

**Time for a Tune-up: Looming Federal Budget Cuts
Mean Contractors Cannot Afford Business-as-Usual**

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I. **Introduction**

Automatic, largely across-the-board spending reductions may be triggered if Congress this year approves spending levels that exceed caps of the Budget Control Act of 2011 (“BCA”). It is believed that reductions generally will be made uniformly across virtually all categories/accounts, with several programs being exempt, such as Social Security, Medicaid, and Federal Retirement programs, and with Medicare cuts being limited to 2%. To implement these budget cuts, the BCA calls for “sequestration” of discretionary and mandatory spending for Fiscal Years (“FY”) 13 through FY21, scheduled to commence on January 1, 2013 unless Congress acts (President has pledged to veto any attempts to change the BCA). There are a number of significant factors in play, such as the President’s defense spending reduction policy announced in January 2012, the President’s budget submitted in February 2012, the possible lapse of the payroll tax extension and unemployment benefits in mid-March 2012, upcoming Presidential/Congressional elections in November 2012, and the expiration of the Bush tax cuts in early January 2013.

Should sequestration occur, \$1.2 trillion in reductions could be required in FY 2013 through FY 2021 spending. Of this total, approximately \$100 billion could come from reduced interest payments on reduced debt (assuming that debt is in fact reduced), however the rest will need to come from DoD (\$547 billion), the other half (\$547 billion) from non-DoD accounts.

This is roughly \$55 billion in cuts each year from DoD (“Security” in BCA parlance) and non-DoD (“Non-Security”) accounts. With apologies to the late Senator Everett Dirksen and his possibly apocryphal comment regarding mere billions of dollars, “a trillion here, a trillion there, pretty soon you’re talking about real money” Something will have to give if budget cuts of this size come to pass.

It will. The Office of Management and Budget (“OMB”) will then determine, in consultation with the agencies, what specific cuts will be made to what specific accounts. The President, Congress and agencies will have some ability to influence where to shift funds among specific line items but, as usual, individual contracting officers and their customers, the program managers, will generally be among the last to know what funds will be available for what programs. Rather, they will be told, late in the process, what funds they have, and will have to make cuts to meet the numbers they are given. Last of all to learn of the practical impact of these budget cuts will be contractors, who already have been enduring years of “just-in-time” incremental funding and in-sourcing actions.

II. Contracting Officer/Program Manager Coping Mechanisms

So when budget Armageddon finally hits, what will agencies do to deal with the challenge? Most likely nothing new, but the familiar bag of tricks used by contracting officers for decades will be deployed more aggressively, along with tougher stances in all negotiations, whether in a formal dispute or not, such as:

- Termination/restructuring of programs and contracts
- Reduced use of terminations for convenience and increased use of deductive changes (see below) and early re-competitions while options are still available

- Acceleration of trend toward firm-fixed-price (“FFP”)-type contracts even when usage of this type is inappropriate (see FAR 16.202-2)
- Reduced quantities being purchased or delivery schedules extended
- Possible increased use of bundled procurements
- Increased use of cost-sharing contracts; pressure to self-fund
- Tougher award fee standards

III. Now What?

Contractors, being even further down the budget pipeline than program managers and contracting officers, have to be even more agile and far-sighted in preparing for budget cuts and, in addition, because of the profit imperative to which Government personnel are not subject, contractors simply cannot conduct business as usual and at the same time hope to remain in business. Again none of the above budget coping mechanisms are new, but what will be different in the years to come is a more sustained and aggressive application of them. In short, to keep the car running as smoothly as possible, contractors must tune up their engines (i.e., systems and business processes) now. Everything discussed in this paper has always been well-advised, but not necessarily a life-or-death matter. The legal distinction between contractual “deductive changes” changes and terminations for convenience can have important bottom-line consequences for contractors and thus should be thoroughly understood. This will be the subject of Section IV below. But before turning to that important legal issue, there are number of other measures that astute contractors will consider and implement which should be highlighted.

