BRIEFING PAPERS® SECOND SERIES

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

SERVICE CONTRACTING IN THE NEW MILLENNIUM—PART II

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This BRIEFING PAPER is the second of two PAPERS focusing on those policies and procedures that are unique to, or principally affect, the Federal Government's acquisition of services. Part I, published last month, discussed the treatment of services as "commercial items" under statutes and Federal Acquisition Regulation Part 12, performance-based service contracting, the requirements for analyzing procurement opportunities against the laws and policy guidance on contract bundling, and ordering mechanisms for services, including orders placed under Federal Supply Schedule contracts and under task order contracts.[1] This Part II addresses a number of other crucial issues affecting the business relationship between federal agencies and private sector service contractors: (1) *public-private competitions under Office of Management and Budget Circular A-76*, (2) the basics of the *Service Contract Act*, and (3) the fundamental elements of *termination for convenience* and *termination for default* of service contracts. As both PAPERS note, new laws or revised regulations or administrative policies currently being considered could affect several of these issues.

IN BRIEF

OMB Circular A-76 Public-Private Competitions

A threshold question is whether services needed by the Government are to be performed by Government employees or contractors.[2] Mechanisms for identifying Government requirements and making this determination are set forth in *OMB Circular A-76, "Performance of Commercial Activities*[3] and in the *Federal Activities Inventory Reform (FAIR) Act of 1998*.[4] Requirements of both Circular A-76 and the FAIR Act are implemented in the Circular's companion *Revised Supplemental Handbook*.[5]

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■ OMB Circular A-76

OMB Circular A-76 establishes federal policy on the performance of "commercial activities." It provides as follow:[6]

> In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary source of national economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs.

Under Government policy as stated in the Circular, agencies may *not* contract out for performance by private sector contractors "inherently governmental functions."[7] However, for "commercial activities" that provide products or services that can be obtained from commercial sources and that are "not inherently governmental," agencies must determine whether they should contract out or have the work performed in-house by Government employees by conducting a public-private cost comparison in accordance with the *Revised Supplemental Handbook*.[8] This cost comparison process is discussed in detail below.

■ FAIR Act

The FAIR Act requires agencies to submit annually to the OMB and to make public commercial activities inventories listing activities performed by agency employees that are "not inherently governmental functions."[9] For activities on these lists, agencies must use competitive procedures and realistic and fair cost comparisons to determine whether to contract out or continue in-house performance.[10]

An agency must submit its commercial activities inventory to the OMB each year by June 30.[11] Appendix 2 of the *Revised Supplemental Handbook* specifies minimum requirements for the content of annual inventory submissions. After the OMB completes its review of an agency's list, it must publish a notice in the *Federal Register* advising that the inventory is available to the public.[12] After publication of the *Federal Register* notice, an agency must make its annual report publicly available.[13]

The FAIR Act gives an 'interested party" the right to submit to the agency a challenge to the exclusion or inclusion of an activity from the list.[14] An "interested party" is uniquely defined for such challenges in the Act as (a) an actual or prospective private sector offeror, (b) a representative of an association with members that are actual or prospective private sector offerors, (c) an officer or employee of an organization within an agency that is an actual or prospective offeror, or (d) the head of a labor organization with members that are officers or employees of an organization that is an actual or prospective offeror.[15]

An interested party may file an initial challenge to the inclusion or exclusion of an activity to the agency within 30 working days after the OMB notice appears in the *Federal Register*. [16] The official designated by the head of the agency to decide initial challenges must provide the interested party a written decision within 28 working days of receiving the challenge.[17]

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An interested party may appeal an agency decision of its initial challenge to the official designated by the head of the agency within 10 working days after receiving the appeal.[18] The agency official deciding the appeal must transmit a written decision to the interested party within 10 working days after receipt of the appeal.[19]

■ "Inherently Governmental Function" vs. "Commercial Activity"

OMB Circular A-76 and the FAIR Act define an "inherently governmental function" as "a function that is so intimately related to the public interest as to require performance by Federal Government employees."[20] It includes the exercise of discretion in applying Federal Government authority, decisionmaking for the Federal Government involving value judgments, and the interpretation and execution of the law.[21] Under this definition, "inherently governmental functions" do not normally include (1) gathering information or providing advice or ideas or (2) ministerial functions "such as building security, mail operations, operation of cafeterias, housekeeping, facilities operation and maintenance, warehouse operations, motor vehicle fleet management operations, or other routine electrical or mechanical services."[22]

Appendix 1 of the *Handbook* defines a "commercial activity" as "the process resulting in a product or service that is or could be obtained from a private sector source."[23] OMB Circular A-76 provides a list of examples of "commercial activities." These examples include audiovisual products and services; automatic data processing; food services; health services; industrial services such as machining, carpentry, electrical, plumbing, heating, painting, calibration, and repair; maintenance, overhaul, repair, and testing; management support, office and administrative services; manufacturing, fabrication, processing, testing, and packaging; other services such as laundry and dry cleaning, mapping and charting, architect and engineer services, geological surveys, cataloging, and training; printing and reproduction; design, engineering, and construction; security; special studies and analyses; systems engineering, installation, operation, maintenance, and testing; and transportation.[24]

■ General Principles

Four general principles can be gleaned from OMB Circular A-76 and the *Revised Supplemental Handbook*.

