It's a Termination! WHAT NOW?

A termination is an extraordinary event and immediately declares the contract physically complete. Professional contract managers will be prepared for such eventualities and will have a plan to attack the issues and resolve the many lingering situations.

By TOM REID

Imagine that you arrive at your desk after a long drawn-out meeting only to find the following notice from your friendly contracting officer:

> **Dated today**
>
> **Your Corporation**
> **Anyplace, Anystate 12345**
>
> **Your Contract No. 123-ABD-C-00456 is completely terminated under the "Termination for Convenience" clause effective immediately. Immediately stop all work, terminate subcontracts, and place no further orders except to the extent that you or a subcontractor wishes to retain and continue for your own account any work-in-process or other materials. Transmit similar instructions to all subcontractors and suppliers. Detailed instructions follow.**

"Terminated?" you think. "They have been pushing us to accelerate deliveries. We have over 100 people involved in this project and more than a dozen subcontractors. They can't do this to us! Can they?" The simple answer is yes. The U.S. government reserves for itself the right to stop performance on any contract that it determines is no longer needed. This is reflected in the "termination" clause included in your contract, and it is *always* in your contract. The right of the government to terminate is such a well-established principle of government contract law that the courts have held that even if the clause is completely omitted from your contract, it will be read into the contract anyway. So yes, it is *always* in your contract, regardless of whether or not it is physically included in your contract.

The more important issue for you, however, is what do you do now? This is not one of those messages you can sit on over the weekend or deal with tomorrow. This notice requires immediate action on your part to minimize any further costs against this project. You may not be able to stop everything with a single phone call, and certain aspects of the work might need to continue for purposes of safety or preservation of property, but as a general rule you want to get the word out to as many people as possible as quickly as possible, along with instructions on what they should do next.

A termination is considered an extraordinary contract action. It has no parallel in commercial law unless you consider a breach of contract "normal." The "termination" clause gives the government the right to cease performance of any contract and minimize the further impact to government funds. If you fail to assist in minimizing these costs, there is a very real possibility that you may end up being unable to recover some of these costs. Unnecessary losses, whether accruing to the government or your company, are inexcusable, so whatever you do, you better do it right now and it better be the most reasonable thing you can do.

By reserving the right to terminate contracts without any prior notice, the government recognizes that this is extraordinary and does not typically hold contractors hostage over these issues. The *Federal Acquisition Regulation* (*FAR*) specifically notes that it is important to be fair to contractors in these situations and that rigid compliance with the cost principles may not serve that purpose. Still, a contractor who does not cooperate and work diligently to minimize continuing costs may be in for a surprise at termination settlement negotiations.

So what should you do? First and foremost, you need to alert your management team and the project manager. Simultaneously, you need to have accounting open new charge numbers to accumulate the costs for the termination from this point forward. You also need to spread the word so that people who have been charging to the project know to start using the new charge numbers immediately. This is also important because, depending on your accounting system, there are some costs that might typically be covered in your overhead pools that will now become direct charges. Some usual examples are your internal subcontracting staff, the prime contracting staff, legal, and possibly accounting, property management, and certain manufacturing functions. The reason for this is the

extraordinary nature of the government action. Wrapping up a significant project can tap into the use of these overhead functions more so than was planned, and suddenly you have a smaller base against which to charge these indirect costs. So it is generally a good idea to charge everything related to the termination directly to those new accounts. Your overhead pools might otherwise get distorted and you might not be successful in recovering those costs on your other contracts.

The next thing you should do is alert all of your subcontractors and exercise the "termination" clause you so wisely placed in their subcontracts. This clause is not one of the mandatory flow-down clauses and some companies miss the importance of it when they structure their boilerplate subcontract agreements. This is a serious oversight. As already mentioned, a termination like this has no counterpart in commercial law. It is treated like a breach of contract and can entitle the subcontractor to recover costs you will not be entitled to claim in your termination proposal to the government. For example, in commercial breach actions, the goal is to put the contractor in the same position it would have been if the contract was fully performed. This means, among other things, that they should be paid the *full* profit they would have made on the entire contract. These are called "anticipatory profits." This is not a category of cost that you will get from the government, so failing to include a proper termination clause in your subcontracts can expose your liability, for which you might not recover.

