



Presents...

Federal Contract Terminations: Preparing for the New Era of Budget Cuts

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Terminations in Government Contracts: Preparing for Budget Cuts



Background

- ❖ **Why we are doing this webinar now: budget cuts and changing priorities**
 - Sequestration may result in \$1.2T in budget cuts (\$109B per year) beginning January 2013
 - Even w/o sequestration, major budget cuts are likely
 - Either way, likely to see reduction in new contracts, changes in procurement vehicles, changes to contract administration, etc.
 - Bottom line: A much more difficult business climate for federal government contractors is on the horizon

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Terminations in Government Contracts: Preparing for Budget Cuts



Agenda

❖ What we will cover

- Termination process
- Cost allowability
- Profit, loss adjustments, special provisions, commercial items, etc.
- Construction-specific issues
- Employee issues
- Default terminations

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Termination for Convenience

- ❖ **Not common in the commercial market**
- ❖ **Gives the Government broad authority to terminate without cause**
- ❖ **Limits contractor's recovery to**
 - Costs incurred
 - Profit on work performed
 - Costs of preparing termination settlement proposal

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Termination for Convenience

- ❖ **When the government wants – except for bad faith**
- ❖ **No-cost settlement versus termination for convenience where**
 - Contractor amenable
 - No government property
 - No debts due the government
- ❖ **No termination where the price of the undelivered portion is less than \$5,000**
- ❖ **If the same item is under contract with both large and small business, preference for continuing performance with the small business**

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General Procedures

❖ Notice of Termination

- In writing
- By the Contracting Officer
- Provide
 - Effective date of termination
 - Scope of termination
 - Any special instructions

❖ After notice of termination, termination contracting officer responsible

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Contractor Obligations Upon Receipt of Termination Notice

- ❖ **Stop work as specified in the notice**
 - Note that for partial termination, contractor is obligated to continue the unterminated work
- ❖ **Discontinue placing further orders on the terminated portion of the contract**
- ❖ **Notify subcontractors**
 - Provide termination notices
 - Assure that scope of subcontractor termination is consistent with the prime contract termination
- ❖ **Notify employees**

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WARN Act Basics

- ❖ **Covered Employers - 100 or more employees**
- ❖ **Triggering Event – Plant Closing or layoff of 50 or more employees / 33% of workforce at site**
- ❖ **Requirement – 60-day advance notice (or pay in lieu of notice) to impacted employees, bargaining representative, state dislocated worker unit, chief local elected official**
- ❖ **Timing – 90-day rolling period for employee calculation**
- ❖ **Penalties – compensation and benefits for violation period up to 60 days; \$500/day for failure to notify officials**
- ❖ **Exceptions – unforeseen business circumstances; natural disaster**
- ❖ **“Mini WARN Acts” – States have separate WARN requirements**

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Termination Preparation/Tips

❖ **Work with Government to Minimize Termination Impact**

- Timing of contract termination
- How much notice will be provided for each phase
- Government employment of contract employees
 - How many jobs insourced
 - When jobs will be posted
 - Process for application/interview process

❖ **Other Statutory Obligations**

- FLSA/state wage payment laws
- COBRA notices
- ADEA/OWBPA requirements

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Contractor Obligations Upon Receipt of Termination Notice

- ❖ **Notify the TCO of any special circumstances that preclude the stoppage of work**
- ❖ **Continue performance of unterminated portion of the contract**
 - Promptly submit REA for impact of termination on unterminated portion of the contract
- ❖ **Settle outstanding liabilities in connection with termination**
- ❖ **Promptly submit termination settlement proposal**
- ❖ **Terminated construction contracts also subject to cleanup of construction site requirement**



Contractor Obligations Upon Receipt of Termination Notice

❖ Inventory

- Segregate and identify inventory allocable to the terminated contract
- Assess the status of the inventory
 - Title
 - Condition
- Protect and preserve the inventory pending disposition
- Prepare inventory schedule and submit to the TCO
- Dispose of inventory as directed by the TCO

