TERMINATING Subcontracts:

CHALLENGES and Best Practices

Best practices for subcontract managers that will make the settlement with subcontractors more efficient and will minimize the trauma and drama that often accompany a government termination for convenience.

By **Tom REID** and **Gregory A. GARRETT**

Last month, we provided information on what to do when you receive a termination on your government prime contract and provided some suggestions on how to be prepared to better deal with one. This month, we want to shift our focus to dealing with the subcontractors who are affected by a termination.

As a prelude to understanding how to deal with a subcontractor, it is important to understand that government contract law and commercial contract law are two very different bodies of law. While there are similarities, there are also many significant differences. The Federal Common Law, as embodied in longstanding judicial precedents and as further reflected in both federal statutes and regulations, including the *Federal Acquisition Regulation* (*FAR*) and the various agency supplements, controls the creation, administration, and interpretation of federal prime contracts. Since this is a matter dealing with a sovereign, the sovereign gets to make the rules. Numerous public policies come into play, including such things as the Christian Doctrine, which requires that certain clauses are automatically read into a government contract whether or not they are actually contained in the contract. Such things do not generally appear in commercial contracts.

Terminating Subcontracts: Challenges for Prime Contractors

Commercial contracts are governed by the laws of the various states, commonly embodied in the Uniform Commercial Code (UCC) as adopted by that state. There have been many versions of the UCC since it was first introduced, and the states have great latitude in what provisions they enact and changes they might make to that body of law. So, while the bulk of the UCC might be considered "uniform" among the states, it is important to refer to the specific version of the state law governing the contract to be sure of applying the proper law. Of critical importance here, however, is that the body of law governing your prime contract is significantly different from the body of law that governs your subcontracts, including the forums where disputes under those agreements would be heard. While some of this can be addressed through the use of various flow-down provisions from your prime contract, that is not always the case, and too many prime contractors are less than meticulous in their subcontracting processes, thus introducing great risk to their performance and profitability.

As noted last month, the federal government reserves to itself the right to terminate a contract for its convenience. The policy underlying this right is that once a good or service is no longer required, the government should not be compelled to complete the contract at public expense. It should be permitted to effectively cancel the contract and by the terms of the clauses it uses, limit the damages the contractor will be entitled to receive. In commercial arenas, such an action is considered a breach of contract and entitles the non-breaching party to more significant damages for the other party's breach. You can see immediately that if a prime contractor does not manage its subcontracts appropriately, it can get squeezed between the two competing legal systems.

Considering these factors, what are the best practices that prime contractors—specifically, their subcontract managers—can use to be prepared for dealing with the termination of their subcontracts, and what is the prime contractor required to do in serving the best interests of itself, its subcontractors, and the government customer?

Including the Correct Termination Clause in the Subcontracts

Under the UCC, the parties can agree to most anything they choose to. If they are silent regarding certain matters, the UCC will fill in the blanks and find that a contract exists with these included provisions. The right of the parties to agree otherwise permits the parties to include items that would not be automatically filled in by the UCC. Thus, the use of government flow-down provisions in subcontracts is completely legal and proper.

The use of mandatory flow-down clauses is one way that the government ensures that its prime contract award will be effectively performed. Typically, a prime contractor wants to ensure that it has included a termination clause in its subcontracts, and most often it should be a variation of one of the clauses that can appear in the prime contract. Recall that the *FAR* includes a series of clauses for different situations and contract types, so if you are awarded a cost-type prime contract, that clause will appear in your prime. Your subcontracts, however, may be either cost-type or fixed-price. Therefore, you may want to include a clause similar to the fixed-price termination clauses that appear in the *FAR* rather than the cost-type clause that appears in your prime. In other words, you do not want to flow the prime contract clause down directly and simply change "government" to say "prime contractor" and "contractor" to mean "subcontractor" throughout, although this is exactly what some contractors do. This is poor contract drafting practice, but more important the prime clause implements the Contracts Disputes Act giving the prime contractor the right to appeal contracting officer final decisions. The subcontractors, with no privity of contract with the government, have no such right. The flow-down termination clause should be tailored to the circumstances and while the prime contract clause is often a good starting point, unconsidered inclusion verbatim is not good contract management.

The termination clause is not a mandatory flow-down clause, so some might argue that it is unnecessary in a subcontract, but this is flawed thinking. When your customer has the right to terminate your contract for convenience and you do *not* reserve an appropriate right to yourself as against your subcontractors, any attempted termination will be viewed in the law as a breach giving rise to rights by your subcontractor to be made whole. This usually includes anticipatory profits, or the profit they would have made if the contract had gone to normal completion. By agreeing with your subcontractors up front that their recovery will be limited to work actually completed and accepted, just as yours will be, you minimize the cost to the government and avoid protracted litigation over your "breach." The government will look carefully at your practices in this regard when conducting a Contractor Purchasing System Review (CPSR). To minimize its costs, the government expects you to include a termination clause in your subcontracts. If you fail to do so on a regular basis it will be a finding in their review. If you fail to do so in a particular termination, the contracting officer will consider whether you made a good faith effort to get one included. Since subcontracts are mutual agreements, there may be situations where a subcontractor will simply refuse to include a termination clause. Your choice becomes whether to award the contract anyway for legitimate business reasons, or to seek a different subcontractor. This level of attention is expected by the government. Your failure to include the clause, thus increasing the costs to the government in a termination, can affect the settlement negotiations and the level of fee you may be entitled to for the completed work.

