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24 N&CR ¶ 37 • TERMINATION FOR CONVENIENCE OF FAR PART 12 COMMERCIAL ITEM CONTRACTS: Is Fair Compensation Required? • Terminations for convenience of traditional Government contracts are governed by required forms, arcane inventory procedures, the Truth in Negotiations Act, Cost Accounting Standards, and Government contracts Cost Principles. See Seidman & Banfield, *Preparing Termination for Convenience Settlement Proposals for Fixed-Price Contracts*, BRIEFING PAPERS No. 97-11 (Oct. 1997). The Government tossed this approach when drafting its Federal Acquisition Regulation Part 12 rules for commercial item contracts. In its place is the "Termination for Convenience" clause for Government purchases of commercial items that appears as paragraph (l) of the FAR 52.212-4 "Terms and Conditions—Commercial Items" clause and FAR 12.403 entitled "Termination." FAR 52.212-4, paragraph (l) states:

> (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.

The measure of recovery under the commercial items clause is the sum of (1) "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination" and (2) "reasonable charges the Contractor can demonstrate to the satisfaction of the Government using its standard record keeping system, have resulted from the termination."

Following the enactment of the Services Acquisition Reform Act of 2003, an Alternate I to the FAR 52.212-4, paragraph (l) clause was promulgated for use in time-and-materials and labor-hour contracts. Alternate I replaces "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination" with "an amount for direct labor hours . . . determined by multiplying the number of direct labor hours expended before the effective date of termination by the hourly rate(s) in the contract, less any hourly rate payments already made to the Contractor." It retains the second prong of the formula for reasonable charges resulting from the termination.

The measure of recovery in the second prong is stated slightly differently in FAR 12.403(d). The FAR 52.212-4 clause requires that a contractor demonstrate charges resulted from the termination "to the satisfaction of the Government." FAR 12.403(d) does not require that proof be to the Government's satisfaction. FAR 12.403(d)(1)(ii) requires proof that costs "directly" resulted from the termination. The FAR 52.212-4, paragraph (l) merely requires proof that charges resulted from the termination.

FAR 12.403(a) sets forth the relationship between the FAR Part 12 provisions for the termination of commercial item contracts and FAR Part 49 applicable to the termination of traditional Government contracts, stating:

> [T]he paragraphs in 52.212-4 entitled "Termination for the Government's Convenience" and "Termination for Cause" contain concepts which differ from those contained in the termination clauses prescribed in 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.

Notes

Traditional Government Contracts—Cost-Based Formula

Traditional Government contracts use a *cost-based formula*. A traditional Government contractor whose fixed-priced contract is terminated for convenience is entitled to recover the following:

(1) Allowable costs incurred in the performance of the work.

(2) Costs allowable under a special termination Cost Principle set forth at FAR 31.205-42. Such costs include unamortized costs incurred prior to the termination, costs continuing after the termination, and settlement expense.

(3) A reasonable profit on the above costs with the exception of settlement expense.

See, e.g., FAR 52.249-2, paragraphs (f), (g), (i); see also FAR 49.113, 49.201, 49.202, 31.205-42. See generally Seidman & Seidman, *Maximizing Termination for Convenience Settlements/Edition II—Part I*, BRIEFING PAPERS No. 08-3 (Feb. 2008); Seidman & Seidman, *Maximizing Termination for Convenience Settlements/Edition II—Part II*, BRIEFING PAPERS No. 08-5 (Apr. 2008).

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," FAR 31.205-42 sets forth a "Termination costs" Cost Principle for traditional Government contracts that establishes the following rules for determining the allowability of costs peculiar to terminations:

(a) "Costs continuing after termination" that cannot be avoided are generally allowable. Unavoidable "[i]dle facilities and idle capacity" and certain unavoidable severance payments are examples of recoverable costs continuing after termination.

(b) "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.

(c) "Loss of useful value" of special tooling and special machinery and equipment is generally allowable to the extent it resulted from the termination.

(d) "Rental costs under unexpired leases" are allowable for a reasonable period, to the extent they cannot be avoided, if necessary for the performance of the terminated contract.

(e) The costs of "alterations of leased property" are allowable when the alterations were necessary for performing the contract.

(f) "Subcontractor claims" are generally allowable. An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors.