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Conference with the TCO

- ❖ **General principles relating to termination settlement**
- ❖ **Extent of termination**
- ❖ **Status of continuing work**
- ❖ **Obligations of contractor to terminate subcontracts and settlement of subcontractor termination proposals**
- ❖ **Identification of subcontractors and dates of subcontractor termination notices**
- ❖ **Identification of personnel handling subcontractor settlements**

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Conference with the TCO

- ❖ **Arrangements for transfer of title and delivery to government of any materials**
- ❖ **Principles to follow with respect to inventory**
- ❖ **Contractor accounting practices**
- ❖ **Form of settlement proposal**
- ❖ **Accounting review of settlement proposals**
- ❖ **Requirements for interim financing**
- ❖ **Schedule for resolution of termination settlement proposal**
- ❖ **Actions taken by contractor to minimize impact on employees**

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Termination Settlement Proposal

❖ Entitlement

- Explanation of why contractor is entitled to payment
- Justification for incurred costs

❖ Quantum

- Detailed quantification of the amount to which the contractor claims entitlement
 - How costs were computed

❖ Certification



Settlement

❖ Audit

❖ Subcontract claims

- Negotiated between Prime and Sub with government approval
- Authority to settle without government approval
- Government may exercise the right to negotiate termination settlement directly with the subcontractor



Disputes

- ❖ **Conversion to a Claim**
 - File CDA certification
- ❖ **Appeal to**
 - Boards of Contract Appeals
 - Court of Federal Claims
- ❖ **Subcontractor disputes**
 - Contract dispute at law
 - In accordance with the terms of the subcontract
 - Judgment treated as prime contractor settlement



Cost Recovery: General Principles

- ❖ **T/C converts FFP to cost-reimbursement contract**
- ❖ **Contractor entitled to recover**
 - Allowable costs of performing terminated work;
 - Reasonable profit on work performed (subject to loss adjustment);
 - Additional costs caused by T/C; and
 - Settlement expenses
- ❖ **Allowability based on FAR Part 31 cost principles, BUT contractor should be compensated fairly**



Cost Recovery: General Principles

- ❖ **Indirect costs may be “converted” to direct costs**
 - If the lack of a normal allocation base otherwise prevents allocating a fair share of those costs to the terminated contract
 - May include applicable burden
 - Must be removed from indirect cost pools
 - Does not violate CAS 401 or 402
- ❖ **Total recovery limited to contract price minus payments already received, plus reasonable costs of settling terminated work**



Cost Recovery: General Principles

- ❖ **Settlement proposals subject to Truth in Negotiations Act (TINA) and must be certified if >\$700,000 TINA threshold**
- ❖ **Contractor must document its costs**
 - For FFP contractors adequacy of records of costs of performance generally subject to “fairness” standard
 - Stricter standard for post-termination and settlement costs: contractor on notice of requirement to keep accurate cost records
 - Establish separate charge number for settlement expenses



Cost Recovery: “Common items”

- ❖ *E.g.*, material which is common to the terminated contract and other work
- ❖ Contractor generally entitled to recover costs of termination inventory, BUT
- ❖ Costs of common items unallowable if the items
 - Are reasonably usable on other work, and
 - Can be retained at cost without sustaining a loss
- ❖ Reduced profit on use of those common items is not a loss



Cost Recovery: Post-termination Costs

- ❖ **Contract costs continuing after T/C may be recovered if the contractor makes all reasonable efforts to discontinue incurring the costs**
- ❖ **Examples**
 - Salaries and ODCs related to de-activating personnel, holding employees at standby pending reassignment, returning employees from remote or foreign locations
 - Severance pay, if required by law, existing employer-employee agreements, an established policy that constitutes an implied agreement, or the circumstances of the particular employment



Cost Recovery: Post-termination Costs

❖ Examples (cont'd)

- Costs of taking inventory and packing and preparing materials for storage or transportation
- Costs of plant or facility shutdown, such as dismantling, restoration, plant rearrangements, removal and shipment of equipment
- Depreciation costs for equipment which was to be used on the terminated contract
- Mitigation costs, such as advertising and selling effort related to equipment made idle by T/C



