

Government Contracts Update

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Sequestration: What Government Contractors Need to Know

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With the 2012 presidential election months away, government agencies and contractors continue to speculate about the possible effects of sequestration. Whether sequestration will actually occur is unknown, as Congressional legislation and presidential approval of alternative deficit reductions could dramatically curb, if not eliminate, the effects of sequestration. If sequestration does occur, however, the Congressional Budget Office estimates that eligible defense programs will be cut by 10% and eligible non-defense programs will be cut by 8.5% in fiscal year 2013. Consequently, contractors should commence preparations for the possibility of drastic cuts in federal spending and position themselves to navigate in an environment of tighter budgets and increased competition.

This client alert provides a background on sequestration, outlines the possible impacts on government contractors and the procurement process, and identifies key steps government contractors can take to prepare for sequestration. To read the article in its entirety click [here](#). Below are the highlights.

What Does Sequestration Mean?

Sequestration is a process in which automatic, indiscriminate across-the-board budget cuts are imposed on government programs to force reductions in spending and meet budgetary goals established by statute. If sequestration does occur, \$1.2 trillion in budget cuts will begin on January 2, 2013, and continue through the following nine years (FY 2021).

Generally, sequestration spending cuts are divided equally between eligible defense and non-defense programs. There are, however, some domestic entitlement programs – Social Security, federal retirement programs and Medicaid – that are exempt from sequestration budget cuts. In addition, the Government Accountability Office (GAO) issued a decision on May 21, 2012, extending exemption from sequestration to U.S. Department of Veterans Affairs (VA) spending. In issuing its decision, the GAO determined that the Statutory Pay-As-You-Go Act of 2010 exempted VA spending – with the exception of limited administrative expenses – from the impact of sequestration by overruling language within the Balanced Budget and Emergency Deficit Control Act of 1985, which limited cuts on veterans' medical care to 2%. The GAO decision affirmed an April 2012 opinion by the Office of Management and Budget (OMB) which similarly concluded that sequestration budget cuts do not apply to VA spending. While not exempt from sequestration, other programs are limited to a fixed percentage of cuts; Medicare cuts, for example, are limited to 2%.

It is also important to remember that the Budget Control Act of 2011 provides a means to avoid sequestration if Congress successfully acts to achieve deficit reduction savings that match the anticipated \$1.2 trillion in funds that will be subject to sequestration. If Congress attains less deficit reduction savings than required, the sequestration cuts will be reduced by the amount in deficit reduction savings actually realized. For example, if Congress provides a plan creating \$80 billion in alternative deficit reductions, and the plan becomes law, the \$1.2 trillion sequestration will still occur, but the sequestration will be reduced by \$80 billion.

Notably, in an attempt to neutralize the effects of sequestration on defense spending and side-step the President's elimination of several defense programs in his 2013 budget request, the U.S. House of Representatives passed its final version of the National Defense Authorization Act on May 18, 2012. The 2013 defense spending bill includes a myriad of amendments, including an amendment which would delay the impact of sequestration on the Department of Defense for a year by replacing proposed defense program reductions with \$78 billion in cuts from eligible non-defense programs. The bill has already been the source of hostility, with the White House threatening to veto the bill because of the inclusion of \$8 billion more in spending than established by the ceiling in the Budget Control Act of 2011. Significantly, the White House's objection appears to focus exclusively on the bill's funding levels, rather than on a delay in sequestration. This narrow objection may indicate that the White House is keeping its options open on what may develop into a highly political issue.

Despite the House's efforts to postpone the effects of sequestration, the expressed hostility from the White House – combined with a likely rejection of the bill from the Senate – keeps the threat of sequestration at the forefront of potential significant government contracts developments over the coming months.

How Will Sequestration Affect Government Contracting?

Towards the end of fiscal year 2012, OMB – after determining the percentage of budget cuts applied to eligible defense and non-defense programs – will begin to issue apportionments to each agency. An apportionment constitutes a legally binding order that forbids an agency from spending more appropriated funds than OMB allocates to the particular agency.

In turn, agencies will have to reevaluate and re-prioritize their agency and mission needs. While agencies will likely reduce personnel in response to budget cuts, the first year of sequestration will also probably result in agencies significantly scaling back the number of new contracts for non-critical programs. Yet, even critical programs will likely be impacted by sequestration, as agencies will begin to restructure their procurement vehicles to find the most effective means to utilize reduced funding.

