

# Preparing for Sequestration and Budget Cuts

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Federal contractors are facing the prospect of "sequestration"-or of the budget cuts that will be required to avoid it. Although it is impossible to predict whether sequestration will in fact occur, or whether Congress will act to prevent it, the likelihood of deep budget cuts over the next decade makes it necessary for federal contractors to begin preparation for the significant disruption that will result from these cuts.

## What Is Sequestration?

Under the Budget Control Act of 2011 (the Act), sequestration is the automatic reduction of spending triggered if Congress approves spending levels that exceed certain "caps" set out by the Act. Although certain programs-Social Security, Medicaid, federal retirement programs and Medicare-are protected from the full impact of sequestration, spending reductions would occur largely across the board under the Act. The Budget Control Act calls for sequestration of spending from FY 2013 through 2021 and, unless Congress otherwise acts to limit spending, it takes effect January 1, 2013.

If sequestration occurs, \$1.2 trillion in spending reductions are required from FY 2013 through 2021. Approximately \$1.1 trillion of these reductions will come from reductions in both Department of Defense (DoD) and non-DoD program expenditures. Sequestration can be avoided under the Act if Congress otherwise acts to implement spending limitations deep enough to avoid the Act's triggers. On February 14, 2012, President Obama proposed a FY 2013 budget that, according to the Office of Management and Budget, avoids the statutory trigger. It does so by, among other things, proposing cuts that will reduce or eliminate altogether spending on a number of well-known federal programs, including numerous DoD contracts.

Thus, in the current economic climate, federal contractors must prepare for budget cuts-whether those cuts are imposed by sequestration or by the reduced spending necessary to avoid it.

## What Are the Likely Effects of Reduced Spending?

At the agency level, sequestration or budget cuts will almost certainly result in reduction of agency personnel, and that means (at least potentially) even greater burdens on government contracting personnel than currently exist. This in turn could result in reduced responsiveness and, possibly, a reduced ability or willingness to address contractor-unique inquiries and requests. Reduced manpower might also result in some reduction in the ability of contracting personnel to monitor contract performance, and may result in spottier audit activity.

The most concerning issue for major federal contractors is the possible downsizing or elimination of key programs. By way of example, after the collapse of the Soviet Union in 1991, federal contractors saw a similar shrinkage of the federal budget, with a concomitant increase in program cancellations and restructures. The effects of sequestration or budget cuts in today's environment could be even more dramatic than those that occurred after 1991.

This prospect is not purely hypothetical. In November 2011, Secretary of Defense Leon Panetta outlined some of these potential impacts in a letter to Senator Lindsey Graham (R-SC). (Secretary Panetta's letter assumes total cuts of close to \$1 trillion in defense spending during the sequestration period, because he adds sequestration cuts to cuts already planned by DoD.) Among other potential effects, Secretary Panetta cites short-term effects on such programs as Joint Strike Fighter (JSF), and the long-term prospect of multiple program cancellations.

### **What Can Contractors Do to Prepare for Budget Cuts?**

Contractors can take steps to prepare for and mitigate the effects of these spending reductions before they occur. The following identifies some of the key issues that contractors should be prepared to address.

**Potential claims.** When a contractor has legitimate claims against the Government, it makes sense to seek to resolve those claims sooner rather than later. This is especially true when federal budgets are tight. A contract with otherwise unexplained cost overruns makes an easy target for budget watchdogs. Overruns may be taken to justify adverse contract action, such as a termination or deductive change. If the contractor can establish through a request for equitable adjustment or contract claim that the Government bears responsibility for some or all of the perceived cost growth, the Government might think twice before terminating a program. At a minimum, a valid claim can reduce the likelihood that the Government will terminate the contract for default rather than for convenience.

**Performance assessments.** For the same reasons, contractors should aggressively review and seek to correct performance assessments that unduly assess blame for contractual issues on the contractor. Adverse assessments not only affect future business, they can weaken arguments for maintaining current budget levels on existing programs. Contractors should understand the circumstances under which they may challenge performance assessments under the Contract Disputes Act.