First, as noted above, inherently governmental functions must be performed in-house by Federal Government employees.[25] Therefore, they are not subject to the requirements of OMB Circular A-76 and the *Handbook*.[26]

Second, a requirement for a commercial activity obtained through a competitively awarded contract will continue to be obtained by contract. A public-private cost comparison is required only "[i]f the Government believes that quality is unacceptable or prices appear unreasonable."[27]

Third, a new requirement for a commercial activity will be obtained by contract from the private sector. A cost comparison is required only "[i]f there is reason to believe that contract service quality or prices may be unreasonable."[28]

Fourth, a cost comparison is generally required for a commercial activity currently performed by Government employees. Continued in-house performance must generally be justified by lower cost.[29] However, the Government may perform commercial activities in-house without performing a cost comparison if (a) necessary to ensure the national defense or intelligence security, (b) necessary to maintain the quality of patient care, (c) necessary to maintain a minimum core capability to fulfill mission responsibilities or meet emergency requirements, (d) the activity is for research and development, (e) there is no satisfactory commercial source available, (f) the activity involves 10 or fewer full-time employees, (g) in-house performance meets or exceeds generally recognized industry and cost standards, or (h) a contractor defaults or is otherwise terminated and

the in-house performance is for interim support.[30]

■ Cost Comparison Process

In sealed-bid procurements, award is made "considering only price and the price related factors" in the invitation for bids.[31] Under OMB Circular A-76, continued in-house performance of commercial activities by agency employees is only justified if the Government prevails in the cost comparison.[32]

In negotiated procurements, factors other than price are considered.[33] Therefore, under the A-76 process, there is first a *private-private* competition among private offerors to select the proposal offering the best value to the Government. This is followed by a *public-private* competition between the Government's "most efficient organization" and the winner of the *private-private* competition.[34]

In general, the A-76 cost comparison process involves the following six steps:

Step 1—Government Preparation of the Performance Work Statement (PWS) and Quality Assurance Surveillance Plan (QASP).[35] The PWS defines the work to be accomplished, performance standards and measures, and time requirements. The PWS should be performance based. It should specify the desired end result without specifying how it is to be accomplished.[36]

The QASP describes the methods of inspection to be used, required reports, and estimated work hours. It need not be included in the solicitation or provided to private sector offerors.[37]

Step 2—Performance of a Management Study To Determine the Government's Most Efficient Organization (MEO). [38] The MEO is the Government's organization for performing the PWS.[39] It is used as the basis for the Government's in-house cost estimate.[40] The MEO may call for changes to the existing management structure and reclassification of personnel to meet the minimum requirements of the PWS.[41]

Step 3—Development of an In-House Government Cost Estimate.[42] The in-house cost estimate is a description of all costs required for performance of the PWS by the MEO. It must be calculated in accordance with Part II of the *Revised Supplemental Handbook.*[43]

Step 4—Issuance of Solicitation.[44] The solicitation is based on the PWS. Before issuing the solicitation the Contracting Officer should carefully review the PWS to ensure that it provides an adequate and appropriate basis for award.[45]

For negotiated procurements, the request for proposals must include the "Notice of Cost Comparison (Negotiated)" solicitation provision at FAR 52.207-2.[46] This provision calls for (1) a *private-private* competition to determine which contractor's proposal offers the best value to the Government followed by (2) a *public-private* competition between the Government and the winning offeror from the *private-private* competition.

All solicitations must contain the "Right of First Refusal of Employment" clause at FAR 52.207-3.[47] This clause gives federal employees a right of first refusal for positions created by a conversion from in-house performance to performance by contract.

Step 5—Comparison of the In-House Bid Against a Proposed Contract Price.[48] For sealed-bid procurements, the CO opens all bids, including the Government's in-house cost estimate, and enters the price of the apparent low offeror on the cost comparison form. The CO makes necessary cost adjustments and announces the apparent successful offeror, subject to an evaluation of responsiveness and responsibility and the determination of any administrative appeals.[49]

For negotiated procurements, the evaluation is a two-step process. A *private-private competition* is first held among private sector offerors. This is followed by a *public-private competition* between the Government and the winning private sector offeror.[50]

In a negotiated "best value" procurement, contractors may offer different approaches to

the Government's needs with award made based on the proposal offering the best value to the Government.[51] Before making a cost comparison between the private sector "winner" and the Government's MEO, the scope of work for the Government proposal is administratively adjusted to ensure that it reflects performance of the same scope of work as offered by the winner of the *private-private competition*.[52]

Step 6—The Administrative Appeal Process.[53] A contractor or representative of Government employees may file an administrative appeal to the purchasing agency. The purpose of the appeal process is to ensure that costs used for comparison are fair, accurate, and calculated in accordance with Part II of the *Revised Supplemental Handbook*.[54]

■ Costs Of Government Performance vs. Costs Of Contract Performance

An A-76 cost comparison requires more than a straightforward comparison of the agency's in-house cost estimate and the contractor's proposed price. Adjustments must be made in a cost comparison to account for the different manner in which Government agencies and contractors compute costs. For example, contractors depreciate capital equipment; the Government recognizes the entire expense when paid. Contractors charge costs to its customers; Government costs are met by different appropriation accounts, revolving funds, or combinations thereof. Contractors purchase insurance; the Government self-insures. Contractors pay taxes to the Government; the Government receives taxes from contractors. The A-76 cost comparison procedures attempt to level the playing field by making adjustments for these differences.[55]

The *Government's in-house cost estimate* is based on the following schedule of costs not common to in-house and contractor performance: personnel costs, materials and supply costs, other specifically attributable costs (depreciation, cost of capital, rent, maintenance and repair, utilities, insurance, travel, MEO subcontracts, and other costs), overhead costs, and additional costs.[56]

The formula for determining the *cost to the Government* of performance by a *private sector contractor* is set forth below:[57]

> Cost of Contract Performance = Contract Price + Contract Administration Costs + Other Additional Costs + One-Time Conversion Costs – Gain From Disposal/ Transfer of Assets – Potential Federal Income Tax Revenue

The *contract price* reflects the cost to perform the PWS as presented by the offeror selected to compete with the in-house workforce.[58] Adjustments to the contract price are specified for other than fixed-priced contracts.[59] Where a contractor eligible for a procurement preference submits a proposal on an unrestricted solicitation, 10% is added to each nonpreference eligible contractor's offer for purposes of determining which offer will be chosen to compete with the Government in-house cost estimate.[60]

Contract administration costs include the cost of reviewing compliance with contract terms, processing payments, negotiating change orders and contract closeout. Factors for determining contract administration costs are listed in the *Handbook* at Table 3-1.[61]

