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U.S. Budget

Lessons Learned from Sequestration Phase I: Preparing for Government Contract Terminations



BY BRETT W. JOHNSON

On March 1, 2013, President Obama signed the order directing sequestration to go into effect. As has been repeated constantly leading up to sequestration, \$85 billion will now be cut from the federal government's budget through Oct. 1, 2013, when the fiscal year ends. Then, a new "sequestration" will take effect. Unless the federal government takes action to direct specific cuts to various programs, such sequestration will continue to occur until \$1.2 trillion is eliminated from the federal budget over the next 10 years. Based on the lessons learned concerning this first sequestration, many companies are evaluating different

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options and showing resilience in the face of uncertainty.

On March 4, 2013, many government contractors realized that sequestration was not going to be immediate. The majority of government agencies have started to release details on how they would begin to implement the required across-the-board cuts. The plans included furloughing government civilian employees, closing national parks, reducing military training and postponing expected future government awards. Although government contractors are encouraged to repeatedly contact contracting officers, contracting officer technical representatives and program managers about the status of existing and future contracts, a common response has been that everything will be impacted by budget cuts—whether due to sequestration or future negotiations—and government contractors, at every level, should begin preparing.

Therefore, the scope and impact of budget cuts is still not fully appreciated. Even local companies that only work on state, county, or city projects will be impacted, because many localized government contracts rely on federal government grants or contract awards to fund certain projects. The local government may only be administering what is in reality a federal government program or mandate. There has always been criticism at the local level in regard to unfunded mandates—i.e., federal statutory requirements for a variety of activities for which there is no attached federal funding. The local authorities should expect more unfunded mandates. As a result, local companies and non-profit organizations that provide services or goods related to such mandates should be concerned about reduced funding.

Although local governments will suffer cutbacks, federal government contractors may want to consider seeking contract opportunities with local government agencies. With balanced budget mandates in many places, local agencies are buffered slightly by the federal government cutbacks. As a result, local governments will continue to fund programs that were originally administered by the federal government but then

cut. The only way to understand the cuts and possible shift to local funding is to have candid conversations with the contracting officers and program managers.

In addition to bidding on local government contracts, there may also be local and federal government programs to assist during any cutback or transition. The local city and county economic development departments may provide assistance. If a company is a small business concern, then the Small Business Administration may also be of assistance.

Foreign Markets. Companies may also look to new nongovernmental commercial markets or foreign governments to maintain their commercial standing and competitive advantage. However, many foreign governments' contracting regulations are just as or even more onerous than the U.S. procurement laws. For example, many foreign governments require that the U.S. company "offset" any sale to the foreign government by making significant purchases in the foreign country's domestic market. These offsets sometimes lead to a confusing matrix of deals between multiple companies to ensure compliance.

In addition to complying with the foreign government contract regulations, the U.S. government contractor must still abide by the U.S. laws, including, at times, confusing international trade laws, such as the Foreign Corrupt Practices Act, the Export Administration Regulations, and the International Traffic in Arms Regulations, to name a few. This is currently a significant area of enforcement by U.S. governmental agencies. Companies should ensure that their policies and procedures, international agreements, and training meet these requirements.

Partnerships and Acquisitions. Whether entering the local government contract market or looking for foreign opportunities, many companies may consider seeking joint ventures or other strategic partnerships with companies that are already in those markets. However, such strategic partnerships may impact a company's small business concern status or have other unintended consequences that could actually reduce opportunities. Although desperate times sometimes call for desperate measures, companies should take due diligence screening of any potential partner very seriously.

Instead of entering into a partnership, companies may take the opportunity surrounding the uncertainty to acquire competitors, lower-tiered subcontractors, or companies that are already established in the local government, foreign government or commercial markets. However, just as in the case of a joint venture partnership, due diligence on any acquisition or merger should

be intense. Both sides of any deal, regardless of how friendly the transaction is, should fully understand the due diligence requirements and ensure that the pricing of any deal is correct and that the necessary representations and certifications are made.

Dealing With Terminations. Companies may choose to stop bidding on government contracts or may attempt to plan for the gradual elimination (or termination) of existing government contracts. The government contractor that is prepared for a possible "stop work" order will be well-positioned to negotiate an orderly exit. As many governmental agencies (at all levels) have not fully explained to their prime contractors the consequences of the existing sequester and the future budget cuts, the importance of candid conversation with government contracting officers about existing contracts and future solicitations cannot be understated. Subcontractors need to have the same candid conversations with the prime contractors about the same issues. Unless there are frank conversations amongst all parties, the ability to manage the budget cuts may be hindered and/or difficult.

If a government contract is terminated, a company should properly respond and ensure that it is complying with the various contractual terms and government regulations in winding down the contract. These terms and regulations, especially regarding the accounting requirements, are onerous. Moreover, companies should ensure that they are maximizing any equitable adjustments or other compensation through properly filed claims, while being considerate of not violating the False Claims Act. As companies are likely going to terminate employees, "whistleblowers" who want to take advantage of the FCA may become the norm. Companies should take any "threat" of a possible FCA violation seriously and may want to initiate an internal investigation. If appropriate, and even if the claim does not have merit, the company also may want to consider a possible voluntary self-disclosure to the government before a whistleblower has an opportunity to report to ensure mitigation of any risk.

The bottom line is that planning is critical to the viability of companies. Such planning cannot occur without gathering as much information on existing and future government contracting opportunities as possible. A company should not simply evaluate the benefit of expending resources on future government contracting opportunities that do not exist. Rather, a company may be better served by expending resources on a strategic process to transit to new (and maybe old) opportunities.