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COUNSEL COMMENTARY

Terminations for Convenience: Why Contract Type Matters

Government contractors must be prepared to maximize their recovery of termination costs.

BY STEPHEN L. BACON

Once a contract is terminated for convenience, the contractor and the government engage in a settlement process that is governed by applicable contract clauses and provisions in the *Federal Acquisition Regulation (FAR)*. The overarching intent of this process is to ensure that the contractor receives "fair compensation."[1]

But the contractor's right to recover "fair compensation" may vary substantially depending on the type of contract at issue. Contractors that have received termination notices as a result of recent events must understand their rights in order to maximize the recovery of termination costs. This article provides an overview of the key principles that apply to convenience terminations for different types of contracts and explains how contractors can ensure they recover costs to which they are entitled.

Fixed-Price Contracts

The termination of a fixed-price contract converts it into a cost-reimbursement contract with certain limitations.[2] In general, the contractor may recover allowable costs incurred during performance, a reasonable profit for the work performed, reasonable termination settlement expenses, and certain special termination costs.[3]

Notably, the contractor's recovery of allowable costs and profit can be impacted if the Termination Contracting Officer (TCO) determines that the contractor would have suffered a loss if the entire contract had been completed. The contractor's performance costs and profit may not exceed the total contract price in any settlement.[4]

Moreover, if the contractor was in a "loss position" at the time of termination, it will not recover any profit and the TCO will apply a "loss adjustment" to the settlement amount.[5]

A loss adjustment is generally applied when the contractor's estimate at completion (EAC) is projected to exceed the total contract price. The loss adjustment lowers the contractor's recoverable costs by the percentage of loss that would have been incurred if the contract had been fully performed.[6]

Thus, if the contractor's EAC is $100 million on a $80 million contract, for example, the recoverable amounts would be adjusted to 80% to reflect the expected loss.[7]

Given the potential impact of a loss adjustment, contractors should use a combination of technical, program and finance personnel to fully understand their EAC so they are well-prepared to respond to the TCO's settlement position.

Contractors should also examine any requests for equitable adjustment (REAs) to submit to increase the contract price. If successful, an REA can potentially eliminate or at least diminish the size of the loss adjustment and improve the contractor's overall recovery.

Cost-Reimbursement Contracts

In a cost-reimbursement contract, the contractor is already entitled to recover its allowable performance costs. Therefore, the primary concern in a termination for convenience is the contractor's fee recovery. The *FAR* states that the contractor's fee recovery is "generally based on a percentage of completion of the contract or of the terminated portion."[8]

In a cost-plus-incentive-fee contract, the available incentive fee pool "shall be adjusted on the basis of target fee, and the incentive provisions *shall not be applied or considered*."[9] In other words, any cost or performance incentives that would normally determine the contractor's fee are inapplicable in a termination for convenience. Instead, the contractor is entitled to a portion of the target fee based on its percentage of completion.[10]

Under the *FAR*, the TCO must consider a variety of factors when determining the contractor's percentage of completion including the "extent and difficulty of the work performed."[11] A contractor's earned value management system (EVMS) may provide useful data for evaluating its percentage of completion, but it should not be used as the exclusive method for assessing progress at the time of termination.

The *FAR* is clear that the "ratio of costs incurred to the total estimated cost of performing the contract . . . is only one factor in computing the percentage of completion," which "may be either greater or less than that indicated by the ratio of costs incurred, depending upon the evaluation by the TCO of other pertinent factors."[12]

These factors include, for example, efforts completed with respect to planning, scheduling, technical study, engineering work, production and supervision, and placing and supervising subcontracts.[13]

After a termination notice is received, contractors should quickly convene knowledgeable program managers, engineers, and finance personnel to rigorously evaluate potential methods for determining their percentage of completion. Once a methodology is selected, the contractor should thoroughly document their approach in the Termination Settlement Proposal (TSP) so that it may be used as the basis for negotiating a fair and equitable termination settlement.

Unlike a fixed fee or incentive fee, an award fee is typically not adjusted based on the contractor's percentage of completion. In general, the contractor's entitlement to the award fee is determined "in the manner provided by the contract."[14] It is therefore critical for contractors to review a contract's award fee plan to determine how the award fee will be dispositioned in the event of a termination for convenience.

For example, the contractor may be entitled to a portion of the award fee allocated to the period during which the termination occurs based on its performance against the established award fee criteria. Contractors should closely examine the contract to determine how the award fee is treated in the event of a termination because methods used can vary significantly by contract.

Contracts for Commercial Products and Services

Contracts for commercial products and services include a special streamlined termination for convenience provision at FAR 52.212-4(l). It provides that the contractor is entitled to (1) "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination;" and (2) "reasonable charges" resulting from the termination that "the contractor can demonstrate to the satisfaction of the government using its standard record keeping system."[15]

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The first prong "specifies a means for compensating the contractor for work it has done before the termination."[16] This is generally determined based on the contractor's physical completion of work and includes partially completed items that have not been delivered or accepted by the government at the time of termination.[17]

The second prong "refers to the recovery of those charges incurred that do not relate to work completed but should be reimbursed to fairly compensate the contractor whose contract has been terminated."[18] This may include start-up costs incurred in anticipation of performing the contract, unavoidable costs continuing after termination, and settlement expenses such as legal and consulting costs.

