



# Terminating Contracts for the Government's Convenience: Answers to Frequently Asked Questions

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## Summary

“Termination for convenience” refers to the exercise of the government’s right to bring to an end the performance of all or part of the work provided for under a contract prior to the expiration of the contract “when it is in the Government’s interest” to do so. Federal agencies typically incorporate clauses in their procurement contracts granting them the right to terminate for convenience. However, the right to terminate procurement and other contracts for convenience has also been “read into” contracts which do not expressly provide for it on the grounds that the government has an inherent right to terminate for convenience, or on other related grounds.

Where termination for convenience is concerned, the “Government’s interest” is broadly construed. Federal courts and agency boards of contract appeals have recognized the government’s interest in terminating a contract when (1) the government no longer needs the supplies or services covered by the contract; (2) the contractor refuses to accept a modification of the contract; (3) questions have arisen regarding the propriety of the award or continued performance of the contract; (4) the contractor ceases to be eligible for the contract awarded; (5) the business relationship between the agency and the contractor has deteriorated; or (6) the agency has decided to restructure its contractual arrangements or perform work in-house. Terminations in other circumstances could also be found to be in the “Government’s interest.”

In contrast, terminations based on the contractor’s actual or anticipated failure to perform substantially as required in the contract are known as “terminations for default.” Such terminations are distinct from terminations for convenience in both their contractual basis and the amount of any recovery by the contractor in the event of termination. However, an improper termination for default will typically be treated as a constructive termination for convenience. Terminations for convenience are similarly distinguishable from “de-scoping” pursuant to any Changes clause incorporated in the contract. The Federal Acquisition Regulation (FAR) also distinguishes between termination for convenience and cancellation of multiyear contracts.

As a rule, the government cannot be held liable for breach when it exercises its right to terminate contracts for convenience because it has the contractual and/or inherent right to do so. This means that contractors generally cannot recover anticipatory profits or consequential damages when the government terminates a contract for convenience. The contractor is, however, entitled to a termination settlement, which, in part, represents the government’s consideration for its right to terminate. The composition of any termination settlement can vary depending upon which of the “standard” Termination for Convenience clauses is incorporated into the contract, among other factors. Such settlements typically include any costs incurred in anticipation of performing the terminated work and profit thereon. Some settlements are “no cost”; others are sizable.

In certain cases, however, exercise of the right to terminate for convenience could result in breach of contract (e.g., the agency entered the contract with the intent to terminate).

Congress is perennially interested in termination for convenience because it is part of the overall framework of federal procurement. However, congressional interest has been particularly high in recent Congresses due to sequestration and other efforts to constrain federal spending. Some contracts were reportedly terminated, or considered for termination, for convenience in FY2013 as a result of sequestration. There has also been interest in ways to reduce the amount of funds that must be obligated or otherwise “reserved” to cover potential termination liability.

## **Contents**

Background.....	2
What Is the Basis for the Government's Right to Terminate for Convenience?.....	2
When Can the Government Terminate a Contract for Convenience?.....	5
Types of Terminations and Other Reductions.....	6
How Is a Total Termination Different From a Partial One? .....	6
What Is a Constructive Termination? .....	7
How Does a Termination for Default Differ from a Termination for Convenience?.....	8
How Does Cancellation Differ from Termination for Convenience?.....	9
What Is the Difference Between Termination for Convenience and De-Scoping and Other Reductions? .....	10
Government Liability in the Event of Termination for Convenience .....	12
How Is a Termination Settlement Arrived At?.....	12
What Could a Termination Settlement Include?.....	13
How Much Can a Termination Settlement Cost? .....	15
Could the Government Ever Face Liability for Breach by Terminating for Convenience? .....	16
Why Must Agencies Generally Obligate or Reserve Funds for Termination Liability?.....	17

## **Contacts**

Author Contact Information.....	19
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Termination for convenience refers to the exercise of the government's right to bring to an end the performance of all or part of the work provided for under a contract prior to the expiration of the contract "when it is in the Government's interest" to do so.<sup>1</sup> Federal agencies typically incorporate clauses in their procurement contracts which grant them the right to terminate for convenience.<sup>2</sup> However, the right to terminate procurement and other contracts for convenience has also been "read into" contracts which do not expressly provide for it on the grounds that the government has an inherent right to terminate for convenience, or on other related grounds.<sup>3</sup>

The right to terminate for convenience has historically been viewed as protecting the public interest by ensuring that the government does not have to pay for something that it may no longer need or want.<sup>4</sup> However, the exercise of this right generally also entails some compensation for the contractor because there arguably would not be a binding contract if one party were unilaterally able to end the contract with no liability to the other.<sup>5</sup> Failure to pay the contractor for the government's exercise of its right to terminate for convenience would also generally be viewed as unfair to agencies' contracting partners, and could diminish the willingness of vendors to deal with the government. This, in turn, could potentially result in the government having to pay higher prices for lower quality supplies and services, as the pool of potential vendors decreases.

Termination for convenience is a topic of perennial congressional and public interest since any government contract could potentially be so terminated. However, interest in termination for convenience has recently been heightened by the implementation of sequestration under the Budget Control Act (BCA) of 2011.<sup>6</sup> Some contracts were reportedly terminated, or considered for termination, for convenience in FY2013 as a result of sequestration.<sup>7</sup> In addition, because of

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<sup>1</sup> 48 C.F.R. §2.101.

<sup>2</sup> See *infra* "What Is the Basis for the Government's Right to Terminate for Convenience".

<sup>3</sup> See *id.* The focus of this report is generally upon procurement contracts. However, in at least one case, the government's right to terminate for convenience has been found to be an implied term of a non-procurement contract that did not expressly include it. See, e.g., *Aerolease Long Beach v. United States*, 31 Fed. Cl. 342, *aff'd*, 39 F.3d 1198 (Fed. Cir. 1994) (finding that a Termination for Convenience clause is to be read into a lease of real property). Leases of real property do not constitute "acquisitions" for purposes of the Federal Acquisition Regulation (FAR) and, thus, do not include the standard Termination for Convenience clauses discussed below.

<sup>4</sup> See, e.g., *Russell Motor Car Co. v. United States*, 261 U.S. 512, 521 (1923) ("With the termination of the war the continued production of war supplies would become not only unnecessary but wasteful. Not to provide, therefore, for the cessation of this production when the need for it has passed would have been a distinct neglect of the public interest."); *United States v. Corliss Steam-Engine Co.*, 91 U.S. 321, 323 (1875) ("[I]t would be of serious detriment to the public service if the power of the head[s] of [federal agencies] did not extend to providing for all ... possible contingencies by modification or suspension of the contracts and settlement with the contractors.").

<sup>5</sup> In order to constitute a binding contract, an agreement must impose cognizable burdens—known as "consideration"—upon each party. A contract that purported to provide one party with the right to bring the contract to an end at any time, without in any way performing as specified in the contract or otherwise compensating the other party, would be found to be nonbinding due to lack of consideration. See, e.g., *First Fed. S&L Ass'n of Rochester v. United States*, 58 Fed. Cl. 139, 145 (2003).

<sup>6</sup> P.L. 112-25, 125 Stat. 240 (Aug. 2, 2011). For more on the BCA, see generally CRS Report R41965, *The Budget Control Act of 2011*, by Bill Heniff Jr., Elizabeth Rybicki, and Shannon M. Mahan. Sequestration under the BCA did not operate in FY2014 or FY2015 in the same way it did in FY2013. Thus, discussions of the effects of sequestration on government contracts often focus on events in FY2013.

<sup>7</sup> See, e.g., Gov't Accountability Office, 2013 Sequestration: Agencies Reduced Some Services and Investments, While Taking Certain Actions to Mitigate Effects, GAO-14-244, Mar. 2014, at 182 (reporting that the Office of Personnel Management "terminated a contract with a call center that handled customer inquiries regarding retirement").

agencies' diminished budget authority, questions have arisen as to how agencies might be able to reduce the amount that they must generally obligate or otherwise "reserve" to cover potential termination liability so that they can allot additional funds to performance of the contract, particularly early in the course of the contract's performance.<sup>8</sup>

This report provides answers to 12 questions regarding termination for convenience frequently asked by congressional committees and staff. These questions and their answers address everything from the contractual and other bases for the government's right to terminate to post-termination settlements between the government and the contractor. They also address differences between termination for convenience and termination for default, cancellation, and certain other actions that the government may take (e.g., "de-scoping" pursuant to a Changes clause). The questions and answers are organized into three sections, one of which provides background information. The other two address (1) differences between the various types of terminations and other reductions that agencies could make in the work performed under a contract; and (2) potential government liability in the event of a termination for convenience.