Additional costs are any additional costs to the Government resulting from special circumstances in a particular cost comparison. Additional costs do not include the cost to hold MEO equipment and facilities on standby to maintain a performance capability.[62]

One-time conversion costs are the costs incurred as the result of the conversion. These costs, for example, may be material- or labor-related.[63]

Gain from disposal/transfer of assets may occur if assets are no longer needed under the Government's MEO. For purposes of the computation, only those assets that are to be used by the Government's MEO and not made available to the contractor are included.[64]

Finally, the *potential federal income tax revenue* from contractor performance must be considered. Since contract performance will result in taxable income, an estimated amount

of such taxes are deducted from the net cost to the Government. Appendix 4 of the *Revised Supplemental Handbook* sets forth tax rates in relation to business receipts by industry. No such adjustment is made for tax-exempt organizations.[65]

■ Cost Comparison Decision

It is not in the Government's interest to convert where estimated savings are minimal. Therefore a conversion from in-house to contractor performance is only justified by a minimum differential of the lesser of (1) 10% of personnel costs or (2) $10 million over the performance period.[66]

■ Protests

Both OMB Circular A-76 and the *Revised Supplemental Handbook* appear to preclude appeals outside the agency or judicial review.[67] However both the General Accounting Office[68] and the U.S. Court of Federal Claims[69] will review an A-76 determination where it is part of a competitive procurement. Only contractors can bring a protest at the GAO concerning an A-76 determination. Federal employees and their unions are not an "interested party" at the GAO[70] and lack standing at the Court of Federal Claims.[71]

Contractor bid protests of agency OMB Circular A-76 determinations have had an unusually high success rate at the GAO.[72] Contractor protests have recently been upheld by the GAO based on the following grounds:

(a) *Solicitation Unduly Restrictive of Competition*—In one protest, the GAO found that a solicitation issued for purposes of an OMB Circular A-76 cost comparison requiring an offeror to have an ISO 9000 certification at the time its proposal was submitted was unduly restrictive of competition. The GAO concluded that the solicitation requirement exceeded the Government's minimum needs because the A-76 cost comparison process provided sufficient time for the contractor to satisfy this requirement.[73] In another case, the GAO sustained a protest of an A-76 cost comparison where the solicitation required contractors to provide facilities for inventory instead of permitting the use of existing Government facilities used by the Government in its MEO proposal.[74]

(b) *Best Value*—In best value procurements, an agency makes a best value determination to determine the winner of a *private-private* competition among contractors. A *public-private* competition is then held between the Government and the winner of the *private-private* competition. To ensure that the Government and winner of the *private-private* competition are competing on an equal basis, the Government MEO often has to be administratively modified to reflect the same level of service. The GAO held that an award to the MEO based upon "adequate" staffing was improper where the cost comparison characterized previously evaluated strengths in the private sector proposal to be "unnecessary expenses."[75]

(c) *Improper Cost Comparisons*—Cost adjustments must reflect differences in how the Government and the contractor account for costs and any additional costs incurred by the Government as the result of a conversion. The GAO has held that it is improper to include the cost of Government-furnished property in a contractor's proposal where the cost is a "common item" that would also be incurred if the Government performed the requirement.[76] Another cost comparison was overturned where the MEO's performance level was not adjusted to apply to either a revised PWS or the private sector proposal.[77]

(d) *Conflicts of Interest*—The GAO has sustained protests of cost comparisons based on conflicts of interest. For example, a cost comparison was set aside based on a conflict of interest where Government evaluators held positions at risk in the cost comparison.[78] Another was overturned where the contractor had access to information not available to other offerors.[79] The GAO held there was an impermissible conflict of interest where a Navy employee and a private sector consultant wrote and edited the PWS and then prepared the MEO for in-house performance.[80]

■ What Next?

There is considerable controversy over the continued efficacy of the OMB Circular A-76 process for conducting *public-private competitions* to determine whether a commercial activity performed by Government employees should be outsourced to the private sector. It is a widely discredited process.

Federal employee unions argue for competitions to determine whether commercial activities that are currently outsourced should be performed by federal employees. Contractors argue these are not Government functions and that the Government should not compete with its citizens. Contractors also argue it would be impracticable to conduct a competition to take commercial work in-house because a new Government infrastructure would have to be created to perform such work.

In addition, contractors are critical of the two-step process in negotiated procurements where the Government competes only against the winner of the *private-private competition*. They argue that this process results in technical leveling and permits the Government unfairly to use the approach that won the *private-private competition*. They assert that the process guarantees that the Government is "at the table" for the final cost comparison without having to "compete" on the same basis as interested private sector bidders.

Moreover, contractors are dissatisfied with the time required to conduct an A-76 cost comparison. In many cases, they feel it is not worth committing the resources for the chance of an award three years later when they can obtain more current opportunities by competing for traditional private-private opportunities or marketing their services through multiple award task order contracts or General Services Administration Federal Supply Schedules.

To address these concerns, Congress in the National Defense Authorization Act for Fiscal Year 2001 directed the GAO to create a panel of experts to study the policies and procedures for transferring commercial activities from Government personnel to the private sector.[81] The GAO created a Commercial Activities Panel composed of representatives of agencies, federal labor unions, and the private sector. In its April 29, 2002, final report, the panel unanimously adopted a set of 10 sourcing principles to guide all federal sourcing policies and recommended replacing the current A-76 public-private procedure with an "Integrated Competition Process." Such process would involve public-private competitions under the framework of the FAR, while using appropriate elements of OMB Circular A-76 to accommodate the special circumstances of the Government as a "bidder."[82] On November 14, 2002, the OFPP issued for public comment a proposed major revision to Circular A-76 to implement the panel's recommendations.[83]

Service Contract Act

Any discussion of the rules unique to the Government's purchase of services must include the McNamara-O'Hara Service Contract Act (SCA) of 1965.[84] The SCA regulates the minimum wages and fringe benefits for "service employees" on *covered* service contracts and subcontracts.[85] It also requires a safe working environment.[86]

The SCA is implemented by mandatory clauses in covered contracts.[87] The clauses must be flowed down to subcontractors.[88] In the discussion that follows, the use of the terms "contract" and "contractor" include "subcontract" and "subcontractor."

