Terminations for Convenience –
“You Want Me to Pay You What?”

Stephen M. Seeger
Seeger, PC
Washington, D.C.

Ben Patrick
Watt, Tieder, Hoffar & Fitzgerald, L.L.P.
Miami, FL

Presented at the 2013 Midwinter Meeting
Making Dollars & Sense of Construction Damages
January 31 & February 1, 2013
Waldorf Astoria Naples Hotel, Naples, Florida

©2013 American Bar Association
I. INTRODUCTION

There are few events in construction that garner more attention than a termination for default. Occasionally called a "death sentence for contractors," a termination for default often triggers the sort of litigation construction lawyers and consultants dream about: a long, bitter fight that will expand to encompass virtually every difficulty on the project as the owner and contractor argue about who was to blame. Viewed in this context, terminations for convenience can seem like a second-fiddle: less lawyer-enriching, less glamorous, less interesting, and ultimately unimportant, as the parties will just sort it out under the contract's guidelines.

And yet, in many ways, terminations for convenience are more important in the industry (both the construction industry and the construction law industry) than terminations for default. First, they are more common, and therefore a construction lawyer or consultant is more likely to encounter a termination for convenience than one for default. Second, they are the typical end-game for an improper termination for default, since many contracts convert wrongful terminations for default into terminations for convenience. Third, they are complex in ways that terminations for default are not, since the contract attempts to segregate recoverable versus non-recoverable costs in a more nuanced manner than a default termination would. Fourth, to paraphrase Tolstoy, all terminations for default are similar, but every termination for convenience is different, because the contracts and regulatory schemes adopted across the country vary significantly in their treatment of terminations for convenience.¹

For all of these reasons, it behooves the construction lawyer and consultant to understand the mechanics of a termination for convenience. This article begins with a summary of the historical roots of the termination for convenience. The article then sets forth, comments on, and compares the termination for convenience language from the major form contract families and
several representative governmental regiments. This article addresses the considerations driving a decision between a termination for default versus for convenience, and the issues arising from the conversion of a wrongful termination for default into a termination for convenience. The article then explores the difference between a termination for convenience and a total deductive change order, which is occasionally used to attempt to achieve the same end result. While no article of any reasonable length could hope to comprehensively summarize such a diverse body of law, it is the authors' hope that this article will provide a solid foundation for any practitioner and serve as a useful resource when faced with a termination for convenience.

II. HISTORY

A. The origins of the termination for convenience clause

The concept of a “termination for convenience” originated in government contracting “principally as a means to end the massive procurement efforts that accompanied major wars.”2 Understandably, the Government wanted to quickly shut-down the extraordinary costs to arm, clothe and feed a war-time effort as soon as possible when the fighting ceased and the accompanying needs decreased. Equally understandable, Government procurement officers could not accurately predict when wars would end or when war-based supply demands would abate. The Supreme Court sanctioned this practice in United States v. Corliss Steam Engine Co.,3 where it held that a Naval contracting official could terminate a wartime supply contract and bind the Government to a settlement agreement with the contractor after the end of the Civil War rendered the contract at issue unnecessary.4 The advent of the World Wars in the early 20th century brought widespread statutory authorization of terminations for convenience.5 For example, the Urgent Deficiency Appropriation Act,6 passed during World War I, “authorized the [P]resident to modify, suspend, or cancel existing or future wartime contracts, if he did so within
six months after a final treaty of peace.” In addition, the Dent Act authorized the Secretary of War “to adjust, pay, or discharge any agreement, express or implied, upon a fair and equitable basis” entered into for wartime purposes prior to the Armistice. Mobilization during World War II likewise required statutory authorization for widespread terminations for convenience, which occurred most notably with the Contract Settlement Act of 1944.

1. The Antideficiency Act

Another justification for the power to terminate contracts for the Government’s convenience stems from the Antideficiency Act, the earliest government-wide version of which was enacted in 1870. The Antideficiency Act provides in pertinent part that no officer or employee of the Government may bind the Government in “a contract or obligation for the payment of money before an appropriation is made unless authorized by law.” Thus, in the early Court of Claims case *Wilder v. United States*, the court invalidated a government contract for the transportation of supplies and goods without any temporal limitation where the relevant appropriation did not cover the costs of transportation for the next fiscal year. The Supreme Court subsequently adopted this line of reasoning in *Leiter v. United States*, when it held that “[a] lease to the Government for a term of years when entered into under an appropriation available for but one fiscal year, is binding on the Government only for that year.”

Eventually, the Antideficiency Act’s limitation on multi-year government contracting became another justification for upholding the termination for convenience clause. In *Varo, Inc.*, for example, the board held that the Government could not evade its obligations to a contractor on a multi-year contract by simply cancelling payment for the final year upon realizing that it had never appropriated the necessary amount of funds. Instead, the board found the Government liable to the contractor for termination for convenience settlement costs,
The effect of the Government’s failure to fund the final year of appellant's contract was a termination of that quantity for the convenience of the Government. 

2. **Widespread regulatory adoption of terminations for convenience**

During the second half of the 20th century, the Government shifted toward new regulations requiring termination for convenience clauses in all government contracts. The 1950 edition of the Armed Services Procurement Regulation required termination for convenience clauses for almost all Department of Defense contracts over $1,000. Likewise, the first edition of the Federal Procurement Regulations allowed any agency, whether civilian or military, to insert a termination for convenience clause “whenever an agency considered it necessary or desirable . . . .” Then, in 1967, termination for convenience clauses became mandatory for all government contracts, with limited exceptions. It was also around this same time period that the Court of Claims held that, where a government contract does not contain an otherwise required termination for convenience clause, courts should not give effect to the omission but rather read the termination for convenience clause into the contract. Currently, FAR 49.502 contains the government-wide requirement for termination for convenience clauses, “with the result that the broad rights developed for war contracts have come to be applied to all types of contracts, civilian as well as military, in times of both peace and war.”

**B. Consideration for termination for convenience**

1. **The federal standard: bad faith or abuse of discretion**

The issue of consideration in the context of a termination for convenience has received minimal attention from courts and boards, whose decisions have often glossed over the issue entirely. For example, in *Kalvar Corp. v. United States*, which established the bad faith or abuse of discretion standard for terminations for convenience, the Court of Claims offered no
discussion as to what consideration the Government had given for its unilateral right to terminate the agreement. Instead, the court assumed that only a showing of governmental bad faith or abuse of discretion, which “requires ‘well-nigh irrefragable proof’ to induce the court to abandon the presumption of good faith dealing,” could limit the Government’s exercise of a termination for convenience.24 The court held that this high standard is met when there is “evidence of some specific intent [by the Government] to injure the plaintiff,” and pointed to Knots v. United States25 (finding governmental bad faith in civilian pay suit when evidence showed conspiracy to get rid of plaintiff), and Struck Construction Co. v. United States26 (finding governmental bad faith when Government engaged in “designedly oppressive” conduct by repeatedly demanding and rejecting performance it knew or should have known to be impossible), as examples.27

In contrast to Kalvar Corp., the Court of Claims engaged in a full discussion of consideration in the context of a termination for convenience in Torncello v. United States.28 The court in Torncello reaffirmed “that the [G]overnment must furnish consideration for its contractual promises as must any private party.”29 The court thus rejected the ASBCA’s interpretation of the termination for convenience clause in that case as allowing the Government to obtain exculpation from its contractual obligations, because such “a route of complete escape vitiates any other consideration furnished and is incompatible with the existence of a contract.”30 The court also rejected the Government’s argument that the obligation of good faith provides sufficient consideration for the termination for convenience clause on the basis that “[i]t does not seem enough to support the [G]overnment’s claim for otherwise unlimited convenience termination for the [G]overnment only to promise not to use it specifically to damage the contractor.”31 Finally, the court rejected the Government’s other argument that not abusing its discretion to terminate for convenience offers the necessary consideration, because “[i]t is
bootstrapping to say that the [G]overnment’s claimed power of unlimited exculpation is saved by the limits on its discretion.”

Instead, the Court of Claims ultimately settled on finding consideration in a termination for convenience clause by restricting “the availability of the clause to situations where the circumstances of the bargain or the expectations of the parties have changed sufficiently that the clause serves only to allocate risk.”

