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WHITE PAPER: THE IMPLICATIONS AND CONSEQUENCES OF A DEBT CEILING IMPASSE FOR CONTRACTORS

INTRODUCTION

As time goes on, the likelihood that a debt ceiling impasse will occur appears to be increasing – especially with both houses of Congress behind two distinct bills (which have not even had an up or down vote yet). While the Treasury was able to stave off the United States hitting the debt ceiling thus far, the buck will literally stop on August 2, 2011 when the United States Government will no longer be able to meet all of its obligations. Of course, as with every budgetary fight including the potential government shutdowns this past spring, government contractors (and federal employees) find themselves in the middle with little ability to influence the outcome. Events are constantly changing, so we recommend attending our audio seminar on Thursday July, 28, 2011 and visiting Centre’s special Debt Ceiling web information portal located at www.debtceilingwatch.com for the latest information.

At Centre, we have been receiving a voluminous number of inquiries seeking general guidance about the debt ceiling impasse. While our attorneys can only give you legal advice after speaking with you about your specific situation, we are releasing this White Paper to provide a general understanding as to what happens in the event the Government fails to raise the debt ceiling. Of course, after reading this, please feel free to contact us (our contact information is at the end) for further information about this or any other issues you may have. It is important to note that this is an unprecedented situation and any guidance is subject to change based upon fast moving news events.

Initially, we cannot emphasize enough the importance of being in contact with your Contracting Officer (“CO”) as the chance of a debt ceiling impasse becomes more real. Hopefully your CO can provide you guidance as to whether your contract would be affected and if it is, what

actions you should take – such as the proper protocol for winding down and receiving reimbursements for doing so.

WHAT CAUSED THE CURRENT SITUATION?

In short, Congress sets a ceiling on the Government's borrowing and any authority to exceed that ceiling must be authorized by Congress.¹ Since 1962, Congress has raised the debt ceiling 74 times (or an average of 1.5 times per year). While in past administrations, raising the debt ceiling has been a fairly routine event, Republicans in the House of Representatives (the "House") have drawn a line in the sand citing an ever increasing Government debt.² We do note (and it is important to keep in mind) that Congress has already authorized all funds for FY 2011. The debt ceiling vote is purely a mechanism to allow the Government to borrow sufficient amounts of money to expend funds already authorized by Congress.

The Congressional Research Service provides a succinct history of the debt ceiling:

The statutory limit on federal debt began with the Second Liberty Bond Act of 1917, which helped finance the United States' entry into World War I. By allowing the Treasury to issue long-term Liberty Bonds in addition to more commonly used short-term debt instruments, the federal government held down its interest costs.

Not coincidentally, since around that time, United States bonds debt has received an AAA (or equivalent) rating. Many economists argue that an AAA rating is necessary to keep interest rates for citizens and corporations low. If it is more expensive for the United States to borrow money, like a rising tide, the cost of credit for others rises higher.

In recent history (to the present day), votes to raise the debt ceiling were usually tied to whether the congressperson's party held the Presidency. For instance, in each of five recorded votes by the House during George W. Bush's administration, about 200 House Republicans voted to raise the debt ceiling. For each of President Obama's three previous requests, no House Republicans voted to raise the debt ceiling. Similarly, then-Senator Obama voted against raising the debt ceiling in 2006 during the Bush administration. President Obama has publicly stated that he regrets that vote.

Whether tied to an ideology to shrink the size of the Government, a genuine concern over this nation's debt, or both, a sector of House Republicans have consistently attempted to limit federal spending since taking office earlier this year. This, along with a Democratic President and a Democratically-controlled Senate has produced stalemates that have only been averted at the last minute. For instance, on April 8, 2011, the Government narrowly averted a shutdown after all sides failed to agree on spending measures for FY 2011. This ideological (or political) struggle has manifested itself on numerous occasions; mostly recently with Congress failing to agree on a bill to fund the FAA. Unfortunately, it will likely continue to manifest itself until the 2012 elections. In

¹ Some Constitutional scholars are of the opinion that the President has unilateral authority to essentially raise the debt ceiling by borrowing additional money to meet current debt servicing needs.

