

# BRIEFING PAPERS<sup>®</sup> SECOND SERIES



PRACTICAL TIGHT-KNIT BRIEFINGS INCLUDING ACTION GUIDELINES ON GOVERNMENT CONTRACT TOPICS

## MAXIMIZING TERMINATION FOR CONVENIENCE SETTLEMENTS/EDITION II—PART I

By Paul J. Seidman and David J. Seidman

The “Termination for Convenience of the Government” clause in a Government contract conveys broad rights on the Government to terminate the contract when termination is in the Government’s interest. The Government may cancel the contract simply because its needs change and regardless of contractor fault.<sup>1</sup> In return for this privilege, the Government agrees to pay the terminated contractor its incurred costs and certain continuing costs in a traditional Government contract. Alternatively, in a contract for commercial items or services under Federal Acquisition Regulation Part 12, the Government agrees to pay the terminated contractor the percentage of contract price reflecting the percentage of completion and charges resulting from the termination.<sup>2</sup>

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All too often, contractors do not know what costs they are entitled to recover following a convenience termination. Contractors may even resort to asking Government personnel for advice. Government personnel, however, are not always knowledgeable, and, more importantly, a contractor request for advice places them in an obvious conflict-of-interest position. Their job is to dispose of termination for convenience claims for as little money as possible rather than to maximize contractor recovery. As a result, contractors often do not claim all their allowable costs in termination settlement proposals and may

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accept improper disallowances of their claimed costs by Contracting Officers and Government auditors. In addition, contractors may accept less than what they are entitled to receive because of a desire not to offend the customer or a need for immediate cash.

This Edition II BRIEFING PAPER is the first of two PAPERS that update and expand BRIEFING PAPERS No. 95-5, *Maximizing Termination Settlements*, which focused on fixed-priced contracts.<sup>3</sup> These BRIEFING PAPERS provide new strategies and cover new topics such as cost-type contracts, indefinite-delivery/indefinite-quantity contracts, FAR Part 12 commercial item contracts, and avoiding the “Termination for Convenience” clause prohibition on the recovery of anticipatory profits.

Specifically, this Part I provides a background discussion of the purpose and effect of the “Termination for Convenience” clause and a review of the standard “Termination for Convenience” clauses for various types of contracts, compares the cost-based formula used for traditional Government contracts with the modified price-based formula used in FAR Part 12 commercial item contracts, summarizes pertinent cost principles, and presents general strategies for maximizing recovery. Part II, to be published later, addresses how to recover specific costs following a termination for convenience and provides strategies for specific contract types such as indefinite-delivery/indefinite-quantity, cost-type, and FAR Part 12 commercial item contracts.

These two BRIEFING PAPERS focus on *what* costs to claim. They are companions to BRIEFING PAPERS No. 97-11, *Preparing Termination for Convenience Settlement Proposals for Fixed-Priced Contracts*, an earlier

PAPER by one of the authors, which focused on *how* to claim costs by putting together an effective termination for convenience settlement proposal.<sup>4</sup>

## Background

### ■ Purpose & Effect Of “Termination For Convenience” Clause

A termination for convenience is “the exercise of the Government’s right to completely or partially terminate performance of work under a contract when it is in the Government’s interest.”<sup>5</sup> The purpose of the “Termination for Convenience” clause in a Government contract is to permit the Government to exercise this right to cancel the contract without incurring liability for anticipatory profit.<sup>6</sup> Anticipatory profit is the profit a contractor would have earned on the cancelled work. Under private sector law, a seller’s damages for cancellation include anticipatory profit,<sup>7</sup> but this is not the case when the Government terminates a contract for convenience. The “Termination for Convenience” clause limits the contractor’s recovery of profit to “profit on work done.”<sup>8</sup>

### ■ Standard Clauses

A “Termination for Convenience” clause is required in all Government contracts. There are different “Termination for Convenience” clauses for different contract types.<sup>9</sup>

“Termination for convenience” clauses for *traditional Government contracts* include the following:

- (a) FAR 52.249-2, “Termination for Convenience of the Government (Fixed-Priced).”



## BRIEFING PAPERS

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- (b) FAR 52.249-1, “Termination for Convenience of the Government (Fixed-Price) (Short Form).”
- (c) FAR 52.249-4, “Termination for Convenience of the Government (Services) (Short Form).”
- (d) FAR 52.249-6, “Termination (Cost-Reimbursement).”

The “Termination for Convenience” clause for Government purchases of *commercial items* appears as paragraph (1) of FAR 52.212-4, “Contract Terms and Conditions—Commercial Items.” A recently promulgated Alternate 1 to that clause includes a provision required to be used where a time-and-materials or labor-hour contract for commercial items is contemplated.<sup>10</sup>

#### ■ “Christian” Doctrine

A “Termination for Convenience” clause is incorporated in every Government prime contract even if it is not physically incorporated. Under the *Christian* doctrine, as set forth in *G.L. Christian & Assocs. v. United States*, a “Termination for Convenience” clause is read into Government prime contracts because it must be included by regulation.<sup>11</sup> The *Christian* doctrine does not apply to subcontracts issued under Government prime contracts.<sup>12</sup> Accordingly, without a proper “Termination for Convenience” clause in a subcontract, a prime contractor could be obligated to pay for anticipatory profits.