(g) "Settlement expenses" for preparation and presentation of a termination settlement proposal and the administration of subcontract terminations are generally allowable. These expenses include the cost of in-house personnel and outside experts such as attorneys and accountants.

FAR 49.202 entitles a contractor to a reasonable profit on its termination costs other than settlement expense. Recovery of allowable costs incurred and profit under a fixed-price contract is limited to the "total contract price." See FAR 52.249-2, paragraph (f) and FAR 49.207. "Total contract price" includes any equitable adjustments to which a contractor is entitled. See FAR 52.243-1 ("Changes—Fixed-Price" clause), 52.243-2 ("Changes—Cost-Reimbursement" clause); see also *Agrinautics*, ASBCA 21512, 79-2 BCA ¶ 14149, 22 GC ¶ 200.

If the Government can prove that the contract would have been completed at a loss, the contractor is not entitled to profit and recovery is subject to a loss adjustment, FAR 49.203(a) and FAR 52.249-2, paragraph (f). 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, FAR 49.203(b), (c).

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FAR 49.201 guarantees a terminated contractor "fair compensation." The fair compensation guarantee overrides the application of any other Cost Principle that would deprive the terminated contractor of "fair compensation." For example, in *Codex Corp. v. United States*, 226 Ct. Cl. 693 (1981), 23 GC ¶ 239, the Court of Claims (predecessor to the U.S. Court of Appeals for the Federal Circuit) held that a terminated contractor is entitled to recover otherwise unallowable precontract costs if nonpayment would deprive it of fair compensation. In *Kasler Electric Co.*, DOTCAB 1425, 84-2 BCA ¶ 17374, 26 GC ¶ 326, the board held bid and proposal costs that were unamortized as the result of the termination to be allowable despite a conflicting Cost Principle, explaining: "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."

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

A contractor's recovery for the termination for convenience of a FAR Part 12 contract for commercial items is the sum of (1) the percentage of the contract price reflecting the percentage of the work performed prior to the notice of the termination and (2) any charges the contractor can demonstrate resulted directly from the termination, FAR 12.403(d); FAR 52.212-4, paragraph (l). This is a *modified price-based formula* since the first element is price based and the second element is cost based. It is a departure from the cost-based formula for traditional Government contracts discussed above. See BRIEFING PAPERS Nos. 08-3 and 8-05.

Key Issues

• *How is the percentage of contract price reflecting the percentage of completion calculated?*—Three possible approaches to calculating the percentage of contract price reflecting the percentage of completion are:

(1) Percentage of physical completion at termination multiplied by total contract price.

(2) Payment of the contract price for completed units of work at termination.

(3) Percentage of effort expended up to the time of termination multiplied by contract price.

The Armed Services Board of Contract Appeals and the Civilian Board of Contract Appeals recently held that percentage of completion means percentage of physical completion rather than the percentage of effort expended, *Red River Holdings, LLC*, ASBCA 56316, 09-2 BCA ¶ 34304, and *Corners & Edges, Inc. v. Department of Health & Human Services*, CBCA 762 et al., 08-2 BCA ¶ 33961.

In *Red River,* where a 59-month lease of a U.S. flag vessel capable of carrying ammunition containers was terminated for convenience after 57 months, the ASBCA held that the percentage of contract completion was 57/59 and did not include unamortized initial costs incurred by the contractor to acquire, reflag, and outfit the vessel. As explained by the board:

> Appellant has not argued that it failed to receive 57/59 of the contract price. Appellant argues that it obtained the $17,329,000 loan in order to acquire and outfit the [vessel] for the contract, it fully completed acquisition and outfitting at the outset of the contract long before its termination and so it is entitled to the remaining loan principal and interest it paid after such termination under the "percentage of the work performed" provision of the termination clause.
>
> . . . The contract did not provide for payment for appellant's obtaining a commercial loan to acquire, reflag and outfit the vessel to comply with specified characteristics. Thus, the contract "work" with respect to the "percentage of the work performed" provision of this contract's termination clause was for appellant to provide a U.S. flag vessel capable of carrying ammunition containers in December 2001 at the Military Ocean Terminal, Sunny Point, NC, for inspection and acceptance and to perform the 59-month charter thereafter. [Citations omitted.]

