Critical Thinking
A Monthly Guest Column

Profits in Government Contracting: The Continuing Tug of War

By
David Z. Bodenheimer

> "Profit: The pot of gold at the end of the rainbow that, if ever found, is subject to confiscation through audits, investigations, and penalties." *The Cynic's Fanciful Dictionary of Government Contracting.*[1]

Hardly any industry in America has ever had its profits dissected, squeezed, and recouped like those of Government contractors. Even before the birth of the United States, cries of profiteering rained down upon farmers selling marked-up goods to Revolutionary armies.[2] Then, out of the Civil War sprang the first version of the False Claims Act amidst allegations of contractors becoming "proverbially and notoriously rich" from windfall profits.[3] The various, now-expired Renegotiation Acts and the still-alive Truth In Negotiations Act zeroed in on supposed excess profits by defense contractors.[4] Countless Congressional hearings have been held and reports have been written, lashing out at excess profits. Those reports carry such provocative titles as:

> *"War Profiteering Prohibition Act of 1985,"* House Committee on Banking, Finance, & Urban Affairs (1985)

> *"Faulty Defense Department Policy Provides Contractors Unintended Profits,"* House Committee on Government Operations (1986)

> *"Continuing Violations of the Truth in Negotiations Act and Estimating System Deficiencies Result in Excess Contractor Profits,"* House Committee on Government Operations (1988)

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These centuries of criticism and controversy have not stamped profit completely out of Government contracting, as the regulations and courts recognize profit to be an integral and necessary component of doing business with a sovereign. The following discussion addresses key aspects of profits and fees in Government contracting including: (1) the regulatory and statutory framework; (2) the right to profit for contract changes and breaches; (3) issues relating to cost-reimbursement fees; and (4) contractors' rights regarding profit analysis.

Regulatory and Statutory Framework

Although recent decades have seen winnowing of the thicket of statutes and regulations governing profit, key provisions remain. These provisions address:

The Recognition of Profit

Since the 1963 Armed Services Procurement Regulation's pronouncement that "Profit generally is the basic motive of business enterprise,"[5] procurement regulations have recognized that profit in contracting is imperative as a performance incentive. Federal Acquisition Regulation 15.404-4(a)(3 states that:

> Both the Government and contractors should be concerned with profit as a motivator of efficient and effective contract performance. Negotiations aimed merely at reducing prices by reducing profit, without proper recognition of the function of profit, are not in the Government's interest. Negotiation of extremely low profits, use of historical averages, or automatic application of predetermined percentages to total estimated costs do not provide proper motivation for optimum contract performance.

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While this regulatory guidance does not guarantee profit, it may offer some leverage in contract negotiations against buyers intent upon hacking profit to the bone.

Limitations Upon Profit and Fee

For certain contracts, statutory restrictions on profit or fee include: (1) 15 percent for cost-plus-fixed-fee contracts for research and development; (2) 6 percent for architect-engineer services; and (3) 10 percent for other cost-plus-fixed-fee contracts.[6]

In addition, regulations generally disallow profit from claims for delay under the Suspension of Work clause (FAR § 52.242-14) and Government Delay of Work clause (FAR § 52.242-17). Not surprisingly, these regulations also provide for fee-free contracts where the contractor agrees under FAR § 16.303 to a cost-sharing arrangement.

Profit for Contract Changes and Breaches

When the Government changes or breaches a contract, profit is almost invariably affected. A contractor's rights may vary, depending on whether the Government's action involves a traditional contract change or a breach of contract claim.

Profit on Contract Changes

For changes increasing a contractor's costs, the right to profit is well established. The entire purpose of an equitable adjustment under the Changes clause is to "keep a contractor whole when the Government modifies a contract."[7] An essential element for keeping the contractor "whole" is an allowance for a fair and reasonable profit.[8] As the Armed Services Board of Contract Appeals (ASBCA) has stated:

> Without the payment of profit which is fair under the circumstances, the Government would be getting something for nothing and the contractor would not truly be made whole.[9]

Despite this well-recognized right to profit, the Government has advanced a number of arguments in an effort to thwart recovery of profit. Three of the more interesting examples involve proposed profit in the original bid, loss contracts, and profit on administrative costs.