### Formulae For Recovery

Traditional Government contracts use a *cost-based formula* to calculate termination costs. FAR Part 12 commercial item contracts use a modified price-based formula.

#### ■ Traditional Government Contracts—Cost-Based Formula

A contractor whose fixed-price contract is terminated for the convenience of the Government is entitled to recover (a) allowable costs incurred in the performance of the work, (b) a reasonable profit for work performed, (c) reasonable settlement expenses, and (d) certain “continu-

ing” (post-termination) costs.<sup>13</sup> A contractor is not entitled to recover profit on settlement expenses.<sup>14</sup>

Recovery of allowable costs incurred and profit under a fixed-price contract is limited to the “total contract price.”<sup>15</sup> “Total contract price” includes any equitable adjustments to which a contractor is entitled.<sup>16</sup> If the Government can prove that the contract would have been completed at a loss, the contractor is not entitled to profit and recovery is subject to a loss adjustment.<sup>17</sup> A loss adjustment reduces the contractor’s termination costs, other than settlement expenses, by the percentage of loss that would have been incurred had the contract been completed.<sup>18</sup>

#### ■ FAR Part 12 Commercial Item Contracts—Modified Price-Based Formula

Rules applicable to the purchase of commercial items are set forth in FAR Part 12. There is a preference for the acquisition of commercial items.<sup>19</sup> Contracts<sup>20</sup> and subcontracts<sup>21</sup> for commercial items are exempt from various statutory requirements, including the Truth in Negotiations Act<sup>22</sup> and the Cost Accounting Standards.<sup>23</sup>

The definition of a “commercial item” is set forth at FAR 2.101. It is broad and generally covers items other than real property “of a type” customarily used for nongovernmental purposes. The definition includes certain support services for a commercial item and certain stand-alone services.<sup>24</sup>

A contractor’s recovery for the termination for convenience of a FAR Part 12 contract for commercial items is composed of two elements: (1) the percentage of the contract price reflecting the percentage of the work performed prior to the notice of the termination, and (2) any charges the contractor can demonstrate resulted directly from the termination.<sup>25</sup> This is a *modified price-based formula* since the first element is price based and the second element is cost based.

### Cost Principles

#### ■ Traditional Government Contracts

(a) *FAR Part 31 Cost Principles*—The FAR provides that the cost principles and procedures of FAR

Part 31 are to be used in determining termination settlement cost under traditional Government contracts.<sup>26</sup> Terminations for convenience have been held to convert a fixed-price contract to a cost-type contract for purposes of ascertaining the contractor's allowable termination costs.<sup>27</sup>

Because contract terminations “generally give rise to the incurrence of costs or the need for special treatment of costs that would not have arisen had the contract not been terminated,” the FAR includes a “Termination costs” cost principle that is to be used “in conjunction with the other cost principles” in FAR Part 31.<sup>28</sup> This cost principle establishes the following rules for determining the allowability of costs peculiar to terminations:<sup>29</sup>

- (1) The cost of “common items” are not allowable unless the contractor submits evidence that the items could not be retained at cost without sustaining a loss. “Common items” are those reasonably usable on the contractor's other work.
- (2) “Costs continuing after termination” despite all reasonable efforts by the contractor to eliminate the costs are generally allowable. “Idle facilities and idle capacity” are an example of costs continuing after termination.
- (3) “Initial costs” not fully absorbed because of a termination are allowable. One example is “starting load costs” such as learning curve costs and training. Another is “preparatory costs” such as initial plant rearrangement and production planning.
- (4) “Loss of useful value” of special tooling and special machinery and equipment is generally allowable to the extent it resulted from the termination.
- (5) “Rental costs under unexpired leases” are allowable for a reasonable period, to the extent they cannot be avoided, if necessary for the performance of the terminated contract.
- (6) The costs of “alterations of leased property” are allowable when the alterations were necessary for performing the contract.
- (7) “Subcontractor claims” are generally allowable. An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors.
- (8) “Settlement expenses” for preparation and presentation of a termination claim and termination and settlement of subcontracts are generally allowable. These expenses include the cost of inhouse personnel and outside experts such as attorneys and accountants.

(b) *“Fair Compensation” Principle*—The FAR cost principles are not applied strictly in determining the allowability of costs in termination settlements under traditional Government contracts. The FAR requires that its cost principles be applied “subject to” the general principle that a contractor whose contract is terminated for convenience is entitled to “fair compensation.”<sup>30</sup> This overriding “fair compensation” principle is set out in the FAR guidance on termination for convenience settlements for fixed-price contracts at FAR 49.201:<sup>31</sup>

A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.

