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MAXIMIZING TERMINATION FOR CONVENIENCE SETTLEMENTS

By Paul J. Seidman and Robert D. Banfield

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.[1] In return for this privilege, the Government agrees to reimburse the contractor for all reasonable and allocable costs incurred in connection with performance, plus a reasonable profit on work done, as well as certain post-termination costs and settlement expenses.

In recent years, as the result of Government downsizing, terminations of contracts for convenience of the Government have become more common as cost-saving initiatives.[2] All too often, however, 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 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.

Focusing on fixed-price contracts, this BRIEFING PAPER discusses (1) the *basic formula for contractor recovery* following a termination for convenience and the application of the Federal Acqui-

IN BRIEF

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sition Regulation *cost principles* and "*fair compensation*" *principle* to that formula, (2) *general strategies* you can follow to maximize your recovery following a termination for convenience, and (3) steps you can take to avoid disallowance of some *specific costs* that are frequently challenged by the Government in termination settlement proposals.[3]

Contractor Recovery

■ Basic 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 "continuing" (post-termination) costs.[4] A contractor is not entitled to recover profit on settlement expenses.[5]

Recovery of allowable costs incurred and profit is limited to the "total contract price."[6] "Total contract price" includes any equitable adjustments to which a contractor is entitled.[7] If the Government can prove that the contract would have been completed at a loss, a contractor is not entitled to profit and recovery is subject to a loss adjustment.[8] 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.[9]

■ Cost Principles

The FAR provides that the cost principles and procedures of FAR Part 31 are to be used in determining termination settlement costs.[10] 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.[11]

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. This cost principle establishes the following rules for determining the allowability of costs peculiar to terminations:[12]

(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 a cost 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 neces-

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★ Although prepared by experts, these papers are, of course, generalized and should not be considered a substitute for professional advice in specific situations. ★

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sary 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.

■ "Fair Compensation" Principle

The FAR cost principles are not applied strictly in determining the allowability of costs in termination settlements but are applied "subject to" the general principle that a contractor whose contract is terminated for convenience is entitled to "fair compensation."[13] This overidding "fair compensation" principle is set out in the FAR guidance on termination for convenience settlements for fixed-price contracts:[14]

> 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 remainder of this PAPER is dedicated to showing how a contractor can best use the cost principles and this general "fair compensation" principle to maximize its recovery following a termination for convenience.

General Strategies

■ Seek Fair Compensation

The "fair compensation" principle quoted previously existed in almost identical form in the FAR predecessor regulations—the Defense Acquisition Regulation, the Federal Procurement Regulations, and the Armed Services Procurement Regulation.[15] Despite its long existence, the fair compensation principle is often overlooked by contractors and the Government.[16]

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."[17] You should always include a *narrative* with your Standard Form 1435 "Settlement Proposal (Inventory Basis)" or SF 1436 "Settlement Proposal (Total Cost Basis)" 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 Contracting Officers 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."[18] Thus, the question is whether a cost is *reasonable*—not whether the Contracting Officer 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."[19] 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.[20] 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."[21] 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.[22]

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.[23]

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.[24] 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."[25]

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.[26] As discussed later in this PAPER, in some circumstances, you can 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.[27] 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;[28] engineering labor;[29] quality assurance, manufacturing management, production control, material control, and purchasing;[30] and office labor of the company president.[31] In charging what would otherwise be indirect costs as direct costs, contractors are required to 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."[32] Costs incurred with respect to a terminated contract are not considered to be incurred "in like circumstances."[33]

■ Avoid Loss Adjustments

If the 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 contractor'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.[34] 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.[35] 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.*[36] To prevail, the Government must prove (1) the contractor operated at a loss and (2) the amount of the loss.[37] 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.[38] However, as recognized by the *Manual,* there is "no contractual requirement for the contractor to furnish an estimate to complete."[39] 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.[40] 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.[41]

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.[42] 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.[43]

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.[44]

■ Request Partial Payment

Partial payments on termination settlement proposals are available before settlement.[45] The partial payment request may be submitted with or after submission of the termination settlement proposal or an interim settlement proposal.[46] Contractors may receive a partial payment that includes, in the aggregate, the following:[47]

(a) 100% of the contract price adjusted for items completed before the termination date or to be completed after the termination date with the Contracting Officer's approval.

(b) 100% of subcontractor settlements the contractor has paid that were approved by the Contracting Officer.

(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.[48] 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.

■ 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, and the use of qualified professionals can make a difference.

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.[49] 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.[50] You should therefore not hesitate to seek help from qualified professionals upon receipt of a notice of termination.

Specific Costs

■ Contractor-Caused Delays

The Government will often try to escape liability after a convenience termination for periods of concurrent or contractor-caused delays. Such disallowance is insupportable to the extent a contractor does not seek compensation in excess of the contract price. As previously discussed, a termination for convenience in effect converts a fixed-price contract into a cost-type contract. A contractor is therefore entitled to recover all of its allowable (reasonable and allocable) costs, including delay costs. Which party is actually responsible for a particular day of delay is irrelevant.[51] You should therefore claim all delay days associated with the terminated effort regardless of responsibility.

■ Defective Or Nonconforming Work

Because a termination for convenience converts a fixed-price contract into a cost-type contract, a contractor is entitled to recover for all of its costs, including costs for defective or nonconforming work.[52] A contractor can recover for defective or nonconforming work as long as it was not the result of willful misconduct or gross negligence. Mere negligence does not bar contractor recovery.[53]

The Government may attempt to disallow the cost of defective work based on the FAR requirement that the Contracting Officer must deduct the "fair value" of termination inventory that is "destroyed, lost, stolen, or so damaged as to become undeliverable" before title or the risk of loss transfers to the Government.[54] However, this requirement applies only to *termination inventory*—"property purchased, supplied, manufactured, furnished, or otherwise acquired for the performance of the contract."[55] It does not deny a contractor the right to claim its incurred costs for defective or nonconforming work.[56] You should therefore claim the cost of defective or nonconforming work in your settlement proposal.

