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Termination of Federal Construction Contracts: Boon or Boondoggle?

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In March 2009, President Obama issued a memorandum to the heads of executive departments and agencies concerning government contracting. The President stated that the federal government should consider terminating existing contracts that are "wasteful, inefficient or not otherwise likely to meet the agency's needs." The Office of Management and Budget (OMB) was directed to issue a governmentwide guidance by July 1, 2009 to create processes to take corrective actions that may include modifying or canceling such contracts.

The President followed up this memorandum in May 2009 with his proposed 2010 budget. In it, approximately $1.5 billion in existing construction programs are to be eliminated. Cuts are proposed for construction programs with the Army Corps of Engineers, EPA, Department of Transportation, etc.

On July 29, 2009, OMB issued a memorandum titled "Improving Government Acquisition." Each federal agency was instructed to develop a plan to save 3.5 per cent of contract spending in FY 2010 and another 3.5 per cent in FY 2011. OMB specifically targeted certain "high risk" contracts. These include cost reimbursement contracts, time and material contracts and noncompetitive contracts. Each agency is to aim to reduce spending on such contracts by 10 per cent.

The political forces may prevent some terminations; however, we can expect many projects to be carefully scrutinized. Some contracting officers may take the opportunity to end projects in which the parties have a troubled relationship. Others may threaten termination unless concessions are granted on changes or claims.

Under the standard Termination for Convenience Clause in federal construction contracts, the Government has the right to terminate a contract "without fault." When it does so, the contractor is to be paid for the work it completed but does not receive compensation for profits lost on the unperformed work. Obviously, losing profits is a prospect no contractor wishes

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What often happens, however, is that the regulations and cases permit a termination payment greater than anticipated. Most contractors do not realize that many costs may be claimed in excess of the simple percentage of the work completed. The treatises state that a termination for convenience generally turns a fixed priced contract into a cost-plus project. Reimbursable costs include one time, nonrecurring costs such as bonds, insurance, mobilization and demobilization. Also included are work in process, including stored materials and materials not yet delivered; identified equipment in the process of being manufactured; subcontractor terminations; lost deposits and fees, etc.

A reasonable overhead and profit markup is allowable on costs of the work. The profit markup is not allowed, however, if the job would have lost money had it been fully performed. In that situation, there is a loss sharing formula to apply. Many contractors are not aware, however, that the contract's value should first be adjusted to include all changes and allowable claims. After adjusting the contract value, the contract may no longer be in the loss position. Therefore, even though the contract was terminated, claims that have been identified need to be documented and submitted to include costs through the date of the termination.

Contractors have also successfully recouped loss of learning curve costs for labor or equipment. Finally, the regulations permit the contractor to be paid for the management, accounting and legal fees incurred to prepare and negotiate the termination settlement proposal.

When a contract is terminated for convenience, the contractor should take full advantage of its rights by consulting with its accountants and attorneys to help recoup the maximum allowable sums. In this way it is often possible to make lemonade out of the lemons.