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THE NASH & CIBINIC REPORT

government contract analysis and advice monthly from professors ralph c. nash and john cibinic

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GUEST APPEARANCE

¶ 28 PARTIAL TERMINATIONS FOR CONVENIENCE: Recovering Reallocated Overhead And Other Costs By Submitting Timely REA On Continuing Portion

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When all or part of a traditional fixed-price Government contract is terminated for convenience, a contractor is entitled to the price of completed deliverables, costs for the terminated work, profit, and settlement expense (the cost of preparing and negotiating its termination settlement proposal). Federal Acquisition Regulation 52.249-2(f), (g) ("Termination for Convenience of the Government (Fixed-Price) (May 2004)" clause). For strategies on how to maximize recovery following a termination for convenience, see Seidman & Seidman, *Maximizing Termination for Convenience Settlements/Edition II—Part I*, 08-3 Briefing Papers 1 (Feb. 2008), and Seidman & Seidman, *Maximizing Termination for Convenience Settlements/Edition II—Part II*, 08-5 Briefing Papers 1 (Apr. 2008). Where the termination is *partial*, the contractor is also entitled to recover an equitable adjustment for its increased cost of performing the continuing work. Paragraph (l) of the FAR 52.249-2 clause states:

> (l) If the termination is partial, the Contractor may file a proposal with the Contracting Officer for an equitable adjustment of the price(s) of the continued portion of the contract. The Contracting Officer shall make any equitable adjustment agreed upon. Any proposal by the Contractor for an equitable adjustment under this clause shall be requested within 90 days from the effective date of termination unless extended in writing by the Contracting Officer.

FAR 49.208 requires the responsible Contracting Officer or Termination CO to ensure there is no duplication of claimed costs in the request for equitable adjustment (REA) of the continued portion and termination settlement proposal.

FAR 2.101 defines "partial termination" as "the termination of part, but not all, of the work that has not been completed and

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accepted under a contract." Contracting personnel sometimes erroneously refer to a termination of all remaining work as partial because some work was completed prior to termination. There is no partial termination under the FAR 2.101 definition unless a portion of the remaining contract is not terminated.

As quoted above, the first sentence in paragraph (l) of the FAR 52.249-2 "Termination for Convenience" clause for traditional fixed-price contracts provides for an equitable adjustment "of the price(s) of the *continued portion of the contract*." (Emphasis added.) It does not provide for an equitable adjustment for the increased cost of terminated work. *Hunter Manufacturing Co*., ASBCA 48693, 97-1 BCA ¶ 28,824, 1997 WL 103325. Where a separately priced item not awarded on and all or none basis is completely terminated, a contractor is not entitled to an equitable adjustment on remaining items. See *Gregory & Reilly Associates, Inc*., FAACAP 65-30, 65-2 BCA ¶ 4918; *Equitable Adjustment for Deleted Work: The Severability Exception to the "Would Have Cost" Rule*, 11 N&CR ¶ 39.

An equitable adjustment on the continuing work can reallocate fixed costs over the reduced quantity of work remaining after a partial termination for convenience. *Missouri Department of Social Services,* ASBCA 59191, 16-1 BCA ¶ 36,563, 2016 WL 7026002, 59 GC ¶ 8, and ASBCA 61121, 19-1 BCA ¶ 37,240, 2019 WL 410465. Such an allocation may permit a contractor to recover costs that would otherwise be unallowable post-termination unabsorbed overhead. Other costs such as labor inefficiency, increased labor costs, and settlement expense are also recoverable. *Hunter Manufacturing*.

Post-Termination Unabsorbed Overhead

Post-termination unabsorbed overhead has been held to be nonrecoverable as a termination cost because it relates to a terminated contractor's ongoing existence as a business. As stated in *Nolan Bros., Inc. v. United States,* 437 F.2d 1371 (Ct. Cl. 1971), 13 GC ¶ 108:

> The plaintiff's home-office overhead after the work under the contract had been terminated on March 27, 1964, related to the plaintiff's existence as an ongoing organization, and was not 'incidental to termination of work under this contract.' Consequently, the Board was correct in rejecting the plaintiff's claim for [general and administrative] expense, as such, during the post-termination period.