■ Precontract Costs

The allowability of precontract costs, in the absence of a termination for convenience, is governed by the FAR "Precontract costs" cost principle, which provides as follows:[57]

> Precontract costs are those incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract....

From this FAR definition, the U.S. Claims Court developed a three-part test to determine when

precontract costs are allowable outside the context of a termination for convenience:[58]

(1) The costs must be incurred to meet the contract delivery schedule.

(2) The costs must be incurred directly pursuant to the negotiation and in anticipation of the award.

(3) The costs would have been allowable if incurred during contract performance.

These limitations on the allowability of precontract costs may not apply strictly after a contract is terminated for convenience, however. As previously discussed, the FAR cost principles must be reconciled with and are "subject to" the general policy that the termination settlement should compensate the contractor fairly.[59] After a termination, a Contracting Officer may not ignore the "fair compensation" principle and summarily disallow precontract costs that are viewed as unallowable under the "Precontract costs" cost principle.[60] In addition, the ASBCA has stated that the earlier during contract performance the termination occurs the more likely the precontract costs should be allowed.[61]

■ Idle Facilities & Idle Capacity

Idle facilities or idle capacity often result from a termination for convenience. Although these costs are allowable and often substantial, many contractors surprisingly fail to claim them. A contractor can recover for idle facilities or idle capacity resulting from a termination under the FAR "Idle facility and idle capacity costs" cost principle[62] or the "Termination costs" principle for "costs continuing after termination."[63]

Idle facilities and idle capacity costs are "costs such as maintenance, repair, housing, rent, and other related costs; e.g., property taxes, insurance, and depreciation."[64] "Facilities" are the contractor's "plant" or "any portion" of the plant including land and equipment whether leased or owned by the contractor.[65] "Idle facilities" are "completely unused" facilities; "idle capacity" is the "unused capacity of partially used facilities."[66]

Several legally insupportable grounds are often advanced by the Government to avoid paying a contractor its allowable idle facilities and idle capacity costs following a convenience termination.

(a) *"The period claimed exceeds one year."* The Government often disallows idle facilities and idle capacity costs on the ground that the contractor is claiming the costs for more than one year. The "Idle facility and idle capacity costs" cost principle states that idle facilities costs "are allowable for a reasonable period, *ordinarily* not to exceed 1 year."[67] The DCAA and Contracting Officers often argue that one year is the maximum period for which these costs can be recovered. This approach is improper. Contractors are entitled to recover idle facilities costs for reasonable periods exceeding one year as long as reasonable steps are taken to eliminate the costs. In allowing recovery for a period of two years, seven-and-a-half months, the ASBCA stated that "[n]o more is necessary to establish a 'reasonable period' for the allowability of idle facilities costs beyond a year than a showing of diligent or reasonable efforts with respect to 'the initiative taken to use, lease, or dispose of such facilities.'" The board recognized that "such initiative may be exercised unsuccessfully for several years" and thus extended the allowability of the costs for the longer period.[68]

(b) *"The facilities are not completely idle."* The DCAA sometimes mislabels "idle capacity" as "idle facilities" and disallows the amount claimed because the "facilities" were not completely idled. Disallowance on this basis is improper. If a contractor manages to find some use for facilities left idle by a termination, the idle facilities become, by definition, "idle capacity" or partially used facilities. Underutilization is all that is required to recover for the costs of "idle capacity."[69]

(c) *"Sales have increased."* The DCAA often disallows all costs claimed for idle facilities or idle capacity if the contractor has experienced an increase in sales. This approach begs the question. The issue is whether the contractor experiences idle facilities or idle capacity as a result of the termination—not whether the contractor's sales volume has changed.

(d) *"The facilities are not 'special tooling.'"* The Government sometimes disallows idle facility or

capacity costs because the facility at issue is not "special tooling." The FAR defines "special tooling" as tooling, machinery, or equipment of such a specialized nature that its use is "limited to the development or production of particular supplies or parts" or "performance of particular services."[70] Although facilities must qualify as "special tooling" to recover for "loss of useful value" under the FAR "Termination costs" cost principle,[71] there is no similar requirement to recover for idle capacity or idle facilities.

■ Rental Costs

Under the FAR "Termination costs" cost principle, rental costs under unexpired leases are allowable in a termination settlement when the rental is shown to have been "reasonably necessary for the performance of the terminated contract."[72] After the termination, the contractor must make reasonable efforts to minimize the costs to the Government.[73]

Rental costs are not limited to the contract period. They are allowable for the contract period existing prior to the termination and "such further period as may be reasonable."[74] A lease period exceeding the contract period is reasonable where the contractor obtained the shortest available lease term for necessary facilities.[75] As with other cost issues, you should not let the Government second-guess the lease term. The reasonableness of the lease term must be based on the circumstances existing when the contractor entered the lease—not the post-termination hindsight of a Government official.

The DCAA sometimes limits unexpired lease costs for terminated contracts to ownership costs based on the FAR "Rental costs" cost principle. This cost principle limits rental charges between *related organizations* to ownership costs.[76] Ownership costs will be materially below fair market value where rented facilities have been depreciated. The ownership cost limitation on rental costs does not apply in the context of a termination for convenience, however.[77] Unlike the "Rental costs" cost principle, the FAR "Termination costs" cost principle does not limit rental costs paid to a related organization to ownership costs.[78]

■ Facilities Capital Cost Of Money

Under the FAR "Cost of money" cost principle, contractors are generally entitled to recover facilities capital cost of money.[79] "Cost of money" is an imputed amount for the cost of capital for facilities devoted to contract performance.[80] Recovery of cost of money does not depend on whether the contractor used borrowed funds or equity capital for the committed facilities.[81] Cost of money is computed by multiplying the net book value of facilities committed to the contract by the interest rate set by the Secretary of the Treasury.[82]

The allowance for cost of money is designed to encourage contractors to invest in capital assets that improve contract performance. Cost of money is not interest on borrowing that is unallowable under the "Interest and other financial costs" cost principle.[83]