The U.S. Court of Appeals for the Federal Circuit recently applied the “fair compensation” principle to a cost-reimbursement contract.<sup>32</sup>

(c) *Profit*—Under a traditional Government contract, a terminated contractor is entitled to profit on preparations made and work done by the contractor on the terminated portion of the contract. Profit is not allowable on settlement expense.<sup>33</sup>

The FAR guidance on termination for convenience settlements for fixed-price contracts requires that the following factors, among others, be considered in negotiating profit:<sup>34</sup>

- (1) Difficulty of work.
- (2) Contractor efficiency.

- (3) Inventive and developmental contributions.
- (4) The rate of profit the contractor would have earned had the contract been completed.
- (5) The rate of profit contemplated by the contractor at the time of award.

#### ■ FAR Part 12 Commercial Item Contracts

The “Termination for Convenience” clause in FAR Part 12 contracts for commercial items—paragraph (1) of the FAR 52.212-4, “Contract Terms and Conditions—Commercial Items” clause—states that the contractor will not be required to comply with contract cost principles or the Cost Accounting Standards.<sup>35</sup> COs may apply the FAR Part 49 principles for contract termination as guidance when terminating commercial item contracts if not inconsistent with the commercial item termination rules.<sup>36</sup> The FAR 49.201 “fair compensation” principle quoted above would appear to apply since it does not appear to be inconsistent with the commercial item termination rules.

### General Strategies

#### ■ Determine If Cancellation Is A Breach

The first step in maximizing recovery is to determine whether a cancellation is a breach of contract. If there is a breach of contract, recovery is not subject to the limitations set forth in the “Termination for Convenience” clause and the FAR cost principles. As previously noted, the “Termination for Convenience” clause allows the Government to cancel without paying anticipatory profits.<sup>37</sup> In addition, where there is a breach of contract by the Government, the limitations on recovery in the FAR cost principles are inapplicable.<sup>38</sup> As a result, a contractor is entitled to recover more if a Government cancellation is a breach of contract not subject to the recovery limitations of the “Termination for Convenience” clause.

Consider the following examples of breach of contract:

(a) *A breach of contract occurs when a prime contractor or upper-tier subcontractor purports to terminate for convenience a subcontract without a “Termination for*

*Convenience” clause.* A termination for convenience of a prime contract not containing the clause by the Government is not a breach. As previously noted, the “Termination for Convenience” clause is a required provision that is read into the Government prime contract even if it is not physically included.<sup>39</sup> However, because the *Christian* doctrine does not apply to subcontracts issued under Government prime contracts, without a proper “Termination for Convenience” clause in a subcontract, a prime contractor that cancels a subcontract could be obligated to pay for anticipatory profits.

(b) *The Government’s failure to order the guaranteed minimum in an IDIQ contract is a breach unless the Government terminates the unordered portion of the guaranteed minimum for convenience during the contract performance period.* The Government cannot avoid liability by issuing a termination for convenience after the contract performance period.<sup>40</sup>

(c) *The Government’s failure to order all of its needs under a requirements contract is a breach.* A requirements contract obligates the Government to order all of its purchased needs from the contractor awarded the contract.<sup>41</sup> The Government’s failure to order all of its needs is a breach of contract entitling a contractor to recover its anticipatory profits.<sup>42</sup>

(d) *A termination for convenience is a breach if it is made in bad faith or is an abuse of discretion.*<sup>43</sup> To prove bad faith, the Federal Circuit requires a showing of intent to harm the contractor and proof by clear and convincing evidence.<sup>44</sup>

(e) *A termination for convenience is a breach if the Government entered the contract without the intention of honoring its obligations.*<sup>45</sup>

A breach of contract based on (a), (b), or (c) is a common occurrence. A breach of contract based on (d) or (e) is unusual. The level of proof required to show bad faith is extremely difficult to meet. The Government rarely enters a contract where it does not intend to meet its obligations.

#### ■ Seek Fair Compensation

The FAR 49.201 “fair compensation” principle quoted earlier in this PAPER existed in almost identical form in the FAR predecessor regulations—the Defense Acquisition Regulation, the Federal Procurement Regulations, and the Armed

Services Procurement Regulation.<sup>46</sup> Despite its long existence, the “fair compensation” principle is often overlooked by contractors and the Government.<sup>47</sup>

If disallowance of a cost would be unfair, you should claim the cost in your termination settlement proposal even if the cost is not allowable under the cost principles. As one board of contract appeals explained in holding that bid and proposal costs were allowable in a termination settlement to provide a contractor fair compensation despite a conflicting cost principle: “A contractor is not supposed to suffer as the result of a termination for convenience of the Government, nor to underwrite the Government’s decision to terminate.”<sup>48</sup> You should always include a narrative with your Standard Form 1435, “Settlement Proposal (Inventory Basis),” SF 1436, “Settlement Proposal (Total Cost Basis),” or SF 1437, “Settlement Proposal for Cost-Reimbursement Type Contracts,”<sup>49</sup> that explains each cost element and why allowance of any cost that may be unallowable under the cost principles is necessary to provide fair compensation.

