

16. EQUITABLE ADJUSTMENTS

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16.1 OVERVIEW OF EQUITABLE ADJUSTMENTS

In Government contracts, the Government has the right to change the terms of the contract unilaterally. When these changes impact the cost of performing the contract or its schedule, an equitable adjustment may be used to ensure fair treatment to both parties, the contractor and the FAA. The adjustment is not limited to cost, but can be a schedule change. The underlying legal concept focuses on the contractor being made “whole”. The Government is also kept “whole” if the changes result in less cost or if the contractor can deliver earlier.

A contractor seeks an adjustment by filing a Request for Equitable Adjustment (REA) proposal. REAs can be filed before or after the contract modification occurs and can originate from the contractor or the Government. REAs filed before contract modification or before the modified work has been completed are often called Engineering Change Proposals (ECPs) or Value Change Proposals (VCPs), if under a cost-sharing arrangement, and can be negotiated the same as any other proposal. REAs filed after the completion of modified work or arising from circumstances other than a contract change are claims.

A **claim** is a written demand or assertion by one of the contracting parties seeking the payment of money, the adjustment or interpretation of contract terms, or other relief arising under or relating to the contract. A claim is normally resolved under the contract clause that provides for relief. If not in dispute when submitted, a voucher, invoice, or other routine request for payment is not a claim.

As stated above, a request or claim for equitable adjustment may encompass more than just a change in cost. Since this is a pricing analysis handbook, this chapter will focus on equitable adjustments that have a pricing impact.

16.1.1 Contract Clauses Providing for Equitable Adjustments

Contract clauses provide for equitable adjustments. The contracting officer, guided by the Federal Aviation Administration Acquisition Management System (FAA AMS), chooses which clauses to include in the contract when it is awarded. Before evaluating an equitable adjustment, the analyst should review the contract clauses included in the specific contract involved. The clause may or may not include information pertaining to which costs are allowable in an equitable adjustment.

Changes

Most equitable adjustments are the result of the contract Changes Clause. In accordance with the clause, the contractor is entitled to a price adjustment if: 1.) the contracting officer changes any aspect of the general scope of the

contract, and 2.) the change affects the cost of performing the work. There is a series of Changes Clauses (FAA AMS Clause 3.10.1.12-16) from which the contracting officer can choose based on the contract type (fixed-price, cost reimbursable, time and materials etc.) and the type of work being performed (construction, services etc.). The various Changes Clauses have relatively the same purpose and use.

A Changes Clause serves four purposes:

1. To provide flexibility for the Government to order unilateral changes, to use technological advances, and to incorporate changes in Government requirements.
2. To provide a means for the contractor to propose changes that will improve efficiency and quality. These proposals are usually referred to as Engineering Change Proposals or Value Engineering Change Proposals (VECPs).
3. To provide the contracting officer authority to add or subtract work within the general scope of the contract or to accelerate or decelerate the contract schedule without going through the process of a new procurement or using new funds.
4. To provide a legal means by which the contractor can process claims through the administrative dispute process.

The Changes Clause does not incorporate every change to the contract. Changes are limited to those which are within the general scope of the contract and the types of changes described by the clause. A change falls under the general scope of the contract if total work performed is essentially the same work or end product as called for in the original contract.

Termination

Under a termination, the contract is partially or completely terminated either for the convenience of the Government or for default by the contractor. When a contract is partially terminated, the contractor may request an equitable adjustment on the continuing portion of the contract. The contractor's claim for costs associated with the terminated portion of the contract are addressed in Chapter 17, "Termination."

Delay and Suspension of Work

The Suspension of Work, Government Delay of Work, and Stop Work Order Clauses govern claims for equitable adjustment resulting from delay and suspension of work. These clauses cover both compensable and noncompensable delays.

Compensable delays are delays for which the contractor can file a claim for payment of expenses caused by the delays. Compensable delays are Government ordered or caused delays. Included in compensable delays are delays antecedent to a change order

Loss of efficiency refers to the contractor's need to increase input to achieve the proper amount of output, when the increase is attributable to the delay or suspension of work or a change in schedule.

whose costs are not recoverable under the Changes Clause. Recoverable costs include idle manpower and equipment, material and labor escalation, **loss of efficiency** or productivity, and unabsorbed overhead.