To be allowable, cost of money must be "specifically identified or proposed in cost proposals relating to the contract under which this cost is to be claimed," and the contractor must maintain adequate accounting records.[84] Thus, if there have been prior cost proposals submitted under the contract, a contractor can claim cost of money only if it was claimed under those cost proposals. If the termination for convenience settlement proposal is the first cost proposal, cost of money can and should be claimed to maximize contractor recovery.[85] You should note that the ASBCA has allowed cost of money under the overriding "fair compensation" principle even though not all the recordkeeping requirements of the "Cost of money" cost principle have been met.[86]

■ Common Items

Often the Government will disallow recovery for materials, tooling, or other inventory on the ground that they are "common items" usable on the contractor's other work. The FAR "Termination costs" cost principle provides that the "costs of items reasonably usable on the contractor's other work shall not be allowable unless the contractor submits evidence that the items could not be retained at cost without sustaining a loss."[87]

Merely because the items are of a type the contractor uses on other work does not justify disal-

lowance as common items. For disallowance to be justified, the contractor must have existing projects for the materials or be in a position to hold the materials for future projects without incurring a loss.[88] You can rebut a "common items" disallowance by demonstrating that the items cannot be retained at cost without sustaining a loss.

■ Costs Under First Article Contracts

Under a first-article contract, the contractor produces a prototype of a new product—the "first article." If the Government approves the first article and exercises its purchase option under the contract, the contractor produces and delivers the production units.[89] When a contract is terminated *prior* to first article approval, the "First Article Approval" clause would appear to preclude any recovery for the costs of *production units.* The clause states:[90]

> Before first article approval, the acquisition of materials or components for, or the commencement of production of, the balance of the contract quantity is at the sole risk of the Contractor. Before first article approval, the costs thereof shall not be allocable to this contract for (1) progress payments, or (2) termination settlements if the contract is terminated for the convenience of the Government.

Although this rule appears harsh, there are several judicially crafted exceptions. For example, where a contractor must order more material than necessary for manufacture of a first article because of *minimum order* quantities imposed by a supplier, the costs of the excess materials that are set aside for production have been held to be allowable.[91]

Costs relating to production units may also be allowable if their incurrence prior to first article approval was *necessary to meet the delivery schedule.* For example, in one case,[92] the cost of special steel for production units purchased prior to first article approval was held to be allowable where 30 days were required for its delivery and production units were due 25 days after first article approval. In another case,[93] the ASBCA allowed recovery of the cost of one long-lead-time component requiring advance purchase to meet the delivery schedule but denied recovery for the costs of other components and production effort not necessary to meet the schedule. Although the board in these two cases only allowed costs for long-lead-time materials, the language and rationale used appear to extend to other production costs that must be incurred prior to first article approval to meet the contract delivery schedule.

In addition, the Government can *waive,* either expressly or by its conduct, the application of the risk provision of the "First Article Approval" clause. The Government waives the risk provision through its conduct by insisting on a delivery schedule that requires production prior to first article approval,[94] approving progress payments for production items,[95] and taking possession of production units.[96] If a review of all the facts and circumstances indicate the Government waived application of the "First Article Approval" clause, a contractor may recover for all costs associated with production quantities.[97]

You should note that where a contractor incurs costs for production units prior to first article approval, the first article is subsequently approved, and the contract is then terminated for convenience, the contractor may recover production unit costs in the termination settlement.[98]

The Government may also contend that the first article costs are unallowable because they were *also necessary for production units.* For example, the Government sometimes disallows the costs of special tooling built by the contractor for the manufacture of the first article on the ground that the special tooling would have been used for production units had the contract not been terminated for convenience prior to first article approval. Disallowance on this basis is improper. The "First Article Approval" clause does not preclude the recovery of costs necessary for manufacture of the first article. Whether the costs are also necessary for production is irrelevant.[99]

In addition, the Government may contend that the "First Article Approval" clause limits contractor recovery in terminations issued prior to first article approval to the *first article price.* The ASBCA has rejected this argument, holding that recovery in a termination for convenience is limited by the "total contract price" rather than the line item price for the first article.[100]

■ G&A Expense On Subcontractor Settlements

The "Termination costs" cost principle provides that an "appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors."[101] Contractors, however, often do not claim general and administrative expense on subcontractor settlements because the G&A expense block of the SF 1435 and SF 1436 termination settlement proposal forms is before the block for subcontractor settlements. You should not fail to claim these allowable costs simply because of the layout of the Government's standard form. G&A expense is an allowable cost of subcontractor termination settlements even if the Government negotiates the final settlement with the subcontractor.[102]

■ Settlement Expenses

Under the FAR "Termination costs" cost principle, a contractor is entitled to recover as "settlement expenses" the accounting, legal, clerical, and similar costs of preparing and negotiating its settlement proposal, of terminating and settling subcontracts, and of storing, transporting, and disposing of termination inventory.[103] As noted earlier in this PAPER, the settlement expenses you may recover include the reasonable fees of outside professionals. If settlement expenses are "significant," the contractor must establish "a cost account or work order...to separately identify and accumulate them."[104]

The Government may pay inhouse settlement expenses based on a contractor's after-the-fact estimates of time expended. However, to avoid the compromises incident to estimates or possible disallowance, you should keep contemporaneous time sheets. As discussed previously, the costs of inhouse personnel may be charged as direct costs even though such costs normally are included in indirect cost pools.[105]

■ Interest

The DCAA generally disallows interest on termination settlement proposals on the ground that a termination settlement proposal is not a "claim" within the meaning of the Contract Disputes Act. The DCAA's practice of across-the-board denial of interest is too broad. Although a routine termination proposal is not a CDA claim, it can mature into one if (a) the proposal is disputed by the Government or not acted upon by the Government within a reasonable period of time, and (b) the contractor subsequently takes the requisite procedural steps (CDA certification and a request for a final decision) to assert the proposal as a claim.[106]

Under the CDA, a contractor is entitled to interest on a successful claim measured from the time the claim was submitted to the Contracting Officer.[107] A "claim" over $50,000 ($100,000 after the Federal Acquisition Streamlining Act becomes effective[108]) must be certified in accordance with the CDA for a contractor to recover interest.[109] The preprinted certification language on standard Government termination settlement proposal forms is not a CDA certification.[110] The ASBCA has recently suggested, however, that the standard form settlement proposal certification could serve as a "defective" CDA certification that is correctable under 1992 amendments to the CDA.[111]

