

Contract Terminations – Not So Convenient



**TERMINATION AHEAD
SLOW DOWN**

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Presented by Paul Slemons & Darrell M. Hineman

ACCOUNTING • TAX • ADVISORY

Please Read

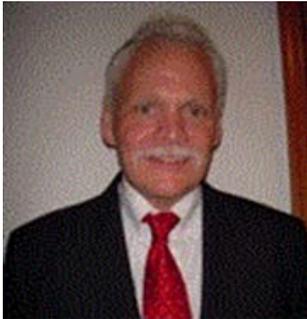
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Presenters Biographies

Paul Slemons, CPA



- Oversaw the settlement of some 9,000 terminated contracts valued at \$30 billion
- 12 years of auditing experience with the DCAA and the OIG.
- Chief of Terminations for the past 28 years

Darrell M. Hineman, CPA, CFE



- Assisted in the preparation of major & minor contractors termination proposals
- Formerly, DCAA auditor for 8 years
- National instructor on FAR and CAS

So Your Contract Has Been Terminated ...

First Question – **Why me?** What did I do wrong?

- Nothing; that's why it is a termination for (the Government's) convenience and not a termination for default or termination for cause

What are the odds this would happen to me?

- DCMA has 345,200 active contracts with 637 in Terminations so – 1 in 542
- So again, **why me?**

What does this mean?

- Think of it as converting your fixed price contract into a cost-reimbursable contract.
- You get paid for your incurred costs plus profit on those costs
- You do not recover anticipatory profits or consequential damages

Termination Settlement

Overriding Objective: Fair Compensation; compensate Contractor fairly for work done and preparation made for terminated portion of contract, including reasonable allowance for profit. (FAR 49.201)

1. Matter of Judgment and cannot be measured exactly
2. Use of business judgment as distinguished from strict accounting principles
3. Cost and accounting data as guides, not rigid measures for ascertaining fair compensation
4. Amount of record-keeping, reporting and accounting related to the settlement should be kept to a minimum compatible with reasonable protection of public interest

Why Can't I Get Anticipatory Profits and Consequential Damages?

PROFIT

“The TCO shall allow profit on preparations made and work done by the contractor for the terminated portion of the contract **but not on the settlement expenses.**

Anticipatory profits and consequential damages shall not be allowed ...”
(See FAR 49.202(a))

SETTLEMENT PROCEDURES

“In no event will the Government pay the prime contractor any amount for loss of anticipatory profits or consequential damages resulting from the termination of any subcontract.”

(See FAR 49.108-3)

I Can't Claim Anticipatory Profits and Consequential Damages - Really?

- Using the termination clauses themselves FAR 52.249-2(g)(2)(i) as an example, the contractor is not entitled to consequential damages. It can only recover: “The costs incurred in the performance of the work terminated.”
- Again, using the termination clause, FAR 52.249-2(g)(2)(iii), the contractor is entitled to: “A sum, as profit on subdivision (g)(2)(i) of this clause ...” Clause (g)(2)(i) references “costs incurred in the performance of the work terminated.” Thus, profit is only on work performed – no anticipatory profit.



So what happens if the termination makes the indirect rates increase and I lose profit margin on all of my other contracts?

Adjustment for Loss

What happens when a project is in a loss position?

- No profit is allowed if the contract would have incurred a loss had the entire contract been completed
- The remainder of the settlement amount must be reduced by the loss ratio



Can I Claim Unabsorbed Overhead?

Post-termination unabsorbed overhead is **not recoverable** in a termination claim (ASBCA No. 52772, 01-2 BCA ¶ 31,557)

- The law is well-settled over many years that post-termination unabsorbed overhead is not recoverable in a termination claim.
- While a contractor has a reasonable contract expectation that its continuing **home office costs** will be absorbed by the performance of the contract work and the contract price to be paid thereunder, that remains a reasonable contract expectation so long as the contract is open and the work is to be performed.
- Once the Government terminates performance of the contract work by default or convenience the basis for this expectation no longer exists, and the contractor's continuing **home office overhead costs** must be absorbed by work on other contracts.

Can I Claim Unabsorbed Overhead?