_Tornello_’s potential for shifting the bad faith or abuse of discretion standard to one of changed circumstances was stifled in the Federal Circuit’s subsequent opinion in _Krygoski Construction Co. v. United States_. As in _Kalvar Corp._, the court in _Krygoski Construction Co._, skirted the issue of consideration to hold that only a showing of bad faith or abuse of discretion would defeat the Government’s right to terminate a contract for convenience. Describing it as dicta, the Federal Circuit also interpreted the changed circumstances test announced in _Tornello_ as applying “only when the Government enters a contract with no intention of fulfilling its promises.” The Federal Circuit then underscored its holding by explaining how the enactment of the Competition in Contracting Act (“CICA”) in the years after _Tornello_ meant that contractors no longer needed the protection of the changed circumstances test because contracting officers are now strongly discouraged by CICA from “shopping for lower prices after contract award.” Although the Federal Circuit did not technically overrule the _Tornello_ decision, the result of _Krygoski Construction Co._ nonetheless has been that “courts and boards have been reluctant to convert terminations for convenience into breach of contract claims in the absence of strong evidence of bad faith or abuse of discretion in the termination decision.”

While the general test articulated in _Kalvar_ is still good law today, the standard of proof required to meet that test has become substantially more forgiving. The "irrefragable proof"
standard governed, since at least Librach in 1959, until Tecom, Inc. v. United States in 2005. In a 30-page opinion, the Tecom court exhaustively analyzed the precedent that gave rise both to the presumption that public officials act conscientiously in the discharge of their duties, and the burden of well-nigh irrefragable evidence needed to overcome that presumption, and found no real historic support for either. The court's exhaustive, and academically rigorous, analysis of this issue spanned 12 pages of its opinion and will be not set forth herein. The result of that analysis was a complete transformation of the presumption of proper conduct and the evidence needed to overcome that presumption:

The Court concludes, following Am–Pro, that when a government official is accused of fraud or quasi-criminal wrongdoing in the exercise of his official duties, there is a strong presumption of good faith conduct that must be rebutted by clear and convincing evidence. But in light of the other precedents discussed above, this Court is unwilling to extend this strong presumption beyond the bound set by the Federal Circuit in Am–Pro, to settings where the rationale does not apply. **When a government official acts under a duty to employ discretion,** granted formally by law, regulation, or contract, and a lack of good faith is alleged that does not sink to the level of fraud or quasi-criminal wrongdoing, **clear and convincing evidence is not needed to rebut the presumption.** Instead, this may be inferred from a lack of substantial evidence, gross error, or the like. And **when the government actions that are alleged are not formal, discretionary decisions, but instead the actions that might be taken by any party to a contract, the presumption of good faith has no application.**

When it is not a discrete decision by one official, but a number of acts that are alleged to constitute a lack of good faith, the acts must be judged in the aggregate, and not on the basis of any particular individual’s bad faith. **Concerning the presumption of regularity,** the Court concludes that it will usually mean only that predicate acts that were required of public officials could be presumed upon proof of their natural results, subject to rebuttal by a preponderance of the evidence. The presumption only takes on a greater significance in the context of administrative record reviews, such as bid protest matters, where it may foreclose discovery absent “evidence suggesting that the agency decision is arbitrary and capricious.”

Thus, a presumption that the court was "loath" to overturn became a simple presumption to be overcome with routine evidence. A burden of proof that previously could be satisfied with (at a minimum) clear and convincing evidence could now be satisfied with a simple
preponderance of the evidence. Almost fifty years of government contracting precedent was upended, and the path forward was made substantially easier for contractors. Ordinarily, such a sweeping about-face would draw sharp criticism from many corners. It is a testament to the quality of the court's analysis and the thoroughness of the history assembled by the court that no serious criticism has been leveled against the opinion.

2. Other interpretations of consideration for termination for convenience

Analysis of private contracts commences with the promise or set of promises that create a duty or, if breached, provide a legal remedy. It is axiomatic that no contract arises from illusory promises or mere statements of intention. The Restatement of Contracts 2\textsuperscript{nd} §2, comment (e) defines illusory promises as “Words of promise which by their terms make performance entirely optional with the ‘promisor’ whatever may happen, or whatever course of conduct in other respects he may pursue, do not constitute a promise. Although such words are often referred to as forming an illusory promise, they do not fall within the present definition of promise. They may not even manifest any intention on the part of the promisor. Even if a present intention is manifested, the reservation of an option to change that intention means that there can be no promisee who is justified in an expectation of performance.” Absent Governmental power or public policy, the few courts that have considered the validity of termination for convenience provisions have struggled to justify them.

a. Good faith and fair dealing

In \textit{Questa Builders, Inc. v. CB Flooring, LLC}, the Court of Appeals of Maryland declined to extend “the near carte-blanche power to terminate that courts have given the Federal Government under convenience termination clauses” to contracts containing termination for convenience clauses between private parties. Instead, the court decided to
interpret the termination for convenience clause consistently with Maryland law, which imposed an implied duty of good faith and fair dealing in all contracts.\(^{43}\) Accordingly, the court held that a termination for convenience clause must be exercised as “a risk-allocating tool,” such that the party with discretion to terminate can only do so if the contract “would subject it potentially to a meaningful financial loss or some other difficulty in completing the project successfully.”\(^{44}\) In addition, the implied duty of good faith and fair dealing requires the party with discretion to terminate to “act reasonably in ensuring that the [contract] did not become inconvenient” and to not “create an inconvenience in order to terminate the contract.”\(^{45}\) Given these limitations then, the Court of Appeals of Maryland concluded that “the right to terminate for convenience . . . provides adequate consideration for the other party to the contract, protecting that party’s expectations in a binding enforceable agreement and prohibiting the terminating party from yanking out arbitrarily the carpet from underneath the agreement.”\(^{46}\)

\(b. \quad \text{Party irrevocably bound by an appreciable period of time}\)

The Court of Appeals of Maryland in \textit{Questar Builders, Inc.},\(^{47}\) also stated that a termination for convenience clause has consideration if the party with discretion to terminate cannot exercise its termination rights, but instead is irrevocably bound to the contract, for an appreciable period of time. However, the court did not rely on this proposition to find consideration because the contract at issue did not contain a time period limitation for the termination for convenience clause.\(^{48}\)

\(c. \quad \text{Good faith change in circumstances}\)

Similar to the court in \textit{Questar Builders, Inc.},\(^{49}\) the Supreme Court of Kentucky in \textit{RAM Engineering & Construction, Inc. v. University of Louisville},\(^{50}\) also turned to the implied duty of good faith in all contracts recognized by its state law to resolve the issue of consideration for a
state government contract containing a termination for convenience clause. Unlike the Court of Appeals of Maryland, however, the Kentucky Supreme Court decided to adopt the changed circumstances language used in *Tornello* to hold that, since the Government is presumed to “act in good faith to contract in [its] best interest at the time of the agreement, . . . then a change in circumstances is necessary for the contract to no longer be in the [G]overnment’s best interest when terminating for convenience.” Thus, even though “contractors ought to expect the [G]overnment to terminate a contract when it is in its best interest to do so,” the Supreme Court of Kentucky held that consideration for a termination for convenience clause only exists when contractors can also “expect that the [G]overnment’s interest will only change if the circumstances surrounding the contract substantially change.”

*d.*  
*Compensation provided in termination for convenience clause*

Several courts, and at least one board of contract appeals, have held that the recoverable settlement costs specified in a termination for convenience clause provide sufficient consideration to make the contract non-illusory.

