Government Shutdown Cost Recovery

Executive Summary

It would appear that absolutely everyone in Washington wants desperately to avoid a shutdown of the Federal Government. It also appears that virtually no one believes at this point that it can be avoided.

Who Will Be Affected?

Some contracts may not be *permitted* to continue. Others may not be *able* to continue. Some contractors will continue work in their own facilities under the funding already on their contracts and with little impact beyond a possible delay in payments. The trick is going to be to decide which ones are which. And, to document the record and segregate the costs to ensure the maximum recovery to which you are entitled.

Which Contracts Will Be Affected

Forget everything you've seen in the news, on the internet or in the Frequently Asked Questions lists coming from the GovCon community groups. Here are the tests:

1. If a contract is funded, productive work is possible and *no Stop Work Order has been issued by the Contracting Officer*, the contractor not only *may* continue work, *it is required*.
2. If funding is not available or has been exhausted, then a Government shutdown is moot. The contract clauses will determine whether contract performance may or may not continue.
3. If the Contracting Officer has issued a Stop Work Order, performance *may not continue*. The Stop Work Order, if one is issued, does not have to reference the shutdown. The Government is not required to state a reason for a Stop Work Order. While it is highly unlikely that the Congress will authorize retroactive payments to contractors (they have never done that in the past), certain costs associated with shutting down performance, standing by for a restart and the restart itself are recoverable even in the event of a shutdown.
4. If funding is available and no Stop Work Order has been issued, then performance should continue. The really problematic situations will be those where access to facilities, people or tools and data is effectively denied as a result of the shutdown and continued performance is not possible. This should be considered a "constructive Stop Work Order" and costs should be identified and collected to facilitate recovery just as if a formal Stop Work Order had been issued.

What To Do

Each currently active contract with the Federal Government should be examined and an affirmative decision made as whether performance should be interrupted or not. We have provided a flowchart to facilitate that review. Some suggestions for how that tool might be used are included with it. Whether you decide that a specific contract's performance may or may not continue, that decision may one day be questioned. At that point, it will be critical to be able to demonstrate that a logical, consistent decision process was followed to support the actions taken.

Every contract, under which performance cannot continue, in whole or in part, should be assigned a separate charge number for accumulation of the shutdown, standby and restart costs for the eventual cost claims that will result. This should occur whether the stop work is pursuant to a formal order from the Contracting Officer or a constructive stop work as a result of a lockout or other lack of access to people, tools or data. Much of the rest of this document is devoted to a discussion of the kinds of costs that are recoverable under a stop work situation.

There is also a discussion of how the rules will change in the unlikely event that a stop work order turns into a Termination for Convenience. A very few contracts might be "overcome by events" during the shutdown. If the statement of work of a delivery order, for example, was specifically for support of an event scheduled to occur during the shutdown and that event was never rescheduled, the entire delivery order might be "cancelled." Such a cancellation in the Government contracting world has a special name. It is called a Termination for the Convenience of the Government of "T for C."

If that should occur, the rules are different and the costs that are recoverable are also different.

Stop Work Orders

Background

Under the terms of the Federal Acquisition Regulation, the Government has the authority to stop work being performed under a contract and to require the contractor to stand by and be prepared to resume work when so directed by the Government. Stop-work orders are commonly issued when a bid protest has been filed by an unsuccessful offeror, or when the Government is considering terminating a contract for its convenience, either because of changing requirements or program performance problems. While most contractors rightly view a stop-work order as bad news, such orders should not in the long run result in losses for contractors.

Contractor Entitlements

Under the terms of the stop-work clauses, the Government may either order the contractor to resume work or terminate the contract for convenience. In either case, the contractor is entitled to an equitable adjustment to the contract price as compensation for the impact of the Government's unilateral decision to stop work. The request for equitable adjustment should normally be submitted within thirty days of the date work resumes or within one year if the contract is terminated for convenience.

Because the Government's authority to stop work is unilateral and because the impact on the contractor's costs can be severe, the equitable adjustment provisions are generous. Normal rules of accounting need not be applied to equitable adjustments for stop-work orders because, like terminations, stop-work orders create unique management and cost burdens on contractors not found in the ordinary course of contract performance.

Cost Recovery

After a stop-work order has been received, the contractor should establish a separate charge number in the accounting records to identify all of the costs incurred as a result of the stop-work order. Items commonly associated with stop-work equitable adjustments include:

- Management costs to implement the stop work, including an orderly cessation of the work, redeployment of resources, and coordination with the Government;
- Idle time for staff who were working on the project;
- Severance pay if stop work is of long duration and necessitates layoffs;
- Idle facility costs;
- Startup and remobilization costs when the stop-work order is lifted and work resumes;
- Recruiting additional staff to replace staff no longer available;
- Inflation adjustments for labor and materials if the performance period is extended as a result of the stop work;
- Unabsorbed overhead to relieve other contracts of the added burdens they bore during the stop-work period;
- *Cost of preparing, submitting and negotiating the equitable adjustment, including costs associated with outside accountants or consultants*; and

- Profit on the above items.

