

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

The webinar will begin shortly. The slides and a recording of the event will be made available to you shortly after the webinar.

September 21, 2011

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

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# Agenda

- » Why we are doing this webinar now: budget cuts and changing priorities
- » What we will cover
  - Termination process – John McCarthy
  - WARN and other employee issues – Rebecca Springer
  - Cost allowability – Linda Bruggeman
  - Profit, loss adjustments, special provisions, commercial items, etc. – Chris Haile
  - Default terminations – Richard Arnholt

# 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

# 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

# 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

# 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

# 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



# 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

# 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

# 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

## 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

# 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

# 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 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

\$800,000      X      \$500,000      =      \$400,000

\$1,000,000

# 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
- » Special termination liability provisions

# 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.



# Termination for Convenience – Commercial Item Contracts

- » FAR Part 12.4 / 52.212-4(I)
- » 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

## 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

# 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



# 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 procurement 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

# Questions?

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