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Government Contracts Update

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Implementation of Sequestration on Government Contracts

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Today, the President issued a Sequestration Order that requires federal agencies to make uniform percentage reductions in each separate item in their budgets. Under that Order, the agencies will be obliged to apply a mandatory percentage cut (effective reductions of 13% from national security programs and 9% from civilian programs) to each covered line item in their budgets, resulting by September 30 in equal reductions of roughly $42.7 billion each from Defense and civilian programs.

After the drama of the announcement, the first days of implementation of the sequester will be an anti-climax. The sequestration statute does not require the agencies to take any action on March 2, March 3, or March 4, etc.. Their only legal duty is that by September 30, they must have reduced the amount of FY 2013 budget authority they obligate by the required percentage amount. The agencies can delay as long as they want in making the cuts. But the longer they wait and the more slowly they phase in the spending reductions, the larger and more abrupt the cuts would have to be in the later months of the fiscal year.

There are only three basic things the agencies can do to reduce spending – cut their outputs (fewer grants to the states, less mail delivery); furlough their employees; and delay entering into new contracts and terminate or reduce the scope of existing contracts. Two of these categories will be the subject of extensive media coverage in the days following the Sequestration Order. The White House will roll out a carefully planned strategy to emphasize the adverse effects of sequestration on the delivery of vital government services. The media also will publicize the agencies giving their workers the required 30-day notice that furloughs will be imposed. This *Government Contracts Update* discusses the third category – the silent killer that will not receive as much media attention – how the agencies actually will cancel or reduce government contracts.

When Will the Effects of Sequestration Hit With Full Force?

Where possible, the agencies will try to defer imposition of important spending cuts until at least April, to give Congress and the President a final opportunity to reconcile their differences once they understand the public's reaction to the initial reductions in services. The more important date for implementation of the sequester may not be March 1, but March 27: the day the existing Continuing Regulation that funds all government agencies expires. This "must pass" legislation providing appropriations for the second half of FY 2013 would provide a logical vehicle for deferring the sequester or modifying the current indiscriminate, across-the-board nature of the cuts for each line item, by giving the President and the agency heads greater discretion in allocating the reductions to better preserve vital government services.

The Department of Defense has explicitly advocated that Congress use the Continuing Resolution to modify or abolish the sequester, and to provide it with discretion to transfer funds from accounts that are overfunded (investment accounts) to those that are underfunded (including critically those that support the training of troops to be deployed to battle zones). The steps Defense has announced to implement sequestration will not have their most significant impacts until April. They include:

- Slowing the obligation of FY 2013 funds, instituting a civilian hiring freeze, ordering layoffs of temporary and term employees, and cutting back on base operations and maintenance (the deferred deployment of the *Harry S. Truman* carrier group is the most visible example of this policy).
- Furloughs for virtually all civilian Defense employees of up to 22 days, or approximately one day per week, will begin "in late April" and continue through September. Thirty days before the furloughs begin, the agency will issue a formal notice informing employees of the possible furloughs.

Defense has given no indication as to when it might start taking significant contract actions to reduce obligations beyond the $4-5 billion available from furloughs. Since it is asking Congress to reform the sequester mechanism by March 27, Defense likely will take some initial steps to address inefficient agreements in March but will try to defer the major contract actions until April 1 or later.

Which Contracts Will Agencies Terminate or Reduce?

Within budget line items, the agencies will have enormous discretion as to which contracts to cut and by how much. To determine which contracts actually will be affected, the agencies have been conducting, and OMB has been overseeing, an extensive review of how each line item can be cut the required percentage while minimizing the adverse effect on the public interest of applying a rigid, unprioritized, across-the-board spending reduction. Defense alone is conducting 2,500 separate sequestration analyses for each of the 2,500 separate line items in its budget.

As part of the implementation process, the agencies have been conducting computer simulations to determine the adverse effects of various patterns of cuts. By a process of trial and error, they will determine which allocation will minimize the harm to the public interest. The agencies will continue to run such scenarios up to and past the date of the Sequestration Order.