As in any equitable adjustment, the contractor is responsible for substantiating the reasonableness of the amounts requested. However, just as in the case of terminations, the contractor is in a very strong bargaining position to be made whole as a result of the Government's unilateral decision to stop the work.

Collecting the Costs

Unlike a contract termination, there is no special contracting officer to whom the claim must be made. The Procuring Contracting Officer (PCO) will negotiate the equitable adjustment in contract costs or price and that is the person to whom the request for equitable adjustment should be directed.

Once negotiated, the additional amounts due under the adjustment would be vouchered in the normal course of the contract. This all assumes, of course, that the stop work order is temporary. If it is not, it will be followed by a notice of contract termination and the rules change completely.

Terminations for Convenience

Background

The Termination for convenience ("T for C") clauses provide government contracting officers with the right to unilaterally terminate contracts when it is in the government's best interest. Federal procurement agencies in the United States initially began using the T for C concept during the Civil War as a means for the government to terminate contracts for wartime supplies at the point they were no longer needed. The 1964 edition of the Federal Procurement Regulations gave agencies the option to use T for C clauses in government contracts, and a revision in June 1967 made the use of the clauses mandatory with limited exceptions. The clauses are incorporated in the Federal Acquisition Regulation (FAR) at §§52-249.

Since a termination for convenience (T for C) clause is required in all Federal contracts, (making it a so-called "Christian Doctrine" clause), a prime contract can be interpreted to contain the clause even if it is not actually present or referenced in the contract. For a subcontract to be terminated, however, the clause must actually be present or referenced in the subcontract. If it is not present, the subcontract is in breach when terminated by the prime. It is the contractor's responsibility to "flow down" the termination clause in all subcontracts or purchase orders under the contract.

First Response

There are a number of actions a contractor should be prepared to take in the event of a Termination for Convenience:

- Issue stop work orders and termination notices to its subcontractors without delay
- Hold meetings singularly or collectively with its subcontractors to clarify requirements and respond to questions
- Stop its own work without delay

- Control and account for all government-owned property and inventory, including prescribed government property reporting for the contractor and its subcontractors
- Establish cost collection codes to segregate and accumulate allowable costs incurred subsequent to termination consistent with regulatory guidance
- Assess the status of the prime contract and subcontracts for undefinitized change orders
- Complete the required Schedule of Accounting Information, SF 1439, for each termination for which a settlement proposal is submitted in which the contractor must describe accounting practices and deviations used in the preparation of its termination settlement proposal

Please note that a Stop Work Order and a Termination Notice are very different. If the Government has decided to termination a contract (either for convenience or for default) it will often issue a stop work order (or notice of suspension of work) as a first step. A stop work order is a brief document and one can be issued much more quickly than a termination notice. Just as the Government often does with a prime contract, if the decision to terminate a subcontract has been made, a stop work order should be issued immediately, followed by the formal notice of termination.

Not every stop work order will be followed by a termination, but *most* contract terminations are preceded by a stop work order.

Contractor Entitlement

When the Government terminates a contract under the T for C clause, the contractor is entitled to recover the reasonable costs of terminating the work. FAR Part 49 provides guidance to the Government Contracting Officer and to the contractor on terminations. Additionally, the cost principle set forth at FAR 31.205-42 prescribes regulations for some of the unique costs and circumstances that may arise in a termination for convenience.

In order to recover the costs, the contract must submit a "termination claim" for the cost of the work already performed, costs of effecting the termination itself and settlement expenses--plus a reasonable profit (on those costs). The contractor may not collect anticipatory profits as it might under a breach of contract.

The changes clause is frequently cited by both government and industry as the basis for negotiating contract adjustments arising from reductions in quantity. The changes clause, however, does not normally permit reductions in the quantity of work under the contract. As a result, reductions in quantity should generally be treated the same as a "constructive" partial termination.

Cost Limitations

The total amount payable to a contractor for a fixed price termination settlement proposal is limited by the total contract price less payments that have been made or are to be made under the contract. The limitation is considered prior to deducting disposal or other credits arising from the termination but it does not include the costs of termination settlement.

If the Government were to terminate a contract very late in the performance of the statement of work, it is actually possible for the costs to date plus the termination settlement costs to be greater than the original price of the contract. It's rare, but it can happen.

Cost type contracts are not constrained by settlement limits. Cost type contracts, however, can be constrained by the limitation of cost or limitation of funds clauses.