*e.*  
*Notice*

A couple of decisions from the Second Circuit have held that a notice requirement in a termination for convenience clause provides adequate consideration to support the contract. The Tenth Circuit has also adopted this proposition. This proposition is also supported by the Uniform Commercial Code regarding the sale of goods. UCC 2-309(3) provides that sales contracts allowing unilateral termination at will are illusory unless the terminator is required to give reasonable or written notice and contracts dispensing with such notice requirements may be invalid if the result is unconscionable. Note, however, the Court of Claims in *Tornello* specifically considered and rejected the notice as consideration argument as unpersuasive.
f. **Party with discretion to terminate incurred obligations upon entering into contract**

The Tenth Circuit in *EDO Corp. v. Beech Aircraft Corp.*\(^57\) addressed a subcontractor’s argument that the contract containing a termination for convenience clause at issue lacked consideration under the Court of Claims’ decision in *Torncello*. The Tenth Circuit rejected this argument, however, by finding that the prime contractor with discretion to terminate had given consideration for the contract at issue when it incurred obligations upon entering into the contract, “unlike in *Torncello*, where the [G]overnment never ordered — nor was it required by the contract to order — any services from the plaintiff.”\(^58\)

g. **Termination for convenience based on another contract supported by sufficient consideration**

The Court of Appeals of Georgia has held that a contract does “not lack mutuality because of a termination for convenience clause benefitting [one party when the contract] was executed to carry out an earlier contract supported by other monetary consideration provided by [that party].”\(^59\)

**III. COMPARISON OF COMMON REGULATORY AND CONTRACTUAL TERMINATION FOR CONVENIENCE DAMAGES PROVISIONS**

**A. Federal Acquisition Regulations - 48 CFR Part 49**

The Federal Acquisition Regulations ("FAR") contain a number of extremely specific provisions related to terminations for convenience. Indeed, it can safely be said that these provisions are, by far, the most detailed and specific termination for convenience regulations the authors studied in preparing this article. The FAR sections applicable change depending on whether the contract was fixed-price or cost-reimbursable. In addition, some sections apply regardless of the contract type. In the interests of clarity, FAR provisions of general application will be analyzed first, followed by the more specific provisions. In addition, none of the analysis
herein pertains to commercial procurements, which are governed by an entirely separate set of FAR provisions. 60

I. Notable Provisions

49.104: Duties of prime contractor after receipt of notice of termination

After receipt of the notice of termination, the contractor shall comply with the notice and the termination clause of the contract, except as otherwise directed by the TCO [termination contracting officer]. The notice and clause applicable to convenience terminations generally require that the contractor—
(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 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;
(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.

49.108-3 Settlement procedure

(a) Contractors shall settle with subcontractors in general conformity with the policies and principles relating to settlement of prime contracts in this subpart and Subparts 49.2 or 49.3. However, the basis and form of the subcontractor’s settlement proposal must be acceptable to the prime contractor or the next higher tier subcontractor. Each settlement must be supported by accounting data and other information sufficient for adequate review by the Government. In no event will the Government pay the prime contractor any amount for loss of anticipatory profits or consequential damages resulting from the termination of any subcontract (but see 49.108-5).

(b) Except as provided in 49.108-4, the TCO shall require that—
1. All subcontractor termination inventory be disposed of and accounted for in accordance with the procedures contained in paragraph (j) of the clause at 52.245-1, Government Property; and
2. The prime contractor submit, for approval or ratification, all termination settlements with subcontractors.
The TCO shall promptly examine each subcontract settlement received to determine that the subcontract termination was made necessary by the termination of the prime contract (or by issuance of a change order—see 49.002(b)). The TCO will also determine if the settlement was arrived at in good faith, is reasonable in amount, and is allocable to the terminated portion of the contract (or, if allocable only in part, that the proposed allocation is reasonable). In considering the reasonableness of any subcontract settlement, the TCO shall generally be guided by the provisions of this part relating to the settlement of prime contracts, and shall comply with any applicable requirements of 49.107 and 49.111 relating to accounting and other reviews. After the examination, the TCO shall notify the contractor in writing of—

1. Approval or ratification, or
2. The reasons for disapproval.

49.201 General

(a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.

(b) The primary objective is to negotiate a settlement by agreement. The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount.

(c) Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of recordkeeping, reporting, and accounting related to the settlement of terminated contracts should be kept to a minimum compatible with the reasonable protection of the public interest.

49.202 Profit

(a) The TCO shall allow profit on preparations made and work done by the contractor for the terminated portion of the contract but not on the settlement expenses. Anticipatory profits and consequential damages shall not be allowed (but see 49.108-5). Profit for the contractor’s efforts in settling subcontractor proposals shall not be based on the dollar amount of the subcontract settlement agreements but the contractor’s efforts will be considered in determining the overall rate of profit allowed the contractor. Profit shall not be allowed the contractor for material or services that, as of the effective date of termination, have not been delivered by a subcontractor, regardless of the percentage of completion. The TCO may use any reasonable method to arrive at a fair profit.

(b) In negotiating or determining profit, factors to be considered include—

1. Extent and difficulty of the work done by the contractor as compared with the total work required by the contract (engineering estimates of the percentage of completion ordinarily should not be required, but if available should be considered);
(2) Engineering work, production scheduling, planning, technical study and supervision, and other necessary services;

(3) Efficiency of the contractor, with particular regard to—
   (i) Attainment of quantity and quality production;
   (ii) Reduction of costs;
   (iii) Economic use of materials, facilities, and manpower; and
   (iv) Disposition of termination inventory;

(4) Amount and source of capital and extent of risk assumed;

(5) Inventive and developmental contributions, and cooperation with the Government and other contractors in supplying technical assistance;

(6) Character of the business, including the source and nature of materials and the complexity of manufacturing techniques;

(7) The rate of profit that the contractor would have earned had the contract been completed;

(8) The rate of profit both parties contemplated at the time the contract was negotiated; and

(9) Character and difficulty of subcontracting, including selection, placement, and management of subcontracts, and effort in negotiating settlements of terminated subcontracts.

(c) When computing profit on the terminated portion of a construction contract, the contracting officer shall—
   (1) Comply with paragraphs (a) and (b) of this section;
   (2) Allow profit on the prime contractor’s settlements with construction subcontractors for actual work in place at the job site; and
   (3) Exclude profit on the prime contractor’s settlements with construction subcontractors for materials on hand and for preparations made to complete the work.

49.203 Adjustment for loss

(a) In the negotiation or determination of any settlement, the TCO shall not allow profit if it appears that the contractor would have incurred a loss had the entire contract been completed. The TCO shall negotiate or determine the amount of loss and make an adjustment in the amount of settlement as specified in paragraph (b) or (c) of this section. In estimating the cost to complete, the TCO shall consider expected production efficiencies and other factors affecting the cost to complete.

(b) If the settlement is on an inventory basis (see 49.206-2(a)), the contractor shall not be paid more than the total of the amounts in paragraphs (b)(1), (2), and (3) of this section, less all disposal credits and all unliquidated advance and progress payments previously made under the contract:
   (1) The amount negotiated or determined for settlement expenses.
   (2) The contract price, as adjusted, for acceptable completed end items (see 49.205).
   (3) The remainder of the settlement amount otherwise agreed upon or determined (including the allocable portion of initial costs (see 31.205-42(c)), reduced by multiplying the remainder by the ratio of—
      (i) The total contract price to


(ii) The total cost incurred before termination plus the estimated cost to complete the entire contract.

(c) If the settlement is on a total cost basis (see 49.206-2(b)), the contractor shall not be paid more than the total of the amounts in paragraphs (c)(1) and (2) of this section, less all disposal and other credits, all advance and progress payments, and all other amounts previously paid under the contract:

(1) The amount negotiated or determined for settlement expenses.
(2) The remainder of the total settlement amount otherwise agreed upon or determined (lines 7 and 14 of SF 1436, Settlement Proposal (Total Cost Basis)) reduced by multiplying the remainder by the ratio of—
   (i) The total contract price to
   (ii) The remainder plus the estimated cost to complete the entire contract.

49-206.2 Bases for settlement proposals

(a) Inventory basis.
(1) Use of the inventory basis for settlement proposals is preferred. Under this basis, the contractor may propose only costs allocable to the terminated portion of the contract, and the settlement proposal must itemize separately—
   (i) Metals, raw materials, purchased parts, work in process, finished parts, components, dies, jigs, fixtures, and tooling, at purchase or manufacturing cost;
   (ii) Charges such as engineering costs, initial costs, and general administrative costs;
   (iii) Costs of settlements with subcontractors;
   (iv) Settlement expenses; and
   (v) Other proper charges.
(2) An allowance for profit (49.202) or adjustment for loss (49.203(b)) must be made to complete the gross settlement proposal. All unliquidated advance and progress payments and all disposal and other credits known when the proposal is submitted must then be deducted.
(3) This inventory basis is also appropriate for use under the following circumstances:
   (i) The partial termination of a construction or related professional services contract.
   (ii) The partial or complete termination of supply orders under any terminated construction contract.
   (iii) The complete termination of a unit-price (as distinguished from a lump-sum) professional services contract.

(b) Total cost basis.
(1) When use of the inventory basis is not practicable or will unduly delay settlement, the total-cost basis (SF 1436) may be used if approved in advance by the TCO as in the following examples:
   (i) If production has not commenced and the accumulated costs represent planning and preproduction or “get ready” expenses.
(ii) If, under the contractor’s accounting system, unit costs for work in process and finished products cannot readily be established.