- **Comply With the Limitation of Funds/Limitation of Costs Clauses.** Despite severe habitat encroachments by FFP contracts, cost reimbursement contracts are not on the endangered species list just yet. And as long as this contract type lives on, the Limitation of Funds and

Limitation of Costs (FAR 52.232-20 and 22, “LOF/LOC”) clauses will survive – and these important clause will continue to be routinely ignored to contractors’ increasing economic peril. Everyone sort of knows what they are and what they require in general terms. But too few know exactly what must be done in the first place, and what to do if the Government does not find more money. Essentially these clause require contractors to notify the contracting officer when they have reason to believe that within next 60 days costs will exceed 75% of total so far allocated to their contracts. This notification requirement is often forgotten altogether, or the contracting officer is notified when costs have been incurred at the 75% level or later, but typically, some notification is made. Where contractors most often fail is in telling the contracting officer who does not come up with more money that they will demobilize if more funds are not obligated; and then do so if more money is not forthcoming. For many years, contractors have been able to get away with working “at risk.” The days when somehow, somewhere, the needed money is found later, may be over. And if so, more and more contractors will be left holding the bag with only a lame dispute/claim argument and little prospect of collecting anytime soon, if ever. So to avoid such fiscal disasters contractors must know the rules, follow them rigorously, and be prepared to walk away, or at least to more intelligently assess risk and proceed in accordance with such assessments rather than in blind faith on the good will of their Government customers.

- **Practice Better Change Management.** Much like LOF/LOC clause compliance, contractors must ensure that their change management systems are functioning at peak efficiency, even if this puts more pressure on the Government. The days when changes could be handled in a leisurely fashion, when constructive change notifications could go out any old time,

when cost impacts could be haphazardly segregated and tracked, and when settlement proposals could be submitted many months or even years after the fact, are gone, at least for contractors who want to continue being profitable.

- **Be Part of the Solution.** Contracting officers and program managers are too frequently not good businesspersons, and have limited insight into the way their contracts work. Left to their own devices, they might have no idea what to do, and may make cuts that do not make sense for either contracting party. Contractors, on the other hand, must know their contracts intimately in order to turn a profit. They more often will know the best way to approach decrements in contract funding and means of carrying out reductions which best preserve program integrity and the contractor's bottom line. For this reason, on a continuing and indeed indefinite basis, contractors need to stay in even closer touch with their customers to learn early of impending reductions, changing priorities, and applicable timetables. With such information, a smart contractor can conceive and be ready to present to the Government options which reduces the pain to the parties overall, and shares it as much as possible.

- **Tune Up Your Key Systems.** Money can be lost in myriad ways on Government contracts, but two of the easiest ways to do so in the new normal of scarce funding are by letting your cost accounting and Government property control systems run down. Auditors have never been truly lenient or easygoing with contractors, whatever Government "watchdogs" might argue. But one must reasonably expect that as contracting officers and programs are squeezed ever more tightly that auditors, their customers will press harder and be more difficult to deal with across the board. The same goes for Government property control – where losses may have been readily written off before, in the future contractors may be called to make up for lost,

stolen, damaged or destroyed property far more often than before. No accounting system can be made foolproof, and no contractor can perfectly manage the millions of line items entrusted to them under Government contracts. But as the Government looks for easy ways to make up budget shortfalls, they will naturally focus first and most intensely on those contractors with weak systems. An intelligent contractor will therefore maximize the chance that when the Government needs to save money by being more aggressive, it will look elsewhere. To do this, internal controls must be scrutinized to ensure they have kept up with the times, that their employees are carrying them out assiduously, and that the Government knows it.

- **Manage the Award Fee Process More Aggressively.** In recent years outstanding award fee scores and resulting high-dollar monetary payoffs have become harder and harder to come by. With the trend toward FFP contracts accelerating, award fee contracts will become more scarce. But, where they continue to exist, contractors can expect contracting officers and program managers to see award fee line items as reprogramming opportunities to divert money not needed to fund award fees to other purposes. Thus, we anticipate that greater attention to quality assurance by Government personnel, with more deficiency reports, more mediocre or worse evaluations and lower scores and awards. Again, the smart contractors will make certain that they are not easy targets of the new “zero-based” award fee evaluations. They will do this by stepping up their own quality control programs, by more promptly and thoroughly responding to quality concerns by their customers, and by more carefully making their presentations to award fee determining officials. Are there costs associated with these measures? Certainly, and these must be weighed against the potential risks of not changing. This will be a very fact-

specific, contract-by-contract or customer-by-customer decision. But not to recognize that undertaking this analysis is crucial is to simply hope for the best – not a great business practice.

