



SESSION GUIDE
SEASON 2023, EPISODE TWENTY-FIVE
PART 49:
CONTRACT TERMINATION

I. Introduction

Like all good things, contracts must eventually come to an end. We previously discussed contract closeout, so we know what happens when a contract runs its course and comes to a natural conclusion. Some contracts, however, come to a premature end. This does not necessarily mean that the contractor has done something wrong, though that certainly can be a reason for termination. Sometimes the Government just doesn't have the resources to continue the contract. Sometimes the need for the contract has ended – e.g., the war is over! Sometimes other circumstances get in the way. No matter the reason for the termination, the FAR has us covered with policies and procedures in **Part 49**! We will examine all the Subparts of **Part 49** except **49.5** and **49.6**. This is because those Subparts deal with contract clauses and termination forms and formats, respectively. They are fairly self-explanatory Subparts, and would rapidly become too “weedy” if we were to go into great detail.

II. Termination of Contracts

There are two basic types of contract terminations: termination for convenience and termination for default. These are colloquially known as T4C and T4D, respectively. A T4C is a “no-fault” termination, while a T4D is a “fault” termination. We will explain these concepts in much greater detail in the coming sections. But first, we need to know who's responsible for which duties during terminations. The FAR tells us that there is actually a termination contracting officer (TCO) who handles the actual termination of the contract, but the CO is the one who issues the notice of termination in the first place. **49.101(d)**. The full duties of the TCO, which kick in after the CO has issued the termination notice, are spelled out in **49.105**. The duties of the prime contractor after receiving the termination notice are described in **49.104**.

However, termination of the contract should not be the first step in the process—nor does a termination need to apply to all portions of a contract. It's possible to terminate only parts of a contract. **49.104(a)**. Termination of any part of the contract is appropriate only when that is in the Government's best interest. Sometimes it's in the Government's best interest to simply allow the contract to run its course, such as when the price of the undelivered balance of the contract is less than \$5,000. **49.101(c)**. Other times, it's in the Government's best interest to negotiate a no-cost settlement with the contractor. **49.101(b)**.

If the situation does escalate to a termination, then the CO must send the notice in writing to the contractor. The notice must contain specific information, which we can find in **49.102(a)**. Termination

notices may be amended (**49.102(c)**), and sometimes a terminated contract may be reinstated (only if the reinstatement is advantageous to the Government, of course) (**49.102(d)**). Regardless, though, the Government and contractor must settle whatever remains of the contract in some manner. Failure to do so leaves both parties on the hook for contract performance and payment, which is counter to the point of a termination!

Question 1 – According to **FAR 49.102(a)(5)**, one of the things that must be included in a termination notice are “steps the contractor should take to minimize the impact on personnel if the termination will result in a significant reduction in the contractor’s workforce.” Identify what specific steps or instructions a contracting officer may likely include in the notice to satisfy this requirement.

A. Settlements

There are a variety of ways in which the outstanding portions of the contract may be settled after a termination for convenience, which we find in **49.103**. We can also find additional guidance for these settlement agreements in **49.109**, for subcontract settlement in **49.108**, and for both prime and sub settlement proposal audits in **49.107**. We also find guidance regarding what should go into a settlement negotiation memorandum in **49.110**. **49.112** tells us how payment of the settlement works. The rest of **41.1** details other, more specific situations. Note that settlement agreements only apply to terminations for convenience! And, if a TCO suspects that the contractor has committed fraud or some other criminal act, the TCO is required to report such information according to agency procedures and stop any negotiating that has already commenced. **49.106**.

So how does the settlement process actually work? First, the prime contractor submits a settlement proposal to the TCO. Then, the TCO either evaluates the proposal on her own or forwards it to an auditing authority. That decision usually depends on whether the proposal will require certified cost or pricing data in line with the thresholds in **15.403-3(a)(1)**. The TCO can submit proposals below that threshold to an auditing authority as well, but such submission is not mandatory, unlike submissions that require certified cost or pricing data. **49.107(a)**. If the TCO does obtain an audit report, though, it is merely advisory. The TCO uses it to negotiate a settlement or issue a unilateral determination. She can

also forward it to prime and higher-tier subcontractors, when appropriate, to help them settle their subcontracts. **49.107(d)**.