"The enlightened approach of allowing unabsorbed overhead in price adjustments should be contrasted with the refusal to grant such recovery in convenience termination settlements." *Unabsorbed Overhead on Supply Contracts: An Idea Whose Time Has Come,* 8 N&CR ¶ 45. By submitting an REA on continuing work a contractor can recover "an increased allocation of overhead to unterminated items in determining a proper equitable adjustment in the price of those unterminated items following a partial termination" not recoverable as termination costs. *Chamberlain Manufacturing Corp.*, ASBCA 16877, 73-2 BCA ¶ 10,139 (citing *Fairchild Stratos Corp*., ASBCA 9169, 67-1 BCA ¶ 6225, 1973 WL 1882, *recons. denied*, 68-1 BCA ¶ 7053, 1968 WL 810).

Giving words their ordinary meaning, one would think that post-termination unabsorbed overhead was recoverable as termination costs under FAR 31.205-42(b) for costs unavoidably continuing after termination. This position has been judicially rejected because post-termination unabsorbed overhead costs are for the continuation of the business and do not relate to the termination. As stated in *Chamberlain Manufacturing*, in interpreting Armed Services Procurement Regulation 15-205.42(b), the substantially identical ASPR provision that predates FAR 31.205-42(b) (''Costs continuing after termination''):

> The continuing costs to which ASPR 15-205.42 refers clearly are only those costs directly related to the terminated contract which cannot reasonably be shut off immediately upon termination. It is obvious that appellant's overhead is a cost which will continue so long as appellant continues to exist as an ongoing organization and is thus not directly related to the terminated contract. Neither are allowable rental costs analogous to appellant's overhead since ASPR 15-205.42(e) [substantially identical predecessor to FAR 31.205-42(e) *Rental under unexpired leases*] manifestly requires that in order for those costs to be allowable they must be clearly and directly related to performance of the terminated contract although they cannot be immediately stopped. Moreover, the continuation of overhead after a termination is a common occurrence and if the drafters of the regulation had intended to allow such costs they could have done so simply and clearly as they did for rental costs.

Costs conceptually similar to post-termination unabsorbed overhead are allowable as termination costs under the FAR, following a complete or partial termination for convenience. The difference between post-termination costs allowable under the FAR and unallowable post-termination G&A is the nexus to the terminated work. For example, allowable costs include (1) preparatory costs incurred "*in preparing to perform the terminated contract*" recoverable as "Initial costs" under FAR 31.205-

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42(c); (2) loss of useful value of special tooling, special machinery and equipment recoverable as "Loss of useful value" under FAR 31.205-42(d) if "*not reasonably capable of use in the other work of the contractor*"; (3) rental under unexpired leases recoverable FAR 31.205-42(e) if the leased facilities are *"shown to have been reasonably necessary for the performance of the terminated contract*"; (4) the cost of alterations and reasonable restorations required by a lease recoverable under FAR 31.205-42(f) "Alterations of leased property" "*when the alterations were necessary for performing the contract*"; and (5) accounting and legal costs "*reasonably necessary for…[t]he preparation and presentation…of settlement claims to the contracting officer*" recoverable as settlement expense under FAR 31.205-42(g)(i). Absent a nexus to the terminated work similar costs are either allocable to other work or are unallowable post-termination unabsorbed overhead. *Chamberlain Manufacturing*.