The Department of Labor is responsible for implementation and administration of the SCA. As a key part of these responsibilities, the DOL issues wage determinations for job classifications.[89] Failure to comply with the SCA may result in withholding of contract payments, debarment from contracting, and contract termination for default.[90]

■ Basic Requirements

A federal service contractor must pay its *service employees* no less than the minimum wage rates and fringe benefits set forth in the ap-

plicable DOL wage determination. Wage determinations are based on the prevailing wage for the job classification in the locale where the contract will be performed. If the contract is a successor to a contract subject to a bona fide collective bargaining agreement, the contractor cannot pay covered employees wages or fringe benefits less than provided for in that agreement.[91]

■ "Service Employees"

A "service employee" is any person engaged in the performance of a covered service contract.[92] *Executive, administrative* and *professional personnel*[93] and *apprentices, student learners,* and *certain employees with disabilities*[94] are exempt from the SCA wage determination requirement. However, contractors must pay *apprentices, student learners,* and *employees with disabilities* the fringe benefits required for their job descriptions.[95]

■ Covered Contracts

The SCA applies to all federal (and District of Columbia) service contracts over *$2,500* whose *principal purpose* is to provide services *in the United States.*[96] Covered "contracts" include all "subcontracts" at *any tier.*[97]

DOL regulations list examples of 55 types of services subject to the SCA.[98] The list, which is not exhaustive, includes motor pool operation and base ambulance services; custodial, janitorial, housekeeping, and guard services; laundry and dry-cleaning; snow and trash removal; aerial spraying and reconnaissance for fire detection; operation, maintenance, or logistics support of a federal facility; and data collection, processing, and analysis services.[99]

■ Exempt Contracts

The SCA exempts contracts for (1) construction and repair of public buildings or public works, (2) manufacturing subject to the Walsh-Healey Act, (3) carriage of freight or personnel where published tariff rates are in effect, (4) communication services (radio, telephone, telegraph, or cable companies) subject to the Communications Act of 1934, (5) public utility services, (6) direct services to a federal agency by an individual or individuals, and (7) operation of U.S. Postal Service contract stations.[100]

The SCA authorizes the DOL to issue *regulations* creating *additional exemptions.*[101] The most important exemptions created by the DOL exempt certain contracts for *commercial services.*

Contracts for the maintenance, calibration, and repair of *automated data processing equipment, scientific* and *medical equipment,* and *office* and *business machines* qualify for the commercial services exemption if (a) the equipment serviced is a commercial item, (b) the price for the services is based on an established catalogue or market price, (c) all employees that perform similar services receive the same compensation, and (d) the contractor certifies compliance with (a)–(c).[102]

Other contracts for commercial services are exempt if the services satisfy the criteria applicable for exemption of ADP services (i.e., established prices, same compensation package, and certification) *and* (1) no service employee will spend more than 20% of the employee's time on the Government work, and (2) *award* will be on a *sole-source basis* or price will not be more important than nonprice factors in the award.[103] The commercial services exempt under this provision are (a) automobile or other vehicle maintenance other than operation of a motor pool, (b) financial services involving the issuance and servicing of credit and debit cards, (c) hotel and motel services for conferences, including related lodging and meals, (d) maintenance, calibration, repair, and installation of equipment by a contractor that delivered the equipment under a sole-source contract, (e) transportation of persons by common carrier, and (f) real estate and relocation services.[104] However, these services are not eligible for exemption if the contract is subject to collective bargaining agreement under § 4(c) of the SCA as amended.[105]

■ Wages & Fringe Benefits

The SCA requires contractors to pay their employees either (1) the wage and fringe ben-

efit rates prevailing in the geographic area of performance or (2) the wage and fringe benefit rate specified under the predecessor contractor's collective bargaining agreement.[106] In no case are employees to be paid less than the minimum wage required under the Fair Labor Standards Act (FLSA) of 1938.[107] The SCA, while not including a requirement for overtime pay, requires that the calculation of overtime rates as required by other labor standards, such as the FLSA,[108] be calculated against wages *without fringe benefits.*[109]

Each covered contract must specify the minimum wage and fringe benefits for each class of service employee used.[110] The DOL determines the applicable minimum wage and fringe benefit rates through its *wage determination process.*[111]

At least 60 days before an anticipated award, the CO must submit to the DOL Wage and Hour Division the Standard Forms 98 and 98a, "Notice of Intention To Make a Service Contract and Response to Notice" and "Attachment A."[112] The CO must list all classes of employees expected to be employed under the contract, the number of employees in each class, and the wages and fringe benefits the Government would pay each class of employee if the services were being performed by a Government employee.[113] The CO must also advise the DOL of any wage determination applicable to the incumbent's contract if based on a collective bargaining agreement.[114] In response, the DOL will issue a wage determination setting forth the wages and fringe benefits for each class of employee.[115]

■ Conformance Procedure

Where a contractor discovers that the wage determination incorporated in a solicitation fails to include a pertinent job classification, the contractor must initiate a DOL *conformance procedure.*[116] The contractor submits an SF 1444, "Request for Authorization of Additional Classification and Rate" to the CO. The contractor will list the proposed classification, a job description, the proposed rate with a supporting rationale, and any agreement or disagreement with the employee's authorized representative or the employee if there is no authorized representative.[117]

The CO reviews the request and submits it along with any recommendations to the DOL.[118] The DOL can adopt the contractor's request or the agency's recommendation, establish its own classification, or determine whether the job description is covered under an existing classification.[119]