The report does not address the termination of agency programs or budget elements. Such terminations could potentially result in the termination of contracts. However, they would not necessarily do so. Similarly, language prohibiting an agency from terminating a "program, project or activity" (PPA) would generally not be construed to bar the agency from terminating contracts for that PPA.<sup>9</sup>

## **Background**

The questions and answers in this section provide background information on termination for convenience, including (1) the legal basis for the government's right to terminate contracts for convenience; and (2) the circumstances in which the government may so terminate.

### **What Is the Basis for the Government's Right to Terminate for Convenience?**

The government's right to terminate contracts for convenience generally arises from the terms of its contracts.<sup>10</sup> The Federal Acquisition Regulation (FAR)—which governs many (although not

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<sup>8</sup> See *infra* "Why Must Agencies Generally Obligate or Reserve Funds for Termination Liability?"

<sup>9</sup> See, e.g., Gov't Accountability Office, National Aeronautics and Space Administration—Constellation Program and Appropriations Restrictions, Part II, B-320091, July 23, 2010 (noting that a PPA is an "element within a budget account," and that NASA did not violate language in an appropriations act prohibiting it from using funds to terminate any PPA of the Constellation Program when it terminated contracts related to the program).

<sup>10</sup> Termination for Convenience clauses are not unique to government contracts. They are also used in contracts between private parties to give the parties some flexibility as to the quantity of supplies or services delivered under the contract, as well as to limit the scope of potential liability under the contract. See, e.g., *At Your Convenience: Courts Are Generally Enforcing Termination for Convenience Clauses in Private Sector Contracts That Are Well Drafted and Prudently Invoked*, 21 *Los Angeles Law* 42 (1998). The general rule is that, absent a clause allowing the contract to be terminated, a buyer who informs a seller that he does not intend to purchase certain supplies and services provided for in the contract has breached the contract and is liable for damages, potentially including anticipatory profits and consequential damages. See, e.g., *Davis Sewing Machine Co. v. United States*, 60 Ct. Cl. 201, 217 (1925). However, a termination for convenience clause avoids the operation of this general rule by granting one or both of the parties the right to engage in conduct that would otherwise constitute breach of contract.

all) acquisitions by executive branch agencies<sup>11</sup>—requires agencies to incorporate in their procurement contracts standard clauses granting the government the right to terminate the contract for its convenience.<sup>12</sup> The exact language of this clause varies depending upon the type and value of the contract, among other things.<sup>13</sup> However, such clauses typically provide that

[t]he Government may terminate performance of work under [the] contract in whole or, from time to time, in part if the Contracting Officer determines that a termination is in the Government's interest.<sup>14</sup>

These clauses typically also specify the form and content of the government's notice to the contractor when it exercises its right to terminate; the contractor's obligations upon receipt of this notice; disposal of the "termination inventory"; procedures for arriving at a termination settlement; items to be included in a termination settlement if the contractor and the agency fail to agree upon the amount to be paid; and the contractor's retention of records pertaining to the terminated portion of a contract.<sup>15</sup>

However, even when the contract does not expressly provide for the government's right to terminate for convenience, the government is generally still able to exercise this right, although the rationale for construing the right to terminate for convenience as an implied term of government contracts has varied over time.<sup>16</sup> The Supreme Court first articulated the theory that the government could terminate contracts for its convenience in upholding the Secretary of the Navy's determination to "suspend" certain contracts for equipment which was no longer needed because the Civil War had ended.<sup>17</sup> The Navy proposed to pay the contractor a reduced amount as "compensation for partial performance."<sup>18</sup> The contractor objected to both the suspension of its

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<sup>11</sup> For more on the FAR, see generally CRS Report R42826, *The Federal Acquisition Regulation (FAR): Answers to Frequently Asked Questions*, by Kate M. Manuel et al..

<sup>12</sup> 48 C.F.R. §§49.501-49.505. Some government contracts have included mutual termination clauses, giving both parties the right to terminate at their convenience. Such clauses may be found to be valid and binding. *See, e.g.*, Appeal of Coast Photo Finishers, ASBCA 19010, 74-2 B.C.A. ¶ 10,896.

<sup>13</sup> *See, e.g.*, 48 C.F.R. §52.249-1 (fixed-price contracts that are not expected to exceed the simplified acquisition threshold); 48 C.F.R. §52.249-2 (fixed-price contracts that are expected to exceed the simplified acquisition threshold); 48 C.F.R. §52.249-3 (fixed-price contracts for dismantling, demolition, or removal of improvements that are expected to exceed the simplified acquisition threshold); 48 C.F.R. §52.249-4 (fixed-price service contracts); 48 C.F.R. §52.249-5 (contracts with educational and other nonprofit institutions); 48 C.F.R. §52.249-6 (cost-reimbursement contracts); 48 C.F.R. §52.249-7 (fixed-price contracts for architect-engineer services).

<sup>14</sup> 48 C.F.R. §52.249-2(a).

<sup>15</sup> 48 C.F.R. §52.249-2. The term "termination inventory" encompasses "any property purchased, supplied, manufactured, furnished, or otherwise acquired for the performance of a contract subsequently terminated and properly allocable to the terminated portion of the contract. It includes Government-furnished property. It does not include any facilities, material, special test equipment, or special tooling that are subject to a separate contract or to a special contract requirement governing their use or disposition." 48 C.F.R. §2.101.

<sup>16</sup> At least one case could be construed as suggesting that the government retains the right to terminate contracts for convenience even if it expressly disclaims this right. *See* Dep't of the Navy, B-86077 (July 21, 1949) (denying a request for additional compensation when the government canceled orders under a Federal Supply Schedules (FSS) contract that the government had promised not to "cancel" or "terminate").

<sup>17</sup> *Corliss Steam-Engine*, 91 U.S. at 323. The Court in *Corliss* did not use the phrase "termination for convenience." However, its references to "suspension of contracts" have been construed to mean termination for convenience and not "suspension of work," as is currently provided for in some federal contracts. *See, e.g.*, *Torncello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982) ("The case that first articulated this idea [i.e., termination for convenience], and which is credited as providing the basic legal theory to support the modern termination for convenience clause, is *United States v. Corliss Steam-Engine Co.*").

<sup>18</sup> *Corliss Steam-Engine*, 91 U.S. at 322-23.

contract and the reduced payment, arguing that the government had breached the contract since the contract did not grant the government the right to take such action. However, the Court found that the government had not breached and, thus, was not liable for anticipatory profits or consequential damages because the right to terminate is a necessary adjunct of the government's authority to contract and an inherent right of the government.<sup>19</sup> The Court based this conclusion, in part, on its view that

it would be of *serious detriment to the public service* if the power of the head[s] of [federal agencies] did not extend to providing for all ... possible contingencies by modification or suspension of the contracts and settlement with the contractors.<sup>20</sup>

Subsequent cases similarly emphasized the “public interest” when affirming the government’s right to terminate for convenience contracts that do not expressly provide for this right,<sup>21</sup> but upheld this right for differing reasons. For example, immediately after World War I, when a statute authorized the President to “cancel” contracts,<sup>22</sup> the Supreme Court found that the government’s right to terminate was, “by implication, one of the terms” of any government contract, since the statute was “binding,”<sup>23</sup> and the contractor “impliedly agree[d]” to the government’s right to terminate by contracting with the government.<sup>24</sup> Subsequently, when federal regulations called for termination clauses to be incorporated into federal procurement contracts,<sup>25</sup> the U.S. Court of Claims (acting as the predecessor of today’s Court of Appeals for the Federal Circuit) found that such clauses were “incorporated, as a matter of law ... [since] the Regulations can fairly be read as permitting that interpretation.”<sup>26</sup> Key to the court’s decision was that it viewed termination for convenience as a “deeply ingrained strand of public procurement policy.”<sup>27</sup> The court also noted that the contractor is entitled to some recovery when the government terminates contracts for convenience, although “[t]he termination clause limits profit to work actually done, and prohibits the recovery of anticipated but unearned profits [on work not yet performed].”<sup>28</sup>

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<sup>19</sup> *Id.* “Anticipatory profits” are profits that the non-breaching contractor could reasonably have realized had the contract been performed. *See, e.g.,* *Elson v. Indianapolis*, 204 N.E. 857, 861 (Ind. 1965). “Consequential damages” are damages that, while not a direct result of the breach, are a consequence of it. *See, e.g.,* *Acker Constr., LLC v. Tran*, 396 S.W.3d 279, 288 (Ark. App. 2012).

<sup>20</sup> *Corliss Steam-Engine*, 91 U.S. at 323 (emphasis added).

<sup>21</sup> *Russell Motor Car*, 261 U.S. at 521.

