Government Contract Terminations: A Primer

by Mary M. Dickens Johnson, CACM
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This white paper provides basic information to persons who are new to the field of contract management or to anyone who might benefit from a review of good, fundamental practices and procedures used in the acquisition profession.

Contract terminations sometimes occur during contract performance due to changes in requirements or because the contractor has not fulfilled its contract obligations. Termination proceedings, either partial or complete, are initiated only when it is determined to be in the best interest of the government to follow such a course. For those working in the federal government or those working on government contracts, Federal Acquisition Regulation (FAR) Part 49 addresses the relevant terminations regulations. The following provides an overview of the terminations process.

There are two types of terminations: termination for convenience (T for C) and termination for default (T for D). For a contractor, it is preferable to receive a T for C because it casts no reflection on the quality of the work performed. A T for D indicates that work was not performed according to schedule or was in some other way defective.

Terminations result from written communications by the user or contracting officer’s technical representative (COTR) stating why the goods or services contracted for are no longer needed. In a T for D, the COTR states why the goods or services performed are defective.

FAR Part 49.101 states that the contracting officer (CO) should proceed with a
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no-cost settlement rather than a termination notice when the following conditions exist: (1) it is known that the contractor will accept such settlement, (2) government property was not furnished, and (3) there are no outstanding payments, debts due the government, or other contractor obligations.

When it is not possible to effect a no-cost settlement, the CO or terminating CO (TCO), if different, prepares a notice of termination, whether for convenience or for default, in accordance with FAR Part 49.102. The notice must contain the contract clause referenced concerning terminations, the effective date of the termination, the extent of the termination, any special instructions, and the steps the contractor should take to minimize the impact on personnel if the termination will result in a significant reduction in the contractor’s work force. The written notice should be sent by certified mail, return receipt requested.

After receipt of a notice of termination, the contractor should comply with the notice and contract clauses. It generally is required that the contractor stop work immediately on the terminated portion of the contract and stop placing subcontracts under the contract. In addition, the contractor should terminate all subcontracts related to the terminated portion of the prime contract. The contractor usually is instructed to perform the continued portion of the contract and to promptly submit any request for equitable adjustment for the rest of the continued portion if it affects changes in cost. Other requirements are care, preservation, and disposition of government property and prompt submission of the contractor’s settlement proposal with schedules and proposed actions to be taken concerning termination inventory.

The TCO’s responsibilities include (1) directing the action required of the prime contractor, (2) examining the settlement proposal of the prime contractor and subcontractors, if any, (3) promptly negotiating a settlement with the contractor for those items that are agreed by negotiation, and (4) promptly settling by determination those elements that cannot be agreed on. The TCO confers with the COTR concerning the direction of contractor activities and to verify the contractor’s claims in its settlement proposal.

A decision to terminate for default is not considered lightly by the contracting office. The CO must discuss all termination avenues, such as T for C, T for D, and no-cost cancellation. Further, legal counsel and input from the contracting staff and technical personnel close to the contract must be sought.

T for D is the most severe form of termination and occurs when the contractor fails to: deliver supplies or perform services within the time specified in the contract, satisfactorily perform any other term or condition of the contract, or make progress and thus endanger performance of the contract.

Work Stoppage
It generally is required that the contractor stop work immediately on the terminated portion of the contract and stop placing subcontracts under the contract.
The government customarily provides warning before a T for D. This warning is conveyed through a show cause notice or a cure notice. A generic version of both types of notice is found in FAR 49.607.

A cure notice is issued to inform the contractor that contractual obligations such as a performance bond have not been supplied. It also may indicate that performance progress on the contract has not been adequate and may endanger meeting contractual obligations. A cure notice customarily provides 10 days, or longer as necessary, for the contractor to supply the necessary documents or otherwise fulfill the requirements.

A show cause notice advises the contractor that a T for D is being considered and informs about the related liabilities. It lets the contractor respond to the CO’s observations about failure to perform and present a convincing argument as to why the government should not terminate the contract for default. The contractor may respond with no explanation regarding performance, which is admitting to failure to perform, or may request a conference to discuss the perceived inadequacies.

The CO must consider many factors when evaluating whether or not to terminate for default. Some of these factors are the severity of the contractor’s failure and the excuses for the failure, the availability of the supplies or services from other sources, and how essential the contractor is to other government acquisitions. In addition, the CO must consider the effect of a T for D on the contractor’s ability to provide services or supplies under other contracts, either current or future.