Corners & Edges concerned a contract for messenger services for which the contractor was to be paid a fixed monthly amount. The CBCA held that the contractor was paid the percentage

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of contract price reflecting the percentage of completion where it was paid the contract price for the actual period of performance. As explained by the board: "Since respondent paid appellant the contract price for the full months appellant performed the contract, and the appropriate ratio of the monthly price for the period of October 1 through 6, 2006, the payments appropriately reflect the percentage or work performed prior to the notice of termination."

In *Red River* and *Corners & Edges*, the amount paid for completed work at the contract price is the same as the percentage of physical completion times the total contract price. This will not be the case if each line item in a contract is not priced in proportion to its contribution to physical completion or if some line items are partially completed. In such cases, the FAR 52.212-4, paragraph (l) clause appears to mandate that the contractor be paid the percentage of physical completion times the total contract price rather than the contract price for the completed line items. The percentage of the contract price reflecting the percentage of completion could be less than that due the contractor for the completed work at line item prices. Yet it would not make sense to permit the Government to pay less than the amount due under the payments clause for work performed by terminating a contract for convenience.

Neither *Red River* nor *Corners & Edges* concerned a time-and-materials or labor-hour contract. Nevertheless, as previously discussed, the "percentage of physical completion multiplied by contract price" approach to recovery adopted in these cases is consistent with the FAR 52.212-4, Alternate I provisions for time-and-materials and labor-hour contracts.

• *What are reasonable charges resulting directly from the termination?*—The commercial item contract formula requires that a terminated contractor be paid reasonable charges resulting from the termination. 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," FAR 31.205-42 sets forth a "Termination costs" Cost Principle for *traditional* Government contracts. As previously noted, this Cost Principle for traditional Government contracts permits a terminated contractor to recover unamortized performance costs and certain costs continuing after termination. Do reasonable charges resulting from the termination mean the same thing?

The commercial items clause speaks of reasonable *charges* resulting from the termination rather than reasonable *costs* resulting from the termination. Unamortized performance costs are not the result of a termination. They are sunk costs incurred prior to the termination. However, it is reasonable to *charge* for *costs* that are unamortized as the result of a termination. This is evident from the allowability of such costs under FAR 31.205-42 in traditional Government contracts because contract terminations "generally give rise to . . . the need for special treatment of costs that would not have arisen had the contract not been terminated." Similarly unavoidable costs continuing after a termination are not the result of a termination because they would have been incurred whether or not the contract was terminated. However as recognized in FAR 31.205-42, it is reasonable to charge for such costs to make a contractor whole after a contract has been terminated for convenience.

There is a split of authority on the allowability of costs that are unamortized as the result of a termination under the commercial items clause. The CBCA recognized the allowability of such costs in C*orners & Edges*:

> The contracting officer's generalized statement in her decision on appellant's termination claim that "under a services contract, the Government is only liable for services rendered before the date of termination" paints with too broad a brush. Under the Termination for Convenience clause of this contract, appellant was also entitled to reasonable charges that a contractor could demonstrate to the satisfaction of the Government resulted from the termination. Boards have recognized a terminated contractor's entitlement to reimbursement for those charges under service contracts containing a similar clause. *Divecon Services, L.P. v. Department of Commerce*, GSBCA 15997-COM, et. al, 04-2 BCA 32,656, at 161,636–67; *Jon Winter & Associates*, AGBCA 2005-129-2, 2005 WL 1423636 (June 20, 2005). However, in this case, since the Government supplied all materials and supplies for the performance of this contract, appellant has not demonstrated that such charges exist.

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The cases cited by the CBCA from its predecessor boards of contract appeals are instructive. In *Divecon Services, L.P. v. Department of Commerce*, GSBCA 15997-COM, 04-2 BCA ¶ 32656, the General Services Administration Board of Contract Appeals awarded the contractor its unamortized performance costs as reasonable charges resulting from the termination. The board began its analysis by referencing the FAR 49.201(a) fair compensation principle for traditional Government contracts, stating: "[T]he overall purpose of a termination for convenience settlement is to fairly compensate the contractor and to make the contractor whole for the costs incurred in connection with the terminated work."

Similarly, in *Jon Winter*, AGBCA 2005-129-2, 2005 WL 1423636 (June 20, 2005), the Department of Agriculture Board of Contract Appeals stated:

> [T]he contracting officer incorrectly interprets the "reasonable charges" portion of the clause. The language of the clause does not state that charges resulting from the termination must have been incurred subsequent to the termination for convenience; the clause does not expressly limit the additional relief to settlement expenses. The clause permits payment of reasonable charges that have resulted from the termination. A contractor may have reasonably incurred costs in anticipation of performing the entire contract, but those costs may not be fully reflected as a percentage of the work performed.