**Fixed-price contracts.** As has occurred in the past, one of the ways that the government will seek to reduce costs is by the increased use of fixed-price contracts, which in the government's view shift the risk of cost growth to the contractor. Even before the Budget Control Act of 2011, DoD made the increased use of fixed-price contracts a policy mandate. In November 2010, Under Secretary of Defense Ashton Carter issued a memorandum to DoD acquisition professionals which, among other things, directed the increased use of fixed-price incentive contracts, decreased reliance on cost plus award fee contracts and reductions in the use of time and materials contracts. Mr. Carter also directed the use of firm fixed-price contracts "to the maximum extent reasonable when ongoing competition is utilized in multiple award contract scenarios." Contractors should recognize that the shift toward fixed-price contracts results in a need for increased vigilance against

government-caused contract changes.

**Shifting Government emphasis.** Although overall spending may ultimately decrease, there are a number of areas where Government spending is likely to increase. For example, the proposed DoD FY 2013 budget indicates increased emphasis on cyber defense, intelligence, surveillance, reconnaissance and space. Likewise, given the potential cancellation of multiple major programs, DoD's focus may shift to more proven, rapidly deployable, commercial technology. Contractors should remain attuned to areas of their industry where government needs are likely to increase.

**Program metrics.** One of the most undervalued litigation tools in federal contracting is the program metric, whether this is understood to mean estimates at completion (and related metrics) or whether it refers to "earned value management" systems. Program metrics are often an early warning system for problem contracts. Why does this matter? It matters because problem contracts are an easy target for budget cutting and program cancellation. Especially in times of shrinking budgets, it is extremely difficult for politicians to justify additional spending on contracts that are in loss positions. Program metrics are *litigation* tools because they also often provide information about possible *government-caused* changes. Thus, when a contractor identifies a variance at completion in a given month or quarter, it makes sense to review the causes of the variance to determine whether the cost growth may be attributable to government direction or interference.

**Termination and deductive change.** The most obvious potential consequence of the kinds of budget cutting currently under consideration in Congress is the termination or reduction of existing programs. Secretary Panetta explicitly warned of this last November, when he said that in FY 2013 sequestration would mean cuts in programs such as Joint Strike Fighter, among others, and that in the long run it could mean the termination of the JSF, littoral combat ship and ground combat vehicle modernization programs. Terminations for convenience are guided by unique Federal Acquisition Regulation (FAR) provisions that specify (and limit) the contractor's cost recovery.

Contractors also should be cognizant of the differences between "partial" terminations for convenience and deductive changes. Although the amounts recovered using these two methodologies are often similar, the methods for measuring costs differ. Those differences can affect recovery in situations where, for example, the contract is in a loss position. Before agreeing to the Government's characterization of its contract action, contractors should assess whether the proposed methodology will make a difference for their cost recovery.

**Contract restructure.** Short of termination, the Government may seek the restructure of its contracts. Restructure often includes the resolution or waiver of existing claims, underscoring once again the importance of early assessment of the causes of contract cost growth and the value of any potential claims against the government.

**Subcontractors and team members.** In situations involving potential partial terminations and deductive changes, prime contractors are likely to face disputes with subcontractors and team members over remaining work share. Contractors who anticipate these scenarios and address them in their teaming agreements and subcontracts will be in a better position to resolve such matters favorably.

**DCMA cost recovery; DCAA withholds.** As many contractors know, the Defense Contract Management Agency (DCMA) has embarked on a cost recovery "initiative" aimed at clearing out the backlog of unresolved matters that have accumulated over the past decade. Many disputes about questioned costs, potential cost accounting standards noncompliances and impacts of voluntary accounting changes have languished. As DCMA works through this backlog, contractors should expect to see increased activity in these areas.

The Defense Contract Audit Agency (DCAA), for its part, has more tools than ever for collection of monies from contractors, including the ability to withhold contractor payments if the agency finds a significant deficiency in the contractor's business systems. In the coming years, contractors will need to be vigilant in protecting their interests against unsupportable payment withholds by DCAA.

**Protests.** In times of shrinking budgets, contractors should expect to see competitors fighting more aggressively for their pieces of the budget pie. This means that increased bid protest activity is a very likely consequence of the anticipated budget cuts over the next few years.

**International Markets.** With declining U.S. Government budgets, contractors may set their sights on international markets. While foreign Governments and international markets may present opportunities, contractors must remain wary of the myriad potential pitfalls associated with doing business internationally, including issues of Foreign Corrupt Practices Act and export control compliance.

## **Conclusion**

Budget cuts are inevitable in the coming years, and federal contractors should begin preparing for the fallout from such cuts now. Wiley Rein Government Contracts attorneys have the depth and breadth of experience necessary to address any questions you may have regarding the potential effects of upcoming budget cuts on your federal contracts.