There are two simple, yet critically important questions that reveal a great deal about how a contract is being managed: (1) "What exactly is the contract?" and (2) "How do you know when it's done?"

The TWO Most Important QUESTIONS About Your CONTRACT—

Part 2 of 2

By Tom REID

Last month we explored the simple but difficult question of determining what comprises a specific contract. We explored such matters as items that are incorporated by reference, items that are referenced in documents that are incorporated into the contract, items that are incorporated or excluded by operation of law, and items that are incorporated as implied terms and conditions.

This month, we will explore the second question in the pair of critical things to understand about your contract: "How do you know when it's done?" As with last month's question, it appears simple on its face. Only when you apply it to specific situations do you realize how difficult it might be. This article will first explore the difference between a contract that is physically complete and one that has been closed out. This requires a look at certain record retention requirements due to the possibility of reopening some matters. We will then explore the various ways in which a contract can be "discharged"—a legal term that is similar to being physically complete, but encompasses many other methods by which contract obligations can be extinguished without being performed. We will then look at the more common situation where contract work is performed and the issues surrounding the various inspection and acceptance clauses that serve to verify performance. We will then look briefly at the unique requirements involved when the government exercises its right to terminate a contract for convenience.

The *Federal Acquisition Regulation* (*FAR*) defines a contract that is physically complete as one in which the contractor has completed all required deliveries, the government has conducted an inspection and acceptance of the deliveries, and all option provisions have expired. Alternatively, a contract is considered physically complete if the government has issued a notice of complete termination. Although the regulation is silent as to a combination, it is possible that a partial termination

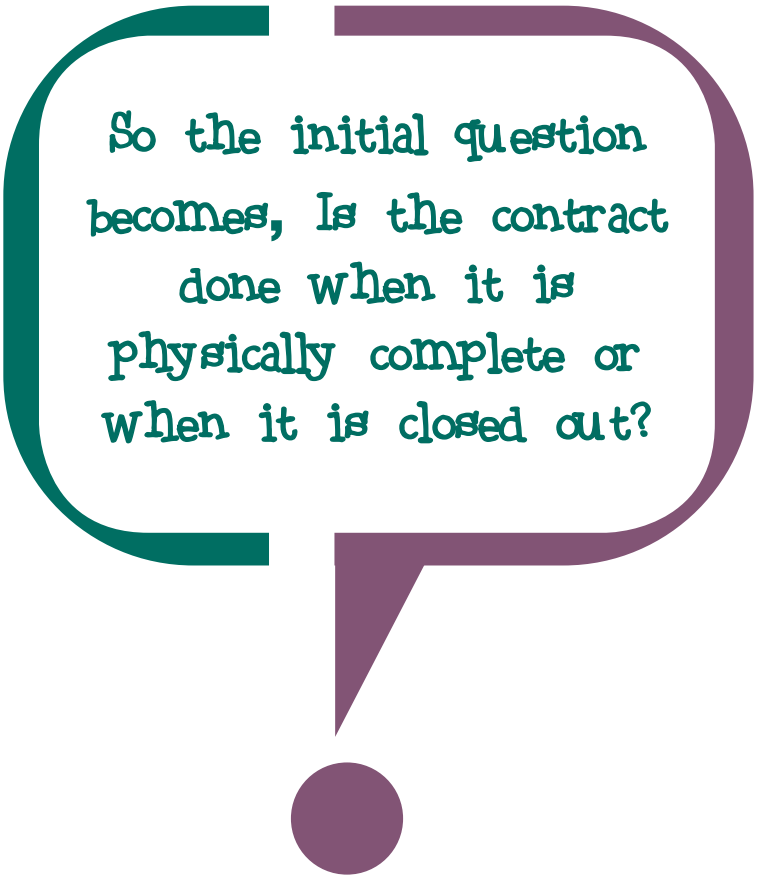
might be issued and the remaining deliveries have been made, inspected, and accepted.[1] The procedures for performing closeout of physically complete contracts are defined at FAR 4.804-5. That section provides a detailed list of actions that attempts to ensure that all possible outstanding matters have been addressed and to enable a positive determination concerning each item. Some of these matters include patent reports, plant clearance inventories for property disposition, and settling subcontracts. For cost-type contracts, the closeout process also includes the incurred cost submissions, indirect rate audits for all applicable years, and closing out any other outstanding audit findings.