<sup>22</sup> *See* An Act Making Appropriations to Supply Urgent Deficiencies in Appropriations for the Military and Naval Establishments on Account of War Expenses for the Fiscal Year Ending June 13, 1917, and For Other Purposes, P.L. 65-23, 40 Stat. 182 (June 15, 1917). This statute and cases construing it have been construed as referring to termination for convenience, even when they do not use this phrase. *See, e.g.,* *Torncello*, 681 F.2d at 764.

<sup>23</sup> *College Point Boat Corp. v. United States*, 284 U.S. 12, 15 (1925).

<sup>24</sup> *DeLaval Steam Turbine Co. v. United States*, 284 U.S. 61, 61 (1931) (“In short, when the [contractor] entered into its contract with the Government, it impliedly agreed, because of the statute, that the Government should have the right to determine when the contract might be terminated.”).

<sup>25</sup> *See, e.g.,* *Torncello*, 681 F.2d at 765-66 (noting that legislation enacted during World War II entitled the government to terminate “war contracts,” and that regulations promulgated beginning in the 1950s made Termination for Convenience clauses standard features of procurement contracts for military and, later, civilian agencies).

<sup>26</sup> *G.L. Christian & Assocs. v. United States*, 312 F.2d 418, 426 (Ct. Cl. 1963).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

## When Can the Government Terminate a Contract for Convenience?

The standard Termination for Convenience clauses prescribed by the Federal Acquisition Regulation (FAR) all provide that a termination for convenience is based on the “Government’s interest,” as opposed to the contractor’s actual or anticipated failure to perform.<sup>29</sup> The FAR does not define what constitutes the “Government’s interest.” However, the term has been broadly construed to encompass many—although not all—interests that the government might assert. For example, federal courts and agency boards of contract appeals<sup>30</sup> have recognized the government’s interest in terminating a contract when

- the government no longer needs the supplies or services covered by the contract;<sup>31</sup>
- the contractor refuses to accept a modification of the contract;<sup>32</sup>
- questions have arisen regarding the propriety of the award, or about continued performance of the contract;<sup>33</sup>
- the contractor ceases to be eligible for the contract awarded;<sup>34</sup>
- the business relationship between the agency and the contractor has deteriorated;<sup>35</sup>
- the agency has decided to restructure its contractual arrangements or perform work in-house;<sup>36</sup>
- the agency seeks to avoid a conflict with the Comptroller General, or a dispute with Congress;<sup>37</sup> or
- the work contemplated by the contract is proving impossible or too costly.<sup>38</sup>

<sup>29</sup> See 48 C.F.R. §2.101 (defining “termination for default” and “termination for convenience”). For more on terminations for default, see *infra* “How Does a Termination for Default Differ from a Termination for Convenience?”.

<sup>30</sup> The boards of contract appeals are administrative tribunals established in procuring agencies to hear and decide disputes under the Contract Disputes Act of 1978. See 41 U.S.C. §7105. There are currently four such boards: the Armed Services Board of Contract Appeals; the Civilian Agency Board of Contract Appeals; the Postal Service board; and the Tennessee Valley Authority board. Previously, there were additional boards.

<sup>31</sup> *Corliss Steam-Engine*, 91 U.S. 321 (1876).

<sup>32</sup> *Saltwater, Inc.*, B-293335.3 (Apr. 26, 2004).

<sup>33</sup> *Nationwide Roofing & Sheet Metal Co., Inc. v. United States*, 14 Cl. Ct. 733 (1988); *Landmark Constr.* B-281957.3 (Oct. 22, 1999).

<sup>34</sup> *Int’l Data Prods. Corp. v. United States*, 64 Fed. Cl. 642 (2005) (contractor participating in the “8(a) Program” for small businesses was sold to a large business).

<sup>35</sup> *Embrey v. United States*, 17 Cl. Ct. 617 (1989).

<sup>36</sup> *Northrop Grumman Corp. v. United States*, 46 Fed. Cl. 622 (2000); *Corners & Edges, Inc., v. Dep’t of Health & Human Servs.*, CBCA Nos. 693, 762, 2008-2 B.C.A. ¶ 33,961; *Exec. Airlines, Inc.*, BSBCA 1452, 87-1 B.C.A. ¶ 19,594. *But see Dellew Corp. v. United States*, 108 Fed. Cl. 357 (2012) (rejecting the government’s argument that a challenge to an insourcing determination was moot because the contract whose functions were insured had been terminated for convenience). In reaching this conclusion, the *Dellew* court noted that the contract was terminated in the middle of an option period and, but for the termination, the plaintiff could still have been performing the contract months after the court’s decision.

<sup>37</sup> *Schlesinger v. United States*, 390 F.2d 702 (Ct. Cl. 1968) (dispute with Congress); *Reiner & Co. v. United States*, 325 F.2d 438 (Ct. Cl. 1963) (conflict with Comptroller General).

<sup>38</sup> *Krygoski Constr. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996); *Nolan Bros., Inc. v. United States*, 405 F.2d (continued...)



Terminations in almost any other circumstances could also be found to be in the government's interest.

It is only in unusual circumstances—such as when the government entered the contract with no intention of fulfilling its promises,<sup>39</sup> or purports to terminate the contract for convenience after the contract has expired<sup>40</sup>—that a termination for convenience could be found to be improper. In such situations, the government could be liable for breach, as discussed below (“Could the Government Ever Face Liability for Breach by Terminating for Convenience?”). On the other hand, because the government has a duty to consider only its own best interests in terminating contracts for convenience, it generally would not be found to have behaved improperly if it declined to terminate a contract for convenience in order to assist the contractor.<sup>41</sup>

## Types of Terminations and Other Reductions

The questions and answers in this section discuss the differences between the various types of terminations, and between termination for convenience and other actions that the government could take. It covers total and partial terminations for convenience, constructive terminations, terminations for default, cancellation, and other reductions that agencies could make in the work performed under a contract, such as “de-scoping.”

### How Is a Total Termination Different From a Partial One?

A “total termination” encompasses all the work remaining to be performed under a contract, while a “partial termination” encompasses only some of the work remaining to be performed (e.g., deleting 50% of the work from a contract for cleaning, inspecting, and coating the roofs of family housing units).<sup>42</sup> When the termination is total, the contractor could be entitled to a “termination settlement” covering the costs of work already performed, but not yet paid for; certain costs incurred in anticipation of performance; and the costs of settling the terminated work, among other things.<sup>43</sup> (See “What Could a Termination Settlement Include?”) When the

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1250 (Ct. Cl. 1969).

<sup>39</sup> See, e.g., *Tamp Corp.*, ASBCA 25692, 84-2 B.C.A. ¶ 17,460 (government agreed to extend the contract, but with the intention to terminate the contract as soon as a contract could be awarded to another vendor). The board viewed the government's undisclosed intention to terminate as making of “mockery” of its assent to the extension and, thus, an abuse of discretion.

<sup>40</sup> See, e.g., *Maxima Corp. v. United States*, 847 F.2d 1549 (Fed. Cir. 1988), *rev'g*, IBCA 1828, 86-2 B.C.A. ¶ 18,888 (government asserted its right to terminate after the contract had expired in order to avoid liability for its failure to make the minimum purchase guaranteed to the contractor under the contract).

<sup>41</sup> *John Massman Contracting Co. v. United States*, 23 Cl. Ct. 24 (1991) (finding that the government did not act improperly in declining to terminate the contract for convenience in order to assist the contractor, even though the government caused the conditions impairing the contractor's performance).

<sup>42</sup> *Kahaluu Constr. Co.*, ASBCA 33248, 90-2 B.C.A. ¶ 22,663.

<sup>43</sup> See, e.g., 48 C.F.R. §52.249-2(g) (providing that, in the event the vendor and the contracting officer fail to agree on the “whole amount” to be paid because of the termination, the contracting officer shall pay the contractor: (1) the contract price for any completed work that has not already been paid for; (2) the total of (a) the costs incurred in performing the work terminated; (b) the costs of settling termination settlement proposals under terminated subcontracts; and (c) profit on costs incurred in performing terminated work; and (3) the reasonable costs of settling the terminated work, including (a) accounting, legal, and other expenses incurred in preparing the termination settlement (continued...))

termination is partial, the contractor could be entitled to a similar settlement as to the terminated work,<sup>44</sup> plus an “equitable adjustment” granting it more money and/or time to perform the work remaining to be performed on those portions of the contract that were not terminated.<sup>45</sup> An equitable adjustment granting the contractor more money in the event of a partial termination may seem somewhat counter-intuitive, since terminations often reduce the overall price of the contract by deleting work. However, situations could potentially arise where the contractor’s costs in performing the remaining portions of the contract are increased by the deletion of work, and the contractor could be entitled to an equitable adjustment to cover those increases.<sup>46</sup>

A partial termination is not the only means by which the government could delete some—but not all—of the work remaining to be performed under a contract. So long as the reduction is within the scope of the contract, agencies could potentially also rely upon any Changes clause incorporated into the contract to delete work covered by that clause.<sup>47</sup> (See below “What Is the Difference Between Termination for Convenience and De-Scoping and Other Reductions?”)

