

Federal Agencies Are Preparing for Sequestration—Are You?

Winter 2013

With each passing day that the President and Congress fail to reach an agreement to avoid or delay “sequestration,” it is becoming more and more likely that federal agencies will be forced to implement \$85 billion in immediate spending cuts over the remainder of the current fiscal year. Even if a last-minute deal can be reached, however, federal spending levels are virtually certain to decline in coming years. Confronted with this new reality, the Office of Management and Budget (OMB) and the Department of Defense (DoD) have begun issuing detailed guidance directing agencies to take steps to prepare for these looming budget cuts. Although much of the focus is on internal agency operations—including draconian measures such as furloughs, and elimination of any activities that are not mission critical—this guidance also directs agencies to look for ways to reduce spending on contracts. Therefore, contractors would be wise to develop their own plans for dealing with these looming cuts, and take steps to protect their contractual rights in the event that the budget ax falls their way.

The Path to Sequestration

How we got to the point where such planning is necessary is no secret. As discussed in OMB's recent guidance, the last-minute deal that was brokered on New Year's Day to avoid the fiscal cliff (the American Taxpayer Relief Act of 2012, or ATRA) only delayed sequestration and the debate on deficit reduction measures for two months. Accordingly, unless Congress acts to amend current law, the President is required to issue a sequestration order on March 1, 2013, that will cancel approximately \$85 billion in budgetary resources across the entire federal government.

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In addition to the looming threat of sequestration, additional uncertainty is created by the expiration on March 27, 2013, of the Continuing Resolution under which the government has been operating. Add to this a need to increase the debt ceiling in August 2013 and the ongoing political stalemate over a long-term solution to the government's fiscal crisis, and you have all the makings of a perfect storm.

Agency Planning

Faced with this uncertain budget picture, OMB issued a memorandum on January 15, 2012, instructing agencies to “intensify efforts to identify actions that may be required should sequestration occur.” Although much of the guidance addresses internal operations and personnel issues, OMB’s “guiding principles” include a number of provisions that are of particular interest to contractors, including provisions which direct agencies to:

- “Review grants and contracts to determine where cost savings may be achieved in a manner that is consistent with the applicable terms and conditions”;
- “Take into account funding flexibilities, including the availability of reprogramming and transfer authority”; and
- “Be cognizant of the requirements of the Worker Adjustment and Retraining Notification (WARN) Act, 29 U.S.C. §§ 2101-2109,” which requires certain employers to provide notification 60 calendar days in advance of plant closings and mass layoffs.

Within days of OMB’s guidance, the Army, Air Force and Navy all issued their own similar guidance directing DoD personnel to prepare for the impacts of sequestration. Like the OMB memo, much of the guidance issued by DoD focuses on internal government operations—including, for example, imposition of hiring freezes and furloughs of civilian employees, termination of temporary employees and elimination of training, conferences and other non-essential activities. Nevertheless, there are a number of other cost-cutting directives that could directly impact contractors. For example:

- As a general matter, the Air Force and Army memos include an overarching directive to “[r]eview contracts for possible longer term cost savings.” These memos also direct Army and Air Force personnel to cancel any ongoing studies that are not Congressionally mandated or mission critical.
- In addition, Air Force and Army commands are directed to “[l]imit supply purchases to essential FY13 consumption” and to “stop minor purchases” that are not deemed “mission critical,” including purchases of unit equipment and information technology (IT) refresh. Where practical, Air Force activities are also instructed to “de-obligate/incrementally-fund contracts to encompass only FY13 (examples include but are not limited to base maintenance contracts, advisory and assistance services contracts, custodial contracts, etc.).”
- Under the Air Force’s guidance, commands are instructed to review their overseas contingency operations (OCO) requirements to identify potential reductions, “such as delaying asset reconstitution and incrementally funding OCO contracts.”