There have been occasions where prime contractors have abused the use of the termination clause. By including this unilateral right, the prime contractor can terminate for almost any reason it chooses, including punishment of the subcontractor, a desire to take over the scope assigned to the subcontractor, or to extort more or different performance from the subcontractor. These are all inappropriate reasons to exercise the right of termination. As a defense, subcon-

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tractors will often ask that the termination clause be drafted to include language that limits the right of the prime contractor to terminate to those situations where the government has terminated that portion of the work covered by the subcontract. This is a fair compromise and affords the subcontractor a little more protection in an environment where its bargaining power may be less than the prime's.

Implementing a Termination of a Subcontract

When you receive the government's notice of termination, one of the immediate instructions is to notify all subcontractors of the termination (effectively terminating their subcontracts if the right has been properly reserved) and to place no more orders. This may also include withholding funding on any subcontract that is incrementally funded. Similar to the notice you receive from the government, you should have prepared a draft termination notice to give to your subcontractors. Do not delay in providing this notice since the continued accruing of costs against the government prime contract may be deemed unreasonable and ultimately disallowed. This can result in your obligation to pay the subcontractor with no commensurate right to be reimbursed by the government.

All of the same instructions received from the government—to stop all work, place no further lower-tier subcontracts, inventory property, inform as to funding, etc.—will apply to the subcontractor. Make clear that this is a definitive action and the subcontractor must comply with this instruction, citing the appropriate termination clause. Record in your files the date, time, and manner of notice given to the subcontractor and ask that they confirm receipt. This will demonstrate your compliance with the contracting officer's direction. The clause that you have flowed down should have shorter response times than those provided by the government to give you an opportunity to get the requisite data—i.e., the termination settlement claim—from all of your subcontractors so that they can be rolled into your claim to the government. So, rather than 120 days for property inventories, for example, you might require 90. Make clear to the subcontractor that these dates are important and any delay will have consequences.

Chances are that there may be subcontractors within your team who have no concept of a government termination. Their entire business experience will have been based on commercial standards where such things do not happen. This may be particularly troubling if the subcontractor will lose a significant proportion of its total business due to this action. They may have ramped up production, or hired additional staff to meet your requirements, and are now faced with a significant business disruption. You will ask them for a settlement proposal, and this entire process might be completely foreign to them. They may have no knowledge of government cost accounting rules or practices. In fact, their entire accounting system may be completely inadequate to provide you the cost proposal that you are now requesting.

Subcontract Termination: Best Practices

The prime contractor's subcontract managers should do several things as soon as possible to assist their subcontractors. Easing their concerns, to the degree possible, and giving them access to tools they may need will encourage prompt response from your subcontractors and avoid delays in getting your own proposal pulled together. A proven best practice is to provide the subcontractor with a briefing of the termination settlement process. Inform the subcontractor that while the contract has ended, they will be paid for the reasonable costs of putting the settlement proposal together. Assist the subcontractor in retaining competent help to do so. These are reasonable costs in a termination. Caution the subcontractor that all work *must* stop on this project and that continuing costs will not be covered. If the subcontractor is providing a commercial item, or other item that they can use, let them know the process that will permit them to convert these items to their own use. Give the subcontractor prompt instructions concerning property disposal and the preservation of all work in process. In a nutshell, the subcontractor will need to do everything that you are doing internally to effect the termination. The difference is that you understand the process and requirements far better than they do. Many subcontractors will need significant hand-holding, yet you also must make sure that your dealings with them are at arm's length. This can be a delicate balance, but it is necessary.

How you treat your subcontractors in this process is one factor that contracting officers will consider in determining your fee for the completed work. Your termination settlement effort is always at cost with no fee, but there is latitude on the fee you earn on the underlying terminated contract. Abuse of subcontractors serves no one's interests. This can be very disruptive and occasionally catastrophic to small businesses. Deal with your subcontractor professionally, but with appropriate sensitivities to their situation. It is good business and simply the right thing to do.

