Government Contracting Fundamentals: TERMINATIONS

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Introduction

- A Government contract can end in many different ways
- A contract can be performed successfully and simply end through a normal close-out process
- The agency might end a contract by deciding not to exercise an option
- Or the contract might be “terminated” by the agency
- The word “termination” is a term of art in Government contracts
- It is essential to determine whether the termination is for “default” or “convenience”

Default Termination

- Default termination is one of the worst things that can happen to a Government contractor.
  - One court called it a “drastic sanction...which should be imposed (or sustained) only for good grounds and on solid evidence.”
- In exercising its right to terminate for default, the Government is effectively discharging its obligations under a contract while exposing the contractor to significant potential liability
- The FAR contains two basic default clauses: FAR 52.249-8, “Default (Fixed-Price Supply and Service)” and FAR 52.249-10, “Default (Fixed-Price Construction)”

  The Government’s rights and obligations under these clauses have been the subject of extensive litigation over the years

The Consequences of Default Termination

- A default termination can be difficult for both parties, with severe economic and time consequences on each side
- The U.S. Court of Claims has said that default termination is a type of forfeiture (*DeVito v. United States*, 188 Ct. Cl. 979 (1969))
- In construction and service contracts, the contractor will be paid for work properly performed before the termination
- In supply contracts, a contractor that has been terminated properly generally has no right to recover costs incurred in producing supplies not accepted by the Government

Contractor Risks

- The Government is not obligated to pay the contractor for the costs of unaccepted work;
- The Government is entitled to the return of progress payments, partial, or advance payments;
- The Government has the right—but not the duty—to appropriate the contractor's material, inventory, construction plant and equipment at the site, and, under supply contracts, drawings and plans, with the price for the appropriated materials to be negotiated;
- The contractor is liable for the excess costs of reprocurement or completion;
- The contractor is liable for actual or liquidated damages;
- The contractor may be subject to debarment; and
- The contractor will have a black mark on its Past Performance record for three years

Government Risks

- Lost time
- Possible exposure to additional costs if the contractor challenges the termination
- The act of termination is an acknowledgment that all of the Government's detailed processes to select the right contractor failed

The Government's Right to Terminate

- The standard clauses identify three separate grounds for termination:
  - The failure to deliver the product or complete the work or service within the stated time;
  - The failure to make progress in prosecuting the work and thereby endangering timely completion; and
  - The breach of the "other provisions" of the contract.

Failure to Perform or Deliver

- A contractor renders timely performance if (a) the product, service or construction work conforms to the specifications and (b) the product is delivered or the work is completed by the specified due date
- Although there are some decisions that indicate that time is not of the essence in Government contracts, the safer assumption is that it is
- In *Radiation Technology, Inc. v. United States*, 177 Ct. Cl. 227 (1966), the U.S. Court of Claims held that summary default termination may be prevented when supplies have been delivered on time and substantially in conformance with the contract's requirements.

  This is called the "substantial compliance doctrine."
- While the *Radiation* case involved a supply contract, the substantial compliance doctrine has been applied in many construction cases

Substantial Compliance Doctrine

- For the substantial compliance doctrine to work, the goods must be delivered on time *and* the contractor must reasonably believe that the goods comply with the specifications
- In other words, knowingly shipping defective parts just to make a deadline is not going to protect against a default termination
- In order to take advantage of the additional time needed to correct under the substantial compliance doctrine, the contractor must demonstrate that the defects are *minor and readily correctible*
- Whether a defect is minor is a *question of fact* based on (a) whether the items are usable; (b) the nature of the product; (c) the urgency of the Government's needs; and (d) the extent of repair and adjustment necessary to produce a fully conforming product

The Cure Period

- If the contractor can meet the requirements above, case law indicates that it will have a reasonable time to cure the defect
- That will vary depending on the nature of the defects and the urgency of the Government's needs
- This means that the quality of the contractor's ability to *communicate effectively* with the Government could play a significant role in the outcome