All of these areas of inquiry and thought, and more, should be considered as contractors gear-up for increased funding scarcity in the years to come. A major legal issue, that is, the distinction and difference in impact between terminations for convenience and deductive changes, must also be understood and acted upon. That is the subject of the next section of this paper.

IV. **Deductive Changes and Partial Terminations for Convenience Compared**

Two of the most commonly used vehicles for decreasing the scope of a contract are the deductive change and the partial termination for the convenience of the government. Although the two are similar, there are key differences between deductive changes and partial terminations that can inform a decision regarding how to achieve a descoping of a contract to the mutual advantage of the Government and the contractor. Generally, a deductive change is used to change specifications or delete minor portions of work; a partial termination is used to delete identifiable or major portions of work. Pricing under a deductive change is prospective, meaning the contract price is reduced by what the deleted work should have cost and a reasonable profit on that amount; pricing under a partial termination is retrospective, meaning that the contractor is entitled to recover the costs incurred on the deleted portion of the work plus a reasonable profit on the work performed. In addition, a contractor can recover attorney and consultant fees incurred in preparing a settlement for partial termination, which may be limited under a deductive change. Overall, often a deductive change results in a more favorable end result for

the contractor on a profitable contract and a partial termination for convenience is more effective for the contractor on a loss contract.

A. Two General Tests for Whether a Modification is a Deductive Change or a Termination for Convenience

There is no “hard and fast line” between what should be characterized as a partial termination for convenience and what should be called a deductive change. *J.W. Bateson Co. v. United States*, 308 F.2d 510, 513 (5th Cir. 1962). The boards and courts have developed two different general non-exclusive tests, “one based on the identifiability of the work eliminated and the other premised on an assessment of whether that work was ‘major’ or ‘minor.’”¹ *Ideker, Inc.*, ENGBCA No. 4389, 87-3 BCA ¶ 20,145. Under one test, a change of “identifiable, segregable items” is generally handled via partial termination for convenience; an alteration of specifications is conventionally accomplished by a deductive change. *Id.* (citing *Doughboy Indus., Inc.*, FAACAP No. 67-3, 66-2 BCA ¶ 5712; *Celesco Indus., Inc.*, ASBCA No. 22251, 79-1 BCA ¶ 13,604; *Frederick Constr. Co.*, ASBCA No. 12108, 68-1 BCA ¶ 6832.). Under the second test, a deductive change should be used to effect deletions of minor portions of work; a partial termination should be exercised to delete major portions of work. *Id.* (citing *J.W. Bateson Co.*, 308 F.2d at 513; *Nager Elec. Co. v. United States*, 442 F.2d 936 (Ct. Cl. 1971)).

In the course of applying these tests, courts and boards accord deference to the contracting officer’s decision or the agreement of the parties to characterize the deletion as a deductive change or as a termination, requiring a “compelling reason” to alter the parties’

¹ A third potential test based on whether the government had a continuing need for the deleted work was established by *Skidmore, Owings, & Merrill*, ASBCA No. 5115, 60-1 BCA ¶ 2570 (continuing need at a reduced rate considered deductive change; no continuing need considered termination for convenience). It is not often followed.

treatment. *See, e.g., Universal Printing Co.*, GPOBCA NO. 9-90, 1994 WL 377586; *Goetz Demolition Co.*, ASBCA No. 39129, 90-3 BCA ¶ 23,241; *P.J. Dick, Inc. v. General Servs. Admin.*, GSBCA No. 12215, 95-1 BCA ¶ 27,574. Because of this deference, contractors should make every effort to influence the contracting officer’s characterization of the change. Note that courts and boards are not, however, bound by such a determination. *Lucas Aul, Inc.*, ASBCA No. 37803, 91-1 BCA ¶ 23,609.

B. Calculating Recovery Under Each Theory: Major Differences

The primary difference between pricing recovery for a deductive change and for a termination is that the focus for a deductive change is prospective—i.e., cost savings—and the focus for a termination is retrospective—i.e., costs incurred and the contract price.