### ■ Avoid Government Second-Guessing

Government auditors and COs sometimes disallow costs because they would have allegedly performed the work in a different manner. For example, they may question a contractor’s subcontracting decisions, lease arrangements, or personnel decisions.

The Government, however, may not substitute its judgment for that of the contractor to disallow costs. As stated by one commentator, “contractors are permitted great discretion in choosing the manner of performance, and unless there has been a clear abuse of discretion, the contractor’s choice, along with the costs resulting from it, will be regarded as reasonable.”<sup>50</sup> Thus, the question is whether a cost is reasonable—not whether the CO would have incurred it. The FAR provides that a cost is “reasonable” if “it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.”<sup>51</sup> You should not allow the Government to second-guess your performance and disallow your “reasonable” costs.

### ■ Reject Impractical Proof Requirements

A fixed-price contractor is not required to document its costs of performance. Nevertheless,

the Government often attempts to avoid paying termination costs because a fixed-price contractor does not have the documentation that would be required for a cost-reimbursement contract.

A liberal approach to proof of costs is required in determining termination costs under a fixed-price contract.<sup>52</sup> The contractor has the burden to prove its termination costs “with sufficient certainty so that the determination of the amount...will be more than mere speculation.”<sup>53</sup> The use of estimates is sufficient when accounting records are unavailable due to no fault of the contractor, although the contractor still has the burden to demonstrate the estimates have a reasonable basis in fact.<sup>54</sup>

A contractor’s burden of proof is higher for settlement expenses and other costs incurred after a contract is terminated for convenience. At this point, the fixed-price contractor knows it is entitled to reimbursement on the basis of costs incurred and therefore has a duty to keep appropriate records.<sup>55</sup>

You should not allow the Government to impose impractical proof requirements after it terminates a contract for convenience. As long as you incurred the costs and provide a reasonable factual basis to substantiate the amount, disallowance for lack of proof is improper.

### ■ Claim All Allowable Costs

Termination costs are often disallowed because the contractor failed to demonstrate entitlement to an equitable adjustment. After a convenience termination, however, a contractor is entitled to recover all of its costs up to the contract price.<sup>56</sup> The contractor does not need to prove entitlement to an equitable adjustment under a separate clause of the contract unless the contractor seeks to recover an amount in excess of the contract price. As explained by the Armed Services Board of Contract Appeals, a convenience termination essentially converts a fixed-price contract into a cost-type contract. Thus, the contractor is entitled to recover its allowable costs “in accordance with the standards of reasonableness, allocability, and cost principles set forth in the regulations.” Determining specific costs attributable to equitable adjustment claims “generally is superfluous unless a ‘loss contract’ is alleged or an increase in contract price is sought.”<sup>57</sup>

You should therefore claim all your incurred costs in a termination settlement proposal irrespective of whether the Government or you are responsible for the costs.<sup>58</sup> As discussed in PART II of this BRIEFING PAPER, in some circumstances, you may even recover the costs of contractor-caused delays and defective or nonconforming work.

### ■ Charge Indirect Costs Directly

After a termination, the contractor is often left in a position where its normal treatment of indirect costs will not result in fair compensation. Under such circumstances, indirect costs may be charged as direct costs under the “fair compensation” principle.

The agency boards of contract appeals have routinely permitted costs normally charged as indirect costs to be charged directly for purposes of computing termination costs.<sup>59</sup> If terminated contractors were required to treat their indirect costs as under a normal contract, only a portion of incurred costs would be recovered. After a termination, the boards have permitted contractors to charge as direct costs the following normally indirect costs: supervisory personnel, freight charges, factory supplies, equipment repairs, small tools, travel, telephone, and other office expenses;<sup>60</sup> engineering labor;<sup>61</sup> quality assurance, manufacturing management, production control, material control, and purchasing;<sup>62</sup> and office labor of the company president.<sup>63</sup> In charging what would otherwise be indirect costs as direct costs, contractors must avoid “double counting” by removing the costs from indirect cost pools.

The above guidance applies to contractors that are subject to the Cost Accounting Standards. It does not conflict with CAS 402, which requires consistent treatment for costs incurred “in like circumstances.”<sup>64</sup> Costs incurred with respect to a terminated contract are not considered to be incurred “in like circumstances.”<sup>65</sup>

### ■ Avoid Loss Adjustments

If a fixed-price contract was being performed at a loss, the contractor is not entitled to profit and the termination recovery is subject to a loss adjustment. Under a loss adjustment, the contrac-

tor’s termination costs, not including settlement expenses, are reduced by the percentage of the loss the contractor would have incurred had the contract been completed.<sup>66</sup> Contractors can often recover profit and avoid loss adjustments by (a) submitting equitable adjustment claims that increase the contract price and (b) holding the Government to its burden of proof.