Limitations on Termination of All Work

- The Government's right to default terminate is limited to the *executory* part of a contract, *i.e.*, the part that has not yet been performed
- For example, a contractor cannot be default terminated for failing to provide records for an audit if all of the actual work was completed (*Donat Gerg Haustechnick*, ASBCA No. 41197, 97-2 BCA ¶ 29,272)
- In construction contracts, this principle is called "substantial completion," and it applies when performance was made in good faith and in compliance with the contract but falls short of complete performance due to minor and relatively unimportant deviations

Progress Failures

- The supply contract “Default” clause provides that termination may occur when the contractor “fails to make progress, so as to endanger performance of this contract…”
- Under the cases that have looked at this language, it is clear that all the Government needs to have is a *reasonable belief* that, for whatever reason or reasons, the contractor cannot complete its work within the time left in its schedule
- The courts and boards have upheld this determination in situations where, for example, the contractor has repeatedly failed to meet industry standards, the contractor has failed to provide a meaningful response to a cure notice, the contractor has failed to submit drawings for approval, or the contractor’s monthly progress reports indicate that delivery will be late

Failure to Comply With Other Contract Provisions

- The supply contract “Default” clause states that the Government may terminate for default based on the contractor’s failure to comply with “other provisions” of the contract
- This means that the Government has the right to terminate prior to the delivery date without the need to establish a progress failure
- A cure notice is required for such an action, so summary termination without the cure notice is improper
- The courts and boards generally will uphold such a termination only if the requirement is *material*

What "Other Provisions" Have Been Invoked?

- Failure to maintain pay records
- Failure to obtain a state license
- Failure to furnish a preproduction sample
- Failure to perform duties under the "Warranty" clause
- Failure to maintain adequate records as required by the "Examination of Records" clause
- In some cases, the failure to perform in accordance with the specifications
- Violation of the Buy American Act

Failure to Proceed

- The Contract Disputes Act of 1978 authorizes agencies to include clauses requiring contractors to proceed with performance pending “final decision of an appeal, action or settlement”
- The standard “Disputes” clause contains such language; the standard “Changes” clause has similar language
- The courts have viewed this duty as protecting the public interest
- There are very few situations that would justify a contractor stopping work under a Federal contract
- As a general rule, the only situations in which a contractor can stop work are when (a) the Government has materially breached the contract; (b) it is impractical to proceed; or (c) the contractor has not received clear direction from the Government

Anticipatory Repudiation

- At common law, the doctrine of “anticipatory repudiation” will apply if there is a definite and unequivocal manifestation of intent on the part of the repudiator that he will not render the promised performance
- Although the “Default” clause does not mention anticipatory repudiation, the case law is clear that the Government retains this common law remedy to terminate under such circumstances
- Anticipatory repudiation can occur at virtually any stage of contract performance

Anticipatory Repudiation

- The acts and words of the contractor must indicate an "unequivocal manifestation of the contractor's intention not to perform." (*Fairfield Scientific Corp.*, ASBCA No. 21151, 78-1 BCA ¶ 13,082, *recons. denied*, 78-2 BCA ¶ 13,429, *aff'd*., 228 Ct. Cl. 264 (1981))
- Anticipatory repudiation has been found when (a) a contractor expressly refused to perform; (b) a contractor failed to give adequate assurances; (c) a contractor has expressly stated an inability to perform; or (d) certain actions have demonstrated a contractor's inability to perform

Subcontractor Termination

- A prime contractor is paid to run the program
- If a subcontractor defaults, the Government has the right to terminate the prime unless the subcontractor's failure to perform is excusable

Subcontract Wrinkles

- A sub should never accept language in its subcontract giving the prime unfettered power to terminate the subcontract for convenience
- Instead, the sub should ask the prime to "put a fence around" its T for C rights, limiting the prime's power to issue a T for C only when the Government has terminated the prime's contract for convenience in whole or in part; and, if the prime's contract is terminated in part, thus giving the prime the right only to terminate that part of the sub's contract that is covered by the partial termination
- If the prime will not agree to do this, the sub should think twice about doing business with the prime