Under a deductive change order, the contract price is reduced by the cost savings realized by the contractor as a result of the change order and a reasonable amount of profit on the deleted work.² *See Celesco Indus., Inc.*, 79-1 BCA ¶ 13,604 (“The measure of the equitable price adjustment is the difference between the reasonable cost of performing without the change or deletion and the reasonable cost of performing with the change or deletion.”). This can be beneficial to the contractor where the “reasonable” profit in the reduction is less than the

² The normal rules do not apply if the contract is severable. If the solicitation is advertised as being severable by line item or phase, the proper measure for a deletion of that line item or phase is the quoted price. *See, e.g., Gregory & Reilly Assocs., Inc.*, FAACAP No. 65-30, 65-2 BCA ¶ 4918; *Eugene Iovine, Inc.*, PSBCA No. 2867, 92-2 BCA ¶ 25,013.

anticipated profit on the work. Note that because the underlying purpose of an equitable adjustment to keep the contractor whole, the price reduction does not include a reasonable amount of profit if the deletion is made to a loss contract. *CRF*, ASBCA No. 17340, 76-1 BCA ¶11857.

Under a termination for convenience settlement of a traditional government contract, the contractor is entitled to recover the costs incurred in the performance of the terminated work plus a reasonable profit on the work performed.³ *See* FAR 52.249-2; *see also* FAR 49.113, 49.201, 49.202, 31.205-42. Because profit recovery is limited to “reasonable” profit, the contractor may receive less than the profit bid on the job. *See* FAR 52.249-2. If the Government can prove that the contractor would have suffered a loss on the contract, the contractor is not entitled to profit on work performed and recovery is subject to a loss adjustment reducing termination costs by the percentage of loss that would have been incurred had the contract been completed. *See* FAR 49.203.

In addition, costs associated with the preparation and negotiation of a termination settlement, including direct labor, administrative costs, and attorneys fees, are recoverable under a partial termination for convenience. FAR 31.205-42(g). Recovery of attorney and consultant fees for a deductive change may be more limited, based on whether the decisionmaker considers them a recoverable contract administration expense or an unallowable claim prosecution cost. *Compare* FAR 31.205-33 *with* 31.205-47.

³ This is the cost-based formula. FAR Part 12 establishes a modified price-based formula for a contractor’s recovery for the termination for convenience of a contract for commercial items. Under that formula, the contractor is entitled to the percentage of the contract price reflecting the percentage of work done prior to notice of termination. FAR 12.403(d).

As a general rule, a deductive change is better for the contractor on a profitable contract and a partial termination for convenience is better for the contractor on a loss contract. *See generally* John C. Person, “Deductive Changes,” Briefing Papers 01-08 (July 2001); Ralph C. Nash, *Government Contract Changes* 18-28 (2d ed. 1989).

There are also at least two procedural distinctions between recovery for a deductive change and a termination for convenience which may inform whether a contractor prefers proceeding on the basis of a deductive change or a termination. First, for a deductive change, the Government has the burden of proving both (1) the extent to which the contract requirements were reduced and (2) the savings which resulted from the reduction. *See, e.g., Celesco Indus., Inc.*, 79-1 BCA ¶ 13, 604; *Noblebrook Contractors, Inc.*, ASBCA 9736, 1964 BCA ¶ 4283. In contrast, the contractor bears the burden of proving termination for convenience damages. *See Lisbon Contractors, Inc. v. United States*, 282 F.2d 759, 767 (Fed. Cir. 1987). This difference in burden may be significant if proof of costs will be particularly difficult.

Second, the contractor must submit its final termination settlement proposal within one year of the effective date of the termination. FAR 52.249-2(e). If the contractor fails to meet this deadline, the Contracting Officer is permitted to unilaterally determine what, if any, amount due to the contractor. *Id.* No such requirement applies to deductive changes. *See Lucas Aul, Inc.*, 91-1 BCA ¶ 23,609 (holding that Contracting Officer’s decision to deny recovery because contractor’s termination settlement was late was in error because the minor deletion was appropriately characterized as a deductive change not subject to the one-year limitation on final termination settlements). Of course, it is always more prudent to submit for costs within one year in order to avoid controversy.