To expedite the settlement and provide a forum for communications, the TCO should promptly hold a conference with the contractor, to which subcontractors may be invited. The conference would cover general principles of the settlement, extent of the termination, status of continuing work, and obligation of the contractor to terminate subcontracts as well as principles to follow when dealing with subcontractors. Another topic to discuss is a tentative time schedule for negotiation of the settlement, including submission by the contractor and subcontractors of settlement proposals, termination inventory schedules, and accounting information schedules. The TCO also may address actions taken by the contractor to minimize the impact on employees adversely affected by the termination. Another important topic to cover is the requirement that the contractor provide accurate, complete, and current cost or pricing data, certified in accordance with FAR 15.804-4(h), when the amount of the terminated part of the settlement plus the estimate to complete the continued portion of the contract exceeds the threshold in FAR 15.804.
The FAR also requires audit review of every prime contractor settlement proposal in excess of $100,000 in order to provide oversight and recommendations. If the TCO requests it, settlement proposals less than $100,000 in value may be submitted to the appropriate audit agency for review. The TCO is obliged to outline the concerns to be addressed and include any facts and circumstances that will assist the audit agency in performing its review. The audit agency will address specific issues raised by the TCO and make any further accounting reviews it considers appropriate. An example of an audit agency that many branches of the government use is the Defense Contract Audit Agency.

Settlement proposals for subcontracting in excess of $100,000 also shall be referred to the agency's audit unit. As in the case of prime contractor settlement proposals where the dollar value is less than $100,000, the TCO may request an audit review when deemed advisable.

According to FAR Part 49.108-1, the subcontractor has no contractual rights against the government when the prime contractor is terminated. In fact, the TCO may grant authorization for subcontract settlements without approval or ratification when the following conditions exist: the amount of the settlement is $100,000 or less, and the TCO is satisfied with the procedures used by the contractor, especially as related to termination inventory.

While the procedures described above generally allow for the contractor's participation in the termination process, the TCO is authorized to make a settlement by determination if an agreement cannot be reached between the contractor and the government or a settlement proposal is not submitted by the contractor within the time period specified by the termination clause. In this case, the TCO determines the amount of settlement in accordance with the termination clause and any cost principles incorporated in the contract, making an appropriate adjustment for loss, if any.

The contractor is allowed 15 days before the termination settlement by determination is issued to substantiate its proposed settlement amount. By using vouchers, verified transcripts of books of account, affidavits, audit reports, and other documents, the contractor may establish that its proposed settlement amount is the correct one. The burden of proof, however, is on the contractor.

The TCO must include in the settlement determination the amount due the contractor and support the decision by detailed schedules and additional information or analyses as appropriate. In addition, the TCO must explain each major item of disallowance. The determination is transmitted to the contractor by certified mail, return receipt requested.

Proposing the Settlement Amount
By using vouchers, verified transcripts of books of account, affidavits, audit reports, and other documents, the contractor may establish that its proposed settlement amount is the correct one. The burden of proof, however, is on the contractor.
After the TCO issues the settlement by determination, the contractor may appeal the decision in accordance with the disputes clause. The only exception to the contractor's right to appeal is when it has not submitted a settlement proposal within the specified time period.

The final requirement is that the TCO must document the negotiations in a settlement negotiation memorandum. The purpose of this memorandum is to describe the principal elements of the settlement so that the termination case file has a summary document for reviewing officials. The memorandum may contain a chronology of events and must document the pricing aspects of the settlement in accordance with FAR 15.808(a).

If the settlement was reached on the basis of individual items, the TCO must discuss the factors considered for each item. When the settlement was made on a lump-sum basis, the TCO needs to support the overall recommended settlement in detail. Negotiation issues such as differences of opinion, questions addressed, and rationale for decisions reached should be included in the settlement memorandum. Any other factors that were considered that would aid the reviewing officials in understanding the settlement should be included.

In summary, the terminations process can take two possible avenues, either for convenience or for default. The T for C does not reflect on the contractor's performance and will not be held against a contractor when it applies for future contracts. A T for D, however, indicates that requirements were not met and may have a negative impact when a contractor is evaluated for future contracts. While a T for C usually cannot be avoided because it results from changes in requirements, a T for D must be avoided if at all possible.

About The Author
Mary M. Dickens Johnson, MA, CPCM, CACM, CPM, has served as a contract specialist with the U.S. General Services Administration Headquarters Office, the Washington Suburban Sanitary Commission and as a consultant with Systems Flow, Inc. of Rockville, Maryland. She is an NCMA Fellow and has published numerous articles in Contract Management magazine on topics as diverse as international export regulations to minority preferences for state and local governments. She is currently employed by the Florida Atlantic University Public Procurement Research Center while pursuing her PhD in Public Affairs.