So the initial question becomes: Is the contract done when it is physically complete or when it is closed out? To further complicate the matter, FAR 4.804-1(c) prohibits the closeout of any contract that is still under litigation (or appeal) or for which the termination actions have not been completed. On occasion, contracts are reinstated following protest, litigation, or termination. While you could view the reinstatement as a new contract, typically the contract file is not sent to record retention until *all* phases of a contract have been performed and closed out—even after reinstatement.

Record retention policies, as defined in FAR 4.805, are designed to retain most contract files for six years and three months after final payment. This odd time frame is designed to accommodate the usual statute of limitations, or period after which claims cannot be made by either party, of six years for contract matters. Since litigation can be commenced on the very last day of the six-year statute of limitations, the extra three months allows for the service of process and the identification of the applicable files before they are destroyed. So even after closeout, and during the record retention period, the contract can be reopened for some issues as many as six years later. So, once again, we pose the question: "When is it done?"

These situations are not uncommon, but they do arise. Some contracts seem to take on lives of their own and seem incapable of dying. Anyone who has spent considerable time in this field has encountered the proverbial "contract from hell," or "Frankencontract." Most contracts, however, have a more usual life-span where the work is performed and accepted, payment is made, and the contract is effectively and permanently closed out. Nonetheless, the obligations of the parties can also be discharged in a manner other than actual performance of the contract requirements.

When a contract no longer holds performance obligations over the parties, it is said to have been discharged. This is similar to the *FAR* concept of being physically complete, but is more expansive. A contract can be discharged by complete performance and the expiration of any options, warranties, or other surviving aspects, but that is not the only way, in the eyes of the law, that this can occur. Typically, discharge is broken into four areas:



- Performance,
- Agreement,
- Breach, or
- Frustration.

This is a significant area of the law concerning contracts, but in the interest of space, only brief mention is provided here of the various methods of discharge without extensive discussion of the legal principles involved.

Ideally, a contract is fully performed by the parties and the obligations of each expire. The government is entitled to strict performance of all requirements under the contract, yet certain legal doctrines still apply. For example, the doctrines of substantial performance, impossibility, and interference can all work to discharge all or part of a contract. Too often the facts surrounding such situations must be adjudicated, but under the Contract Disputes Act, contracting officers have authority to settle such claims.

The parties may also agree to consider the contract complete. If both parties still have remaining obligations, they might complete the contract by agreement. A bilateral agreement that releases both parties from further obligation is the most common form of agreement. An accord and satisfaction allows each party to walk away from an agreement without resolving the underlying dispute. A rescission and substitution allows the parties to negate the original contract and enter into a new agreement that requires different performance. This might be due to changed circumstances, lack of funding, or new technology as just a few possible examples where this might be appropriate. A variation on this is an agreement of novation, where one party accepts the substitution of the other party, thus discharging the original party from its obligations.

The government, under the Changes clause, reserves to itself the right to make certain changes in the contract, thus creating substituted performance by the contractor. This right gives rise to a commensurate right of the contractor to request an equitable adjustment. Another legal doctrine that can modify the underlying contract obligations is known as "waiver." This is different than forbearance, where a party might delay in exercising its rights under a contract. Waiver results in the extinguishment of whatever right originally existed. The obligation is not performed; the receiving party has simply waived its right to demand the performance.

A contract may also be discharged through breach of contract by one of the parties. This may occur either in anticipation of performance where a clear intention to not perform has been expressed (called anticipatory repudiation), or by the failure of a party to meet a term or condition of the contract—for example, the failure to provide a required bond.

Frustration is a very specific type of impossibility to perform. When the subject matter of the contract has been destroyed (for example, a vehicle under contract to be sold is destroyed in a severe hail storm), the contract as intended by the parties can no longer be fulfilled. When more personal services are required, the death or incapacity of the person intended to perform the services can serve to discharge the contract. Suppose, for example, you had contracted with a specific painter for a portrait and an injury rendered his hands incapable of holding a brush for some period of time.