Proposed Profit. In some cases, the Government has argued that the contractor's profit on changed work should be limited to the profit rate reflected in the contractor's original bid for the contract. While the courts and administrative boards of contract appeals (Boards) have considered the contractor's original bid as a factor in determining the appropriate profit rate in come cases, the contractor has generally recovered a higher profit rate on contract changes than had been proposed in the initial bid.[10]

Loss Contracts. Where the contractor is in a loss position on a contract, the Government has sought to zero out profit on claims for changes. However, this position has not succeeded in claims for extra work:

> Profit is applied to the additional work only; it does not serve to reprice the entire contract or the unchanged work, and does not alter the original terms of the parties' bargain. The parties remain in the same relative profit or loss position on the bid work as before. While it is proper to hold a contractor to the risks assumed at contract formation – to perform the bid work at a loss where it is so bid, it is not proper to hold the contractor to this same risk when performing additional work, and undertaking additional risk, which it had no reason to anticipate at the time of award and which it is obligated to perform under the Changes clause.[11]

For deductive changes where the Government seeks a price reduction due to a reduction in the scope of work, the Government is ordinarily entitled to an allocation of overhead and profit on top of the deducted share of costs associated with the change. However, where the deducted work would have been performed at a loss, the courts and ASBCA have refused the Government's demand for profit because of the unfairness of pyramiding the contractor's losses by deducting a profit that would never have been earned under the original contract.[12]

Administrative and Other Expenses. As a general rule, the courts and Boards apply the profit rate not only to direct costs, but also overhead and other administrative costs as well.[13] In one case, the government agency involved objected to allowing profit on the cost of preparing and negotiating a request for equitable adjustment. However, the contractor's claim for profit was sustained in that case: "Profit is a consideration when determining an equitable adjustment, as it is in any other cost based pricing action, unless profit is

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expressly excluded by some pertinent contract provision."[14]

Profit on Contract Breaches

In a few older cases involving breach of contract, the courts curiously disallowed requests for profit.[15] The better, and more modern, rule allows recovery of profit for contract breaches for the following reasons. First, the very purpose of a "restitutionary" remedy (sometimes called a *quantum meruit* recovery) is to prevent the breaching party from being enriched and to make the injured party whole.[16] Given this objective for restitution, why should the Government get a windfall by breaching the contract, leaving the contractor less "whole" than if a simple contract change had occurred? Second, cases involving commercial disputes generally recognize profit as a necessary part of the cost of performance. This recognition is made to assess accurately the reasonable value of the goods or services provided.[17] Third, the right to profit in breach claims against the Government has been recognized more recently. For example, one court allowed a 15 percent profit based upon a finding of breach of contract due to defective specifications from the Government.[18]

Calculating the Profit Rate

So how can a fair profit rate be determined? Of course the answer has as many facets as the colors in the pot-of-gold's rainbow. Nonetheless, a surprising number of cases have centered upon a 10 percent profit rate as the going rate for doing business with the Government.[19] This 10 percent profit rate has even been considered with respect to *quantum meruit* recovery in a case involving an implied contract where the court found the express contract to be unauthorized.[20] For contractors seeking higher profit rates, support exists for 15 percent profit rates in cases involving contract changes and breaches.[21] By the same token, ample authority exists for the Government to pursue a lower profit rate in such situations.

In determining an appropriate profit rate, many factors have been considered. For example, if the changed work imposes greater risk and difficulty upon a contractor than the original bargain, the contractor can justify a higher profit rate than for the work specified within the scope of the original contract.[22] As another example, in cases where a contractor already has incurred the costs of the additional work, a lower profit rate has sometimes been justified because the risk associated with performed work is lower than risk in future work.[23]

The Fight for Fee

With respect to fees under cost-reimbursement contracts, contractors often face unique problems and issues not common to fixed-price contracting. In addition to statutory and regulatory restrictions on the amount of fee as discussed above, contractors with cost-reimbursement contracts have weathered attempts to reduce their fees, changes affecting contract risk and complexity that justified increased fees, and special problems with the Limitation of Funds clause.

Avoiding Reductions in Fee

Given that the Government cannot readily avoid paying costs incurred under a cost-reimbursement contract, the fee is often the target when the Government becomes unhappy with contract performance. When a contract provides for an award fee, the Government obviously has the upper hand in disputes.[24] However, contractors have had more success in disputes involving other fee arrangements.