The Termination Settlement Process

The termination process must begin with a settlement proposal. Your notice to the subcontractor will ask for one. If the

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underlying subcontract is cost-type, then you have made a prior determination that the subcontractor's accounting system can accommodate government cost accounting. Preparing a proposal from such a system is relatively easy if proper charge numbers and cost accounting disciplines have been used. The proposal should be prepared on the inventory basis and the reasonableness of the proposal should be relatively straightforward. The lower in the subcontracting tiers you go, however, the more likely you are to encounter fixed-price subcontracts with subcontractors who use a very unsophisticated accounting system. The determination to award them a fixed-price contract may have rested solely on the fact that their accounting system cannot perform government cost accounting. And yet the first thing you ask them for is a proposal based on their costs expended to the date of termination.

This may be a situation where a termination total cost proposal is appropriate, but you must remain cognizant of the pitfalls such a proposal entails. The simple theory behind a total cost proposal is "I spent this much money, so you owe me that amount." What this ignores is whether the original proposal had any real basis for the numbers, the work proceeded effectively and efficiently, the contractor experienced excessive/unnecessary spoilage or waste, and the contractor included any costs that would typically be considered unallowable on a government contract. Unfortunately, a total cost proposal may be the only alternative when a cost proposal based on the inventory method cannot be generated. This is why permission from the contracting officer is required before such a proposal is accepted by the government. Depending on instructions from your contracting officer, you may need to obtain his or her approval for such a proposal even from the subcontractor. This is again a situation where an outside resource (expert independent consulting firm) may be beneficial to both the subcontractor and the prime. Experts experienced in such costing matters can be well worth their cost to the subcontractor, the prime, and, ultimately, the government.

Many subcontractors are going to be inexperienced or otherwise lack the sophistication necessary to prepare such a proposal. While you can provide certain levels of guidance and even training, keep in mind the need to maintain arm's-length dealings. While the proposal needs to be generated promptly, it must also be accurate. Speed can introduce errors that take longer to identify and correct than if care had been taken in the initial proposal. Your timelines in reporting to the government and submitting your settlement proposal are relatively firm. Further, both you and the subcontractor may begin to experience cash flow impacts during this process. Everyone is better served by getting proposals in promptly and then negotiating a settlement as soon as practicable. Delays cause many problems such as fading memories, lost records, and we have even seen the disappearance of the subcontractor. Failing to deal with subcontractors effectively can also encourage litigation. It is important to have the right response team available to assist in getting the subcontractor proposals submitted timely and negotiated promptly.

You may also need to request from the government an assist audit where the subcontractor's costs are proprietary, such as when you are teaming with a company that is sometimes your prime, sometimes your subcontractor, and always your competitor. These audits can greatly delay settlement and as a result should be identified and requested as soon as possible. Otherwise you will need to conduct a proper audit of the subcontractor's proposal. This is where you need to properly balance whatever assistance you provide to the subcontractor with your need to maintain the arm's-length dealings. If your company is large enough, different teams of people might be engaged to keep a firewall between these two functions.

If the subcontractor is particularly recalcitrant and you are unable to negotiate a settlement with them, you have several options—all of which must be considered in consultation with your contracting officer. Litigation may be the only option in some cases, but certainly not a preferred approach. You must alert the contracting officer if litigation is initiated against you during this process, and you must have specific contracting officer permission to initiate litigation. Failure to do so can result in unallowable costs. You also have the option, with contracting officer consent, to omit that subcontractor from your proposal and transfer the responsibility for settlement to the government. This is a rare situation, but recognized in the regulations as an option. We have personally seen this occur when certain long-term environmental issues would have inappropriately delayed settlement of all other issues under the contract and when extensive property records needed to be reviewed and audited in the midst of a plant closing that was continuing beyond the termination of the prime contract.

Conclusion

Rarely are government programs managed exclusively with the internal resources of a prime contractor. Inevitably, there will be subcontractors and there will often be many subcontractors with many tiers of subcontractors below them. In a termination, all of these business arrangements must be concluded and closed out. Quick action on the part of the prime contract manager, the sharing of as much information and expertise as possible as soon as possible, and the use of outside resources where appropriate

Best Practices in Managing Subcontract Terminations

- **Understand the differences** between federal common law and applicable state Uniform Commercial Code principles.
- **Use the correct termination clause** properly modified for the specific relationship between the prime and the subcontractor.
- **Don't overreach** with your subcontractors in the use of the clause.
- **Provide training** for your subcontractors before it is needed.
- **Be reasonable** in settlements.
- **Make sure that you have the requisite authority** from your contracting officer before settling subcontract claims.
- **Be conscious** of your subcontractors' cash flow needs; negotiate settlements promptly.

will greatly facilitate the preparation of the prime contractor's settlement proposal. Cash flow issues will arise and will need to be addressed. Early identification of government property and constant communication among all of the parties will facilitate contract close-out.

The body of law that governs a government contract is different from the body of law that governs your subcontracts. A failure to recognize those differences and deal with them effectively can result in the generation of costs that you will not be able to recover from the government under your prime contract. It takes careful administration of both the prime and the subcontracts with close attention to detail in both cases to make this process as painless as possible. **CM**

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