■ Penalties For SCA Violations

A "party responsible" for SCA violations is liable to employees for the amount of any improper deductions, rebates, or underpayments.[120] Each of the following is a "party responsible": (1) the contractor or subcontractor, (2) a corporate officer who actively directs and supervises contract performance, and (3) any other person who exercises control, supervision, or management authority over performance of the contract.[121]

The DOL may direct a CO to withhold the amount due for any underpayments from any Government contract.[122] A "party responsible" can also be debarred for SCA violations. Debarment for three years is required for a party responsible found to have violated the SCA, *unless* the Secretary of Labor issues a recommendation against debarment based on "unusual circumstances" (which is unusual).[123] In addition, SCA violations are grounds for a contract termination for default.[124]

■ Mandatory Contract Clauses

Provisions implementing the SCA are set forth in the FAR "Service Contract Act of 1965, As Amended" clause.[125] Covered *fixed-price* contracts must also incorporate a "Fair Labor Standards Act and Service Contract Act—Price Adjustment" clause.[126] Under this clause, the contractor may obtain an adjustment in the contract price for a contract modification imposing a new wage determination. The clause limits the adjustment to actual increases or decreases in wages and fringe benefits and corresponding increases in social security, unemployment taxes, and workers' compensa-

tion insurance. The adjustment does not include general and administrative expense, overhead, or profit.[127]

Where the price adjustment clause does not cover a particular increase in the cost of performance (i.e., a wage determination increasing the required wages during the *base* year of a multiyear or option contract), the contractor is entitled to an equitable adjustment under the contract's "Changes" clause. An equitable adjustment under the "Changes" clause includes general and administrative expense, overhead, and profit on the increased wages.[128]

The CO must also insert the FAR "Statement of Equivalent Rates for Federal Hires" clause. This clause sets forth the equivalent wages and fringe benefits that would be paid by the Government for the various classes of service employees expected to be used under the contract.[129]

Termination For Convenience

■ Other Than FAR Part 12 Contracts for Commercial Services

Service contracts, other than FAR Part 12 contracts for commercial services, may contain either the FAR 52.249-2 "Termination for Convenience of the Government (Fixed-Priced)" clause, which is not limited to services or the FAR 52.249-4 "Termination for Convenience of the Government (Services) (Short Form)" clause.

Whether the "Termination for Convenience of the Government (Services) (Short Form)" clause is used has a significant effect on contractor recovery. Under the other "Termination for Convenience" clauses, a contractor is generally entitled to recover its allowable costs (which include certain costs continuing after termination), settlement expense, and profit.[130] Under the "Termination for Convenience of the Government (Services) (Short Form)" clause, the Government is "liable only for payment...for services rendered before the effective date of termination."[131]

The FAR limits the use of the "Termination for Convenience of the Government (Services) (Short Form)" clause to instances where the CO determines the successful offeror will not incur substantial charges in preparation for and in carrying out the contract and would, if terminated for the convenience of the Government, limit termination settlement charges to services rendered before the date of termination.[132]

After a termination for convenience, a service contractor is faced with two issues. *First*, does the contract include the short form services clause, which limits recovery to services rendered? If the short form clause is not included, the contractor's termination for convenience recovery is not limited to services rendered. *Second*, if the short form clause is included, was its inclusion reasonable under the standards set forth in the FAR?

Under what is known as the *Christian* doctrine, clauses required by law or regulation will be "read into" a Government contract even though not actually included in the contract. The doctrine is based upon *G.L. Christian v. United States,*[133] in which the Court of Claims read a "Termination for Convenience" clause into a contract because it was required by regulation. Where the inclusion of the "Termination for Convenience of the Government (Services) (Short Form)" clause is an abuse of discretion, judges have used the *Christian* doctrine to substitute the appropriate "Termination for Convenience" clause. For example, an abuse of discretion was found in a guard service contract where the contractor was required to provide weapons and uniforms. The Armed Services Board of Contract Appeals reasoned that such items provided the basis for a claim for "other than services rendered."[134] Similarly, the use of the short form clause in a contract for maintenance services was held to be erroneous. The General Services Administration Board of Contract Appeals stated that because of start-up costs, a determination could not be made that a termination for convenience claim would not result in a claim for "other than services rendered."[135]

■ FAR Part 12 Contracts For Commercial Services

A contractor's recovery for the termination for convenience of a FAR Part 12 contract for commercial services is governed by FAR 12.403(d).[136] This provision states as follows:

> When the contracting officer terminates a contract for commercial items 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. The convenience termination formula for recovery under noncommercial item contracts includes (a) allowable costs incurred in the performance of the work, (b) certain "continuing" (post-termination) costs, (c) a reasonable profit for work performed, and (d) reasonable settlement expenses.[137]

To interpret the commercial item contract convenience termination provisions, FAR 12.403(a) provides that COs may continue to use FAR Part 49 "as guidance" to the extent that it does not conflict with FAR Part 12 and the "Contract Terms and Conditions—Commercial Items" 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 FAR commercial item provisions inconsistent with a contractor's right to "fair compensation" as set forth in FAR 49.201. Therefore, the same techniques for maximizing convenience termination recovery would appear to apply to contracts for commercial items subject to the FAR Part 12 rules.[138]

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 that 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 COs 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 CO 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 on the ground that such costs are for a contractor's ongoing business rather than the terminated contract,[139] the commercial item provisions appear to conflict with these rules. 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 (a) Uniform Commercial Code § 2-708(2), which defines "damages" as including "reasonable overhead," (b) commercial law cases awarding unabsorbed overhead,[140] and (c) the fact that the limitations on allowability in the FAR Part 31 cost principles are expressly inapplicable in the settlement of commercial item contract convenience terminations.

Finally, the commercial item contract provisions deprive the Government of its right to audit the contractor's records after a termination for convenience. However, a contractor still has the burden of proving its costs. If

a CO 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.