Under FAR 52.212-4(l), the contractor is not required to comply with onerous cost accounting standards or cost principles in FAR Part 31. Nevertheless, the contractor's termination costs should be supported by "a regular, organized method for tracking relevant costs" to satisfy the FAR 52.212-4(l) "standard record keeping" requirement.[19]

Indefinite-Delivery, Indefinite-Quantity Contracts

The termination of an indefinite-delivery, indefinite-quantity (IDIQ) contract may present certain unique risks to contractors. IDIQ contracts do not specify a firm quantity of supplies or services that will be ordered, but they must include a minimum guaranteed quantity and a maximum quantity.

On IDIQ contracts, a contractor's start-up costs will often exceed the relatively small minimum guaranteed amount. Contractors incur these start-up costs in anticipation of receiving sufficient orders to justify the expense. But when an IDIQ contract is terminated for convenience, a contractor may not have received enough orders to cover the start-up costs it incurred.

In *Sage Acquisitions LLC v. Department of Housing and Urban Development*, the Civilian Board of Contract (CBCA) appeals held that "[t]he risk of any losses incurred by the contractor as a result of start-up costs that exceeded this minimum lies squarely with the contractor."[20]

The contractor in that case had performed contracts to manage and market properties and its termination claim included costs exceeding the guaranteed minimum amounts. The Board denied the claim on the basis that "the Government had no further obligation under the contracts because the guaranteed minimums had already been met."[21]

Sage Acquisitions is in tension with the Court of Federal Claims' decision in *Value Recovery Holding, LLC v. United States*.[22] In that case, a contactor for debt collection services incurred costs to obtain an Authorization to Operate (ATO) to meet the contract's cybersecurity requirements. The ATO was needed before the contractor could receive accounts for collection through the issuance of task orders under the IDIQ contract. After the contract was terminated for convenience following a bid protest, the contractor claimed the ATO costs under FAR 52.212-4(l).

The government moved to dismiss the claim because the contractor "was never guaranteed earnings sufficient to offset the costs" and "this known risk

was simply realized by the termination for convenience."[23]

But the Court rejected this argument because the termination "removed [the contractor's] opportunity to perform and, therefore, eliminated any possibility that [the contractor] could offset the required preparatory costs."[24]

Because the termination "removed a necessary element of fairness underlying the original decision to allocate risk to the contractor," the Court concluded that the contractor made a plausible claim for recovery of the ATO costs.[25]

The differing viewpoints in *Sage Acquisitions* and *Value Recovery* have significant implications for IDIQ contractors, especially contractors that have incurred substantial "start-up" costs to be ready to perform task and delivery orders.

Conclusion

There may be many terminations for convenience that will need to be resolved in the coming years. Many of the contractors impacted will have no prior experience with the intricate rules that apply to the termination settlement process.

Given the complexity of that process, the *FAR* allows contractors to recover their legal and expert consulting costs as termination settlement expenses. For contractors who are or may be facing a termination, it is critically important to understand your termination rights and how to maximize the recovery of costs. As illustrated above, the contractor's strategy is heavily influenced by the terminated contract type. **CM**

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The views expressed in this article are those of the author and do not necessarily reflect the views of Rogers Joseph O'Donnell or its clients. This article is for general information purposes and is not intended to be and should not be construed as legal advice.

ENDNOTES

1 FAR 49.201.
2 Praecomm, Inc. v. United States, 78 Fed. Cl. 5, 12 (2007).
3 FAR 52.249-2(g); FAR 31.205-42.
4 FAR 52.249-2(f).
5 See FAR 49.203.
6 FAR 49.203(b)(3).
7 Id.
8 FAR 49.305-1(a).
9 FAR 49.115(b)(2) (emphasis added).
10 FAR 52.249-6(h)(4)(i).
11 FAR 49.305-1(a).
12 FAR 49.305-1(b).
13 FAR 49.305-1(a).
14 FAR 49.305-1(a).
15 FAR 52.212-4(l).
16 SWR, Inc., ASBCA No. 56708, 15-1 BCA ¶ 35,832.
17 TriRad Technologies, Inc., ASBCA No. 58855, 15-1 BCA ¶ 35,898.
18 SWR, Inc., 15-1 BCA ¶ 35832.
19 ACLR, LLC v. United States, 162 Fed. Cl. 610, 616 (2022), aff'd No. 2023-1190, 2024 WL 4315111 (Fed. Cir. Sept. 27, 2024).
20 Sage Acquisitions, LLC v. Dep't of Hous. & Urb. Dev., CBCA No. 7319, 23-1 BCA ¶ 38,315.
21 Id. The CBCA's decision was affirmed by the Federal Circuit, but the decision does not address whether the minimum guarantee limited the contractor's recovery of termination costs and it is not clear whether the issue was specifically raised on appeal. See Sage Acquisitions LLC v. Sec'y of Hous. & Urb. Dev., 119 F.4th 973, 976 (Fed. Cir. 2024).
22 Value Recovery Holding, LLC v. United States of Am., No. 21-1467, 2022 WL 3641779 (Fed. Cl. Aug. 1, 2022)
23 Id. 9
24 Id.
25 Id. at 10.