A contract is a loss contract if it would have been completed at an amount in excess of the contract price. The contract price includes the nominal price plus any equitable adjustments to which a contractor is entitled.<sup>67</sup> Thus, a contractor can use equitable adjustment claims to increase the total contract price and avoid application of the loss formula. The “contract price” set forth by a contractor on standard forms for termination settlement proposals should include any equitable adjustments to which the contractor is entitled.

The burden of proving entitlement to a loss adjustment is on the Government.<sup>68</sup> To prevail, the Government must prove (1) the contractor operated at a loss and (2) the amount of the loss.<sup>69</sup> A contractor can often avoid application of the loss formula by holding the Government to this burden. If left to its own devices, the Government often fails to meet its burden of proof.

The easiest way for the Government to meet its burden is to obtain an admission from the contractor. The Defense Contract Audit Agency Contract Audit Manual advises DCAA auditors (who perform audits of termination settlements for many agencies in addition to the Department of Defense) to request the contractor to provide an estimate to complete the terminated portion of the contract.<sup>70</sup> However, as recognized by the Manual, there is “no contractual requirement for the contractor to furnish an estimate to complete.”<sup>71</sup> Nevertheless, many contractors, without knowledge of their rights or the consequences of their actions, voluntarily provide an estimate. Instead, contractors should carefully consider whether it is to their advantage to comply with a Government request for an estimate to complete.

Absent a contractor estimate to complete, the Government will attempt its own calculations. The Government must demonstrate that its calculations

are well founded.<sup>72</sup> The Government will often come forward with just a percentage-of-completion calculation. Standing alone, a percentage-of-completion calculation is insufficient to justify application of the loss formula.<sup>73</sup>

The Government's estimate to complete must take into consideration the possibility of increased productivity, lower overhead, and lower general and administrative expenses in the later phases of contract performance.<sup>74</sup> Where the contract requires production of different types of units or termination occurs early in the contract, any Government estimates predicting the contractor's total costs if the contract had not been terminated may be too speculative to support a loss adjustment.<sup>75</sup>

Loss adjustments may also be denied where performance of the contract was interrupted by numerous changes. Numerous changes often lead to a failure of proof by making it impossible to segregate costs for which the Government is responsible from costs for which the contractor is responsible.<sup>76</sup>

Alternatively, a contractor may want to provide an estimate to complete in support of its claimed profit. As previously noted, one of the factors in determining profit is "[t]he rate of profit the contractor would have earned had the contract been completed."<sup>77</sup> Estimated profit is calculated by subtracting costs incurred at the time of termination from an "estimate at completion." The estimate at completion is the sum of costs incurred at the time of termination and the estimate to complete.

The FAR does not state whether all costs (direct and indirect costs) or just direct costs should be considered in determining whether a contract is a loss contract. You may be able to avoid a loss adjustment by pointing out there is no loss (and therefore no loss contract) if revenues would have exceeded direct costs at completion.

An accounting textbook defines "[l]osses" as "decreases in owner's equity that do not result from expenses or distributions to owners."<sup>78</sup> There is no decrease in equity as long as fixed costs are met. Any revenue above fixed costs increases an owner's equity. Therefore, under this definition, the Government is not entitled to a loss adjustment if revenues at completion would have exceeded direct costs.

### ■ Frontload Profit

In negotiating or determining the contractor's recovery of profit, the FAR guidance on termination for convenience settlements for fixed-price contracts requires the CO to consider, among other factors, the "[e]xtent and difficulty of the work done by the contractor as compared to the total work required by the contract."<sup>79</sup> As stated by the Department of the Interior Board of Contract Appeals, "The implication of the FAR provision is that as the extent and difficulty of the completed work becomes greater as compared to the terminated work then the profit determined should also be greater. As the contractor comes closer to finishing the work and the difficult parts of it, its profits should come correspondingly close to the full profit contemplated."<sup>80</sup>

To maximize recovery, you should use a structured approach such as the weighted guidelines method set forth in Defense FAR Supplement. The weighted guidelines method makes use of factors such as performance risk, contract type risk, and facilities capital employed, which normally result in frontloading profit.<sup>81</sup>

### ■ Request Partial Payment

Partial payments on termination settlement proposals are available before settlement.<sup>82</sup> The partial payment request may be submitted with or after submission of the termination settlement proposal or an interim settlement proposal.<sup>83</sup> Contractors may receive a partial payment that includes, in the aggregate, the following:<sup>84</sup>

- (a) 100% of the contract price adjusted for items completed before the termination date or to be completed after the termination date with the CO's approval.
- (b) 100% of subcontractor settlements the contractor has paid that were approved by the CO.
- (c) 90% of the direct costs of termination inventory including materials, purchased parts, supplies, and direct labor.
- (d) 90% of other allowable costs not included above that are allocable to the terminated requirements including settlement expenses.

- (e) 100% of partial payments made to subcontractors.