Waiver

- If the Government does not exercise its right to terminate within a reasonable time, and the contractor relies to its detriment on such forbearance by continuing to perform, the Government will be held to have waived its right to terminate. (*DeVito v. Unites States*, 188 Ct.Cl. 979 (1969))
- Once a delivery date passes, the C.O. has a reasonable time in which to terminate, giving the C.O. time to investigate and determine what course of action is in the Government's best interest
- One key element of waiver is that the Government indicates a willingness to have the contractor continue performance.
- This willingness can be demonstrated through unreasonable delay or through certain acts of the Government (*e.g.*, allowing the contractor to work through several missed deadlines and continuing to pay progress payments)

POLLING QUESTION No. 1

True or False:

(a). The word “termination” is a term of art in Government contracting.

(b). Although a contractor clearly faces risks when a default termination occurs, the Government has some risks as well.

(c). The Government always assesses a defaulted contractor for the excess costs of reprocurement.

(d). No matter what the reason for default termination, the Government must give the contractor a reasonable opportunity to cure.

Reestablishment of the Delivery Date After Waiver

- Once a waiver has occurred, the Government may regain its right to terminate by establishing a new delivery schedule, which must be specific and reasonable, or via a bilateral agreement

The Decision to Terminate

- When the Government has the legal right to terminate, it may not be in its best interest to do so
- The big question is how to finish the work that was supposed to be done under the contract
- The Government bears the burden of proving a default termination was justified
- The decision is highly discretionary, based on the C.O.'s business judgment

FAR 49.402-3, "Procedure for Default"

- FAR 49.402-3 lays out the steps a C.O. should take when a default termination is considered. Among the steps to be taken, the C.O. "shall consider":
  - The terms of the contract and applicable law and regulations
  - The specific failure of the contractor and the excuses for the failure
  - The availability of the supplies or services from other sources
  - The urgency of the need for the supplies or services and the period of time required to obtain them from other sources, as compared with the time delivery could be obtained from the delinquent contractor
  - The degree of essentiality of the contractor in the Government acquisition program and the effect of a termination for default upon the contractor's capability as a supplier under other contracts
  - The effect of a termination for default on the ability of the contractor to liquidate guaranteed loans, progress payments, or advance payments, and
  - Any other pertinent facts and circumstances

Discretionary Decision

- While the failure of a C.O. to document her reasoning under FAR 9.402-3 can be problematic, many courts and boards have held that the factors are not a prerequisite to a valid termination
- However, FAR 49.402-3 clearly represents a best practice, and a C.O.'s failure to apply **the seven factors** before terminating a contract can present serious litigation risk for the Government
- In addition, a C.O. is not limited to considering the seven factors in FAR 49.402-3; other factors might legitimately come into play

(f) The contracting officer shall consider the following factors in determining whether to terminate a contract for default:

(1) The terms of the contract and applicable laws and regulations.

(2) The specific failure of the contractor and the excuses for the failure.

(3) The availability of the supplies or services from other sources.

(4) The urgency of the need for the supplies or services and the period of time required to obtain them from other sources, as compared with the time delivery could be obtained from the delinquent contractor.

(5) The degree of essentiality of the contractor in the Government acquisition program and the effect of a termination for default upon the contractor's capability as a supplier under other contracts.

(6) The effect of a termination for default on the ability of the contractor to liquidate guaranteed loans, progress payments, or advance payments.

(7) Any other pertinent facts and circumstances.

Termination Procedures

- The “Default” clause for supply and service contracts requires that a “cure notice” be sent to the contractor before terminating based on a failure to make progress or a failure to perform any other provision of the contract
- A standard cure notice gives the contractor ten days to respond, but a C.O. can allow more time
- Failure to send a cure notice, if one is required, will be deemed an improper termination
- A cure notice is to be used *only* when the delivery or performance schedule has not yet expired
- A cure notice is not required if the contractor has repudiated the contract
- A cure notice is also not required if there are less than ten days remaining before the due date

Adequacy of a Cure Notice

- A cure notice must be in writing
- Its adequacy will be judged in light of correspondence and conversations preceding the notice
- The goal is to adequately advise the contractor of the deficiencies giving rise to the cure notice
- A cure notice need not cite each and every failure, but it must list with enough specificity the performance failures that have placed the contractor in jeopardy of default termination