*Question 2 – What are the ways in which contracts terminated for convenience may be settled? Does the FAR indicate a preference for one of these ways over the others? If so, what is it? [Hint: check out **49.103**]*

Speaking of subcontracts, how does that work in a settlement context? We know from our discussion two chapters ago that subcontractors do not have “privity of contract” with the Government. This also means that a subcontractor has no contractual rights against the Government in the event of any termination of a prime contract. **49.108-1**. So, what can subcontractors do when a prime contract is terminated? In any type of termination, the sub can make a claim (or, as a last resort, sue or arbitrate) against the prime for outstanding costs, depending on the language in the subcontract. (For that reason, subcontracts should contain provisions governing the parties’ rights in the event of a termination).

49.108-5. However, for settlement-related issues, the parties’ rights may depend on the type of termination. Unless the TCO explicitly indicates otherwise, in a termination for convenience, primes are directed to terminate all subcontracts relating to any part of the prime contract that was terminated. This also means that primes should include clauses giving them the right to terminate the subcontract in the event of a prime contract termination; otherwise the prime may be caught between a prime contract that was terminated and a subcontract that cannot be terminated. **49.108-2(a)**.

Most of this negotiation takes place between the prime and sub, so why is it important to the Government? It’s important because the Government reimburses the prime for necessary costs related to subcontract terminations. **49.108-3(a) and (c)**. The Government won’t reimburse the prime for just any subcontract settlement, though. The TCO must approve the amount of the settlement, except in a few specific circumstances in which he may allow the prime to make subcontract settlements without approval or ratification. **49.108-4(a)**. However, those unapproved settlements are still subject to review! **49.108-3(c)**.

*Question 3 – True or False? A prime contract may request assistance from the Government in settling subcontractor terminations? Explain your answer. [Hint: check out **49.108**]*

So, a termination settlement has occurred, whether by negotiation or determination. Now what? Now the contractor and TCO execute a settlement agreement. That agreement must cover two major areas: 1) any setoffs the Government has against the contractor that may be applied against the terminated contract, and 2) *all* settlement proposals of subcontractors, except proposals specifically excluded from

the settlement so they can be separately settled elsewhere. **49.109-1**. Setoffs here are anything the contractor might owe back to the Government— in other words, the settlement agreement must cover what the contractor owes the Government and what the Government owes the contractor. There are a variety of specific topics these two areas cover, including issues like Government property and settlement by determination. Each of these topics is separately dealt with in the remainder of **49.109**. The TCO must also prepare a settlement negotiation memorandum at this time; we can find the factors the TCO must include in this memo in **49.110**. Additionally, if there are any unsettled contract changes by the time we get to this phase, the TCO might have to settle those too. We look to **49.114** for guidance in that area.

Now that we know how the process of settlement negotiation works, we need to know how payment of the settlement works. Payment can be either partial or final. Partial payments occur happen during the course of negotiation, if the contract authorizes such payments. **49.112-1(a)**. Prime contractors can submit requests for partial payment to the Government. However, if a sub wants to be paid using a partial payment, it must submit its request through the prime (remember, the sub doesn't have privity of contract with the Government!), and the prime forwards the request to the Government. The Government then pays the prime, who pays the sub. The TCO is generally in charge of approving the amount to be paid under partial payment requests using the procedures in **49.112-1(b) through (h)**.

Final payment is the last step in the settlement process. The contractor submits a voucher or invoice to the Government. When the parties have negotiated a settlement, the invoice or voucher should show the amount agreed upon in the negotiations, minus any partial payments made during the negotiations. **49.112-2(a)**. When the TCO has made a settlement by determination, the contractor has two options. It can either accept the determination and simply submit an invoice or voucher for the determined amount minus any partial payments (**49.112-2(b)(1)**), or it can appeal the determination (**49.112-2(b)(2)**). If it appeals, it must then accept the amount ultimately determined in the appeals process, and submit that amount as a voucher or invoice.

*Question 4 – Can the Government pay interest on the amount due under a settlement agreement? Why or why not? [Hint: check out **49.112-2(d)**]*

B. Terminations for Convenience

We mentioned above that all the settlement procedures and policies we discussed generally only apply to terminations for convenience, unless the FAR specifically notes that they apply to terminations for default as well. But what is a termination for convenience? We know that the termination for convenience kicks off because it's in the Government's interest to kick off, and not because the contractor has done anything wrong, but that doesn't answer the question of what the termination actually includes. The actual contents of the settlement agreement or determination and the specifics of

some of the procedures depend on the contract type we're dealing with. For all terminations for convenience, we start with the basic settlement requirements we discussed in the previous section. For additional principles for fixed-price contracts, we turn to **49.2**, and for additional principles for cost-reimbursement contracts, we turn to **49.3**. Other contract types are governed by the basic requirements in **49.1**, unless otherwise specified in these Subparts or in **Part 16**.