Occasionally, a contract is predicated on the occurrence of a specific event, such as the rezoning of land. If the event never occurs, the contract's purpose has been frustrated and it is legally discharged. A supervening event of illegality can also discharge a contract. This might be the case where, for example, a party intends to enter the country to perform work and political situations prevent their lawful entry into the country.

Occasionally, a contract is discharged by operation of law. Two of the more common situations occur when a party declares bankruptcy or when too much time has passed and the law has provided for a "statute of limitations." In the former, the law says that once a bankruptcy filing is made with

the court, all contracts in the name of the bankrupt party are subject to repudiation. In the latter case, the law will not enforce a contract where too much time has passed. Memories fade, evidence disappears, and there is a sense that if the parties were not concerned about enforcing the contract during that time limit, the courts will not hear the case.

Some of the instances previously discussed are often addressed through clauses of the contract. One common example is the "force majeure" clause, which specifies that under the listed situations, including unusually severe weather, declarations of war, riots, labor disputes, and other situations out of the control of either party, the parties are relieved from performance. This typically only permits a delay in performance—in extreme situations, performance might be relieved entirely. While there may be a question of fact surrounding whether one of the listed events has occurred, it is nonetheless a process by which contract obligations can be discharged.

Ideally, both parties enter into a contract with the expectation that the obligations of each party spelled out in the contract will be performed, and for the vast majority of contracts, that is exactly what happens. It is important to recognize, however, that knowing when your contract is "done" goes far beyond simple performance and in many cases, as previously discussed, can be discharged in a variety of ways—some voluntary and some involuntary. Let's now turn our attention to those cases where performance does occur. Even then it is not always easy to know when a contract is complete.

Inspection and Acceptance

A properly crafted contract will include the provisions related to inspection and acceptance. The *FAR* provides a series of such clauses[2] for different circumstances and reserves to the government the right to inspect in most cases "at all places and times." This includes subcontractor locations. Whether interim inspections occur, there is an implied right in all contracts for a buyer to conduct an inspection prior to acceptance of tendered goods or services. One common source of constructive changes in government contracts occurs when the inspection is not conducted in accordance with the contract terms, giving rise to a contractor's claim for an equitable adjustment. A well-crafted contract will have explicit inspection provisions and a well-managed contract will ensure that those provisions are followed. Proper delegation of responsibilities to a contracting officer's representative in writing will define the authority of the contracting officer's representative to conduct inspections, whether interim or final. Excessive inspections, however, or those conducted in a manner that interferes with performance, may give rise to a contractor's right to an equitable adjustment and in severe cases discharge of the contractor's obligations. It is important that all those who act for either party to a contract are aware of the inspection requirements and acceptance criteria.

FAR 46.103 states that it is the contracting officer's responsibility to receive "from the

activity responsible for technical requirements any specifications for inspection, testing, and other contract quality requirements essential to ensure the integrity of the supplies or services…." It then goes on to specify explicitly that it is the responsibility of the requiring organization to specify the inspection criteria. This does not absolve the contracting officer from proper contract administration, but it does make clear that the inspection criteria should be included in the statement of work. Problems arise when the requirements are either omitted, misstated, or not followed. Sometimes this is due to the requiring activity knowing what it wants rather than what it requested. Drafting specifications, including the inspection and acceptance portions, is an art and not everyone who attempts to do so does it well. A conscientious contracting officer will make sure that the inspection and acceptance requirements are included, match the requiring activity's needs and expectations, and are fully communicated to the entire team. Contractors are often hesitant to raise issues about inspection statements, even if ambiguous. This is a proper item for inclusion in the post-award conference agenda to facilitate an open discussion of the subject. In administration, the contracting officer must then ensure that those provisions are followed. Too often all of this is left to the requiring activity, which may or may not understand legal contracting principles.

Consequently, there are occasions where no one really knows when the contract is done. Worse, the requirement becomes one of "when you meet the inspector's desires." Poorly drafted contracts allow for this unacceptable standard.