## What Is a Constructive Termination?

The FAR and some of the standard Termination for Convenience clauses used in government contracts require the government to give the contractor written notice of its intent to terminate.<sup>48</sup> This notice is to include, among other things, the effective date of the termination; the extent of the termination; and any steps that the contractor should take to minimize the impact of the termination on personnel, if the termination will result in a “significant reduction” in the contractor’s workforce.<sup>49</sup> The notice also directs the contractor to cease work; furnish notice of

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proposal; (b) the termination and settlement of subcontracts; and (c) storage and other costs related to the termination inventory). It is important to note, however, the certain Termination for Convenience clauses may provide for more limited recovery. *See, e.g.*, 48 C.F.R. §52.249-4 (“If this contract is terminated, the Government shall be liable only for payment under the payment provisions of this contract for services rendered before the effective date of termination.”).

<sup>44</sup> *See, e.g.*, 48 C.F.R. §52.249-2(g).

<sup>45</sup> *See, e.g.*, 48 C.F.R. §52.249-2 (l) (“If the termination is partial, the Contractor may file a proposal with the Contracting Officer for an equitable adjustment of the price(s) of the continued portion of the contract.”); *Drain-A-Way Sys., Inc.*, GSBICA No. 7022, 84-1 B.C.A. ¶ 16,929 (“The customary Termination For Convenience clause permits repricing the continued portion of a contract where performance is made more costly, or less profitable, as a result of a partial termination.”). An “equitable adjustment” is “fair adjustment” intended to cover the contractor’s costs, as well as profit on the work performed. *See, e.g.*, *United States v. Callahan Walker Constr. Co.*, 317 U.S. 56, 61 (1942). The amount of the adjustment is determined by the “difference between what it would have reasonably cost to perform the work as originally required and what it reasonably cost to perform the work as changed.” *Modern Foods, Inc.*, ASBCA 2090, 57-1 B.C.A. ¶ 1,229.

<sup>46</sup> *Henry Spen & Co., Inc.*, ASBCA 20766, 77-2 B.C.A. ¶ 12,784 (“We have recognized previously that a partial termination necessarily requires the unterminated work to carry a heavier share of fixed overhead costs than contemplated by the parties when the contract was entered into, and compensated the contractor therefor as part of an equitable adjustment for the unterminated units ... Essentially, this [is] a repricing of the unterminated work to reflect the added burden because of the smaller quantity, consistent with the provision[s] ... of the termination clause for an equitable adjustment on the continued portion of the contract.”).

<sup>47</sup> *See, e.g.*, *Ideker, Inc.*, Eng. BCA 4389, 87-3 B.C.A. ¶ 20,145 (“Historically, the contracting officer has been given considerable ... discretion as to which clause should be used to delete work.”); *Indus. Consultants, Inc.*, VABCA 3249, 91-3 B.C.A. ¶ 24,326 (“The Termination for Convenience clause must be used when major portions of the work are deleted and no additional work is substituted. Otherwise, either clause may be used.”).

<sup>48</sup> *See, e.g.*, 48 C.F.R. §52.249-1 (“The Contracting Officer, *by written notice*, may terminate this contract, in whole or in part, when it is in the Government’s interest.”) (emphasis added).

<sup>49</sup> 48 C.F.R. §49.102(a).

the termination to each immediate subcontractor and supplier affected by the termination; and take certain other actions as to the termination inventory and the settlement of subcontracts.<sup>50</sup>

In practice, however, not all terminations for convenience result from such a written notice. In some cases, a court or board of contract appeals finds that the agency has constructively terminated a contract by its conduct even though no termination notice has been issued. The concept of “constructive termination” is a “judge-made doctrine that allows an actual breach by the government to be retroactively justified.”<sup>51</sup> Courts and boards of contract appeals may invoke this doctrine in order to avoid finding breach in “situations where the government stops or curtails a contractor’s performance for reasons that are later found to be questionable or invalid.”<sup>52</sup> Constructive termination for convenience is perhaps most commonly found when an improper termination for default is “converted” into a constructive termination for convenience.<sup>53</sup> (See “How Does a Termination for Default Differ from a Termination for Convenience?”) However, courts and boards of contract appeals have also found constructive termination for convenience in other circumstances, including when (1) the parties fail to agree upon the terms of a definitive contract after the work under a “letter contract” has been completed;<sup>54</sup> (2) the contracting officer improperly repudiates the contract;<sup>55</sup> (3) the government improperly uses a “change order” to delete work beyond the scope of the contract;<sup>56</sup> and (4) the government fails to make any requisite progress payments.<sup>57</sup>

## **How Does a Termination for Default Differ from a Termination for Convenience?**

Unlike a termination for convenience, which is based on the government’s interests, a “termination for default” is based on the contractor’s anticipated or actual failure to perform substantially as required by the contract.<sup>58</sup> The standard terms of federal procurement contracts grant the government the right to terminate contracts for default, as well as for convenience, by providing that the government may, subject to certain conditions,

terminate this contract in whole or in part if the Contractor fails to (i) [d]eliver the supplies or to perform the services within the time specified in this contract or any extension; (ii)

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<sup>50</sup> 48 C.F.R. §49.601-2.

<sup>51</sup> *Erwin v. United States*, 19 Cl. Ct. 47, 53 (1989). Courts developed this doctrine based upon general principles of contract law articulated by the Supreme Court in *College Point Boat Corp. v. United States*. See *College Point Boat Corp.*, 267 U.S. at 15 (“A party to a contract who is sued for its breach may ordinarily defend on the ground that there existed, at the time, a legal excuse for nonperformance by him, although he was then ignorant of the fact.”).

<sup>52</sup> *Erwin*, 19 Cl. Ct. at 53.

<sup>53</sup> See, e.g., *United Partition Sys., Inc. v. United States*, 90 Fed. Cl. 74, 94 (2009); *Keeter Trading Co. v. United States*, 79 Fed. Cl. 243 (2007); *Casebolt Co. v. United States*, 421 F.2d 710 (Ct. Cl. 1970).

<sup>54</sup> *Mite Corp.*, ASBCA 10021, 66-2 B.C.A. ¶ 6,052. A “letter contract” is a “written preliminary contractual instrument that authorizes the contractor to begin immediately manufacturing supplies or performing services.” 48 C.F.R. §16.603-1. Federal regulations require that such contracts be “definitized,” or reduced to final form, within a certain period. See generally 48 C.F.R. §16.603-2(c).

<sup>55</sup> *Best Foam Fabricators, Inc. v. United States*, 38 Fed. Cl. 627, 638 (1997); *Albano Cleaners, Inc. v. United States*, 455 F.2d 556 (Ct. Cl. 1972).

<sup>56</sup> *Kahaluu Constr. Co.*, ASBCA 33248, 90-2 B.C.A. ¶ 22,663.

<sup>57</sup> *Delta Eng. Servs.*, ASBCA 24787, 84-3 B.C.A. ¶ 17,590.

<sup>58</sup> See 48 C.F.R. §2.101.

[m]ake progress, so as to endanger performance of this contract ...; or (iii) [p]erform any of the other provisions of this contract ....<sup>59</sup>

The standard terms further provide that “[i]f, after termination, it is determined that the Contractor was not in default, or that the default was excusable, the rights and obligations of the parties shall be the same as if the termination had been issued for the convenience of the Government.”<sup>60</sup> In other words, if the government exercises its right to terminate for default, and is later found to have exercised this right improperly, the default termination will be treated as a constructive termination for convenience, as previously discussed (see “What Is a Constructive Termination?”).<sup>61</sup> Thus, the government would generally be liable to the contractor for only a termination settlement, not damages for breach.<sup>62</sup>

When a contract is terminated for default, the contractor may be entitled to payment for any work it has already performed for which it has not been paid.<sup>63</sup> However, it is generally not entitled to profit on costs incurred in anticipation of performance,<sup>64</sup> and it could potentially be liable to the government for liquidated damages, any excess costs of re-procurement, or certain other costs.<sup>65</sup>

## **How Does Cancellation Differ from Termination for Convenience?**

Commentators sometimes use the terms “termination” and “cancellation” as if they were synonymous. The Federal Acquisition Regulation (FAR), however, distinguishes between

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<sup>59</sup> 48 C.F.R. §52.249-8(a)(1).