V. **Termination for Convenience Considerations**

If a contract is restructured through a partial termination for convenience, Prime

Contractors should kept in mind the following key considerations:

A. A Contractor's Obligations When a Contract is Terminated

Upon receipt of written notice of a termination for convenience, the prime contractor incurs the following responsibilities:⁴

- (a) Stop work immediately on the terminated portion of the contract and stop placing subcontracts thereunder;
- (b) Terminate all subcontracts related to the terminated portion of the prime contract;
- (c) Immediately advise the [Termination Contracting Officer ("TCO")] of any special circumstances precluding the stoppage of work;
- (d) Perform the continued portion of the contract and submit promptly any request for an equitable adjustment of price for the continued portion, supported by evidence of any increase in the cost, if the termination is partial;
- (e) Take necessary or directed action to protect and preserve property in the contractor's possession in which the Government has or may acquire an interest and, as directed by the TCO, deliver the property to the Government;

⁴ There are even obligations that may precede receipt of written notice of termination. Under the Worker Adjustment and Retraining Notification (WARN) Act, certain employers must give 60-day notice of specified significant shutdowns and layoffs. 29 U.S.C. § 2101 et seq. Advance knowledge of a termination for convenience may trigger WARN Act obligations. In addition, Department of Defense regulations require a prime to transmit a Contracting Officer's notice of substantial reduction in or termination of a major defense program to employees and major first-tier subcontractors, with notice requirements thereafter flowing down the chain of contracting. DFARS 252.249-7002(c)-(d).

(f) Promptly notify the TCO in writing of any legal proceedings growing out of any subcontract or other commitment related to the terminated portion of the contract;

(g) Settle outstanding liabilities and proposals arising out of termination of subcontracts, obtaining any approvals or ratifications required by the TCO;

(h) Promptly submit the contractor's own settlement proposal, supported by appropriate schedules; and

(i) Dispose of termination inventory, as directed or authorized by the TCO.

FAR 49.104. Remember that complying with each of these obligations will require coordination with subcontractors and vendors.

Take note that there are variations in termination clauses and best practices depending upon the type of the contract at issue and the profit status of the contract. In particular, although the Government's ability to terminate a contract for convenience is robust, there are situations in which an attempted termination is actually a breach of contract entitling the contractor to traditional anticipatory profit damages. Especially in light of the fact that a contractor is entitled to attorney and consultant fees related to the preparation of a termination settlement, it is to a contractor's advantage to seek professional advice in this area. A contractor can recover the costs of settlement preparation even if ultimately not entitled to any other termination costs. *See, e.g., Engineered Sys., Inc.*, ASBCA No. 18241, 74-1 BCA ¶ 10,492. Although some considerations common to all terminations for convenience are highlighted below, this does not represent the full scale of a contractor's options and considerations when a termination is at hand.

The FAR defines termination inventory as “any property purchased, supplied, manufactured, furnished, or otherwise acquired for the performance of a contract and properly allocated to the termination of the contract.” FAR 2.101. Contractors are required to dispose of termination inventory as directed by the TCO. FAR 49.104. Contractors and their subcontractors should therefore segregate termination inventory and create a complete listing of its contents. This facilitates the compliance with the contractor’s obligation to preserve Government property.

If a termination for convenience of a fixed-price contract is partial, the contractor is entitled to an equitable adjustment because there is less work over which to spread fixed costs as a consequence of the change. FAR 49.104(d), 49.208, 52.249-2(l). A request for an equitable adjustment must be made within 90 days. FAR 52.249-2(l).

Amid obligations to stop work, manage inventory, consider the need for equitable adjustment, and notify and coordinate subcontractors, one of the prime contractor’s primary concerns is the preparation of a final settlement proposal, which must be submitted within one year of notice of termination. *See* FAR 52.249-2(e). The FAR provides cost accounting principles specific to termination costs in section 31.205-42 which is to be used in conjunction with the other cost principles in Part 31. But do not lose sight of the premise that the FAR requires that cost principles be applied in light of the fundamental guidance that a terminated contractor is entitled to fair compensation. FAR 49.113, 49.201(a). Even if not allowed by strict construction of the FAR’s cost accounting principles, include any costs required for fair compensation in your termination settlement proposal.