Noncompensable delays are delays for which no price adjustment is made. The most common noncompensable delays are excusable delays. Excusable delays are due to causes beyond the contractor's control and with no fault or negligence by the contractor. Excusable delays usually result in a schedule change with no cost impact to the Government.

Differing Site Conditions

Construction contracts include a Differing Site Conditions Clause. This clause allows the contractor to request an equitable adjustment when the conditions at the construction site differ from what was previously known. The clause specifically covers: 1.) subsurface or latent physical conditions at the site differing materially from those represented in the contract, or 2.) unknown physical conditions at the site, of an unusual nature, differing materially from those originally encountered.

16.1.2 Equitable Adjustments Not Specifically Covered by Contract Clauses

Breach of Contract

Breach of contract occurs when a party unjustifiably fails to perform in accordance with its contractual obligations. Breach of contract settlements are similar to equitable adjustments, except that cost principles do not apply. These claims are often resolved through the jury verdict method, which is discussed in a later section.

Constructive Changes

The Changes Clause asserts that a "written order" must be given to the contractor stating the change, but this requirement is not always met. Lack of a written order does not preclude recovery of costs. A constructive change occurs when: 1.) the contractor performs work beyond that required by the contract without a formal change order, and 2.) it is perceived that the work originated from a Government informal order or is due to Government fault. A Government informal order can be defined as words or deeds excluding advice, comments, suggestions, or opinions. There are four general categories

of constructive changes:

1. Disagreement over contract requirements.
2. Failure of the Government to cooperate during contract performance.
3. Defective specifications and misleading information.
4. Acceleration of contract performance to finish sooner than what is stated in the contract schedule.

Implied-In-Fact (Quantum Meruit)

The translation of Quantum Meruit is “as much as he deserves”. It is the doctrine under which recovery can be made when Quasi or Implied contracts exist. This form of recovery is designed to avoid unjust enrichment of one party. When the contractor performs an effort that benefits the Government, this implies a Government obligation to pay for the benefits. Quantum Meruit also covers partial performance under an unenforceable contract. Basically, the Government should pay for any benefits received at someone else’s expense.

The measure used to settle Quantum Meruit claims is often value, not cost. In such an instance, the fair market value of the benefits received by the Government would be reasonable.

16.2 CONTRACT DISPUTES UNDER THE FAA CONTRACT DISPUTES CLAUSE

The FAA, as a result of the 1996 *Transportation Appropriations Act (Public Law 104-50)*, is no longer subject to the Federal Acquisition Regulations (FAR) and Subchapter V of Chapter 35 of Title 31, relating to the procurement protest system. Included in this is the *Contract Disputes Act*. The FAA has written a specific contract clause (FAA AMS Clause 3.9.1) that covers contract disputes and the FAA Dispute Resolution System.

Due to the above changes, some of the methods previously used for settling claims may or may not remain applicable to the FAA. However, many issues have legal precedence, and decisions are often based on these. Whenever possible, this chapter refers to court and board of appeals decisions instead of regulations to make the analyst aware of any legal precedence.

In addition to explaining the FAA Dispute Resolution System, the FAA Contract Disputes Clause (FAA AMS Clause 3.9.1) also provides for the payment of interest on contract disputes. Interest is not usually an allowable cost in government contracting. An exception is when the Government does not comply with the *Prompt Payment Act* when paying vouchers. Another exception is under the FAA Contract Disputes Clause. Interest is allowable

and accrues from the time the contracting officer receives the claim or from the time payment is due, whichever is later, until the claim is paid. The clause provides for simple interest based on the current rate as set by the Secretary of the Treasury for each six-month period. This interest should be included in an equitable adjustment that results from a contract disputes claim.

16.3 QUANTIFYING AN EQUITABLE ADJUSTMENT

The basis by which the cost impact of an equitable adjustment is quantified varies based on whether the circumstances leading to the equitable adjustment resulted in the addition or deletion of work, from the contractor's viewpoint.

16.3.1 Additional Work

When work is added, it is quantified using 1.) actual costs, 2.) a cost proposal submitted prior to performance of the extra work, or 3.) some measure of the difference between actual costs and those originally bid. An equitable adjustment for additional work can be submitted prospectively or retroactively.