Timeliness Requirements

FAR 52.249-2(l) states: "Any proposal by the Contractor for an equitable adjustment under this clause shall be requested within 90 days from the effective date of termination unless extended in writing by the Contracting Officer." This is less than the one year allowed for submission of a termination settlement proposal following a termination for convenience provided for in paragraph (e) of the clause. Paragraph (l) does not require that a request for additional time to submit an REA on the nonterminated portion be submitted within the stated 90-day period. This differs from paragraph (e), which requires that a request to extend the one-year period for submitting a termination settlement proposal be submitted in writing before the year expires. The failure of a contractor to submit a timely REA on the continuing portion may result in the forfeiture of its right to recover post-termination unabsorbed overhead other than conceptually similar costs made allowable by the FAR.

Some Costs Recoverable As Equitable Adjustment On Continuing Work Or Termination Costs

Tribunals have given contractors some flexibility in claiming costs other than a reallocation of fixed costs as an equitable adjustment on the continuing work or termination costs for the terminated portion in a termination settlement proposal. The extent of flexibility is unclear.

In *Dunbar Kapple, Inc.,* ASBCA 3631, 57-2 BCA ¶ 1448, 1957 WL 441, the board stated: "It should make no difference in the final amount paid whether a particular item is settled on the basis of price adjustment on the continued portion of the contract or as a cost of termination, as the items claimed by appellant in his request for a price increase are allowable under the Statement of Principles which are incorporated into the contract by Paragraph (f) of the [Armed Services Procurement Regulation] 'Termination' clause." The result should be the same under substantially identical provisions in the FAR, which replaced the ASPR. FAR 49.113 states that the FAR Part 31 cost principles apply subject to the fair compensation guarantee in FAR 49.201.

In *Aero Components Co.,* ASBCA 42620, 92-1 BCA ¶ 24,565, 1991 WL 242893, 34 GC ¶ 10, the contractor claimed unamortized costs relating to a first article approved prior to termination in its termination settlement proposal. The Government argued the costs were unallowable because they related to continuing work and were not submitted in an REA on the continuing work within 90 days of termination. The board sustained the appeal, stating: "Whether this particular price adjustment is considered as a component of a termination for convenience settlement or as an equitable adjustment makes no essential difference. No possible prejudice has been shown to the Government by appellant's submission of one form instead of two."

Aero held the 90-day period for submitting an REA on the continuing portion of the work to be inapplicable because the contract contained the FAR 52.249-1, "Termination for Convenience of the Government (Fixed-Price) (Short Form)" clause without the 90-day deadline and the contractor did not agree to the 90-day requirement imposed in a unilateral modification by the CO. It is unclear how the board would have ruled had the contract included the FAR 52.249-2, "Termination for Convenience of the Government (Fixed-Price)," or other clause imposing the 90-day deadline. It should not have made a difference. Unamortized initial costs and preparatory costs are recoverable termination costs under the FAR 31.205-42(c) termination cost principle for "Initial costs." See Manos, 1 GOVERNMENT CONTRACT COSTS & PRICING § 49:5 (June 2019 Update) and cases cited therein.

In *Precision Specialty Corp. v. United States,* 15 Cl. Ct. 1 (1988), the Government contended the contractor's claim for

increased production costs, manufacturing overhead, and legal expense was untimely because it was for an equitable adjustment on the nonterminated portion that should have been submitted within 90 days of termination rather than the one year allowed for a termination settlement proposal. The Claims Court disagreed:

> Precision had two options…after receipt of notice of the partial termination: (i) to file a "termination claim" for costs allocable to the *terminated portion* of the contract and incurred due to the convenience termination *within one year* of the effective date of the termination; or (ii) to file a claim for an equitable adjustment *of the price specified in the continued (i.e., not terminated) portion* of the contract within 90 days of the effective date of the termination. Thus, depending on the option exercised by plaintiff, it had either *one year* from the termination date to submit a "termination claim" *or 90 days* from that date to submit a claim for an "equitable adjustment."
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> The court observes, as of paramount significance, that [Defense Acquisition Regulation] § 8–309(c) admonishes the terminating contract officer to assure himself "that no portion of the costs included in the equitable adjustment for the *continued* portion of the contract are included in the termination settlement" (emphasis added). **This directive undoubtedly indicates that the contractor could assign specific cost increases *either* to an equitable adjustment claim or a termination claim, but must choose one form or the other to avoid the probable result of double compensation for the same costs.** [Citations omitted.] [Boldface emphasis added.]

