

Your Contract Has Been Terminated—Now What?

Written by Nick Sanders

Wednesday, 20 February 2013 11:01



It's inevitable, really.

Given the budget pressure on the Federal government—which *already* includes the use of Continuing Resolutions in lieu of budget appropriations, and may well include automatic sequestration cuts in the near future—it's inevitable that, sooner or later, one of your contracts is going to be terminated "for the convenience" of your Federal customer.

Perhaps more than one contract will be terminated for convenience. Maybe all of your contracts will be terminated. Maybe none of them will be. Maybe it'll be one or more of your subcontracts with a larger Prime. Obviously, we can't predict the future with certainty (and neither can you)—but we'd bet that at least one of your current contracts will receive a T4C Notice within the next year.

So let's say you receive the dreaded T4C Notice and you are directed to stop work immediately, wrap things up, and submit a Termination Settlement Proposal. What do you do?

Well, the first piece of advice we have for you is: *Don't Panic.*

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A T4C is obviously not good news, but it's not terrible news either.

When you receive a T4C, do the following—

1.

Stop.

2.

Consider the situation.

3.

Plan your actions.

4.

Work your plan.

5.

Profit.

Wait. *Profit?* How can you make a profit when your contract's been terminated before completion?

Trust us, you can. You can profit on a T4C—you can perhaps make more profit than you initially planned, had the contract been performed to completion.

Before you scoff at that assertion, allow us to elaborate.

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We had this client (who shall remain nameless), that had several contracts with the Department of Energy. Large ones. All the active contracts were losing money—they were hemorrhaging red ink like somebody had opened a major cash flow artery. The only (and we do mean *only*) contract that was recording a profit was the single contract that had been T4C'd. Termination had been the best thing that had ever happened to that particular contract. If only all the other ones had been T4C'd as well, the company might still be in business today.

So when we say that you can make a profit on your T4C, we mean it.

Back to the Termination for Convenience: when you receive that dreaded T4C Notice, you need to do a couple of things right away.

First, you need to stop work.

Now, that doesn't mean turn off the lights and walk out the door. To the contrary, you must cease ongoing contract performance in a reasonable, prudent, and measured manner. For example, you don't tell your procurement staff to stop work—because they need to flow down the T4C Notice to your contract suppliers and subcontractors, and they need to administer the supplier termination efforts. You also don't stop the production machines, leaving materials in the middle of fabrication.

Instead, you take measures to shut down production like a prudent business person, and you protect the government's interest. That means finishing production at a reasonable stopping place, carrying the finished and unfinished goods to property storage, and logging them in. That means saving all work and logging/indexing what's been done and what's not been done. Doing all this may take a few days. As we used to say, "You can turn off a faucet, but there's still a few drops left to go."

Remember, you're going to have to justify all this work to Government auditors. So it's not a license to permit employees to keep charging numbers beyond that which is necessary and prudent. Consider it a rapid ramp-down, or perhaps a safe landing without power. Approach the situation in a business-like and prudent manner.

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(Did we mention the whole *Don't Panic* thing? It's going to become a recurring theme in this article.)

You're going to want to establish a termination settlement charge number—separate from your ongoing program charge numbers—to accumulate the costs of preparing the termination settlement proposal. You may want to establish multiple charge numbers or a WBS in order to keep track of who's charging what. You need to make sure that the personnel who will be working the termination settlement have a place to charge their time and expenses. In addition, you need to expect that certain indirect personnel will be charging that number as well. Yes, in the case of a termination, your finance, accounting, contracts, property, and other indirect functions may start record their time directly to that number. (You may need to figure out how to burden those costs.)

The foregoing strongly implies that you're going to want to establish some initial budgets for the termination settlement efforts, much like you would for any project. That's going to keep your Finance folks busy for a while; and they'll be charging their time to the termination settlement effort as well.

Speaking of Finance, you will also need to make sure you have a current and valid Estimate-at-Completion, as of the T4C Notice date or as close to it as you can come. You need to know your actual costs incurred as of the T4C Notice Date and your at-completion variances (if any) as of that date as well. That's going to prove to be absolutely critical downstream.

To the extent you have at-completion variances, do you understand why they occurred? Do you have contract changes for which you need to seek contract modifications via Request for Equitable Adjustment?