As sequestration will certainly impact the way in which the government chooses to spend its money, government contractors should consider the following key impacts sequestration will have on the procurement process:

- **Impact on New Contracts:** The most significant impact sequestration will likely have on government contracting will be a decrease in the number of new contracts awarded, as agencies eliminate programs that are not critical to their missions. Sequestration will also potentially impact the types of contracts awarded, as agencies move away from contract vehicles which place the cost risk on the government and its budget. For example, agencies will be less likely to use cost-reimbursement and labor-hour contracts, instead favoring firm-fixed-price contracts that provide the government with a greater degree of cost certainty. Indefinite Delivery/Indefinite Quantity contracts will also become a more viable option for the government, as these contract vehicles provide agencies with the ability to negotiate at the task order level. Taking their limited resources into account, agencies could turn away from best-value procurements, relying more heavily instead on lowest-price, technically acceptable solutions.
- **Impact on Existing Contracts:** Limited funds could also cause agencies to reduce the products or services being purchased on existing contracts. Agencies may choose to “de-scope” the quantity, capability, and breadth of contract performance through deductive change orders as well as partial and, in some cases, complete contract terminations for convenience. Notably, the government could try to limit reliance on terminations for convenience to avoid or limit the recoveries of terminated contractors. Contractors should also expect agencies to restructure their contracts in an effort to defer any possible costs to the future. Such contract restructuring may result in the utilization of term contracts, extension of contract schedules to match funding and the waiver of existing contractor claims. Finally, contractors could see an increased reluctance on the part of the government to exercise their option periods, which in turn may cause contract renewal to become a negotiation point for contract pricing.
- **Claims Litigation:** Sequestration could bring a greater number of requests for equitable adjustment (REA) and certified claims as contractors seek reimbursement for government-initiated actions impacting their contracts, such as constructive acceleration, stop-work orders, government delays, and deductive change orders. In addition, with less work on the foreseeable horizon, contractors could be less likely to accept “scope creep,” in the hopes of maintaining the favor of an agency and more work down the road, and instead pursue their claims more aggressively. Conversely, budget cuts will force the government to use litigation as a means to recoup funds from government contractors. For example, Boards of Contract Appeals may begin to docket a greater number of quantum-related disagreements brought by the government. As compared to the past, where if the contractor prevailed on entitlement the government would likely negotiate a settlement, new fiscal realities could make the government more litigious in this area.
- **Bid Protests:** Sequestration will certainly bring an increase in bid protest litigation, as contractors compete for a limited number of contracts, especially in the first year of sequestration. The protests will likely come from incumbents seeking to extend their performance of the contract as well as offerors who need to receive the award to remain viable with a particular agency, product or service.

How Should Contractors Prepare for the Effects of Sequestration?

It is difficult to predict whether sequestration will actually occur in January, or perhaps in subsequent months, because sequestration is entangled in the larger macroeconomic policy debate concerning

what the appropriate level of taxing and spending will be going forth in our country – a problem that has been hotly debated in Congress for many years without resolution. Predicting the outcome of congressional debate on this issue is particularly difficult in today's environment because of two complicating factors: the outcome of the 2012 presidential elections and the effect that changes in taxes or outlays would have on the country's slow recovery from the recession.

Notwithstanding these difficulties, the possibility that sequestration will occur is sufficiently great that it is important that government contractors take proactive steps to address the future impacts of sequestration.

- **Watch for “scope creep.”** As agencies seek to obtain more for less, contractors must ensure that their personnel understand the company's obligations under the contract and notify upper management of any potential scope creep immediately. If it appears that the government has changed the contract, the company must give prompt notice of the change and take steps to ensure that it captures the costs associated with the changed work.
- **Prepare for possible WARN Act implications.** As many companies could be forced to significantly reduce personnel in response to the across-the-board federal budget cuts, contractors must also consider the applicability of the Worker Adjustment and Retraining Notification (WARN) Act and its protections. Generally, the WARN Act requires employers with 100 or more employees to provide 60 days' advance written notice to employees prior to the closing of a work site resulting in the loss of 50 or more employees, or mass company layoffs resulting in employment loss for 500 or more employees (or less if accounting for at least 33% of the total workforce). As agencies will not know whether sequestration will occur until the final hour, they are unlikely to pass information to contractors concerning impacted contracts prior to the actual date of sequestration. Thus, contractors should familiarize themselves with the WARN Act requirements, and be prepared to quickly notify covered employees if informed that their contracts are subject to termination or reduction, necessitating workforce cutbacks. Many of the defense industry's top contractors, however, may choose a more conservative approach by issuing notices prior to the November election. Notably, such mass layoff notices – strategically issued just days before the election – could successfully apply pressure on Congress to solve the sequestration problem.
- **Develop strategies for an increasingly competitive market.** It is important that government contractors begin considering new means to attract government contracts and differentiate themselves from their competitors. For example, utilization of unique bidding strategies, such as price-sharing, may give contractors an edge when competing for a limited number of contracts.
- **Develop strategies to engage policy officials and trade associations.** Given that agencies will begin to eliminate programs they deem to be non-critical, contractors should also consistently advocate the importance of the programs which their contracts support through interactions with policy officials and trade associations. On a more micro level, it is crucial for contractors to maintain personal contacts within agencies, within the context of the applicable ethics regulations, in an effort to foster a favorable relationship with the agency and to keep abreast of agency developments impacting their contracts. It is important to understand that in many cases, however, those within the agency may not know whether sequestration has eliminated a program until very late in the process.

Sequestration will bring many changes with respect to how the government will choose to spend its limited resources. Consequently, government contractors should begin to plan for sequestration and how they will address the impending effects on the federal procurement process. For more information, please contact [Paul Debolt](#), [John Cooney](#), [Christina Kube](#) or any of the attorneys in Venable's [Government Contracts Practice Group](#).