

17. TERMINATION

Table of Contents

17.1 OVERVIEW.....	17-2
17.2 GENERAL PRINCIPLES.....	17-2
17.2.1 Termination for Convenience of the FAA.....	17-3
17.2.2 Partial Terminations.....	17-5
17.2.3 Termination for Default by the Contractor.....	17-6
17.3 TERMINATION COSTS.....	17-6
17.3.1 Common Items.....	17-7
17.3.2 Costs Continuing After Termination.....	17-7
17.3.3 Initial Costs.....	17-7
17.3.4 Loss of Useful Value.....	17-7
17.3.5 Rental Under Unexpired Leases.....	17-8
17.3.6 Alterations of Leased Property.....	17-8
17.3.7 Settlement Expenses.....	17-8
17.3.8 Subcontractor Claims.....	17-9
17.3.9 Profit/Fee Adjustment/Loss.....	17-9
17.3.10 Termination Cost Limit.....	17-11
17.3.11 Inventory.....	17-12
17.4 SUMMARY.....	17-13

17.1 OVERVIEW

This chapter addresses the terms, concepts, and issues involved in the termination of Government contracts. Emphasis is placed on termination proposal costs and issues which might arise during terminations for convenience or default. Section 17.2 will discuss general principles of termination and section 17.3 will discuss termination costs and associated issues.

17.2 GENERAL PRINCIPLES

Termination clauses within a contract give the contracting officer authority to terminate a contract for convenience or for default and to enter into settlement agreements with the contractor (FAA AMS Toolbox Guidance T3.10.6). The contracting officer (CO) initiates the termination process by sending a written notice, via certified mail, to the contractor. This written notice of termination states the effective date of termination, extent of termination, type of termination (convenience or default) and additional actions required. Generally, once a contract or portion thereof has been terminated, the contractor must stop all work, terminate subcontracts, if applicable, perform on the continued portion of the contract, dispose of termination inventory, and prepare a settlement proposal. The contracting officer must work with the contractor to dispose of inventory and to negotiate the settlement proposal. In each of the following subsections general considerations for termination for convenience, partial terminations, and termination for default will be addressed. Common terms are defined in Table 17-1.

A termination for convenience may be settled in the following manner:

- Negotiated agreement
- CO determination
- Costing out
- Combination of the above

Term	Definition
Continued Portion of the Contract	The portion of the partially terminated contract that the contractor must continue to perform. [par. b]
Effective Date of Termination	The date on which the notice of termination requires the contractor to stop performance under the contract. [par. c]
Other Work	Any current or scheduled work of the contractor, whether Government or commercial, other than work related to the terminated contract. [par. d]
Settlement Agreement	A written agreement in the form of an amendment to a contract settling all or a severable portion of a settlement proposal. [par. f]
Settlement Proposal	A proposal for effecting settlement of a contract terminated in whole or in part, submitted by a contractor or subcontractor in the form, and supported by the data, detailed in FAA AMS Toolbox Guidance T3.10.6. [par. g]
Termination Inventory	Any property purchased, supplied, manufactured, furnished, or otherwise acquired for the performance of a contract subsequently terminated and properly allocable to the terminated portion of the contract. It includes FAA-furnished property. It does not include any facilities, material, special test equipment, or special tooling that are subject to a separate contract or to a special contract requirement governing their use or disposition. [par. j]
Terminated Portion of the Contract	That portion of the contract that is terminated by the notice of termination. [par. e]
Unsettled Contract Change	A contract change that is not settled by the notice of termination. [par. h]

A termination for convenience of the FAA is, as the term implies, at the unilateral discretion of the FAA--through no fault of either party. The contracting officer may terminate any contract for convenience when it is in the FAA's interest. In contrast with cancellation, termination can be effected at any time during the life of the contract and can be either partial or complete. The right of the Government to terminate contracts for convenience is an important factor in maximizing flexibility in procurement and use of procurement funds.

Fixed-Price Contracts

If a fixed-price contract is terminated for convenience, one of two methods of submitting settlement proposals are utilized: inventory basis or total cost method.