Impact of Denial of a Cure Period

- If a ten-day cure notice is required, the failure to issue one will invalidate the ensuing termination
- Termination prior to the expiration of the ten-day period is also improper

Responding to a Cure Notice

- The contractor's response must adequately assure the Government of performance – very similar to U.C.C. § 2-209
- The C.O. should make an independent analysis of the response to determine whether a termination should still occur
- Assurances generally include both the contractor's acts (*e.g.*, hiring more people) and its words (*e.g.*, the submission of reasonable proposed work schedules or explanations for excusable delay)

The Show-Cause Notice

- The concept of a show-cause notice is mentioned in FAR 49.402-3
- Not mandatory – it is something the Government is permitted to do
- Not necessary when the delivery date has passed
- A show-cause notice does not grant the contractor an automatic ten-day extension
- Nor does it waive a prior delivery date

Delays

- Unanticipated delays are a fact of life in the world of Government contracts
- The FAR contains many clauses that deal with delays (*e.g.*, “Suspension of Work,” “Government Delay of Work,” and “Stop-Work Order” clauses)

Allocation of Risk for Delay

- As a general rule, the contractor will bear the risk of both time and cost for delays that it causes or are within its control
- Also, a contractor is excused from performance due to delays caused by things for which neither it nor the Government is responsible
- A contractor will be excused from performance due to delays caused by factors for which neither it nor the Government is responsible, *but the contractor must bear the cost impact of such delays*
- The Government is responsible for both time and cost impacts of delays it causes, that are under its control, or for which it has agreed to compensate the contractor

Excusable Delay

- The concept of “excusable delay” is intended to protect the contractor from sanctions for late performance
- If a contractor has been excusably delayed, it is protected from default termination, liquidated damages, actual damages, or excess costs of reprocurement or completion
- Most excusable delays are temporary, and the contractor is expected to resume performance when the delay has ended
- Excusable delays in fixed-price supply and service contracts are governed by ¶ ¶ (c) and (d) of the “Default” clause at FAR 52.249-8
- Excusable delays in construction contracts are governed by ¶ (b) of the “Default” clause at FAR 52.249-10

Three Factors to Meet in Order to Prove Excusable Delay

- It has to be "beyond the control of the contractor"
- It has to be without the contractor's fault or negligence
- It must be unforeseeable (*i.e.*, no knowledge or reason to know before bidding)

Examples of excusable delays, *if the three criteria above are satisfied*:

- Strikes
- Unusually severe weather
- Government acts, both contractual or sovereign
- Subcontractor or supplier delays, if they are, in turn excusable
- Floods
- Fires
- Epidemics
- Freight embargoes, Acts of God

Termination Notice

- FAR 49-402-3(g) provides guidance on the form of a termination notice
- It must clearly state the contract is being terminated for default
- Strict compliance may not be absolutely necessary, especially if the contractor has not been prejudiced by the Government's failure
- A proper termination notice will come in the form of a C.O.'s final decision and must include language advising the contractor how to appeal the decision
- Even if a C.O. fails to include proper grounds for default termination in the cure notice, it will be upheld if proper grounds did in fact exist at the time of termination

Excess Costs of Reprocurement

- Both the supply contract and the construction contract default clauses provide that “in addition to any other rights and remedies provided by law or under this contract,” the Government has the right to assess excess costs
- These have come to be known as the “excess costs of reprocurement”
- The language in the first bullet means that if, for some reason, the Government fails in its effort to collect excess costs, it still has the right to collect actual damages if they can be proved
- Under the so-called “Fulford Doctrine,” a defaulted contractor can wait until the assessment of excess costs to challenge the underlying termination

Excess Costs of Reprocurement

- The Government has to satisfy several factors in order to assess excess costs:
  - The reprocured supplies must be the same or similar to the ones involved in the termination;
  - The Government must have actually incurred the costs; and
  - The Government must have acted reasonably in the reprocurement process
- Reasonableness is the key word – the Government's actions must have been reasonable under the circumstances
- This is consistent with the common law duty of the damaged party to mitigate its damages

