Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Budget Cuts: Don't Forget About Your Rights, Contractors

Law360, New York (January 17, 2013, 12:49 PM ET) -- In the run-up to the so-called fiscal cliff on Dec. 31, 2012, many contractors had their eyes on Washington, D.C., for hints about the fate of their programs. That's understandable, since contractors have a legitimate interest in knowing whether the projects they hope to work on next year will be funded and at what level. And, when Congress reached a deal over the New Year's holiday to avert the so-called fiscal cliff, many contractors breathed a sigh of relief.

Actually, any sense of calm may be premature, since some of the toughest issues were not resolved in the bill that Congress passed and the president signed in early January. Rather, those budgetary challenges were pushed two months down the road, when, according to media reports, $110 billion in spending cuts will again kick in.[1]

Thus, contractors would be justified to wonder what the future holds. And, while some of the answers may come from Washington, contractors should not overlook their contracts as the primary source that governs their rights.

For instance, let's say your program is eliminated as a result of sequestration and your contract is terminated for the convenience of the government. Typically, the government has the right to terminate a contract when it no longer wants the products or services covered by that contract, whether for lack of funding, changed priorities or almost any other reason. Once upon a time, it was said that a court could find that a convenience termination was made in bad faith and therefore was a breach of contract entitling the contractor to damages, but such cases have been exceedingly rare. For all practical purposes, a termination for convenience is nearly impossible to challenge.

But, contractors do have rights — the most important of them being the right to submit a termination settlement proposal under the clauses at Federal Acquisition Regulation § 52.249-1, -2 or -6. While there are nuances depending on which clause is in your contract, the basic idea is that the contractor is entitled to be paid for work already performed, generally with a reasonable profit, and to recover the costs resulting from the termination, including professional fees incurred in preparing the termination settlement proposal.

To avoid such costs, many contracting officers will present the contractor with a modification making a "no-cost termination" and will ask for the contractor's signature. Think twice and consult an attorney before doing that, since that signature generally will waive any rights the contractor may have to receive a termination settlement.

Let's say your program is not eliminated completely, but your contract is partially terminated. Again, the government generally has that right, but again, you as the contractor have rights also. As above, you may submit a termination settlement proposal seeking payment for work already performed, with profit, and for the costs resulting from the partial termination.

One way in which a partial termination differs from a complete termination is that the partial termination may affect how overhead is absorbed by the portion of the contract which was not terminated. Thus, it might be appropriate for your termination settlement proposal to include an increase in the unit price of the remaining work.

A question that often arises when the government wants to end some of the work under a contract is whether the contracting officer should issue a partial termination for convenience under the termination clause or a deductive change to the contract under the changes clause. If a major part of the work is deleted and nothing is substituted in its place, that will be a termination.[2] Otherwise, the contracting officer has a great deal of discretion.

Some cases have said that a change in the specifications or in the scope of work that decreases the cost of or time required for performance of any part of the contract work should be treated as a deductive change, while a partial termination is more appropriate if the contracting officer is reducing the number of units or supplies to be delivered, eliminating identifiable items of work, or reducing the quantity of work required under the contract.[3]

Why does it matter whether the event is called a partial termination or a change? That could be the subject of an article in its own right. Briefly, though, there are both procedural and substantive differences between the recovery available under a termination for convenience and the recovery available under a change. Generally, though not always, the latter is more favorable to the contractor.

So far, our discussion has focused on fixed-priced and fixed-unit-priced contracts. What if you have a cost-reimbursement contract and the government reduces the amount of funding available to you as a result of sequestration, thus cutting down on the work you can do?

Cost-type contracts should include the limitations of funds clause and/or the limitation of costs clauses, both of which tell the contractor to stop work when it runs out of funding. This has two consequences. First, it means that the government may not terminate the contractor for default if the contractor does stop working when the funding runs out. Second, it means that a contractor that continues performing after funding runs out does so at its own risk. Contractors cannot safely rely on oral promises by a contracting officer or other program personnel that funding is “on its way.” In fact, personnel who make such statements could be in criminal violation of the Federal Anti-Deficiency Act.

Notably, if the government reduces your contract funding by $1, it may lose more than $1 worth of work. The reason is that costs of laying off workers will generally be allowable costs under a cost-reimbursement contract, thus eating up part of the remaining funds.

One interesting twist occurs when a government agency that is running low on funds reallocates funds from work that is more profitable for the contractor to work that is less profitable for the contractor. In that event, depending of course on the specific language in the contract, the contractor may have a basis to bring a claim against the agency for its lost opportunity to earn that profit.

Will there be sequestration come March 2013? We don’t know. But we do know that contractors that are affected by any type of contract termination, deductive change or funding reduction resulting from the agency’s budget woes have rights under their contracts, which should not be overlooked.

--By Kenneth B. Weckstein and Shlomo D. Katz, Brown Rudnick LLP

Kenneth Weckstein is a partner and Shlomo Katz is a member in Brown Rudnick's Washington, D.C., office.

[1] See, e.g., Congress Passes Cliff Deal: Hard-Fought Bill Averts Broad Tax Hikes, Spending Cuts, but Puts Off Major Issues, online edition Jan. 2, 2013, http://online.wsj.com/article/SB10001424127887323320404578215373352793876.html

[2] J.W. Bateson Co. v. United States, 308 F.2d 510 (5th Cir. 1962).

[3] See, e.g., Celesco Industries Inc., ASBCA No. 22251, 79-1 BCA ¶ 13,604.