Inventory Basis

The inventory basis for submitting settlement proposals (presented on Standard Form 1435 (SF 1435)) is the method preferred by the Government because it requires the contractor to associate the costs and profit in the settlement proposal directly with units or services terminated. The contractor may claim only costs chargeable or allocable to the terminated portion of the contract. It limits the claim to residual items resulting from the termination, i.e., items that have been completed and delivered to the Government are not considered in the termination. Value is not the only interest in termination inventory, but also whether all inventory items are properly identified and made available to the Government.

Total Cost Method

In contrast, a claim based on a total cost method (presented on SF 1436) is for all costs incurred under the entire contract up to termination. This includes labor, material, indirect costs, settlement expenses, and profit, less the contract price of delivered items. When use of the inventory basis is not practical or will delay settlement, the total cost basis may be used if approved in advance by the CO. It is important to note that the contractor does not select the method for submission of a settlement proposal. That determination is made by the CO. In theory, a settlement proposal submitted on the inventory basis or the total cost method should result in the same settlement amount.

Cost-Type

A cost-type contract can be settled by the contractor either by preparing a termination proposal for settlement by negotiation or simply continuing to bill costs, including settlement expenses, on public vouchers. This simplified termination treatment is known as **vouchering out** costs. Vouchering out is available to the contractor for a period of six months after the effective date of the termination. SF 1437 must be used if the contractor has not vouchered out all costs in six months. The final settlement proposal is due no later than one year after the date of termination.

No-Cost Settlements

A contractor can agree to a no-cost settlement when: 1.) little or no cost has been incurred for the terminated part of the contract, 2.) the contractor is willing to waive recovery, 3.) no Government property was furnished, and

4.) no amounts are due to the Government under the contract. Such might be the case if the contractor has purchased inventory for the contract and wants to retain it.

17.2.2 Partial Termination

When the Government decides there is still a need for part, but not all of a contract, the contract can be **partially terminated** if the terminated portion of the contract is clearly severable from the continuing portion. In a

Partial Termination means the termination of a part, but not all of the work that has not been completed and accepted under a contract.

[FAA AMS Toolbox Guidance T3.10.6, Section A-4, par. e]

partial termination, the contractor may request an equitable adjustment to the price of the items remaining on the continuing portion of the contract. The contractor must submit its request to the CO before the terminated portion of the contract is settled. Not all requests for equitable adjustment of the price will be honored. The increase in price for the remaining portion of the contract must be directly related to the effects of partial termination.

Examples that can increase the unit costs of remaining items and would normally be acceptable for an equitable adjustment include:

- Loss of volume discounts,
- Increase in overhead rates applicable to non-terminated units, and
- Unabsorbed setup or starting load costs.

A decrease in quantity on the contract will reduce the direct labor base used for distributing overhead costs; therefore, the overhead rate will increase, assuming no other changes unrelated to the terminated effort occur in the indirect pools or bases. The allowable portion of this increase is limited to the impact on the continued portion of the terminated contract.

The impact on all other work of the contract is not recognized in an equitable adjustment. Neither the overhead costs that would have been absorbed by the terminated units nor the anticipatory profits can be recognized.

When an equitable adjustment is appropriate, the CO can either negotiate before the termination is settled or negotiate the Request for Equitable Adjustment (REA) along with the termination settlement proposal. In either case, the important thing is to ensure there is no duplication of cost recovery in the equitable adjustment and termination settlement.

The distinction between partial and complete terminations is strictly in what remains to be produced on the contract. If the disposition of termination inventory is the only delivery to be made after the termination, it is a complete termination; otherwise, it is partial.

17.2.3 Termination for Default by the Contractor

Termination for default is essentially a remedy for a breach of contract by the contractor. If the contractor is not meeting its contractual obligations (for example, not meeting contract specifications or not delivering on time), the Government can exercise its rights under the contract and terminate for default.