Termination For Default

A termination for default can have disastrous consequences for a contractor.[141] There is a sudden loss of work and of its contribution to overhead. An opportunity to make a profit is lost. Instead, the contractor is faced with the prospect of a potential liability for excess costs of reprocurement and the potential need to litigate to protect its rights. To make matters worse, a default may limit or preclude a contractor's ability to obtain additional Government work.

■ Other Than FAR Part 12 Contracts For Commercial Services

Fixed-priced contracts for services expected to exceed the simplified acquisition threshold, other than FAR Part 12 contracts for commercial services, are required to include the FAR 52.249-8 "Default (Fixed-Price Supply and Service)" clause.[142]

(1) *Grounds*—Under this clause, a contract may be terminated for default based on any of the following *grounds*: (a) failure to timely perform, (b) failure to meet specifications, (c) failure to make progress so as to endanger performance, (d) failure to perform "other" contract provisions, and (e) the judicially created doctrine of anticipatory repudiation.[143]

Service contractors may avail themselves of two categories of *defenses*: (a) defenses available under all Government contracts and (b) *substantial performance,* an additional defense under service contracts.

(2) *Defenses Under All Contracts*—The following defenses to a default termination are available under all non-FAR Part 12 Government contracts, including those for services: (a) excusable delay, (b) defective specifications and impossibility, (c) waiver of contract due date, (d) CO failure to follow procedural requirements, and (e) CO abuse of discretion.[144]

(3) *Substantial Performance*—Service contractors have also been able to use as a defense the judicially created doctrine of *substantial performance*. The typical service contract includes numerous tasks to be repeatedly performed. The failure to perform one task, while technically a default under the "Default" clause,[145] will not by itself generally support a termination for default of the entire contract. In service contracts, a default termination is only justified where *instances of noncompliance* result in the contract not being *substantially performed.*

What is *substantial performance* must be determined on a *case-by-case* basis. For example, in one case, the ASBCA found undermanning of certain guard posts during peak traffic periods on more than one occasion indicated less than exemplary performance but did not arise to the level of a substantial failure to perform.[146] However, in another case, the failure to provide any guard service for 21 hours, with sporadic compliance over a weekend, justified termination of the entire contract for default for failure to perform.[147]

■ FAR Part 12 Contracts For Commercial Services

FAR Part 12 contracts for commercial services are required to include the FAR 52.212-4 "Contract Terms and Conditions—Commercial Items" clause.[148] Paragraph (m) sets forth provisions for a "termination for cause"—the equivalent of a termination for default in other than FAR Part 12 contracts—as follows:

> (m) *Termination for cause.* The Government may terminate this contract, or any part hereof, for cause in the event of any default by the Contractor, or if the Contractor fails to comply with any contract terms and conditions, or fails to provide the Government, upon request, with adequate assurances of future performance. In the event of termination for cause, the Government shall not be liable to the Contractor for any amount for supplies or services not accepted, and the Contractor shall be liable to the Government for any and all rights and remedies provided by law. If it is determined that the Government improperly terminated this contract for default, such termination shall be deemed a termination for convenience.

FAR 12.403 provides the following guidance for applying this provision:

> [The "Termination for cause" paragraph] contain[s] concepts which differ from those contained in the termination clauses prescribed in [FAR] Part 49. Consequently, the requirements of Part 49 do not apply when terminating contracts for commercial items and contracting officers shall follow the procedures in this section. Contracting officers may continue to use 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.

From a practical standpoint there appears to be little difference between the clauses in FAR Part 12 commercial item contracts and other Government contracts.

(a) *Grounds*—The commercial items "termination for cause" provision sets forth three grounds for default: (1) any default by the contractor, (2) failure to comply with any contract terms and conditions, and (3) failure to provide adequate assurances of performance. These grounds appear essentially the same as those in an other than FAR Part 12 contract for commercial items.

First, *any default by the contractor* in a FAR Part 12 contract appears to be the same as *failure to timely perform* and *failure to meet specifications* in other than FAR Part 12 contracts for commercial items.

Second, *failure to comply with any contract terms and conditions* in a FAR Part 12 contract would appear to be equivalent *to failure to perform other contract provisions* in other than FAR Part 12 contracts for commercial items.

Third, *failure to provide adequate assurances of performance* in a FAR Part 12 contract would appear to be the same as *failure to make progress so as to endanger performance* in other than FAR Part 12 contracts for commercial items. Before the termination for default of the non-FAR Part 12 contract for failure to make progress, a CO must issue a *"cure" notice*. The cure notice must advise the contractor that it has 10 days or a longer specified period to provide adequate assurances that timely performance will be forthcoming.[149]

Finally, as noted above, *anticipatory repudiation* is a judicially created doctrine.[150] The underlying rationale appears to apply when the Government purchases commercial items under FAR Part 12.

(b) *Defenses*—In general the same defenses are applicable as in non-FAR part 12 contracts. Paragraph (f) of the FAR 52.212-4 "Contract Terms and Conditions—Commercial Items" clause, entitled "Excusable delays," excuses the contractor from default if "nonperformance is caused by an occurrence beyond the reasonable control of the Contractor and without its fault or negligence." This language appears to incorporate the non-FAR Part 12 defenses of (1) excusable delay as well as (2) defective specifications and impossibility *if the contractor did not assume the risk*.

Excusable delay or excuse of performance for *defective specifications or impossibility* is often based on the *implied warranty* of Government-designated specifications. Under this doctrine, the Government warrants that contractor compliance with Government-furnished or designated design specifications will result in acceptable contract performance.[151] In contracts for commercial items, the seller rather than the Government furnishes or designates the specifications. Under such circumstances, there is no Government warranty of specifications.[152]

Waiver of contract due date[153] and *substantial performance*[154] are judicially created doctrines. The rationales underlying each of these defenses appears to be as applicable to FAR Part 12 contracts as other Government contracts. Waiver of contract due date[155] and substantial performance[156] are defenses to breach of contract in contracts for services between private entities.