<sup>60</sup> 48 C.F.R. §52.249-8(a)(g). These provisions serve to avoid the operation of the general rule that a party which ceases performance in the belief that the other party has anticipatorily repudiated or breached the contract does so at the risk of being incorrect as to whether repudiation or a material breach occurred.

<sup>61</sup> See *supra* note 53 and accompanying text.

<sup>62</sup> See, e.g., *Hedin Constr. Co., Inc. v. United States*, 408 F.2d 424, 431 (Ct. Cl. 1969) (noting that, because of the Termination for Convenience clause incorporated into the contract, the remedy in the case of an improper termination for default is provided for in the contract); *Green Constr. Co., Inc., GSBCA 2071*, 68-1 B.C.A. ¶ 6,883 (claims of improper termination for default are claims under a specific contractual provision).

<sup>63</sup> 48 C.F.R. §52.249-6(h) (Termination (Cost-Reimbursement)) (providing that, if the vendor and the contracting officer fail to agree on the amount of costs to be paid, the contractor shall be paid: (1) all costs reimbursable under the contract not previously paid; (2) the costs of settling and paying termination settlement proposals under terminated subcontracts; (3) reasonable costs of settling the work terminated (e.g., accounting and legal costs); and (4) in the case of contracts that provide for award or incentive fees, a fee proportionate to the total number of supplies or services delivered to and accepted by the government under the contract); 48 C.F.R. §52.249-8(f) (Default (Fixed-Price Supply and Service)) (“The Government shall pay contract price for completed supplies delivered and accepted.”); 48 C.F.R. §52.249-9(f) (Default (Fixed-Price Research and Development)) (“The Government shall pay the contract price, if separately stated, for completed work it has accepted and the amount agreed upon by the Contractor and the Contracting Officer for (1) completed work for which no separate price is stated, (2) partially completed work, (3) other property described above that it accepts, and (4) the protection and preservation of the property.”).

<sup>64</sup> Compare 48 C.F.R. §52.249-2(g)(2)(iii) (expressly authorizing recovery of a “sum, as profit,” on costs incurred in performing the work terminated) with 48 C.F.R. §52.249-6(h) (not allowing profit on costs incurred in anticipation of performance, but allowing some recovery of any fee payable under the contract on work performed).

<sup>65</sup> See, e.g., 48 C.F.R. §52.211-11(a) (“If the Contractor fails to deliver the supplies or perform the services within the time specified in this contract, the Contractor shall, in place of actual damages, pay to the Government liquidated damages of \$\_\_ per calendar day of delay.”); 48 C.F.R. §52.249-7(c) (“If the termination is for failure of the Contractor to fulfill the contract obligations, the Government may complete the work by contract or otherwise and the Contractor shall be liable for any additional cost incurred by the Government.”); 48 C.F.R. §52.249-10(a) (“The Contractor and its sureties shall be liable for any damage to the Government resulting from the Contractor’s refusal or failure to complete the work within the specified time, whether or not the Contractor’s right to proceed with the work is terminated.”).

termination and cancellation. The FAR defines “cancellation” as the bringing to an end of the “total requirements of all remaining program years,”<sup>66</sup> and contrasts cancellation with termination on the grounds that

termination can be effected at any time during the life of the contract (cancellation is effected between fiscal years) and can be for the total quantity or partial quantity (where as cancellation must be for all subsequent fiscal years’ quantities).<sup>67</sup>

In other words, for purposes of the FAR, cancellation affects only multiyear contracts, and occurs between fiscal years. Termination, in contrast, can affect multiyear contracts (at times other than between years) or other contracts (at any time). A “multiyear contract” is one that extends over more than one year without the government having to establish and exercise options for each program year after the first.<sup>68</sup>

When a multiyear contract is canceled, the contractor is generally paid a “cancellation charge.” This charge is like a termination settlement in that it covers

(1) costs (i) incurred by the Contractor and/or subcontractor, (ii) reasonably necessary for performance of the contract, and (iii) that would have been equitably amortized over the entire multiyear contract period but, because of the cancellation, are not so amortized, and (2) a reasonable profit or fee on the costs.<sup>69</sup>

However, cancellation charges generally cannot exceed the “cancellation ceiling” specified in the contract.<sup>70</sup> This ceiling represents the maximum amount that the contractor may recover (although the contractor will not necessarily recover this amount).<sup>71</sup> The ceiling is lowered each year to exclude amounts allocable to items included in the prior year’s program requirements.<sup>72</sup>

## **What Is the Difference Between Termination for Convenience and De-Scoping and Other Reductions?**

Termination for convenience is sometimes confused with “de-scoping” or other actions that the government could take pursuant to a contract that would reduce or limit the work that might have been originally contemplated by the parties to the contract. Partial terminations for convenience, in particular, can resemble “de-scoping” pursuant to any Changes clause incorporated in the contract. Many (although not all) federal procurement contracts include a Changes clause that permits the government “at any time ... [to] make changes within the general scope of th[e]

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<sup>66</sup> 48 C.F.R. §17.103.

<sup>67</sup> 48 C.F.R. §17.104(d).

<sup>68</sup> In contrast, contracts that extend over more than one year because of the exercise of options are known as “multiple year contracts.” 48 C.F.R. §17.103. An “option” is a “unilateral right in a contract by which, for a specified time, the Government may elect to purchase additional supplies or services called for by the contract, or may elect to extend the term of the contract.” 48 C.F.R. §2.101.

<sup>69</sup> 48 C.F.R. §52.217-2(d). The cancellation charge is computed and claimed as if it were a settlement proposal under the Termination for Convenience clause. 48 C.F.R. §52.217-2(e).

<sup>70</sup> 48 C.F.R. §52.217-2(c) (“If cancellation under this clause occurs, the Contractor will be paid a cancellation charge not over the cancellation ceiling specified in the Schedule as applicable at the time of cancellation.”).

<sup>71</sup> Continental Elecs. Mfg. Co., ASBCA 14749, 71-2 B.C.A. ¶ 9,108.

<sup>72</sup> *Id.*

contract” to certain terms of the contract,<sup>73</sup> such as (1) the contract specifications; (2) the method or manner of performing the work; (3) any government-furnished property or services to be used in performing the contract; (4) the method of shipping or packing; (5) the place of delivery (for supplies); and (6) the time and place of performance (for services).<sup>74</sup> When the proposed reductions are among those contemplated by any Changes clause and are “within the scope of the contract,” the contracting officer generally may *either* “de-scope” the work pursuant to the Changes clause *or* partially terminate it for convenience.<sup>75</sup>

Terminations should also be distinguished from determinations not to exercise options, or not to order more than the minimum quantity under an indefinite-quantity/indefinite-delivery (ID/IQ) contract.<sup>76</sup> In both of the latter situations, the contractor ends up not obtaining work that the contractor may have been counting on, or that the parties may have contemplated being performed. However, in these situations, the contractor has no legal entitlement to the work that the government determines not to have performed, which is not the case with terminations. An *option* is a “a unilateral right in a contract by which, for a specified time, the Government may elect to purchase additional supplies or services called for by the contract, or may elect to extend the term of the contract.”<sup>77</sup> If the government decides not to exercise the option, the contractor is entitled to no recovery.<sup>78</sup> Similarly, a contractor under an ID/IQ contract is entitled to only the minimum purchase guaranteed in the contract,<sup>79</sup> and cannot recover if the government fails to

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<sup>73</sup> See, e.g., 48 C.F.R. §52.243-1 (standard clause applicable to fixed-price contracts for supplies, as well as “alternate” clauses for use in contracts for services, including architect-engineer and professional services); 48 C.F.R. §52.243-2 (standard clause applicable to cost-reimbursement contracts, as well as “alternate” clauses to be used in contracts for services, for supplies and services, for construction, and for research and development); 48 C.F.R. §52.243-3 (standard clause applicable to time-and-materials and labor-hour contracts); 48 C.F.R. §52.243-4 (standard clause applicable to contracts for (1) dismantling, demolition, or removal of improvements, or (2) construction, when a fixed-price contract is contemplated and the contract amount is expected to exceed the simplified acquisition threshold); 48 C.F.R. §52.243-5 (standard clause used in contracts for construction, when the contract amount is not expected to exceed the simplified acquisition threshold).

<sup>74</sup> See, e.g., 48 C.F.R. §52.243-1(a). In some cases, the Changes clause applies only to changes to specifically enumerated terms of the contract, while in other cases, it is drafted so as to apply to terms of the same general type as those enumerated. Compare 48 C.F.R. §52.243-2 (permitting the contracting officer to “make changes within the general scope of this contract in any one or more of the following: (1) [d]rawings, designs, or specifications when the supplies to be furnished are to be specially manufactured for the Government in accordance with the drawings, designs, or specifications[;] (2) [m]ethod of shipment or packing[;] (3) [p]lace of delivery”) with 48 C.F.R. §52.243-4 (permitting the contracting officer to “make changes in the work within the general scope of the contract, including changes (1) [i]n the specifications (including drawings and designs); (2) [i]n the method or manner of performance of the work; (3) [i]n the Government-furnished property or services; or (4) [d]irecting acceleration in the performance of the work”). However, “specifications” are included in all the standard clauses, and this term is generally understood to encompass changes in quantity, as well as in certain other aspects of the work to be performed (e.g., product features).