(iii) If the contract does not specify unit prices.

(iv) If the termination is complete and involves a letter contract.

(2) When the total-cost basis is used under a complete termination, the contractor must itemize costs incurred under the contract up to the effective date of termination. The costs of settlements with subcontractors and applicable settlement expenses must also be added. An allowance for profit (49.202) or adjustment for loss (49.203(c)) must be made. The contract price for all end items delivered or to be delivered and accepted must be deducted. All unliquidated advance and progress payments and disposal and other credits known when the proposal is submitted must also be deducted.

(3) When the total-cost basis is used under a partial termination, the settlement proposal shall not be submitted until completion of the continued portion of the contract. The settlement proposal must be prepared as in paragraph (b)(2) of this section, except that all costs incurred to the date of completion of the continued portion of the contract must be included.

(4) If a construction contract or a lump-sum professional services contract is completely terminated, the contractor shall—

(i) Use the total cost basis of settlement;

(ii) Omit Line 10 “Deduct-Finished Product Invoiced or to be Invoiced” from Section II of SF 1436 Settlement Proposal (Total Cost Basis); and

(iii) Reduce the gross amount of the settlement by the total of all progress and other payments.

(c) Other basis. Settlement proposals may not be submitted on any basis other than paragraph (a) or (b) of this section without the prior approval of the chief of the contracting or contract administration office.

2. Analysis of the provisions

The FAR anticipates a structured, bottom-up approach to resolution following termination. The prime contractor is required to settle with each of its subcontractors and suppliers, and submit each settlement to the TCO for approval. As these settlements are approved, the sums liquidated in those settlements are added to the sum to be paid to the prime contractor. In finalizing the settlement with the prime contractor, the FAR wisely notes "[t]he use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement."
a. Pricing methodology

The FAR establishes a hierarchy of termination pricing methodologies. The FAR recognizes that an inventory basis "is preferred." When the inventory basis "is not practicable or will unduly delay settlement," the prime contractor may use a total cost basis for pricing the settlement. The TCO must approve, in advance, the use of total cost basis pricing. No pricing methodology other than inventory or total cost basis can be used without the prior approval of the chief of the contracting or contract administration office.

b. Recovery of profit

The FAR allows profit both for work performed and for "preparations made," but not for work not yet performed or materials not yet delivered. The prime contractor cannot recover profits if it appears that the prime contractor would not have made a profit on the project had the project been prosecuted to completion, an issue mostly ignored by other form contracts. The contracting agency bears the burden of proving that the prime contractor would not have made a profit if it denies the prime contractor's request for profits. In addition, "this requirement to disallow profit in a case of loss is not applicable to situations in which the Government substantially contributed to the increased costs and it is not possible to separate that portion of the loss from possible losses caused by the contractor."

c. Recovery for non-conforming work

The federal courts and contract boards have commonly held that a contractor can recover for work performed, even if that work does not meet the applicable specifications. The rationale for this rule is that a contrary rule (disallowing recovery) "would, in effect, convert a convenience termination into a termination for default, even though a convenience termination is not based upon any fault or negligence on the part of the contractor." This rule is not
unlimited, however: “[t]o the extent the Government establishes that alleged deficiencies stemmed from gross disregard by [the contractor] of its contractual obligations, the costs of performing such grossly deficient work would be considered unreasonable and hence unallowable.”72

d. Unabsorbed overhead

In addition to direct costs of project performance, a contractor incurs a number of indirect costs, such as insurance, home office administrative staff, and home office rent and utilities. These overhead costs are allocated proportionately to the projects on which the contractor is working at the time, and are therefore paid via receipts from those projects. When a contractor is terminated before the project is completed, the overhead allocated to that project will no longer be recovered, as the termination "decreases the stream of direct costs against which to assess a percentage rate for reimbursement[,]" of overhead costs.73 In such a situation, the remaining portion of the overhead is referred to as "unabsorbed," in that it was never "absorbed" into project payment applications, because the project was terminated prior to completion.

While the FAR is silent on the issue of unabsorbed overhead, nothing in the FAR excludes unabsorbed overhead from compensation. Based on the lack of an explicit prohibition, the Federal Circuit and the Armed Services Board of Contract Appeals have found that a terminated contractor is entitled to seek compensation for unabsorbed overhead.74 The contractor bears the burden of establishing the portion of its overhead properly attributable to the project. If the project was terminated after performance began, the Federal Circuit has held that the Eichleay formula75 is the only proper method for allocation of overhead.76

In Nicon, Inc. v. United States,77 the Federal Circuit confronted, but did not resolve, the issue of how to allocate overhead when the contract is terminated before commencement. The
court recognized that the *Eichleay* formula could not be used when the contract was terminated prior to the contractor beginning work, but rejected the government's contention that when *Eichleay* was not applicable, or would render a zero dollar value, no recovery for overhead was allowed. Speaking in terms broadly applicable to all disputes under the FAR, the court held "[i]t would be inappropriate in the termination for convenience setting, where fairness to the contractor is the touchstone, to rigidly apply a formula developed in different factual circumstances and thereby deny the contractor fair compensation for unabsorbed home office overhead. Indeed, such would be contrary to the letter and spirit of 48 CFR § 49.201(a)."78 The court remanded for further consideration of Nicon's unabsorbed overhead without mandating the use of any particular formula to calculate the same.

B. *Caltrans – Section 8-1.11 (2006)*

While many state transportation authorities have promulgated their own detailed termination for convenience procedures, those established by the California Department of Transportation (or "Caltrans") are typical of the genre, and serve as the basis for other states' provisions.

1. **Excerpted contract language**

If the Director elects to terminate the contract, the termination of the contract and the total compensation payable to the Contractor shall be governed by the following:

(A) The Engineer will issue the Contractor a written notice signed by the Director, specifying that the contract is to be terminated. Upon receipt of the written notice, the Contractor will be relieved of further responsibility for damage to the work (excluding materials) as specified in Section 7-1.16, "Contractor's Responsibility for the Work and Materials," and, except as otherwise directed in writing by the Engineer, the Contractor shall:

   (1) Stop all work under the contract except that specifically directed to be completed prior to acceptance.
   (2) Perform work the Engineer deems necessary to secure the project for termination.
   (3) Remove equipment and plant from the site of the work.
   (4) Take action that is necessary to protect materials from damage.
(5) Notify all subcontractors and suppliers that the contract is being terminated and that their contracts or orders are not to be further performed unless otherwise authorized in writing by the Engineer.

(6) Provide the Engineer with an inventory list of all materials previously produced, purchased or ordered from suppliers for use in the work and not yet used in the work, including its storage location, and such other information as the Engineer may request.

(7) Dispose of materials not yet used in the work as directed by the Engineer. It shall be the Contractor's responsibility to provide the State with good title to all materials purchased by the State hereunder.

(8) Subject to the prior written approval of the Engineer, settle all outstanding liabilities and all claims arising out of subcontracts or orders for materials terminated hereunder. To the extent directed by the Engineer, the Contractor shall assign to the Department all the right, title and interest of the Contractor under subcontracts or orders for materials terminated hereunder.

* * *

(D) The total compensation to be paid to the Contractor shall be determined by the Engineer on the basis of the following:

(1) The reasonable cost to the Contractor, without profit, for all work performed under the contract, including mobilization, demobilization and work done to secure the project for termination. In determining the reasonable cost, deductions will be made for the cost of materials to be retained by the Contractor, amounts realized by the sale of materials, and for other appropriate credits against the cost of the work. Deductions will also be made, when the contract is terminated under the authority of Section 7-1.165, "Damage by Storm, Flood, Tsunami or Earthquake," for the cost of materials damaged by the "occurrence." When, in the opinion of the Engineer, the cost of a contract item of work is excessively high due to costs incurred to remedy or replace defective or rejected work, the reasonable cost to be allowed will be the estimated reasonable cost of performing that work in compliance with the requirements of the plans and specifications and the excessive actual cost shall be disallowed.

(2) A reasonable allowance for profit on the cost of the work performed as determined under Subsection (1), provided the Contractor establishes to the satisfaction of the Engineer that it is reasonably probable that the Contractor would have made a profit had the contract been completed and provided further, that the profit allowed shall in no event exceed 4 percent of the cost.

