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Government Contract Terminations



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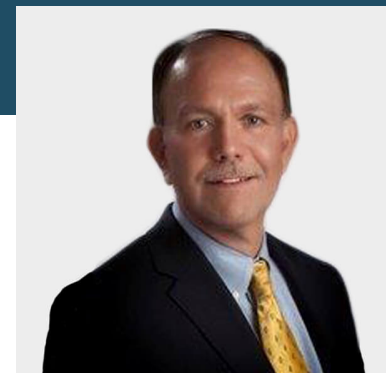


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Government Contracts Terminations: Concepts, Background and Best Practices

What is a Contractual Termination?

- Right of the government to order the contractor to immediately cease performance, either partial or total
- Generally, two types:
 - Termination for default (also known as termination for cause)
 - Termination for convenience
- Each type of termination has different causes, effects and remedies
- In most federal government contracts, termination is one-sided
 - i.e., the contractor does not have a termination right
- Significant differences from commercial (i.e., non-government) contracts
 - Termination for convenience concept
 - One-sided nature of termination
 - Incorporation of right to terminate for convenience through the *Christian* doctrine

Details of Termination Process FAR Part 49

- Subpart 49.1 -- General Principles
- Subpart 49.2 -- Additional Principles for Fixed-Price Contracts Terminated for Convenience
- Subpart 49.3 -- Additional Principles for Cost-Reimbursement Contracts Terminated for Convenience
- Subpart 49.4 -- Termination for Default
- Subpart 49.5 -- Contract Termination Clauses
- Subpart 49.6 -- Contract Termination Forms and Formats

Termination for Default

Termination for Default

- Right of the Government to terminate the contractor's performance—in whole or part—due to an anticipated or actual failure to perform a material contractual obligation
- Relevant regulations at FAR Subparts 49.1 and 49.4
- Relevant contract clauses at FAR 52.249-6 through -10
 - FAR 52.249-6 – Termination (Cost Reimbursement)
 - FAR 52.249-7 – Termination (Fixed-Price Architect-Engineer)
 - FAR 52.249-8 – Default (Fixed-Price Supply and Service)
 - FAR 52.249-9 – Default (Fixed-Price Research and Development)
 - FAR 52.249-10 – Default (Fixed-Price Construction)
- Contracts for commercial products and commercial services use different regulations/clauses
 - FAR 12.403(c) – Termination for cause
 - FAR 52.212-4(m) – Termination for cause

Termination for Default – Causes

- Failure to deliver the supplies or perform the services within the time specified in the contract
 - The government is generally entitled to strict compliance, but principles of substantial compliance for supply contracts or substantial completion for construction contracts may protect the contractor for minor departures from the specifications
- Failure to perform any other provision of the contract
 - The provision must be considered a material or significant requirement of the contract
- Failure to make progress in the work, so as to endanger performance of the contract
 - Contracting Officer must have a reasonable belief that there is no reasonable likelihood that the contractor can perform the entire contract within the time remaining for performance
- Common law doctrines also apply
 - Anticipatory repudiation
 - Failure to give adequate assurances

Termination for Default - Process

- Contracting Officer issues show cause notice
 - While recommended, not actually required in all circumstances (for fixed-price)
 - Can include the required 10-day cure notice for failures to make progress or failures to comply with other provisions of the contract
 - Cost reimbursement contracts require a 10-day cure notice in all instances
- Contractor responds to show cause notice
- Contracting Officer issues notice of termination for default
- Contractor immediately follows instructions in the notice, including notifying subcontractors, ceasing work as required and protecting work in progress
- Contracting Officer convenes conference to manage the settlement process
- Negotiations to reach a possible settlement
- Contracting Officer determines what work to accept
- Contracting Officer issues Final Decision, articulating remedies of the Government
- Contractor appeals, seeking to convert the termination for default to a termination for the Government's convenience

Termination for Default - Defenses

- FAR 49.401(b):
 - “If the contractor can establish, or it is otherwise determined that the contractor was not in default or that the failure to perform is excusable; i.e., arose out of causes beyond the control and without the fault or negligence of the contractor, the default clauses . . . provide that a termination for default will be considered to have been a termination for the convenience of the Government, and the rights and obligations of the parties governed accordingly.” (Emphasis added.)
- Excusable Delays
 - Examples: (1) acts of God or of the public enemy, (2) acts of the Government in either its sovereign or contractual capacity, (3) fires, (4) floods, (5) epidemics, (6) quarantine restrictions, (7) strikes, (8) freight embargoes, and (9) unusually severe weather.
- Waiver
 - The government may be found to have waived its right to terminate for default if it does not exercise the right within a reasonable period of time after the default, and the contractor detrimentally relied on the failure to terminate and continued performance with the government’s knowledge or implied consent.
 - But the government may “forbear” for a reasonable period after the default to investigate the reasons for the apparent default