<sup>75</sup> See, e.g., *J.W. Bateson Co. v. United States*, 308 F.2d 510, 513 (5<sup>th</sup> Cir. 1962) (“[T]he proper yardstick in judging between a change and a termination in projects of this magnitude would best be found by thinking in terms of major and minor variations in the plans.”). Changes are “within the general scope of the contract” when the parties should have “fairly and reasonably” contemplated them at the time when they entered the contract. Reductions that would not have been fairly and reasonably contemplated by the parties are generally treated not as changes, but as partial terminations for convenience. See *Freund v. United States*, 260 U.S. 60, 63 (1922).

<sup>76</sup> An “indefinite-quantity” contract is one that obligates the government to obtain an “indefinite quantity, within stated limits, of supplies or services [from the contractor]” over the term of the contract. 48 C.F.R. §16.504(a). One that is “indefinite-delivery” does not specify in advance the dates upon which supplies or services are to be supplied, but rather authorizes the placement of orders for supplies or services as they are needed over the course of the contract.

<sup>77</sup> 48 C.F.R. §2.101.

<sup>78</sup> See, e.g., *Dixon Pest Control, Inc.*, ASBCA 41042, 92-1 BCA ¶ 24,609; *D & S Mfg. Co., Inc.*, ASBCA 32865, 87-1 BCA ¶ 19,351.

<sup>79</sup> 48 C.F.R. §16.504(a)(1). The minimum quantity must be a “more than nominal amount.” See, e.g., *Goldwasser v.* (continued...)

make purchases in excess of the minimum.<sup>80</sup> In contrast, when the government wholly or partially terminates a contract for convenience, the government is taking away work that the contractor is legally entitled to perform, and the contractor is potentially entitled to a termination settlement or other remedy.

## **Government Liability in the Event of Termination for Convenience**

The questions and answers in this section focus upon the government's potential liability in the event of a termination for convenience. It begins by addressing how termination settlements are typically arrived at and what they may include before discussing the circumstances in which the government could potentially face liability for breach as a result of the exercise of its contractual and/or inherent right to terminate for convenience.

### **How Is a Termination Settlement Arrived At?**

When the government exercises its right to terminate, it is typically obligated, pursuant to the terms of the contract, to pay the contractor for certain costs, discussed below (see "What Could a Termination Settlement Include?"). This payment is commonly referred to as a "termination settlement," and the contract generally also prescribes the procedures for arriving at the termination settlement. The standard termination clauses prescribed by the Federal Acquisition Regulation (FAR) generally require the contractor to submit a "final termination settlement proposal" to the contracting officer within one year from the effective date of the termination (or any longer period granted by the contracting officer).<sup>81</sup> This proposal can form the basis for an agreement between the contractor and the contracting officer regarding all or part of the amount to be paid because of the termination.<sup>82</sup> However, if the contractor fails to submit a proposal within the requisite time period, the contracting officer may determine the amount, if any, due to the contractor and pay it.<sup>83</sup> Similarly, if the contractor and the contracting officer fail to agree on the "whole amount" to be paid, the contracting officer may determine the amount based upon certain factors specified in the contract (e.g., the price for any completed work that has not already been paid for, costs incurred in performing the terminated work).<sup>84</sup> Such determinations constitute "final decisions" of the contracting officer, and may be appealed pursuant to the

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United States, 325 F.2d 722 (Ct. Cl. 1963) (contract with a minimum quantity of \$100 compared to estimated price of \$40,000 "would have been a one-sided bargain, bordering upon lack of mutuality"); *Tennessee Soap Co. v. United States*, 126 F. Supp. 439 (Ct. Cl. 1954) (a \$10 minimum order was nominal and thus insufficient).

<sup>80</sup> See, e.g., *Bliss Co. v. United States*, 74 Ct. Cl. 14 (1932) (government not liable for losses due to the contractor's plant being idled for lack of orders); *Alta Constr. Co., PSCBA 1395, 87-2 BCA ¶ 19,720* (government's awarding orders to a competitor of the contractor does not give rise to a breach of contract claim).

<sup>81</sup> See, e.g., 48 C.F.R. §52.249-2(e). The one-year limitation has been found not to apply in cases of constructive termination for convenience. See, e.g., *Earth Property Servs., Inc., ASBCA 36764, 91-2 B.C.A. ¶ 23,753*.

<sup>82</sup> See, e.g., 48 C.F.R. §52.249-2(f).

<sup>83</sup> See, e.g., 48 C.F.R. §52.249-2(e).

<sup>84</sup> See, e.g., 48 C.F.R. §52.249-2(g).

contract's Disputes clause, so long as the contractor submitted a final termination settlement proposal within the requisite time period.<sup>85</sup>

Any settlement agreement reached by the parties modifies the contract,<sup>86</sup> and is generally binding upon them.<sup>87</sup>

## **What Could a Termination Settlement Include?**

The standard Termination for Convenience clauses in federal procurement contracts also generally address the specific components of any settlement between the government and the contractor for claims arising from a total or partial termination. These components can vary depending upon the terms of the contract, but generally include (1) payment for work already performed, but not yet paid for; (2) costs incurred in anticipation of performance; (3) costs arising from the termination and settling the termination; and (4) some recovery for profit, in the case of fixed-price contracts, or recovery of award or incentive fees, in the case of cost-reimbursement contracts.<sup>88</sup> A “fixed-price contract” is a contract whereby the contractor agrees to supply certain supplies or services to the government at a predetermined price, while a “cost-reimbursement contract” is one that provides for the government to pay the contractor allowable costs incurred in performing the contract up to a total cost specified in the contract.<sup>89</sup>

Because of this focus upon costs, termination has frequently been described as effectively converting fixed-price contracts into cost-reimbursement contracts,<sup>90</sup> and the cost principles and procedures from Part 31 of the FAR—which typically apply only to cost-reimbursement contracts—generally govern “all costs claimed, agreed to, or determined” under the standard Termination for Convenience clauses.<sup>91</sup> The application of Part 31 is, however, subject to the

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<sup>85</sup> See, e.g., 48 C.F.R. §52.249-2(l); R & D Mounts, Inc., ASBCA 17667, 74-2 B.C.A. ¶ 10,740 (contractor's failure to submit a settlement proposal within the requisite time period was fatal to its appeal). The Disputes clause establishes procedures for handling claims by the parties to a government procurement contract. See 48 C.F.R. §52.233-1. A “claim” is a “written demand or written assertion by one of the contracting parties seeking, as a matter of right, the payment of money in a sum certain, the adjustment or interpretation of contract terms, or other relief arising under or relating to th[e] contract.” 48 C.F.R. §52.233-1(c).

<sup>86</sup> See, e.g., 48 C.F.R. §49.001 (“Settlement agreement means a written agreement in the form of a contract modification settling all or a severable portion of a settlement proposal.”) (emphasis in original).

<sup>87</sup> As with any contract, exceptions would be made for agreements procured by fraud, misrepresentation, coercion, or a mistake that would make the agreement otherwise unenforceable. See, e.g., Narragansett Machine Co., WDBCA 1557, 4 CCF 60433 (1947). In addition, the parties could provide for certain exclusions or reservations as part of the agreement. See, e.g., Bell Aircraft Corp., ASBCA 4736, 59-2 B.C.A. ¶ 2,349.

<sup>88</sup> See *supra* notes 43 and 63.

<sup>89</sup> See generally CRS Report R41168, *Contract Types: Legal Overview*, by Kate M. Manuel. Costs are “allowable” if they are reasonable; allocable; comply with any applicable standards promulgated by the Cost Accounting Standards Board or, alternatively, generally accepted accounting principles and practices appropriate to the circumstances; are provided for by the terms of the contract; and meet any limitations set forth in Part 31 of the FAR. 48 C.F.R. §31.201-2(a)(1)-(5). A cost is “reasonable” if, “in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.” 48 C.F.R. §31.201-3(a). Costs are “allocable” if they were incurred specifically for the contract; benefit both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or are necessary to the overall operation of the business. 48 C.F.R. §31.201-4(a)-(c).

<sup>90</sup> *White Buffalo Constr., Inc. v. United States*, 52 Fed. Cl. 1, 4 (2002) (“When a fixed-price contract is terminated for convenience, it is essentially converted into a cost reimbursement contract.”).

