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Sequestration, Austerity And Terminations: Lions, Tigers And Bears—Oh My

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With the highest probability of sequestration since 1986, and the likelihood of an austerity period even if sequestration is avoided, a Government contractor's next logical step is to determine how budget cuts for existing programs may be enacted. Whether through sequestration or austerity, the Government's cuts will undoubtedly affect many programs and include both the Government workforce and that of contractors. Because of the need to support the industrial base, these cuts will likely hurt service contractors more than manufacturers.

Contractors should expect the Government to use three basic means to reduce spending on contracts: termination for default (T for D), termination for convenience (T for C) and deductive changes. The regulations and case law have defined, although not bright-line, usages for each of these mechanisms. The contractor does, however, have distinct rights and cost recoveries available under each mechanism—even under a T for D. This article provides an overview of each likely budget-cutting mechanism, the process entailed with each, and contractor recoveries available under each mechanism. Finally, the article will contrast partial terminations and deductive changes—the differences between the two and the comparison in cost recovery under each methodology. Contractors may face these two situations specifically, and should be well-armed to survive these most likely budget-reduction mechanisms.

Terminations and Deductive Changes—Addressing the Basics

The U.S. Government provides itself the unique contractual benefit under the Terminations clauses[2] of allowing itself to terminate contracts unilaterally, in full or in part, for both default and convenience. It also provides itself the authority under the Changes clauses[3] to modify terms authorized by the Changes clauses without the contractor's concurrence.[4] While on its face this seems unfair to the contractor, there are prescribed, albeit somewhat different, remedies available to make the contractor whole for costs resulting from a termination or change.

With the looming possibility of sequestration and the certainty of austerity, the Government will use T for D, T for C and deductive changes to reduce spending on programs that are underperforming or have already had money committed that the Government is no longer able to spend. As a general roadmap for contractors, the Federal Acquisition Regulation spells out the termination process in FAR pt. 49, from the contracting officer's perspective. As a contractor, it is important to know:

(1) which Government contract termination or change method is appropriate for your circumstances;

(2) what processes are followed under each termination or change method; and

(3) what contractor remedies are available under each termination or change method.

T for D

Overview

Default terminations can be full or partial. Regardless, they require the Government to show in a written notice of default to the contractor that:

(a) the contractor has failed to deliver products or services on time, or failed to perform the work specified under the contract within the time specified by the contract[5];

(b) the contractor is making progress in performing the work at a rate that endangers the performance of the contract[6]; or

(c) the contractor fails to perform any other provisions of the contract.[7]

Essentially, it is the remedy for a common law contract breach. When the contractor is deficiently performing some aspect of the contract and has not corrected the deficiency, the Government will issue a cure notice or a show cause notice. The difference between the notices issued is relatively straightforward:

(1) If a contract is to be terminated for default before the delivery date, then a cure notice is required by the Default clause.

(2) If there is not enough time remaining in the contract to permit a realistic cure (10 days or more), then the cure notice will not be used.[8] A show cause notice[9] will be used, requiring the contractor to show a realistic reason as to why it is not in default by demonstrating that it is able to meet a deadline, able to make sufficient progress as not to endanger the performance of the contract or providing quality products or services, or is following other contractual terms and conditions.

T for D Process

It is possible that the Government, in its budget-cutting goals, will attempt to terminate for default—in whole or in part—some contracts that really should be a T for C or treated as a deductive change. Using a T for D provides the Government with some similarities to and some distinct advantages over T for Cs and deductive changes. With a T for D, the Government:

(a) pays the contract price for supplies, products or services that have been delivered or accepted (same as a T for C or deductive change);

(b) negotiates a price for manufacturing supplies and partially completed work (same as a T for C or deductive change); and

(c) pays for the protection and preservation of the property it has accepted (same as a T for C or deductive change).

However, unlike a T for C or deductive change, the contractor may be held liable to the Government for the cost of completing the supplies, products and services.[10] Additionally, the contractor is not entitled to other cost recoveries allowed under a T for C or a deductive change and may have to return progress payments. This all pales in comparison to the T for D black mark on a contractor's past performance record that will affect its ability to obtain additional Government contract work.

Contractor Remedies

If a contractor has any questionable performance or contractual issues, it is to the Government's financial advantage in a sequestration or budget-cutting environment to use a T for D if possible. Aside from any litigation under the Disputes clause arising from T for D causes, the T for D is still a valid vehicle for the Government to eliminate contracts and cut budgets, if it can establish that the contractor was in default. However, since it may appear to be a lucrative, low-cost way to cut contracts, it may not always be used appropriately.

