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POSTSCRIPT: TERMINATION FOR CONVENIENCE OF FAR PART 12 COMMERCIAL ITEM CONTRACTS

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The short-form contract provisions in the "Contract Terms and Conditions-- Commercial Items" clause in Federal Acquisition Regulation 52.212-4 will undoubtedly remain a puzzle for many years because they introduce new language describing old legal principles. Perhaps the most troublesome paragraph of this clause is the termination for convenience paragraph, stating:

> (l) *Termination for the Government's convenience*. The Government reserves the right to terminate this contract, or any part hereof, for its sole convenience. In the event of such termination, the Contractor shall immediately stop all work hereunder and shall immediately cause any and all of its suppliers and subcontractors to cease work. Subject to the terms of this contract, the Contractor shall be paid a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination, plus reasonable charges the Contractor can demonstrate to the satisfaction of the Government using its standard record keeping system, have resulted from the termination. The Contractor shall not be required to comply with the cost accounting standards or contract cost principles for this purpose. This paragraph does not give the Government any right to audit the Contractor's records. The Contractor shall not be paid for any work performed or costs incurred which reasonably could have been avoided.

In *Termination for Convenience of FAR Part 12 Commercial Item Contracts: Is Fair Compensation Required?*, 24 N&CR ¶ 37, Paul **Seidman** provided a very thorough analysis of this language, including the various interpretations that had been arrived at by the boards of contract appeals. In particular, he argued that the clause required fair compensation and that *Red River Holdings, LLC*, ASBCA 56316, 09-2 BCA ¶ 34304, was incorrectly decided because it did not arrive at that result. Since this was an admiralty case, it was appealed to the U.S. District Court for Maryland (rather than the U.S. Court of Appeals for the Federal Circuit), which has agreed with Paul in reversing the board decision, *Red River Holdings, LLC v. U.S.*, Civil No. PJM 10-534, 2011 WL 2160887 (D. Md. May 31, 2011).

The Fair Result Analysis

There seems to be little disagreement that the standard "Termination for Convenience" clauses are intended to take away a contractor's claim for the profits that would have been earned but for the termination but are otherwise intended to ensure that the contractor is not financially harmed by the termination. This intention is played out in the rather generous termination cost principles in FAR 31.205-42. The district court concluded that the language of the commercial items clause was not intended to change that result. First, the court described the contractor's argument:

> Red River argues that the purpose of the [commercial item rules] was to streamline federal procurement and facilitate the acquisition of commercial products, not to somehow abrogate the fair compensation principles that have long informed contractor reimbursement after terminations for convenience. Along these lines, Red River asserts that the most critical distinction between [FAR] 52.212-4(l) and those provisions of the FAR that no longer apply to commercial items is not found in its compensation provisions, but rather in its admonitions

that: (1) the "[c]ontractor shall not be required to comply with the cost accounting standards or contract cost principles for [the] purpose [of demonstrating entitlement]"; and (2) "[t]his paragraph does not give the Government any right to audit the Contractor's records." See 48 C.F.R. § 52.212-4(l). These provisions, Red River maintains, reflect the streamlining and burden-eliminating purposes of the FASA, and thus constitute the pivotal distinction between [FAR] 52.212-4(l) and other termination-for-convenience provisions in the FAR.

Red River also notes that the newly-promulgated FAR provisions expressly state that "[c]ontracting officers may continue to use [FAR] part 49 as guidance to the extent that part 49 does not conflict with this section and the language of the termination paragraphs in 52.212-4." 48 C.F.R. § 12.403(a). [Footnote omitted.] With this provision in mind, Red River points to those sections of the FAR, such as [FAR] 52.249-2(g), that expressly permit recovery of incurred costs and reasonable profits, see 48 C.F.R. § 52.249-2(g), and argues that--because those provisions are not, in its view, in "conflict" with [FAR] 52.212-4(l)--they should guide a decision-maker in determining what types of charges are recoverable when a commercial items contract is terminated for the Government's convenience.