"Termination for default is generally the exercise of the FAA's contractual right to completely or partially terminate a contract by reason of the contractor's actual or anticipated failure to perform its contractual obligations." [FAA AMS Toolbox Guidance T3.10.6, Section A-3, par. a(1)]"

Clauses 3.10.6-4 through 6 covering Termination for Default (Fixed Price) provide the FAA the right to terminate all or any part of a contract when the contractor:

- a) fails to make delivery of the supplies or perform the services according to the contract schedule,*
- b) fails to complete any material requirement of the contract within the time specific in the contract or,*
- c) fails to make progress to a degree that this failure endangers performance of the contract or,*
- d) fails to perform any other contract provision, or*
- e) fails to meet contractual obligations.*

[FAA AMS Toolbox Guidance T3.10.6, Section A-3, par. b(1)]"

Under a termination for default, the Government is not liable for any contractor costs on undelivered work and is entitled to the repayment of advance and progress payments applicable to that work. The CO may direct the contractor to transfer title and deliver to the FAA completed supplies and manufacturing materials.

17.3 TERMINATION COSTS

FAA AMS Toolbox Guidance T3.3.2, (Section A-6, paragraph gg), lists areas of cost associated with

Settlement expenses are costs reasonably necessary for the preparation and presentation of settlement claims.

a termination. In the following sections, termination costs and issues are discussed. Included in the discussion of termination costs are **settlement expenses**. Unlike termination costs, settlement expenses are not fee bearing and generally require detailed analysis to verify that settlement costs are not included in termination expenses and are therefore subject to fee/profit.

17.3.1 Common Items

Common items are items that can be used by the contractor on contracts other than the one being terminated. These costs are generally unallowable, unless the contractor submits evidence that the items could not be retained at cost without sustaining a loss.

17.3.2 Costs Continuing After Termination

Costs continuing after termination are generally unallowable, unless the contractor can show that they could not be terminated despite reasonable efforts. Generally the contractor should make the CO aware of any issues as soon as possible. In some cases it might be to the Government's benefit to continue work. For example, it may be in the Government's best interest to authorize the contractor to continue working on a product which is near final completion but worth only scrap value in its current state.

17.3.3 Initial Costs

Initial costs, including starting loads and preparatory costs, are allowable as follows: [FAA AMS T3.3.2 (Contract Cost Principles), Section A-6, par. gg(3)].

1. Starting load costs incurred in the early part of production which are not fully absorbed because of termination.
2. Preparatory costs incurred in preparing to perform the terminated contract.
3. Initial costs that are either charged direct or indirect.
4. If initial costs are claimed and have not been segregated on the contractor's books, they shall be segregated for settlement purposes from cost reports and schedules reflecting that high unit cost incurred during the early stages of the contract.
5. If the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end-items called for by the contract immediately before termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used such as machine hours or labor hours.

17.3.4 Loss of Useful Value

Loss of useful value is a term used to describe special tooling and machinery that were bought specifically for use on the terminated contract and cannot be put to use on other contracts. This area can have many facets and can be complicated if the equipment has been used on various contracts. In general loss of useful value is allowable provided: [FAA AMS T3.3.2 (Contract Cost Principles), Section A-6, par. gg(4)].

1. The item is not reasonably capable of use in the other work of the contractor;
2. The FAA's interest is protected by transfer of title or by other means deemed appropriate by the contracting officer; and
3. The loss of useful value for any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the item was acquired.

Issues which must be resolved before this can be settled are:

1. Whether the item(s) were bought specifically for the terminated contract;
2. Whether they were charged direct to the contract;
3. What the intended usage was for the equipment; and
4. If the equipment actually lost value (i.e., it cannot be used on other contracts).

17.3.5 Rental Under Unexpired Leases

Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when shown to have been reasonably necessary for the performance of the terminated contract. The key issue is whether the contractor has made all reasonable efforts to terminate the lease or use the lease for other purposes to reduce the cost to the Government. If the contractor is unsuccessful at terminating the lease or subleasing, the Government may allow costs for a reasonable period of time, and then determine the remainder to be unallowable.

17.3.6 Alterations of Leased Property

The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for performing the contract. Key issues here are 1.) how were the cost of alterations charged and 2.) can these alterations be used for future efforts.