Prospective Pricing

Prospective pricing is when an equitable adjustment is priced before performance of the additional work. The adjustment is based on the estimated cost submitted by the contractor and is subject to analysis and negotiation similar to that performed for any proposal.

Retroactive Pricing

Retroactive pricing is when an equitable adjustment is priced after performance of the additional work. Additional work that is retroactively priced is based on the actual costs incurred.

16.3.2 Deleted Work

When work is deleted, the FAA should receive a credit against the contract for the amount the deleted work would have cost the contractor had the work not been deleted.

Courts have granted an exception when: 1.) the change is a complete deletion of a **firm fixed-price item**, 2.) there are ambiguous specifications, 3.) there are special contract provisions or agreements, and 4.) the change is the deletion of minor items.

Firm fixed-price items are items that are not dependent on any other item in the contract and whose costs cannot be segregated. Whether an item is firm fixed-price depends on contract provisions and is not the same as separate unit prices.

16.4 ALLOWANCE OF COSTS IN EQUITABLE ADJUSTMENTS

The FAA Contract Cost Principles and CAS are applicable to equitable adjustments in determining what costs are allowable. Another source to consult when determining the allowable amount is FAA “Not To Exceed” (NTE) orders. The FAA sometimes issues an NTE amount with a change order. If the contractor accepts this amount, costs in excess of the amount are not allowable in an equitable adjustment. If the contractor takes exception to the NTE amount, the contractor can request an equitable adjustment or file a claim for expenses greater than the NTE.

In general, costs are allowable if they are:

- Reasonable;
- Allocable;
- In accordance with CAS, if applicable (see Chapter 14, “Cost Accounting Standards”); otherwise GAAP and practices appropriate to the particular circumstances;
- Compliant with the terms of the contract; and
- In accordance with the FAA’s Contract Cost Principles (see Chapter 13, “Cost Principles”).

16.4.1 Reasonableness of Actual Costs

Actual costs are an amount determined on the basis of cost incurred as distinguished from forecasted cost. In the past, actual costs have been presumed **reasonable** because they

meet the requirement for accurate, complete, and current cost data. More recently, this presumption of reasonableness has been abandoned.

A cost is **reasonable** if in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

The contractor has the burden of proving that actual costs are reasonable. The contractor has discretion in incurring costs, but there are limits to this discretion. If contracting officer approval is required, costs are only reasonable if approval was obtained prior to incurrence of the costs. For purposes of evaluating actual costs, the analyst may be able to review the cost accounting books and records of the contractor. Reviewing these records is contingent on their availability per contract clauses or a contracting officer’s request for such information. Costs are unreasonable if the contractor exhibited poor business judgment or incurred unnecessarily expensive costs in light of the facts and circumstances. Costs are also unreasonable if the Government’s interest was disregarded.

16.4.2 REA Preparation/Presentation Costs Versus Claim Preparation

The cost of preparation and presentation of claims against the United States Government is not allowable in an equitable adjustment or damages award. The basis for this comes from two sources: the FAA's Contract Cost Principles and legal precedence in court cases.

An exception to this unallowability occurs under the *Equal Access to Justice Act of 1985*. This Act entitles attorney's fees to certain prevailing litigants in administrative proceedings and civil cases in federal court in which the Federal Government is a party and where the Government's position was not substantially justified. In addition to attorney's fees, the Act also allows for the recovery of costs of expert witnesses, studies, analyses, engineering reports, and lists or other projects which are necessary for the preparation of the case. This Act has been extended to claims settled by the Boards of Contract Appeals but not to claims settled by the FAA or through alternative dispute resolution. Using precedence, the Claims Court deems REA proposal costs recoverable for directed changes and constructive changes. Generally, costs prior to the issue becoming a dispute are allowable.

16.5 INDIRECT COSTS IN EQUITABLE ADJUSTMENTS

Indirect costs and/or profit are added to a contract adjustment under the title "mark-up". The mark-up amount is added after all other costs are included. Some issues have been raised regarding the application of indirect costs to an equitable adjustment that separate them from ordinary indirect costs. These issues are discussed below.