The Claims Court's statement that a contractor "must choose one form or the other" makes sense if applied to a particular cost which can only be claimed once. However, it makes no sense if it means a contractor may not submit an REA on the continued portion and a termination settlement proposal.

Nolan Bros. and *Chamberlain Manufacturing* indicate post-termination unabsorbed overhead other than that recoverable under a FAR provision may only be recoverable in an REA on the continuing portion of the work. To fully recover, a contractor should submit an REA on the continuing work. It appears other costs may be claimed in the REA and/or termination settlement proposal.

A contractor may be able to reallocate overhead in its termination settlement proposal without submitting an REA on the continuing work. In *Nicon v. United States,* 331 F.3d 878 (Fed. Cir. 2003), 45 GC ¶ 262, the Federal Circuit states unabsorbed overhead can be claimed in a termination settlement proposal as an initial cost and preparatory expense:

> Although unabsorbed overhead is not specifically listed in the FAR's "Termination for Convenience of the Government (Fixed–Price)" clause as one of the costs that will be paid under a settlement, it is also not excluded anywhere and could be asserted under the category of "costs incurred in the performance of the work terminated, including *initial* cost and preparatory expense allocable thereto." 48 C.F.R. § 52.249–2(g)(2)(i) (2002) (emphasis added). Furthermore, although unabsorbed overhead is not mentioned in 48 C.F.R. § 31.205–42 as a cost peculiar to a termination situation, the costs listed there "are to be used in conjunction with the other cost principles in [FAR] subpart 31.2," none of which would appear to prevent, as a matter of law, the award of unabsorbed overhead damages in a termination for convenience settlement if they are properly allowable and allocable.

Nicon concerned unabsorbed overhead resulting from delays before work commenced while a partial termination for convenience requires a reallocation of fixed costs to the reduced scope of work. Nevertheless, the rationale for allowing recovery appears the same. Arguably such a reallocation would apply to continuing but not terminated work as it does if an equitable adjustment on continuing work were submitted. This would arguably avoid a conflict with cases holding post-termination unabsorbed overhead to be unallowable.

Measure Of Recovery

An equitable adjustment on the nonterminated portion of the contract is comprised of (1) a reallocation of overhead increasing the unit prices of continuing work and (2) other costs resulting from the partial termination. See Anderson, Recovery of Indirect Costs: Pricing of Equitable Adjustments Terminations for Convenience 186–94 (1989).

• *Reallocated Overhead.* In *Deval Corp.,* ASBCA 47132, 99-1 BCA ¶ 30,182, 1998 WL 883199, the board provided a formula for calculating the unabsorbed overhead component of an equitable adjustment on the nonterminated quantity resulting from a partial termination for convenience based on the contractor's increased cost of performing the nonterminated work. This cost approach requires determination of (1) a contractor's actual overhead rate for the reduced volume, and (2) the overhead rate it would have experienced had there been no reduction in volume. The unabsorbed overhead component is

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calculated by multiplying the difference between these two rates by the nonterminated units of production. In *Fairchild Stratos Corp*, ASBCA 9169, 67-1 BCA ¶ 6225, *recons. denied,* 68-1 BCA ¶ 7053, 1968 WL 810, the ASBCA used as the measure what the unit price would have been had the parties known of the reduced quantity at the time of award rather than increased cost. The board did not use actual costs because of the difficulty of separating the increased overhead resulting from the partial termination for convenience of this Navy contract from that resulting from the subsequent complete termination for convenience of much larger Air Force contracts. This is consistent with cases requiring actual costs to compute an equitable adjustment if available. See *Propellex v. Brownlee,* 342 F.3d 1335 (Fed. Cir. 2003).

