
Sequestration Is Here – Now What Happens to Government Contractors?

By Daniel S. Herzfeld

On March 1, 2013, President Obama ordered the implementation of across-the-board cuts – sequestration – primarily directed to military and domestic discretionary spending because the White House and congressional leaders could not agree to an alternative. The Balanced Budget and Emergency Deficit Control Act of 2011 requires this sequestration, which means that the executive branch must implement \$85 billion in cuts over the remaining months of Fiscal Year 2013. This alert provides background on the expected cuts and how the sequestration may affect contractors. Notably, the sequestration is separate from the continuing resolution funding the federal government that ends on March 27, 2013. If Congress does not act to fund discretionary spending for the remainder of Fiscal Year 2013, then the government will shut down. We have also prepared pointers for federal contractors in the event of a shutdown.

What Is Being Cut?

Half of the \$85 billion in cuts will come from defense programs and the other half will come from non-defense domestic discretionary programs. As the Office of Management and Budget (“OMB”) stated in its March 1, 2013 report to Congress, this will result in a 7.8 percent reduction in non-exempt defense discretionary funding, 5.0 percent reduction in non-exempt nondefense discretionary funding, 2.0 percent reduction to Medicare, 5.1 percent reduction to other non-exempt nondefense mandatory programs, and 7.9 percent reduction to non-exempt defense mandatory programs.

The March 1 OMB report includes an illustrative example of the approximate dollar amounts that will be cut from various budget accounts, with clear implications for government contractors. For example, the OMB report states, under the heading Department of Defense (“DOD”) “Procurement,” that DOD will need to reduce \$11.5 billion in various procurement categories such as Navy aircraft (\$1.6 billion), Air Force

aircraft (\$1.7 billion), and Navy shipbuilding (\$1.7 billion). The OMB report states that the sequester will require reductions of over \$1.5 billion in military construction (beyond the \$11.5 billion in reductions in general military procurement) and numerous cuts to other budget accounts that almost certainly include acquisition funds. Outside the cuts to DOD appropriations, there are significant cuts in other departments. For example, there is the much talked about cuts to air traffic controllers found in the \$629 million cut to the Federal Aviation Administration.

These cuts need to be made by the end of Fiscal Year 2013, and they will be implemented on a rolling basis over the next several months, not all at once. There has also been some indication that agencies may be awaiting passage of a new continuing resolution on or before March 27, 2013, in the hopes that the sequestration cuts will be restructured or eliminated as part of a political deal.

How Will Sequestration Affect Contractors?

Just before the sequester took effect on March 1, OMB issued broad guidance on how the sequester should be administered, including how agencies should approach acquisition. OMB stated that “agencies should ensure that any contract actions are both cost-effective and minimize negative impact on the agency’s mission to the extent practicable.”

New Contracts: OMB instructed that agencies “should only enter into new contracts or exercise options when they support high-priority initiatives or where failure to do so would expose the government to significantly greater costs in the future.” As a result, contractors may face longer lead times until award of contracts for procurements that an agency deems lower priority. Agencies may also cancel solicitations they previously issued, weighing that certain contract actions are not cost-effective during this time of austerity.

Ongoing Contracts: For contracts currently being performed, OMB stated: “Agencies may also consider de-scoping 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.” Agencies are to evaluate the “costs and benefits of such actions, and appropriately inform and negotiate with contractors.”

A Contractor should do its utmost to communicate with the contracting officer on each of its contracts to ascertain whether the agency intends to terminate part or all of a contractor’s contract (or associated task or delivery orders). The contractor should make its case against any proposed cuts, but be prepared to provide advice to the agency regarding restructuring work under the contract to minimize monetary impact to the contractor while maximizing delivery of goods and services to an agency. If a contracting officer takes action, here are several standard devices that it likely will use, some of which provide for contractor remedies:

- **Termination for Convenience:** If an agency partially or fully terminates a contract for convenience, offerors may be able to recover reasonable termination costs, including reasonable overhead and profit on completed work and a percentage of any fee earned, if applicable.
- **Changes:** Rather than terminating a contract for convenience, an agency may issue written change orders or constructively order changes “re-scoping” the contract. The agency may also attempt to direct performance of additional work without providing additional compensation. Follow the terms of a contract’s change order clause, which usually requires notification to the contracting officer within 30 days (although this time period can vary) seeking an equitable adjustment in price, delivery schedule, or

both. Courts and boards may waive this 30-day requirement, but contractors should generally attempt to notify a contracting officer of any such effects within the 30-day period to minimize roadblocks to receiving compensation for increased costs due to changes in work.

- **Stop-Work Orders/Delays:** The contracting officer may issue a stop-work order, but not terminate the contract. If such a stop-work order issues, the contractor should communicate in writing with the contracting officer to determine whether the contractor needs to stay on standby during the work stoppage. To the extent the government stops work or otherwise delays a contractor's performance, a contractor may be able to receive a schedule adjustment and, in some circumstances, receive compensation. Bear in mind that acquisition and other civilian employees are likely to be furloughed for at least some period of time (for example, some agencies intend to furlough employees one day per week), so it is possible government-caused delays can also occur because of other facets of sequestration.
- **Termination for Default:** Continue to perform and meet all material, contractual requirements despite the sequestration order. Agencies may be looking for reasons to eliminate underperforming contractors through default termination.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author.

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