The Government must “promptly” process the partial payment application.<sup>85</sup> A prompt partial payment may allow the contractor to avoid being forced to accept an unreasonably low Government settlement offer because of a need for immediate cash. You should therefore always submit an SF 1440 “Application for Partial Payment” with your termination settlement proposal.<sup>86</sup>

#### ■ Schedule All Inventory

The contractor should be sure to include all termination inventory—any property acquired for the performance of and properly allocable to the terminated contract—in the inventory disposal schedules submitted to the Government.<sup>87</sup> The Plant Clearance Officer is the authorized representative of the CO responsible for screening, redistributing, and disposing of contractor inventory.<sup>88</sup> If the CO or PCO accepts inventory, the Government bought it and cannot claim that the inventory is not allocable to the contract.<sup>89</sup>

Alternatively, the contractor should not schedule inventory unrelated to the contract. This could constitute civil<sup>90</sup> or criminal fraud.<sup>91</sup>

#### ■ Do Not Agree To Perform Terminated Work At No Cost

The FAR suggests COs consider the inclusion of a provision in a settlement of a “complete termination” preserving the Government’s rights “concerning defects, guarantees, or warranties” and imposing other contractor obligations concerning terminated work.<sup>92</sup> A contractor should not agree to any continuing obligations in a complete termination other than those in the “Termination for Convenience” clause without adequate compensation.

#### ■ Obtain A Release From Post-Termination Performance Obligations

To avoid any misunderstanding concerning the scope of a termination for convenience, in any settlement agreement, the contractor should obtain a release from all post-termination performance obligations other than those specified in the “Termination for Convenience” clause.

#### ■ Request An Equitable Adjustment For Nonterminated Work

Where the termination for convenience of a fixed-priced contract is *partial*, a contractor is entitled to an equitable adjustment for its increased cost of performing the continuing work.<sup>93</sup> An example of a case gone awry is *International Data Products Corp v. United States*. There, the termination notice, borrowing from the FAR language regarding settlement of a “complete termination”<sup>94</sup> stated: “This termination will not affect the rights and liabilities of the parties...concerning defects, guarantees or warranties relating to any articles or component parts furnished to the Government by the Contract...nor...software upgrades as required by Section C of the contract.” Instead of requesting an equitable adjustment for its increased cost of performing the nonterminated work, the contractor contended it was entitled to the entire cost of such work because it was terminated. The Federal Circuit held that (1) the warranty services and software upgrades were not terminated and (2) the contractor was not entitled to additional compensation for this continuing obligation because it was included in the price of the items previously purchased.<sup>95</sup>

Instead of requesting the full cost of performing work that was not terminated, the contractor in *International Data Products* should have claimed its additional cost of performing the nonterminated work. The additional cost of providing warranty services or software upgrades may have been substantial since the contractor may not had the personnel on staff to do this work after the termination for convenience.

*International Data Products* appears to be limited to instances where the termination notice advises that warranty and software upgrade obligations are not terminated. You may be faced with a similar dilemma. As previously discussed, the FAR suggests that a CO consider including provisions in a settlement agreement requiring a contractor to perform such work after a “complete” termination.<sup>96</sup>

If you receive a partial termination for convenience, be sure to submit a request for equitable adjustment for the increased cost of performing the nonterminated work. As discussed below, the “Termination for Convenience” clause allows a

contractor less time to submit a request for equitable adjustment on the nonterminated work than it does for submitting a termination settlement proposal. Nevertheless, tribunals have given contractors some flexibility in claiming costs either as a request for equitable adjustment on the nonterminated work or as a cost of the terminated portion of the contract in its termination settlement proposal.<sup>97</sup>

### ■ Submit A Timely Proposal

A prime contractor in a *traditional* Government contract must submit its “final” termination settlement proposal to the Government within one year of the effective date of the termination.<sup>98</sup> The “effective date of termination” is the date on which the notice of termination requires the contractor to stop performance. If, however, the contractor receives the notice after the date fixed for termination, then the “effective date of termination” is when the notice of termination is first received.<sup>99</sup> When a board of contract appeals converts a termination for default to a termination for convenience, the effective date of termination is the date the contractor receives the board’s decision.<sup>100</sup>

The deadline for a subcontractor to submit its proposal to a prime contractor (or higher-tier subcontractor) is set forth in the subcontract. The period is often six months, which is less than the one year allowed a prime contractor to submit its settlement proposal to the Government.<sup>101</sup>

The period allowed for submitting a proposal can be extended by the Termination CO, prime contractor, or higher-tier subcontractor. A prime contractor or subcontractor must request a time extension in writing before the deadline.<sup>102</sup> Deadlines must be met at any cost even if the proposal needs to be revised at a later date. If a deadline is not met, a contractor forfeits its right to judicial review of the amount the CO determines is owed. In other words, if you fail to submit a timely “final” settlement proposal, the CO can pay whatever the CO decides, and you are without a remedy.<sup>103</sup> A similar forfeiture rule is incorporated in most subcontracts.