The court essentially agreed with this reasoning, stating:

> [The] potential unfairness [argued for by the Government] cannot plausibly be squared with the [commercial item statute], which was enacted to enhance the efficiency of government procurement, *see* S. Rep. No. 103-258, at 1-2 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 2561, 2562, and not to somehow undercut the longstanding principle that "[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." *Jacobs Eng'g [Group, Inc. v. U.S.]*, 434 F.3d [1378] at 1381 [(Fed. Cir. 2006)] (internal citation and quotation marks omitted). Absent a clear statutory expression of congressional intent to abrogate prevailing principles of fairness in the administration of government contracts, the Court declines to construe [FAR] 52.212-4(l) in a manner that might allocate a disproportionate share of the risk of unexpected changes in circumstances to contractors.

The Claimed "Charges"

The litigation involved the "charges" that should be paid under the termination paragraph of the clause. The contract had called for a 59-month charter of a vessel that the contractor was to purchase and refit for Navy usage, but the Navy terminated the charter at the end of the 57th month. The contractor asserted that it was entitled to the loan principal, interest, and insurance costs that it would have recouped had the charter gone for the full 59 months. It also claimed general and administrative expenses and profit for the lost two months and, if the loan principal, interest and insurance costs were not paid, the unrecouped costs of refitting the vessel and two months depreciation. The board had ruled that the Government was correct in determining that the reasonable "charges" were only settlement costs--cost incurred *after* the termination. Without ruling on each of the claimed costs, the court agreed, in principle, with the contractor, stating:

> [FAR 52.212-4(l)] entitles a commercial items contractor whose contract is terminated for the Government's convenience to the following: (1) payment of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination"; and (2) a payment as compensation for settlement costs or costs *reasonably* incurred in anticipation of contract performance, *provided such costs are not adequately reflected as a percentage of the work performed*, [footnote 17] and *provided such costs could not have been reasonably avoided.* [Footnote 18.] To the extent that the Board's decision below concluded that [FAR] 52.212-4(l)'s reference to "reasonable charges" does not include costs incurred "solely for the purpose of contract performance, or incurrence of costs in anticipation of such performance," . . . that decision is inconsistent with the Court's holding here and must therefore be REVERSED.
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> [Footnote 17.] Clearly, a contractor may not recover additional amounts, however reasonable or necessary, if the expenses with which they are associated are reflected in the percentage-of-work-performed payment. It is worth repeating that [FAR] 52.212-4(l)'s second, "reasonable charges" component contemplates *only* those expenses that--even after a percentage-of-work-performed payment--would otherwise go uncompensated. Pursuant to the regulation's plain language, the *contractor*--and not the Government--bears the burden of proving that any such charges: (a) are reasonable, (b) were not reasonably avoidable, and (c) are not reflected in

> the mandatory percentage-of-work performed payment. Any concern that the Court's construction of [FAR] 52.212-4(l) could erode the purposes of the [commercial item statute] by "opening the floodgates" to all manner of additional charges is fully mitigated by this three-part burden of proof that the contractor must bear.
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> [Footnote 18.] As the Court construes [FAR] 52.212-4(l), the regulation's first component--payment of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination"-- contemplates that a percentage-of-work-performed payment will generally provide a contractor with compensation for costs incurred *and* some amount of profit on those costs. The Court thus concludes that the regulation's second, "safety valve" component--which permits compensation for any reasonable, unavoidable costs not reflected in the first component--generally does *not* contemplate *additional* allowances for profit.

Based on this statement of the general principles applicable to the determination of termination costs, the court accepted the Government's argument that some of the costs were not properly chargeable because they did not fall within the standard termination cost principle. This specifically recognized the Government's argument that the loan principal, interest, and insurance payments were capital costs that had been accounted for because the vessel was chartered in subsequent contracts. The court therefore remanded to the board to determine the charges that should be paid in accordance with its answers to the following questions:

> (1) Do Red River's claimed loan principal and interest amounts, which it paid to finance the acquisition of a capital asset that it could--and ultimately did--retain for use on subsequent government contracts, constitute costs reasonably incurred in anticipation of performance of *this* contract, or are they more appropriately categorized as amounts expended to acquire a general purpose asset for which Red River has other uses?
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> (2) If the [vessel] is in fact a general purpose asset for which Red River has other uses, should the shipyard costs Red River incurred to modify the vessel in preparation for its contract with the Navy be considered separately, as costs reasonably incurred in anticipation of performance of *this* contract?
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> (3) If the [vessel] is in fact a general purpose asset for which Red River has other uses, should Red River be entitled to amounts reflecting asset depreciation for months 58 and 59 of its original contract with the Navy?
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> (4) Do Red River's claimed insurance costs constitute unavoidable costs reasonably incurred in anticipation of performance of *this* contract, or, rather, should they be categorized as costs of a type that Red River would ordinarily have to carry to insure a general purpose asset--irrespective of the asset's use in a particular contractual engagement?
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> (5) Can Red River's claimed general and administrative expenses be properly construed as costs reasonably incurred *prior to* the Navy's early termination of the parties' contract, or, rather, are such costs more appropriately categorized as non-compensable overhead expenses associated with the *terminated* portion of the contract? [Footnotes omitted.]

Our Conclusion

While some readers might conclude that this decision will have little influence because it is a district court decision, its strong analysis and careful reasoning should carry great weight. The judge carefully reviewed all of the decisional law in earlier board of contract appeals decisions as well as Paul **Seidman's** analysis in arriving at a very sound interpretation of this somewhat cryptic language. Hopefully, Government agencies will accept the guidance of the court and apply the normal termination cost principles to terminations for convenience of commercial item contracts. RCN

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ADDENDUM • The formula for recovery for terminations for convenience of commercial item contracts in paragraph (l) of FAR 52.212-4 is (1) the percentage of the contract price reflecting the percentage of completion at termination, *plus* (2) reasonable charges resulting from the termination. In *Termination for Convenience of FAR Part 12 Commercial Item Contracts: Is Fair Compensation Required?*, 24 N&CR ¶ 37, I reviewed the clause, its regulatory history, and how it has been judicially interpreted. My article discussed *Red River Holdings, LLC,* ASBCA 56316, 09-2 BCA ¶ 34304, which limits recovery under the second prong of the commercial item formula to just settlement expense. It concluded that such limitation on recovery is contrary to (a) the plain language of the clause, (b) its reg-

ulatory history, and (c) the "fair compensation principle," which requires that that terminated contractors receive fair compensation.

In *Red River Holdings, LLC, v. U.S.*, Civil No. PJM 10-534, 2011 WL 2160887 (D. Md. May 31, 2011), the Maryland District Court took a step in the right direction by reversing the ASBCA decision and holding (1) initial costs allowable under prong two of the commercial item formula for reasonable charges resulting from the termination, and (2) the "fair compensation" principle applies to Federal Acquisition Regulation Part 12 commercial item contracts. The court professes to uphold the "fair compensation" principle. Nevertheless, "unfair compensation" may result from (a) unnecessary language (dictum) indicating recovery for reasonable charges resulting from the termination under the second prong is limited to unamortized initial costs and settlement expense and (b) its holding that profit is not allowable under prong two.

The district court opinion states:

> [T]he Court holds that § 52.212-4(l) of the FAR entitles a commercial items contractor whose contract is terminated for the Government's convenience to the following: (1) payment of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination"; and (2) a payment as compensation for settlement costs or costs *reasonably* incurred in anticipation of contract performance, *provided such costs are not adequately reflected as a percentage of the work performed*, and *provided such costs could not have been reasonably avoided*. [Footnotes omitted.] [Emphasis in original.]

Item "(2)" appears to preclude the recovery of costs unavoidably continuing after termination recoverable under the FAR 31.205-42 cost principle in traditional Government contracts.

With respect to profit, the court states at footnote 18:

> As the Court construes [FAR] 52.212-4(l), the regulation's first component-- payment of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination"--contemplates that a percentage-of-work-performed payment will generally provide a contractor with compensation for costs incurred *and* some amount of profit on those costs. The Court thus concludes that the regulation's second, "safety valve" component-- which permits compensation for any reasonable, unavoidable costs not reflected in the first component--generally does not contemplate *additional* allowances for profit. [Emphasis in original.]