The contractor should be aware of the appropriate use of the T for D, document its version of key issues (like schedule slippage and subcontractor defaults), and then request the Government to excuse the default circumstances based on the contractor's documented chronology of events. If the default cause and circumstances can be shown to be excusable, the T for D will be converted to a T for C. In summary, it is only appropriate for the Government to use a T for D if there are material contract delinquency circumstances that cannot be cured—such as delivery schedule issues, project progress issues, or a contractor's unwillingness to follow contract provisions.

T for C

Overview

In a future world of budget cuts and sequestration, the one guarantee is that there will be T for Cs. As with the T for D, it is important to understand the underlying reasoning for a full or partial termination—both for cost recovery and for business purposes. The Government has the absolute right to terminate for convenience, any contract, in full or in part under the various T for C clauses when it is in the Government's interest.

There is a long and storied history of T for C, going back to *U.S. v. Corliss Steam-Engine Co.*[11] in 1875, in which the U.S. Supreme Court supported the Government's right to terminate a contract when completion of the contract was not in the Government's best interest—even though the contract had no termination clause and there was no statutory authority to terminate. Subsequent court decisions have narrowed the Government's right to terminate for convenience slightly,[12] but it remains a broad Government right that is substantially unaltered.

T for C Process

A CO initiates a T for C after determining that it is in the Government's best interest to terminate the contract and subsequently issuing a notice of termination. The notice of termination must specify the extent of the termination and the effective date of the termination. Immediately upon receiving a notice of termination a contractor must do several things,[13] including,

(1) stop work as specified in the notice;

(2) place no further subcontract orders, except as necessary to complete the continued portion of the contract in the case of a partial termination;

(3) terminate all subcontracts to the extent that they relate to the work terminated;

(4) assign to the Government, as directed by the CO, all right, title and interest of the contractor under the subcontracts terminated, in which case the Government shall have the right to settle or to pay any termination settlement proposal arising out of those terminations;

(5) with approval or ratification to the extent required by the CO, settle all outstanding liabilities and termination settlement proposals arising from the termination of subcontracts;

(6) as directed by the CO, transfer title and deliver to the Government—

  (a) the fabricated or unfabricated parts, work in process, completed work, supplies, and other material produced or acquired for the work terminated; and

  (b) the completed or partially completed plans, drawings, information and other property that, if the contract had been completed, would be required to be furnished to the Government;

(7) complete performance of the work not terminated;

(8) take any action that may be necessary, or that the CO may direct, for the protection and preservation of the property related to the contract that is in the possession of the contractor and in which the Government has or may acquire an interest; and

(9) use its best efforts to sell, as directed or authorized by the CO, any property of the types referred to in item (6) above, if the contractor

  (a) is not required to extend credit to any purchaser; and

  (b) may acquire the property under the conditions prescribed by, and at prices approved by, the CO.

The proceeds of any transfer or disposition will be applied to reduce any payments to be made by the Government under this contract, credited to the price or cost of the work, or paid in any other manner directed by the CO.

Although the CO issues the notice of termination, the termination is usually settled by a terminating CO.

Contractor Remedies

The next step in the process is contractor settlement. Settlement can occur in one of four ways[14]:

(1) negotiated agreement;

(2) determination by the TCO;

(3) costing-out under vouchers using SF 1034, Public Voucher for Purchases and Services Other Than Personnel; or

(4) a combination of these methods.

There are three bases for settlement proposals under T for Cs:

(a) no-cost settlement,

(b) the inventory basis, and

(c) the total cost basis.

Any other basis for settlement requires the approval of the chief of the contracting or contract administration office.[15] No-cost settlement is the preferred method for the Government if the contractor has not incurred costs (or is willing to waive costs incurred) under the contract, and if the Government is due no costs under the contract. If a no-cost settlement cannot be executed, then the other two approved bases for settlement (inventory or total cost) may be used. Of the two, the inventory basis is the method preferred by the Government.

Generally, under the total cost method, the contractor can recover its incurred cost (up to the total contract price) allowable under the FAR pt. 31 cost principles and allocable under the Cost Accounting Standards. Also, depending on the complexity of the settlement and the ability of the contractor's staff to perform the work, outside consultants may be retained to calculate the settlement cost and prepare the settlement proposal. The outside consultant's and attorneys' reasonable fees are allowable as part of the settlement proposal.