Protecting Against a Threatened Termination for Default

- Avoid anticipatory repudiation
 - Do not communicate an inability or unwillingness to perform in accordance with the terms of the contract, either verbally or in writing
 - Do not take any measures that might be construed as an unwillingness to perform (e.g., pulling necessary equipment from the project site)
- Other strategies
 - Keep the government updated on progress
 - Provide assurances of successful completion/delivery, especially when requested
 - Maintain a dialog with the government, but do not concede any failures
- If termination looks imminent, think creatively
 - Can the government be convinced that termination is not in its interest?
 - Are there flaws in the government's position that can be pointed out?
 - Will the threat of litigation make the government think twice?
 - Is there a possibility of a no-cost settlement without termination?
- Often a default termination is something that the government wants to avoid, due to the time, money and effort to obtain the replacement services

Ramifications of a Default Termination

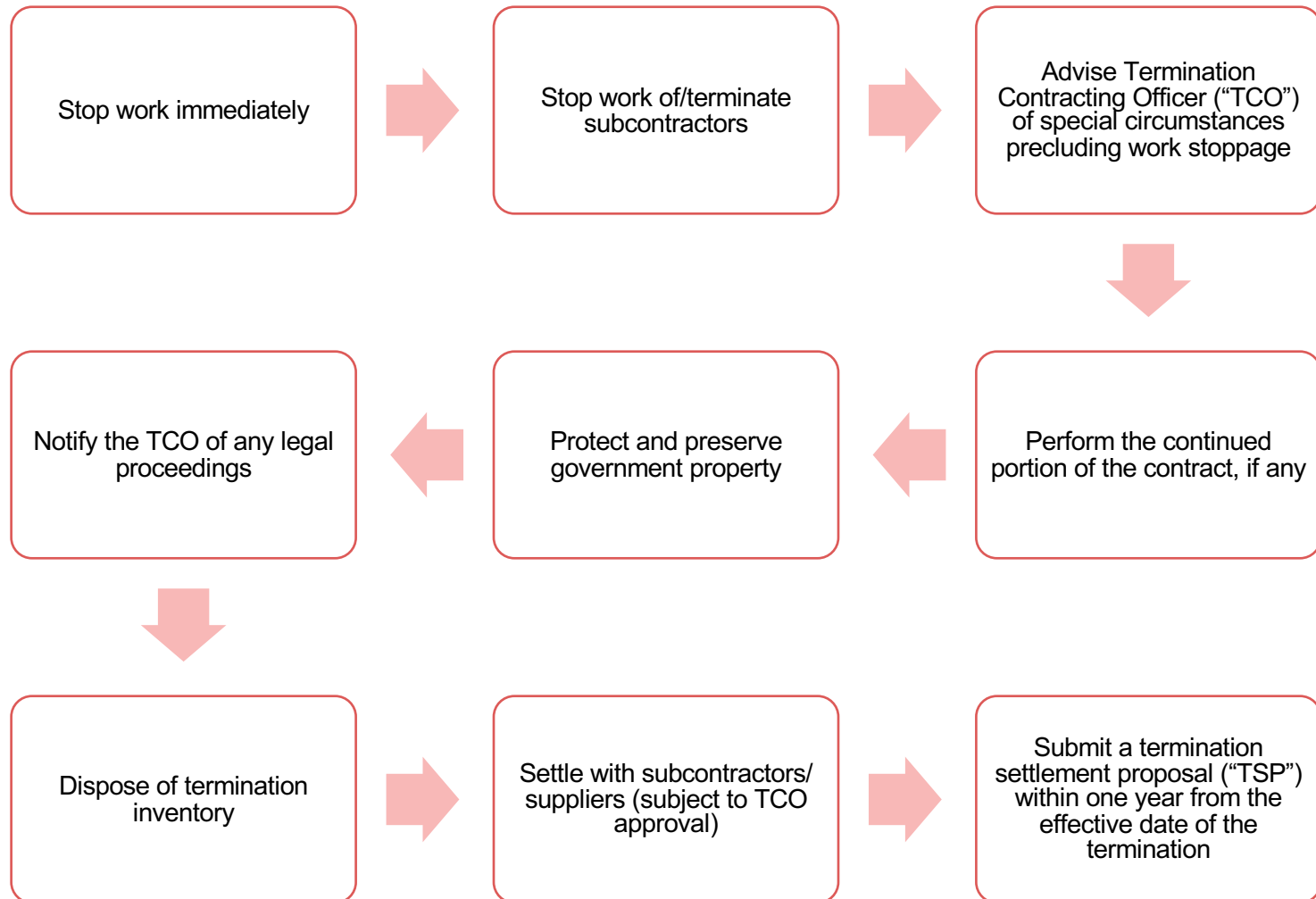
- Financial consequences
 - Contractor generally cannot recover costs of undelivered work (except in cost-reimbursement contracts)
 - Contractor must repay advance and progress payments
 - Contractor liable for excess procurement costs (i.e., cost government incurs procuring the supplies or services from another contractor)
 - Contractor may be liable for liquidated damages
 - Contractor may be liable for common law damages
- Other consequences
 - Termination for default published in Federal Awardee Performance and Integrity Information System (“FAPIIS”)
 - Reputational damage and negative impact on future past performance evaluations
 - Increases risk of suspension or debarment—FAR 9.406-2(b)(1)(i) causes for debarment include
 - “Willful failure to perform in accordance with the terms of one or more contracts”
 - “A history of failure to perform, or of unsatisfactory performance of, one or more contracts”

