



Sequestration:

Preparing for Unprecedented Cuts to Federal Spending

Angela Styles
Partner

Kris Meade
Partner

Mike Gill
Senior Policy Advisor

Steve McBrady
Counsel

Steve Rice
Associate

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Introduction

Angela Styles

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Angela Styles
202.624.2500
astyles@crowell.com

crowell  moring

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Introduction: Sequestration

- ❖ **Overview of Sequestration**
 - Requires federal government to cut \$1.2 trillion from the budget, beginning FY 2013 and continuing through FY 2021
 - Split equally between defense and non-defense programs, with a few exceptions

- ❖ **What does this mean for contractors?**

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Angela Styles
202.624.2500
astyles@crowell.com

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Introduction: Sequestration

- ❖ **Substantial cuts likely to mean:**
 - Reduction in agency personnel
 - Reduction in number of new contracts
 - Changes in administration of existing contracts
 - Changes in procurement vehicles
 - Increase in bid protest activity
 - Increase in claims activity
 - **Bottom line:** much more difficult business climate for federal government contractors on horizon

- ❖ **Although alternatives to sequestration are being discussed, contractors cannot afford to plan on Congress reaching a compromise before Jan. 1**

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Angela Styles
202.624.2500
astyles@crowell.com

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Budget Control Act of 2011

Mike Gill

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Mike Gill
202.508.8843
mgill@crowell.com

crowell  moring

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Sequestration - Budget Control Act of 2011

- ❖ **New sequestration process automatically cuts spending across-the-board**
- ❖ **Spending cuts apply to FY 2013 – FY 2021**

Process Entails 4 Steps

1. Discretionary spending limits for FYs 2013-2021 revised into security and non-security
2. Reduction amount calculated – equally divided between two categories: Defense and Nondefense
3. Amounts further divided between discretionary and direct within each category (excluding certain programs)
4. Reductions achieved through combination of sequestration and downward adjustment of revised discretionary limits

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Sequestration - What Gets Cut

- ❖ **Spending cut trigger - Cannot raise any taxes**
- ❖ **Won't Cut: Social Security, veterans' benefits, civilian and military retirement, and all low-income subsidies including Medicaid and the "welfare" programs (food stamps, SSI, etc.) are exempt. Net Interest payments would also be exempt.**
- ❖ **Revises Statutory Limits on Discretionary Spending**
 - (1) to redefine the security and nonsecurity categories; and
 - (2) to set annual limits for each of these categories through FY 2021Creates firewall to protect 50% Defense 50% NonDefense split
- ❖ **Will Cut: Defense, all discretionary spending, Medicare, farm subsidies, mandatory housing subsidies, and a few smaller mandatory spending programs**

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Mechanics of Sequestration

Required Goal: Must cut spending by \$1.2 trillion over nine years.

1. Subtract interest savings (18% of the total, or \$216 billion) = \$984 billion of spending cuts
2. Divide by nine, to allocate the spending reductions equally across the nine FY 2013 – FY 2021 = \$109 billion per year for each of FY 2013 – FY 2021
3. Divide by two, to allocate the spending reductions between defense and nondefense functions

Result: \$54 billion Defense / \$54 billion NonDefense

4. Categories are further divided proportionally between discretionary and nonexempt direct spending yielding four amounts of required spending reductions, respectively in:
 - (1) defense discretionary appropriations,
 - (2) defense direct spending,
 - (3) nondefense discretionary appropriations, and
 - (4) nondefense direct spending

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Sequestration - Agency flexibility?

Question: When facing cuts, can affected Departments and Agencies pick and choose amongst their programs?

Answer: No, the legislative language refers to accounts

Question: Can Congress?

Answer: Yes, through FY 2014-FY2021 Appropriations process

❖ **The required spending reductions are achieved each year (FY 2013-FY2021) through a combination of a sequestration process and the downward adjustment of the revised discretionary spending limits.**

- Specifically, the reductions required are implemented in three parts
 1. For discretionary spending for FY 2013, a sequestration of budgetary resources in that year;
 2. For discretionary spending for FY 2014-FY 2021, a downward adjustment of the revised discretionary spending limits; and
 3. For direct spending, a sequestration of budgetary resources in each year from FY 2013 through FY 2021

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Sequestration – What does this mean?