As the result of a recent decision of the U.S. Court of Appeals for the Federal Circuit, it is unclear when a "claim" must be certified to recover interest.[112] The decision, by one panel of the Federal Circuit, held that in order for there to be a CDA "claim," the *amount* of the claim as well as the contractor's *entitlement* had to be disputed at the time of certification. Because this decision has been withdrawn and the case is being reheard by the entire court, contractors should cover all bases by certifying their claims and requesting a Contracting Officer final decision at least twice. The first certification and request for final decision should accompany the initial submission of the termination settlement proposal. The second certification and request for final decision should be made after the Government disputes the claim or a reasonable period of time has passed and the Government has not acted. Depending upon how the Federal Circuit ultimately resolves the issue of when a "claim" arises, a contractor will likely be entitled to CDA interest from either the date of the first or second certification.

★ 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. 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.

2. 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.

3. 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.

4. 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.*

5. 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.

6. Avoid *loss adjustments* by submitting *equitable adjustment claims* to increase the total contract price and holding the *Government* to its *burden of proving* it is entitled to a loss adjustment.

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

8. Remember that although *precontract costs* are sometimes unallowable under the FAR cost principles, they are allowable in the context of a termination for convenience if necessary for "fair compensation."

9. Claim any *idle facilities* or *idle capacity costs* incurred despite your unsuccessful efforts to discontinue them. Remember that recovery of these costs is not limited to one year but to a "reasonable period," and that the facilities need not be completely idle or qualify as "special tooling."

10. Claim *unexpired lease costs* if the lease cannot be terminated or the property sublet and the leased property and the lease term were *necessary* when acquired.

11. Be aware that you may claim *facilities capital cost of money* if you claimed cost of money in *prior* cost proposals or the termination settlement proposal is the *first* cost proposal.

12. Do not accept "*common items*" disallowances for items you cannot use or hold without incurring a loss.

13. Bear in mind that *production costs* incurred *prior to first article approval* are allowable if (a) the costs were incurred due to a supplier's requirements for *minimum order quantities* or were *necessary to meet the production schedule,* (b) the "First Article Approval" clause is *waived,* or (c) the costs were also *necessary for manufacture of the first article.* The recovery of costs incurred prior to first article approval is *not* limited to the line item price of the first article.

14. Remember to claim *G&A expenses on subcontractor settlements.* Do not be confused by the layout of the standard forms for termination settlement proposals.

15. To facilitate recovery of *settlement expenses,* make sure that *inhouse personnel* keep *time sheets.* Charge the time of inhouse personnel *directly*

in your termination settlement proposal. Remember that *outside professional fees* are also recoverable as settlement expenses.

16. To recover *interest* on your termination settlement proposal, provide a *CDA certification* and request a *final decision* on the proposal from the Contracting Officer. Until the Federal Circuit or Congress clears up the confusion in existing case law, cover all bases by certifying your claim and requesting a final decision *at least twice*—upon initial submission and again after the Government disputes the claim or has not acted within a reasonable time.

★ REFERENCES ★

1/ See, e.g., FAR 52.249-2.

2/ See generally Pushkar, Janik & Rhodes, "Dealing With the Effects of Downsizing," Briefing Papers No. 93-5 (Apr. 1993).

3/ See generally Martell & Featherstun, "Convenience Terminations: More Selected Problems," Briefing Papers No. 91-13 (Dec. 1991), 9 BPC 529; Pettit & Vacketta, "Convenience Terminations: Selected Problems," Briefing Papers No. 90-12 (Nov. 1990), 9 BPC 245.

4/ See FAR 52.249-2, paras. (e), (f), (h). See also FAR 49.113, 49.201.

5/ FAR 49.202.

6/ FAR 49.207. See FAR 52.249-2, para. (e).

7/ See FAR 52.243-1 ("Changes—Fixed-Price" clause), 52.243-2 ("Changes—Cost-Reimbursement" clause). See also Agrinautics, ASBCA 21512 et al., 79-2 BCA ¶ 14149, 22 GC ¶ 200.

8/ FAR 49.203(a). See FAR 52.249-2, para. (f).

9/ FAR 49.203(b), (c).

10/ FAR 49.113.

11/ See, e.g., Durette, Gmbh, ASBCA 34072, 91-2 BCA ¶ 23756.

12/ FAR 31.205-42.

13/ FAR 49.113, 49.201(a).

14/ FAR 49.201(a).

15/ See DAR 8-301; FPR 1-8.301; ASPR 8.301.

16/ See generally Amavas, Gildea & Duquette, "DCAA Audits," Briefing Papers No. 94-9 at 8 (Aug. 1994).

17/ Kasler Elec. Co., DOTCAB 1425, 84-2 BCA ¶ 17374, 26 GC ¶ 326. See also Codex Corp. v. U.S., 226 Ct. Cl. 693 (1981), 23 GC ¶ 239 (precontract costs).

18/ Rishe, Government Contract Costs 10-20 (Federal Publications Inc. 1984). See Aeronca Mfg. Corp., ASBCA 3844, 58-1 BCA ¶ 1724.

19/ FAR 31.201-3(a).

20/ See FAR 49.201(a), (c). See also Algonac Mfg. Co., ASBCA 10534, 66-2 BCA ¶ 5731, affd., 192 Ct. Cl. 649, 428 F.2d 1241 (1970), 12 GC ¶ 297.

21/ Lisbon Contractors, Inc. v. U.S., 828 F.2d 759 (Fed. Cir. 1987), 6 FPD ¶ 113 (quoting Willems Indus., Inc. v. U.S., 155 Ct. Cl. 360, 295 F.2d 822 (1961), cert. denied, 370 U.S. 903 (1962), 3 GC ¶ 565), 29 GC ¶ 296.