The next thing you will need to do is to coordinate the accumulation of all data, including cost data, related to the project. The government will expect you to alert them to current funding levels and the expected need for further funding through the termination process. The regulations give you a full year to submit your proposal with an option to extend that if the contracting officer feels there is good cause to do so. For cost-type contracts, you can continue to voucher those costs for only six months, and for fixed-price contracts you are not entitled to any payments until the claim is settled. While there are a few exceptions for this practice under fixed-price contracts, it is clear that the sooner you can get your termination claim submitted and negotiated, the better for everyone.

Your Responsibilities

Among the things you will be responsible for coordinating are the following:

- Determining if any of the work needs to continue because it has commercial value to your company;
- Determining if work should continue on work-in-progress due to safety concerns, to avoid damage to equipment, to avoid spoilage to items with commercial value, or to avoid any undue loss to the government;
- Documenting your file with all of the details of the notice and the actions you took in response thereto;
- Notifying all of your subcontractors and instructing them to notify their subcontractors to the lowest tier;
- Collecting all property inventories;
- Discussing with the contracting officer any funding needs;
- Alerting the contracting officer of any pending or threatened litigation, or any litigation arising throughout the settlement process;
- Identifying and informing the contracting officer of all completed items;
- Providing disclosure of and copies of all patents and related intellectual property matters to the contracting officer;
- Determining the number of employees that will be affected and what must be done to comply with the Workers Adjustment and Retraining Notification Act (WARN Act); and
- Preparing the final termination settlement proposal.

Each of these will be discussed. You must also acknowledge receipt of the notice from the contracting officer. Just like every other contract, it eventually becomes physically complete and must move into a closeout

phase. A termination has the effect of immediately declaring a contract physically complete. Thus, the remainder of the process closely parallels a normal closeout process.

Commercially Useful

If any of the product, whether complete or work-in-progress, has commercial value for your company, you can request that it be released to you. You may have to refund any portion of the work that has been billed to the government, but one overriding policy with terminations is to avoid waste and spoilage whenever possible. The regulations even caution contracting officers that if the work is mostly complete, let the contract run to its normal completion and dispose of the product via surplus sale. That will be far cheaper than engaging in the termination process. This will involve careful accounting on your part and a senior-level decision on whether to forego the sale of the product and work-in-progress to the government under the termination process. Unless you have an immediate sales opportunity, or the product is of a standard commercial type, it may or may not make sense to add it to your inventory. There are often variances, even with commercial items, that have been made to meet a government purpose that makes the items unsuitable for standard commercial use. This is purely a business decision on the part of you and your company's management. It tends to be non-reversible, so make the decision quickly and stand by it.

Safety, Damage, and Spoilage

The government does not want to lose whatever salvageable benefit there might be in the work-in-progress. Clearly, if a significant test is in progress, or a heat or vacuum treatment is in process, you do not typically just turn off the switch. An assessment must be made of the work-in-progress and what stage of completion it might reach with minimal effort. This is not something you can decide on your own, however. Your assessment must be discussed with the contracting officer and government contracting officer technical representatives and their decision will control. Obviously, production lines cannot easily be stopped and restarted, so this is a very early conversation that must be held to mitigate costs while giving the government the option of continuing.

Documenting Your Files

Every contract manager should understand the importance of complete file documentation. In terminations, it is not unusual for the contract to be turned over to completely new people on both sides of the agreement. Some agencies maintain contracting officers specially trained in terminations and even refer to them as "termination contracting officers." People will often be quickly reassigned or released from employment, so the importance of thorough and complete file documentation is readily apparent. This should be a routine practice for all contract managers, but we have all inherited files that were less than complete and understand the problems this can cause. In a termination, one common outcome of incomplete file documentation is an inability to support certain costs and thus suffering the loss of the business being terminated *and* an overall loss on the effort. Write it down. Put it in the file. Keep copious notes and follow up with the contracting officer on all decisions made and agreed to.