² This White Paper does not address the veracity of either party's claims regarding the debt and deficit and only examines the current political situation to give contractors an exhaustive background.

fact, just yesterday, news reports had House Minority Whip Steny Hoyer (D-MD) predicting that we will face another fierce budget battle this fall that will likely come down to the wire.

While a debt ceiling impasse can have similar consequences for some contractors as the potential government shutdown, it is important to take note of the differences.

HOW IS THIS DIFFERENT THAN THE POTENTIAL GOVERNMENT SHUTDOWN?

In answering this question, there is good news and bad news (which will be explored in greater detail below). The good news is that all FY2011 expenditures have been authorized. Thus, work should (with some noted exceptions) be able to continue as normal. The bad news is that prime (and maybe sub) contractors may not get paid on time. On a more macro level, further bad news is found in the overall damage to the economy that a debt ceiling impasse will cause and the added expense for contractors to finance debt at a time when they may need to rely on additional debt due to the Government's failure to pay its bills to them on time. Many argue that a debt ceiling crisis will have much more far ranging consequences than a Government shutdown because, for instance, the credit rating agencies may downgrade the Government's debt to AA from AAA which could have disastrous effects on the economy for decades to come.

Like the budget fights earlier this year, all of this has created a sea of uncertainty for contractors. Without knowing how/when/if there will be appropriations or when/if they will be paid, contractors have even more difficulty creating long-range strategic plans (which are inherently difficult to start with). To help grasp the possible avenues we could travel down over the next few days or months, this White Paper runs through the most likely scenarios as they exist today after which we will offer some general advice.

1. **The debt ceiling is raised (with attendant spending cuts) for a period of time through the 2012 Presidential election.** For planning purposes, this is the most attractive option (and is currently being pushed in a proposal by Senate Majority Leader Harry Reid). We do caution, however, that this does not mean there will not be a budget fight this fall.
2. **The debt ceiling is raised (with attendant spending cuts) for a period of time short of the 2012 Presidential election.** Such a bill (if signed by President Obama) will set up a similar fight between now and the 2012 election. A bill containing this framework is being pushed by Speaker of the House John Boehner.
3. **The debt ceiling is not raised.** This is the scenario few would like to see. Should this scenario come to fruition, the Government would prioritize payments to take care of the debt first. After that, payments would be made based upon political or governmental necessity. It is likely that, depending on the program, the Government will prioritize payments to contractors below other payments (such as those to active duty military and social security recipients).³ *The Washington Post* has a helpful

³ This could lead to a rash of litigation against the Government (which would not have a defense) for its failure to pay monies owed. In certain situations (under the "squeaky wheel gets oiled" frame of mind), this may be the best option if a contractor requires those funds to continue operations.

interactive chart that illustrates this situation: <http://www.washingtonpost.com/wp-srv/special/politics/federal-debt-limit-you-choose-who-gets-paid/?hpid=z2>.

4. **There will be a short-term debt ceiling raise.** This seems increasingly likely as all parties have yet to come to agreement. Such an agreement will have the effect of putting off this dispute for 10-30 days when it will once again likely come down to a last minute deal. This, of course, ignores the possibility that a short term deal could result in a bond downgrade.

Some other less talked about consequences of a failure to raise the debt ceiling that could directly impact contractors includes the following:

- *First*, Government workers could be furloughed making performance of certain contracts impossible. Should your contract require performance on a government site or review by a government employee at specific times, you may be forced to stop performing.
- *Second*, to the extent work supports furloughed employees, the contract may be terminated for convenience.
- *Third*, while prime contractors may not be paid, subcontractors may still have to be paid depending on the language of the parties' contract.
- *Fourth*, the Government may partially shutdown (though this does not necessarily portend a pause in performance of existing contracts since FY2011 funds have already been authorized – unlike with the potential Government shutdown this past spring).
- *Fifth*, certain agencies may issue wholesale terminations of contracts for convenience or stop work orders to prevent late payment penalties or lawsuits.
- *Sixth*, the procurement system could face constraints or a shutdown if GAO or federal court employees are furloughed. This would not allow a contractor to ignore statutes of limitation (which is the deadline to file a case).

