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.
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:

\[
\text{Contract Price} \times \frac{\text{Costs Incurred}}{\text{Full Perf. Costs}} = \text{Recovery}
\]
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 \times \frac{500,000}{1,000,000} = \$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
» 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(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
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 reprocurement 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 reprocurement 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 repurchase 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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