Notifying subcontractors and dealing with the issues unique to them will be discussed in more detail in the second part of this article, which will appear in the August 2011 issue of *Contract Management*. For present purposes, it is important that you provide the termination notice to each of them and document your files of the date, time, manner, and points of contact in your contract file.

Property Inventories

One of the early deadlines in a termination is the identification and release of the property. If there is a need elsewhere in the government, the sooner that is known and the property transferred the less expense is occasioned to the government. Full inventories must be prepared and transmitted within 120 days of the termination. This facilitates future use of the property, including any that has been provided to the subcontractors, and avoids potential storage costs that would be allowable if a contractor is required to retain the property. High attention should be given to this activity and property specialists should be brought in to manage the effort. The schedules are detailed and with the revised FAR Part 45 now rather ubiquitous, each contractor will have its own system for managing property.

A Dozen Tips on How to be Prepared for a Termination

1. Stay informed about current politics and economics, and not just on a national level, but within your customer. There are often hints concerning what programs might be terminated.
2. Stay current on the program status. Is the main deliverable entering into a three-week test that cannot be interrupted? Are you about to bring a major subcontractor onto the program or hire a significant number of people internally?
3. Read FAR Parts 49 and 52.249. Know the clauses. Confirm the right one is in each of your contracts.
4. Prepare the necessary briefing material. Tailor it to what each department needs to know. Include a briefing for the human resources department to give to the affected employees. This might involve some senior-level policy choices or some union issues. Know them beforehand.
5. Have points of contact in each department. This will typically include legal, supply chain, finance, human resources, program management, property management, and senior management. Hold periodic meetings with them to ensure they are current on the rules and practices.
6. Make sure that your internal policies are well written and easy to follow. It is not the time to discover that you have no policies or procedures (or the ones you have are simply unworkable or outdated) while in the midst of accommodating a termination.
7. Consider the impact of the WARN Act on each of your programs. Involve your legal and human resources departments to think about the correct decisions in the case of a termination of one or more programs. If appropriate, have legal or human resources discuss these possibilities with affected unions.
8. Have a source list for outplacement services in case they are needed. This might be a situation where a requirements contract can be awarded to accommodate any transition of employees.
9. Be able to move quickly to establish new charge numbers for the entire program. Upon receipt of the termination notice, charging to the program should cease immediately and all further costs should be accumulated in the termination accounts. A three-day turnaround for setting up new charge numbers is unacceptable.
10. Have a termination proposal team ready to mobilize to either handle the termination or to provide guidance and leadership to those on the program who will implement the changes.
11. Develop the rigid practice of completely documenting your files. What was agreed to, what was discussed, when notices were given, and all of the other important facts, meetings, reports, and inspections will be very valuable as the termination process unfolds.
12. Consider a requirements contract with a reputable termination consultant who can jump in quickly and assist in the many things that must occur in a very short timeframe.

All government-owned property, whether government-furnished property or contractor-acquired property, must be reported. Any items that have been completed but not yet accepted by the government might also be included here. If the government has paid the costs, the property is theirs. Closing inventory will either fall into completed items or work-in-progress items and will need to be dispositioned. Alert the contracting officer of any such items and follow his or her instructions.

Funding and Litigation

Under a cost-type contract termination, vouchering of costs will continue for no more than six months. Within that time, the bulk of the costs should have been realized and contractors should not be in a financial bind. This might not be true for small businesses, especially those who have a significant portion of their total work terminated. Equally true, many small businesses only have fixed-price contracts, so the vouchering option is not open to them. Discussions should be held with the contracting officer on total funding needs and any pending or newly initiated litigation. If the termination happens toward the end of the fiscal year, the government might need the funds currently on your contract and seek to de-obligate them quickly. You will need to have your facts and data well prepared to prevent an excess de-obligation. You will need to work with your finance and accounting team, as well as legal, to assess whether there are any contingent liabilities attributable to this contract. Reserves must be maintained for any pending litigation and other contingent liabilities. If the government has not done its homework regarding the complete status of the program, it can result that the termination becomes more expensive than continuing the program. This is not a pleasant surprise to a contracting officer, so having all of your information readily available for this assessment is critical.