And along that line, do you have authorized but unfunded work? Do you have REAs in process that have not yet been approved? You need to push those along. The best people to push those issues are the program team that was in place at the time of the T4C Notice. (We'll discuss HR issues in a second.)

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The point is, you need to push. And it may be the case that your customer is going to fail to fund those authorized changes, or deny those REAs. If so, you're going to want to file certified claims as soon as possible. Waiting until the negotiations or, God forbid, the litigation, is a *really bad* idea. (See, *e.g.*, *Systems Development Corp. v. McHugh*, C.A. Fed, Sept., 2011.)

The goal is to have the contract value at the time of the T4C Notice be accurate, so that you can evaluate the contract's profit or loss position at the time of the T4C Notice. If you were at a loss position, then the loss will affect your Termination Settlement. (There's a fairly complex formula for calculating the impact of the at-completion loss on the eventual settlement, but you don't need to bother with it if you can show that your program was not in a loss position at the time of termination.)

All of the foregoing actions comprise early responses to the T4C Notice. All of them should be worked immediately upon receipt.

While you are working your immediate actions, your property control folks will be inventorying all government property, including raw stock, unfinished goods, and finished goods that had not yet been accepted. They have 120 days from the T4C Notice date to submit termination inventory schedules (and a request for Plant Clearance action) to the Termination Contracting Officer (TCO), using the SF 1428.

Meanwhile, your procurement folks will be working with the suppliers to receive their Termination Settlement proposals and claims. Your Finance folks will be looking at whether you need to break any leases. Your accounting folks will be looking at capital assets (including test equipment and tooling) to see if there are any items that have lost all future economic value because of the termination.

You're going to be busy, very busy. Lots of people are going to be employed full-time in shutting down the program and preparing the Termination Settlement proposal. But even so, there may be workforce impacts. Some of your direct charging workforce may need to be reassigned or even laid-off. So your HR folks are going to be busy as well.

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The key HR aspect will be to retain your program team in the face of the termination. You need to retain those people until all questions have been answered and all termination actions have been taken. We are reminded of one program termination where the staff immediately was laid-off *en masse*, leaving unfinished work on desks. That turned out to be a *huge* mistake, as the company ended up hiring consultants—including consulting engineers and consulting project managers—to painstakingly reconstruct the history of the program and determine where the at-completion variances came from. Don't make that same mistake.

Speaking of employee retention and potential lay-offs, what are your established cost accounting practices regarding severance pay? Is severance pay charged to an indirect cost pool, or are you going to try to convince your TCO that it should be a recoverable termination cost? That's an issue best decided early in the termination process, we believe.

And speaking of indirect costs, the loss of the terminated work may impact your forecasted indirect rates. That needs to be addressed, if only with respect to potential impacts on the non-terminated work.

You are going to be preparing a Termination Settlement Proposal (TSP). You have one year to submit it. It's going to use special termination forms, such as the SF 1439, but make no mistake: it's a proposal. And it's very likely to be audited by DCAA or other similar Government auditors. Consequently, your claimed costs will need to be supported, very much as if you were submitting a cost proposal subject to the Truth-in-Negotiation Act (TINA). Here's [a link](#) to the DCAA audit program. Take a look at it and get ready for the audit. The costs of supporting the audit may be allowable termination settlement costs!

The auditors are going to use the Cost Principle at FAR 31.205-42 as their guide regarding what costs are allowable in the TSP. Regardless of the auditors' strict interpretation, the reality is a bit different. The FAR Cost Principles are not strictly applied to terminations; instead, the FAR establishes that the Cost Principles are to be applied subject to the general principle that a contractor is entitled to "fair compensation." (See FAR 49.201.)

Moreover, don't forget to read FAR 49.303-5(d), which states—

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If an overall settlement of costs is agreed upon, agreement on each element of cost is not necessary. If appropriate, differences may be compromised and doubtful questions settled by agreement. An overall settlement shall not include costs that are clearly not allowable under the terms of the contract.

That language is going to be helpful in negotiating a price in response to an adverse audit report.

However, despite the helpful FAR language, the fact of the matter is that, generally speaking, your TSP will be cost-based, even if your contract was firm, fixed-price in nature. That's going to throw some smaller contractors for a loop—especially if their accounting systems were not set up for cost-reimbursement contracts. This is where hiring SME consultants, and perhaps experienced attorneys, makes good business sense. (Those costs are allowable TSP costs as well.)