- Army commanders are further directed to implement “across the board efficiencies” and take other steps to reduce funding for base operations support (BOS) requirements by at least 30 percent. In addition, the Army guidance imposes limits on facilities sustainment activities that are not directly related to matters of “life, health or safety”; as well as maintenance and reset orders and contracts that do not directly support deployed units.
- In addition, the Army has imposed additional approval requirements for the award or modification of contracts in excess of \$500 million, while the Air Force has implemented a review process requiring acquisition personnel to monitor certain programs and, “as prudent, halt or delay contracts to reduce expenditures.”
- Finally, in light of the budget uncertainty created by the Continuing Resolution, the Navy has prohibited commands from initiating any FY13 new starts, multiyear procurements or contracts for increases over FY12 quantities.

In light of these directives and the dimming prospects of a deal to avoid sequestration, the pressure is clearly on for agencies to find ways to reduce contract costs—as the Army put it, “we must begin to slow spending now and plan for the worst.”

Planning for Contractual Impacts

There are a variety of different ways in which these efforts to “slow spending” could impact contractors. Some of the more obvious methods that agencies are likely to employ include declining to exercise options, not funding incrementally funded contracts, delaying contract awards, and de-obligating funding. As OMB's guidance warns, however, any efforts to achieve cost savings through existing contracts must be carried out “in a manner that is consistent with the applicable terms and conditions.” Therefore, contractors should take steps to preserve their contractual rights in connection with any cuts to their particular contracts.

For example, agencies may seek to achieve savings through **deductive changes** (*i.e.*, reducing contract scope), or through total or partial **terminations for convenience**, in which case the contractor should evaluate whether it is entitled to **re-price** any remaining work. Contractors in these circumstances should also take immediate actions to avoid incurring additional costs for descoped and terminated work (*e.g.*, issuing stop work orders to subcontractors), and document the impacts resulting from the termination or descoping (*e.g.*, setting up charge lines to address potential cost impacts).

The government may also look for cost savings by modifying existing contracts, in which case the contractor may be entitled to an **equitable adjustment** to compensate for any increased costs or time required to perform the modified work. Contractors faced with potential changes under commercial item contracts should be especially mindful of the unique terms and conditions that apply under those contracts, including the requirement that “changes” to commercial item contracts may be made only by mutual agreement of the parties.

Given the significant pressure on agencies to identify cost savings, it is also foreseeable that the government may advance contract interpretations that either increase or change contract work in ways that the contractor believes are inconsistent with the terms of the contract. Thus, contractors should be attuned to **constructive changes** driven by tighter purse strings.

With the pressures on agencies to reduce personnel through hiring freezes and other measures (including potential furloughs), contractors should also be watchful for potential government-caused **delays** and other potential **claims** resulting from any failure by the government to provide sufficient oversight, cooperation, or other required assistance. At the other end of the spectrum, contractors may find themselves having to defend against **government claims** or **default terminations** in circumstances where the agency might have previously been willing to enter into a “no cost” or standard termination for convenience or excuse performance that was less than stellar.

Finally, the government may also seek to **restructure contracts**, in lieu of terminating or cancelling completely, to achieve cost savings. While a restructuring in some cases might represent a “win-win” for both parties, restructuring contracts often includes the resolution or waiver of existing claims. Therefore, contractors faced with a restructuring should be attuned to any existing claims in which they may have to ensure that such claims are addressed or preserved.

In planning for these potential impacts, contractors may wish to **think proactively** and look for ways of assisting the government customers with managing tighter budgets. For example, if the government is willing to delay contract performance to save costs, the contractor can help identify areas where a schedule delay not only assists the agency, but also assists the contractor with its contract and cost performance. Similarly, if the agency is looking for ways to descope the contract, the contractor may be able to suggest work reductions that preserve the more profitable parts of the contract, while reducing the overall cost of the contract to the government. Contractors may also be willing to accept different or delayed payment in lieu of termination or descoping.

There is no doubt that sequestration brings uncertainty and would best be avoided. Contractors, like their government customers, should be planning ahead now on how to deal with the fallout of sequestration if it is not avoided this time.