You may remember that profit *is* allowed in Government contracting! It's allowed in terminations for convenience too. However, it is only permitted for preparations made and work already performed on the contract. It is *not* allowed on the settlement expenses or for work that may have been scheduled but not yet performed (e.g., "anticipatory profits"). In comparison, a standard commercial will rarely allow the buyer to terminate for its own convenience; if it attempts to do so it will be considered a breach of contract and the seller will be entitled to be made whole, which may include the recovery of lost profits. **49.202(a)**. There are a variety of factors to consider when negotiating or determining profit, which we find in **49.202(b)**. The TCO must also consider deductions (**49.204**) and completed end items (**49.205**) in the settlement process. The majority of **49.2** is, however, taken up with settlement proposals, which, as we know, are the responsibility of the contractor. **49.206-1** tells contractors how to submit settlement proposals, **49.206-2** tells contractors about bases for settlement proposals, and **49.206-3** tells contractors how and when to submit inventory disposal schedules.

As a general rule, a contractor holding a contract that is terminated for convenience will be entitled to recover its costs to date, a reasonable profit on those costs, and the reasonable costs of termination itself (e.g., severance payments, unexpired leases). Note that there are some limitations on settlements. On the Government side, the total amount payable to the contractor *before deducting any credits* (including inventory disposal, which we mentioned above) and excluding settlement costs may not exceed the total cost of the contract. **49.207**. This is reasonable when we think about it; what would be the point of a termination for convenience if the settlement ended up being more expensive than simply letting the contract run its course? Additionally, on the contractor side, the contractor may request an equitable adjustment after a partial termination in certain circumstances. **49.208**.

Question 5 – What are the two bases for settlement proposals, and which is preferred? Can a contractor submit a proposal on any other basis? Why or why not? [Hint: check out **49.206-2**]

Settlement of cost-reimbursement contracts is a little different because of the difficulties inherent in that flavor of contracting—namely, cost allowability, which must come into play during a termination for convenience of a cost-reimbursement contract. **49.301**. Whether the contractor may continue to use vouchers or not depends on whether the contract is partially terminated. If the contract is completely terminated, then the contractor must cease using the vouchers it would normally use to request reimbursement. **49.302(a)**. When the contract is only partially terminated, then the contractor can continue to use vouchers, but with some restrictions. **49.304-3**. We can find the procedures used after vouchers have been completely discontinued in **49.303**, and the procedures for partial termination in

49.304. Otherwise, the procedures for settlement and so forth are broadly similar to those used for fixed-price contract terminations.

Sometimes a fee is also included in a cost-reimbursement contract. What happens to that fee in case of a termination for convenience? The short answer is much the same thing that happens to profit in a fixed-price contract. The fee to be paid is adjusted based upon the percentage of the work the contractor has completed, and what costs it has already expended in preparing to do further work.

49.305-1(a). Note that in construction contracts, the percentage completed is a percentage of total effort, not a percentage of actual construction work, because of the multifaceted nature of construction.

49.305-2(a).

Question 6 – When must the contractor submit its final settlement proposal for a terminated cost-reimbursement contract? What must that proposal include? What must it *not* include? [Hint: check out **49.303-1**]

C. Terminations for Default

Subpart 49.4 brings us to the dreaded termination for default which many courts characterize as a “drastic sanction”. In **49.401(a)**, the FAR defines termination for default as “generally the exercise of the Government’s contractual right to completely or partially terminate a contract because of the contractor’s actual or anticipated failure to perform its contractual obligations.”

The grounds for a termination for default are specified in **49.402-1**. *The Government may terminate for default if the contractor fails to make delivery or perform the services in a timely way, fails to perform any other provision of the contract, or fails to make progress and that failure endangers contract performance.* Like terminations for convenience, terminations for default have somewhat different procedures based on the type of contract—fixed-price (**49.402**) or cost-reimbursement (**49.403**). Unlike terminations for convenience, though, these differences are profound. In general, the procedures used for a termination for default of a cost-reimbursement contract will be broadly the same as those used for a termination for convenience of such a contract. **49.403(b) and (c)**. That’s because in a cost-reimbursement contract, the contractor is entitled to its allowable costs, regardless of the quality of its performance. But the procedures for termination for default of a fixed-price contract are quite different. There is no negotiation of profit or fee or anything like that in that situation. In fact, per **49.402-2(a)**, the Government is not liable for the contractor’s costs for any undelivered work, and is also entitled to repayment of any advance or progress payments made toward that work.