Cost Recovery: Initial Costs

- ❖ **Initial costs, both “starting loads” and preparation costs, are generally allowable**
- ❖ **Examples**
 - Nonrecurring higher labor costs early in production if contractor can show positive learning (declining labor hours or costs) prior to the T/C
 - Initial plant rearrangement and alterations, management and personnel organization, and production planning
- ❖ **May be recovered under T/C even if the same costs would not have been allowable as precontract costs, *e.g.*, planning costs incurred prior to start of performance**



Cost Recovery: Loss of Useful Value

- ❖ **Applies to special tooling, machinery and equipment**
- ❖ **Not applicable to real property**
- ❖ **Loss of useful value generally allowable if**
 - It is not reasonably capable of use in other work;
 - Government's interest protected, *e.g.*, by transfer of title; and
 - Amount limited to same ratio as the terminated contract bears to other contracts for which the tooling, machinery or equipment was acquired



Cost Recovery: Unexpired Leases

- ❖ **Rental costs under unexpired leases are generally allowable if**
 - Lease was reasonably necessary for performance of the contract and
 - Reasonable effort made to reduce the continuing cost, *e.g.*, by termination or assignment of the lease
- ❖ **Costs of lease period extending beyond contract completion date may be allowable if reasonable, *e.g.*, if shorter lease was not available**
- ❖ **Amount reduced by residual value of the lease**



Cost Recovery: Settlement Expenses

- ❖ **Costs of preparing T/C settlement proposals, including equitable adjustments, are allowable**
- ❖ **Not considered unallowable costs of prosecuting claims against the Government**
- ❖ **May be allowable even after an appeal from a TCO's unilateral determination, so long as the costs are incurred for negotiation purposes**
- ❖ **Settlement expenses are not subject to the overall contract price limitation**
- ❖ **No profit on settlement expenses**



Cost Recovery: Subcontractor Settlements

- ❖ **Subcontractor claims are generally allowable, if reasonable**
- ❖ **May include prime's allocable indirect costs**
- ❖ **Allowability of settlements not always dependent on whether the costs would have been allowable if claimed by the prime contractor, BUT**
- ❖ **Reasonableness usually measured by amount that would have been paid if subcontract included a T/C clause**



Limitations on Recovery – Loss Adjustment

- ❖ **If the Contractor would have sustained a loss on the entire contract had it been completed, then:**
 - No Profit
 - Reduce the recovery using a loss adjustment / Loss Ratio:

$$\frac{\text{Contract Price}}{\text{Full Perf. Costs}} \times \text{Costs Incurred} = \text{Recovery}$$



Limitations on Recovery – Loss Adjustment

Example Application of a Loss Adjustment

Contract Price = \$800,000

Expected Full Performance Costs = \$1,000,000

Costs Incurred = \$500,000

$$\begin{array}{r} \$800,000 \\ \hline \$1,000,000 \end{array} \quad \times \quad \$500,000 = \$400,000$$



Limitations on Recovery – Loss Adjustment

- ❖ **Defending against the loss adjustment**
 - Documentation of changes
 - Documentation of government delays
 - Submission of REAs and Claims
 - Cost projections
 - Learning curves and efficiency



Other Limitations on Recovery

- ❖ **May not exceed the total contract price**
- ❖ **Limitation of Costs Clause**
- ❖ **Limitation of Funds Clause**
 - Included in incrementally-funded cost contracts
 - Not notify gov't when costs incurred reach a certain percentage.
- ❖ **Special termination liability provisions**
 - Ensure these are adequately funded



Termination for Convenience Cost-Reimbursement Contracts

- ❖ **Recovery of costs incurred in performance**
- ❖ **Continuing costs**
- ❖ **Settlement costs**
- ❖ **Percentage of the fee equal to the percentage of completion of work contemplated under the contract (excluding subcontract effort included in subcontractors' termination proposals), less previous payments for fee.**



Adjustment of Fee - Construction Contracts

- ❖ **% of completion = total work effort, not just actual construction work**
 - Mobilization, use of an finances, contracting for and receipt of materials, placement of sub-Ks, preparation of drawings, job admin, demob, etc
 - Assign a weighted value depending on importance and value (total should be easily divisible), and % of completion of each factor established by specific facts
 - % completion of each factor applied to the weighted value gives overall % of contract completion, which is then applied to total K fee (or fee applicable to terminated portion) to arrive at equitable adjustment