The agency Contracting Officers will play a relatively small role in determining how the cuts will be allocated. At some point, the COs will be informed by higher-ranking officials how much they should reduce the portfolio of contracts they manage and how quickly they should act to generate the required savings. The COs then will choose the appropriate contract action to produce the necessary savings and inform the contractor of the agency's decision. By contrast, the agency policy officials in charge of the program that a contract supports – the actual agency clients – will be the ones who conduct the policy debate with headquarters officials (generally the Comptroller or another officer in charge of the budget) to advocate that their function should be spared or suffer only a relatively modest reduction, and that the cuts should be allocated elsewhere.

Through months of planning, the agencies have developed a broad policy sense as to how they will allocate the reductions and have cleared their analyses with the President through OMB. The agencies are now determining at a level of detail precisely how those reductions should be spread among individual functions that support the program to be cut, and then to the individual contracts that support each specific function. On February 27, OMB instructed agency heads on behalf of the President that their sequester plans "should identify any major contracts that they plan to cancel, re-scope or delay..."

> *As a general matter, agencies should only enter into new contracts or exercise their options when they support high-priority initiatives or where failure to do so would expose the government to significantly greater costs in the future. Agencies also may consider descoping or terminating for convenience contracts that are no longer affordable within the funds available for Fiscal Year 2013, should no other options exist to reduce contracting costs in these instances. Should such steps be necessary, agencies must evaluate the associated costs and benefits of such actions, and appropriately inform and negotiate with contractors.*

Defense is ahead of the other agencies in informing the public of the general steps it will take to implement the sequester. It will:

- Protect troops in combat and provide full readiness support for forces deploying or preparing to deploy (especially to Afghanistan), but will stretch out readiness support for units to be deployed later. Units with such lower priorities may experience reductions in equipment repairs, training exercises, and new purchases of equipment.
- Reduce training, base operating expenses, and facilities maintenance.
- Cut back on Air Force flying time, reduce Navy readiness and fleet operations, and both services will defer maintenance.

The civilian agencies also have developed similar broad action plans but have not yet announced them to the public at the same level of detail as Defense.

Even if it understands which functions are likely to be reduced, an individual company has little actionable information about whether its specific contract(s) will be cancelled, in whole or in part, or scaled back; whether the orders it receives in FY 2013 will be reduced toward the minimum level required by its agreement; or whether the agency may decide not to exercise an option as had been expected. Unless it takes proactive steps to engage its agency clients and its CO, a contractor may not know its fate until the CO notifies it of the agency's formal contract action(s).

What to Expect on March 2 and the Days Thereafter

Now that the Sequestration Order has been issued, the agencies will start implementing their expenditure reduction plans by reducing their level of services, furloughing staff, and reducing contract

expenditures. The mass media and the trade press will pay great attention to reductions in services (for example, closing air traffic control towers) and issuance of employee furlough notices. But there will be less coverage of which specific contracts the agency will cut, by how much, and on what schedule. That information will emerge slowly over time, as COs inform contractors on an individual basis as to how their contracts may be cancelled or modified.

This period of uncertainty may last for some time because, as noted above, (1) the agencies do not have to act immediately on March 2 and have an obligation only to make the required cuts by September 30; and (2) Defense (and perhaps other agencies) may have sequenced their reductions so that many of their contract actions will occur only after April 1, in the hope that Congress will eliminate or reduce the scope of their sequester obligations in adopting the Continuing Resolution for the second half of FY 2013. In the face of this uncertainty, a contractor that has not been told its fate must be proactive and push its agency client and its CO for as much information as possible concerning its position.

On February 27, OMB on behalf of the President authorized agency heads to communicate with government contractors "regarding elements of the agency's planning that have a direct impact" on them. OMB stated that the communications "should be as specific as possible in order to provide sufficient detail to be helpful to these stakeholders in understanding the implications" of the reduction in spending.

From a contractor's perspective, ***the most important defensive measure to be followed during the implementation of sequestration is to avoid the agency's unilaterally establishing the reduction in scope.*** If a contractor learns from the agency that its contract(s) may be eliminated or reduced, it should immediately develop its own proposed restructuring strategy and approach the agency CO on its own initiative to present these alternatives. In many cases, this will be the only way in which the contractor can play some role in deciding its fate.