Jon Winter does not reference the FAR 49.201(a) fair compensation principle. Nevertheless, consistent with that provision, it addresses whether the contractor was fairly compensated. The AGBCA stated: "Although the contractor states that it is unfair for the contractor to 'get stuck with the bill' because of a termination for convenience, the record does not demonstrate that the contractor has been unfairly compensated. If one utilizes an hourly rate for the two individuals that would be consistent with the contract price, the contractor has been fully compensated and is not 'stuck with a bill.'"

In *Red River*, however, the ASBCA held that costs unamortized as the result of a termination are unallowable, stating:

> Appellant's contention that it obtained the $17,329,000 commercial loan to finance the vessel's acquisition, reflagging and modification for the sole purpose of performing contract 3300, and so the loan principal and interest for the two terminated months of the charter are reasonable charges that resulted from the termination , is unpersuasive. Incurrence of costs solely for the purpose of contract performance, or incurrence of costs in anticipation of such performance, are not criteria under the FAR 52.212-4(l) "reasonable charges" provision. Moreover, appellant obtained such loan to finance the vessel's acquisition, reflagging and modification shortly after contract award, more than four years before the [Contracting Officer] in 2006 constructively terminated the last two months of the charter. We hold that the costs of the loan, reflagging and vessel modification did not "result from" the termination. [Citations omitted.]

Under the approach taken by the ASBCA in *Red River,* costs continuing after termination that would be allowable under the FAR 31.205-42 Cost Principle for traditional Government contracts are not allowable under the commercial items clause because they are sunk costs that would have been incurred irrespective of the termination. The only post-termination cost that appears to be allowable under *Red River* is settlement expense.

Red River appears to confuse reasonable "charges" resulting from a termination with reasonable costs resulting from a termination. The significance of the use of the term "charges" in the clause instead of costs is evident from the regulatory history of the rule. Under the proposed rule "actual direct costs" resulting from the termination were allowable, 60 Fed. Reg. 11198, 11216 (Mar. 1, 1995). Under the final rule, "reasonable charges" resulting from the termination are allowable, 60 Fed. Reg. 48231, 48254 (Sept. 18, 1995).

Unamortized performance costs are not reasonable costs resulting from the termination. However, it is reasonable to charge for performance costs that are unamortized as the result of a termination. This is evident from the allowability of such costs under the FAR 31.205-42 Cost Principle for traditional Government contracts because contract terminations "generally give rise to the . . . the need for special treatment of costs that would not have arisen had the contract not been terminated." Similarly unavoidable costs continuing after a termination would have been incurred anyway and therefore are

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not incurred as the result of a termination. However, as recognized in FAR 31.205-42, it is reasonable to charge for such costs to make a contractor whole after a contract has been terminated for convenience.

Is There A Difference?

Recovery for the termination of a commercial item contract may be a rough equivalent of recovery for the termination of a traditional Government contract.

First, the cost-based formula for a traditional Government contract provides for a downward loss adjustment if a contract would be completed at a loss. Prong 1 of the commercial item formula, which provides for recovery of the percentage of contract price reflecting the percentage of completion, results in a similar downward adjustment if a contract is being performed at a loss.

Second, FAR 31.205-42 provides for the recovery of unamortized performance costs and costs unavoidably continuing after termination in a traditional Government contract. In *Corners & Edges*, the CBCA held that prong 2 of the commercial item formula for reasonable charges resulting from a termination includes unamortized performance costs. Based on the rationale in that case, the formula also appears to include costs unavoidably continuing after termination. As previously noted, this approach was rejected by the ASBCA in *Red River*, which the author believes to be wrongly decided.

If anything, the commercial item standard of reasonable charges resulting from a termination may be broader than the particular continuing costs allowable under the FAR 31.205-42 Cost Principle for traditional Government contracts. FAR 31.205-42 provides for the recovery of *particular costs* resulting from a termination, while the commercial items provision allows the recovery of *all reasonable charges* resulting from the termination. Also, as previously noted, Government contract Cost Principles that provide a basis for denying costs are inapplicable to commercial item contract terminations.