The limitation on recovery imposed by the court on the second prong is illogical, contrary to its plain meaning, contrary to the mandate in the Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, that FAR commercial items clauses adopt standard commercial practices, provides for less recovery than that available under traditional Government contracts, and is inconsistent with the "fair compensation" principle that the court purports to uphold.

The Limitation On Recovery Is Illogical

The court provides no explanation for its gratuitous statement that second prong recovery is limited to unamortized initial costs and settlement expense. A likely reason is that this is all that Red River requested under the second prong. The fact that Red River did not request other costs does not mean that other reasonable charges resulting from a termination are unallowable. Such costs include, but are not necessarily limited to, costs continuing after termination allowable under FAR 31.205-42 in traditional Government contracts.

The court concludes that a contractor is not entitled to profit under the second prong because it may be able to recover some profit under the first prong. The first prong entitles a contractor to the percentage of contract price reflecting the percentage of completion.

The court justifies its position based on its characterization of the second prong as a "safety valve." This is the

court's characterization. It has no basis in statute, legislative history, regulation, rulemaking history, or logic.

Prong two is not a mere "safety valve." Rather, it is the primary source of the net recovery to a terminated contractor. All that prong one does is restate the right to be paid for completed work at the contract price. It is irrelevant to the termination because the contractor is entitled to such amount under the paragraph (i) "Payment" term of the FAR 52.212-4 "Terms and Conditions-- Commercial Items" clause irrespective of whether the contract is terminated for convenience.

• *The Limitation On Recovery Is Inconsistent With The Commercial Items Clause*. Prong two of paragraph (l) of the commercial items clause, FAR 52.212-4, speaks of reasonable *charges* resulting from the termination rather than reasonable *costs* resulting from the termination. It is clearly reasonable to *charge* for costs unavoidably continuing after termination and profit under prong two. The reasonableness of such charges is evidenced by the allowability of costs unavoidably continuing after termination and profit under FAR 31.205-42 in traditional Government contracts. Reasonableness is also evident from the fact that continuing costs and profits are recoverable as damages for cancellation of a private sector contract for commercial items under Uniform Commercial Code § 2-708.

• *The Limitation On Recovery Is Inconsistent With The FASA Mandate To Adopt Standard Commercial Practices.* FASA § 8002(b)(1) directs that the FAR include, to the maximum extent practicable, only clauses--"(A) that are required to implement provisions of law or executive orders applicable to acquisitions of commercial items or commercial components, as the case may be; or (B) that are determined to be consistent with standard commercial practice." A termination for convenience clause is not required to implement a statute or executive order. FASA therefore requires that the termination for convenience clause be "consistent with standard commercial practice."

"Standard commercial practice" is set forth in the UCC, which has been adopted in 49 states. UCC § 2-708(2) states that "the measure of damages [for cancellation by the buyer includes] . . . the profit (including reasonable overhead) which the seller would have made from full performance by the buyer." Both costs unavoidably continuing after termination and profit on all costs incurred are recoverable under UCC § 2-708(2).

Standard commercial practice as reflected in UCC § 2-708(2) is for payment of anticipatory profit--the profit (including reasonable overhead) *which the seller would have made from full performance by the buyer*." (Emphasis added.) A terminated contractor is not entitled to anticipatory profit under a traditional Government contract, FAR 49.202.

The district court in *Red River* did not construe the commercial items clause to adopt the standard commercial practice as required by FASA and to provide for anticipatory profit not allowable under traditional Government contracts. Instead, the court went in the opposite direction by precluding the recovery of profit allowable on unamortized initial costs under a traditional Government contract.

In *Commercial Item Terms and Conditions: Neither Fish Nor Fowl*, 10 N&CR ¶ 61, Professor Cibinic criticized the inclusion of a termination for convenience clause in FAR Part 12 commercial item contracts as inconsistent with standard commercial practice. However, if anticipatory profits are recoverable under the commercial items formula, there would be no inconsistency.

• *The "Fair Compensation Principle" Provides For Profit On Preparations For Work To Be Performed*. The district court in *Red River* purports to adopt the "fair compensation" principle for traditional Government contracts. Nevertheless, its holding that profit is unallowable on initial costs is inconsistent with the "fair compensation" principle as set forth in FAR 49.201(a) and 49.113. FAR 49.201(a) states: "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*." (Emphasis added.)