- The **risk is voluntarily assumed** by every Government contractor when the contract provides for Government termination rights.
- While it is true that under the regulations, certain termination costs may be recoverable if the contractor used reasonable effort to discontinue them after termination, but was unable to do so, (FAR 31.205-42(b)), **home office overhead costs** do not fall into this category because they are costs required to maintain the ongoing business and inevitable, are not subject to discontinuation.



(Joint Venture G.C.D.-E Lykiardopoulos & J. Lydakos & Asphaltiki, S.A., ASBCA No. 47285, 97-1 BCA ¶ 28, 976. See also Nolan Brothers, Inc., supra, at 1389.)

How Adequate Does Support Need to Be?

- All of my contracts are **sealed bid** and I do not even maintain a job cost system. **Then what?**
 - “When actual, standard, or average costs are not reasonably available, estimated costs may be used if the method of arriving at the estimates is approved by the TCO. (See FAR 49.206-1(c))
 - Contractors shall not be required to maintain unduly elaborate cost accounting systems merely because their contracts may subsequently be terminated.”
 - Further, the Board has allowed estimates. In Arnold H. Liebowitz (1976) GSBCA CCR-1, 76-2 BCA 11,930 when the Board accepted the contractor’s estimate of hours worked which was based on reconstruction of records, such as appointment diaries and memoranda.

How Adequate Does Support Need to Be?

- So while perfect accounting records are not required, **support must be more than mere speculation**. Bare cost summaries without any underlying documentation constitute mere speculation and do not discharge the contractor's burden of proving that the purported costs were in fact incurred.
- “Under a termination for convenience, a **contractor has the burden of proving** costs incurred.
- Damages must be substantiated and supported by a preponderance of the evidence.
- “Mere allegations without substantiated explanatory facts that support the statements are not sufficient to carry the necessary burden of proof.



What About First Article Limitations?

What do the first article clauses say about terminations?

- FAR 52.209-3(g) and FAR 52.209-4(h), “Until first article approval is granted, only costs for the first article and costs incurred under this authorization are allocable to this contract for ... (2) termination settlements if the contract is terminated for the convenience of the Government.”

So why would contractors assume this risk and go into full production just to get a price break?

- See Slide 1 – the odds of a contract being terminated are 1 in 542

What Impact Do Limitation of Funds/Cost Have on Settlement?

- FAR 52.232-22(f)(1) LOF – The Government is not obligated to reimburse the Contractor for costs incurred in excess of the total amount allotted by the Government to this contract”
- FAR 52.232-20(d)(1) LOC – “The Government is not obligated to reimburse the Contractor for costs incurred in excess of the estimated cost specified in the Schedule”

How is Inventory/PCARSS Handled?



Inventory disposal schedules.

Unless disposition instructions are otherwise included in this contract, the Contractor **shall** complete SF 1428, Inventory Schedule B, within the Plant Clearance Automated Reutilization Screening System (PCARSS).

DFARS 252.245-7004

Effective April 20, 2012

Information on PCARSS can be obtained from the plant clearance officer and at <http://www.dcmamil/ITCSO/CBT/PCARSS/index.cfm>.

Inventory/PCARSS

NO	(a)	(b)	(c)	(d)	(e)
1	METALS	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
2	RAW MATERIALS (other than metals)	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
3	PURCHASED PARTS	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
4	FINISHED COMPONENTS	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
5	MISCELLANEOUS INVENTORY	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
6	WORK-IN-PROCESS	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
7	SPECIAL TOOLING AND SPECIAL TEST EQUIPMENT	<i>Inventory totals (Detail on SF-1428, Schedule B)</i>			
8	OTHER COSTS (from Schedule B)	<i>Total as detailed on page 2, Schedule B of this form</i>			
9	GENERAL AND ADMINISTRATIVE EXPENSES (from Schedule C)	<i>Total as detailed on page 2, Schedule C of this form</i>			
10 TOTAL (Items 1 to 9 inclusive)	□			
11	PROFIT (explain in Schedule D)	<i>Total as detailed on page 2, Schedule D of this form</i>			
12	SETTLEMENT EXPENSES (from Schedule E)	<i>Total as detailed on Page 3, Schedule E of this form</i>			
13 TOTAL (Items 10 to 12 inclusive)	□			
14	SETTLEMENTS WITH SUBCONTRACTORS (from Schedule F)	<i>Total as detailed on Page 3, Schedule F of this form</i>			
15	ACCEPTABLE FINISHED PRODUCT	<i>Inventory totals (Details on SF-1428, Schedule B) at contract price</i>			
16	GROSS PROPOSED SETTLEMENT (Items 13 thru 15)	□			
17	DISPOSAL AND OTHER CREDITS (from Schedule G)	<i>Total as detailed on page 3, Schedule G of this form</i>			
18	NET PROPOSED SETTLEMENT (Item 16 less 17)	□			
19	ADVANCE, PROGRESS & PARTIAL PAYMENTS (from Schedule H)	<i>Total as detailed on Page 4, Schedule H of this form</i>			
20 NET PAYMENT REQUESTED (Item 18 less 19)	□			

