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## **RJO Update: Government Contracts**

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### **If Budget Sequestration Trims Your Contract: What Contractors Need to Know About Partial Terminations and Deductive Changes**

*By Neil H. O'Donnell and Dennis J. Callahan*

The looming specter of the budget sequestration provisions of the Budget Control Act of 2011 has been a hot topic for months. Absent delaying legislation, Congress's inability to pass a deficit reduction plan will trigger sequestration on January 2, 2013. Sequestration will cut nearly \$1 trillion in federal spending over nine fiscal years. The cuts are evenly divided by year (\$110 billion) and are evenly split between defense and non-defense spending (\$55 billion each).

While sequestration is widely discussed as a 10 percent across-the-board reduction, for two main reasons the impact on federal contractors likely will be even more pronounced than this figure suggests. First, the cuts will be taken disproportionately from contracts with outside providers of goods and services to the government. The President has indicated that he will exempt military pay and benefits from the cuts, and, along the same lines, the Administration may only furlough civilian employees for 30 days without effecting layoffs that directly impact national employment figures. Second, because the 2013 fiscal year begins on October 1, 2012, the FY2013 sequestration will not take effect until the start of the fourth month of the fiscal year. Thus, in FY2013 a year's worth of cuts will be squeezed into 9 months.

Sequestration was never intended to be implemented; rather, it was designed to force a congressional compromise on discretionary spending cuts. The compromise effort has failed so far, and the fall elections and subsequent lame duck period hold diminishing promise of such an orderly resolution. If sequestration occurs, agencies will have many ways to address the cuts in FY2014 and beyond, such as postponing or cancelling planned procurements, not exercising option years, reducing orders under ID/IQ contracts, or curtailing expenditures by not obligating additional funds and invoking limitations of funds clauses. To achieve the required cuts in FY2013 (and likely to a lesser extent thereafter), however, federal agencies in many instances seem certain to reduce the amount of goods and services called for under existing contracts rather than terminate the contracts in their entirety.

Whether an agency trims a contract by way of a partial termination under the Termination for Convenience clause, or, rather, by effecting a deductive change under the Changes clause, can significantly impact the contractor's recovery. If the contract generates significant profits, the recovery rules dictate that the contractor will be better off if the deletion is classified as a deductive change. But if, on the other hand, the contract generates little profit

or is a money loser, it will be to the contractor's advantage if the deletion is treated as a partial termination.

If deletions of work are inevitable, in negotiating contract reductions, or responding to agency attempts unilaterally to effect a certain type of reduction, contractors must understand which alternative is more advantageous for each affected contract.

**A. There Is No Clear Rule for Determining How to Characterize a Deletion of Work**

Although the issue has been litigated often, neither the boards of contract appeals nor the courts have established a consistent approach to determining whether a deletion of work constitutes a partial termination or a deductive change. As a general proposition, to determine which clause is appropriate judges have compared the nature of the deleted work to that remaining on the contract, rather than basing the determination on the percentage of contract value represented by the deleted work. If the agency still requires the work, but transfers it to other contracts, or if the specifications change, resulting in a reduction of work, the deletion is more likely to be classified as a deductive change. On the other hand, if the agency eliminates a segregable item of work from a contract, the board or court is more likely to view the deletion as a partial termination. So, for example, while the deletion of one building from a contract for the construction of a ten-building campus likely will be treated as a partial termination, a simplification in the design of all ten buildings that lowers the contract value 10% will more likely be classified as a deductive change.

Given the nature of the review process, a judge may accord slight deference to the contracting officer's determination of the appropriate procedure, but a contractor may contest the CO's choice. If the parties agree to proceed under the Termination for Convenience clause or the Changes clause, however, the board or court is unlikely to question the agreement, and will hold the parties to it. *See Lucas Aul, Inc.*, ASBCA 37803, 91-2 BCA ¶23,609.