Multiple Means of Recovery

Since the termination settlement proposal represents only the costs *directly associated with terminating the work*, a termination may give rise to the preparation of other proposals. In the case of a partial termination, an adjustment in the price of the unterminated work may be in order. This proposal provides a vehicle for increasing a contractor's cost recovery.

Settlement Methods

Prime contractor termination settlement proposals may be settled through negotiation, by vouchering in the case of the cost type contract, or by unilateral determination. Under negotiation, there are two principal techniques for quantifying and settling the termination settlement proposal. These methods are the inventory basis and the total cost basis.

Under the inventory basis, only the uncompleted, undelivered goods or services are quantified using the termination cost principles and procedures. The value of completed and delivered goods or services are quantified using their contract unit price.

Under the total cost basis, the contract becomes in essence a cost reimbursement contract. Thus, under the total cost basis even completed and delivered goods/services are quantified in the termination settlement proposal using the termination cost principles and procedures.

In some cases like supply contracts the inventory basis is preferred. In other cases like construction contracts the total cost basis is required. In many cases where the inventory basis is preferred, however, the total cost basis may be used if approved by the contracting officer. When there are completed and delivered goods/services the two techniques can yield different outcomes. When there are no completed or delivered goods/services, however, both techniques yield identical results.

Terminated cost type contracts may continue to voucher costs for six months after the termination date. The termination costs are vouchered in the same manner as normal interim billings.

Unilateral determination is the final method for settling prime contractor termination proposals. The Terminating Contracting Officer (TCO) may issue a unilateral determination when the contractor fails to submit its termination proposal within the prescribed time period or when the parties cannot mutually agree on the settlement amount.

Termination Costs

Termination costs are guided by the cost principle at FAR §§31.205-42. *In the cost principle, eight types of costs are identified that may be included in the contractor's termination settlement proposal.*

Common items

The costs of items reasonably usable on the contractor's other work are not allowable costs of a termination. Thus, in order for the costs of common items to be allowable costs of a termination they must be in excess of the reasonable quantitative requirements of other work. Furthermore, in order for them to be usable on other work they must be suitable for use in the contractor's normal course of business. Thus, even if they are items normally used in the contractor's industry they do not qualify as common items if they are not normally used in the contractor's normal course of business. Finally, even if the items were inventoried by the contractor prior to the receipt of the contract the items should not be considered common items if they are of no value to the contractor subsequent to the termination.

Costs continuing after termination

Costs that cannot be discontinued immediately after the effective date of termination are generally allowable costs of a termination as long as they are not attributable to the negligent or willful failure of the contractor to discontinue those costs. These costs can include idled facilities costs; the costs of deactivating, reassigning, returning or relocating employees; severance payments required by law, agreement or established company policy; the costs of early retirement; the costs of completing parts in order to avoid loss; costs incurred while the contractor determines how to terminate the contract; and plant reconversion costs if their exclusion would be inequitable.

Initial costs

Initial costs include various types of non-recurring costs such as excessive spoilage, idle time, reduced productivity and increased training costs encountered in the early period of performance. They also include various preparatory costs, such as plant rearrangement and alterations; management and plant organization; and manufacturing and production engineering. A contractor's bid and proposal costs can even be claimed if proper adjustments are made.

Loss of useful value

The costs associated with the loss of useful value for special tooling, special test equipment and special machinery are also allowable costs of the termination. The definitions provided in FAR §45.101 should be used in determining whether these items exist under the contract. The treatment of these items as either a direct or indirect cost is not a determinant factor to their existence.

Rental under unexpired leases

Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when it can be shown that they have been reasonably necessary for the performance of the terminated contract provided that the amount of rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable and that the contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such leases.

Alterations of leased property

The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for the performance of the contract.

Settlement expenses

Accounting, legal clerical and similar expenses necessary for the preparation and presentation of the proposal to the contracting officer are allowable as are the costs of terminating and settling any subcontracts. In addition, the costs of inventorying, storing, transporting, protecting and disposing of any termination property are also allowable. The indirect costs associated with the salary and wages incurred as settlement expenses are also allowable. Frequently, these indirect costs are limited to payroll taxes, fringe benefits, occupancy costs and the costs of immediate supervision; however, the allowable indirect costs are not absolutely limited to those areas.

Even the costs of outside consultants are recoverable as settlement expenses. As a result of that recoverability, it may be more advantageous to utilize outsiders instead of pulling employees from their normal duties and disrupting day-to-day activities. On the other hand, if the termination is substantial, settlement efforts are a way to keep employees active and get them paid while waiting for the next project to come through. In fact, there are provisions for partial payment while preparing the termination settlement proposal.