So what’s the procedure for terminating a fixed-price contract for default? The first step is for the contracting officer to consider whether it’s really necessary, or if some other type of termination would do. **49.402-3(a)**. The factors to consider when determining whether to terminate for default are in

49.402-3(f). Except for instances where the contractor has already missed a delivery date, the CO must give the contractor a “cure notice,” specifying the failure and giving the contractor at least 10 days to cure the failure. If after receiving the contractor’s response to the cure notice the CO is leaning toward terminating the contract for default, she should if possible notify the contractor in writing and give the contractor an opportunity to “show cause” why the contract should not be terminated for default.

49.402-3(e)(1). Once the termination is imminent, the CO shall provide a written notice to that effect to the surety (if any), and should also provide a copy of the actual default termination notice to the surety if the CO does decide to terminate the contract for default. **49.402-3(e)(2).** The actual termination notice should include the information in **49.402-3(g)**, and should be distributed to the same parties to which the original contract was distributed, per **49.402-3(h)**.

Question 7 – FAR 49.402-3 and FAR 49.403 each note that a contracting officer must provide a contractor with at least ten (10) days to cure a default or deficient performance prior to terminating a contract for default. Under what circumstance may the Government terminate a contract for default without a cure notice? [Hint: check out 49.402-3(c) and 49.403(a)]

Question 8 – Other than a termination for convenience or a no-cost cancellation, what other options are available to the CO in lieu of a termination for default? [Hint: check out 49.402-4]

What happens if the Government still needs the supplies or services the contract was supposed to provide under the terminated contract? The Government can actually have the contractor pay for those supplies or services (i.e., “costs to cover”), if those costs exceed the price that would have been paid to the terminated contractor. The rules for such action are in **49.402-6**. Remember, a termination for default happens because the contractor failed to perform, or did something wrong, so the Government may also be able to assess penalties and damages! It can also demand other damages from the contractor, in line with **49.402-7**, and liquidated damages in line with **49.406**. However, these damages are not the only way the Government can make itself whole after a termination for default. The

Government may also allow the surety (mostly in fixed-price construction contracts) to take over for the contractor after a termination for default, using the procedures in **49.404**. Alternatively, a different contractor may complete the contract. **49.405**.

Discussion Questions

1. FAR FUN LLC's contract was just terminated by an agency for convenience. What critical steps should they take before submitting a termination settlement proposal?

2. True or False? A prime contractor is required to flow down the termination clauses set forth in its prime contract to all "non-commercial" subcontractors. Explain your answer.

3. Identify the type of termination action a contracting officer could take, if faced with the following circumstances. Explain your answer.

a. A contractor's failure to meet a contract requirement due to a "force majeure"

b. A contractor's failure to meet a contract requirement due to a contractor's mistaken interpretation of a material specification

c. A contractor's failure to meet a contract delivery due date due to Government "over inspection" during contract performance

d. A contractor's failure to meet a contract requirement on a severable portion of a contract.

e. A contractor's failure to meet a contract requirement due to a lack of adequate personnel or equipment

4. Under what circumstances may a contracting officer issue a "no cost" termination? [Hint: Check out FAR 49.109-4]

5. FAR FUN LLC's terminated contract proposal contains reimbursement for many costs. They include: reimbursement for money paid to subcontractors, payment for performance prior to termination date, costs incurred in returning materials that were no longer to be used under the government contract, as well as profit that would have been had if the contract not been terminated. Which of these is not allowed? Explain your answer.

6. General audit guidance states that when terminating a negotiated contract, there are three (3) steps the TCO must and may complete. What are these steps? [Hint see Resources]

7. How many factors must a contracting officer consider before terminating a contract for default? Beyond the long list of factors, what else does the FAR provide with respect to the review process prior to a termination for default [Hint: check out **49.402-3**]

8. **FAR Question:** In this chapter, we've spoken quite a bit about settlement. Identify the specific part of the FAR that governs the allowability of termination costs requested in a termination settlement proposal submitted under a FAR Part 12 commercial item contract??

Answer Key

Answer 1 – In that situation, the contractor should take the following actions: (i) Promptly inform the local State Employment Service of your reduction-in-force schedule in numbers and occupations, so that the Service can take timely action in assisting displaced workers; (ii) Give affected employees maximum practical advance notice of the employment reduction and inform them of the facilities and services available to them through the local State Employment Service offices; (iii) Advise affected employees to file applications with the State Employment Service to qualify for unemployment insurance, if necessary; (iv) Inform officials of local unions having agreements with you of the impending reduction-in-force; and (v) Inform the local Chamber of Commerce and other appropriate organizations which are prepared to offer practical assistance in finding employment for displaced workers of the impending reduction-in-force. If practicable, the contractor should also urge subcontractors to take similar actions.