Termination for Convenience

Termination for Convenience

- Right of the Government to terminate the contractor's performance—in whole or part—if/when the Contracting Officer determines that termination is in the Government's interest
- Has its roots in the protection of the public fisc as a mechanism to ensure that the government does not have to pay for something that it may no longer need or want
- Relevant regulations at FAR Subparts 49.1 through 49.3
- Relevant contract clauses at FAR 52.249-1 through -7
- Contracts for commercial products or commercial services use different regulations/clauses
 - FAR 12.403(d) – Termination for the Government's convenience
 - FAR 52.212-4(l) – Termination for the Government's convenience

Contractor Responsibilities Upon Receipt of a Notice of Termination (FAR 49.104)



General Process of a Termination for Convenience

- Contracting Officer provides notice
- Contractor immediately follows instructions in the notice, including notifying subcontractors and immediately ceasing work as required
- Contracting Officer convenes conference to manage the settlement process
- Contractor protects work in progress and seeks clarifications in writing of any points/issues not covered by the notice
- Within one year of the termination, Contractor prepares settlement proposal, including settlement proposals of subcontractors
- Contractor seeks/government provides approval to settle subcontractor proposals
- Negotiate settlement
- If settlement cannot be negotiated, contracting officer issues unilateral determination
- Contractor appeals unilateral determination

Resolving a Termination for Convenience

- Government has almost unlimited discretion regarding the decision to terminate for convenience
 - Contractor generally cannot obtain damages for breach unless it can show that government acted in bad faith or decision to terminate was an abuse of discretion
- Most often resolved by negotiation and mutual agreement
 - If no mutual agreement, the Contracting Officer may make a unilateral determination of the amount due to the contractor, from which the contractor may appeal
- Contractor generally entitled to the following:
 - Contract price for completed and accepted supplies/services
 - Cost incurred in performance of the terminated work, including initial costs and preparatory expense (FAR Part 31 cost principles apply)
 - Costs of settling and paying the settlement proposals of subcontractors
 - Fair and reasonable profit on the cost of work performed (but no profit on work not performed as a result of the termination), or in a cost reimbursement contract, a percentage of the fee equal to the percentage of completion of the work
 - Reasonable costs of settlement of the terminated work

The “Fair Compensation Principle”

- FAR 49.201(a) – “A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portion of the contract, including a reasonable allowance for profit”
- FAR 49.206-1(c) “Settlement proposals must be in reasonable detail supported by adequate accounting data. . . . When actual, standard, or average costs are not reasonably available, estimated costs may be used . . .”
- FAR 49.303-5(d) “If an overall settlement of costs is agreed upon, agreement on each element of cost is not necessary. . .”