Termination for Convenience Commercial Item Contracts

- ❖ **FAR Part 12.4 / 52.212-4(L)**
- ❖ **Payments to Contractor:**
 - “percentage of the contract price reflecting the percentage of work performed prior to the notice of termination”
 - “Reasonable charges . . . that have resulted from the termination”
 - Does not require compliance with CAS or contract cost principles
 - Can be demonstrated using the contractor’s “standard record keeping system”
 - FAR Part 49 provisions are only “guidance”
- ❖ **Non-standard termination provisions**



Partial Terminations for Convenience

- ❖ **Termination of part, but not all, of the work that has not been completed and accepted**
- ❖ **Contractor may seek an equitable adjustment for increased costs of continued work**



Deductive Changes

- ❖ **Alternative to a partial termination**
- ❖ **Based upon the “Changes” clause**
- ❖ **The contract price is reduced by the cost of the deleted work**
- ❖ **Reduction generally will include overhead and profit elements in addition to direct costs avoided**



Terminations for Default

- ❖ **Grounds for T for D**
- ❖ **Notice rules & responses**
- ❖ **Establishing the record before and after notice**
- ❖ **Potential consequences**
- ❖ **Contractor recovery & potential liability**
- ❖ **Appeals/conversion to T4C**



Grounds for Default Termination

❖ Examples

- Repudiation
- Failure to deliver or proceed
- Severe progress problems
- Defective product
- Failure to comply with other contract provisions

❖ **FAR 49.402-3 lists factors agency must consider before termination, but highly discretionary**

❖ **Decision will be upheld if basis existed at time of termination even if not listed in termination notice**

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Cure Notice

- ❖ **T for D may be improper if written cure notice not issued, or if termination based on ground not mentioned in cure notice**
- ❖ **Cure period of 10 days**
- ❖ **Not required if**
 - Performance schedule has expired or fewer than 10 days remain on contract
 - Futile – e.g., repudiation
- ❖ **Response - cure or give “adequate assurance”**
- ❖ **Gov’t must fully evaluate response**



Show Cause & Termination Notices

❖ Show Cause

- If T for D is deemed appropriate, show cause notice is encouraged, but not mandatory.
- No required response period
- Issuance of show cause notice after due date does not impact gov't's right to T for D for failure to timely deliver

❖ Termination Notice

- Grounds for default, liability for excess procurement costs, right to appeal
- Failure to comply with formal FAR requirement not fatal to T for D unless contractor prejudiced

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Establishing the Record

❖ Before notice

- Be alert to customer dissatisfaction
- Diligently address perceived or actual performance issues
- Fully document delay & performance issues
- For issues relating to differing contractual interpretations, consider getting legal involved early

❖ After cure notice

- Timely, complete response
- Provide proof deficiency is cured or give “adequate assurance” of performance

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Consequences of T for D

❖ Severe impact

- Contract harm
 - Gov't not liable for costs of unaccepted work
 - Return progress, partial, or advance payments
 - Excess procurement costs
 - Liquidated damages
- Broader issues - Reputational/past performance, possible debarment

❖ T for D = species of forfeiture

- Gov't held to “strict accountability in using this sanction”



Recovery & Potential Liability

❖ Recovery

- *Service & construction* - Payment for work properly performed prior to termination
- *Supplies* – no right to recover cost for supplies not accepted by gov't
- No recovery for anticipated profit

❖ Potential liabilities

- Excess costs of reprocurement or completion
 - Same or similar supplies, actually incurred excess costs, acted reasonably to minimize excess costs
- Other rights and remedies provided by law or contract



Appeals & Conversion

- ❖ **CO can reinstate if doing so would be advantageous to the gov't**
- ❖ **Appeals - COFC or Boards**
 - Agency counsel or DoJ? Timing? Process/expense?
- ❖ **Not arbitrary, based on a judgment on the merits, consideration of the alternatives, free from outside influence**
- ❖ **Conversion to termination for convenience**
 - Permits recovery of costs incurred (but still not anticipated profit unless termination was in bad faith)
 - Removes reputational stain

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Questions?

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