(When the space provided for any information is insufficient, continue on a separate sheet.)

What About Subcontractors?

- FAR 49.108-3 -- Settlement Procedure.
- Contractors shall settle with subcontractors in general conformity with the policies and principles relating to settlement of prime contracts in this subpart and Subparts 49.2 or 49.3.... Each settlement must be supported by accounting data and other information sufficient for adequate review by the Government.



What About Commercial Terminations?

How do FAR Part 12 and FAR Part 13 terminations differ?

- Recovery is determined by a simple, two-pronged formula consisting of “a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination, **plus reasonable charges the Contractor can demonstrate** . . . have resulted from the termination.”

Unlike FAR Part 49, neither FAR 52.212-4(l) nor FAR 12.403 expressly mentions incurred costs, continuing costs, or reasonable profit.

Who's Reading the Proposal?

Keep in mind that the proposal is actually prepared for several customers, not just one. Customers reading the proposal include:

- Procuring Contracting Officer (PCO), if the termination administration was retained by the office;
- Termination Contracting Officer (TCO) and staff, if assigned;
- Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) or customer's audit office;
- Plant Clearance Office and the local administration office, if assigned; and
- Agency's Legal team.

Remember: The readers' immediate concern is notification of all stakeholders. Followed by, when it's going to be settled and what is the final settlement price!

Prime Contractor Must:

- Stop work immediately on the terminated portion of the prime contract
- Terminate all subcontracts related to the terminated portion of the prime contract
- Immediately advise the TCO of any special circumstances precluding the stoppage of work
- Perform the continued portion of the contract and promptly submit any request for an equitable adjustment of price for the continued portion of the contract (supported by evidence of any increase in the cost) if the termination is partial

Prime Contractor Must:

- Take necessary or directed action to protect and preserve property
- Promptly notify the TCO in writing of any legal proceedings growing out of any subcontract
- Settle outstanding liabilities and proposals arising out of termination of subcontracts, obtaining any approvals or ratifications required by the TCO
- Promptly submit the contractor's own settlement proposal, supported by appropriate schedules
- Dispose of termination inventory as directed or authorized by the TCO

The Terminating Contracting Officer (TCO) Should

Promptly hold a conference with the contractor to develop a program for effecting the settlement, including:

1. General principles relating to the negotiation of any settlement proposal, including obligations of the contractor under the termination clause of the contract
2. Extent of the termination; the point at which work is stopped; and the status of any plans, drawings, and information that would have been delivered had the contract been completed
3. Status of any continuing work
4. Obligation of the contractor to terminate subcontracts and general principles to be followed in negotiating subcontractor settlement proposals

The Terminating Contracting Officer (TCO) Should

5. Names of subcontractors involved and the dates termination notices were issued to them
6. Contractor personnel handling review and settlement of subcontractor settlement proposals and the methods being used
7. Arrangements for transfer of title and delivery to the Government of any material required by the Government
8. General principles and procedures to be followed in the protection, preservation, and disposition of the contractor's and subcontractors' termination inventories, including the preparation of termination inventory schedules

The Terminating Contracting Officer (TCO) Should

9. Contractor accounting practices and preparation of SF-1439 (Schedule of Accounting Information (FAR 49.602-3))
10. The form in which to submit settlement proposals
11. Accounting review of settlement proposals
12. Any requirements for interim financing in the nature of partial payments
13. Tentative time schedule for negotiation of the settlement, including submission by the contractor and subcontractors of settlement proposals, termination inventory schedules, and accounting information schedules (see FAR 49.206-3 and 49.303-2)