If only part of the contract or subcontract is terminated, a contractor is entitled to an equitable adjust-

ment of the price of the continued portion of the contract or subcontract to reflect the fact that there is less work over which to spread fixed costs.<sup>104</sup> The “Termination for Convenience” clause requires that a prime contractor submit any request for an equitable adjustment following a partial termination within 90 days unless this period is extended in writing by the CO.<sup>105</sup> A subcontractor should look to its subcontract to determine the deadline for submission of a request for an equitable adjustment.

As previously noted, tribunals have given contractors some flexibility in claiming costs either as a request for equitable adjustment on the nonterminated work or as a cost of the terminated portion of the contract in its termination settlement proposal.<sup>106</sup> The “Termination for Convenience” clause allows more time for the latter type of filing. Nevertheless, the best practice is to request an extension of time to submit costs that can be included in a request for equitable adjustment on the nonterminated portion of the contract as part of your termination settlement proposal.

The “Termination for Convenience” clause for *commercial item* contracts (paragraph (l) of the FAR 52.212-4 clause) does not set a time limit on the submission of a termination settlement proposal after a termination for convenience.

### ■ Obtain Professional Help

A contractor whose contract has been terminated for convenience should obtain professional help from qualified Government contract attorneys and accountants. Terminations for convenience present arcane legal and accounting problems. The use of qualified professionals can greatly increase recovery.

Cost should not be a barrier. Reasonable professional fees related to a termination for convenience are generally recoverable as settlement expenses under the FAR “Termination costs” cost principle.<sup>107</sup> The costs of professional help have been held to be recoverable even if it is ultimately determined that the contractor has no termination costs it can claim other than the fees for the professional advice.<sup>108</sup> You should therefore not hesitate to seek help from qualified professionals upon receipt of a notice of termination.

## ★ GUIDELINES ★

These *Guidelines* are intended to assist a contractor in maximizing its recovery after a contract has been terminated for convenience. They are not, however, a substitute for professional representation in any given situation.

1. Determine if cancellation is a breach of contract rather than a termination for convenience. Examples of breach of contract are the termination for convenience of a subcontract without a termination clause, failure to order the guaranteed minimum under an IDIQ contract, failure to purchase all requirements under a requirements contract, a bad faith termination, and the termination of a contract where the Government never intended to meet its obligations. A contractor is entitled to anticipatory profits for a breach of contract but not for a termination for convenience.

2. If disallowance by the Government of an incurred cost would be “unfair,” claim the cost in your termination settlement proposal even if it is unallowable under FAR cost principles. Explain in the accompanying narrative why the cost is allowable under the overriding principle that a contractor is entitled to “fair compensation” in a convenience termination.

3. Do not let the Government second-guess your costs. If you exercised reasonable judgment in incurring the costs, allegations by Government officials that they would have acted differently are not grounds for disallowance.

4. Do not let the Government escape liability by imposing impractical proof requirements for costs incurred under a fixed-price contract. Provide the best available information and explain in the accompanying narrative or audit rebuttal why better documentation is unavailable.

5. Keep in mind that a termination for convenience in essence converts a fixed-price contract to a cost-reimbursement contract. Claim all your incurred costs up to the total contract price regardless of which party is responsible for the costs, including costs for contractor-caused and concurrent delays and costs for defective or nonconforming work.

6. Make sure to charge indirect costs as direct costs to obtain “fair compensation.” Avoid double counting by removing costs charged directly from overhead cost pools.

7. Remember that the total contract price is the original contract price plus any equitable adjustments to which a contractor is entitled. Avoid loss adjustments by submitting equitable adjustment claims to increase the total contract price.

8. Keep in mind that it is difficult for the Government to prove it is entitled to a loss adjustment absent a contractor admission. Consider avoiding loss adjustments by not providing an estimate to complete and thereby holding the Government to its burden of proof.

9. Remember that the FAR does not define a loss. Avoid loss adjustments by pointing out that from an accounting standpoint there is no loss if revenues at completion would have exceeded direct costs.

10. Keep in mind that most profit is earned at the beginning of a contract because of increased difficulty and risk. A contractor should therefore frontload profit to maximize recovery.

11. Remember to request a partial payment on your termination settlement to facilitate cash flow.

12. Be sure to schedule all inventory allocable to the contract. If the Plant Clearance Officer accepts it, the Government bought it and cannot later claim it is not allocable to the contract.

13. Be aware that the FAR suggests that a CO consider including a provision in a settlement agreement for a complete termination that would require contractors to correct defects, provide warranty work on delivered items, and perform other terminated work. You should not agree to such a provision without adequate compensation.

14. To avoid disputes concerning the scope of a termination, you should obtain a release of any continuing obligations other than those specified in the termination notice or clause in any settlement agreement.

**15.** Where a termination for convenience is partial, submit a request for equitable adjustment for the increased cost of performing the nonterminated work.

**16.** Be sure to submit a timely termination settlement proposal or, if the termination is partial, a request for equitable adjustment for the increased cost of performing the continuing work. If a contractor fails to submit a timely proposal, it forfeits its right to judicial review. A CO can pay whatever he wants, which may be nothing.