(3) The reasonable cost to the Contractor of handling material returned to the vendor, delivered to the Department or otherwise disposed of as directed by the Engineer.

(4) A reasonable allowance for the Contractor's administrative costs in determining the amount payable due to termination of the contract.

All records of the Contractor and the Contractor's subcontractors, necessary to determine compensation in conformance with the provisions in this Section 8-1.11, shall be open to inspection or audit by representatives of the Department at all times after issuance of the notice that the contract is to be terminated and for a period of 3 years, thereafter, and those records shall be retained for that period.
2. **Notes and Analysis**

While the Caltrans provisions look Spartan compared to the FAR, they are much more detailed than many contracts and governmental procurement procedures. As with the FAR, Caltrans allows profit only on work actually performed, and only when the contractor can demonstrate it would have made a profit on that work. Unlike the FAR, Caltrans caps profit at four percent, regardless of the profit the contractor would have made had the contract been completed. Like FAR, but unlike many contracts, Caltrans also recognizes that the prime contractor will incur expenses associated with calculating its termination costs, and Caltrans makes those costs compensable.

The Caltrans provisions are also notable for their detailed description of the actions to be taken by the contractor upon receipt of the termination notice. While the FAR contains a similarly descriptive set of instructions, most contract families have little or no description of the steps the contractor should take when it has received a termination notice. Although the lack of specificity allows latitude for the owner to direct the contractor as the owner sees fit under the circumstances, certain actions are almost always advisable, and the silence of form contracts on these issues is not beneficial, even if it may not always be harmful.

**C. AIA Standard Form Contracts**

1. **Excerpted contract language**


   § A.14.4.1 The Owner may, at any time, terminate the Design-Build Contract for the Owner’s convenience and without cause.

   § A.14.4.2 Upon receipt of written notice from the Owner of such termination for the Owner’s convenience, the Design-Builder shall: [.1] cease operations as directed by the Owner in the notice; [.2] take actions necessary, or that the Owner may direct, for the protection and preservation of the Work; and [.3] except for work directed to be performed prior to the effective date of termination stated in the notice, terminate all existing contracts and purchase orders and enter into no further contracts and purchase orders.
§ A.14.4.3 In the event of termination for the Owner’s convenience prior to commencement of construction, the Design-Builder shall be entitled to receive payment for design services performed, costs incurred by reason of such termination and reasonable overhead and profit on design services not completed. In case of termination for the Owner’s convenience after commencement of construction, the Design-Builder shall be entitled to receive payment for Work executed and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed.

b. A201 (2007) – 14.4

§ 14.4.1 The Owner may, at any time, terminate the Contract for the Owner’s convenience and without cause.

§ 14.4.2 Upon receipt of written notice from the Owner of such termination for the Owner’s convenience, the Contractor shall: [.1] cease operations as directed by the Owner in the notice; [.2] take actions necessary, or that the Owner may direct, for the protection and preservation of the Work; and [.3] except for work directed to be performed prior to the effective date of termination stated in the notice, terminate all existing subcontracts and purchase orders and enter into no further subcontracts and purchase orders.

§ 14.4.3 In case of such termination for the Owner’s convenience, the Contractor shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed.


§ 7.2.2 If the Owner terminates the Prime Contract for the Owner’s convenience, the Contractor shall promptly deliver written notice to the Subcontractor.

§ 7.2.3 Upon receipt of written notice of termination, the Subcontractor shall [.1] cease operations as directed by the Contractor in the notice; [.2] take actions necessary, or that the Contractor may direct, for the protection and preservation of the Work; and [.3] except for Work directed to be performed prior to the effective date of the termination stated in the notice, terminate all existing Sub-subcontracts and purchase orders and enter into no further Sub-subcontracts and purchase orders.

§ 7.2.4 In case of such termination for the Owner’s convenience, the Subcontractor shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed.

d. B102 (2007) – Article 5

§ 5.5 The Owner may terminate this Agreement upon not less than seven days’ written notice to the Architect for the Owner’s convenience and without cause.

§ 5.6 In the event of termination not the fault of the Architect, the Architect shall be compensated for services performed prior to termination, together with Reimbursable Expenses then due and all Termination Expenses as defined in Section 5.7.

§ 5.7 Termination Expenses are in addition to compensation for the Architect’s services and include expenses directly attributable to termination for which the Architect is not otherwise
compensated, plus an amount for the Architect’s anticipated profit on the value of the services not performed by the Architect.

§ 5.8 The Owner’s rights to use the Architect’s Instruments of Service in the event of a termination of this Agreement are set forth in Article 3 and Section 6.3.

§ 6.3 If the Owner terminates the Architect for its convenience under Section 5.5, or the Architect terminates this Agreement under Section 5.3, the Owner shall pay a licensing fee as compensation for the Owner’s continued use of the Architect’s Instruments of Service solely for purposes of the Project as follows: $______.

e. C132 (2009) – Article 9

§ 9.5 The Owner may terminate this Agreement upon not less than seven days’ written notice to the Construction Manager for the Owner’s convenience and without cause.

§ 9.6 In the event of termination not the fault of the Construction Manager, the Construction Manager shall be compensated for services performed prior to termination, together with Reimbursable Expenses then due and all Termination Expenses as defined in Section 9.7.

§ 9.7 Termination Expenses are in addition to compensation for the Construction Manager’s services and include expenses directly attributable to termination for which the Construction Manager is not otherwise compensated, plus an amount for the Construction Manager’s anticipated profit on the value of the services not performed by the Construction Manager, as set forth below.

§ 9.7.1 In the event of termination for the Owner’s convenience prior to commencement of construction, the Construction Manager shall be entitled to receive payment for services performed, costs incurred by reason of such termination and reasonable overhead and profit on Preconstruction services not completed during the Preconstruction Phase.

§ 9.7.2 In the event of termination for the Owner’s convenience after commencement of construction, the Construction Manager shall be entitled to receive payment for services performed and costs incurred by reason of such termination, along with reasonable overhead and profit on services not completed during the Construction Phase.

2. Notes and Analysis

a. Recovery of Lost Profits

The AIA forms have long been notable for allowing contractors and designers to recover lost profits on work not yet performed. No other family of standard-form contracts provides such a recovery, and as discussed herein, the propriety of allowing a recovery of lost profits for work not performed has been one of the more hotly contested issues surrounding termination for convenience damages. Needless to say, this term is frequently revised or negotiated out of the final contract documents.
b. Notice of Termination

It is also notable that the AIA forms treat the termination of contractors differently than the termination of designers and construction managers. A141 and A201, contracts for design-builders and contractors, respectively, allow an immediate termination, effective upon delivery of the notice of termination. In contrast, B102 and C132, contracts for designers and construction managers, respectively, require at least seven days’ notice of the termination. It is hard to understand why designers and contractors would be treated differently with respect to the required notice. It is even harder to understand why designers would be given notice and contractors would not be. The work of the contractor is harder to immediately stop—indeed, in many instances, the contractor cannot immediately stop work without creating hazardous conditions (for example, structures relying on temporary bracing or rigging for soundness ought not to be left in that conditions for weeks or months while a new contractor is brought on).

The difference in treatment is sharpened when the contractor’s obligation to take steps to protect and preserve the work is considered. Both A141 and A201 require the contractor to take such steps before leaving the project site, and consider the work required to take such steps to be compensable costs. Given that the contractor must take such action, it would make sense to give the contractor advance notice of the termination, so that the contractor can plan, phase, and execute the work in an orderly and efficient manner. In contrast, B102 and C132 create no follow-on obligations for the designer or construction manager—all they must do is cease work. It is surprising that the construction participants whose exit from the jobsite is the hardest are given no notice of the termination, while the participants whose exits are easiest are to be afforded at least a week’s notice.
c. Other Allowable Costs

With the exception of their allowance for lost profits on unexecuted work, the AIA documents are notable for their lack of specificity with respect to allowable costs. In general, all of the documents state only that the terminated entity is to be paid for the work performed to date, and for costs incurred “by reason of” the termination. This lack of specificity invites contention, even with respect to costs whose recoverability should be clear. Demobilization costs are a good example. Contractors will always want compensation for their demobilization costs in a termination for convenience setting. Under the AIA contract form, the owner could argue that the demobilization costs were always going to be incurred by the contractor, whether the contractor was terminated or not, and therefore those costs are not incurred “by reason of” the termination. The ambiguous phrasing, coupled with the lack of specific examples, creates a substantial potential for disagreement among the project participants.