Upon learning that the agency plans to delete some of its work, a contractor's first reaction is likely to be to attempt to persuade the agency to make its required cuts elsewhere. But, in case that effort proves unsuccessful, the contractor should also act quickly to determine its preferred procedure if the cuts do occur, and attempt to steer the contracting officer to adjust the contract under the more advantageous clause. If the agency rejects such an attempt and the matter comes before a third party decision maker, the contractor can renew its objection.

The uncertainty and timing of the FY2013 sequestration may offer an opportunity for a company whose contract is to be trimmed to engage the contracting officer proactively in "framing" the deletion as either a partial termination or a deductive change. If, say, an agency suddenly is forced to delete work from dozens of contracts, it may be amenable to negotiating a quick resolution to the reduction, including reaching agreement on the preliminary issue of the appropriate contract clause under which to proceed.

## B. Measures of Recovery for Partial Terminations and Deductive Changes

How a deletion of work is classified determines how the contract price will be adjusted to account for the deleted items, and which costs will be allowed. The differences in recovery can greatly impact the contractor's bottom line.

### 1. Partial Terminations

The Termination for Convenience clause provides that the CO shall make an equitable adjustment to the contract price that is designed to leave the contractor in the same position it would have been in had the parties initially contracted for the reduced amount of work. So long as the contractor anticipated turning a profit, it is allowed a *reasonable* profit on the work performed. The application of "reasonable" profit on the performed portion of the contract can be disadvantageous to the contractor where the work already accomplished has proved to be highly profitable.

By the same token, however, where a partially terminated contract is not profitable, the contractor can cut its losses by not taking additional losses on the unprofitable deleted work. The Termination for Convenience clause requires that the contractor suffer a loss on the costs that it has already incurred equal to the percentage loss it would have incurred if the entire contract had been completed. But such a percentage reduction still means the contractor avoids the full dollar value of the loss it would have incurred if the contract had been completely performed. Moreover, in a convenience termination the contractor may recover post-termination costs, such as rental costs on unexpired leases, and its settlement expenses, such as accounting and legal costs incurred in preparing and presenting its settlement claim to the agency.

In sum, then, recovery under the Termination for Convenience clause typically has a moderating effect on the contract's profitability. Just as the recovery rules scale back anticipated "outsized" profits to a "reasonable" level calibrated to the amount of work performed, where the contract is in a loss position the recovery calculation moderates the dollar amount of losses the contractor would have taken on the terminated work.

### 2. Deductive Changes

In contrast to the Termination for Convenience formula, recovery under the Changes clause reduces the contract price by the contractor's cost of the deleted work and the profit attributable to that work. Thus, on a highly profitable contract subjected to a deductive change, the contractor can bank its profits on the performed portion of the contract, without a reduction to a "reasonable" rate. Conversely, if the contractor is in a loss position it will bear the full brunt of the anticipated losses on the entire contract, because the contract price will be reduced by the (high) cost of performing the deleted work, leaving the contractor in the same loss position it would have been in had the contract been completed.

### C. Partial Termination vs. Deductive Change Scenarios

In the example above, it is clear that eliminating a building from a contract to construct a campus of buildings indicates a partial termination while simplifying the design of all the buildings indicates a deductive change. But many, if not most, government actions that unilaterally delete work from contracts are not so black-and-white. What if the government deletes a floor devoted to a computer room from a contract to construct a 10-story building? The contract is now for a building with 9 floors (a partial termination, eliminating one floor?), with reduced electrical and load capacity requirements (a deductive change, in that it affects the construction of the entire building?). All other aspects of the deal being equal, how contractors should seek to characterize such “grey area” deletions of work often will be dictated by the contractor’s profitability position with respect to the project.

#### 1. Partial Termination vs. Deductive Change: Substantial Profit Anticipated

First assume that the deletion of the computer room is characterized as a partial termination and that the contract price was \$10 million. If the contractor was able to construct the building for \$7 million, it would anticipate a \$3 million profit on the entire contract. But after the partial termination the contractor is allowed only a “reasonable” profit, say 10%, on the now 9-story building. If the contractor’s cost then is \$6 million, its “reasonable” profit will be 10% of that amount, or \$600,000. In this unfavorable result, the contractor’s great decrease in the dollar value of its margin, \$2.4 million (\$3 million - \$600,000, or 80% of the anticipated profit), dwarfs the percentage of work deleted from the contract (\$1 million/\$7 million, or 14% of the work).