Termination Costs: FAR 31.205-42

- “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”
- Cost principle provides general rules of allowability and unallowability
 - (a) common items—transfer items to other work when reasonable
 - (b) continuing costs—idle facilities, severance pay, unabsorbed overhead
 - (c) initial costs—starting load and preparatory costs
 - (d) loss of useful value—special tooling, and special machinery and equipment
 - (e) rental under unexpired leases
 - (f) alterations of leased property—allowed if necessary for performing the contract
 - (g) settlement expenses—accounting, legal, clerical costs incurred to present to contracting officer
 - (h) subcontractor claims—contractor does not earn profit on subcontract effort included in the termination settlement proposal

Termination Forms FAR Subpart 49.6

Form	Form No. SF-	Cost Type	Fixed Price		
			Short Form	Inventory Basis	Total Cost Basis
Amendment of Solicitation / Contract Modification	30	✓	✓	✓	✓
Inventory Schedule B	1428/29	✓		✓	✓
Inventory Schedule E for Use With Short Form Settlements	1434		✓		
Inventory Basis Settlement Proposal	1435			✓	
Total Cost Basis Settlement Proposal	1436				✓
Cost Reimbursement Settlement Proposal	1437	✓			
Short Form Settlement Proposal	1438		✓		
Schedule of Accounting Information	1439	✓		✓	✓
Partial Payment Request	1440	✓	✓	✓	✓

Special Considerations in Partial Terminations for Convenience

Partial Terminations for Convenience

- “Partial termination” results when only some of the work remaining to be performed is terminated
- A partial termination usually will require an equitable adjustment
 - Fixed-price contracts – FAR 52.249-2(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.”
 - Cost-reimbursement contracts – FAR 52.249-6(l): “The Contractor and Contracting Officer must agree to any equitable adjustment in fee for the continued portion of the contract when there is a partial termination.”

Partial Termination versus Change

- Government may delete some—but not all—of the work remaining to be performed under a contract through the termination clause as a partial termination or through the Changes clause
- Reductions are contemplated by a Changes clause and “within the general scope of the contract”—contracting officer generally may either “de-scope” the work (Changes clause) or partially terminate it for convenience.
 - See, e.g., *J.W. Bateson Co. v. United States*, 308 F.2d 510, 513 (5th Cir. 1962) (“[T]he proper yardstick in judging between a change and a termination in projects of this magnitude would best be found by thinking in terms of major and minor variations in the plans.”).
- Changes are “within the general scope of the contract” when the parties should have “fairly and reasonably” contemplated them at the time when they entered the contract. Reductions that would not have been fairly and reasonably contemplated by the parties are generally treated not as changes, but as partial terminations for convenience.
 - See *Freund v. United States*, 260 U.S. 60, 63 (1922).

Partial Termination versus Change

- In a deductive change, Government is entitled to a downward equitable adjustment in the contract price, measured by “what the cost of the deleted work would have been to the contractor.”
 - *Glover Constr. Co., Inc.*, ASBCA No. 29194, 29924, 85-2 BCA 18,093 (April 29, 1985)
- In partial termination, contractor seeks to re-price the remaining work
- Examples of partial termination REAs on the continuing portion of the contract (from DCAA Audit Manual § 12-103):
 - (1) A volume decrease that increases material, labor, or indirect unit costs. The contractor may no longer be able to take advantage of quantity discounts. Direct labor unit costs may increase because the work reduction may prevent the contractor from realizing labor improvement (learning) curve benefits projected in the negotiated price. Labor unit costs may also increase because there are fewer units over which to distribute setup costs. Indirect cost rates may increase when assigning fixed overhead charges over a lesser volume.
 - (2) Initial (starting load) costs may not be recovered due to the partial termination.