The Government often relies on FAR Part 49 rules to deny recovery of post-termination unabsorbed overhead and anticipatory profit. See *Defense Contract Audit Agency Contract Audit Manual* ¶¶ 12-305.7 and 12-307 (Apr. 16, 2010). However, it appears reasonable to charge post-termination unabsorbed overhead and profit resulting from a termination for convenience. This is evident from *Uniform Commercial Code* § 2-708(2), applicable to private sector contracts, which defines "damages" as including "the profit (including reasonable overhead) that the seller would have made from full performance by the buyer."

In *Corners & Edges*, the CBCA stated that "lost profits and consequential damages are not available under the [commercial item contract] Termination for Convenience clause," citing *International Data Products Corp. v. U.S.,* 492 F.3d 1317 (Fed. Cl. 2007), and *Praecom v. U.S.*, 78 Fed. Cl. 5 (Fed. Cl. 2007). The board's reference *to International Data Products* is questionable because that case did not concern the termination for convenience of a contract with the commercial items clause. The board's reliance on *Praecom* is also questionable. Although *Praecom* concerned a contract with the commercial items termination for convenience clause, the Court of Federal Claims cited *International Data Products* for the principle that lost profits are not recoverable without considering the differences in the clauses.

It also appears reasonable to charge the cost of overturning a legally insupportable termination for cause in litigation. In traditional Government contracts, such costs are unallowable under the FAR 31.205-47 "Costs related to legal and other proceedings" Cost Principle. The proceedings Cost Principle is not grounds for disallowing costs claimed by a terminated commercial items contractor. As previously noted, commercial item contract terminations are not subject to Cost Principles.

Strategy

It does not appear that the Federal Circuit will resolve the conflict between the ASBCA decision in *Red River* and the CBCA decision in *Corners & Edges* in the near future. Red River appealed the ASBCA decision first to the Federal Circuit (No. 2010-1073) and subsequently to the U.S. District Court for Maryland (Civil Action No. 10-0534). On May 4, 2010, the Federal

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Circuit transferred its case to the district court because it concerns a maritime contract. (The Contract Disputes Act, 41 USCA § 603, defers to federal maritime statutes on suits from boards of contract appeals concerning maritime contracts.) 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?

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*. 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.

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.

A Question Of Fairness

The FAR Cost Principles are not applied strictly in determining the allowability of costs in termination settlements under fixed-priced traditional Government contracts. FAR 49.201(a) and FAR 49.113 require that the Cost Principles be applied "subject to" the general principle that a contractor whose contract is terminated for convenience is entitled to "fair compensation."

The appellant in *Red River* argued it was entitled to unamortized performance costs under FAR 49.201 and 49.113. The ASBCA appears to hold that the "fair compensation principle" is inapplicable to commercial items procurements, stating:

> Thus, to allow such costs as preparatory and insurance costs—which might be allowable in terminated non-commercial, fixed-price contracts, see FAR 31.205-42(b), (c)(2)—in this commercial item contract would conflict with FAR 12.403(a) and 52.212-4(l). Moreover, the cases and regulations which appellant cites to support recovery of such items as preparatory and insurance costs apply in the context of recognizing or determining termination costs of non-commercial item contracts under FAR 52.249-2 and its predecessor regulations.

The FAR 49.201 and 49.113 fair compensation principles also do not appear in the FAR provisions for cost-reimbursement contracts. Nevertheless, the U.S. Court of Appeals for the Federal Circuit applied the "fair compensation" principle to a cost-reimbursement contract in *Jacobs Engineering Group v. U.S.*, 434 F.3d 1378 (Fed. Cir. 2006), 48 GC ¶ 49. See also *Termination of Cost-Reimbursement Contracts: A Novel Interpretation of the Termination Clause*, 20 N&CR ¶ 17.

Red River is fundamentally unfair. Under *Red River*, a small business contractor can incur millions of dollars in preparation costs yet be entitled to nothing if the contract is terminated for convenience prior to any measurable physical performance. It is a trap for the unwary. To avoid an unjust result, the FAR Part 12 commercial items provisions should be amended to expressly incorporate the fair compensation principle as set forth in FAR 49.201 and 49.113. The FAR should also make clear that unamortized costs incurred prior to a termination and costs continuing after a termination despite all reasonable efforts are recoverable under the commercial items termination for convenience clause. *Paul J. Seidman*