Abuse of discretion would also appear to be a defense. More specifically, the "termination for cause" provision, like the "Default" clause,[157] does not require the CO to terminate. Instead, both advise that the CO "may" terminate, and FAR 12.403(b) states that the CO "should exercise the Government's right to terminate a contract for commercial items…for

cause only when such a termination would be in the best interests of the Government." This is analogous to the FAR guidance for non-FAR Part 12 contracts that sets forth factors for the CO to consider in determining whether to terminate for default.[158]

Finally, *failure to follow required procedures* may possibly be a defense to a termination for cause. However, its applicability would be limited. As noted, the "Default" clause for other than FAR Part 12 service contracts requires the Government to issue a cure notice giving the contractor at least 10 days to cure a deficiency before issuing a termination.[159] There is no such requirement under the FAR Part 12 "termination for cause" provision.

GUIDELINES

These *Guidelines* are intended to assist you in understanding the Federal Government's acquisition of services. They are not, however, a substitute for professional representation in any specific situation.

1. Remember that a *cost comparison* is generally required for a *commercial activity* currently performed by *Government employees*. Continued in-house performance must generally be justified by *lower cost*. Adjustments must be made in a cost comparison for the *different* manner in which Government agencies and contractors compute costs.

2. Keep in mind that both *contractors* and *agency employee representatives* may challenge a cost comparison by filing an *administrative appeal* with the agency.

3. Be aware that only a *contractor* can challenge an A-76 determination by filing a *protest* at the *GAO* or the *U.S. Court of Federal Claims*. A protest may be filed only after an unsuccessful agency administrative appeal. Contractor protests of agency A-76 determinations have had an unusually high success rate.

4. Remember that the SCA requires a federal service contractor to pay its *service employees* no less that the *minimum wage rates* and *fringe benefits* set forth in the applicable *DOL wage determination*. The SCA applies to *all* federal service contracts over $2,500 whose principal purpose is to provide services in the United States.

5. Recognize that under the SCA, a "service employee" is any person engaged in the performance of a covered service contract. *Executive, administrative* and *professional personnel* and *apprentices, student learners,* and *certain employees with disabilities* are *exempt* from the SCA wage determination requirement.

6. Bear in mind that the SCA *exempts*, among other things, construction contracts, most manufacturing contracts, communications services contracts, and public utility service contracts. In addition DOL has issued a regulation exempting certain *contracts for commercial services*.

7. Be aware that service contracts *other than* FAR Part 12 contracts for *commercial services* may contain *either* the FAR 52.249-2 "Termination for Convenience of the Government (Fixed-Priced)" clause, which is not limited to services, or the FAR 52.249-4 "Termination for Convenience of the Government (Services) (Short Form)" clause.

8. Note that the FAR "Termination for Convenience of the Government (Services) (Short Form)" clause severely limits the costs a service contractor may recover following a convenience termination. The use of the *short form* clause is *limited* to instances where the successful offeror will *not* incur substantial costs in preparing for or carrying out the work. If this clause is used inappropriately, a court or board may *replace* it with the FAR clause not limited to services, which does not contain these restrictions on recovery.

9. Keep in mind that under a *FAR Part 12 contract for commercial services*, a contractor may recover following a termination for a convenience for the percentage of contract price reflecting the *percentage of work performed* and any charges a contractor can demonstrate *resulted directly from the termination*. A contractor may prepare its settlement proposal using its standard

accounting system, and the Government has *no audit rights*.

10. Recognize that there are *unresolved questions* concerning the *extent* of contractor recovery for termination for convenience under the *FAR Part 12* termination for convenience provisions.

11. Bear in mind that the judicial doctrine of *substantial performance* is an additional defense to a termination for *default* of a *service contract*. Service contractors may also avail themselves of defenses available to *other* contractors.

12. Note that FAR Part 12 contracts for commercial services use the term *termination for cause* instead of *termination for default*. Nevertheless, the rules governing a termination for cause are *similar* to those for a termination for default.

★ REFERENCES ★

1/ See Paul J. Seidman, Robert D. Banfield, Alan L. Chvotkin, and Steve Charles, "Service Contracting in the New Millennium—Part I," Briefing Papers No. 02-11 (Oct. 2002).

2/ See generally Joseph J. Dyer, "The OMB Circular A-76 Public-Private Competition Process," Briefing Papers No. 01-5 (Apr. 2001); Stephen E. Ruscus, "The Fair Act," Briefing Papers No. 99-13 (Dec. 1999); Agnes P. Dover, "Outsourcing & Privatization: Recent Developments," Briefing Papers No. 97-4 (Mar. 1997).

3/ OMB Circular No. A-76, "Performance of Commercial Activities" (Aug. 4, 1983) (revised June 14, 1999) (available at http://www.whitehouse.gov/omb/circulars/).

4/ Pub. L. No. 105-270, 112 Stat. 2382 (1998); see 31 U.S.C. § 501 note.

5/ OMB Circular No. A-76, Revised Supplemental Handbook, "Performance of Commercial Activities" (Mar. 1996) (updated through Transmittal Memorandum No. 20, June 14, 1999) (available at http://www.whitehouse.gov/omb/circulars/) [hereinafter Handbook].

6/ OMB Circular No. A-76, supra note 3, ¶ 4.a.

7/ Id. ¶¶ 5.b, 6.e.

8/ Id. ¶¶ 5.a, 6.a.

9/ Pub. L. No. 105-270, § 2(a), (c).

10/ Id. § 2(d), (e).

11/ Id. § 2(a); Handbook, supra note 5, app. 2, ¶ A.

12/ Pub. L. No. 105-270, § 2(b), (c); Handbook, supra note 5, app. 2, ¶ G.1; see, e.g., 67 Fed. Reg 64,150; 44 GC ¶ 409.

13/ Pub. L. No. 105-270, § 2(c); Handbook, supra note 5, app. 2, ¶ G.1.

14/ Pub. L. No. 105-270, § 3(a); Handbook, supra note 5, app. 2, ¶ G.2.

