

# Sequestration and Terminations for Convenience

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# Agenda

- Background.
- Fiscal cliff.
- Expectations.
- Results of sequestration in general.
- Changes and T4Cs.
- Recommendations.

Materials in this presentation are general in nature. They cannot—and should not—replace consultation with a competent legal professional. Nothing on this presentation should be considered rendering legal advice.



# Background

- FY 2013 began on October 1, 2012.
- FY 2013 appropriations bills haven't been passed.
- Defense authorization bill hasn't been passed.
- Federal government is operating under temporary funding measure (continuing resolution) until March 27, 2013.
  - Continues 2012 funding levels with a 0.6% increase.
  - Office of Management and Budget has directed conservative spending.

# Fiscal Cliff

- Bush tax cuts will expire on December 31, 2012.
- Sequestration will start on January 2, 2013, unless Congress acts. \$1.2 trillion over a 10-year period.
- Debt ceiling will have to be raised to avoid default.

# Expectations

- **Lame-duck session:** Congress will address these issues after election day and before new Congress begins.
- Congress expected to pass annual defense authorization bill.
- But if Congress doesn't address issue, sequestration will occur.

# Fiscal Year 2013 Sequestration Process

- Unless exempt or subject to special rules, FY 2013 sequestration reductions are uniform by category for accounts and “programs, projects and activities” within accounts.
- Prior years unobligated balances subject to sequestration for DOD but not for other agencies.
- Three primary steps:
  - OMB Director issues Sequestration Order;
  - President issues Sequestration Order; and
  - Agencies implement Sequestration Order.

# Sequestration in Action

- Total additional reduction required by Budget Control Act of 2011 = \$1.2T
- Joint committee saving achieved = \$0
- Debt service savings assumed = \$216B
- Remaining spending reduction target = \$984B
- Divide spending reduction by number of years in fiscal years 2013 – 2021 ( $\$984\text{B}/9$ ) = \$109.4B per year.
- Divide FY 2013 equally between national defense (budget function 050) and all other functions ( $\$109.4/2$ ) = \$54.7B for DOD and \$54.7B for all else.
- For FY 2013, determine FY 2013 funds already obligated from 10/1/12 to 1/2/13.
- Apply special rules, statutory exemptions and discretionary exclusions.
- For FY 2013 only, apply uniform percentage to each non-exempt category and each program, project and activity.
- For FY 2014 and beyond, sequester for discretionary spending has different procedures – no automatic, across-the-board action.



# Preparation for Sequestration

- Assess your business plan in light of potential impairments:
  - Funds promised but not obligated by 1/2/13 may never materialize
  - Funds already spend are exempt from sequestration but that may only increase the cuts to funds remaining
  - Funds obligated but not yet spent may be reduced or clawed back by unilateral contract action:
    - Change orders under Changes Clause
    - T4C
- Determine which of your contracts are at risk and how much
  - Survey contracts and group them by program
  - Identify any work performed “at risk” and get it funded before 1/2/13

# What does this mean for government contractors?

- Change orders.
- T4Cs (partial or entire).



# Change Orders



# Change Orders

- Express Changes under changes clauses.
  - CO issues change order or modification.
  - Done through SF 30.



# Five Basic Types of Changes Clauses

1. Fixed-price supply or service contracts (FAR 52.243-1).
  - Alternates I through V.
2. Cost-reimbursement contracts (FAR 52.243-2).
  - Alternates I through V.
3. T&M/labor-hours contracts (FAR 52.243-3).
4. Fixed-price construction contracts (FAR 52.243-4).
5. Commercial items (FAR 52.212-4)—not unilateral; changes may be made only by agreement of both parties.

# Common Features of Changes Clauses

- Alternative versions; must check to see which particular version is stated in contract or incorporated by reference in contract.
- Contain procedures for the CO to order changes.
- Describe the types of changes that may be made.
- **Provide for equitable adjustment if the change increases or decreases the cost and/or time of performance.**
  - **Additive change:** contractor entitled to an increase in price if change results in an increase in contractor's cost.
  - **Deductive change:** government entitled to a reduction in price if change decreases the contractor's cost.
  - Contractor has a duty to proceed with work even if there is a dispute over the amount of the equitable adjustment.

# Change Orders

- Requirements under changes clauses:
  - Change is permitted only within the general scope of the contract. Cannot be a “cardinal change”; that is, one beyond the scope of the contract.
  - Change must be one of the types described in the particular changes clause.
  - Only CO acting within scope of his/her authority has the power to issue change order or modification.

# Request for Equitable Adjustment (REA)

- **Equitable adjustment:** An equitable adjustment encompasses the quantitative difference between the reasonable cost of performance without the added, deleted or substituted work and the reasonable costs of performance with the addition, deletion or substitution.
- Burden of proving amount of equitable adjustment is on claimant.
- To prove the amount of equitable adjustment, it is not necessary that the amount be proven with absolute certainty or mathematical exactitude.