D. ConsensusDOCs Standard Form Contracts

1. Excerpted contract language

a. Doc 200 (2011) – Article 11.4

11.4.1 Upon written notice to the Constructor, the Owner may, without cause, terminate this Agreement. The Constructor shall immediately stop the Work, follow the Owner’s instructions regarding shutdown and termination procedures, and strive to minimize any further costs.

11.4.2 If the Owner terminates this Agreement for Convenience, the Constructor shall be paid: (a) for the Work performed to date including Overhead and profit; (b) for all demobilization costs and costs incurred as a result of the termination but not including Overhead or profit on Work not performed; and (c) a premium set forth in a schedule below.

11.4.3 If the Owner terminates this Agreement, the Constructor shall: (a) execute and deliver to the Owner all papers and take all action required to assign, transfer, and vest in the Owner the rights of the Constructor to all materials, supplies and equipment for which payment has been or will be made in accordance with the Contract Documents and all subcontracts, orders and commitments which have been made in accordance with the Contract Documents; (b) exert reasonable effort to reduce to a minimum the Owner’s liability for subcontracts, orders, and commitments that have not been fulfilled at the time of the termination; (c) cancel any subcontracts, orders, and commitments as the Owner directs; and (d) sell at prices approved by
the Owner any materials, supplies and equipment as the Owner directs, with all proceeds paid or credited to the Owner.

b. **Doc 750 (2011) – Article 10.4**

10.4 **TERMINATION BY OWNER** Should the Owner terminate its contract with the Constructor or any part which includes the Subcontract Work, the Constructor shall notify the Subcontractor in writing within three (3) Business Days of the termination and, upon written notification, this Agreement shall be terminated and the Subcontractor shall immediately stop the Subcontract Work, follow all of the Constructor’s instructions, and mitigate all costs. In the event of Owner termination, the Constructor’s liability to the Subcontractor shall be limited to the extent of the Constructor’s recovery on the Subcontractor’s behalf under the Subcontract Documents, except as otherwise provided in this Agreement. The Constructor agrees to cooperate with the Subcontractor, at the Subcontractor’s expense, in the prosecution of any Subcontractor claim arising out of the Owner termination and to permit the Subcontractor to prosecute the claim, in the name of the Constructor, for the use and benefit of the Subcontractor, or assign the claim to the Subcontractor. If the Owner terminates the Constructor for cause, through no fault of the Subcontractor, the Subcontractor shall be entitled to recover from the Constructor its reasonable costs arising from the termination of this Agreement, including reasonable overhead and profit on Work not performed.

2. **Notes and Analysis**

   a. **No notice provision for prime contract termination.**

   The prime contract does not require notice for a termination for convenience. While the absence of a notice provision is arguably to the owner’s benefit, the reality is that a no-notice termination for convenience will likely only increase the compensable costs the contractor will incur in attempting to shut the project down. A notice provision would not need to be very long---a week would suffice---but excluding it entirely is likely to increase costs and conflicts.

   In addition, the subcontract contains a limitation requiring the contractor to notify the subcontractor of the termination within three days of that termination. Because the subcontractor’s recovery is limited to what the owner pays the prime contractor, and because the owner will likely take the position that all work should have stopped on the day of the termination, these contract provisions create a reasonable possibility of conflict. The prime contractor can follow the subcontract and notify the subcontractor three days after the
termination, and the owner can follow the prime contract and refuse to pay for work performed by the subcontractor on days two and three, and the subcontractor can follow the subcontract and diligently perform its work up until the notice of termination, and the result will be that the subcontractor will work two days for free (or have to litigate to obtain payment). This could be solved by requiring notice for the termination of the prime contract. If this change is not made, the prime contractor should be required to provide notice to the subcontractor within twenty-four hours of the termination, to minimize the potential harm to the subcontractor.

b. No independent right to terminate subcontract for convenience

One notable feature of the form subcontract is that it does not give the prime contractor the right to terminate an individual subcontract for convenience. Rather, terminations for convenience are limited to instances where the owner terminates the prime contract for convenience. There are a number of occasions in which a prime contractor, and sometimes even the subcontractor, would benefit from a termination for convenience even while the project (and the prime contract) moves forward. It is curious that the form subcontract does not allow for such a mechanism. One of the cannons of contract drafting is to seek agreement upfront, when all parties still get along, rather than defer the resolution of issues until a later point. There would be little harm in revising the provision to give the prime contractor the power to terminate the subcontract for convenience.

E. EJCDC Standard Form Contracts

1. Excerpted Contract Language

   a. E-500, Agreement Between Owner and Engineer (2008) -- Article 6.05

B. Termination: The obligation to provide further services under this Agreement may be terminated:

   * * *
2. For convenience,
   a. By Owner effective upon Engineer’s receipt of notice from Owner.
C. Effective Date of Termination: The terminating party under Paragraph 6.05.B may set the
effective date of termination at a time up to 30 days later than otherwise provided to allow
Engineer to demobilize personnel and equipment from the Site, to complete tasks whose value
would otherwise be lost, to prepare notes as to the status of completed and uncompleted tasks,
and to assemble Project materials in orderly files.
D. Payments Upon Termination:
   1. In the event of any termination under Paragraph 6.05, Engineer will be entitled to
      invoice Owner and to receive full payment for all services performed or furnished in accordance
      with this Agreement and all Reimbursable Expenses incurred through the effective date of
      termination. Upon making such payment, Owner shall have the limited right to the use of
      Documents, at Owner’s sole risk, subject to the provisions of Paragraph 6.03.E.
   2. In the event of termination by Owner for convenience or by Engineer for cause,
      Engineer shall be entitled, in addition to invoicing for those items identified in Paragraph
      6.05.D.1, to invoice Owner and to payment of a reasonable amount for services and expenses
directly attributable to termination, both before and after the effective date of termination, such
as reassignment of personnel, costs of terminating contracts with Engineer’s Consultants, and
other related close-out costs, using methods and rates for Additional Services as set forth in
Exhibit C.

b. C-700, Standard General Conditions of the Construction Contract
(2007) -- Article 15.03

15.03 Owner May Terminate For Convenience
A. Upon seven days written notice to Contractor and Engineer, Owner may, without cause
   and without prejudice to any other right or remedy of Owner, terminate the Contract. In such
   case, Contractor shall be paid for (without duplication of any items):
   1. completed and acceptable Work executed in accordance with the Contract
      Documents prior to the effective date of termination, including fair and reasonable sums for
      overhead and profit on such Work;
   2. expenses sustained prior to the effective date of termination in performing
      services and furnishing labor, materials, or equipment as required by the Contract Documents in
      connection with uncompleted Work, plus fair and reasonable sums for overhead and profit on
      such expenses;
   3. all claims, costs, losses, and damages (including but not limited to all fees and
      charges of engineers, architects, attorneys, and other professionals and all court or arbitration or
      other dispute resolution costs) incurred in settlement of terminated contracts with Subcontractors,
      Suppliers, and others; and
   4. reasonable expenses directly attributable to termination.
B. Contractor shall not be paid on account of loss of anticipated profits or revenue or other
   economic loss arising out of or resulting from such termination.

14.03 Owner May Terminate for Convenience

A. Upon seven days' written notice to Design/Builder, Owner may, without cause and without prejudice to any other right or remedy of Owner, elect to terminate the Contract. In such case, Design/Builder shall be paid (without duplication of any items) for:

1. Completed and acceptable Work executed in accordance with the Contract Documents prior to the effective date of termination, including fair and reasonable sums for overhead and profit on such Work;

2. Expenses sustained prior to the effective date of termination in performing services and furnishing labor, materials or equipment as required by the Contract Documents in connection with uncompleted Work, plus fair and reasonable sums for overhead and profit on such expenses;

3. Amounts paid in settlement of terminated contracts with Subcontractors, Suppliers, and others (including but not limited to all fees and charges of engineers, architects, attorneys and other professionals and all court or arbitration or other dispute resolution costs incurred in connection with termination of contracts with Subcontractors, Suppliers and others); and

4. Reasonable expenses directly attributable to termination.

B. Except as provided in paragraph 14.03.C, Design/Builder shall not be paid on account of loss of anticipated profits or revenue or other economic loss arising out of or resulting from such termination.