15/ Pub. L. No. 105-270, § 3(b); Handbook, supra note 5, app. 2, ¶ G.2.

16/ Pub. L. No. 105-270, § 3(c); Handbook, supra note 5, app. 2, ¶ G.3 (revised from 30 "calendar" days to 30 "working" days by Transmittal Memorandum No. 22 (Aug. 31, 2000)).

17/ Pub. L. No. 105-270, § 3(d); Handbook, supra note 5, app. 2, ¶ G.4 (revised from 28 "calendar" days to 28 "working" days by Transmittal Memorandum No. 22 (Aug. 31, 2000)).

18/ Pub. L. No. 105-270, § 3(e)(1); Handbook, supra note 5, app. 2, ¶ G.5.

19/ Pub. L. No. 105-270, § 3(e)(2); Handbook, supra note 5, app. 2, ¶ G.5.

20/ OMB Circular No. A-76, supra note 3, ¶ 6(e); Pub. L. No. 105-270, § 5(2); see Handbook, supra note 5, pt. I, ch. 1, ¶ B (referring for guidance to OFPP Policy Letter 92-1, "Inherently Governmental Functions" (Sept. 23, 1992), 57 Fed. Reg. 45,096 (Sept. 30, 1992)).

21/ OMB Circular No. A-76, supra note 3, ¶ 6(e); Pub. L. No. 105-270, § 5(2).

22/ Pub. L. No. 105-270, § 5(2)(C).

23/ Handbook, supra note 5, app. 1.

24/ See OMB Circular A-76, supra note 3, attach. A; see OFPP Policy Letter 92-1, supra note 20, ¶ 5 (stating that the list of "commercial activities" in OMB Circular A-76 is an "authoritative, nonexclusive list of functions that are not inherently governmental functions" and that they "therefore may be contracted").

25/ OMB Circular A-76, supra note 3, ¶ 5.b.

26/ Handbook, supra note 5, pt. I, ch. 1, ¶ B.1.

27/ Id. pt. I, ch. 1, ¶ D.1.

28/ Id. pt. I, ch. 1, ¶ D.2.

29/ Id. pt. I, ch. 1, ¶ C.8; OMB Circular A-76, supra note 3, ¶ 8.d.

30/ Handbook, supra note 5, pt. I, ch. 1, ¶ C.

31/ FAR 14.408-1(a).

32/ Handbook, supra note 5, pt. I, ch. 3, ¶ J.1.

33/ FAR 15.101-1, 15.101-2.

34/ Handbook, supra note 5, pt. I, ch. 3, ¶ J.3.

35/ Id. pt. I, ch. 3, ¶ A.3.

36/ Id. pt. I, ch. 3, ¶ C.

37/ Id. pt. I, ch. 3, ¶ D.1.

38/ Id. pt. I, ch. 3, ¶ A.3.

39/ Id. app. 1 (definition of "Most Efficient Organization (MEO)").

40/ Id. pt. I, ch. 3, ¶ E.4.e.

41/ Id. pt. I, ch. 3, ¶ E.2.

42/ Id. pt. I, ch. 3, ¶ A.3.

43/ Id. pt. I, ch 3, ¶ E.4.e.

44/ Id. pt. I, ch. 3, ¶ A.3.

45/ Id. pt. I, ch. 3, ¶ G.1,

46/ Id. pt. I, ch. 3, ¶ G.3.

47/ Id. pt. I, ch. 3, ¶ G.4.

48/ Id. pt. I, ch. 3, ¶ A.3.

49/ Id. pt. I, ch. 3, ¶ J.1.

50/ Id. pt. I, ch. 3, ¶ J.3.

51/ FAR 15.101-1.

52/ Handbook, supra note 5, pt. I, ch. 3, ¶ J.3.

53/ Id. pt. I, ch. 3, ¶ A.3.

54/ Id. pt. I, ch. 3, ¶ K.

55/ Id. pt. II, ch. 1, ¶ A.3.

56/ Id. pt. II, ch. 2, ¶ A.7.

57/ Id. pt. II, ch. 3, ¶ H & illus. II-1.

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59/ Id. pt. II, ch. 3, ¶ B.2.

60/ Id. pt. II, ch. 3, ¶ B.4.

61/ Id. pt. II, ch. 3, ¶ C.

62/ Id. pt. II, ch. 3, ¶ D.

63/ Id. pt. II, ch. 3, ¶ E.

64/ Id. pt. II, ch. 3, ¶ F.

65/ Id. pt. II, ch. 3, ¶ G.

66/ Id. pt. II, ch. 4, ¶ A.

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69/ International Graphics v. United States, 4 Cl. Ct 186 (1983).

70/ American Fed'n of Gov't Employees, AFL-CIO, Comp. Gen. Dec. B- 282904.2, 2000 CPD ¶ 87, 42 GC ¶ 225.

71/ American Fed'n of Gov't Employees, AFL-CIO v. United States, 258 F.3d 1294 (2000), 43 GC ¶ 137, cert. denied, 122 S. Ct. 920 (2002).

72/ See GAO Commercial Activities Panel, Final Report: Improving the Sourcing Decisions of the Government 19–20, app. D (Apr. 30, 2002) (available at http://www.gao.gov); James J. McCullough, Deneen J. Melander & Steven A. Alerding, "Feature Comment: Year 2001 OMB Circular A-76 Cost Comparison Developments," 44 GC ¶ 1 (Jan. 9, 2002).

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83/ The proposed revision is available on the OMB website at http://www.whitehouse.gov/omb/circulars/index.html. See 67 Fed. Reg. 69,769 (Nov. 19, 2002); 44 GC ¶ 455.

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142/ FAR 49.504.

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144/ For a detailed discussion, see Briefing Papers No. 98-12, supra note 141, at 4–6.

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147/ Sentry Corp., ASBCA 29308, 84-3 BCA ¶ 17,601.

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150/ Kennedy v. United States, 164 Ct. Cl. 507 (1964), 6 GC ¶ 106.

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