How Sequestration Will Impact Existing Gov't Contracts

Law360, New York (July 10, 2012, 1:33 PM ET) -- Pursuant to the Budget Control Act of 2011, an automatic budget-cutting process known as sequestration is scheduled to occur in January 2013.[1] While the political leaders seem to agree that this would be harmful on multiple fronts and should not be allowed to occur, no viable solution has yet been offered.

In keeping with the maxim of hoping for the best but planning for the worst, this article provides a brief overview the impacts that sequestration will have on existing contracts and contract actions, and key facts that contractors need to know about their contracts to be prepared should sequestration occur.

The impacts that sequestration will have on existing contracts and contract actions relating to nonexempt programs[2] turns on a few key factors, namely:

- the type of contract action in question;
- the fiscal year of the funds that have been used or will be used;
- whether any modifications are envisioned; and
- whether the contract is incrementally funded.

These are interrelated issues and will be addressed in the sections that follow.

Existing Fully Funded Contracts

The government is generally required to obligate the funding for the full costs of a contract at the time of contract award.[3] This is necessary to prevent violations of the Anti-Deficiency Act, 31 U.S.C. § 1341 et seq., as it ensures that the agency has sufficient funds to satisfy its obligations and does not incur liabilities in excess of its available funding.[4]

Because of this requirement, sequestration alone should have no direct impact on already awarded contracts for which the full funding has already been obligated and the contract is expected to stay within budget.[5] In this scenario, the necessary funding from FY 2012 (or earlier) has already been obligated and the cuts to FY 2013 funding should have no impact.

Existing Incrementally Funded Contracts

An incrementally funded contract is one for which the agency has special authority to obligate only the current year's costs at the time of contract award, with the subsequent years' costs obligated annually thereafter. These special authorities may be standing authorities for a particular type of contract (e.g., utilities contracts[6]) or project-specific (e.g., expensive construction projects[7]).

Sequestration could significantly impact incrementally funded contracts. Most directly, the funding cuts for FY 2013 and beyond may leave an agency with insufficient funding for the phases of the contract occurring in those fiscal years. The risk of future-year funding lapses could also pose risks to the continued performance of already executed, already paid-for phases of incrementally funded contracts for nonseverable services (e.g., construction).

Specifically, if the agency determines that it will be able to fund the future-year phases of an incrementally funded contract under its sequestration-level budgets, it may choose to terminate the contract for convenience now rather than continue performance on a contract that, either way, will be left incomplete.[8]

Because of these risks, it is important for a contractor performing to know what priority the agency attaches to its incrementally funded contract. While an agency may not apply one appropriation to expenses properly directed to another,[9] agencies do have discretion to prioritize expenses within a particular appropriation and will be required to do so should sequestration occur. The higher the priority that the agency attaches to the contract, the greater the chance that the next incrementally funded phase may survive sequestration.

Options Under Existing Contracts

Pursuant to 31 U.S.C. § 1502(a), time-limited funds may only be obligated for expenses incurred or contracts executed during the fund's period of availability. As a corollary to this statute, the bona fide needs rule provides that time-limited funds may only be obligated for goods or services that are necessary to satisfy a bona fide need arising during the funds' period of ability.[10] A contract option is considered a bona fide need of the fiscal year in which it is exercised, and thus must be financed with funds current for the fiscal year in which it is exercised.[11]

For contract options that are exercised before FY 2013, sequestration should have no direct impact on the execution and payment of that option. As discussed above, the necessary funding from FY 2012 (or earlier) will already have been obligated and the cuts to FY 2013 funding should not have a direct impact.

For contract options scheduled for exercise on or after Jan. 2, 2013 (the effective date for sequestration), sequestration will have a significant impact on the government's ability to exercise the option. Any such option would need to be financed with funds that are legally available for obligation in FY 2013, which may not be available because of the FY 2013 sequestration spending cuts. If a contractor were to continue performance in anticipation of an option that is ultimately not executed for this lack of funds, it would do so at its own risk and likely would not be compensated for this performance.[12]

For contract options scheduled for exercise between the start of FY 2013 and Jan. 1, 2013, the impact of the pending sequester is unclear. This largely owes to the fact that the Office of Management and Budget has not yet made public its decisions of how to address executive branch spending during this period. OMB distributes funds to agencies through a process known as apportionment. This process essentially tells the agency how much it has available to spend during a given time period, typically for the fiscal quarter.[13] By limiting the agency's spending ability, the apportionment process prevents agencies from depleting their funding early in the fiscal year and having to later seek deficiency or supplemental appropriations.[14]

While the FY 2013 appropriations acts have not yet been finalized, the funding levels set forth therein will certainly be higher than those that would be triggered under sequestration. The question is whether OMB's apportionment decisions for the first quarter of FY 2013 will be made with an eye toward the funding reductions that are scheduled to occur at the start of the second quarter of FY 2013. On one hand, OMB's past practice suggests that it will not consider the possibility of sequestration in making its first quarter FY 2013 apportionments.