The Terminating Contracting Officer (TCO) Should

14. Actions taken by the contractor to minimize impact upon employees affected adversely by the termination

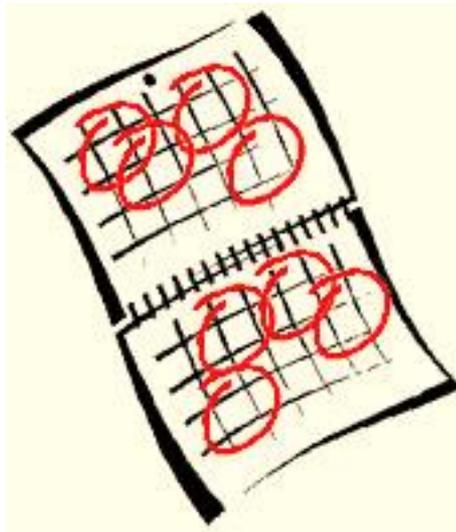
(See letter notice in FAR 49.601-2(g) – Letter Notice)

15. Obligation of the contractor to furnish accurate, complete, and current cost or pricing data, and to certify to that effect in accordance with FAR 15.403-4(a)(1) when the amount of a termination settlement agreement, or a partial termination settlement agreement plus the estimate to complete the continued portion of the contract, exceeds the threshold in FAR 15.403-4

Number of Days to Keep in Mind - Schedule

UNLESS OTHERWISE NEGOTIATED WITH THE TCO:

- Inventory disposal schedule must be completed within 120 days, unless extended in writing
- Settlement cost proposal, including subcontractor costs, must be completed within 365 days



Questions to Ponder

- In your opinion, what are the roadblocks to settling a terminated contract for convenience within six months?
- What areas do contractors struggle to provide reasonable amount of information to settle?
- In what areas can the process for terminated contracts for convenience be improved?

Classification of Cost Per FAR

31.205-42

Common Items – reasonably usable on other work, with exceptions

Costs Continuing after Termination – not negligent or willful failure to discontinue

Initial Costs – nonrecurring and starting load costs not absorbed or included as indirect costs

Loss of Useful Value – special equipment, tooling and machinery not already expensed

Rental Under Unexpired Leases – given efforts to reduce the costs

Alteration of Leased Property – alteration were necessary

Settlement Expenses – Accounting, legal and clerical costs necessary

Subcontractor Claims – allocable portion plus your applied indirect costs

Special Areas of Cost Recovery

- Unsettled Changes
 - Recognized but unnegotiated changes
 - Constructive changes
 - Undefined contractual actions
 - Pre-contract Proposal Costs
- Pre-contract Proposal Costs
 - Bid & Proposal Costs
 - Standby Time
 - Severance Pay
 - Training
 - Idle Facilities

Best Practices

Contractors should:

- Treat termination as a project
- Appoint project manager
- Establish termination charge number
 - Proper treatment of previously indirect work reclassified as direct work

Best Practices

Contractors Should:

Manage and monitor communication

- Management & Termination Team
- Termination Contracting Officer & Representatives (e.g. Plant Clearance Officer, auditor, Technical, etc.)
- Subcontractors & Suppliers
- Track communications

Best Practices

Contractors should:

Organize a termination team

- Operations
- Human Resources
- Inventory Manager
- Accounting / Program Control / Pricing
- Contracts / Subcontracts / Purchasing
- Outside expertise, Legal, CPAs, Consultants

Prepare and implement settlement plan

Track cost value and funding

Develop a settlement proposal (i.e. report)

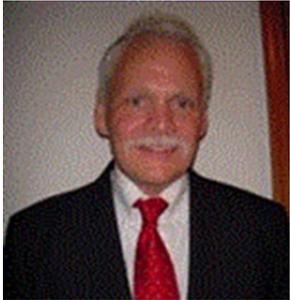


Team members
Depend upon
the size and
complexity of the
Organization
and/or
Terminated
Contract Value

QUESTIONS & COMMENTS



Thank You



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