There is no excuse for poor contract drafting. Each of the participants on the team, including the contracting office, the requiring activity, and the contractor, must be reading from the same document with the same understanding of its impact. While it is important to know how and when final inspection and acceptance occurs, this same issue may arise throughout performance. Consider the contract that includes milestone payment provisions. Are all parties to the contract in full agreement concerning when the milestone has been achieved? These interim inspection points can be critical to contractor cash flow and thus sustained performance. Poorly drafted provisions and poorly administered inspection procedures and criteria can impact all of the parties in significantly bad ways.

You will not be able to state definitively when your contract is done unless there is clarity in the inspection and acceptance provisions. While they are to originate with the requiring activity, contracting officers must ensure that the entire team is knowledgeable of the requirements and that they are followed. If the requiring activity leaves this important aspect to the contracting officer, who in turn is leaving it to the requiring activity, while the contractor is hesitant to raise any concerns up front, no one will know when the contract is done. Or stated differently, they all "know" when it is done; it's just that none of them agree and it is uncertain which one may be correct.

Terminations for Convenience

When a contract is terminated, for default or convenience, it is fully discharged. If the termination is partial, that portion that is terminated is fully discharged. For complete terminations, the contract is over. There remain, of course, the closeout activities. For a convenience termination, closeout includes a final settlement proposal, but even for a termination for default the issues of patent disclosures, property disposition, and, depending on the circumstances, final payment or vouchering still remain.

Convenience terminations are unique to government contracts and as a matter of policy every government contract contains a Termination for Convenience clause. The rationale is that public funds should not be expended for goods or services no longer required by the government. The remedy is also used to correct for an award that is determined to have been made without complying with all acquisition requirements. The effect of a termination for convenience is to permit the government to stop performance and limit the contractor's recovery. In commercial contracts, this would be considered a breach of contract and would entitle the nonbreaching party the right to be put in the position it would have been if the contract were fully performed. That is to say that they would get the full profit that would have been earned upon completion. With a government termination for convenience, the contractor gets profit *only* on the work actually performed. Anticipatory profits are not permitted.

In one sense, a termination is final and definite. Once the government terminates, all further progress on performance is stopped at all levels. The hierarchy of subcontracts is requested to submit settlement proposals and within one year the prime contractor is required to submit its proposal for final settlement to the government. In the eyes of the law, all performance obligations of the contractor apart from closeout activities are discharged. The *FAR* contains the following language, however:

> *Reinstatement of terminated contracts.* Upon written consent of the contractor, the contracting office may reinstate the terminated portion of a contract in whole or in part by amending the notice of termination if it has been determined in writing that…[c]ircumstances clearly indicate a requirement for the terminated items, and…[r]einstatement is advantageous to the government.[3]

Note that this section is premised on "written consent of the contractor." If a terminated contract is fully discharged, the only basis to reinstate the contract is by mutual agreement of the parties. Effectively the parties are entering into an entirely new contract. It may look amazingly similar to the terminated contract, and in fact by this regulation must be exactly like the terminated contract. So was the original contract "done" when it was terminated, or has it become a phoenix contract that has risen from the ashes to live on? Perhaps in this case it doesn't matter. The parties have agreed to continue performance, and they will still have to know what the contract is and when it is ultimately done.

Every contracting professional should be able to answer the two most important questions about each of their contracts: "What is the contract?" and "How do you know when it's done?" As these two articles have discussed, these are not always simple questions to answer.

Determining exactly what the contract *is* and when it is *done* can be a challenge, but it is a critical part of contract management. Instituting a level of formality in your contract operations assists in resolving both of these questions. Professional contract managers take these responsibilities seriously and work with their team to ensure clear communication. Can you say without hesitation that you know exactly what is in each of your contracts and when you will know that it is done? As a professional contract manager, you should. **CM**

ABOUT THE AUTHOR

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Send comments about this article to cm@ncmahq.org.

ENDNOTES

1. FAR 4.804-4.
2. *See* FAR 52.246.
3. FAR 49.102(d).