# REAs

- Quantum of adjustment.
  - Depends in part on the type of contract involved.
  - Typically entitled to increased costs and reasonable profit on added work.
    - Relatively small changes: usually use profit rate in the original contract
    - 10% profit regarded as norm.
  - Actual costs should be provided when available.
    - Requires contractor to segregate costs after receiving the change order.
    - CO may order change order accounting (FAR 43.205 and 52.23-6).
  - Contactor entitled to costs in preparing the REA; costs includes attorneys' fees (FAR 31.205-33).
  - Interest is not recoverable.

# Three Methods of Calculating Quantum

1. Actual costs.
2. Total costs.
3. Jury verdict method.



# REA Procedure

- Usually must submit REA within 30 days of receipt of change order (express changes).
- CO usually cannot consider REA after final payment.
- REA must contain prescribed certification (10 U.S.C. § 2410(a); DFARS 243.204-70; DFARS 252.243-7002):

“I certify that the request is made in good faith, and that the supporting data are accurate and complete to the best of my knowledge and belief.”

# REA Procedure (cont'd)

- Not an adversarial proceeding against government; negotiation with government.
- Usually required to submit certified cost or pricing data in Table 15-2 format (FAR 15.408).
- Subject to audit.

# Terminations for Convenience



# Terminations for Convenience

- Standards for termination for convenience (T4C).
- Termination procedures.
- What may contractors get paid.
- Partial terminations.



# Standards for T4C

- Generally, government's decision is conclusive.
- Exceptions:
  - **Bad faith:** Contractor must show that government intended to injure contractor.
  - **Abuse of discretion:** No reasonable relation to government's best interest.
- Little of chance of success in pursuing exceptions. Evidence must be clear and convincing.

# Terminations for Convenience

- T4C clauses are found in FAR Part 52.
- There are several contract clauses that are required to be included, in some form, in most government contracts—T4C is one of those.
- FAR 49.502 prescribes when T4C clauses are to be used.
- There are several variations of the clause, each designed for the specific contract type.



# Types of T4C Clauses

- Fixed-price contracts.
  - Short form T4C clause for contracts less than \$100,000 (FAR 52.249-1).
  - Long form T4C clause for contracts over \$100,000 (FAR 52.249-2).
- Dismantling, demolition, or removal Contracts (FAR 52.249-3).
- Service contracts (FAR 52.249-4).
- Educational and other nonprofit institutions contracts (FAR 52.249-5).
- Cost-reimbursement contracts (FAR 52.249-6).
- Architect-engineer contracts (FAR 52.249-7).
- Commercial item contracts (FAR 52.212-4).

# Two Primary Steps

- Notice sent by government.
- Contractor must do certain things.



# Termination for Convenience Notice

- Written Notice—prescribed in FAR Subpart 49.6.
  - Statement that contract is being terminated for convenience of the government.
  - Effective date of termination.
  - Extent of termination (if partial).
  - Special instructions, if any (such as work in progress, GFE, etc.).
  - Steps contractor should take to minimize effect of termination, especially on personnel.
  - TCO responsible after issuance of notice of termination.

# Contractor's Duties (FAR 49.104)

- Stop work immediately on terminated portion.
- Follow government instructions. Failure to do leads to disallowance of costs.
- Terminate all affected subcontracts (FAR 49.108-2: “prime contractors should include a termination clause in their subcontracts for their own protection”).
- Immediately advise TCO regarding any special circumstances.

# Contractor's Duties (cont'd)

- Continue performance of work not terminated.
- Take all action necessary to protect and preserve government property.
- Notify TCO of any legal action related to termination.
- Settle subcontractor's claims (with approval if required by TCO).
- Submit settlement proposal.
- Dispose of termination inventory as directed by TCO.

# Settlement Principles & Limitations

- Government must compensate contractor fairly.
  - Including a reasonable allowance for profit.
- Objective: settlement by agreement without segregating particular elements of costs or profit.
  - FAR requires that TCO negotiate fair and prompt settlement with contractor.
- Cost and accounting data used as guidelines, but should not be applied rigidly.
  - Costs may be estimated, difference compromised, and doubtful questions settled by agreement.

# Settlement Methods

1. Negotiated agreement.
2. Determination by TCO.



# Settlement by Negotiation

- Settlement proposal:
  - Must be submitted promptly, but no later than 1 year after effective date of termination (contained in notice of termination).
  - Must be supported by accounting data.
  - Settlement proposal audited by the government.
  - Negotiated agreement.
  - Standard forms for settlement proposals (FAR 49.602-1)



# Settlement by Determination by TCO

- If parties cannot agree or settlement proposal not submitted timely, TCO issues a settlement by determination based on the applicable T4C clause and cost principles.
- Contractor may appeal TCO's final decision under the disputes clause.

# Settlement

- Generally, a settlement proposal is not a claim because it is not a dispute, but submitted for purposes of negotiations.
- However, settlement proposal can become a claim for purposes of Contract Disputes Act:
  - Contractor requests a final decision and TCO does not accept settlement proposal;
  - Negotiations are at impasse, requiring TCO to issue final decision; or
  - TCO issues a final decision.