Computation of Excess Costs

- The basic rule is that the excess costs figure will be the difference in price between the defaulted contract and the reprocurement contract, as adjusted for all increases in the original contract price to which the defaulted contractor is entitled
- For example, the assessment figure might be reduced to account for price increases due to changes, suspensions and changed conditions encountered by the contractor
- The Government is entitled to recover excess costs incurred during the entire reprocurement period, including additional option years, as long as the original contractor had agreed to perform for the duration

POLLING QUESTION No. 2

True or False:

(a). The "substantial compliance" doctrine applies only to Government construction contracts.

(b). In order to avail itself of the substantial compliance doctrine, the contractor must demonstrate that the alleged defects are minor and correctible.

(c). A cure period must last at least ten days.

(d). Stopping work under a Government contract is a risky move for a contractor.

Termination for Convenience

- A unique clause – one of the principal differences between Government contracts and commercial contracts
- A reminder that the Government is not like any other party – it is a *sovereign*
- The T for C power is so important that it is *read into* a contract even if the Government failed to include it—this is called the "Christian Doctrine," and it applies only at the prime-contract level
- This clause gives the Government the broad right to terminate without cause, and it limits the contractor's recovery to costs incurred, profit on work performed, and the costs of preparing the termination settlement proposal
- There is no recovery for anticipated profit

Background

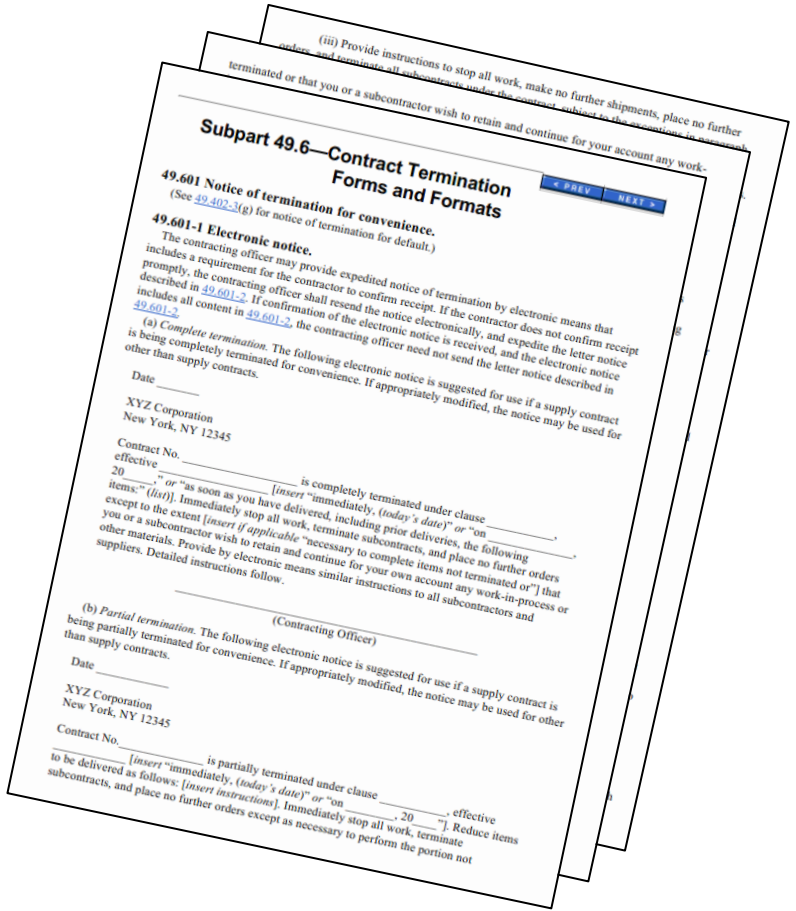
- The T for C clause was developed as a way to give the Government an exit ramp from massive contracts that were awarded during wartime
- Although the concept was developed in the mid-1800s, it was only after WWI that it was used in large numbers
- The decision to terminate must be made in the *Government's best interest*; the Government has no duty to terminate to benefit the contractor
- At common law, a T for C would be a breach of contract, with the contractor entitled to recover all damages flowing from that breach