22/ Tagarelli Bros. Const. Co., ASBCA 34793, 88-1 BCA ¶ 20363, 30 GC ¶ 342 (Note), affd. on reconsideration, 88-2 BCA ¶ 20546.

23/ Industrial Refrigeration Serv. Corp., VABCA 2532, 91-3 BCA ¶ 24093, 33 GC ¶ 251 (Note).

24/ Seven Science Indus., ASBCA 23337, 80-2 BCA ¶ 14518.

25/ Note 11, supra.

26/ Worsham Const. Co., ASBCA 25907, 85-2 BCA ¶ 18016, 28 GC ¶ 243 (Note).

27/ Agrinautics, note 7, supra; Amplitronics, Inc., ASBCA 20545, 76-1 BCA ¶ 11760, 18 GC ¶ 373; American Elec., Inc., ASBCA 16635, 76-2 BCA ¶ 12151, 31 GC ¶ 289 (Note), affd. in part and modified in part on other grounds on reconsideration, 77-2 BCA ¶ 12792.

28/ Okaw Indus., Inc., ASBCA 17863, 77-2 BCA ¶ 12793.

29/ Agrinautics, note 7, supra.

30/ Condec Corp., ASBCA 14234, 73-1 BCA ¶ 9808, 15 GC ¶ 295.

31/ Amplitronics, Inc., note 27, supra.

32/ 48 CFR § 9904.402-40.

33/ See generally AT&T Technologies, Inc. v. U.S., 18 Cl. Ct. 315 (1989), 8 FPD ¶ 131, 31 GC ¶ 372.

34/ FAR 49.203.

35/ See note 7, supra.

36/ Systems & Computer Information, Inc., ASBCA 18458, 78-1 BCA ¶ 12946; R&B Bewachungs GmbH, ASBCA 42214, 92-3 BCA ¶ 25105.

37/ Maitland Bros., ASBCA 43088, 93-3 BCA ¶ 26007, affd. on reconsideration, 94-1 BCA ¶ 26285.

38/ DCAA Contract Audit Manual ¶ 12-307a(2) (Jan. 1995).

39/ DCAA Contract Audit Manual ¶ 12-307a(3) (Jan. 1995).

40/ Note 28, supra. See also Systems & Computer Information, Inc., note 36, supra.

41/ See Scope Electronics, Inc., ASBCA 20359, 77-1 BCA ¶ 12404, 19 GC ¶ 146, affd. on reconsideration, 77-2 BCA ¶ 12586. See also R&B Bewachungs GmbH, note 36, supra.

42/ FAR 49.203(a); note 28, supra.

43/ Note 28, supra.

44/ Astro Dynamics, ASBCA 41825, 91-2 BCA ¶ 23807; R.H.J. Corp., ASBCA 12404, 69-1 BCA ¶ 7587, 11 GC ¶ 195. See also Scope Electronics, Inc., note 41, supra; Douglas Corp., ASBCA 8566, 69-1 BCA ¶ 7578, 11 GC ¶ 239, affd. on reconsideration, 69-1 BCA ¶ 7699.

45/ FAR 49.112-1(a). See FAR 52.249-2, para. (i).

46/ FAR 49.112-1(a).

47/ FAR 49.112-1(b).

48/ Note 46, supra.

49/ FAR 31.205-42(g). See generally Vacketta, Yesner & Snyder, "Recovery of Legal Costs," Briefing Papers No. 93-12 (Nov. 1993).

50/ Engineered Sys., Inc., ASBCA 18241, 74-1 BCA ¶ 10492, 16 GC ¶ 160; Freedom Elevator Corp., GSBCA 7259, 85-2 BCA ¶ 17964; Contract Maintenance, Inc., ASBCA 20689, 77-1 BCA ¶ 12446.

51/ Note 26, supra.

52/ Caskel Forge, Inc., ASBCA 7638, 1962 BCA ¶ 3318, 4 GC ¶ 258.

53/ Morton-Thiokol, Inc., ASBCA 32629, 90-3 BCA ¶ 23207, 32 GC ¶ 254.

54/ FAR 49.204, 52.249-2, para. (g).

55/ See FAR 45.601.

56/ See generally Youngstrand Surveying, AGBCA 90-150-1, 92-2 BCA ¶ 25017.

57/ FAR 31.205-32.

58/ Penberthy Electromelt Intl., Inc. v. U.S., 11 Cl. Ct. 307 (1986), 5 FPD ¶ 120, 29 GC ¶ 40. See also Radant Technologies, Inc., ASBCA 38324, 91-3 BCA ¶ 24106, 33 GC ¶ 253. See generally Wiener, "The Allowability of Precontract Costs," 91-11 Govt. Contract Costs, Pricing & Accounting Rep. 3 (Federal Publications Inc., Nov. 1991).

59/ Note 13, supra. See Kasler Elec. Co., note 17, supra; Codex Corp. v. U.S., note 17, supra.

60/ RHC Const., IBCA 2083, 88-3 BCA ¶ 20991. See also Bennie J. Meeks t/a Lawn Grooming Serv., GSBCA 6605-REM, 85-2 BCA ¶ 17947.

61/ See Metered Laundry Servs., Inc., ASBCA 21573, 78-2 BCA ¶ 13451.

62/ FAR 31.205-17.

63/ FAR 31.205-42(b). See Fiesta Leasing & Sales, Inc., ASBCA 29311, 87-1 BCA ¶ 19622, affd. on reconsideration, 88-1 BCA ¶ 20499.

64/ FAR 31.205-17(a).

65/ Note 64, supra.

66/ Note 64, supra.

67/ FAR 31.205-17(b)(2) (emphasis added).

68/ General Dynamics Corp., ASBCA 19607, 78-1 BCA ¶ 13203 (quoting Aerojet Gen. Corp., ASBCA 15703 et al., 73-1 BCA ¶ 9932, 15 GC ¶ 355).

69/ Fiesta Leasing & Sales, Inc., note 63, supra.

70/ FAR 45.101.

71/ FAR 31.205-42(d).

72/ FAR 31.205-42(e).

73/ FAR 31.205-42(e)(2).

74/ FAR 31.205-42(e)(1).