# General Limitations

- May not exceed contract price.
  - May include settlement expenses.
  - May include valid pending claims, defective specifications, and so forth in original contract price.
- No consequential damages.
  - Damages arising from special circumstances not ordinarily predictable.

# Special Termination Costs

- Precontract costs.
- Initial costs.
- Termination inventory costs.
- Post-termination costs.
- Settlement expenses.



# Precontract Costs

- Costs incurred before effective date of contract.
- May be recovered if—
  - Incurred directly in pursuit of contract of, negotiation of, and expectation of award of contract.
  - Incurrence was necessary to meet delivery schedule of proposed contract.
- **Standard:** good faith and reasonable business judgment.

# Examples of Precontract Costs

- Capital improvements to production facilities.
- Cost of training employees.
- Planning for expected production.
- Depreciation costs for equipment during period of preparation for performance.
- **Contrary example:** Architect's review of plans not compensable because contractor didn't show review was necessary to meet delivery schedule.

# Initial Costs

- Contractors often incur abnormally high labor, material, and administrative costs at beginning of contract.
- Causes: inexperience, organizational activities, waste, inefficiency.
- Can be recovered if they are nonrecurring.
- Recovery of these costs may be limited.

# Termination Inventory Costs

- Materials and other items acquired to perform the contract.
- Contractor doesn't have to prove that work strictly complied with contract specifications.
- Contractor may be required to transfer materials to government or to sell items.
- Contractor may be responsible for destroyed, lost, damaged, or spoiled materials.



# Post-Termination Costs

- Costs that can't be discontinued after effective date of termination.
- Generally recoverable if contractor tries to end the costs as soon as possible.

# Examples of Post-Termination Costs

- Personnel costs.
- Severance pay.
- Cost of completing components so that total loss is avoided.
- Costs of replacing or repairing machinery, tools, or equipment worn out or broken down before termination.
- Costs related to plant facilities or equipment.

# Examples (cont'd)

- Depreciation costs of facility especially constructed for contract performance.
- Unabsorbed overhead costs (1) if termination barred contractor from getting new government business (2) if reasonable for contractor to “wind up” its business.
- Rental expenses for unexpired leases, provided contractor tries to reduce these expenses.

# Excluded Post-Termination Costs

- Nothing for damages that can't normally be expected or predicted.
- Nothing for speculative damages.
- **Examples:** No recovery for—
  - Loss of bonding capacity
  - Impaired reputation
  - Impaired credit

# Settlement Costs

- Expenses related to the preparation of settlement claim:
  - Accounting, legal, clerical costs.
  - Storage, transportation, and protection of property.
  - Indirect costs related to paying personnel: payroll taxes, fringe benefits, occupancy costs, and immediate supervision.

# Questions for Settlement Costs

1. Were expenses reasonably necessary for or related to termination?
2. Is there proof the expenses were incurred?
3. Is amount of the expenses reasonable?



# Subcontractor Issues

- Settlements between the prime and subcontractors require government approval.
- Primes should provide T4C clause in contracts with subcontractors.
- Government-approved settlements with subcontractors will almost always be part of settlement costs of contractor.

# Subcontractor Settlements Not Approved When Evidence of—

- Bad faith.
- Self dealing.
- Willful neglect or wrongdoing.
- Unreasonable defense of litigated subcontractor claims by contractor.



# Profit

- May be part of settlement.
- Factors considered will be difficulty of work and efficiency of contractor.
- May be according to standard used for measuring allowable profit.
- Contractor may have to prove—
  - Not performing contract at loss.
  - Contractor's expected profit was realistic in view of past experience and peculiarities of contract.

# No Profit in Settlement Costs

- Profit is from work terminated, not from settlement efforts.



# Loss Adjustments

- Applies to fixed-price contracts.
- If contractor would have had a loss as result of completing contract, loss must be reflected in settlement.
- Contractor can't benefit from T4C.
- FAR spells out formula for applying a loss formula in such cases.

# T4C of Commercial Items Contracts

- Special Rules for Commercial Items Contracts
  - Contractor not required to comply with cost accounting standards or contract cost principles.
  - Government does not have right to audit contractor's records solely as a result of termination.
  - No time limit for submission of settlement proposal.
  - Final settlement is not restricted to the contract value.
  - No allowance for partial payments prior to final settlement.
  - No certification required on the proposal.

# T4C of Commercial Items Contracts

- Contractor entitled to—
  - Percentage of contract price reflecting the percentage of work performed before notice of termination
  - and**
  - Any costs directly related to termination.

# Recommendations

- Prime contractors: make sure subcontracts have a T4C clause.
- Keep good financial records.
- Do what the notice of T4C says to do.
- Once you receive notice of T4C, make sure you begin termination of subcontractor contracts.
  - Deal with subcontractors at arm's length.
  - Make sure you get TCO approval.

# Recommendations (cont'd)

- Be proactive in attempting to reduce expenses associated with termination.
- Keep a record of why you do everything you do as you wind up the contract.



# Questions?

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