17.3.7 Settlement Expenses

Settlement expenses include accounting, legal, clerical and similar costs necessary for preparation of the settlement proposal. Additionally, settlement costs include costs for storage, transportation, protection, and disposition of property acquired or produced for the contract. Indirect costs incurred for the areas above are allowable. Overhead costs are limited to payroll taxes,

fringe benefits, occupancy costs, and immediate supervision costs. A separate account for settlement expenses should be established if costs are significant. Severance payments are specifically excluded from settlement expenses.

Many issues may arise during the analysis of settlement expenses. Initially, determination of whether the costs were in fact necessary is required. Other issues which may come up are as follows:

- Post-termination costs such as relocation, temporary assignment, and retraining are sometimes allowable depending on the situation. Generally, it must be shown that the actions were a direct result of the termination and were cost-effective; and
- Unabsorbed overhead is generally unallowable in complete terminations. Some precedent has been set for reimbursement for partial terminations. Although the Government and courts have been adamant in not paying for unabsorbed overhead, this remains a major area of contention with the contractor.

17.3.8 Subcontractor Claims

Subcontractor claims are submitted to the Government by the prime contractor for approval and ratification before the prime contractor includes the costs in its settlement proposal. The prime contractor is responsible for negotiating a settlement with the subcontractor. Often, the subcontractor and the prime include the same type of costs in their proposals. Since some of the issues are the same issues the prime contractor wants to negotiate with the Government, a conflict of interest is often created. The Government must be careful to ensure consistency when determining allowability and reasonableness. Additionally, as is often the case, if the subcontractor elects not to allow the prime contractor to see their confidential/proprietary data the government has to mediate between the subcontractor and the prime contractor. It is in the Government's best interest to closely monitor any negotiations with the subcontractors.

17.3.9 Profit/Fee Adjustment/Loss

Loss Adjustment (Fixed-Price)

Termination is not intended to be a means of recovering from a loss situation; therefore, in a fixed-price contract an adjustment should be made if it is apparent that there would have been a loss. An estimation of costs to completion based on costs incurred is necessary to assess if a loss would have been incurred by the contractor had the entire contract been completed. A loss applies to an adjustment of the price paid for acceptable finished items, not to the settlement costs. If the settlement is on an inventory basis

the contractor shall not be paid more than the total of the following, less all credits, unliquidated advances and progress payments:

- The amount negotiated or determined for settlement expenses;
- The contract price, as adjusted for acceptable completed end-items; and
- The remainder of the settlement amount reduced by total contract price divided by the sum of total costs incurred before termination and the estimate to complete.

When adjusting for a loss, the Government has the burden of proving that a loss adjustment is appropriate. Loss adjustments are also subject to the following conditions: 1.) if the increase in costs is due to actions made by the Government, no loss adjustment should be made and 2.) if the contractor is entitled to a price adjustment, a loss adjustment may be inappropriate and/or subject to changes in price

(*Admin. of Gov't Contracts, GWU: 866-867*).

NOTE:

A loss adjustment does not apply to cost reimbursement contracts, but the contractor must submit a termination claim delineating costs.

Profit/Fee Adjustment

Because only a portion of the contract will have been completed at the time of termination, the profit/fee as originally negotiated may not be appropriate. The profit/fee level may need to be adjusted to reflect the percentage of the contract's completion. Profit/fee should only be adjusted if at termination the contractor is in a profit situation. The termination clause of the contract may state a basis for profit restriction. If so, this clause should be used as a guide in determining profit. Further considerations in adjusting profit/fee differ based on the type of contract.

Fixed-Price Contracts

The contractor has the burden of proof in adjusting profit on a fixed price contract. Per AMS Toolbox Guidance T3.10.6, Section A-3, par. b(1), using FAR 49.2 as a guideline, the following nine criteria may be helpful for determining profit:

1. Extent and difficulty of the work done as compared to total work required by the contract.
2. Engineering work, production scheduling, planning, technical study and supervision, and other necessary services.
3. Efficiency with regard to (a) attainment of quantity and quality production, (b) reduction of costs, (c) economic use of materials, facilities, and manpower, and (d) disposition of termination

inventory.

4. Amount and source of capital and extent of risk assumed.
5. Inventive and developmental contributions, and cooperation with the Government and other contractors in supplying technical assistance.
6. Character of the business, including the source and nature of materials and the complexity of manufacturing techniques.
7. The rate of profit the contractor would have earned.
8. The rate of profit both parties contemplated when the contract was negotiated.
9. Character and difficulty of subcontracting.