Contractors are entitled to reasonable costs, including, qualifying continuing costs,⁵ and settlement costs. *See, e.g.*, FAR 52.249-2, 31.205-42. Although for purposes of calculating costs, termination essentially converts a fixed-price contract into a cost-type contract, the Government cannot avoid paying termination costs because the fixed-price contractor does not have the type of detailed documentation of costs associated with a cost-type contract. *Cf. Durette, GmbH*, ASBCA No. 34072, 91-2 BCA ¶ 23,756. In fact, because of this conversion, the contractor is entitled to recover costs related to any delays regardless of fault, *Worsham Constr. Co.*, ASBCA No. 25907, 85-2 BCA ¶ 18016, and defective or nonconforming work, *Caskel Forge, Inc.*, ASBCA No. 7638, 1962 BCA ¶ 3318. The contractor's burden to prove its costs is only to demonstrate "with sufficient certainty so that the determination of the amount . . . will be more than mere speculation." *Lisbon Contractors, Inc.*, 828 F.2d at 767.

Partial payments on termination settlement proposals are available before final settlement. FAR 49.112-1(a); *see, e.g.*, FAR 52.259-2(m)(1). Partial payments can help ease the pressure to settle because of cash flow, as the Government is required to act promptly to resolve partial payment requests. *See* FAR 49.112-1(a).

Avoid loss adjustments by forcing the government to meet its burden to prove that the contract at issue is a loss contract and the quantum of the loss. Because termination costs are based on work performed rather than work deleted, a contractor has no obligation to furnish an estimate to complete work. *See* Defense Contract Audit Agency Contract Audit Manual ¶ 12-

⁵ Qualifying continuing costs are those which cannot be avoided "despite all reasonable efforts by the contractor." FAR 31.205-42(b). A significant example is idle facilities and idle capacity, governed by FAR 31.205-17.

307a(3) (Nov. 16, 2007). If such an estimate would be an admission of a loss contract, it would be wise to consider whether to cooperate with such a request.

Beware settlement provisions that impose any obligations concerning terminated work. In fact, some commentators have suggested securing releases from post-termination performance obligations to avoid disputes. Paul J. Seidman & David J. Seidman, “Maximizing Termination for Convenience Settlements,” Briefing Papers 08-3 at 10-11.

B. Managing Subcontractors and Vendors After Termination

Although a subcontractor has no contractual rights against the Government upon termination of a prime contract, it may have rights against a prime. FAR 49.108-1. Notably, although the *Christian* doctrine operates to read termination for convenience clauses into every Government prime contract, it does not apply to subcontracts. *G.L. Christian & Assocs. v. United States*, 312 F.2d 418, 425 (Ct. Cl. 1963). Therefore, if a subcontract does not include a proper termination for convenience clause, a prime contractor could be obligated to pay traditional damages for cancellation of the contract, including anticipatory profit. *See* U.C.C. § 2-708.

Assuming a proper termination clause, there are a number of considerations for managing subcontractors and vendors in the event of termination of the prime contract for the convenience of the government. First, upon receipt of notice of termination, the prime should provide a notice of termination to subcontractors that mirrors the notice provided by the Government.⁶ *See*

⁶ Note that it, if a fixed-price subcontractor is very near to completion of its work, it may be more expensive to terminate for convenience than to allow the subcontractor to finish its work because of the impact of termination-related costs. Some commentators have suggested that it would be wise to obtain the Government’s approval in the event the prime contractor decides to

FAR 49.104. In the event of a partial termination, this will require the prime to carefully review subcontracts to determine which subcontractors are affected by the termination and what work should continue, as a subcontract terminated in error generally cannot be unilaterally reinstated.

