

Sequestration Still Looms Large

Summer 2012

It was never supposed to happen.

Late last year, Congress and the President resolved the debate over raising the debt ceiling by agreeing to a deal in the 2011 Budget Control Act that would automatically trigger massive, indiscriminate cuts in spending beginning on January 1, 2013. In total, the cuts would slash spending by \$1.2 trillion over the next 10 years, including more than \$500 billion from the Department of Defense (DoD) alone. The idea behind the deal, however, was to make the cuts so punitive and irrational that Congress and the President would have no choice but to reach a “grand bargain” solving the country's long-term budget deficits. Now, with less than six months to go before sequestration is scheduled to take effect, it appears that Congress and the President are no closer to reaching a deal that would stave off potential disaster for both the federal Government and the entire government contracting industry.

There has been much posturing by lawmakers on both sides of the aisle over the past few months. Most recently, on June 28, House Armed Services Committee head Rep. Buck McKeon (R-CA) sent a letter to Senate Majority Leader Harry Reid (D-NV) accusing Reid and the Senate Democrats of blocking a vote on a Republican-drafted plan to avoid defense budget cuts under sequestration. Reid fired back on July 11, claiming that House Republicans were playing the role of obstructionists by refusing to consider Democratic-led efforts to include revenue increases as part of any sequestration compromise. For his part, President Obama appears intent on using the threat of defense cuts to force Republicans to abandon their stance against including revenue increases as part of any deal.

Despite the lack of progress, DoD is not currently planning for sequestration, according to Deputy Secretary of Defense Ashton Carter. “Maybe later in the summer [the Office of Management and Budget] will have to request that we take a look at it and try to determine what steps could be taken, but I don't want to mislead you here,” Carter recently said. Sequestration “would have devastating effects on our readiness and our workforce, and disrupt thousands of contracts and programs.”

Not to mention the impact on contractors and their employees. Because of a federal statute requiring companies to give workers 60 days' notice before mass layoffs, contractors may be forced to send layoff notices to tens, or even hundreds, of thousands of employees before November if a deal is not reached. Lockheed Martin, for example, has said that it may be forced to send warnings to all 123,000 of its employees.

With all of this uncertainty, contractors have no choice but to prepare for budget cuts in some shape or form. As explained in our last *Government Contracts Issue Update*, “Preparing for Sequestration and Budget Cuts,” contractors can mitigate the effects of spending reductions by being prepared to address the following key issues, among others:

- **Potential claims.** With tight agency budgets, contractors should seek to resolve legitimate claims sooner rather than later. At a minimum, it may make the Government think twice before attempting to terminate a contract or reduce the scope of work through deductive changes.
- **Fixed-price contracts.** As a result of the pending budget cuts, DoD will continue to increase the use of fixed-price contracts. Contractors should recognize that the shift requires increased vigilance against government-caused contract changes.
- **Shifting Government emphasis.** Contractors should remain attuned to areas of their industry where Government needs are likely to increase, such as cyber defense, intelligence, surveillance, reconnaissance and space. It will likely also shift to more proven, rapidly deployable, commercial technology.
- **Program metrics.** Program metrics are often an early warning system for problem contracts and can also provide critical information about potential government-caused changes.
- **Termination and deductive change.** Terminations and deductive changes are inevitable. Contractors 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.
- **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.** Contractors that anticipate in their agreements inevitable disputes resulting from partial terminations and deductive changes will be in a better position to resolve such matters favorably.
- **DCMA cost recovery; DCAA withholds.** Contractors can expect to see increased activity from both the Defense Contract Management Agency (DCMA) and the Defense Contract Audit Agency (DCAA) in the fallout from pending budget cuts. Contractors must be vigilant in protecting their interests.

It remains to be seen whether sequestration will occur in January. Budget cuts in one form or another, however, are inevitable. Contractors should begin preparing now.