- *Other Costs Resulting From Partial Termination*. Manos, 2 Government Contract Costs & Pricing § 87:19 (June 2019 Update), describes costs recoverable in an equitable adjustment in a traditional Government contract as follows: "An equitable adjustment is determined on the basis of the increase or decrease in the contractor's cost of performance, or more specifically, "the difference between what it reasonably would have cost to perform the work as originally required and what it reasonably cost to perform the work as changed."…In addition, an equitable adjustment includes profit on the changed work." These recoverable costs include increased material costs due to the loss of quantity discounts, increased labor costs due to decreased labor efficiency, and settlement expense. *Hunter Manufacturing Co.*

- *No Double Counting*. FAR 49.208(b) states: "The TCO shall also ensure that no portion of the costs included in the equitable adjustment are included in the termination settlement." See *Precision Specialty Corp*.

Commercial Item Contracts

The FAR 52.212-4(l) commercial item termination for convenience clause authorizes the Government to partially terminate for convenience but does not expressly provide for an equitable adjustment on continuing work. The clause entitles a terminated contractor to recover (1) the percentage of contract price reflecting the percentage of completion, commonly referred to as "prong 1," plus (2) reasonable charges resulting from termination, commonly referred to as "prong 2." *SWR, Inc.*, ASBCA 56708, 15-1 BCA ¶ 35,832, 2014 WL 7084933, explains these provisions as follows:

> [I]t is clear the language…sets forth a procedure or process for the government to compensate fairly a contractor whose contract has been terminated for convenience. The first prong of the sentence providing for payment to the contractor of "a percentage of the contract price reflecting the percentage of work performed" prior to the termination notice, by its plain language, specifies a means for compensating the contractor for the work it has done before termination. *The second prong of the sentence providing for payment to the contractor of "reasonable charges" the contractor can "demonstrate" "have resulted from the termination," when read in conjunction with the first prong of the sentence relating to recovery for work completed, refers to the recovery of those charges incurred that "do not relate to work completed" but should be reimbursed to fairly compensate the contractor whose contract has been terminated.* [Citation omitted.] [Emphasis added.]

For a discussion of cost recovery in commercial item contracts, see Seidman, *Postscript III: Termination for Convenience of FAR Part 12 Commercial Item Contracts*, 33 NCRNL ¶ 26, and Seidman, *Postscript II: Termination for Convenience of FAR Part 12 Commercial Item Contracts*, 29 NCRNL ¶ 21.

In *Individual Development Associates, Inc.,* ASBCA 53910, 04-2 BCA ¶ 32,740, 2004 WL 2039350, *recons. denied,* 05-2 BCA ¶ 32,985, 2005 WL 1303183, the ASBCA held that an equitable adjustment on nonterminated work was not recoverable in a commercial item contract because, among other things, the commercial item clause authorized partial terminations but did not provide for an equitable adjustment on continuing work. The board stated:

> We turn now to appellant's final argument, which is that the termination of [contract line item number] 0001 entitles appellant to an equitable adjustment for the increased costs to the continuing contract work. Appellant admits and we hold that the termination clause does not include any language indicating that such an equitable adjustment is due appellant for this termination. In addition, and more importantly, the language of the commercial termination clause permits such a termination. Thus, no change to the contract terms and conditions results from this termination, and even if there were such a change, the changes clause for commercial contracts contained in this contract does not have any equitable adjustment language.
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> Appellant correctly points out that paragraph l of the standard FAR 52.249-2, TERMINATION FOR CONVENIENCE OF THE GOVERNMENT (FIXED-PRICE) (SEP 1996) clause provides for an equitable adjustment if the partial termination causes an increase in the costs of the continued work. However, this clause was not present in this contract because it is a commercial contract. The commercial termination clause contained in this contract does not include this equitable adjustment language.