In one case, the Government improperly used a default termination to avoid paying an incentive fee. The Board in that case overturned the default and reviewed each delivery order to determine the appropriate incentive fee. The contractor recovered incentive fees on orders that had been substantially performed, as well as on orders for which Government action prevented substantial performance.[25]

The Government also has attempted to use the Inspection of Services clause to reduce the fixed-fee due to dissatisfaction with the contractor's "cost containment performance." In this case, the Board denied the attempt to reduce the fixed portion of the fee under a cost-plus-award-fee contract. It stated that:

> It has not been shown that a reasonable contractor, given the uncertainty of estimating and achieving contract costs, would enter into a CPAF contract knowing that a cost overrun might not only result in a zero award fee but also in the reduction of a considerable portion of the base fee as well regardless of how well the principal contract services were performed.[26]

In a creative use – or some would say abuse – of the funding ceiling, one contracting officer tried to "reduce, after-the-fact, the funding allocated to a contract after those costs have been incurred and that fee earned, and

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thereafter argue that the contractor is not entitled to recover sums in excess of the newly-reduced ceiling"[27]. Not surprisingly, the Board rejected this retroactive attempt to deny costs already incurred and fee already earned: "The Contracting Officer's action therefore may not stand, any more than a contractor may unilaterally increase the contract price"[28], the board said.

Gaining Additional Fee

Contractors are often alert to opportunities for obtaining additional fees, and their vigilance may pay off, despite Government objections.

Where the Government changes have substantially increased the complexity and difficulty of performance, the contractor may be entitled to an increase in fee. For example, in one case, additional work involving design study and creation of new components (rather than use of commercial items) entitled a contractor to an increase in the fee percentage from 7 percent to 10 percent on the changed work.[29]

In a variation on the changes theme, the Government's failure to exercise an option strictly in accordance with its terms represents a constructive change for which the contractor is entitled to an equitable adjustment. In one case where the contractor proposed an increased award fee for the period covered by the improperly exercised option, the Board concluded that the Government was bound by the higher award fee amount as proposed.[30]

Cost Overruns and Limitation of Funds Clause

When the contract overruns its budget, one of the more common questions is what happens to the fee. More often than not, the answer depends upon the language in the contract.

When the contractor reaches or exceeds the funding ceiling, the Government may choose to terminate the contract for convenience. The issue then arises as to whether the contractor may recover costs (exclusive of fee) up to the ceiling and then collect fees in excess of the ceiling. Where the Limitation of Funds clause limits the Government's obligation for "costs" incurred (without reference to fee), the cases generally have held that a contractor first recovers its full costs up to the ceiling (without any reduction for fee) and then collects fee over and above the ceiling.[31] Conversely, when the contract specifies that the Limitation of Funds clause includes *both* fee and cost, the contractor may not recover *either* cost or fee above the ceiling.[32]

Requirements Relating to Profit Analysis

Federal regulations establish mandatory requirements for agencies to perform profit analysis under certain circumstances. In particular, FAR §□15.404-4(b)(1) states that "agencies making noncompetitive contract awards over $100,000 totaling $50 million or more a year – (i) Shall use a structured approach for determining the profit or fee objective in those acquisitions that require cost analysis." Given that the Defense Department awards over $50 million of contracts each year, the Defense Federal Acquisition Regulation Supplement (DFARS) mirrors the FAR requirement by mandating "a structured approach for developing a prenegotiation profit or fee objective on any negotiated contract action that requires cost analysis." Exceptions are made for competitive contracts, cost-plus-award-fee contracts, and Federally Funded Research and Development Centers. *See* DFARS §□215-404-4(b) and (c).

The courts have construed the earlier version of these profit regulations to impose a duty upon the agency to consider the prescribed factors in determining a fair and reasonable profit.[33] Where the agency makes a "perfunctory" demand for slashing a contractor's price without consideration of the factors prescribed by regulation for analyzing profit, the courts have found a regulatory violation that entitles the contractor to a fair evaluation of profit.[34]

CONCLUSION

Profit is hard enough to earn under any circumstances, but Government contractors face challenges that are truly unique to doing business with the Government. Nonetheless, the regulations and Board and court cases provide certain safe harbors to protect the profit earned. They also have created opportunities to gain additional profit.