Limitations on the Right to Terminate for Convenience

- Almost non-existent
- There have been some cases that said a bad-faith termination will not be upheld, but even that concept has been severely limited

Procedural Requirements

- Although there are few such requirements, the termination can only be effected via written notice
- FAR 49.601 provides model forms



Subpart 49.6—Contract Termination
Forms and Formats

49.601 Notice of termination for convenience.

(See 49.402-3(g) for notice of termination for default.)

49.601-1 Electronic notice.

The contracting officer may provide expedited notice of termination by electronic means that includes a requirement for the contractor to confirm receipt. If the contractor does not confirm receipt promptly, the contracting officer shall resend the notice electronically, and expedite the letter notice described in 49.601-2. If confirmation of the electronic notice is received, and the electronic notice includes all content in 49.601-2, the contracting officer need not send the letter notice described in 49.601-2.

(a) *Complete termination.* The following electronic notice is suggested for use if a supply contract is being completely terminated for convenience. If appropriately modified, the notice may be used for other than supply contracts.

Date _____

XYZ Corporation
New York, NY 12345

Contract No. _____ [*insert* "immediately, (*today's date*)" *or* "on _____, 20 _____," *or* "as soon as you have delivered, including prior deliveries, the following items:" (*list*)]. Immediately stop all work, terminate subcontracts, and place no further orders except to the extent [*insert if applicable* "necessary to complete items not terminated or"] that you or a subcontractor wish to retain and continue for your own account any work-in-process or other materials. Provide by electronic means similar instructions to all subcontractors and suppliers. Detailed instructions follow.

_____
(Contracting Officer)

(b) *Partial termination.* The following electronic notice is suggested for use if a supply contract is being partially terminated for convenience. If appropriately modified, the notice may be used for other than supply contracts.

Date _____

XYZ Corporation
New York, NY 12345

Contract No. _____

_____ [*insert* "immediately, (*today's date*)" *or* "on _____, 20 _____, effective to be delivered as follows: [*insert instructions*]. Immediately stop all work, terminate subcontracts, and place no further orders except as necessary to perform the portion not

Deletion of Work

- Both the T for C clause and the Changes clause provide mechanisms for deleting work
- The pricing formulas are very different
- If major portions of the work are deleted and not replaced, the T for C clause should be used

Constructive Termination

- Designed by the courts and boards to protect the Government (and the taxpayer) from breach damages
- Any Government action that prevents a contractor from continuing performance will be adjusted under the T for C clause (*John Reiner & Co. v. United States*, 163 Ct. Cl. 381 (1963))
- This concept also is invoked in the event of a wrongful default termination – the remedy is to convert it to a T for C

Settlement

- The terminated contractor has one year to submit its termination settlement proposal
- This is not considered to be a claim under the Contract Disputes Act, although it could be converted to a claim at a later date if the parties cannot settle the matter

Recoverable Costs

- A T for C settlement will be based on the cost principles in FAR Part 31
- The contractor bears the burden of proving its costs
- Although the cost principles are to be used in settling T for C claims, FAR 49.201 provides that strict application of the cost principles is not required, focusing instead on “fair compensation”
- Settlement costs can include things such as common items, costs continuing after termination, initial costs, loss of value of assets, rental costs, subcontract claims and termination inventory
- A contractor can also recover its settlement expenses, including accounting and legal expenses
- It is important to note that a terminated contractor has an obligation to mitigate its costs

Profit

- A contractor is entitled to recover fair and reasonable profit on “costs incurred in the performance of the work terminated, including initial costs and preparatory expense allocable thereto”
- A contractor is not entitled to recover anticipatory profit

Loss Adjustment

- The standard convenience termination clause states that, if it appears that the contractor would have incurred a loss had the entire contract been completed, an appropriate adjustment shall be made to reduce the amount of the settlement to reflect the indicated rate of loss
- FAR 49.203 provides that the formula for applying the loss adjustment is to multiply the incurred costs of the terminated portion of the contract by the ratio of the contract price to the total incurred costs plus the estimate to complete the work
- In addition, the recovery available to the contractor is capped at the total price of the contract