2. Notes and Analysis

The approach taken to termination costs in the EJCDC documents are comparable to the other form contract families. None of the EJCDC documents allow profit on unperformed work. The EJCDC documents for contractors and design/builders explicitly anticipate, and make compensable, costs the contractor or design/builder will incur in terminating and settling out subcontracts. While no contract family makes these costs non-compensable, most are silent on the issue. The EJCDC's explicit recognition of these costs is a better approach. The EJCDC also explicitly allows compensation only for acceptable work performed in accordance with the contract documents. The FAR takes the opposite approach, allowing compensation for all work completed, even if the work is not strictly acceptable.
The EJCDC contracts allow the recover of "reasonable expenses directly attributable to termination," but never describe what might fall within that category. The lack of specificity benefits none of the participants. Attorneys' fees and the cost to prepare a final payment application may all fall in this category. One could reasonably argue that demobilization costs do not fall within this category, as the contractor would always have incurred demobilization costs, and thus the costs are not "directly attributable to termination," but rather were always contemplated. While it seems clear that the contractor is entitled to compensation for demobilization costs, the lack of specificity in the contracts is apt to give rise to disputes like this one.

IV. PHILOSOPHICAL/FUNDAMENTAL DIFFERENCES IN ALLOWABLE COSTS UNDER TERMINATION FOR CONVENIENCE PROVISIONS.

The various contract form families and government regulatory schemes approach allowable costs in different ways. An analysis of where these provisions differ, and where they agree, highlight some of the common issues that confront parties in terminations for convenience.

A. Recovery of Profit

The question of whether, and to what extent, a contractor can recover profit for a project is one of the most hotly-contested issues in any termination for convenience. That dispute is reflected in the widely-varying approaches used by the standard contracts and government procurement provisions. Of the termination clauses surveyed in this paper, only one (the AIA forms) allows the contractor to recover profit on work not performed. The FAR allows profit "on preparations made and work done[,]" which is perhaps slightly more generous than the rest of the clauses surveyed herein.
The position taken in the AIA contracts is neither inadvertent nor the product of haphazard thinking. The original draft for the 1987 edition of the A201 contained a termination for convenience provision. That provision was removed from the final draft because the AIA became concerned that a termination for convenience provision rendered the contract illusory, insofar as the owner is not strictly obligated to do anything under the contract---the owner could terminate the contract the day after it was signed, and have no obligations at all. In 1997, the AIA incorporated a termination for convenience clause into the A201, but drafted that clause so that the contractor could recover anticipated profits. This way, the AIA reasoned, the contract cannot be illusory, because the owner will always have some obligations under the contract. Even if the contract is terminated the day after execution, the owner is liable for the contractor's anticipated profits.80

The issue of whether a termination for convenience clause renders a contract illusory has seldom been analyzed in connection with termination for convenience cases. One of the few cases to discuss the issue at length was Torncello v. United States.81 The court began by noting that "one of the most elementary propositions of contract law [is] that a party may not reserve to itself a method of unlimited exculpation without rendering its promises illusory and the contract void[.]")82 Unfortunately, it was this analysis that led the Torncello court to propound the "changed circumstances" test for convenience terminations under the FAR, a test that has since been struck down.83 This complication notwithstanding, much of the analysis in Torncello could be used to persuasively argue that a contract that contains a termination for convenience clause that could be used to wholly exculpate the owner from all obligations under the contract renders the contract itself illusory. The AIA's contracts avoid that argument entirely by allowing for the recovery of anticipated profits.
Both the FAR and the Caltrans provisions also anticipate the possibility that the contractor would not have made a profit had the project been completed, and provide guidance regarding how to proceed in such instances. However, the provisions differ on their treatment of the loss. The FAR expects that the contractor's likely total loss will be calculated and that loss deducted from the overall recovery to the contractor, in the form of a "loss adjustment." The Caltrans provision merely precludes any recovery for profit if the contractor would not have made a profit on the completed project. It is, perhaps, telling that government contracting provisions anticipate the possibility that the contractor would have lost money on the project, while contract forms widely used on private projects feel no need to address the issue.

The Caltrans provision is also the only provision that sets a hard cap on the contractor's profits. Under the Caltrans rules, the contractor is not entitled to a profit of more than four percent, no matter how large its profit would have been had the project been completed. Philosophical arguments can be made on both sides of the issue of profit for a contractor whose contract was terminated. However, it seems inequitable to deny the contractor any profit if the contractor would have lost money on the entire project, but cap the contractor's profit (at a fairly low level) no matter how much money it would have made on the entire project. If there is to be a hard ceiling on profits, there should also be a hard floor (and the hard floor should not be zero, as it currently is). Alternatively, if the owner is going to limit the contractor's profit recovery (regardless of what the contractor's actual profits would have been), the owner should also guarantee the contractor some profit (regardless of what the contractor's actual profits would have been).
B. Calculation of Termination for Convenience Recovery for Costs Incurred

Of the regulations and contracts reviewed herein, only the FAR provides any guidance regarding how costs are to be tracked for termination for convenience payment purposes. As discussed in the section pertaining to the FAR, the FAR provides an order of preference for cost accounting methods. The FAR prefers an inventory basis.\(^{86}\) When an inventory basis "is not practicable or will unduly delay settlement," the prime contractor may use a total cost basis for pricing the settlement, but must first obtain approval from the Termination Contracting Officer.\(^{87}\) No pricing methodology other than inventory or total cost basis can be used without the prior approval of the chief of the contracting or contract administration office.\(^{88}\)

Silence on the issue of cost calculation does not benefit any party to the contract. When the contract provides no guidance on the proper way to calculate the costs subject to compensation, the contractor will frequently elect to use a total cost analysis, as that methodology will almost certainly yield the highest total reimbursement. The owner will usually object, and argue that total cost method calculations are disfavored in the law. The contractor will respond that the contract is silent, and therefore the contractor can use any method it wants. Both parties will have a valid point, and they will be engaged in a dispute that could easily have been avoided.

C. Recovery of Costs for Demobilization, Accounting, and Legal Fees Associated with a Termination for Convenience

In addition to the costs the contractor incurred to build the job up to the date of the termination, the contractor is going to incur certain costs post-termination as a result of the termination. Many of these costs are truly extra-contractual, in that the costs would never have been incurred but for the termination, and are not the sort of costs that would be recoverable but
for the termination. The standard contracts and regulations analyzed herein differ widely in their consideration and treatment of these costs.

1. Demobilization costs

Demobilization is not a true additional cost, as the contractor would always have incurred some demobilization costs. In many instances, the contractor has also submitted a bid price for mobilization and demobilization costs, therefore the parties will have to determine whether that price should be used in the termination context, or whether another method will be used to price the demobilization costs. The FAR, Caltrans, and ConsensusDOCs all make demobilization costs explicitly compensable. The AIA and EJCDC contracts do not address demobilization costs. As discussed in connection with the AIA and EJCDC contracts, it was likely the intention of the contract drafters that demobilization costs be compensable as costs related to or caused by the termination. However, as noted above, a particularly disagreeable owner could make a decent argument that demobilization costs are unrelated to the termination, as the contractor would have incurred them regardless. Removing this ambiguity would be easy, and would benefit all parties.

2. Accounting costs

Drafting a final payment application after a termination for convenience is not as easy as drafting a regular final payment application, or drafting a progress payment application. Special consideration needs to be given to issues like reasonable profit, unabsorbed home office overhead, subcontractor settlement costs, and other costs that simply would not have arisen had the contract proceeded to completion. Terminated contractors justifiably expect that these additional costs will be compensable.
The FAR makes accounting expenses explicitly compensable. Caltrans allows recovery of "administrative costs" related to the termination, which would likely cover accounting expenses. The form contract families do not explicitly deal with accounting costs. Contractors are left to make the argument that such costs fall within the "costs arising from the termination" catch-all category used by most of the form contract families. The EJCDC would allow the recovery of accounting expenses if they arose out of a dispute between the prime contractor and a subcontractor. Why accounting expenses would be recoverable under these circumstances but no others is, frankly, hard to understand.

3. **Legal fees**

Because a prime contractor who has been terminated for convenience must typically terminate all of its subcontracts, lawyers often become involved in terminations for convenience. Whether or not full-blown litigation ensues, formal settlement agreements are often required (and almost always advisable). Therefore, consideration must be given to the compensability of legal fees incurred by the prime contractor as a result of the termination.