Subcontractor claims

The prime contractor and each subcontractor are responsible for prompt settlement of their respective subcontractors. Contractors are required to settle with subcontractors in general conformity with the policies and principles relating to settlement of prime contracts. Thus, subcontractor settlements are generally allowable provided that the settlement is not more favorable than what the subcontractor would have been able to obtain had it contracted directly with the government. This requirement includes a prohibition against permitting the prime contractor to recover anticipatory profits or consequential damages that were included in a subcontractor's settlement proposal.

If the subcontractor obtains a final judgment against the prime contractor, however, the judgment should be treated by the government's TCO as a cost of settling the terminated subcontract. In this case, the final judgment amount can include consequential damages and anticipatory profits provided that the prime contractor had made reasonable efforts to include a termination clause or similar language prohibiting the recovery of consequential damages or anticipatory profits in the subcontract.

Generally, the Government's TCO must approve or ratify any prime contractor settlements with subcontractors. The TCO, however, may, after written request from the prime contractor, give written authorization to the prime contractor to settle terminated subcontract proposals of $100,000 or less without approval or ratification. For contracts awarded prior to January 22, 1991 the threshold is $25,000.

While the government reserves the right to approve or ratify first tier subcontractor termination settlement proposals, no such requirement exists for lower-tier subcontracts. Instead, each level of subcontractors and the prime contractor must submit certifications that there is no known information about lower-tier sub contract settlements that would serve to cast doubt on the reasonableness or allocability of the settlements to the terminated portion of the prime contract.

Clearly, the settlement of subcontracts can be extensive and expensive. Consequently, it is only appropriate that indirect costs may be allocated to the amount of settlements with subcontractors. Contractors should be careful, however, to avoid any double counting of costs arising from both subcontractor settlements and its own termination settlement costs.

Unabsorbed Overhead

Unabsorbed overhead is the misallocation of indirect costs to final cost objectives other than those for which the costs were incurred. This can occur when indirect costs are allocated using a cost base that is unexpectedly reduced because of a change. The change that is most often associated with unabsorbed overhead is a performance delay but a termination may also yield similar results.

Unabsorbed overhead is not an allowable termination cost because, whether correctly or incorrectly, it is not considered to be a cost of terminating the work. Unabsorbed overhead would be an allowable cost of any unsettled change proposals, however. Particularly if the termination was preceded by a stop-work-order--as is often the case.

While unabsorbed overhead is not an allowable termination cost many of the costs that otherwise comprise unabsorbed overhead can be recovered through other means. The termination cost principle recognizes that terminations represent an unusual circumstance that can warrant special treatment. This language, in essence, opens the door for contractors to change their cost allocation procedures on-the-fly. Similar opportunity exists even on terminated contracts that are covered by Cost Accounting Standards. Thus, contractors may successfully recover the costs comprising unabsorbed overhead by designing methods for allocating as a direct cost of the terminated contract as much as possible of the otherwise indirect costs.

Profit

The contractor is entitled to a reasonable profit on its termination costs. Considering, however, that profit may not be given on the cost of terminated subcontracts or settlement expenses the contractor may need to segregate various costs so that profit may be appropriately calculated.

Timing

Prime contractors should submit their termination settlement proposals within one year of the termination date. Extensions in time to submit the termination settlement proposal may be requested by the contractor and may be granted by the terminating contracting officer.

Within the one year time period the prime contractor should have also received subcontractor termination settlement proposals. Therefore, when including a termination clause in subcontracts and

purchase orders, the prime contractor should have imposed a shorter period of time for receiving termination settlement proposals than it has for submitting its own proposal.

Audit

The government has the authority to audit the prime contractor's termination settlement proposal under several contract clauses. Principally these clauses are the Audit-Negotiation or Audit-Sealed Bidding clauses. Although contractors are required to include these clauses in their subcontracts, the government may not have subcontract audit privileges if these clauses or similar language are omitted from the subcontract.

Summary

Termination of a contract is not a simple matter. Contractors should expect to expend considerable effort in settling a terminated contract. The effort associated with understanding the consequences to the organization and then maximizing the recovery of costs associated with those consequences will prove substantial. Satisfying the responsibilities relative to subcontract settlement will also be expensive and time consuming.

All of these costs are recoverable. Furthermore, interim proposals may be submitted and partial payments requested. Thus, government financing is available for as much as 90 percent of the allowable costs incurred prior to final settlement.

Although a Contracting Officer may use his discretion in determining the amount of partial payments, that discretion must be reasonably exercised and directed at protecting the government's financial interest. Since the government will almost always have some amount of financial liability to the contractor, a Contracting Officer that denies the requests for partial payments will most likely abuse his authority and entitle the contractor to recover interest on the unpaid partial payment.