Preparing for Sequestration's Storm

''. . .the storm is up, and all is on the hazard.''[1]

A figurative hurricane threatens government contractors. So many will be affected that the potential hurricane of sequestration could devastate not only government contractors, but also the economies of nearly every state in the union. When hurricanes form, people prepare. They board up windows, evacuate low-lying zones, tie down boats, and ready emergency supplies. While sequestration is clearly possible, preparations for it remain minimal, based largely on the assumption that an economic disaster so unthinkable could never happen. While such an attitude in the face of a level 5 hurricane like Katrina would have been considered foolhardy, it seems the norm for sequestration.

Sequestration, should it occur, will automatically remove more than $1.2 trillion dollars from agencies' budgets over the next ten years in an across-the-board manner — half from defense and half from civilian agency budgets. These annual cuts in mission funds will disrupt priority and non-priority programs alike. To avoid sequestration, a congressional agreement to cut amounts approximately equal to the ''triggered'' or sequestered cuts is required. Additionally, sequestration may combine with debt ceiling limitations on spending that would exacerbate these cuts. As budget cuts occur, relations between federal agencies and their contractors will likely fray. To quickly attain curtailed spending objectives, agencies may cancel solicitations, abruptly down-scope work on current contracts, refuse to exercise options, terminate contracts for default on which they had been forbearing, refuse to fund incrementally funded contracts, and take other actions to implement across-the-board cuts. Agencies can be expected to minimize contractor rights to recover costs by avoiding terminations for convenience.

At its core, the concept of sequestration was a threat that Congress imposed on itself to force congressional budget compromise. Sequestration's budget cuts were deemed so draconian that few believed Congress would allow it to happen. Today, however, the threat may become reality as the January 2013 sequestration deadline nears and hope fades for timely congressional compromise in the politically-charged election year. Each day that passes without an agreement sufficient to avoid sequestration makes contractor preparation increasingly necessary.

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For any business, a dramatic reduction in the market means a fight for survival. This article briefly explores the impact of sequestration and budget cuts that contractors should consider. Whether sequestration occurs, or Congress agrees to budget cuts similar in scope, these fiscal decisions have broad implications. Contractors would be prudent to prepare for the day when federal agencies (customers) across the government will have even less funds available for some programs, and none for others.

THE IMPACT OF SEQUESTRATION »

The Balanced Budget and Emergency Deficit Control Act of 1985 (''BBEDCA'') first authorized sequestration.[2] The Budget Control Act of 2011 recently included sequestration as an enforcement mechanism for spending reductions by agencies.[3] Sequestration can also occur, however, under the Statutory Pay-As-You-Go Act of 2010.[4] The BBEDCA contains a variety of sequestration exemptions: Social Security; certain veterans programs; net interest; unobligated balances carried over from prior years for nondefense programs; low income assistance programs, such as the Children's Health Insurance Program, Supplemental Nutrition Assistance Program, Temporary Assistance for Needy Families, and Supplemental Security Income; a variety of special budget accounts; specified federal retirement and disability accounts; prior legal obligations of the federal government in specified budget accounts; Medicare Part D payments; particular economic recovery programs; refundable tax credits to individuals; and various ''split treatment programs,'' such as federal aid for highways, Highway Traffic Safety Grants, and the like.[5] Special rules also apply for federal employee pay, student loans, federal administrative expenses, Medicare disbursements, and other programs.[6] Because of these exemptions, sequestration will almost exclusively affect programs with discretionary funding, and hit those programs harder because of the exemptions.[7]

Under the Budget Control Act of 2011 (''BCA'')[8] sequestration is triggered by one of two scenarios: 1) appropriation by Congress of more than the allowed spending limit caps for fiscal years 2012 to 2021; or 2) failure of Congress to enact legislation developed by the Joint Select Committee on Deficit Reduction by January 15, 2012 to reduce the deficit by at least $1.2 trillion.[9] Congress failed to meet this January 15, 2012 deadline, and has yet to reach agreement on allowable spending limits. Congressional inaction has created a looming ''hurricane effect'' on the economy, including and especially the defense industry. Absent congressional agreement, the sequestration process will begin January 2, 2013. The pernicious effect of sequestration, in addition to the amount of the cuts, will be its across-the-board reduction of spending by all agencies without concern for existing priorities or the exercise of agencies' business judgments. Even the president is empowered only to prevent sequestration's effects on military personnel.[10]