Now consider if the deletion of the computer room is characterized as a deductive change. The contractor can construct the 9-floor building for \$6 million and will be paid the original \$10 million contract price less the cost of the deleted work (\$1 million) and the profit attributable to that work. In this high-profit scenario (30%), the profit attributable to the reduced work would be \$300,000 (\$1 million \* 30%). Here, the contractor would be paid \$8.7 million (\$10 million - \$1.3 million cost of deleted work and profit thereon), its costs would be \$6 million, and its profit would be \$2.7 million. While this is not the \$3 million profit contractor anticipated before the deductive change, it is a much better outcome for the contractor than under the partial termination calculus. The contractor would have preserved most of its anticipated profit on this favorable contract.

#### 2. Partial Termination vs. Deductive Change: Loss Position

If instead of anticipating a large profit, suppose the contractor was operating at a 30% loss. The contractor would expect to expend \$13 million to construct the building, and, as a result, it would expect to take a \$3 million loss on the original \$10 million contract. Assume that the computer room floor and associated work comprised 15% of the project, or \$1.5 million of the original contract price. Operating at a 30% loss, it would have cost the contractor \$1,950,000 to construct the computer room floor (\$1.5 million \* 130%).

Under the partial termination loss adjustment formula, the contractor is able to reduce its anticipated losses. The formula applies the expected loss percentage only to the costs actually incurred, or \$8.5 million of the original contract price. Thus, the contractor's dollar loss is 30% of \$8.5 million, or \$2,550,000. This is \$450,000 better than if the contract had been completed and the contractor had lost the full \$3 million. The contractor would be paid \$8.5 million, and its costs would be \$11,050,000 (\$13 million – \$1,950,000). While no one wants to lose \$2,550,000 on a contract, the partial termination formula would allow the contractor to cut its absolute dollar loss from the anticipated \$3 million.

In the deductive change situation, using the same assumptions the contract price of \$10 million would be reduced by the contractor's actual cost of performing the deleted work (\$1,950,000), so the contractor would be paid \$8,050,000 for work it costs the contractor \$11,050,000 to perform, resulting in the same \$3 million loss as if the contract had been completed. The contractor suffers the full loss on the contract without the moderating effect that would occur if the reduction in work were treated as a partial termination. If classified as a deductive change, the contractor must absorb the full extent of its anticipated losses over the entire contract (\$3 million), and not the reduced quantum of losses as under the partial termination analysis.

#### **D. Summary**

Real world government contracting is much more complicated and fluid than the tidy examples above. But it is a good bet that if sequestration comes to pass, work called for under many federal contracts will be deleted in 2013, and many of those contract actions will not be amenable to neat characterization as partial terminations or deductive changes. Contractors whose work is to be cut will be well served to appreciate early on the very different potential impact to the project's bottom line of these competing characterizations as they frame the work deletion in their negotiations with the contracting officer.

#### ***How We Can Help Your Company***

RJO has assisted many clients facing deletions of work to their federal government contracts. Often, we are called upon to help clients avoid such deletions of work, either by persuasion or litigation, or to negotiate or litigate terms to help our clients maximize their recoveries and minimize their liability. We also assist both prime and subcontractors in connection with deletions of work at lower contracting tiers. Neil H. O'Donnell ([nodonnell@rjo.com](mailto:nodonnell@rjo.com)), who has been named one of the leading government contract lawyers in the country by Chambers USA every year since 2005, has presented on terminations at West's Annual Developments in Government Contracts for nearly 25 years. Dennis J. Callahan ([dcallahan@rjo.com](mailto:dcallahan@rjo.com)) has specialized in public contracts advice and litigation for over five years.