75/ See generally TDC Mgmt. Corp., DOTBCA 1802, 91-3 BCA ¶ 24091.

76/ FAR 31.205-36(b).

77/ See FAR 31.205-36(c).

78/ Note 72, supra.

79/ FAR 31.205-10.

80/ FAR 31.205-10(a)(1).

81/ Note 80, supra.

82/ Note 80, supra.

83/ Note 80, supra. See FAR 31.205-20.

84/ FAR 31.205-10(a)(2).

85/ See Spectrum Leasing Corp. v. General Servs. Admin., GSBCA 12189, 95-1 BCA ¶ 27317.

86/ See Fiesta Leasing & Sales, Inc., note 63, supra.

87/ FAR 31.205-42(a).

88/ Essex Electro Engrs., Inc., DOTBCA 1025 et al., 81-1 BCA 14838, reconsideration denied, 81-1 BCA ¶ 15109, affd., 702 F.2d 998 (Fed. Cir. 1983), 1 FPD ¶ 79, 27 GC ¶ 101 (Note); Fiesta Leasing & Sales, Inc., note 63, supra.

89/ See generally Ewing, Lawrence & Zenner, "First-Article Contracts," Briefing Papers No. 93-6 (May 1993).

90/ FAR 52.209-3, para. (g) ("First Article Approval-Contractor Testing" clause); FAR 52.209-4, para. (h) ("First Article Approval—Government Testing" clause).

91/ See Switlik Parachute Co., ASBCA 18024, 75-2 BCA ¶ 11434.

92/ Young Metal Prods., Inc., ASBCA 15701, 71-1 BCA ¶ 8827.

93/ Century Electronics, ASBCA 29123, 85-3 BCA ¶ 18232.

94/ AVCO Corp., ASBCA 15252, 73-1 BCA ¶ 9958.

95/ Note 94, supra.

96/ Marvin Engrg. Co., ASBCA 18356, 74-1 BCA ¶ 10587.

97/ See note 94, supra.

98/ Varo, Inc., ASBCA 16606, 72-2 BCA ¶ 9720.

99/ Cape Tool & Die, Inc., ASBCA 46433, 95-1 BCA ¶ 27465, 36 GC ¶ 482.

100/ Concord Elec. Co., ASBCA 31012, 85-3 BCA ¶ 18484, 28 GC ¶ 243 (Note).

101/ FAR 31.205-42(h).

102/ Note 26, supra; Bolinders Co., ASBCA 5740, 60-2 BCA ¶ 2746, 2 GC ¶ 562.

103/ FAR 31.205-42(g)(1).

104/ FAR 31.205-42(g)(2).

105/ See Baifield Indus., Div. of A-T-O, Inc., ASBCA 20006, 76-2 BCA ¶ 12096, affd. on reconsideration, 76-2 BCA ¶ 12203.

106/ Garden Mach. Corp. v. U.S., 14 Cl. Ct. 286 (1988), 7 FPD ¶ 15, 30 GC ¶ 265.

107/ 41 USC § 611.

108/ P.L. 103-355, § 2351, 108 Stat. 3243 (1994) (amending 41 USC § 605).

109/ Fidelity Const. Co. v. U.S., 700 F.2d 1379 (Fed. Cir.), 1 FPD ¶ 68, 25 GC ¶ 86, cert. denied, 464 U.S. 826 (1983). See also ReCon Paving, Inc. v. U.S., 745 F.2d 34 (Fed. Cir. 1984), 3 FPD ¶ 52, 26 GC ¶ 325.

110/ Note 106, supra; Cubic Defense Sys., Inc., ASBCA 39859, 91-2 BCA ¶ 23748.

111/ Spiffy Enters., Inc., ASBCA 44802, 95-1 BCA ¶ 27454. See 41 USC § 605(c)(6). See generally 34 GC ¶ 641.

112/ Reflectone, Inc. v. Kelso, 34 F.3d 1031 (Fed. Cir. 1994) (advance sheets: removed from bound volume), 13 FPD ¶ 76, 36 GC ¶ 493, vacated and suggestion for rehearing in banc granted, 34 F.3d 1039 (Fed. Cir. 1994).


FEDERAL PUBLICATIONS INC

1997 REVISION NOTE

Maximizing Termination For Convenience Settlements

Briefing Papers No. 95-5

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This REVISION NOTE (a) covers the subject matter in the *same order* as in the original BRIEFING PAPER and (b) lists *all* the headings that appear in the original PAPER—even headings for which there are *no* current revisions. You can thus easily determine (after reading the original PAPER) whether there have been new developments applicable to each particular section of the PAPER.

Contractor Recovery

For an examination of recent decisions by the U.S. Court of Appeals for the Federal Circuit interpreting the scope of the Government's right to terminate a contract for convenience—including *Krygoski Const. Co. v. U.S.*, 94 F.3d 1537 (Fed. Cir. 1996), 15 FPD ¶ 88, 38 GC ¶ 522, and *Caldwell & Santmyer, Inc. v. Glickman*, 55 F.3d 1578 (Fed. Cir. 1995), 14 FPD ¶ 46, 37 GC ¶ 423—see Cibinic, "Convenience Termination: What Are the Limits?," 10 NASH & CIBINIC REP. ¶ 52 (Oct. 1996).

Effective October 1, 1995, FAR 12.403(d) provides the basic rules for determining the contractor's recovery under *commercial item* contracts that are terminated for the Government's convenience. See 60 Fed. Reg. 48231 (Sept. 18, 1995). These rules are discussed in a new section below titled "Commercial Item Contracts."

- **Basic Formula**
- **Cost Principles**
- **"Fair Compensation" Principle**

General Strategies

- **Seek Fair Compensation**
- **Avoid Government Second-Guessing**
- **Reject Impractical Proof Requirements**
- **Claim All Allowable Costs**
- **Charge Indirect Costs Directly**
- **Avoid Loss Adjustments**
- **Request Partial Payment**
- **Obtain Professional Help**

Specific Costs

- **Contractor-Caused Delays**
- **Defective Or Nonconforming Work**

In *Best Foam Fabricators, Inc. v. U.S.*, 38 Fed. Cl. 627 (1997), 16 FPD ¶ 89, 39 GC ¶ 485, the U.S. Court of Federal Claims held *for the first time* that the costs of producing defective items are allowable convenience termination costs. The court found board of contract appeals precedent, such as cited in the original BRIEFING PAPER, persuasive in reaching its decision.

