Management Alert

Fiscal Cliff Special Alert: Sequestration Begins

While it may not be the end of days, it is the end of days leading up to sequestration. Today, March 1, after meeting with Congressional leaders, President Obama will sign an order directing federal agencies to implement $85 billion in cuts. Those cuts are to be made between now and September 30 (the end of this fiscal year), although the Congressional Budget Office has projected that "only" about $42 billion in federal cash outlays will decline over this period because many federal contracts are scheduled to end months or years down the road. Nonetheless, if no budget agreement has been reached by October 1, a second set of sequester cuts will begin automatically. All told, the cuts must total $1.2 trillion over ten years. Even in a large (and somewhat growing) economy, that is a deep gash.

What does this mean for private sector employers? With defense costs constituting 19 percent of discretionary spending, defense will have to absorb half of overall cuts. Consequently, defense contractors and the economies they help support (*e.g.*, Maryland, Virginia, Alabama, and South Carolina) will likely be hit hardest. Some contractors have already received written notice that their contracts, or particular projects pursuant to those contracts, are at risk if sequestration occurs and if cuts proceed as planned. (The latter remains a major "if", because OMB and the individual agencies have discretion in how they apportion, schedule, and account for the cuts.) Others have received at least informal written assurance that particular projects are *not* at risk; that might change, however, depending on how defense agencies ultimately allocate cuts. Many defense contractors, like most contractors generally, have heard only conflicting rumors or radio silence.

One vexing legal unknown is whether sequestration triggers the 60-day layoff notice period required under the WARN Act. *See*, Seyfarth Shaw LLP -- Management Alert, *"Fiscal Cliff No. 1: WARNing, WARNing"* (12/5/12). One might have expected guidance from the Department of Labor on this subject, given that DOL issued guidance last summer saying no notice was required back then, because sequestration cuts – then scheduled to commence January 2 – were still an "unforeseeable business circumstance" (an employer defense under WARN). Since then, however, the Department has been mostly reticent about what employers should do to comply with WARN. Instead, DOL has decried the effects of sequestration on non-employer stakeholders, such as AFSCME-represented federal employees and mineworkers now purportedly at risk *of death* due to OSHA's prospective lack of inspection funds. Much of the above is doubtless driven by the Administration's recent and ongoing message: sequestration cuts will hurt, and will hurt badly.

Having agreed to revenue hikes last January, including increases in the payroll tax and the top income tax bracket, Republicans are standing firm on their counterpoint: that further budget savings must come from alternative spending cuts, not from additional revenue. Some on both sides of the aisle hope for a "grand bargain" addressing loopholes in the tax code, plus constraints on Medicare and Social Security – the bulk of non-discretionary federal spending. Given renewed partisan rancor, however, it is hard to imagine our nation's leaders joining hands and finding a path out of this collective national fiasco. At least not in the near-term.

Unfortunately, the near-term matters. The continuing resolution that funds our federal government is set to expire March 27. Should Congress and the White House remain at impasse, then a full federal shutdown would be triggered. Even most of those who believe "government is the problem" do not want that, especially not if they hope to be re-elected. Given the recent inaction in Washington, however (apart from partisan posturing), most bets on reasonable, responsible compromise are off.

As sequestration cuts kick in, and if business loses confidence in the government's ability to manage its own finances, the effects of sequestration could well stall the nation's sputtering economic recovery. Then, private employers beyond federal contractors could be forced to take drastic measures. Many have already held hiring in abeyance, waiting to see whether sequestration would come to pass. Now, like the federal agencies themselves, some private employers are again contemplating (or planning) furloughs, pay freezes, and the like. Should layoffs spread beyond the defense industry, 2013 could start to look like 2009. Some think it does already. Stay tuned.

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