Intellectual Property

Just like a normal closeout, the intellectual property—including inventions—created

during performance, software developed or licensed, and all of the other myriad items covered in FAR Part 27 must be accounted for and dispositioned in accordance with the contracting officer's instructions. If your company is such a size that it has intellectual property counsel, they should be brought into the process (and direct charged to the termination as discussed above). Otherwise, the contract manager will be responsible for making sure this matter is fully documented and reported to the contracting officer. Final patent reports, releases, licenses, and other intellectual property documents should be maintained in a related file for proper closeout and disposition. If your contract contains any of the *Defense FAR Supplement* (*DFARS*) clauses, there will likely be even greater reporting and record-keeping requirements.

Employees

In many terminations, this is the biggest and most sensitive issue. You may need to keep some critical skills on the terminated project, yet those are the very people who are most likely to be immediately captured for other projects. You have to balance the needs of the terminated program against the needs of ongoing programs and the employees' best interests. This is a very difficult challenge. If the employees are relatively easily redeployed in your company, or if the terminated contract is small, for example, this task is simpler. It becomes more complicated if you employ more than 50 employees and will be laying off a significant percentage of your total employment. The WARN Act requires that when certain levels of layoffs will occur, numerous notifications must be provided and the affected employees are entitled to either a lengthy notice of up to 60 days or pay in lieu thereof. This can quickly escalate the costs of the termination.

The intricacies of the WARN Act are beyond the scope of this article, and many contracting officers are not aware of the impact of this law on their terminated programs, making the assessment of the total cost of compliance a high-priority task. If the termination notice was a complete surprise, there are arguments supporting the use of an exception in the law that permits shorter notice periods. If, however, the layoffs were foreseeable, then the full notice must be given.

Is a slow-down in the level of contracting dollars to be expended by the federal government foreseeable? Arguably, yes. The real issue is whether *your* project could reasonably anticipate its demise. And therein lays the complexity of this analysis.

Most contracting officers recognize that these are legitimate costs in a termination of any magnitude, but bring your legal, human resources, and financial folks together to assess this very technical, emotional, and personal aspect of a large-scale termination. It can have a dramatic effect on the total cost of the termination settlement and your ability to recover these costs.

Settlement Proposal

Settlement proposals are typically prepared on the inventory basis, meaning that a full cost accounting of everything completed or in process is identified and the costs identified accordingly. With contracting officer permission, there is a possibility of a total cost claim, but this is the exception and involves many assumptions that can distort the actual settlement. The preparation of a termination settlement proposal is often as complex and labor intensive as the competitive proposal for a major program. Since a termination is generally a surprise, you may not have the resources available to manage this effort. The costs of the settlement proposal are allowable under the termination, so, if needed, get whatever outside help you might require to promptly close out your subcontracts and get your settlement proposal in to the government as quickly as possible.

Preparation

What should be apparent is that a termination is a quick-moving contract action that, even if partial, is totally disruptive to the project. The time to get prepared for a termination is long before it occurs. After receipt of the notice, too many things are happening too quickly to treat this as your training period. So what can you do to prepare?

As a professional contract manager, you should be aware of the basic tenets of FAR Part 49. Take some time to read it. It includes specific form language that easily translates into checklists. Make sure that your company policies are up to date and

that everyone who is in a position to learn of a termination or potential termination is trained to recognize the signs and symptoms of a troubled program. Set up a list of frequently asked questions about terminations on your website, and just as the government has specially trained termination contracting officers, it might be prudent to designate one member of your team as the termination focal point. Terminations are an excellent topic for brown-bag meetings or monthly NCMA events.