16.5.1 Overhead and General and Administrative (G&A) Expense

Except for unabsorbed overhead, the evaluation of overhead and G&A expense for an equitable adjustment is basically the same as it is for any proposal. Overhead and G&A analysis is discussed in Chapter 10, "Indirect Costs".

Equitable adjustments, though, raise an important issue. Fixed costs in overhead do not change when volume changes. This has caused a continuous debate concerning whether overhead should be included in an equitable adjustment. If overhead is included, should the overhead rate in the original bid be used or should an adjusted overhead rate be included? Court decisions are inconclusive. A solution to the problem may be the calculation of a new indirect rate when there is a major change and the use of the original rate when the change is minor.

16.5.2 Unabsorbed Overhead

Unabsorbed overhead represents overhead costs which, although allocable to a particular contract or project, cannot be charged to that contract because it has been delayed, suspended, or terminated.

Unabsorbed overhead is fixed manufacturing overhead and G&A costs which continue to be incurred during a period of shutdown or idling of factory or facilities.

Unabsorbed overhead is a real cost to the contractor; for every dollar that is not recovered the contractor’s profit is reduced by one dollar.

More specifically, unabsorbed overhead is the fixed overhead costs (e.g., facilities cost) that continue to be incurred at the usual rate when there is a less than usual direct cost base over which to allocate the fixed overhead costs. The FAA should compensate the contractor when the less than usual direct cost base results from FAA caused work stoppages, idle facilities, inability to use available manpower, etc.

Methods of calculating unabsorbed overhead have been defined in various court cases. The most well known formula is the Eichleay Formula.

The Eichleay Formula

The Eichleay Formula was named for the decision in which it was adopted (Eichleay Corp., *Armed Services Board of Contract Appeals* 5183, 60-2 BCA ¶2,688, *mot. for reconsid. denied*, 61-1 BCA ¶2,894 (1960)). Use of the Eichleay formula is limited to Government caused delays, disruptions, and suspensions of work. The formula is a three step process as follows.

- **Step 1: Calculate the amount of overhead allocable to the contract.**

$$\frac{\text{Direct contract billings}}{\text{Total billings for contract period}} \times \text{Total overhead for contract period} = \text{Allocable Overhead}$$

In the above equation, direct contract billings are the dollar value of all direct costs billed against the contract for which an equitable adjustment is requested. Total billings for the contract period are the total dollar value of all billings for all work performed by the contractor (not just the work for the specific contract in question) during the contract period of the specific contract in question.

- **Step 2: Use the amount of overhead allocable to the contract to calculate a daily overhead amount.**

$$\frac{\text{Allocable overhead}}{\text{Actual days of contract performance}} = \text{Daily overhead}$$

- **Step 3: Use the daily overhead amount to calculate unabsorbed overhead**

$$\text{Daily overhead} \times \text{Number of days of delay} = \text{Unabsorbed overhead}$$

Variations

A modified version of the Eichley formula was used in *Schindler Haughton Elevator Corp., GSBCA 5390, 80-2 BCA ¶ 14,671 (1971)*. In the following set of equations, the term original is used to denote the period of performance and price as contained in the contract, which may differ from the actual performance period or cost. This is what distinguishes this equation from the Eichley formula that uses actual contract billings and the actual performance period.

- **Step 1: Calculate the amount of original overhead allocable to the contract.**

$$\frac{\text{Original contract price}}{\text{Total billings for original contract period}} \times \frac{\text{Total overhead for original contract period}}{\text{original contract period}} = \text{Original allocable overhead}$$

- **Step 2: Use the amount of original overhead allocable to the contract to calculate a daily overhead amount.**

$$\frac{\text{Original allocable overhead}}{\text{Original days of contract performance}} = \text{Daily overhead}$$

- **Step 3: Use the daily overhead amount to calculate unabsorbed overhead.**

$$\text{Daily overhead} \times \text{Number of days of delay} = \text{Unabsorbed overhead}$$

Another variation was used in *Carteret Work Uniforms, ASBCS 1647, 6 CCF 61,561 (1954)*. This is a two step calculation that uses the overhead rate incurred during the delay period. This equation is applicable when the delayed contract comprises the only work in progress when the delay occurred.