To prepare for this eventuality, a contractor should conduct a vulnerability assessment of its portfolio of government contracts to determine which ones are funded from line items subject to sequestration. For these contracts, the company should:

- Determine how much of its portfolio has already been funded;
- Determine how its subcontracts or teaming agreements address the impact of less work in calculating the parties' workshare;
- Review existing contracts for potential cost growth or schedule slippage;
- Review performance assessments to identify and resolve problems quickly, because in the climate created by sequestration, a contractor cannot afford to take the blame for government-caused problems; and
- Ensure that relevant company employees know the terms of its primary contracts and subcontracts. They should be alert for potential scope creep and should understand the notice provisions and the clauses governing the requirements to continue performance.

It is particularly important that company officials who deal with the government know the difference between apparent authority and actual authority. In the constrained climate post-sequestration, clients at an agency may urge a contractor to modify some aspect of its performance or ask it to undertake some work on the promise that the obligational authority to fund the request will be forthcoming. It is very difficult to say "no" to a major customer, especially when that person has been able to deliver funding to support similar requests in the past. But post-sequester, that may no longer be possible, and the contractor could find itself in a position where it has undertaken work without authorization from the CO for the contract and is unable to obtain payment.

Contractors should alert the requisite employees of this risk and remind them of the importance of dealing only with officials who have actual authority. The contractor also should have a process in place under which any such requests from agency clients are referred to senior corporate officials so that they, and not the line client relations contact, can consider the risks and decide whether to proceed.

The difference between apparent authority and actual authority also will have special significance in a period of agency furloughs. In some situations, a contractor may need to receive permission to proceed from a specific agency official, but that person may be on furlough on the day the company calls to seek approval. The corporate officials who make such calls must understand that in the absence of that particular official, the company may not be authorized to proceed based on a statement by another person in that office who answers the call.

In addition, it is important that the contractor determine what clauses in its government contracts and its subcontracts will be relevant to issues arising from sequestration. One of the "implications" of

learning that a contract(s) may be adversely affected is that the contractor will have to turn around and perform the same type of analysis. It will need to determine whether its subcontracts should be de-scoped or terminated, based on an analysis of the legal rights of its subcontractors and consideration of what type of downstream contract action would make the best sense under the circumstances.

Finally, in the period before it receives formal notification from the CO about whether its contract(s) are on the chopping block, a contractor may face difficult questions about how to respond to employee questions about their status and whether to issue notices under the WARN Act or more liberal State counterpart legislation.

During the period of uncertainty before the contractor receives definite word on the status of its contract (s), the most important consideration in responding to employee questions is that the employer must be open and truthful about its best understanding, if any, of the steps an agency intends to take. The communications an employer makes to employees also must take into account the requirements of the WARN Act, state laws, and the provisions of collective bargaining agreements, if any, by which it is bound.

The WARN Act obligations are not always simple for contractors to understand. These difficulties rose to the upper reaches of the Administration prior to the Fall elections. To provide guidance to contractors — and to head off the issuance of large numbers of WARN Act notices prior to the election based on the possible, but not certain, risk that their contract(s) would be affected — the Administration issued a Memorandum on September 28, 2012 informing contractors that:

> *[I]f (1) sequestration occurs and an agency terminates or modifies a contract that necessitates that the contractor order a plant closing or a mass layoff of a type subject to WARN Act requirements; and (2) that contractor has followed a course of action consistent with DOL guidance, then any resulting employee compensation costs for WARN Act liability as determined by a court, as well as attorneys' fees and other litigation costs (irrespective of litigation outcome), would qualify as allowable costs and be covered by the contracting agency, if otherwise reasonable and allocable.*

This Guidance remains outstanding today and should provide some comfort to a contractor wrestling with the risks presented by various courses of action.

Conclusion

Over the next few months as the agencies implement their sequestration plans, government contractors may face a series of difficult questions about what the law requires and how they should respond to various communications from the contracting agency. The **Venable Government Contracts team** would be happy to assist you in thinking through the problems that you may face.