FAR Part 52, likewise, contains the various termination clauses. Read them. Understand their differences. Compare them to your contract and verify that the correct clause is contained in your contract. If not, request a modification. Keep your termination briefing material current. When the notice arrives, you will need to notify, and train, your finance lead, your program lead, your senior management, and the employees who are affected. Thus, your human resources department also needs to be in this loop. You will not have the time or luxury of taking a week to put these materials together or train your people. Post-termination mischarging due to inadequate notice to those charging to the program only complicates the termination settlement proposal. Your supply chain personnel will also need immediate information. It is wise to have a person in that department as a designated point of contact for terminations as most of your suppliers will not have the depth or breadth of knowledge about the subject as you do. More about this topic will be explored in next month's issue of *Contract Management*.

Too often contract managers figure there will be plenty of time "later" to catch up on the record-keeping on a contract. Failure to keep your files current and well documented will become a major impediment to a quick and comprehensive settlement proposal. While this message is mentioned often, it continues to be a problem: *keep your files up to date*! Once a termination is issued, everything that was your "normal" suddenly isn't. There will not be enough time to do what you should have already done and also manage the termination process. This is the single most common problem in termination settlement proposals, and poorly documented claims do not settle for 100 cents on the dollar. This means that you will lose money solely due to your poor file maintenance. This should never happen.

Another critical area to explore is whether you have adequately accounted for your potential termination liability." According to the "limitation of funds" and "limitation of costs" clauses, the contractor is required to reserve from the available funds a sufficient amount to cover the costs of a termination. Despite this contractual requirement, too many programs run the funds to zero before they are replenished. Both the government and the contractors are complicit in this mismanagement. Occasionally, contractors even begin spending their own funds, over and above whatever funding the government has provided for contract performance. Some companies even have written policies on how to facilitate this because it is so common. This is a very bad practice contractually. By the terms of the contract, and in accordance with the Anti-Deficiency Act, it is possible that no further funding will be made available and the total cost of the termination will fall on the contractor. At best it will lead to protracted dispute litigation that becomes very expensive for both parties. Clearly, the better practice is to follow the terms of the contract and the applicable clauses and reserve from the current funding enough funds to cover your potential termination liability. It is a requirement of the contract and it is just good business. Verify that your accounting system includes this reserve and that it is frequently reviewed by your management team to ensure it reflects current program needs.

Default Terminations

This article is focused on terminations for convenience, and the principles apply for the most part to terminations for default on a cost-type contract. The applicable clause in cost-type arrangements is simply called "terminations" and applies for either default or convenience. Default terminations are far more serious since you will *not* be paid for a termination settlement proposal and you might possibly not get paid at all for items and services not delivered or nonconforming items and services that were. If your program is in serious trouble, you should know it. If a delivery deadline is going to be missed, or if you are in noncompliance with any term or condition of your contract, you should be in regular contact with your contracting officer. Default

terminations should *never* be a surprise. The best defense is to perform the work to the best of your ability and actively manage the contract. The second best defense is to develop a good working relationship with your contracting officer and keep him or her completely informed—even if the news is bad. A good relationship will do more to make a bad situation better than most anything else. If the termination for default is later deemed inappropriate, it will be turned into a convenience termination and you will recover all of the costs discussed here. Therefore, you should implement all of the same practices as if it were a termination for convenience. Getting to the point where a termination for default is converted to a termination for convenience may take several years as the disputes process unfolds, and that is not the time to begin thinking about what the termination costs were several years previously.

Conclusion

A termination is an extraordinary event and immediately declares the contract physically complete. The process of wrapping up a program that may have been proceeding at full strength is a difficult and challenging activity. It requires quick action and rapid decision-making. Many people can be affected, and generally it is not in a positive way. Emotions and costs can run high. Professional contract managers will be prepared for such eventualities and will have a plan in place to attack the issues and resolve the many lingering situations. Their people will be trained and aware of the process, accounting will be well documented, and the contract files will fully support the ultimate termination settlement proposals. For the unprepared, a termination will become a significant low point in their careers. **CM**

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