- **Step 1: Calculate the excess overhead rate caused by the delay.**

$$\text{Actual overhead rate during the delay} - \text{Normal billable overhead rate} = \text{Excess overhead rate}$$

- **Step 2: Use the excess overhead rate to calculate unabsorbed overhead.**

$$\text{Excess overhead rate} \times \text{Total original base costs} = \text{Unabsorbed overhead}$$

16.5.3 Profit/Fee

The reason for adding profit to some equitable adjustments was stated in *New York Shipbuilding Co., ASBCA 16164, 76-2 BCA ¶ 11,979 (1976) @ 57,427*. The board stated, "Without the payment of a profit which is fair under the circumstances, the Government would be getting something for nothing and the contractor would not truly be made whole." The concept of allowing or not allowing profit fits with the reason for an equitable adjustment. The adjustment should put the contractor into a profit or loss position equal to that which would have been, had the change, delay, or disruption not occurred.

Whether profit is allowable as part of an equitable adjustment depends on the contract clauses involved and the type of claim.

If profit is applied to the adjustment, the amount of profit should reflect the nature of the work and the risk involved (see Chapter 12, "Profit/Fee"). With small changes, often the same profit percentage as originally negotiated is used in the equitable adjustment. Some contract clauses limit the profit percentage. If the changed work has a higher degree of risk than the original contract work, the adjustment may receive a higher profit percentage than was included in the original contract. A lower degree of risk may receive a lower profit percentage.

16.6 METHODS OF EVALUATING EQUITABLE ADJUSTMENTS

The amount awarded as an equitable adjustment should be the difference between what the work did or will actually cost and what the work would have cost had the change or reason for dispute not occurred. Because accounting records and estimates are not perfect, this can be quite difficult. The amount can be evaluated using comprehensive cost and technical analysis, the total cost method, or the jury verdict method.

16.6.1 Comprehensive Cost and Technical Analysis

Comprehensive cost and technical analysis works best when costs associated with the equitable adjustment are segregated from costs that fall under the unmodified contract. The segregation allows for technical analysis to determine which costs are consistent with the alleged cause of the costs. It is not always possible for the contractor to segregate costs especially when there is a large number of changes.

Using cost and technical analysis, either the contractor or Government may

estimate the cost impact. Acceptance of an estimate hinges on who is making the estimate; the basis of the estimate; how detailed the back-up data are; and specific factual performance data. Estimates may be subjective or objective.

Subjective

Subjective estimates are often questioned as to their validity. Vague evidence, uncorroborated estimates, unpersuasive affidavits, ball park estimates, and unaudited negotiating figures will often be disregarded in favor of more objective, factual information. The probability an estimate being accepted by the Government increases as the amount of factual information supporting the estimate increases.

Objective

An objective approach to determining the amount of equitable adjustment is more defensible. Actual data, expert testimony, and statistical techniques are important in supporting an estimate. Expert testimony can be used to assert the relationship of actuals and estimating data to the situation or the validity of statistical techniques and estimating methodology. The expert is not usually an employee of the Government or contractor unless the expert is someone with many years of experience. The expert should be chosen according to his/her experience in the field and should be someone who can be objective about the situation.

Another way of showing objectivity is to use statistical techniques such as a learning curve. For statistical techniques to be seen as valid, they must be applicable to the current situation, consistently applied, and part of the original claim. Statistical techniques are most effective when they are used with actuals and expert testimony.

16.6.2 Total Cost Method

The total cost method is used when the causal relationship (the relationship between changes and associated costs) is not discrete enough to identify specific costs. The basic formula is as follows:

$(\text{Cost of changed work} - \text{Cost of work in original bid}) + \text{Profit} = \text{Equitable adjustment}$

The above equation finds the delta cost between the changed work and the work on the contract and then adds a profit to this delta. The equation relies upon two major assumptions: 1.) all costs expended were for the original work plus this change and 2.) the original price was reasonable. The second assumption is quite important. If a change order occurs and the total cost method is used, a contractor could use this to recover from an understated original bid or a “buy-in”. Usually a total cost claim occurs after the work

has been completed. At this point, the contractor may recognize that he is in a loss situation and may attribute the loss to a change.

Since the total cost method is often inaccurate, the courts reject the total cost method if another method is possible. The court might not reject the total cost method if the contractor can convince the court that this is the best way to estimate all the costs for which the Government is responsible.