- ❖ **Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in new discretionary appropriations for defense programs**
- ❖ **Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in new discretionary appropriations for nondefense programs**
- ❖ **Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in mandatory budgetary resources for nonexempt defense programs**
- ❖ **Reductions of 2.0 percent each year in most Medicare spending because and reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in mandatory budgetary resources for other nonexempt nondefense programs and activities**

Source: CBO, Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act, September 12, 2011

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Mike Gill
202.508.8843
mgill@crowell.com

crowell  moring

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Impact on New / Existing Contracts

Steve Rice

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Steve Rice
202.624.2744
stephan.rice@crowell.com

crowell  moring

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Sequestration: Impact on New / Existing Contracts

❖ Impacts on new contracts

- Reduction in number of new contracts
 - Driven by cost and priority of need
 - Existing programs or long-planned projects not necessarily safe
- Changes in procurement vehicles
 - Lots of flexibility for the gov't and lots of restrictions for contractors
 - More IDIQs, Firm Fixed Price

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Steve Rice
202.624.2744
stephan.rice@crowell.com

crowell  moring

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Sequestration: Impact on New / Existing Contracts

❖ Impacts on Existing Contracts

- Existing Fully-Funded Contracts
 - Should be safe
- Existing Incrementally-Funded Contracts
 - Already-funded phases should be safe
 - Future-year phases at risk
- Options Under Existing Contracts
 - Once awarded, options should be safe
 - Options scheduled for award after Jan. 2, 2013 at risk

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Steve Rice
202.624.2744
stephan.rice@crowell.com

crowell  moring

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Sequestration: Impact on New / Existing Contracts

❖ Impacts on Existing Contracts

- IDIQs / Task and Delivery Order Contracts
 - Guaranteed minimum should be safe
 - Already-funded task/delivery orders should be safe
 - Orders scheduled for issuance after Jan. 2, 2013 at risk
- Modifications to Existing Contracts
 - In-scope changes should be safe regardless of when executed
 - Out-of-scope changes at risk

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Steve Rice
202.624.2744
stephan.rice@crowell.com

crowell  moring

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Sequestration: Impact on New / Existing Contracts

- ❖ **What to know about your contracts:**
 - Whether the contract relates to a program deemed exempt from sequestration
 - Whether it is fully-funded or incrementally-funded
 - What year and “color” of money does the agency use for your contract / options / task orders
 - When the agency plans to exercise options / issue task or delivery orders
 - What modifications are planned

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Steve Rice
202.624.2744
stephan.rice@crowell.com

crowell  moring

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Key Employment Law Considerations

Kris Meade

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Kris Meade
202.624.2854
kris.meade@crowell.com

crowell  moring

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Sequestration - Key Employment Law Considerations

- ❖ **Personnel reductions – inevitable?**
 - Mass layoffs
 - Furloughs
 - Reduced Hiring

- ❖ **Timing is Key Issue**

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Kris Meade
202.624.2854
kris.meade@crowell.com

crowell  moring

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Sequestration - WARN Act

- ❖ **“To Notify or Not to Notify” - WARN Act Considerations**
 - Federal WARN Act Requires Employers with 100 or more Employees to Give 60-Day Notice
 - Plant Closings – shut down resulting in employment loss for 50 or more employees
 - Mass Layoff - employment loss for 500 employees, or 50-499 employees if they make up 33% of workforce
 - “Single Site of Employment”

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Kris Meade
202.624.2854
kris.meade@crowell.com

crowell  moring

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Sequestration - WARN Act

- ❖ **State WARN Acts Impose More Onerous Requirements**
- ❖ **NY Example - Employers with 50 or More Employees to Give 90-Day Notice**
 - Plant Closings - resulting in employment loss for 25 or more employees
 - Mass Layoff - employment loss for 250 employees, or 33% of workforce and at least 25 employees