Prime contractors are responsible for obtaining subcontractor settlement proposals to incorporate claims for termination costs into the eventual termination settlement proposal submitted to the TCO. In this role, the prime's objective is to negotiate a fair and prompt settlement. If settlement negotiations with a subcontractor are not proceeding productively, a prime should always advise the TCO and generally can choose among a few action options: (1) if permitted by the termination clause, make a unilateral determination of the subcontractor's entitlement; (2) request Government assistance; or as a last resort (3) request that the TCO resolve the termination settlement proposal excepting the subcontractor settlement proposal, FAR 48.108-6.

All termination settlements with subcontractors are subject to the review and approval of the TCO.⁷ FAR 29.108-4. Importantly, the prime contractor is responsible for performing all necessary accounting reviews and audits of subcontractor settlement proposals, FAR 49.107, and must certify in its settlement proposal form that its settlements with subcontractors were fair and reasonable, based on costs allocable to the terminated portion of the contract, negotiated in good faith and not more favorable to the subcontractor because of the promise of eventual Government reimbursement, and made in accord with certificates from subcontractors with respect to the

deviate from the typical termination procedures. *See* Patricia A. Meagher & Greg S. Bingham, "Administering Subcontracts After a Termination," Briefing Papers 04-04 (Mar. 2004).

⁷ Contractors can request that the TCO delegate the authority to approve subcontractor settlements for less than \$100,000. FAR 49.108-4.

propriety of their own proposals. *See, e.g.*, Settlement Form 1435. Ultimately, the prime is responsible for the all contents of the termination settlement proposal.

VI. **Using Option Year Negotiations as Leverage—Key Considerations**

Option Year negotiations present one potential opportunity for restructuring a contract, because both parties come to the table with potential leverage over the other. The Government's leverage derives primarily from the rule that an option contract binds the option giver, but not the option holder, who retains both the power to exercise it and the privilege not to. *See Green Management Corp. v. United States*, 42 Fed. Cl. 411, 434 (1998) (citing *Dynamics Corp. of America v. United States*, 389 F.2d 424, 431 (Ct. Cl. 1968)). By contrast, the Contractor's leverage derives from the rule that options can only be exercised in strict accordance with contract terms. *Alliant Techsystems, Inc. v. United States*, 178 F.3d 1260, 1275 (Fed. Cir. 1999). As a result, if the Government needs continued performance on different terms, the Government will have to obtain the bilateral agreement of the Contractor.

Given the breadth of discretion afforded to it, the Government's leverage may often be superior. The Government's decision not to exercise an option can provide a vehicle for relief only if the contractor proves that the decision was made in bad faith or was so arbitrary or capricious as to constitute an abuse of discretion. *Blackstone Consulting, Inc. v. General Services Administration*, CBCA 718, 09-1 BCA ¶ 34,103, at 168,636. It is exceedingly difficult to show that the decision not to exercise an option was made in bad faith or that it constituted an abuse of discretion:

[I]n order to overcome the presumption of good faith on behalf of the government, the proof must be almost irrefragable. “Almost irrefragable proof” amounts to clear and convincing evidence. In the cases where the court has considered allegations of bad faith, the necessary “irrefragable proof” has been equated with evidence of some specific intent to injure the plaintiff.

Galen Medical Associates, Inc. v. United States, 369 F.3d 1324, 1330 (Fed. Cir. 2004); *see also Am-Pro Protective Agency, Inc. v. United States*, 281 F.3d 1234, 1239-40 (Fed. Cir. 2002) (citing *Price v. Symsek*, 988 F.2d 1187, 1191 (Fed. Cir. 1993) for the proposition that clear and convincing evidence is “evidence which produces in the mind of the trier of fact an abiding conviction that the truth of a factual contention is ‘highly probable’”). Applying this standard, the Boards have held:

In determining whether the decision not to exercise the option was so arbitrary or capricious as to constitute an abuse of discretion, we consider —(1) evidence of subjective bad faith on the part of the government official, (2) whether there is a reasonable, contract-related basis for the official’s decision, (3) the amount of discretion given to the official, and (4) whether the official violated an applicable statute or regulation.

AFR & Associates, Inc., 09-2 at 169,169 (quoting *McDonnell Douglas Corp. v. United States*, 182 F.3d 1319, 1326 (Fed. Cir. 1999) (citing *United States Fidelity & Guaranty Co. v. United States*, 676 F.2d 622, 630 (Ct. Cl. 1982))).