Commercial Item Contracts

- FAR 52.212-4, “Contract Terms and Conditions – Commercial Items,” contains a clause called “Termination for the Government’s Convenience”
- That clause provides that the Government “reserves the right to terminate this contract, or any part hereof, for its sole convenience”
- If that should happen, the “Contractor shall be paid a percentage of the work performed prior to the notice of termination, plus reasonable charges the Contractor can demonstrate to the satisfaction of the Government using its standard record keeping system, have resulted from the termination. The contractor shall not be required to comply with the cost accounting standards or contract cost principles for this purpose. This paragraph does not give the Government any right to audit the Contractor’s records.” FAR 52.212-4(l)

No-Cost Terminations

- Not very prominent, but can be an effective way to get out of difficult contracts
- FAR 49.101 says in pertinent part:
  - *The contracting officer shall effect a no-cost settlement instead of issuing a termination notice when—*
    - *(1) It is known that the contractor will accept one,*
    - *(2) Government property was not furnished, and*
    - *(3) There are no outstanding payments, debts due the Government, or other contractor obligations.*

No-Cost Terminations, cont.

- FAR 49.103, “Methods of Settlement,” provides that settlement of terminated cost-reimbursement contracts and fixed-price contracts may be effected by negotiated agreement
- FAR 49.109-4, “No-cost settlement,” provides as follows:
  - The TCO shall execute a no-cost settlement agreement…if—
    - (a) The contractor has not incurred costs for the terminated portion of the contract or
    - (b) The contractor is willing to waive the costs incurred and
    - (c) No amounts are due the Government under the contract.

POLLING QUESTION No. 3

True or False:

(a). The Termination for Convenience clause at FAR 52-249-2 is a mandatory flowdown clause.

(b). Even though the T for C clause is not a mandatory flowdown, a wise prime contractor always flows a version of the clause down to its subcontractors.

(c). Both the T for C clause and the Changes clause provide mechanisms for deleting work under a Government contact.

(d). A constructive termination is only possible under a Federal construction contract.

POLLING QUESTION No. 4

True or False:

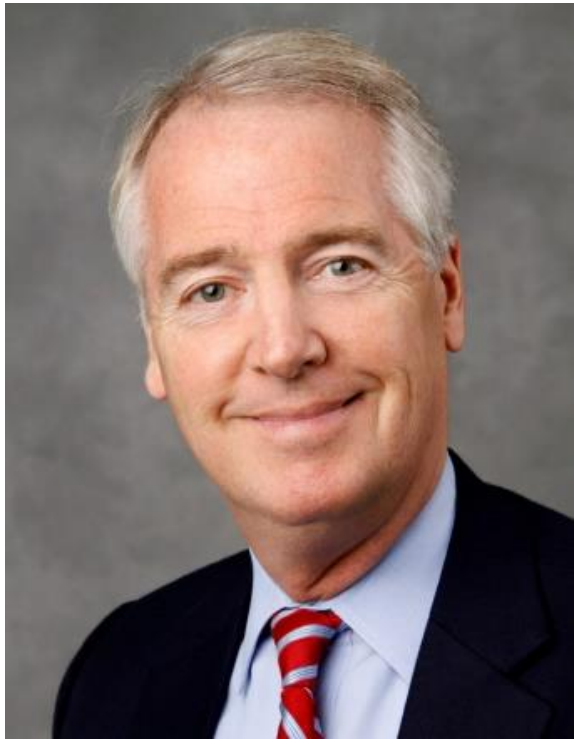
(a). Under the standard T for C clause, a contractor has 90 days to submit its settlement proposal.

(b). A contractor has the burden of proving the costs contained in its settlement proposal.

(c). A terminated contractor has the duty to mitigate its costs.

(d). When a contract is terminated for convenience, a contractor is limited to recovering the profit it originally proposed when competing for the contract.

Thank you!



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