Any material reduction in agency funding necessarily disrupts the procurement planning process and forces agencies to reexamine and reorganize their priorities. Not surprisingly, mission-essential (or core) work will be accorded precedence over work that is not as necessary. The redirection of available funds toward agency priorities will assuredly impact existing contracts, particularly those that are deemed less important, which will cause service and supply disruptions for contractors. Agency officials will seek to do more with less. In short, federal contractors will be competing for a shrinking pool of discretionary funds.

With respect to the Department of Defense (''DOD'') budget, estimated cuts of $54.7 billion will occur in 2013.[11] War costs, emergency disbursements, and unobligated balances carried over from prior years are all subject to sequestration.[12] For 2013, the president will have the option to exempt some military personnel, but at the expense of cuts in other defense programs.[13]

By all accounts, the effects of these defense budget cuts are projected to be drastic. The National Associa-

tion of Manufacturers (''NAM''), in a report attempting to project the effect of the defense cuts alone, projected a loss in excess of 1.2 million jobs by 2014, including a loss of 200,000 federal civilian and military positions.[14] The NAM report also predicted an increase in the unemployment rate of 0.7 percent.[15] Unlike a hurricane, few states would be spared from the devastation. The NAM report projected that ten states would bear the brunt of the projected job losses, with California bearing the largest loss (148,000), followed by Virginia (114,000), Texas (109,000), Florida (56,600), New York (42,100), Maryland (40,200), Georgia (38,700), Illinois (35,400), Pennsylvania (34,700), and North Carolina (34,200).[16]

Sequestration was intended to be so unthinkable that it would force Congress to act. It is not Congress, however, that will suffer the effects of its own inaction. Federal agencies will be left to reconstruct shattered agency acquisition plans and upended budget priorities. To date, agency preparations for these wide-scale budget changes remain largely nonexistent, or at least undisclosed. For instance, Fred Vollrath, Principal Deputy Assistant Secretary for Readiness and Force Management, testified before Congress that DOD was not preparing for sequestration, primarily because DOD could not come to grips with the devastating effects of the cuts.[17] On July 31, 2012, the Office of Management and Budget (''OMB'') issued a memorandum to agency heads (''Memorandum'') that discussed sequestration.[18] The Memorandum, however, did not express any sense of urgency regarding sequestration. Rather, it stated that: ''The President has made clear that the Congress should act to avoid such a sequestration.''[19] The Memorandum further stated that ''. . . OMB will be holding discussions on these [sequestration] issues with you and your staff in the coming months . . . In the meantime, agencies should continue normal spending and operations since more than 5 months remain for Congress to act.''[20] This portends that agencies' reactions to sequestration, if and when it occurs, will be abrupt, largely unplanned, and uncoordinated at the contracting level.

Contractors will be on the receiving end of these chaotic cost reductions. In short, federal agencies may react differently to an abrupt decline in available funds and contractors cannot expect any cushion resulting from agency preparations for these cuts. Given this uncertainty, contractors should begin to prepare.

POTENTIAL AGENCY ACTIONS »

Faced with the looming threat of sequestration, agencies will consider strategic ways to mitigate these extreme budget pressures. To do so, agencies may pursue any number of contractual options. In an April 2012 report, the Congressional Research Service (''CRS'') identified many actions agencies could use to respond to sequestration reductions using existing contractual methods. According to CRS, agencies could:

1. Cancel solicitations;
2. Decline to exercise options;
3. Use the Limitation of Funds clause (FAR 52.232-22);
4. Place minimum orders under ID/IQ contracts;
5. Increase the use of the contract Changes clause;
6. Reduce the level of work under contracts (i.e., ''down-scoping'');
7. Revise the contract period of performance;
8. Order stop work/stop shipment (a form of down-scoping);
9. Accelerate completion of performance;
10. Terminate contracts for default;
11. Cancel multi-year contracts; and
12. Terminate contacts for convenience.[21]

Agencies can be expected to utilize any or all of these methods to achieve cost savings and respond to revised funding levels.