You will also have to decide whether to price the TSP via the “inventory basis” or the “total cost basis”. The total cost basis of settlement pricing is preferred for complete terminations of construction and lump-sum professional services contracts. In other cases, the inventory basis is preferred—but it's negotiable.

Profit will be allowed on work performed up to the date of the T4C Notice. Profit will not be allowed on the post-termination settlement efforts. The amount of profit to be recouped will be a matter of negotiation.

The amount of the termination settlement will be reduced if the contract was in a “loss position” at the time of termination. (That's where the current EAC and maximized contract value come into play.) Here's what [one law firm](#) has to say about this—

The burden of proving entitlement to a loss adjustment is on the Government. To prevail, the Government must prove (1) the contractor operated at a loss and (2) the amount of the loss. A contractor can often avoid application of the loss formula by holding the Government to this burden. If left to its own devices, the Government often fails to meet its burden of proof.

Note: those same attorneys say that if you have a FFP contract that was T4C'd, you shouldn't perform an EAC, because doing so gives the Government insight into your contract's loss position, if it was in a loss position. What can we say? We disagree.

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Note that we stated that the TSP is due in one year. And indeed, it may well take a full year to prepare a major program TSP, including settling with all subcontractors and suppliers. It may well take even longer to get that TSP audited and reach a negotiated settlement with the TCO. Too many contractors think that they have to wait that entire period to get paid; as a result their cash flow needlessly suffers. The reality is that there are ample opportunities to get paid along the way, especially if the terminated contract was cost-type.

For instance, the FAR permits a terminated contractor to continue invoicing, using the SF 1034, for up to six months after the T4C Notice date. (See FAR 49.302(a).) That's ample time to get significant costs reimbursed—especially if you focus on settling with your large subcontractors first. As you settle with them, any settlement payments become your costs, and you can seek quick reimbursement.

In addition, don't forget to use the SF 1440 ("Application for Partial Payment") to your advantage. Our same attorney friends quoted above offer this advice regarding the SF 1440—

The partial payment request may be submitted with or after submission of the termination settlement proposal or an interim settlement proposal. Contractors may receive a partial payment that includes, in the aggregate, the following:

- (a) 100% of the contract price adjusted for items completed before the termination date or to be completed after the termination date with the CO's approval.
- (b) 100% of subcontractor settlements the contractor has paid that were approved by the CO.
- (c) 90% of the direct costs of termination inventory including materials, purchased parts, supplies, and direct labor.
- (d) 90% of other allowable costs not included above that are allocable to the terminated requirements including settlement expenses.
- (e) 100% of partial payments made to subcontractors.

The Government must "promptly" process the partial payment application.

And note that those same attorneys reference an "interim" TSP. This is encompassed by the following direction provided to DOD TCOs—

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With TCO consent, proposals may be filed in successive steps covering separate portions of the contractor's costs.

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Each interim proposal must include all costs of a particular type, unless otherwise authorized by the TCO.

As a reference, here's [the link](#) to the official DOD TSP pricing direction.

You may note that that DOD pricing direction states—

The maximum amount of a termination settlement may not exceed the sum of:

- Total contract price as reduced by:
- The amount of any payments previously made, and
- The contract price of any work not terminated;

Plus

- Reasonable settlement costs including:
- Accounting, legal, clerical, and other expenses reasonably necessary for preparation of termination settlement proposals and supporting data;
- The termination and settlement of subcontracts (excluding the amounts of such settlements); and
- Storage, transportation, and other incurred costs reasonably necessary for the preservation, protection, or disposition of the termination inventory.

The foregoing is not strictly true—especially the part about the total contract price establishing the maximum amount of the termination settlement. In certain, relatively rare, circumstances, the contractor may be entitled to recover more than the total contract price. (See *Jacobs*

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Engineering Group v. U.S.
, 434 F.3d 1378, Jan. 2006.

[Here's a link](#)

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To sum up: *Don't Panic.*

You have a lot of work ahead of you. There's a lot to manage and a number of hoops to jump through. But a T4C is not a catastrophe. Instead, it's an opportunity to demonstrate your business acumen. If you treat your T4C as its own project, you'll find yourself doing quite well.