As discussed in the original BRIEFING PAPER, the Government sometimes attempts to use FAR 49.204, "Deductions," to reduce a termination settlement amount by the "fair value" of termination inventory that is "destroyed, lost, sto-

len, or so damaged as to become undeliverable." This provision only applies, however, to termination inventory—not to costs incurred to produce defective or nonconforming work. In *E.R. Mandocdoc Const. Co.*, ASBCA 43701, 95-2 BCA ¶ 27800, 37 GC ¶ 496, electrical equipment purchased to perform a building renovation contract was damaged before the contract was terminated by the Government for convenience. The ASBCA held that FAR 49.204 did not allow the Government to refuse to pay for the damaged equipment as part of the termination settlement. The termination converted the fixed-price contract to a cost-reimbursement type, and the costs incurred for purchasing materials for the contract were allowable costs, and there was no evidence that the equipment, although damaged, was "undeliverable" for the purposes of FAR 49.204.

■ Precontract Costs

In *Best Foam Fabricators, Inc. v. U.S.*, 38 Fed. Cl. 627 (1997), 16 FPD ¶ 89, 39 GC ¶ 485, the U.S. Court of Federal Claims held that precontract costs are allowable termination costs if the contractor satisfies the three-part *Penberthy Electromelt* test set forth in the original BRIEFING PAPER even if *all* production units were completed before contract award.

■ Idle Facilities & Idle Capacity

■ Rental Costs

■ Facilities Capital Cost Of Money

The General Services Administration Board of Contract Appeals (GSBCA) held that in the case of a contract awarded without cost data, a contractor is not required to "identify [facilities capital cost of money] in the original proposal to avoid waiving [facilities capital cost of money] in subsequent cost-based changes." *AT&T v. General Services Admin.*, GSBCA 11730, 95-2 BCA ¶ 27869, 37 GC ¶ 531. Although *AT&T* did not involve a termination for convenience, the GSBCA relied on the *Spectrum Leasing* and *Fiesta Leasing* convenience termination decisions cited in this section of the original BRIEFING PAPER.

■ Common Items

In *Symetrics Industries, Inc.*, ASBCA 48529, 96-2 BCA ¶ 28285, 38 GC ¶ 317, the Government denied the contractor's claim for a lost quantity discount for components involved in a partial contract termination, contending that the components were "common items" reasonably usable on the contractor's other work. The ASBCA agreed, holding that, although it is not binding on the board, the DCAA *Contract Audit Manual* states that the test of what is a "common item" is "whether the contractor can divert the item to other work without loss." In this case, the contractor failed to prove that the items were retained at a loss.

■ Costs Under First Article Contracts

In *Balimoy Mfg. Co.*, ASBCA 49730, 96-2 BCA ¶ 28605, 38 GC ¶ 574, the ASBCA held that when a portion of the minimum order quantity is required for first article production, the cost of the entire minimum order is "allocable to the first articles rather than to the production units."

■ G&A Expense On Subcontractor Settlements

■ Settlement Expenses

■ Interest

The issues raised by the 1994 *Reflectone* decision cited in the original BRIEFING PAPER were resolved by an *en banc* panel of the U.S. Court of Appeals for the Federal Circuit. In *Reflectone, Inc. v. Dalton*, 60 F.3d 1572 (Fed. Cir. 1995), 14 FPD ¶ 63, 37 GC ¶ 411, the court held that the CDA "does not require that 'a written demand...seeking as a matter of right, the payment of a sum certain' must already be in dispute when submitted to the [Contracting Officer] to satisfy the definition of 'claim,' except where that demand or request is a 'voucher, invoice or other routine request for payment.'" Thus, the CDA (and FAR) do not require that there be a dispute both as to entitlement and quantum in order for a contractor submission to constitute a "claim."

More recently, however, the Federal Circuit resurrected some of the jurisdictional uncer-

tainties regarding whether a settlement proposal submitted following a termination for convenience is a routine submission that must satisfy the "in dispute" requirement or is a nonroutine submission that qualifies as a CDA "claim." In *Ellett Const. Co. v. U.S.*, 93 F.3d 1537 (Fed. Cir. 1996), 15 FPD ¶ 90, 38 GC ¶ 426, the court apparently held that it can be both. The court held that a termination for convenience settlement proposal, when initially submitted, is not a "claim" because "it is for the purpose of negotiation, not for a contracting officer's decision." However, a termination settlement proposal ripens into a CDA "claim" that accrues interest if (1) negotiations reach an impasse, (2) the Contracting Officer issues a final decision, or (3) the contractor's submissions indicate the contractor "desires" a final decision. See generally Cibinic, "The *Ellett* Case: What's All the Fuss About?," 11 NASH & CIBINIC REP. ¶ 8 (Feb. 1997).

Two subsequent ASBCA cases interpreting *Ellett* shed some light on determining whether termination for convenience settlement proposals constitute CDA "claims." In *Mid-America Engrg. & Mfg.*, ASBCA 48831, 96-2 BCA ¶ 28558, 38 GC ¶ 477, the board held that the contractor's original certified settlement proposal constituted a "claim" because it was a nonroutine request for payment, it provided sufficient information regarding the claim, and it was certified. Furthermore, the contractor had requested a final decision after more than a year of negotiation. In *National Interior Contractors, Inc.*, ASBCA 46012, 96-2 BCA ¶ 28560, 38 GC ¶ 477, the ASBCA found that an uncertified settlement proposal ripened into a "claim" when negotiations between the parties reached "an impasse." In sum, it appears that a termination for convenience settlement proposal that otherwise satisfies all the CDA criteria for a "claim" will not be considered a claim if the parties are not "in dispute." However, once it is clear that the parties will not be able to reach agreement, the original proposal will ripen into a "claim" without the contractor having to make an additional submission.