To implement sequestration, agencies will strain to conserve funds whenever possible. Indeed, ''do more with less'' is already a mantra at some agencies. This policy may result in more aggressive contract administration actions, such as the use of terminations for default instead

of convenience (in whole or in part), in order to save the government the cost of paying for work already performed. Also, contracting officers may pursue liquidated damages for failure to meet small business goals, a remedy which up to now has been largely ignored. In addition, agencies may adopt more aggressive negotiation positions with federal contractors, and request detailed cost or pricing information, even when not required by law, to attain the lowest proposed prices. As federal dollars become scarce, agencies may increasingly rely on audit and investigative authority to ensure that contractors have systems in place to monitor and control contract costs, and are compliant with all contract accounting and reporting requirements. Such audits could potentially lead to other investigations and allegations (false statements, false certifications, counterfeit parts). Contractor resentment against such actions will be misplaced – contracting offices will be acting either out of necessity or mandates from upper echelons of their agencies.

Congress could delay sequestration, and push it months into the future. For government contractors, this will not alter the need for preparation, whether sequestration is delayed or takes place as scheduled early in January 2013. A delayed sequestration will be no less economically devastating, but will allow prudent contractors more time to prepare.

CONTRACTOR CONSIDERATIONS AND PREPARATIONS »

There are a wide variety of actions contractors can take to prepare for sequestration and its lasting effects. We list some of them below.

» Contractors should conduct an internal self-assessment of their government business, examining each contract in its inventory. Because a contract's significance is directly related to its size, contracts should be listed by the amount of their remaining revenues. This exercise also will list contracts in order of their risk of loss, because larger contracts present bigger targets for budget-cutting agency officials. In many instances, agency perspectives on such contracts will run inversely proportional to contractor interests, i.e., larger contracts enable agencies to make the greatest cuts, while to contractors they represent the potential for the greatest revenues. A thorough self-assessment will help to prioritize efforts and assess risk.

» To the extent possible, contractors should preserve and build on work that supports an agency's core capabilities. Specifically, contractors should assume that the less mission-essential activities will soon be phased out (options not exercised, contracts terminated).

» Contractors should review their dependence on subcontracts versus prime contracts. Subcontracts with large primes that have likely program continuity have a good chance of survival. On the other hand, subcontracts in higher risk areas could prove problematical if the prime contract ends. Generally, however, subcontractors have little to no control over continuation of work, are prohibited from talking directly to the government, and have little to no program input. Prime contracts or subcontracts performing in core mission areas are safest, while those in lesser priority areas carry the highest risks of termination or cancellation.

» Contractors should perform, perform, and perform. Nothing strengthens relations with program and contracting offices like performance that is on time and within budget. Part of the self-assessment described above should include a determination about which contracts are most crucial. Management teams should also visit their core teams to address and resolve schedule or performance issues.