> Equitable adjustments relate to increased costs caused by actions of the government. Thus, termination proposals under the standard Termination for Convenience clause which claim more than $100,000 must be audited. FAR 49.107. On the other hand, terminations under commercial contracts do not relate to such costs because the contractor is not required to adhere to contract cost principles and the government has no right to audit contractor's termination proposals.
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> FAR 12.403(a) indicates that [FAR] Part 49 relating to standard terminations does not apply because different principles govern contracts with standard contract termination provisions than ones with commercial termination clauses. It, however, permits the use of Part 49 as a guide when the governing principles are not in conflict. Clearly, the rules relating to equitable adjustment in Part 49 relate to costs, which appear not to be principles used in commercial terminations. Rather, termination under Part 12 allows for recovery of "reasonable charges" in addition to a percentage of price. Appellant's argument for an equitable adjustment to the continuing work due to the partial termination must be rejected.

The ASBCA has not reversed *Individual Development Associates*. Nevertheless its mechanical interpretation is inconsistent with the fair compensation safety net *SWR* requires in prong 2—reasonable charges resulting from termination.

The *SWR* prong 2 test for recovery is arguably met for equitable adjustments on the nonterminated portion because the charges (1) relate to terminated rather than the completed work and (2) should be reimbursed to fairly compensate the contractor for the terminated work. It is reasonable to charge for an equitable adjustment on nonterminated work following a partial termination for convenience because it is recoverable in a traditional Government contract. FAR 12.403(a) permits COs to use FAR Part 49 for traditional Government contracts as guidance to the extent FAR Part 49 does not conflict with the commercial item termination for convenience provisions in FAR Part 12. The provisions concerning equitable adjustment on the nonterminated portion in the FAR 52.249-2 "Termination for Convenience" clause mandated by FAR Part 49 do not conflict with FAR Part 12.

Strategy

If you receive a partial termination for convenience of a traditional Government contract, be sure to reallocate indirect costs and claim other resulting costs in a timely REA for the increased cost of performing continuing work. A contractor has some latitude in claiming costs other than a reallocation of fixed costs as an REA on continuing work or as termination costs for terminated work in a termination settlement proposal. *Nicon* indicates a contractor may be able to reallocate fixed overhead over continuing work as initial and preparatory costs in its termination settlement proposal. However, the right to such a reallocation other than in an equitable adjustment on continuing work is unclear. To avoid unnecessary disputes a contractor should file a timely REA on continuing work that reallocates overhead over the reduced scope of work.

A contractor should consider requesting an extension of the 90-day deadline on requests for equitable adjustment on continuing work to permit concurrent submission with its termination settlement proposal one year after the effective date of termination. This will facilitate avoiding double counting, which is in the interest of both the Government and contractor.

A contractor should not agree to any continuing obligations in a complete termination other than those in the "Termination for Convenience" clause without adequate compensation. Although partial terminations for convenience are encouraged by FAR 49.603-1(b)(7), COs must consider the inclusion of a provision in a settlement of a "complete termination" preserving the Government's rights "concerning defects, guarantees, or warranties" and imposing other post-termination contractor obligations concerning terminated work. See *Fixed-Price IDIQ Contracts: High Risk Ventures*, 21 N&CR ¶ 43.

If a contractor has continuing obligations, a termination is partial rather than "complete." To be fairly compensated and to be assured of reallocating post-termination unabsorbed overhead other than that expressly allowable in the FAR, a contractor must submit a timely REA on the nonterminated portion of the contract.

For the reasons previously stated, an equitable adjustment on the nonterminated portion may be recoverable under FAR Part 12 commercial item contracts. FAR 12.403 states that COs may use Part 49 as guidance in commercial item contracts to the extent it does not conflict with the FAR 52.212-4(l) clause for commercial item contract terminations for convenience. Nothing in FAR 49.603-1(b)(7), encouraging COs to terminate less than all performance obligations, is inconsistent with FAR 52.212-4(l). *Paul J. Seidman*

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