<sup>91</sup> See, e.g., 48 C.F.R. §52.249-3 (Termination for Convenience of the Government (Dismantling, Demolition, or Removal of Improvements)); 48 C.F.R. §52.249-5 (Termination for Convenience of the Government (Educational and continued...))



general principle that the purpose of a termination settlement is to “fairly compensate” the contractor<sup>92</sup> (i.e., the cost principles will not necessarily be strictly applied).<sup>93</sup> Part 31 specifically contemplates the following costs as potentially allowable (i.e., included in settlements under the government contract to which it is allocable)<sup>94</sup> when a contract is wholly or partially terminated:

- *common items*: the costs of items “reasonably usable on the contractor’s other work” if these items could not be retained at cost without the contractor sustaining a loss;<sup>95</sup>
- *costs continuing after termination*: costs which cannot be discontinued immediately after the termination “[d]espite all reasonable efforts by the contractor”;<sup>96</sup>
- *initial costs*: nonrecurring labor, material, and related overhead costs incurred in the early part of production as a result of factors such as training, lack of familiarity with the product, or excess spoilage due to inexperienced labor; and preparatory costs incurred in preparing to perform the terminated work, such as initial plant rearrangement and alterations and production planning;<sup>97</sup>
- *loss of useful value* of special tooling, machinery and equipment, provided that the items are not “reasonably capable of use” in the contractor’s other work, and the government’s interest is protected;<sup>98</sup>
- *rental under unexpired leases*, minus the residual value of such leases, provided that the amount of rent claimed does not exceed the reasonable use value of the property, and the contractor makes “all reasonable efforts” to terminate or otherwise reduce the cost of the lease;<sup>99</sup>
- *alterations of leased property*: alterations and reasonable restorations required by the lease, when the alterations were necessary for performing the contract;<sup>100</sup>
- *settlement expenses*: accounting, legal, clerical, and similar costs reasonably necessary for preparing settlement claims and for termination and settlement of subcontracts; reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract; and indirect costs related to salary and wages incurred as settlement expenses in relation to the foregoing;<sup>101</sup> and

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Other Nonprofit Institutions)); 48 C.F.R. §52.249-6 (Termination (Cost-Reimbursement)).

<sup>92</sup> See 48 C.F.R. §49.113; 48 C.F.R. §49.201(a).

<sup>93</sup> See 48 C.F.R. §49.201(a) (“The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.”).

<sup>94</sup> 48 C.F.R. §2.101.

<sup>95</sup> 48 C.F.R. §31.205-42(a).

<sup>96</sup> 48 C.F.R. §31.205-42(b). In contrast, costs that continue after the effective date of the termination due to the contractor’s “willful or negligent failure to discontinue” are unallowable. *Id.*

<sup>97</sup> 48 C.F.R. §31.205-42(c).

<sup>98</sup> 48 C.F.R. §31.205-42(d).

<sup>99</sup> 48 C.F.R. §31.205-42(e).

<sup>100</sup> 48 C.F.R. §31.205-42(f).

<sup>101</sup> 48 C.F.R. §31.205-42(g).

- *subcontractor claims*, including the allocable portion of the claims common to the contract and the contractor's other work, as well as an "appropriate share" of the contractor's indirect expenses, provided that the amount allocated is "reasonably proportionate" to the relative benefits received and is otherwise consistent with Part 31 of the FAR.<sup>102</sup>

Other costs could potentially also be allowable, depending upon the circumstances, because "[t]he purpose of a termination settlement is to compensate a contractor fairly, ... and to make [the contractor] whole for costs incurred in performing the terminated work."<sup>103</sup>

## How Much Can a Termination Settlement Cost?

The amount of any termination settlement can vary considerably, depending upon when in the course of the contract's performance the termination occurs and the costs that the contractor incurs as a result of the termination, among other factors. In some cases, contractors may be entitled to—or agree to—a "no cost" settlement.<sup>104</sup> In other cases, the amount of the settlement can be in the billions of dollars.<sup>105</sup> The settlement costs cannot, however, generally exceed the "contract price less payments otherwise made or to be made under the contract,"<sup>106</sup> and the Government Accountability Office (GAO) has found that potential termination costs are generally not, in themselves, so large as to justify continued performance of contracts which agencies might otherwise consider terminating.<sup>107</sup>

Because the costs of any termination settlement could potentially be high, and agencies are generally required to obligate or otherwise "reserve" funds to cover potential termination liability, the possibility of termination for convenience can significantly affect agencies' financial management practices and other operations, even though the likelihood of terminating any particular contract is low.<sup>108</sup> (See "Why Must Agencies Generally Obligate or Reserve Funds for

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<sup>102</sup> 48 C.F.R. §31.205-42(h).

<sup>103</sup> Freedom Elevator Corp., GSBCA 7259, 85-2 B.C.A. ¶ 17,964.

<sup>104</sup> See, e.g., Marianas Stevedoring & Dev. Co., Inc., ASBCA 18264, 73-2 B.C.A. ¶ 10,272 (finding that the parties' agreement, "whereby any costs generated by the termination would remain for the account of the party experiencing them in the first instance and any liability of one party to the other generated by the termination would be extinguished," was binding on the parties).

<sup>105</sup> See Gov't Accountability Office, *Defense Acquisitions: Termination Costs Are Generally Not a Compelling Reason to Continue Programs or Contracts That Otherwise Warrant Ending*, GAO-08-379, Mar. 2008 (noting that the total settlement for the termination of the contract for the Crusader field artillery system was \$1.66 billion, while that for the Tri-Service standoff attack missile was \$2.4 billion). These figures are given in current, not constant, dollars.

<sup>106</sup> 48 C.F.R. §49.207 ("The total amount payable to the contractor for a settlement, before deducting disposal or other credits and exclusive of settlement costs, must not exceed the contract price less payments otherwise made or to be made under the contract."). See also *Solar Turbines, Inc. v. United States*, 23 Cl. Ct. 142, 149 (1999) (applying the Limitation of Cost clause to preclude the contractor's recovery on a termination claim involving amounts in excess of the funds allotted to the contract on the grounds that the "ceiling is binding and is not linked in any way to the timing of any termination for convenience"); *Pickard & Burns Electronics*, ASBCA 12736, 68-2 B.C.A. ¶ 7,149 (finding that the Limitation of Cost clause precluded recovery of termination costs in excess of the specified amount because the Termination clause committed the government to pay costs and expenses "reimbursable in accordance with this contract," and the Limitation of Cost clause is part of those terms).

<sup>107</sup> See *Defense Acquisitions: Termination Costs Are Generally Not a Compelling Reason to Continue Programs or Contracts*, *supra* note 105.

<sup>108</sup> See, e.g., Gov't Accountability Office, *NASA Needs To Better Assess Contract Termination Liability Risks and Ensure Consistency in Its Practices*, GAO-11-609R, at 1, July 12, 2011 (reporting that, in FY2010, the National (continued...)

Termination Liability?") However, in addition to generally being "capped" by the contract price, the amount of any termination settlement could also be limited by the operation of certain contract clauses, such as the Special Termination Cost clause included in certain Department of Defense Contracts.<sup>109</sup>

## Could the Government Ever Face Liability for Breach by Terminating for Convenience?

As a general rule, the government does *not* face liability for breach of contract when it terminates a contract for convenience because the government's right to terminate for convenience is an express or implied term of the contract. (See "What Is the Basis for the Government's Right to Terminate for Convenience?") However, in certain narrow circumstances, the government could potentially face liability for breach because the termination for convenience is found to have been motivated by bad faith or to constitute an abuse of discretion.<sup>110</sup> The number of such cases is arguably limited by the difficulty of proving bad faith or an abuse of discretion on the government's part.<sup>111</sup> Bad faith, in particular, "is an onerous charge that requires 'well-nigh irrefragable proof,'"<sup>112</sup> and public officials are presumed to perform their duties correctly, fairly, in good faith, and in accordance with the laws and regulations.<sup>113</sup>

In certain cases, though, courts and boards of contract appeals have found breach when the government exercises its right to terminate for convenience. Such cases generally involve situations where (1) the government entered the contract with the intent to terminate it,<sup>114</sup> or (2) the government purported to terminate the contract for convenience after the contract expired in order to avoid liability under the contract.<sup>115</sup> These findings impliedly or expressly reflect fundamental principles of the common law of contracts. For example, in finding breach when the government entered the contract with the intent to terminate it, courts and boards have described the government's undisclosed intent to terminate as making a "mockery" of its purported assent to the contract.<sup>116</sup> Mutual agreement by the parties is fundamental to any contract. Similarly, in

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Aeronautics and Space Administration terminated 28 of 16,343 contracts and orders, for a termination rate of about 0.17%); Defense Acquisitions, *supra* note 105, at 8 (reporting that in FY2006, the Defense Contract Management Agency's Terminations Center processed about 600 terminations, only 10% of which involved terminated items valued at more than \$1 million).