Answer 2 – For cost-reimbursement contracts or fixed-price contracts the ways a termination for convenience can be settled are: (a) negotiated agreement, (b) determination by the TCO, (c) costing-out under vouchers using SF 1034, or (d) a combination of these methods. There is a preference for the TCO to settle by agreement.

Answer 3 – True. Although it is rare, in accordance with FAR 49.108-7, a contracting officer can assist a prime contractor settle a subcontract termination.

Answer 4 – The Government shall not pay interest on the amount due under a settlement agreement or a settlement by determination. The Government may, however, pay interest on a successful contractor appeal from a contracting officer's determination under the Disputes clause at 52.233-1.

Answer 5 – The two bases for settlement proposals are: (i) inventory basis or (ii) total cost basis. Inventory basis is preferred.

Answer 6 – A contractor must submit its termination settlement proposal to the contracting officer within one year of the date of termination, using the form prescribed in 49.602-1. It shall not include costs not allowed by the contracting officer, or previously vouchered and formally questioned by the Government but not yet decided as to allowability.

Answer 7 – A contracting officer may terminate a contract for default without a cure notice when a contractor fails to make timely delivery of supplies or perform services within the specified time. The Government may terminate a contract for default when it is considered appropriate (assuming clause 52.249-6 is present in the contract); however, a 10 day notice must be provided to the contractor before termination.

Answer 8 – In lieu of issuing a termination for default, the contracting officer can also elect the following: (i) Permit the contractor, the surety, or the guarantor, to continue under a revised delivery schedule; (ii) Permit the contractor to continue by means of a subcontract or other business arrangement with an acceptable third party, provided the rights of the Government are adequately

preserved; or (iii) If the supplies and services are no longer needed, the contractor is not liable to the Government for damages and can execute a no-cost termination settlement agreement.

Discussion Questions Answer Key

1. At a minimum, the contractor should (i) stop work immediately; (ii) consult FAR part 49 (especially 49.104); (iii) determine if employees will be affected and take steps to mitigate impact; (iv) notify subcontractors who will be affected; and (v) within 120 days, submit an inventory disposal schedule.
2. False. They are not required, but a termination clause is in the interest of the prime. The subs do not have privity of contract with the Government and should sue the prime in the event of termination; flowing down a termination clause is protective of the prime in that instance.
3. A. No termination, the contractor's default was caused by the force majeure.
B. Termination for convenience if the contractor could prove the Government knew of the mistake at the time of award. Termination for default if otherwise.
C. No termination, the contractor's default was caused by Government action.
D. Partial termination for default.
E. Termination for default - poor planning on the part of the contractor is not the fault of the Government.
4. A contracting officer may issue a "no-cost cancellation under the following conditions: (i) The contractor has not incurred costs for the terminated portion of the contract or (ii) The contractor is willing to waive the costs incurred and (iii) No amounts are due the Government under the contract.
5. Per FAR 49.108-3, a contractor may not recover "future/anticipatory profits."
6. In that situation, the CO must (i) review the termination notice, (ii) conduct post-termination conference, and (iii) maintain a termination case file.
7. "The contracting officer MUST consider 7 factors before terminating a contract for default." The CO must also determine whether the failure to perform is excusable.
8. In that situation, the CO should consult FAR 12.403 and FAR 52.212-4(l) and (m).

APPENDIX

All of the following materials are linked and can be found via the Links Document or online.

[Air Force Termination for Default Guide](#)

A guidebook published by the Air Force in May 2007 concerning Termination for Default and related templates. The guide reviews when a new contract has centralized TCO functions, terminating a contract for default, special actions, appeals, and closing out the files. The document templates include CO statement, notice, various letters and necessary administrative documents in the termination process.

[DCAA Contract Audit Manual Ch 12](#)

DCAA handbook chapter on auditing contract termination, delay/disruption, and other price adjustment proposals or claims. The chapter reviews guidance and information surrounding contract termination procedures, general audit guides for terminations, price adjustment auditing considerations, and delay/ disruption auditing concerns.

[DCMA Termination for Convenience Guidebook](#)

The DCMA guidebook providing guidance, suggestions and best practices on issues relating to the settlement of contracts terminated for convenience. The guidebook goes through the process of a termination for convenience chronologically reviewing the notice, post termination conference, settlement proposals, prenegotiation objectives, settlement and special issues.

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