Special Considerations in FAR Part 12 Terminations

FAR Part 12 Terminations

- Different standards apply to contracts for commercial products or services
 - Standards of FAR Part 49 **do not apply**, but contracting officers may use Part 49 as guidance to the extent it does not conflict with FAR 12.403 and FAR 52.212-4
 - FAR Part 31 cost principles **do not apply**, and government **does not have** audit rights
- Termination for cause
 - Cure notice required if terminating for a reason **other than** late delivery
 - Government's rights include "all the remedies available to any buyer in the marketplace," but the "preferred remedy" is charging defaulted contractor with excess procurement costs
 - Information regarding termination for cause must be reported in accordance with agency procedures
- Termination for convenience
 - For fixed-price contracts, contractor is paid "a percentage of the contract price reflecting the percentage of the work performed" plus "reasonable **charges** the contractor can demonstrate directly resulted from the termination"

FAR Part 12 Terminations – Recent Drivers

- Afghanistan withdrawal
- Border Wall cancellation
- Pandemic

FAR Part 12 Terminations – Recent Case Law

- *JKB Solutions & Services, LLC v. United States*, 18 F.4th 704 (Fed. Cir. 2021)
 - JKB held IDIQ contract with the Army for instructor services
 - Army issued three year-long task orders with a price per class and a total price for 14 classes
 - Army only paid for classes taught, rather than total price in each order
 - JKB sued for breach, but COFC ruled that Army had partially and constructively terminated for convenience because contract included FAR 52.212-4
 - Federal Circuit reversed, holding that the contract did not include an applicable termination for convenience clause
 - Federal Circuit determined that the commercial items termination clause was inapplicable because this was a contract for services
 - Very odd analysis, since the FAR definition of “commercial items” at the time included both products and services
 - Federal Circuit remanded to COFC to assess whether another termination for convenience clause was included through the *Christian* doctrine
 - Case has unclear impact, as FAR no longer uses the term “commercial items”

Profit and Loss on Fixed-Price Contracts (FAR 49.2)

Fixed-Price Contracts FAR Subpart 49.2

Key Points	FAR Reference
Settlement Profit Factors	49.202(b)
Anticipatory Profit	49.202(a)
Adjustment for Loss	49.203

Settlement Profit Factors: FAR 49.202 & 49.203

- Extent and difficulty of work performed as compared with the total contract requirements
- Engineering work, production scheduling, planning, technical study and supervision
- Contractor efficiency related to (i) quality, (ii) cost reduction, (iii) resource management and (iv) inventory disposal
- Capital investment and risk assumed
- Inventive and developmental contributions
- Complexity of manufacturing techniques
- Contractor's profit rate assuming a completed contract
- Profit rate contemplated by the parties during contract negotiations
- Subcontracting environment, including effort to negotiate settlements of terminated subcontracts
- TCO has broad discretion to determine profit, but is instructed in the FAR not allow profit if it appears that the contractor would have incurred a loss had the entire contract been completed
- “Anticipatory profits and consequential damages shall not be allowed...”

Loss Adjustment Example One: Inventory Basis

Total Contract Price (“TCP”) = \$45M

Total Cost Incurred at Termination
 (“TCI”) = \$30M

Estimated Cost to Complete at
 Termination (“ETC”) = \$20M

$$\frac{\text{TCP}}{\text{TCI} + \text{ETC}} = \frac{\$45\text{M}}{\$30\text{M} + \$20\text{M}} = \frac{\$45\text{M}}{\$50\text{M}} = 90\%$$

Loss Adjustment Example One (cont.)

<u>Cost Type</u>	<u>Amount</u>	<u>Loss Adjustment</u>	<u>Amount Recoverable</u>
Settlement Expenses	\$1,000,000	N/A	\$1,000,000
Acceptable Completed Items (at Contract Price)	5,000,000	N/A	5,000,000
Remaining Costs (WIP, O/H, G&A, Other Costs, Subcontractor Settlements)	2,000,000	90%	1,800,000
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Total	\$8,000,000		\$7,800,000
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Fee Adjustment and Other Considerations on Cost- Reimbursement Contracts (FAR 49.3)

Fee Adjustment On Cost Plus Contracts

- FAR 49.115(b) – Cost-plus-incentive-fee contracts
 - Fee adjustment is based on FAR 49.3 provisions
 - Incentive provisions do not apply to the terminated portion of the contract
- FAR 49.305-1
 - (a) Fee adjustment generally based on percent complete
 - Considers extent and difficulty of work performed
 - Fee does not include allowance for fee for subcontract effort included in subcontractor TSPs
 - (b) “The ratio of costs incurred to the total estimated cost of performing the contract... is only one factor in computing the percentage of completion.”

Vouchering: FAR 49.302

- Continue normal cost-reimbursement billing procedures after termination
- Voucher period ends the last day of the sixth month following the month of termination
- Creates incentive to maximize termination effort during voucher period
- Important for cash flow

THANK YOU



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