<sup>109</sup> See generally 48 C.F.R. §249-7000(c) ("The Contractor agrees to perform this contract in such a manner that the Contractor's claim for special termination costs will not exceed \$\_\_\_\_. The Government shall have no obligation to pay the Contractor any amount for the special termination costs in excess of this amount.").

<sup>110</sup> *Krygoski Constr. Co.*, 94 F.3d at 1541 ("When tainted by bad faith, or an abuse of contracting discretion, a termination for convenience causes a breach.").

<sup>111</sup> See, e.g., *Kalvar Corp. v. United States*, 543 F.2d 1298 (Ct. Cl. 1976).

<sup>112</sup> *Knotts v. United States*, 121 F. Supp. 630 (Ct. Cl. 1954).

<sup>113</sup> See, e.g., *Librach v. United States*, 147 Ct. Cl. 605 (1959).

<sup>114</sup> See, e.g., *Salsbury Indus. v. United States*, 905 F.2d 1518, 1521 (Fed. Cir. 1990) ("When the government contracts with a party knowing full well that it will not honor the contract, it cannot avoid a breach claim by advertent to the termination for convenience clause."); *Caldwell & Santmyer, Inc. v. Glickman*, 55 F.3d 1578 (Fed. Cir. 1995) (same); *Tamp Corp.*, ASBCA 25692, 84-2 B.C.A. ¶ 17,460 (same).

<sup>115</sup> See, e.g., *Maxima Corp.*, 847 F.2d 1549 (government asserted its right to terminate after the contract had expired in order to avoid liability for its failure to make the minimum purchase required under the contract).

<sup>116</sup> *Tamp Corp.*, ASBCA 25692, 84-2 B.C.A. ¶ 17,460. See also *Travel Centre v. Gen. Servs. Admin.*, GSBICA 14057, (continued...)

finding that “retroactive terminations” constitute breach, courts and boards have emphasized that the government “may not use the standard termination for convenience clause to dishonor, with impunity, its contractual obligations.”<sup>117</sup> In other words, the government’s express or implied contractual right to terminate contracts for convenience expires with the contract, and cannot thereafter be asserted to avoid liability for the government’s failure to perform as required during the term of the contract.

## Why Must Agencies Generally Obligate or Reserve Funds for Termination Liability?

The Anti-Deficiency Act is a federal statute which generally prohibits the obligation of federal funds in excess of amounts actually appropriated under law.<sup>118</sup> As a result, when a federal agency enters into a contract, the agency must generally have sufficient funds to cover the cost of the contract, plus any liability that may arise if the agency chooses to terminate the contract before it expires. In the case of a typical single-year contract, the total recovery by the contractor may not exceed the contract price.<sup>119</sup> Therefore, it is generally not necessary for a federal agency to set aside funds for termination liability for single-year contracts, as the federal government’s liability would always be within the amount required to pay for full performance under the contract.

However, where the contract gives the agency an option to renew, the contractor may have initial outlays that would not be recouped if the government chooses not to renew beyond the base period of the contract. In order to provide some security for the contractor in these situations, renewable (i.e., multiple year) contracts frequently contain provisions requiring the government to pay some form of “termination charge” in the event that a renewal option is not exercised.<sup>120</sup> Notably, in contrast with a typical single-year contract, here the government may be liable for more than the cost of performance under the contract from its inception up until the refusal to renew. Therefore, the Anti-Deficiency Act generally requires that an agency have sufficient funds

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98-1 B.C.A. ¶ 29,536 (1997), *recon. denied*, 98-1 B.C.A. ¶ 29,541 (finding that the government had breached the contract, which it purported to terminate for convenience, because the government had withheld crucial information demonstrating that the estimates of potential business on which the contractor based its proposal were vastly overstated, and the contract was “doomed to failure from the beginning”).

<sup>117</sup> *Torncello*, 681 F.2d at 772. In *Torncello*, the government had entered a requirements contract for “on call” pest-control services at naval housing facilities. The court found that the government breached this contract by ordering lower-priced services from another vendor who had competed for the contract awarded to *Torncello* because the contract entitled *Torncello* to supply all the Navy’s requirements for pest-control services at these facilities. The government attempted to avoid liability by asserting that it could have terminated the contract for convenience at any time, but it had not, in fact, so terminated. *Torncello* is sometimes construed as precluding agencies from terminating requirements contracts. However, this is arguably an over-expansive reading of the court’s decision, and *Torncello*’s holding was subsequently limited by the decision of the U.S. Court of Appeals for the Federal Circuit in *Krygoski Construction Co. v. United States*. While not addressing a requirements contract, the *Krygoski* court read *Torncello* as holding only that the government cannot terminate a contract for convenience in bad faith. See *supra* note 114.

<sup>118</sup> 31 U.S.C. §1341.

<sup>119</sup> 48 C.F.R. §49.207 (“The total amount payable to the contractor for a settlement, before deducting disposal or other credits and exclusive of settlement costs, must not exceed the contract price less payments otherwise made or to be made under the contract”).

<sup>120</sup> For more on the differences between multiyear and multiple year contracts, see *supra* note 68 and accompanying text.

to cover any such termination charges, in addition to the price of one year of performance under the contract, before entering into such a contract.<sup>121</sup>

The required obligation of termination costs also arises in the context of multiyear contracts authorized under the Federal Acquisition Streamlining Act of 1994 (FASA),<sup>122</sup> as amended, or other authority. Multiyear contracts are defined under FASA as contracts of up to five years in length.<sup>123</sup> Multiyear contracts are an exception to the Anti-Deficiency Act, but FASA imposes its own requirement to set aside termination costs. Specifically, FASA provides that civilian agencies may only enter into multiyear contracts if they *either* obligate the full cost of the contract over the entire term, *or* obligate the cost of the first year of the contract plus the estimated costs associated with any termination of the contract.<sup>124</sup>

Termination costs are generally obligated from the same fund under which the underlying contract would be funded. Consequently, if an agency were not required to obligate potential termination liability when entering into a contract, the purchasing power of a particular appropriation would be increased. To this end, exceptions to the general requirement to set aside funds for termination liability have been enacted by Congress. For example, Congress has previously specified that a particular federal agency “shall not be required to obligate funds for potential termination liability in connection with” specific programs.<sup>125</sup> Congress has also specifically appropriated or designated additional funds to cover potential termination liability.<sup>126</sup> In other cases, Congress has placed ceilings on the amount of termination liability that an agency may negotiate with a contractor.<sup>127</sup>

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<sup>121</sup> B-174839, 62 Comp. Gen. 143 (Jan. 28, 1983) (finding that upon entering 5-year contract, with option to renew for additional 5-year periods for up to 20 years, Navy is required to record obligation of funds for costs of the base 5-year period plus any termination expenses for failure to renew).

<sup>122</sup> P.L. 103-355, 108 Stat. 3243 (1994).

<sup>123</sup> 10 U.S.C. §§2306b-2306c (procurements of defense agencies); 41 U.S.C. §3903 (procurements of civilian agencies).

<sup>124</sup> 41 U.S.C. §3903(b)(1). FASA’s provisions regarding the multiyear contracts of defense agencies differ somewhat. *See generally* 10 U.S.C. 10 U.S.C. §§2306b-2306c.

<sup>125</sup> *E.g.*, Department of Defense Appropriations Act, 2001, P.L. 106-259, §8145, 114 Stat. 705 (Aug. 9, 2000) (exempting B-2 Link 16/Center Instrument Display/In-Flight Planner Program).

<sup>126</sup> *E.g.*, Department of Defense Appropriations Act, 2000, P.L. 106-79, §8147, 113 Stat. 1271 (Oct. 25, 1999) (appropriating \$300 million for F-22 program termination liability); John Warner National Defense Authorization Act for FY2007, P.L. 109-364, §812(f)(2)(A), 120 Stat. 2317 (Oct. 17, 2006) (authorizing Secretary of Defense to establish special reserve account to cover termination costs of major weapon systems in pilot program); 10 U.S.C. §7233(h) (authorizing termination liability for leases of vessels to be paid from amounts originally available for performance of the contract, amounts available for operation and maintenance of such vessels, or funds appropriated for costs).

<sup>127</sup> *E.g.*, Oceans Act of 1992, P.L. 102-587, §5223, 106 Stat. 5081 (Nov. 4, 1992) (capping termination liability for certain business services provided to the Coast Guard Support Center in Kodiak, Alaska, at \$842,047).

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