These guidelines are somewhat subjective and require the use of sound judgment.

Fixed-Price Incentive (FPI) Contracts

There are different ways to adjust incentive prices depending on whether the contract was partially or completely terminated. Under a **partial termination**, completed items should be paid for according to target price and an incentive price revision should take place. In a **complete termination**, delivered and accepted items should be paid for at established prices.

Cost Reimbursement Contracts

Fee in a cost-reimbursement contract should be assessed according to the percentage of completion of the contract as based on 1.) the difficulty of work done versus the total work requirement and 2.) the ratio of costs incurred versus the total cost estimate. In this situation, the Government has the burden of proof.

Cost-Plus-Incentive-Fee (CPIF) Contracts

Like FPI contracts, CPIF contracts require different adjustments for partial and complete termination. When there is a **partial termination**, an adjustment must be made to incentive fee and possibly to target cost. With a **complete termination**, the fee paid should be assessed according to the target fee.

17.3.10 Termination Cost Limit

Per FAA AMS (Toolbox Guidance T3.3.2 (Contract Cost Principles), Section A-6, par. gg(9)), total termination costs, excluding settlement expenses, must not exceed the contract ceiling price for fixed-price contracts, and the estimated cost or allocated funds (whichever is less) of cost reimbursement contracts. The total costs may exceed the price or costs only in instances of

authorized, unpriced work.

17.3.11 Inventory

When a termination for convenience occurs, generally the Government owns all materials, purchased parts, and work-in-process that were purchased and received before termination. While unprocessed inventory may be relatively simple to identify and cost, work-in-process is not always so easy. Work-in-process includes labor and indirect costs in addition to material and parts.

This is particularly important in fixed-price arrangements because completed items will be priced separately from incomplete terminated items. The CO, working with pricing and audit advisors, must reach agreement with the contractor on how this will be done. A Plant Clearance Officer will verify the quantity, quality, and physical allocability of items to the terminated portion of the contract. Important issues to note and verify include: material acquired prior to the contract, possible unreasonable quantities procured ahead of need, common items, and items that can be returned to vendors for credit.

It may be necessary to negotiate with the contractor to keep items for possible future use. These may include items regularly used in commercial products, items that could be used in the future, or items that could be converted to other uses. The contractor may face excessive inventory quantity, excessive inventory value, or unreasonable risk of loss, and might not want to assume items at full purchase cost. In some cases, the CO may negotiate a price the contractor will pay to keep the items. Obviously, this would be more than scrap value, after considering handling costs, and would be done after some assurances that other Government elements have no need for the items at the price.

Depending of the type of contract and basis for settlement, various different forms are required for the settlement proposal. A quick reference for these forms is shown in the next section.

Inventory Schedule Forms

- SF 1426/7: Schedule A - Metals in Mill Product Form
- SF 1428/9: Schedule B - Raw materials, purchased parts, furnished components, finished products, plant equipment and miscellaneous inventory.
- SF 1430/31: Schedule C - Work-in-Process
- SF 1432/3: Schedule D - Special Tooling and Special Test Equipment

- SF 1434: Schedule E - Short Form - use with SF 1438 only.

17.4 SUMMARY

The following are the main concepts discussed in this chapter:

General Principles for:

- Termination for Convenience of the FAA
- Partial Terminations
- Termination for Default

Termination Costs for:

- Common items
- Costs Continuing after Termination
- Initial Costs
- Loss of Useful Value
- Rental Under Unexpired Leases
- Alterations of Leased Property
- Settlement Expenses
- Subcontractor Claims
- Profit/Loss/Fee adjustments
- Inventory

After reading this chapter, the reader should be familiar with the terms and concepts associated with terminations for convenience and for default. The analyst should keep in mind that strict cost and accounting data used to support the issues discussed in this chapter are not always necessary when determining a fair settlement. Estimates and negotiated agreements are often just as effective. When analyzing the costs submitted in a contractor's settlement proposal, business judgment versus strict accounting data should be the analyst's guide.