The basic difference between inventory basis and total cost basis settlements is that the inventory basis itemizes only those incurred costs attributable to the terminated portion of the contract, while the total cost basis itemizes the entire cost of the contract and allows for reimbursement of allowable costs up to the contract price.

Allowable costs under a T for C generally include the actual, standard or estimated costs of the following:

(1) precontract costs, generally if they were incurred directly pursuant to the negotiation and in anticipation of the award of the contract, and where their incurrence was necessary to comply with the proposed delivery schedule[16];

(2) initial costs, such as abnormally high labor, material and administrative costs that are incurred at the beginning of a contract to "ramp up" for performance[17];

(3) completed supplies or services, such as completed end items or deliverables to be delivered at the contract price under the contract, which have been accepted but not delivered[18];

(4) cost of facilities capital[19];

(5) termination inventory, if directed by the TCO[20];

(6) loss of useful value of special tooling, machinery and equipment[21];

(7) rental under unexpired leases, with some limitations[22];

(8) restorations of leased property (assuming the alterations were necessary under the contract)[23];

(9) post-termination costs in accordance with FAR 31.205-42(b)[24];

(10) settlement expenses, including,

  (a) accounting, legal, clerical and similar costs necessary for the preparation and presentation of the settlement claim and the termination and settlement of subcontracts[25];

  (b) reasonable costs for the storage, transportation, protection and disposition of property acquired or produced for the contract[26];

  (c) indirect costs related to salary and wages incurred as settlement expenses in (a) and (b)—normally, such indirect costs shall be limited to payroll taxes, fringe benefits, occupancy costs and immediate supervision costs[27];

(11) subcontractor claims,[28] assuming that the contractor flowed down a terminations clause to the subcontractor, in accordance with the provisions at FAR pt. 49.108-1; and

(12) profit on the preparation for and work done on the terminated portion of the contract, *but not on the termination settlement expenses or the dollar value of the subcontractor settlement costs*.[29] Profit for the subcontractor costs will be taken into consideration based upon the contractor's efforts. Profit *is not allowed* if the contract, when completed, would have been in a loss position.[30] Anticipatory profits on the work not performed on the terminated portion of the contract are not permitted. Additionally, if the contract is in a loss position, the "loss ratio" is applied to reduce the contractor's recovery by a ratio equivalent to the percent loss it would have on the entire contract, if it had been completed.[31] The loss ratio is calculated as set forth in FAR pt. 49.203 and applies to both inventory basis and total cost basis settlements.

(a) The loss ratio is calculated by taking the total contract price and dividing it by the sum of the terminated contract's cost and estimated cost to complete. If a contract is in a loss position, the resulting quotient will be less than 100 percent. That percentage is then applied to settlement cost (exclusive of FAR pt. 31.205-42(g) settlement expenses) to calculate the allowable final settlement cost.

Also, under a partial termination, a contractor may request an equitable adjustment in the price of the continued work of a fixed-price contract. For example, if a contract is partially terminated and has incurred costs for expendable tools, dies or fixtures for the terminated portion of the contract and for which there is no other use, the contractor would be entitled to an equitable adjustment on those expendable tools, dies or fixtures.

The contractor has one year from the effective date of the termination to submit a final settlement proposal to the TCO. The contractor also has to certify a final settlement proposal as accurate, current and complete if it exceeds the Truth in Negotiations Act threshold[32] (currently $700,000). Once a settlement proposal has been submitted, the TCO is required to have an audit performed on any prime or subcontractor settlement proposals in excess of $100,000. Once all the required reviews have been performed and the contractor and Government agree upon the settlement proposal, a settlement agreement is reached[33] and a settlement negotiation memorandum is prepared by the TCO. It is advisable for contractors to prepare their own settlement negotiation memorandum and keep it on file.

Deductive Changes

Overview

Work scope and deliveries may be eliminated from a contract by employing a deductive change under the Changes clause[34] appropriate for the contract. Under this method, the Government changes the specifications for minor portions of the work, and the contractor is theoretically left unharmed because deleted work cost and a reasonable profit are deleted from the contract.

Deductive Changes Process

The process for a deductive change is the same as for any contract change. The CO may, at any time, *by written order, and without notice to the sureties,* make changes within the general scope of a contract.[35] Specific Changes clauses are applicable to fixed-price, cost-reimbursement, and time-and-materials or labor-hours contracts. Each different clause (with or without alternate clauses) defines what can be changed by the Government under each contract type as enumerated. There are a number of clauses and alternate clause combinations addressing what can be changed, so it is important for a contractor to be cognizant of those applicable to its contracts.