All contractors should be aware of the Prompt Payment Act (PPA) if they are not already. The PPA provides a statutory interest rate for all late payments to contractors. This interest rate is established twice annually and now sits at 2.5% (though it is compounded monthly for the first year). It is entirely possible that contractors will be required to continue to work even if they have no hope of receiving payment in the near future (though an argument can be made that a contractor who *knows* they will not be paid is required to stop work to avoid being categorized as a knowing volunteer in violation of federal law).

WHAT KINDS OF CONTRACTS ARE AFFECTED BY THE DEBT CEILING CRISIS?⁴

In theory, no contracts should be affected by the debt ceiling impasse because all FY2011 appropriations have been approved. This is in stark contrast to the potential government shutdown where because there were no appropriations, work would not be permitted to continue for certain contracts by law. The reality is, however, some contracts can be affected on the front end (without even getting to payment issues) because of the unique circumstances presented by the debt ceiling impasse.

The most obvious contracts affected are ones that require input from Government employees or where performance takes place at Government sites. If the Government hits the debt ceiling, it will be forced to prioritize payments. First on the list will naturally be payments to service current debt and if possible, to purchase new debt. What comes next is anyone's guess, but there is no doubt that some Government employees will be furloughed and Government sites closed.

In addition, dozens of agencies are already taking measures to batten down the hatches in the face of decreased funding. This may lead to stop work orders or terminations for convenience of your contract.

No matter what, the question to ask is: Do I need the Government to keep performing?

If the answer is yes, it is important to do a number of things immediately, including:

1. Take an inventory of your contracts and contact your CO – do not wait for the Government to contact you. Your CO will probably be overwhelmed with inquiries and will probably not seek you out;
2. Document all wind-down, start-up and maintenance costs; and
3. Create separate billing categories in conjunction with your accounting department for wind-down, wind-up and contingency costs.

The above are general rules to which there are always exceptions. Of course, you can contact us and we can look at your contract and provide further guidance.

HOW WORK STOPS

Once again, if a debt ceiling impasse occurs, everyone will be in uncharted waters. It is much less complicated for the Government to shut itself down (after priorities are specified) than shutting down contractor work with all the legal, regulatory, and cost implications involved.

The cleanest and easiest way for a CO to stop work would be to issue a stop work order pursuant to FAR §52.242-15. However, the more likely scenario would be that instead of individual

⁴ The information provided herein is not legal advice and should not be construed and/or relied on as such. Moreover, each situation is different. For each of the general rules outlined here, there are exceptions. Should you wish for a legal opinion, we advise you to contact us or another attorney with expertise regarding this area who can review your underlying contract and particular situation and guide you.

stop work orders, broad guidance would be issued for all contractors to follow. Of course, if it is not specific enough, such guidance can easily raise more questions than answers.

The CO has a wide range of discretion and by contacting her or him ahead of time, contractors can possibly work out a plan prior to debt ceiling impasse.

Moreover, it is important for contractors to do the following while shutting down: (1) mitigate any damages/losses/expenses; (2) document every cost or expense; and (3) account for and document everything that is done. By following these steps, contractors will have a greater chance of recovering the costs associated with shutting down should they be required to do so. In effect, the debt ceiling impasse would create a partial government shutdown.

Further, it is also important for contractors to know where their employees are working. The Government shutdown would be worldwide, so for contractors overseas, determinations have to be made with what to do with overseas employees to mitigate costs. In some instances it may make monetary sense to keep those employees overseas for a short period of time instead of bringing them home on the next available flight without regard to expense.