• *The District Court Opinion Will Deprive Many Contractors Of "Fair Compensation."* The "fair compensation" principle requires that a contractor not suffer as the result of a termination, *Jacobs Engineering Group, Inc. v. U.S.*, 434 F.3d 1378 (Fed. Cir. 2006), 43 GC ¶ 49. A contractor that cannot recover costs unavoidably continuing after termination may be deprived of fair compensation. See *General Electric Co.*, ASBCA 24111, 82-1 BCA ¶ 15,725 *recons. denied*, 83-1 BCA ¶ 16,207.

As previously noted, prong two of FAR 52.212-4, paragraph (l), is the primary source of recovery for a terminated commercial items contractor rather than a mere "safety valve." Not allowing profit under prong two will therefore deprive many contractors of "fair compensation." The situation is particularly egregious where a contractor incurs substantial preparation costs but is terminated before making any deliveries. Under such circumstances there is no recovery of profit under either prong one (which overlaps with the "Payments" clause) or prong two.

Impact Of The Maryland District Court Decision Is Unclear

An ASBCA opinion is the opinion of the board rather than the judge that wrote it. ASBCA opinions are therefore binding on all ASBCA judges. This contrasts with opinions of Court of Federal Claims judges, which are only persuasive authority and not binding on other COFC judges.

An ASBCA opinion has no precedential value to the extent overruled by the U.S. Court of Appeals for the Federal Circuit. However, the effect of a U.S. District Court reversal of the ASBCA in a maritime contract case on the ASBCA in nonmaritime cases is unclear. It is the law of the case for the parties to the *Red River* litigation. However, it is not binding on the Civilian Board of Contract Appeals, the COFC, or the Federal Circuit.

Strategy

Hopefully, the traditional Government contract forums--the boards, the COFC, and the Federal Circuit--will adopt the portion of the district court opinion providing for allowability of unamortized startup costs under prong two, but reject the portion of such opinion imposing limitations on recovery under prong two. Until that happens, contractors should consider the following advice from my prior article on FAR Part 12 commercial item terminations for convenience, 24 N&CR ¶ 37:

> Where does that leave a commercial item contractor dissatisfied with the amount a Contracting Officer is willing to pay as the result of a termination for convenience?
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> A contractor can elect to challenge a final decision denying its claim in either the cognizant board of contract appeals or the Court of Federal Claims. A terminated defense contractor that seeks to recover unamortized performance costs or unavoidable continuing costs should avoid the *Red River* precedent by bringing suit in the Court of Federal Claims instead of the ASBCA. If the terminated contract is with a civilian agency, the contractor may want to bring suit at the CBCA based on its favorable decision in *Corners & Edges* [CBCA 762, 08-2 BCA ¶ 33,961]. The Court of Federal Claims has not ruled on this issue and it possibly could follow *Red River*. This choice of forum recommendation is premised upon the current state of the law. A contractor should check recent decisions and regulatory changes before submitting an appeal to determine if this is still a good recommendation.
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> Also, terminations for convenience often follow Government-caused delays. Such delays may result from a stop work order. They also could result from the Government's failure or inability to take an action required for contractor performance, such as making a worksite available. This results in unamortized performance costs a defense contractor could not recover under *Red River*. Nevertheless, a contractor may be entitled to an equitable adjustment for such costs under the "Changes" and "Disputes" clauses. See *SAWADI Corp*, ASBCA 53073, 01-1 BCA ¶ 31357; *Commercial Item Disputes: Using New Contract Language*, 17 N&CR ¶ 2.

For a discussion of how to maximize recovery following a termination for convenience, see **Seidman** & **Seidman**, *Maximizing Termination for Convenience Settlements/Edition II--Part I*, Briefing Papers No. 08-3 (Feb. 2008) and **Seidman** & **Seidman**, *Maximizing Termination for Convenience Settlements/Edition II--Part II*, Briefing Papers No. 08-5 (Apr. 2008). *Paul J. **Seidman***

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