Contractor Remedies

Contractors have the normal remedies available under the Changes clauses, including requests for equitable adjustment. However, in the case of deductive changes, there are generally no significant areas of cost that can be affected due to the presumed minor or non-identifiable nature of the work deleted. Three key legal distinctions are drawn as the line between a deductive change and a partial termination, and will be discussed in greater detail later in this article. Any

request for equitable adjustment, if such exists, must be asserted within 30 days after the date of the receipt of the written order changing the contract.[36] One problem with deductive changes is that the contractor may or may not be able to recover significant costs that could be recovered as settlement expenses under a T for C. Also, with fixed-price contracts, a deductive change (as compared to a T for C) can be beneficial or harmful depending upon the contract profit/loss margins before the change.

Partial T for C vs. Deductive Changes

Case Law Contrast

The courts have held that judgment must be used in deciding between the use of a T for C or a deductive change. In *J.W. Bateson Co. v. U.S.,* the court stated,

> It is obvious that there can be no hard and fast line between a "termination" and a "change" in the sense of these contracts. By a shift of circumstances, the two words may be made to verge on each other, or, on the other hand, may be made to stand far apart.

However, the courts have also developed three legal distinctions/tests to help relieve some of the uncertainty between a partial T for C and a deductive change. The cases that led to these distinctions are:

(1) *J.W. Bateson Co. v. U.S.*[37]—major and minor variations;

(2) *Appeal of Celesco Indus., Inc.* [38]—elimination of identifiable work; and

(3) *Appeal of Skidmore, Owings, & Merrill*[39]—Government's continuing need for the work.

In *J.W. Bateson Co. v. U.S.*, the court decided,

> The long and short of it is that the proper yardstick in *judging between a change and a termination ... would best be found by thinking in terms of major and minor variations* in the plans.

(Emphasis added.)

In *Appeal of Celesco Indus., Inc.*, the board found,

> We conclude accordingly that the partial termination notice represented by Modification P00019 reduced appellant's obligations and tasks under the contract. However, such changes in the specifications or in the scope of work are usually treated as deductive changes rather than termination actions. *The latter are more appropriate for a reduction of the number of units or supplies to be delivered, elimination of identifiable items of work, reduction in the quantity of work required under the contract, or similar reductions in contract tasks.*

(Emphasis added.)

In *Appeal of Skidmore, Owings, & Merrill,* the board decided,

> Ordinarily termination for the convenience of the Government is used when the Government's need for the article or thing called for in the contract no longer exists.

It is to the contractor's advantage to know these distinctions. If there are major variations in the plan, elimination of identifiable work, or the Government's lack of a continuing need for the products or services, a partial termination appears more appropriate. Otherwise, if there are minor variations in the plan, elimination of non-identifiable work, or the Government has a continued need for the products or services, a deductive change appears in order. There are differences to recovery, discussed later, between a partial termination and a deductive change that make understanding the case law as it applies to the contractor's circumstances imperative.

Recovery Differences

There can be significant differences in recovery between a partial termination and a deductive change.

Profit

Because a deductive change is prospective, profit on the elimination of the service or product is lost—at the rate at which the profit was proposed. For example, if profit was proposed at five percent, the reduced portion of the work or product would include the cost of the work product plus five percent. The profit margin of the overall contract prior to the deductive change remains unchanged after the deductive change, except for the profit attributable to the deleted work.

Under a partial T for C, there is no allowance for recovery of anticipatory profits (only profit on any work actually performed under the terminated por-

tion of the contract). Similar to a deductive change, the canceled work will not include any profit recovery, except for profit attributable to work performed under the terminated portion of the contract. The significant game changer for a partial T for C is whether or not that contract is in a loss position, which triggers the loss ratio requirements.

At a minimum, if actual profit is equal to the profit proposed on the contract, there is effectively no recovery difference in profit between a deductive change and a partial T for C. If the contract is in a significant profit position, a deductive change is preferred to a T for C because the deleted work is at a lower profit margin than may have actually been realized to date. This has the effect of shifting profit from the end of the contract to the beginning—including some of what would be anticipatory profit under a T for C; whereas under a T for C, there is no shift, and the anticipatory profit is not allowable or recovered.

However, if a contract is in a loss position and is a partial T for C, the loss ratio requirements of FAR 49.203(b)–(c) apply. These requirements effectively allocate a portion of the loss from the terminated portion of the work to the portion of the work not performed. Therefore, if the contract is in a loss position, a partial T for C is preferable to a deductive change, as the contractor bears only a portion of the loss.

