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Client Alert

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An Update on Sequestration and Government Contractors

Overview. “Sequestration” refers to automatic federal spending cuts put in place by the Budget Control Act of 2011. The cuts go into effect January 2, 2013, unless Congress passes legislation to avoid that result. The spending reductions total \$1.2 trillion over the next nine years. This translates to about \$109 billion in cuts each fiscal year, divided between defense and non-defense programs. Sequestration, in addition to certain tax cuts scheduled to expire at the same time, are popularly called the “fiscal cliff.”

As January 2, 2013 approaches, federal government contractors, subcontractors, and grantees should pay attention to how the government may implement these cuts.

Recent Developments. On August 7, 2012, President Obama signed into law the Sequestration Transparency Act of 2012 (PL 112-155). The law required the President to submit a “detailed report” to Congress on the White House’s sequestration plans. The White House delivered its nearly 400 page report on September 14, 2012.

Despite its length, the [report](#) provides little concrete guidance, though it does identify raw dollar and percentage cuts for affected programs. Total defense spending for FY 2013 will be reduced by \$54.667 billion, with a similar reduction for non-defense functions. After identifying limited exemptions (including poverty-related programs on the non-defense side and military personnel on the defense side), this translates to a 9.4% reduction in all non-exempt defense programs, and a 10% cut to certain mandatory defense programs. On the non-defense side, cuts are set at 8.2% for non-exempt discretionary programs and 7.6% for certain mandatory programs.

Although the cuts would return defense spending to 2006 levels, it is the immediate nature of the cuts with no phase-in period, and the uncertainty as to which specific programs cuts will be applied, that creates the most concern for contractors, subcontractors and grantees.

The Act’s cuts become mandatory unless Congress reduces its spending (which would reduce the sequestered amounts) or amends the Budget Control Act. Congress adjourned on September 21, 2012, without addressing sequestration, and Congress will not reconvene until after the November 6 general election. There is no guarantee that Congress will act during the lame duck session. Analysts have discussed possible scenarios that include sequestration being: (1) averted by last minute Congressional action, (2) postponed by Congress for up to six months, (3) in effect briefly before Congress acts, or (4) in force for some time, despite its unpopularity.

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Possible Effects. How government contractors and grantees will be affected (including state contractors and grantees on projects funded by federal dollars) depends upon how each agency prioritizes its spending. Numerous interest groups have predicted various scenarios, ranging from fiscal doom to limited initial effects. Exercise caution when examining these predictions, as many parties may be disseminating predictions to pressure Congress to act.

As a practical matter, sequestration likely will affect new contracts and procurements, which may be reduced or cancelled to avoid incurring new obligations, and the renewal of existing contracts containing option years. Competition for a share of the reduced funding pool also is likely to increase. Contractors servicing areas deemed to be lower-priority could be hardest hit; other contractors may feel little effect.

Existing contracts also may be affected, but many contractors are operating under contracts funded through previous appropriations, so the immediate impact of sequestration may be limited. Contractors should confirm whether the sources of funding for their contracts will be affected.

Agencies may exercise their contractual authority to reduce costs, such as terminating contracts for convenience or renegotiating contract terms and quantities. Litigation over contracting issues may increase as a result of these efforts. Claims for equitable adjustment may arise (see, e.g., FAR 49.208), and contractors should be prepared to document and request an equitable adjustment in the event of a partial termination, and address flow-down clauses in subcontracts that may provide authority to not renew, or to terminate, a subcontract.

One additional issue that has gained attention is whether employers with 100 or more employees may be required to give [WARN Act](#) notices to employees possibly affected by sequestration. As of September 28, the Obama administration, affirming guidance previously provided by the Department of Labor, is advising that contractors should not provide WARN Act notices “because of uncertainty of whether sequestration will occur, and if it did, what effect it would have on particular contracts, among other factors.” It further advises that the contracting agency can reimburse contractors for any resulting WARN Act liability, including litigation costs. Some members of Congress have disputed this advice and urged employers to issue WARN notices on November 2 (60 days before sequestration would occur). Contractors subject to the WARN Act who may be affected by sequestration should contact counsel to review their obligations.

As the deadline approaches, contractors and grantees should watch for guidance from their client agencies as to their specific plans. Affected subcontractors should stay in contact with their contractors. Contractors and grantees should also prepare contingency plans to address the funding uncertainties caused by sequestration.