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Kris Meade
202.624.2854
kris.meade@crowell.com

crowell  moring

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Sequestration - WARN Act

- ❖ **“Unforeseeable Business Circumstances” Exception - Reduces 60-Day Notice Requirement**
 - *Loehrer v. McDonnell Douglas*: Navy’s cancellation of defense contract was “sudden, dramatic and unexpected” despite advance notice of potential cancellation
 - *Watson v. Michigan Industrial Holdings*: Customer’s cessation of payments and cancellation of contract was sudden and unexpected, and led to demise of employer’s business

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Kris Meade
202.624.2854
kris.meade@crowell.com

crowell  moring

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Sequestration - WARN Act

- ❖ **Is “Conditional Notice” the Answer?**
 - Federal/NY WARN Acts permit conditional notice
 - Notice conditional “upon the occurrence or non-occurrence of an event, such as renewal of a major contract”
 - Event must be “definite” and lead to mass layoff/plant closing as a consequence
 - *Poland v. CSC Applied Techs.* - conditional notice issued - contract with U.S. Postal Service may not be renewed and layoffs would ensue
 - Notice sufficient because it apprised employees of anticipated end of contract and potential job loss

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Sequestration - WARN Act

❖ Is Conditional Notice the Answer? (cont'd)

- *Loehrer v. McDonnell Douglas*: “it seems that an employer would in most situations be well-advised to undertake notification to fend off the prospect of liability”
- Benefit of Conditional Notice
 - Reduces potential WARN Act liability
- Disadvantages of Conditional Notice
 - Notice may be premature and unwarranted
 - Anxiety among employees could spur mass exodus and other operational difficulties

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Proposals to Delay or Avoid Sequestration

Steve McBrady

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Steve McBrady
202.624.2547
smcbrady@crowell.com

crowell  moring

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Sequestration: Proposals to Delay or Avoid

- ❖ **Congress belatedly grappling with potential impacts of sequestration**
 - Defense Secretary Leon Panetta has stated that sequestration would cause “catastrophic damage” to the U.S. military
 - According to the Bipartisan Policy Center, “full defense and non-defense sequester cuts for just next year could cost the economy more than 1 million jobs in 2013 and 2014” and reduce GDP by 0.5% in 2013
 - Sen. Levin (D-MI), Chairman of the Senate Armed Services Committee, stated that “80 to 90 percent” of Congress wants to prevent sequestration
- ❖ **The question is: what can / will Congress do?**

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Steve McBrady
202.624.2547
smcbrady@crowell.com

crowell  moring

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Sequestration: Proposals to Delay or Avoid

- ❖ **Sequestration not set in stone, yet**
 - Budget Control Act is a law, can be changed before January
 - Congressional action – to avoid
 - Under the Act, sufficient deficit reductions will offset sequestration
 - Under the Act, even *insufficient* deficit reductions will partially offset effects of sequestration
 - Congressional action – to delay
 - One-year delay of sequestration process
 - Other proposals under consideration

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Steve McBrady
202.624.2547
smcbrady@crowell.com

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Sequestration: Proposals to Delay or Avoid

- ❖ **Congressional action – timing**
 - August 1, acting OMB Director Jeffrey Zients to testify before House Armed Services Committee regarding implementation of defense cuts
 - August 15, Secretary Panetta will provide Congress with a detailed assessment of sequestration's impact on nat'l security
 - Significance of November 2 and November 6
 - Lame duck session prior to January 2013
 - Prospect of “last minute” fix

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Steve McBrady
202.624.2547
smcbrady@crowell.com

crowell  moring

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Questions?

- ❖ **Angela Styles**
astyles@crowell.com
- ❖ **Kris Meade**
kmeade@crowell.com
- ❖ **Steve McBrady**
smcbrady@crowell.com
- ❖ **Mike Gill**
mgill@crowell.com
- ❖ **Steve Rice**
stephan.rice@crowell.com

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