RAMIFICATIONS FOR PRIME CONTRACTORS AND SUBCONTRACTORS

If nothing else, there is a good chance a debt ceiling impasse will prevent prime contractors from being paid on time. If there is no subcontractor relationship, then the prime should ensure it has hoarded enough cash to continue performing.

For prime contractors with subcontractors, they should also: (i) examine their subcontracts to see if payment to the subcontractor is triggered by payment from the Government or by performance; and (ii) see if the subcontractor can get through a period of time without payment from the Government. Each of these circumstances is rife with legal issues.

For subcontractors, it is important to also examine your subcontract to see when payment from a prime contractor would be triggered and examine your cash reserves to see how your company would be affected by non-payment.

These issues will be discussed in greater detail in Centre's audio seminar.

RAMIFICATIONS FOR EMPLOYEES AND EMPLOYERS

Should contracts be put on hold, contractors have the following additional options:

1. Reassign employees to other contracts/projects that are still ongoing;
2. Ask employees to take outstanding vacation/leave time;
3. Require employees to take overdue or needed training; and
4. As a last resort, furlough affected employees.

Each situation will, of course, be different depending on each contractor's business situation and the best guess on how long a debt ceiling impasse will last. Further, it is important to keep local,

state, and federal laws as well as employment contracts in mind when deciding what actions to take with your employees.

Some additional considerations for employers will be whether other operations supported by the affected contracts will be able to continue, such as bid and proposal costs or general office overhead and operations and if not – at what cost?

WHAT IS RECOVERABLE?

All is not lost – expenses incurred because of a debt ceiling impasse would probably be recoverable. Normal winding down expenses such as unabsorbed overhead, material cost, employee costs (including costs of extending employment contracts) can be recovered. However, back pay and consequential damages will not be recoverable.

There may be some flexibility in obtaining shutdown or startup costs using equitable adjustments or ratification of intervening contractual activities.

SOME SPECIFIC ISSUES

IT/Internet contracts pose a specific problem. For instance, if a government agency hosts a website that has some unaffected services and some affected services, is the website still hosted or does it go offline if it can not be separated out?

Also, some subcontractors working on multiple programs must ensure they continue working on the correct contracts, and prime contractors need to ensure the proper flow-down clauses are included in subcontracts.

It is important to note that court/protest deadlines are likely to be unaffected although it is unknown at this time what happens to a protest if there is no one there to receive it.

CONCLUSION

The possible debt ceiling impasse has raised a lot of unresolved issues. Like with the potential government shutdown, there is no bright line rule (each case is different) and no provision of the FAR that deals with this.

If you are a contractor, it is important to:

- Take an inventory of your current contracts;
- Contact your CO to get an understanding if and how your contract will be affected. If the CO does not know or is unwilling to help, push your request up the chain of command;
- Stay in constant communication with all parties;
- Document everything you do and save all evidence of payments;
- Account for everything you do in winding down and starting up;
- Mitigate your costs whenever possible; and

- Seek recovery of your expenses as soon as possible.

What happens to each particular contract depends on the place of performance, whether the Government is necessary for contract performance, and the agency's funding situation. If you are still unsure what to do, we invite you to contact us for further information.

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ABOUT THE AUTHOR



Eric, a Senior Attorney at Centre Law Group, has extensive experience in developing strategies for and managing all stages of complex multi-million dollar complex commercial, intellectual property, and government contracts matters in various state and federal courts from commencement through trial. In addition, Eric successfully briefed and argued appeals in the federal Second Circuit Court of Appeals and New York appellate courts.

Eric, who has been a trusted legal advisor to many businesses throughout his career, has also lectured on intellectual property issues in federal procurement and recently received a multi-million dollar verdict on behalf of a sub-contractor (which was in a dispute with a prime contractor) after trial that was reported as one of the largest verdicts in Virginia in 2010.

Eric has also spoke at the National Contract Management Association's annual conference in Denver, Colorado this July.