Endnotes

[1] Like the pot of gold at the end of the rainbow, this dictionary has yet to come to light, proving as ephemeral and elusive as profits on some Government contracts.

[2] James F. Nagle, *A History of Government Contracting* 6 (1992).

[3] *United States ex rel. Newsham v. Lockheed Missiles and Space Co.,* 722 F. Supp. 607, 609 (N.D. Cal. 1989) *quoting* 1 F. Shannon, *The Organization and Administration of the Union Army, 1861-1865*, at 54-56 (1965).

[4] The last Renegotiation Act, 50 U.S.C. App. §§ 1211-1233, lapsed in 1976, but Congress has periodically attempted to resuscitate it.

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[5] Armed Services Procurement Regulation § 3-808.1(a) (1963)
10 U.S.C. § 2306(e); 41 U.S.C. § 254(b); FAR § 15.404-4(c)(4)(i).

[6] 10 U.S.C. § 2306(e); 41 U.S.C. § 254(b); FAR § 15.404-4(c)(4)(i).

[7] *Bruce Constr. Co. v. United States*, 324 F.2d 516, 163 Ct. Cl. 97, 100 (1963); *accord, Lemar Constr. Co.,* ASBCA Nos. 31161, 31719, 88-1 BCA ¶ 20,429 (1987).

[8] *United States v. Callahan Walker Constr. Co.,* 317 U.S. 56, 61 (1942); *George Bennett v. United States,* 371 F.2d 859, 178 Ct. Cl. 61, 69-70 (1967); *Unarco Material Handling,* PSBCA No. 4100, 00-1 BCA ¶ 30,682 at 151,525 (1999).

[9] *New York Shipbuilding Co.,* ASBCA No. 16164, 76-2 BCA ¶ 11,979 at 57,427 (1976).

[10] *Ryan-Walsh, Inc. v. United States,* 37 Fed. Cl. 639, 659-60 (1997) (court allowed 10 percent profit on direct labor, even though contractor only bid 5 percent); *Keco Indus., Inc.,* ASBCA Nos. 15184, 15547, 72-2 BCA ¶ 9576 at 44,734 (1972) (Board allowed 5 percent profit even though Government claimed that contractor bid no profit in original proposal).

[11] *Stewart & Stevenson Services, Inc.,* ASBCA No. 43631, 97-2 BCA ¶ 29,252 at 145,522 (1997). *Accord, Litton Systems, Inc.,* ASBCA No. 49787, 00-2 BCA ¶ 30,969 at 152,842 (2000).

[12] *Keco Indus., Inc. v. United States,* 364 F.2d 838, 176 Ct. Cl. 983, 991 (1966); *CRF, A Joint Venture,* ASBCA No. 17340, 76-1 BCA ¶ 11,856 at 56,804-05 (1976).

[13] *Neal & Co., Inc. v. United States,* 36 Fed. Cl. 600, 649 (1996); *Yamas Constr. Co.,* ASBCA No. 27366, 86-3 BCA ¶ 19,090 at 96,485 (1986). *But see, Ryan-Walsh, Inc. v. United States,* 37 Fed. Cl. at 660 (10 percent profit applied only to direct labor costs).

[14] *Unarco Material Handling,* PSBCA No. 4100, 00-1 BCA ¶ 30,682 at 151,526 (1999).

[15] *Meva Corp. v. United States,* 511 F.2d 548, 206 Ct. Cl. 203, 221 (1975) (no profit for "jury verdict" damages); *Laburnum Constr. Corp. v. United States,* 325 F.2d 451, 163 Ct. Cl. 339, 353 (1963) (no profit due to "statutory prohibition against cost-plus-percentage-of-cost procurement," even though the contract was firm-fixed-price).

[16] *W. F. Magann Corp. v. Diamond Mfg. Co.,* 775 F.2d 1202, 1208 (4th Cir. 1985). *See* 12 Williston, *Contracts* 286-87 (3d ed. 1970).