Court rulings have been interpreted to mean that the total cost method can only be used when:

GUIDELINES FOR THE TOTAL COST METHOD (Federal Court):

WRB Corp. v. United States, 183 Ct. 409 (1968) set four safeguards for using the total cost method: "The acceptability of the method hinges on proof that..."

- 1.) The nature of the particular losses makes it impossible or highly impracticable to determine them with a reasonable degree of accuracy;
- 2.) The plaintiff's bid or estimate was realistic;
- 3.) Its actual costs were reasonable; and
- 4.) It was not responsible for the added expenses."

- Other methods of estimating the cost are impossible or impracticable due to the nature of the costs, not due to the contractor's inaccurate accounting system;
- There is a realistic bid price which can be supported using expert testimony, comparison to other work, and comparison to an Independent Cost Estimate (ICE), or there is an estimate of what the contractor should have bid or what the work would have cost using updated information;
- The actual costs are reasonable, which is presumed; and
- The contractor is not responsible for any cost increase.

Analyzing a Total Cost Claim

Before calculating whether a Total Cost claim is accurate, the analyst should review the circumstances to see if a total cost claim is appropriate. The answer to all the following questions should be "yes".

- Did the Government cause the problems?
- Was the original bid reasonable?
- Were the actual (incurred) costs reasonable?
- Did the contractor keep adequate records?
- Did the contractor prove impacts?

As a further check, the analyst should evaluate the appropriateness of claimed interest, mark-ups (overhead, G&A, profit, etc.), improper changes, and other costs.

For estimating the amount of an equitable adjustment under the Total Cost method, an actual loss ceiling should be calculated. An actual loss ceiling is the difference between actual direct costs and the bid estimate. This amount is considered to be equitable. The ceiling takes into consideration cost differences that may be due to something other than the contract dispute and any previous adjustments received by the contractor. Worksheet 16-1 shows a sample calculation of a ceiling.

Worksheet 16-1. Calculating An Actual Loss Ceiling

Cost Element	Example Amount	
Total Contractor Cost (Actual paid-out direct cost)		\$33,500,000
Less Disallowed Cost (Net value of all variances from the contract not included in the claim)	(\$500,000)	
Adjusted Total Cost (Also called Restated Damages Amount)		<u>\$33,000,000</u>
Less Total Contract Value	(\$19,500,000)	
Actual Loss		<u>\$13,500,000</u>
Fair Markup or Total Cost × Bid % Markup (Indirect costs)	(\$1,350,000)	
Amount to Makeup Contractor Loss		<u>\$14,850,000</u>
Less any interim adjustments	(\$250,000)	
Adjusted Ceiling Amount		<u>\$14,600,000</u>

When the contractor's claim is for an amount greater than the adjusted ceiling, the contractor is said to be requesting excessive enrichment. Excessive enrichment occurs when the equitable adjustment awards the contractor above the expected return based on the original agreement terms. The contractor would be in a better profit position than if the change had not occurred.

16.6.3 Jury Verdict Method

Under the jury verdict method, the court or an impartial party decides the amount of adjustment based on conflicting and/or incomplete evidence when exact calculation of the adjustment amount cannot be made. The jury verdict method is also used when it is clear that costs were incurred but the amount of increase is not clear. Use of the jury verdict method requires that there is some means by which to estimate the equitable adjustment amount. Another use of the jury verdict method is to reduce the amount of the claim when causation is not fully supported.

The outcome of a claim settled by Jury Verdict is at the discretion of the court or an impartial party. Most of the time, the court or impartial party uses one

of the calculation methods used by either the contractor or the Government, whichever is more accurate and has more factual support. On occasion, the court or impartial party throws out both methods for calculating the adjustment and derives its calculation based on the evidence presented.

16.7 SUMMARY

Equitable adjustments are required any time a contract modification or a claim has a cost or schedule impact. The types of costs the contractor can recover depend on the specific contract clauses involved and the contractor's ability to prove that an actual cost impact was realized. The amount of equitable adjustment is dependent on the ability to measure the costs involved. The amount can be determined through a comprehensive cost and technical analysis, the total cost method, or the jury verdict method.