- As always, customer relations are critical, and during this period of uncertainty contractors should work to maintain or strengthen relations with agency program officials and contracting offices. Initiating contract disputes ''for the sake of a principle'' or ''to send a signal'' or ''to gain respect'' would be counterproductive at this time. Now more than ever, contractors should keep relationships as sound as possible with federal contracting and program offices. Open communications channels are a valuable asset when budgets are in flux.
- Public companies will face very difficult decisions with respect to projected contracts and revenue targets. Given the expected disruptions and possible chaos in some sectors of the government contract marketplace, carefully worded qualifications concerning the lack of reliability of revenue projections should be crafted now, before the pressure of real cuts begins.
- For contractors who also perform commercial work, judicious asset determinations should be made vis-a-vis non-government markets. In this regard, contractors need to ascertain what equipment, machinery, facilities, and so forth would be leveraged in pursuit of commercial opportunities. Skill sets of employees should be similarly evaluated. A contractor seeking to preserve or even increase its commercial marketplace share should accord such assessments a priority.
- For some contractors, it would be worthwhile to conduct a compliance review. A careful compliance review could reveal internal problems unknown to management. Such a review could detect and correct business system deficiencies or risks prior to discovery by government auditors, and avoid the impact on the contractor's competitiveness.
- Contractors should not assume that any of their contracts will be terminated for convenience. In all likelihood, only a lucky few will benefit from the cost recovery provisions applicable to terminations for convenience. The Termination for Convenience clause[22] is one of the more liberal relief-granting clauses in the FAR and provides for significant contractor cost recoveries. For that reason, agencies will be unwilling to direct terminations for convenience.
- Contractors should prepare for the fact that agencies might have no choice but to curtail programs by not renewing contracts, or simply by not exercising options, barring contractors' rights to recover additional payments. Thus, when reviewing existing contracts, contractors should ascertain which of their contracts could be vulnerable to non-renewal or non-exercise of options. Contractors should be aware that marketing efforts to persuade contracting officers not to end a contract/program could be challenging if funding decisions are made several layers above the contracting officer/program manager level.
- Faced with untenable budget realities, agencies might be forced to minimize liability for unreimbursed expenses, such as costs that were capitalized/amortized over the contract term. As mentioned above, agency officials might either let certain programs expire when the contract ends or choose not to exercise options. Even where this is not done, agencies will administer contracts in a manner that precludes contractor recovery of any unbilled capitalized/amortized expenses.
- Contractors facing contract performance disputes or government claims should consider creative negotiation and alternative dispute resolution strategies. Because cost reductions will be inevitable anyway, nonmonetary solutions could, in some cases, be more effective than protracted and costly claims litigation (i.e., contractors might agree to ''no-cost'' terminations in exchange for removal of negative performance ratings or upgrading to more favorable ratings).

» Contractors' indirect cost projections, such as overhead or general and administrative expenses, might be subjected to major downward pressures. For this reason, contractors should carefully review the cost elements in their indirect pools and prepare to alter them as necessary. Contractors should also develop business case scenarios that will reflect the base changes in anticipation of agency actions. Similarly, contractors should examine the terms of any forward price rate agreements for possible revisions.[23]

» Just as individuals who anticipate losing their jobs will cut expenses, so too businesses expecting a precipitous decline in revenues should look immediately for costs to cut. There is evidence that this has already begun at some contractors, where funds for travel, training, R&D, machinery and equipment, new leases and other accounts have recently been withdrawn. Monies saved should, of course, be accumulated into financial reserves.

» Contractors should reduce debt now, to the extent possible, as a vital part of self-preservation. During this period of great market turmoil, flexibility will be key as the magnitude and timing of budget cuts and program curtailments cannot be predicted, even by agency officials. A critical factor for the survival of any business will be its debt level. On this point, the greater the debt service burden is to constrained cash flow, the more difficult it will be for a business to survive.

» Legally, contractors must have a strategy for implementing the Worker Adjustment and Retraining Notification (''WARN'') Act.[24] The WARN Act requires employers with more than 100 employees (excluding part-time), or having employees working more than 4,000 hours, to issue sixty (60) days written notice prior to mass lay-offs.[25] Whether to issue WARN notices must be the subject of very careful assessments because such notices almost inevitably cause severe disruptions in the workforce. Failure to provide timely notice in some instances has been found excusable. For example, in one case where employees sued their employer for failure to provide timely WARN notices, the Eighth Circuit entered judgment in favor of the contractor after finding that the cancellation of a government contract was not ''foreseeable.''[26] In light of all the publicity surrounding sequestration, however, an argument that it was not foreseeable carries a high risk of failure. Uncertainty in this area heightened when the Department of Labor recently announced that WARN Act notices would not be required as a result of sequestration.[27] It will remain for the courts ultimately to decide if such an announcement can waive the requirements of a statute. In any event, it would seem prudent for employers to establish full communication with employees and their union representatives regarding WARN Act issues.