**17.** Remember that if a contract is partially terminated for convenience, the “Termination for Convenience” clause allows less time for submitting a request for equitable adjustment on the nonterminated portion than for submit-

ting a settlement proposal for the terminated portion.

**18.** After a partial termination for convenience, some tribunals have allowed a contractor to claim costs recoverable as an equitable adjustment on the continuing portion in its termination settlement proposal as a cost of the terminated effort. Nevertheless, the best practice is to obtain permission from the CO to do this before your request for equitable adjustment on the nonterminated portion is due.

**19.** Obtain professional help to prepare and negotiate the settlement proposal. Knowledge and experience result in better recoveries. Also, a contractor is entitled to recover its reasonable legal and accounting fees incurred in preparing and negotiating its settlement proposal as settlement expense.

## ★ REFERENCES ★

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| <p><b>1/</b> See, e.g., FAR 52.249-2.</p> <p><b>2/</b> See FAR 52.212-4, para. (l).</p> <p><b>3/</b> Seidman &amp; Banfield, “Maximizing Termination for Convenience Settlements,” Briefing Papers No. 95-5 (Apr. 1995).</p> <p><b>4/</b> Seidman &amp; Banfield, “Preparing Termination for Convenience Settlement Proposals for Fixed-Price Contracts,” Briefing Papers No. 97-11 (Oct. 1997).</p> <p><b>5/</b> FAR 2.101.</p> <p><b>6/</b> FAR 49.202(a).</p> <p><b>7/</b> U.C.C. § 2-708.</p> <p><b>8/</b> E.g., FAR 52.249-2, para. (f); see <i>G. L. Christian &amp; Assocs. v. United States</i>, 160 Ct. Cl. 1, 312 F.2d 418, reh’g denied, 160 Ct. Cl. 58, 320 F.2d 345, cert. denied, 375 U.S. 954 (1963); <i>Dairy Sales Corp. v. United States</i>, 219 Ct. Cl. 431, 593 F.2d 1002 (1979).</p> <p><b>9/</b> See FAR 49.502.</p> <p><b>10/</b> See 71 Fed. Reg. 74,667 (Dec. 12, 2006) (adding FAR 52.212-4, alt.1).</p> | <p><b>11/</b> <i>G.L. Christian &amp; Assocs. v. United States</i>, 160 Ct. Cl. 1.</p> <p><b>12/</b> See generally Darst, “Subcontract Incorporation-By-Reference &amp; Flowdown Clauses Under Federal Government Construction Projects,” Briefing Papers No. 05-7 (June 2005).</p> <p><b>13/</b> See, e.g., FAR 52.249-2, paras. (f), (g), (i); see also FAR 49.113, 49.201, 49.202, 31.205-42.</p> <p><b>14/</b> FAR 49.202(a).</p> <p><b>15/</b> E.g., FAR 52.249-2, para. (f); see FAR 49.207.</p> <p><b>16/</b> See FAR 52.243-1 (“Changes—Fixed-Price” clause), 52.243-2 (“Changes—Cost-Reimbursement” clause); see also <i>Agrinautics, ASBCA 21512 et al.</i>, 79-2 BCA ¶ 14149, 22 GC ¶ 200.</p> <p><b>17/</b> FAR 49.203(a); see, e.g., FAR 52.249-2, para. (f).</p> <p><b>18/</b> FAR 49.203(b), (c).</p> <p><b>19/</b> FAR 12.101.</p> |
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- 20/ FAR 12.503.
- 21/ FAR 12.504.
- 22/ FAR 15.403-1(b)(3), (c)(3).
- 23/ 41 U.S.C.A. § 422(f)(2)(B); see FAR 12.214.
- 24/ See Seidman, Banfield, Chvotkin & Charles, "Service Contracting in the New Millennium—Part I," Briefing Papers No. 02-11 (Oct. 2002).
- 25/ FAR 12.403(d); FAR 52.212-4, para. (l).
- 26/ FAR 49.113. See generally Arnavas, "Government Contract Cost Recovery," Briefing Papers No. 01-6 (May 2001).
- 27/ See, e.g., Durette, GmbH, ASBCA 34072, 91-2 BCA ¶ 23756.
- 28/ FAR 31.205-42. See generally Manos, Government Contract Costs & Pricing ch. 49 (Thomson West 2004 & Supp. 2007).
- 29/ FAR 31.205-42.
- 30/ FAR 49.113, 49.201(a).
- 31/ FAR 49.201(a).
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- 35/ FAR 52.212-4, para. (l).
- 36/ FAR 12.403(a).
- 37/ See FAR 49.202(a); G.L.Christian & Assocs. v. United States, 160 Ct. Cl. 1, 312 F.2d 418, reh'g denied, 160 Ct. Cl. 58, 320 F.2d 345, cert. denied, 375 U.S. 954 (1963); Dairy Sales Corp. v. United States, 219 Ct. Cl. 431, 593 F.2d 1002 (1979).
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- 40/ Maxima Corp. v. United States, 847 F.2d 1549 (Fed. Cir. 1988).
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