[17] *W. F. Magann Corp. v. Diamond Mfg. Co.,* 775 F.2d at 1208; *Continental Cas. Co. v. Schaefer*, 173 F.2d 5, 8 (9th Cir. 1949); *Najjar Indus. Inc. v. City of New York,* 451 N.Y.S. 2d 410, 413 (Sup. Ct. 1982); *City of Portland v. Hoffman Constr. Co.,* 286 Ore. 789, 596 P.2d 1305, 1314 (1979) (collecting cases).

[18] *Big Chief Drilling Co. v. United States*, 26 Cl. Ct. 1276, 1321 (1992). *See also, George Bennett v. United States,* 371 F.2d 859, 178 Ct. Cl. 61, 69-71 (allowing 6 percent profit on breach of contract claim).

[19] *Neal & Co., Inc. v. United States,* 36 Fed. Cl. at 649-50 (10 percent profit recognized on both direct costs and delay claims); *Techno Engineering & Constr., Ltdl,* ASBCA No. 36869, 90-1 BCA ¶ 22,566 at 113,242 (rejecting 4 percent offered by contracting officer, where Government had normally accepted 10 percent); *Ideker, Inc.,* ENG BCA Nos. 4389, 4602, 87-3 BCA ¶ 20,145 at 101,981 (1987) (finding 10 percent to be a reasonable profit rate); *Kong Yong Enter. Co., Ltd.,* ASBCA No. 21605, 80-1 BCA ¶ 14,314 at 70,556 (1980) (remanding case and suggesting a profit of 10 percent).

[20] *Yosemite Park & Curry Co. v. United States,* 582 F.2d 552, 217 Ct. Cl. 360, 375 (1978).

[21] *See, e.g., Big Chief Drilling Co. v. United States*, 26 Cl. Ct. at 1321; *Yamas Constr. Co.,* ASBCA No. 27366, 86-3 BCA ¶ 19,090 at 96,485 (1986).

[22] *Ryan-Walsh, Inc. v. United States,* 37 Fed. Cl. at 659-60.

[23] *See Texas Instruments, Inc.,* ASBCA No. 27113, 90-1 BCA ¶ 22,537 at 113,096 (1989) ("contractor's risk of performance is diminished" by "after-the-fact pricing").

[24] With respect to award fees, FAR § 16.405-2(a) states: "This [award fee] determination and the methodology for determining the award fee are unilateral decisions made solely at the discretion of the Government."

[25] *C. S. Smith Training, Inc.*, DOT CAB No. 1273, 83-1 BCA ¶ 16,304 at 81,017-18 (1983). *See also, Technology, Incorp.,* ASBCA No. 14083, 71-2 BCA ¶ 8956 at 41,631 (after termination for convenience, contractor entitled to 24 percent of fee based upon direct labor expended at time of the termination).

[26] *Holmes & Narver Services, Inc.,* ASBCA No. 33025, 88-3 BCA ¶ 20,932 at 105,782 (1988).

[27] *TEM Associates, Inc.,* DOT BCA No. 2556, 93-2 BCA ¶ 25,759 at 128,179 (1993).

[28] *Id.* at 128,180.

[29] *American Pipe & Steel Corp.,* ASBCA No. 7899, 1964 BCA ¶ 4058 at 19,904 (1964). *See also, Franklin W. Peters and Associates,* IBCA No. 762-1-69, 71-1 BCA ¶ 8615 at 40,035 (design changes under a reclamation contract entitled the contractor to additional fee).

[30] *Safeguard Maintenance Corp.,* IBCA No. 3379-E, 95-1 BCA ¶ 27,383 at 136,500 (1994).

[31] *Allied-Signal Aerospace Co.,* ASBCA No. 46890, 95-1 BCA ¶ 27,462 at 136,834 (1995); *John J. McMullen Associates, Inc.,* ASBCA No. 22450, 79-1 BCA ¶ 13,818 at 67,772 (1979).

[32] *Textron Defense Systems v. Widnall,* 143 F.3d 1465, 1469 (1998).

[33] *Newport News Shipbuilding & Dry Dock Co.v. United States,* 374 F.2d 516, 179 Ct. Cl. 97, 115 (1967).

[34] *Bethlehem Steel Corp. v. United States,* 423 F.2d 300, 191 Ct. Cl. 141, 146-47 (1970).