes or large subs, who may also demand access to intellectual property in exchange for facilitating access to DoD contracts through their auspices.

Finally, as was consistently pointed out by participants in the Panel's Industry Roundtables, small companies are afraid of being swept up into the world of the ITAR. First, it should be remembered that if you produce a defense product (whether or not you export), you are required to register with the Department of State (\$2,250 the first year, at least \$2,750 per year thereafter) and meet all ITAR standards in your own facility. Among other things, this means if you have any non-US citizen in your company, provision must be made to deny that person access to ITAR-controlled data, or a license must be obtained from the State Department. It may be worth noting that over the past decade, while roughly a third of all start-up companies in computers, communications and semiconductors have been founded by immigrants, only 8% of aerospace and defense companies have had such founders. ITAR restraints no doubt contribute to this disparity.

Perhaps more critically, small companies worry that if their technology becomes involved in a defense product, not only the specific product but the underlying technology may be declared to be under ITAR control, which may make their product unavailable or unattractive for export. While export controls and the ITAR are the jurisdiction of the House Foreign Affairs Committee, in recent years significant changes in export control law have been made in defense authorizations bill. Also, under the current administration's export control reform initiative, it is the DoD that has chaired all but one of the interagency task forces reviewing the US Munitions List (USML) categories to see what hardware and technologies might remain under ITAR control, and what might be moved to control under the Export Administration Act administered by the Department of Commerce. The Congress might wish to explore the advantages of allowing DoD, at the outset of a DoD funded program such as an SBIR contract, to determine under what control system, if any, the technology or hardware produced by a contract would fall. This would provide greater certainty to the small business as to the implications of undertaking a DoD sponsored program.

The notion that there may be technology gold in the small business hills should not be seen as a new phenomenon. While most Americans are aware of the iconic founding of Apple by Steve Jobs and Steve Wozniak in a garage in 1976, they may be less familiar with Bill Hewlett and Dave Packard founding Hewlett-Packard in a garage in 1939. Clearly little companies can do big things, and DoD needs to have access to such companies. Hopefully the report of the Panel will assist in assuring that access.