Settlement Expenses

As previously discussed, in a T for C the contractor is in a position to recover reasonable contract settlement expenses. Thus, a T for C is preferable when the contract reduction requires substantial settlement expenses. Since a deductive change is prospective and just deletes a minor portion of the work, even if a request for equitable adjustment is appropriate for the change, it is likely to be so minor that settlement-type expenses may not be substantial or may be limited.

Conclusion

In conclusion, it is important for a contractor to know its contractual rights when it comes to a T for D, a T for C, or a deductive change. It is also important to know the allowability of the costs associated with each mechanism, and the ability to recover them. The coming sequestration and period of austerity will make understanding the details of these rights important to contractors as they discuss with the Government whether to convert T for Ds to T for Cs, and deductive changes to T for Cs. Most importantly, knowing the processes and proper positions that come with each type of termination or deductive change will make a contractor ready to walk through the dark forest ahead.

❖ Endnotes

1 Mary Karen Wills, CPA, is a Director with the Berkeley Research Group and the head of its Government Contracts Advisory Services practice. J. Andrew Stowe is a Senior Managing Consultant with the Berkeley Research Group.

2 FAR 52.249-1, Termination for Convenience of the Government (Fixed Price) (Short Form); FAR 52.249-2, Termination for Convenience of the Government (Fixed Price); FAR 52.249-3, Termination for Convenience of the Government (Dismantling, Demolition, or Removal of Improvements); FAR 52.249-4, Termination for Convenience of the Government (Services) (Short Form); FAR 52.249-5, Termination for Convenience of the Government (Educational and Other Nonprofit Institutions); 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); FAR 52.249-12, Termination (Personal Services).

3 FAR 52.243-1, Changes—Fixed-Price; FAR 52.243-2, Changes—Cost-Reimbursement; FAR 52.243-3, Changes—Time-and-Materials or Labor-Hours; FAR 52.243-4, Changes; FAR 52.243-5, Changes and Changed Conditions.

4 FAR 2.101 "Change order" means a written order, signed by the contracting officer, directing the contractor to make a change that the Changes clause authorizes the CO to order without the contractor's consent.

5 FAR 52.249-8(a)(1)(i); FAR 52.249-9(a)(1)(i); FAR 52.249-10(a).

6 FAR 52.249-8(a)(1)(ii); FAR 52.249-9(a)(1)(ii); FAR 52.249-10(a).

7 FAR 52.249-8(a)(1)(iii); FAR 52.249-9(a)(1)(iii); FAR 52.249-10(a).

8 FAR 49.607(a), Cure notice.

9 FAR 49.607(b), Show cause notice.

10 FAR 52.249-8(b); FAR 52.249-9(b); FAR 52.249-10(a).

11 91 U.S. 321, 23 L.Ed. 397 (1875).

12 The two limitations to this broad authority to T for C are bad faith and a clear abuse of discretion.

13 FAR 52.249.

14 FAR 49.103.

15 FAR 49.206-2(c).

16 FAR 31.205-32.

17 FAR 31.205-42(c).

18 FAR 49.205(a).

19 FAR 31.205-10.

20 FAR 52.249-2(b)(8)–(9).

21 FAR 31.205-42(d).

22 FAR 31.205-42(e).

23 FAR 31.205-42(f).

24 FAR 31.205-42(b), Costs continuing after termination. Despite all reasonable efforts by the contractor, costs that cannot be

discontinued immediately after the effective date of termination are generally allowable. However, any costs continuing after the effective date of the termination due to the negligent or willful failure of the contractor to discontinue the costs shall be unallowable.

25 FAR 31.205-42(g)(i).

26 FAR 31.205-42(g)(ii).

27 FAR 31.205-42(g)(iii).

28 FAR 31.205-42(h).

29 FAR 49.202(a).

30 FAR 49.203(a).

31 FAR 49.203(b)–(c).

32 FAR 49.105(c)15.

33 FAR 49.109.

34 FAR 52.243-1; FAR 52.243-2; FAR 52.243-3; FAR 52.243-4; FAR 52.243-5.

35 FAR 52.243 (a).

36 FAR 52.243 (c), (e).

37 *J.W. Bateson Co. v. U.S.*, 308 F.2d 510.

38 *Celesco Indus., Inc.*, ASBCA 22251, 79-1 BCA ¶ 13604.

39 *Skidmore, Owings, & Merrill*, ASBCA 5115, 60-1 BCA ¶ 2570.