For instance, in the April 2011 budget showdown, OMB did not issue its guidance on the threatened "Government shutdown" until the day before the shutdown was to occur.[15] The presumed rationale for this late issuance was it could be construed as an admission that the political parties could not reach a deal, which could in turn be perceived as a political defeat.

This same rationale would seem to apply here, as OMB likely will not follow an apportionment approach suggesting that sequestration is a fait accompli when three months and a lame-duck session of Congress remain in which to strike a deal. But on the other hand, OMB cannot simply turn a blind eye to the cuts that may be on the horizon — especially given the political parties' inability to reach a deal even for matters that they agree on, never mind a matter with such far-reaching budgetary and debt consequences as sequestration.[16]

Against this background, what steps may a contractor take to safeguard its interests with regard to contract options that are scheduled for exercise in FY 2013?

First, as discussed above, the contractor should attempt to learn from the agency what priority the agency attaches to these options. If the option is a high priority, then there is a greater chance that the option will be exercised even if sequestration occurs. And if the option is not a high priority, at least the contractor will have that knowledge and can begin positioning itself now for the possibility that the option may not be exercised.

Second, to the maximum extent possible, the contractor should push to have the option exercised in FY 2012 or the first quarter of FY 2013, as funding will still be available for these options at pre-sequestration levels. Note, however, that this solution may not be available for a significant swath of contracts; because of the bona fide needs rule, an agency generally[17] cannot exercise an option in FY 2012 (or the first quarter of FY 2013) if the need for that good or service will not mature until FY 2013 (or FY 2014). But to the extent that such early or moved-up exercise of options is permitted by law, it may be one means by which contractors can avoid — or at least postpone — the impacts of sequestration.

IDIQs and Task and Delivery Orders

The impact of sequestration on indefinite delivery, indefinite quantity ("IDIQ") contracts is governed by elements discussed in each of the above sections.

First, the guaranteed minimum under an IDIQ must be obligated at the time of contract award.[18] Thus, for already awarded IDIQs, the funding from FY 2012 (or earlier) has already been obligated for the guaranteed minimum and the cuts to FY 2013 funding should have no impact on the agency's ability to pay the guaranteed minimum.

Second, the task or delivery orders under an IDIQ are subject to the same general rules discussed above for options; that is, the obligations occur as the orders are placed and are chargeable to the fiscal year in which the orders are placed.[19] Sequestration should thus have no impact on the issuance and payment of task or delivery orders that are made before the end of FY 2012, and should have little to no impact on orders made before the effective date of sequestration in January 2013. This same rationale applies with regard to orders placed under similar forms of task or delivery order contracts, such as multiple award task order contracts.

Modifications to Existing Contracts

For contract modifications that result in price adjustments, the impact of sequestration turns on whether the modification is beyond or within the scope of the original contract and the timing of the modification.

"If the modification exceeds the scope of the original contract, for example, by increasing the quantity of items to be delivered, the modification amounts to a new obligation and is chargeable to funds current at the time the modification is made."[20] In addition to likely requiring a sole-source justification for such a modification, any out-of-scope modifications occurring in FY 2013 would need to be financed with funds that are legally available for obligation in FY 2013. But because of the FY 2013 sequestration spending cuts, agencies simply may not have the funds available to finance such a modification.

If the modification is within the scope of the original contract, the increased cost is deemed to "relate back" to the original contract obligation and must be paid from the same year of funds as were obligated for the original contract.[21] For instance, when a construction contract is modified solely to reflect the additional costs of differing site conditions, and not to change the project itself, it is generally viewed as an in-scope modification that should be financed with the same year of funds as were originally obligated for the contract.