In *Balimoy Mfg. Co.*, ASBCA 49730, 96-2 BCA ¶ 28605, 38 GC ¶ 574, the contractor submitted its termination settlement proposal while challenging a termination for default before the board. The ASBCA held the proposal was a "claim" which entitled the contractor to interest *from the day it was received.* The board acknowledged the Federal Circuit's decision in *Ellett* without further comment on the "impasse" requirement discussed above.

In *Ellett*, the Federal Circuit also held (as had already been suggested by the ASBCA, as noted in the original BRIEFING PAPER) that the certification language on the standard form termination proposal qualifies as a *defective* CDA certification that is correctable during litigation.

Commercial Item Contracts

[NOTE: This is a new section not found in the original BRIEFING PAPER.]

In September 1995, the FAR Council issued a final rule to implement the provisions in the Federal Acquisition Streamlining Act of 1994 dealing with the acquisition of commercial items. P.L. 103-355, § 8002, 108 Stat. 3243 (Oct. 13, 1994). The new regulations and contract clauses were *optional* in solicitations for commercial items issued between October 1 and December 1, 1995, and are *mandatory* for commercial item solicitations issued after December 1, 1995. See 60 Fed. Reg. 48231 (Sept. 18, 1995). The final rule completely revised FAR Parts 10, 11, and 12 and the policies and procedures for acquiring commercial items.

The regulations contemplate the use of only one set of standard terms and conditions in commercial item contracts—the new "Contract Terms and Conditions–Commercial Items" clause—and intend that these terms be consistent "to the maximum extent practicable" with "customary commercial practice." FAR 12.301(a). Nevertheless, the new clause contains some provisions traditionally found only in Government contracts, including a "Termination for the Convenience of the Government" term. FAR 52.212-4, para. (l).

The contractor's recovery in the convenience termination of a commercial item contract is governed by FAR 12.403(d), which provides in part:

> When the contracting officer terminates a contract for commercial tiems for the Government's convenience, the contractor shall be paid—
>
> (i) The percentage of the contract price reflecting the percentage of the work performed prior to the notice of the termination, and
>
> (ii) Any charges the contractor can demonstrate directly resulted from the termination. The contractor may demonstrate such charges using its standard record keeping system and is not required to comply with the cost accounting standards or the contract cost principles in part 31. The Government does not have any right to audit the contractor's records solely because of the termination for convenience.

The FAR 12.403(d) formula quoted above for commercial item contracts is a departure from the formula for noncommercial item contracts. As discussed in the original BRIEFING PAPER, the convenience termination formula for recovery under noncommercial item contracts includes (a) allowable costs incurred in the performance of the work, (b) a reasonable profit for work performed, (c) reasonable settlement expenses, and (d) certain "continuing" (post-termination) costs.

To interpret the new commercial item contract convenience termination provisions, FAR 12.403(a) provides that Contracting Officers may continue to use FAR Part 49 "as guidance" to the extent that it does not conflict with FAR Part 12 and the clause at FAR 52.212-4.

Several observations regarding the contractor's convenience termination recovery under a commercial item contract can be made. *First*, there is nothing in the new FAR commercial item provisions inconsistent with a contractor's right to "fair compensation" as set forth in FAR 49.201. Therefore the techniques for maximizing convenience termination recovery set forth in the original BRIEFING PAPER would appear to apply to contracts for commercial items subject to the new rules.

Second, questions remain to be resolved regarding application of the FAR 12.403(d) formula for contractor recovery, such as (1) how to measure the "percentage of the work performed" and (2) how to determine what charges "directly resulted from the termination." For example, is percentage of performance to be mechanically calculated based on units delivered or physical progress or does it include initial costs allowable as under noncommercial item contract terminations? Are charges resulting "directly" from termination limited to settlement expenses or do they include "continuing" (post-termination) costs which are expressly allowable for noncommercial item contracts? Although the measure of recovery set forth in FAR 12.403(d) is ambiguous, because FAR 12.403(a) directs Contracting Officers to continue to use FAR Part 49 for guidance to the extent it does not conflict with FAR Part 12, there appears to be no authority permitting a Contracting Officer to reduce a contractor's recovery below costs allowable under FAR Part 49.

Third, although the Government often relies on the FAR Part 49 rules to deny recovery of post-termination unabsorbed overhead in convenience termination settlements under noncommercial contracts (discussed in the original BRIEFING PAPER) on the ground that such costs are for a contractor's ongoing business rather than the terminated contract (see *J.W. Cook & Sons, Inc.*, ASBCA 39691, 92-3 BCA ¶ 25053), the new commercial item provisions appear to conflict with these rules. However, post-termination unabsorbed overhead is clearly a cost resulting directly from the termination within the meaning of FAR 12.403(d). The argument for allowability of these costs is further buttressed by (1) Uniform Commercial Code § 2-708(2), which defines "damages" as including "reasonable overhead," (2) commercial law cases awarding unabsorbed overhead (see, e.g., *Jericho Sash & Door Co. v. Building Erectors, Inc.*, 286 N.E.2d 343 (Mass. 1972); *Distribu-Dor, Inc. v. Karadanis*, 8 U.C.C. Rep. 36 (Cal. Ct. App. 1970); *Vitex Mfg. Corp. v. Caribtex Corp.*, 377 F.2d 795 (3d Cir. 1967); *Huffman Towing, Inc. v. Mainstream Shipyard & Supply, Inc.*, 388 F. Supp. 1362 (N.D. Miss. 1975) (relying on UCC § 2-708(2) for recovery of overhead in a maritime case)), and (3) the fact that the limitations on allowability in the FAR Part 31 cost principles are expressly inapplicable in the settle-

ment of commercial item contract convenience terminations.

Finally, you should note that the new commercial item contract provisions deprive the Government of its right to audit the contractor's records after termination for convenience. However, a contractor still has the burden of proving its costs. If a Contracting Officer issues a final decision denying the costs, thus forcing the contractor to litigate, the Government would be entitled to obtain the information in discovery in litigation.

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