» Contractors should regularly communicate with their employees anyway, and not merely in the context of WARN Act compliance. Management teams that continually inform employees — the greatest asset of almost all companies — about developments are better poised to weather the fiscal storm than firms that keep employees in the dark.

» Contractors should approach claim filings carefully. In a period where money is tight, programs may have limited funds to pay claims. However, filing a formal claim before the Boards of Contract Appeals or the Court of Federal Claims provides the government access to the judgment fund, which is an immediate source of funds to pay the claim, even if settled. The agency can repay the judgment fund out of program funds over the next three years. As discussed earlier, the mere act of filing litigation runs counter to maintaining strong relations with the agency. Presenting the litigation as a strategy for the agency to access the judgment fund could help preserve, and not disrupt, relations.

CONCLUSION »

If sequestration occurs, it will impose devastating effects on contractors. Even if Congress acts to avoid sequestration, it will nevertheless be forced to make deep cuts in federal programs, across defense and non-defense sectors alike. Federal contractors urgently need to prepare now for these developments, reviewing and adopting the recommendations set forth above as applicable. Many contractors will not survive the perfect storm of intense competition, dramatic reductions in agency spending, harsh regulatory oversight, and agencies dedicated to making budget cuts that severely reduce badly needed contactor revenues. Chances of survival will most assuredly be higher for those prepared for these impending revenue reductions.

END NOTES »

[1] William Shakespeare, Julius Caesar, Act V, Scene I (Cassius stating: "Why, now blow wind, swell billow, and swim bark. . .the storm is up, and all is on the hazard.")

[2] See Title II of P.L. 99-177, 1985.

[3] See P.L. 112-25.

[4] See Title I of P.L. 111-139.

[5] See Title II of P.L. 99-177, 1985; see also "Budget "Sequestration" and Selected Program Exemptions and Special Rules, Congressional Research Service ("CRS"), Report for Congress, 7-5700, April 27, 2012 ("Report for Congress"), at Summary.

[6] Ibid. at 5-6.

[7] CRS, Report for Congress, at 7.

[8] P.L. 112-25.

[9] Ibid.

[10] CRS, Report for Congress, at 9.

[11] See "How Across-the-Board Cuts in the Budget Control Act Will Work," Center on Budget and Policy Priorities, by Richard Kogan, at 5.

[12] Ibid.

[13] Ibid.

[14] See "Defense Spending Cuts: The Effect on Economic Activity and Jobs," National Association of Manufacturers, by Jeffrey Werling, Inforum / University of Maryland, at v.

[15] Ibid.

[16] Ibid., at vii.

[17] See "Defense Department Has Not Begun Planning For Sequestration, Official Tells House Panel," by Louis C. La-Brecque, BNA Contracts Report, Vol. 98, No. 5, July 31, 2012

(98 FCR 123, 7/31/12)(98 FCR 123, 7/31/12).

[18] See "Memorandum For the Heads of Executive Departments and Agencies," from Jeffrey D. Zients, Acting Director of Office of Management and Budget.

[19] Ibid., at 1.

[20] Ibid., at 2.

[21] "Government Procurement in Times of Fiscal Uncertainty," Kate M. Manuel and Erika K. Lunder, Congressional Research Service, Report No. R42469, April 6, 2012. The report did not address the impact on government contractors (see footnote 217).

[22] FAR 52.249.1 through 52.249-7.

[23] See FAR 42.1701.

[24] 29 U.S.C. §§ 2101-2109 (1994).

[25] Ibid., at §§ 2101(a) and 2101(3)(B).

[26] See Loeher v. McDonnell Douglas Corp., 98 F.3d 1056 (8th Cir. 1996).

[27] "Labor Department: Sequester Layoff Notices Not Required by WARN Act," By Paul M. Krawzak, Congressional Quarterly, July 30, 2012. While not covered by the WARN Act, federal civil servants may receive layoff notices for agency downsizings related to program curtailments. See "Pentagon Official Says Civilian Workforce Could Get Layoff Notices 4 Days Before Election," National Contract Management Association Contract Management, July 27, 2012.