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Client Alert

Expect Excellence

March 2013

Over-the-Cliff: Advice to Contractors Facing Sequestration

Overview

Automatic spending cuts caused by “sequestration” went into effect on March 1, 2013, after the federal Government could not avoid or further delay sequestration as Congress and the President had agreed during January of 2013. We discussed sequestration more extensively in a prior alert.

To implement the cuts, the federal Government is considering both long and short term steps, including lowering the number of new contracts awarded and eliminating or reducing spending on current government contracts.

Termination for Convenience

Cuts to existing Government contracts could take the form of a Termination for Convenience (“T4C”), an exercise of the Government’s contract right under the Federal Acquisition Regulations (“FAR”) to completely or partially terminate performance of work under a contract when it is in the Government’s interest. FAR 2.101. There is no duty for the Government to terminate for a contractor’s benefit.

T4C is included in various FAR clauses, including FAR 52.249-1 through 52.249-7. The relevant clause depends upon the type and dollar amount of the contract. The Government also could use T4C to delay or reduce the scope of current contracts. Other options are available to the Government that can result in a painful outcome for the contractor.¹ This alert focuses on the government T4C option.

Remedies for a Contractor if a T4C Occurs

Contractors facing a T4C are entitled to a monetary remedy as set out by the relevant FAR clause in your Government contract. These remedies could include:

1. The contract price for completed supplies or services accepted by the Government;

¹ For example, the Government can, depending on the circumstances: (a) Cancel solicitations; (b) Decline to exercise options; (c) Use the Limitation of Funds clause (FAR 52.232-22); (d) Place minimum orders under ID/IQ contracts; (e) Increase the use of the contract changes clause; (f) Reduce the level of work under contracts (i.e., “down-scoping”); (g) Revise the contract period of performance; (h) Issue stop work/stop shipment orders (like down-scoping); (i) Accelerate completion of performance; (j) Terminate contracts for default; and (k) Cancel multi-year contracts. See “Government Procurement in Times of Fiscal Uncertainty,” Kate M. Manuel and Erika K. Lunder, Congressional Research Service, Report No. R42469, April 6, 2012.

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SMITH ANDERSON

Client Alert

2. Reasonable costs incurred in the performance of the work terminated;
3. A fair and reasonable profit, if the contractor would not have sustained a loss over the contract's period of performance; plus
4. Reasonable costs of settlement of the work terminated, including administrative, legal, clerical and other expenses reasonably necessary.... (see FAR 52.249-2(g) & FAR 52.249-6(h)).

These recoverable costs may be limited by other restrictions. After a T4C announcement, a contractor must submit a termination settlement proposal to the contracting officer within one year. If a contractor fails to submit its settlement proposal within the required time period, the contracting officer may unilaterally determine the amount due the contractor. FAR 49.109-7.

Don't let the contracting officer make that decision without your input. The contractor has the burden of establishing its proposed settlement amount. FAR 49.109-7(c).

Subcontractors and the T4C

What about subcontractors? They are entitled to some form of settlement with their prime. FAR 49.108-1. These need to be handled expeditiously so the prime contractor can incorporate those subcontractor recovery amounts into the prime's settlement proposal. Subcontractor claims are generally allowable. FAR 31.205-42(h). Subcontractor settlement agreements will be examined to ensure they were conducted at "arm's-length" and reasonable. Moreover, it is important that prime contractors carefully consider the provisions in their subcontracts. Prime contractors should mirror or flowdown the T4C provisions to ensure that the subcontractor's recovery also is limited.

Recoverable settlement expenses can be quite high so long as they are reasonably necessary for (1) the preparation and presentation, including supporting data, of settlement claims to the contracting officer; and (2) the termination and settlement of subcontracts. They could include indirect costs related to salary and wages incurred as settlement expenses related to (1) and (2) above, such as payroll taxes, fringe benefits, occupancy costs and immediate supervision costs. FAR 31.205-42(g).

What if T4C Might Happen

What can the contractor do if it believes a T4C might occur?

First, contractors should avoid having an attractive contract to cancel. If you are performing poorly, improve your performance. Termination for default can negate any recovery through an equitable adjustment.

Second, document all actions and related costs associated with responding to the T4C. Keep detailed records of all costs associated with T4C from notice forward, including all costs associated with settling the claim with the Government, including legal fees.

SMITH ANDERSON

Client Alert

Third, review your contract to understand what your rights are in the event of a T4C.

Fourth, anticipate tight timelines to respond to adverse actions related to your contract.

Fifth, check with your experts on what costs are eligible for reimbursement.

Sixth, be diligent in resolving subcontractor claims to ensure they are reasonable and all associated costs are identified.

Finally, be mindful of the False Claims Act in your submissions to the Government. Outside auditors may be a good backstop to verify the accuracy of your claims.

What if the Government denies your termination settlement proposal? Once a contracting officer renders a final decision, and the parties are at an impasse, the proposal becomes a claim under the Contract Disputes Act.

Suspension of Work

The government can suspend, interrupt, or delay work for the convenience of the government as well. This may create a compensable claim. FAR 52.242-14. A contractor may be entitled to delay costs and/or performance period extension, although profit is not recoverable. FAR 52.242-14(b)(2). Note that a contractor may not recover delay costs for more than 20 days unless the contractor notifies the Government of the delay.

Changes to a contract issued by the contracting officer in writing may trigger a contractor's right to an equitable adjustment. FAR 43.204 and FAR 52.243-1 through FAR 52.243-7. Generally, a contractor must assert its rights to an adjustment within 30 days after receipt of a written change order or notice.

Final Thoughts

The foregoing rules can vary depending on the type of contract, and this alert does not attempt to address every contingency. Remember that timelines can be critical to identifying what costs are recoverable. The burden of proof is generally on the contractor in these situations. Finally, there are many other Government contractors facing the same challenges; prepare to experience delays while you stand in line to interact with your contracting officer.

Remember the Boy Scout Motto: Be Prepared! Preparing with Government contracting specialists early, rather than later, can provide a greater chance of success when dealing with the Government.