Because in-scope modifications are financed with prior-year funds, whereas sequestration only effects future-year (i.e. FY 2013 and beyond) funds, sequestration should have little impact on an agency's ability to execute and fund in-scope modifications to existing contracts.[22]

Conclusions and Recommendations

As demonstrated above, there is no one-size-fits-all answer for whether and how a contractor may prepare itself for the potential impacts of sequestration. Each contract and contract action is unique, and contractors will need to examine their individual contracts and pending contract actions to determine whether and how they may be impacted by sequestration. In performing this evaluation, a contractor should seek to learn the following:

- whether the program to which its contracts relate has been deemed exempt from sequestration;
- the funding source and funding years for its current and anticipated contracts, options, and task or delivery orders;
- whether its contract are fully or incrementally funded;
- what priority the purchasing agency attaches to the contractor's current and anticipated contracts, options and task or delivery orders; and
- know what modifications are planned for existing contracts.

With these facts in hand, a contractor may be able to predict its contracting future and avoid — or at least postpone — the strains that may be posed by sequestration.

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[1] See generally U.S. House of Representatives, Committee on the Budget, Frequently Asked Questions About Sequestration Under the Budget Control Act of 2011 at 2 (Dec. 13, 2011).

[2] Certain categories of programs have been deemed exempt from sequestration by Congress. See GAO, Agency Operations: Agencies Must Continue to Comply with Fiscal Laws Despite the Possibility of Sequestration, at 7 n. 29 (Apr. 25, 2012) (“GAO 2012 Report”). These include Social Security Benefits, the Supplemental Nutrition Assistance Program, and all programs administered by the Department of Veterans Affairs. See id. & Letter from Steven D. Aitken, Deputy General Counsel, Office of Management and Budget, to Ms. Julia Matta, Assistant General Counsel for Appropriations and Budget, GAO, dated April 23, 2012.

[3] See OMB Circular A-11 § 31.6 (2011); see also DoD Financial Management Regulation, DOD 7000.14-R, Vol. 2A, Ch. 1 ¶ 010202.A (Oct. 2008) (“DoD FMR”).

[4] See OMB Circular A-11 § 31.6.

[5] That said, an agency could elect to terminate a fully funded contract for convenience.

[6] See GAO Redbook at 13-207 & 40 U.S.C. § 501(b)(1)(B).

[7] See, e.g., P.L. 111-383 § 2411, 124 Stat. 4137, 4450-51 (2011) (providing 12th funding phase for incrementally funded chemical weapons demilitarization facility).

[8] Admittedly, this is an unlikely course of action, as the Government is generally loathe to cancel already-begun, large-scale construction contracts for lack of funding and leave monuments to incompletion. And even when it does, the project is often completed in time. See, e.g., The Washington Monument, http://en.wikipedia.org/wiki/Washington_Monument#Construction.

[9] See GAO 2012 Report (providing that the Anti-Deficiency Act and Purpose Statute restrictions continue to apply during sequestration).

[10] See generally GAO Redbook at 5-11 et seq.

[11] See id. at 5-41.

[12] See FAR 32.704(a)(1)(iv)(C).

[13] OMB Circular A-11 § 120.1.

[14] Id. § 120.2.

[15] See Memorandum from Jacob J. Lew, Director, OMB, Subject: Planning for Agency Operations During a Lapse in Government Funding (Apr. 7, 2011).

[16] See, e.g., Ezra Klein, DREAMing of Bipartisanship, Wash. Post, June 18, 2012.

[17] As with most fiscal rules, there are limited exceptions. For instance, 10 U.S.C. § 2410a permits the U.S. Department of Defense to obligate funds for a severable services contract in one fiscal year even if contract performance will cross into the next fiscal year, so long as the total contract length does not exceed one calendar year.

[18] Interagency Agreements — Obligation of Funds Under an Indefinite Delivery, Indefinite Quantity Contract, B-308969, May 31, 2007.

[19] Id.

[20] GAO Redbook at 5-33.

[21] See id. at 5-35; see also DOD Financial Management Regulation, Vol. 3 Ch. 10 ¶ 100201.A. (providing that expired funds remain available after expiration to adjust or liquidate the original obligation).

[22] One important caveat is that this statement is contingent on Congress not also ordering a rescission of funds, whether through a new law in connection with sequestration or otherwise. A rescission is when Congress essentially “takes back” the unobligated balance of an account. If this were to occur, agencies would also have less prior-year funding at their disposal to fund in-scope modifications to existing contracts. That said, there is no indication.