The EJCDC contracts make attorneys' fees explicitly recoverable, if they ensue from a dispute with a subcontractor. Under all other regulations and contract families analyzed herein, the prime contractor will need to make a case for the cost arising out of the termination.

V. **FACTORS FOR CONSIDERATION OF TERMINATION FOR CONVENIENCE VS. TERMINATION FOR DEFAULT**

Detailed termination for cause/default clauses have appeared in construction contracts since at least the end of the 19th century. The AIA General Conditions refer to the process of terminating a contract on the basis of one party’s breach as “termination for cause.” In contrast, the FAR refers to this process as “termination for default.”
Section 14.21 of the AIA General Conditions establishes the owner’s right to terminate the contract for cause on the basis of the contractor’s material breach:

The Owner may terminate the Contract if the Contractor

.1 repeatedly refuses or fails to supply enough properly skilled workers or proper materials;
.2 fails to make payment to Subcontractors for material or labor in accordance with the respective agreements between the Contractor and the Subcontractors;
.3 repeatedly disregards applicable laws, statutes, ordinances, codes, rules and regulations; or
.4 otherwise is guilty of substantial breach of a provision of the Contract Documents.

Likewise, FAR 52.249-10(a) sets out the Government’s default termination rights for construction contracts:

If the Contractor refuses or fails to prosecute the work or any separable part, with the diligence that will insure its completion within the time specified in this contract including any extension, or fails to complete the work within this time, the Government may, by written notice to the Contractor, terminate the right to proceed with the work (or the separable part of the work) that has been delayed.

A. Requirements of termination for cause/default

In the context of both private and public construction contracts, courts and boards consider a termination for cause/default as “‘a ‘drastic sanction,’ which should be imposed (or sustained) only for good grounds and on ‘solid evidence.’”92 Accordingly, Bruner & O’Connor on Construction Law advises that a valid termination for cause/default must sufficiently satisfy the following set of criteria:

(1) [T]he contractor materially breached its contract, based upon an evaluation of the circumstances under the doctrines of substantial performance, economic waste, excusability, waiver, cure, mitigation, impracticability, and principles of contract interpretation;
(2) the material breach was not induced, preceded, or otherwise excused by the terminating party's own supervening material breaches of contract;
(3) the termination decision resulted from the exercise of independent discretion and good-faith motives of those having authority to terminate the contract;
(4) the breaching party and its surety were given adequate notice of and an opportunity to cure deficiencies deemed sufficiently material to warrant termination;
(5) the terminating party terminated the contract in strict compliance with contractually specified termination procedures;
(6) the breaching party’s performance bond surety was allowed to exercise its post-termination performance rights;
(7) if there was no performance bond or if the surety refused to acknowledge its performance obligations, the terminating party’s reletting of the contract was both necessary and reasonably accomplished in mitigation of damages; and
(8) the terminating party’s compensable completion costs were reasonably incurred and properly accounted for.93

To defeat a claim of improper or wrongful termination for cause/default, the owner as the terminating party bears the initial burden of showing by a preponderance of the evidence that the termination was justifiable based on the above set of criteria.94 Breaches considered sufficient enough to justify a termination for cause/default include the contractor’s anticipatory repudiation, the contractor’s failure to make adequate progress, defective work by the contractor, the contractor’s nonpayment to subcontractors, the contractor’s insolvency or bankruptcy, and the contractor’s failure to meet licensing, insurance, bonding, or other statutory or regulatory requirements.95 Once the owner has met its initial burden of proof, then the contractor “is charged with showing that its failure was excusable.”96

In the private contracts setting, the AIA General Conditions require that the owner give the contractor and its surety “seven days’ written notice” before the owner exercises its termination for cause rights.97 Although the AIA General Conditions do not explicitly state that the owner’s notice to the contractor must afford it an opportunity to cure its unsatisfactory performance, courts typically find the opportunity to cure implicit in the notice requirement even in the absence of a provision to that effect.98

For government contracts, the FAR imposes on the owner specific obligations to submit a 10-day cure notice prior to exercising its default termination rights.99 Should the contractor fail to cure its unsatisfactory performance within the prescribed time period, then FAR
49.402-3(g) provides that the owner shall issue a default termination notice detailing the contractor’s actions constituting default, the consequences of default, and the contractor’s rights to appeal the default decision. Although failure to provide a cure period pursuant to a cure notice will generally invalidate the owner’s default termination, the owner’s failure to strictly adhere to the procedures for issuing a default termination notice will not lead to the overturning of a default termination unless the contractor can demonstrate resulting prejudice.

B. Advantages and disadvantages of termination for cause/default

Undoubtedly, the remedies available to the party terminating the contract under a termination for default provision are more attractive than the remedies available under the termination for convenience clause. For example, the AIA General Conditions provide that a termination for cause entitles the owner to stop payment to the contractor until all work on the project has been completed. In addition, AIA Document A201-2007 § 14.2.2 establishes the following actions the owner may take upon terminating the contractor for cause:

1. Exclude the Contractor from the site and take possession of all materials, equipment, tools, and construction equipment and machinery thereon owned by the Contractor;
2. Accept assignment of subcontracts pursuant to Section 5.4 [governing contingent assignment to the Owner of subcontracts in the event of the Contractor’s default]; and
3. Finish the Work by whatever reasonable method the Owner may deem expedient. Upon written request of the Contractor, the Owner shall furnish a detailed accounting of the costs incurred by the Owner in finishing the Work.

The owner may hold the contractor liable should the costs of completing the work and other damages caused by the contractor’s default exceed the unpaid balance of the contract price. Notably, the AIA General Conditions require that the owner pay the contractor the difference between the unpaid balance and the owner’s costs of finishing the work and other damages should the unpaid balance exceed the owner’s costs and damages.
Like the AIA General Conditions, the FAR also allows the owner to “take possession of and use any materials, appliances, and plant on the work site necessary for completing the work” and to hold the contractor liable for “any increased costs incurred by the Government in completing the work.”\textsuperscript{105} With regards to reprocurement costs, the Federal Circuit in\textit{Cascade Pacific International v. United States}\textsuperscript{106} established the following three conditions that the owner must demonstrate in order to establish that its excess costs are reasonable and hence recoverable:

1. The reprocured supplies [or services] are the same as or similar to those involved in the termination;
2. The Government actually incurred excess costs; and
3. The Government acted reasonably to minimize the excess costs resulting from the default.

The first condition requires “comparing the item reprocured with the item specified in the original contract,”\textsuperscript{107} and, as it applies to construction contracts in particular, involves showing that the reprocured construction services do not “materially alter[] the terms and conditions . . . of the original contract” or result in a “substantial increase in the original contract price.”\textsuperscript{108} The second condition mandates that “the Government show what it spent in reprocurement.”\textsuperscript{109} Finally, to satisfy the third condition, the owner must show that it “act[ed] within a reasonable time of the default, use[d] the most efficient method of reprocurement, obtain[ed] a reasonable price, and mitigate[d] its losses.”\textsuperscript{110}

Notwithstanding the foregoing available remedies, termination for cause/default represents “a drastic adjustment of the contractual relationship” that has the potential of inflicting far reaching negative consequences upon the owner.\textsuperscript{111} Termination for cause/default is a sure formula for involvement of lawyers because contractors/subcontractors\textbf{must} contest such default terminations. Bonding companies typically require principals to report all terminations and contractors are encouraged to clear their record to maintain bonding. Similarly, many owners –
and particularly Governmental entities – require bidders to disclose all instances of default termination as part of their proposal or bid packages on new work. A default termination on a past performance review can haunt a government contractor for years. As a result, contractors are thus highly motivated to contest a default termination. While this may be appealing to lawyers, it may not have the same appeal to construction clients.

In addition to inviting litigation, a termination for default exposes owners to liability for a wrongful termination for cause/default in a subsequent action by the contractor. Under the FAR, if the Government wrongly default terminates the contractor, the contractor’s remedy is limited to costs recoverable under the termination for convenience. The AIA regime of documents does not have such a fall-back position and, if unmodified, a wrongful termination may result in traditional damages for breach of contract albeit with a waiver of consequential damages. That said, one of the most common changes encountered is a limitation on liability for wrongful termination to amounts recoverable under the termination for convenience provision.

Regardless, a termination for cause/default often subjects the owner to lost time and substantial additional costs as it has to repeat many of the steps it took prior to awarding the contract, such as carefully scoping the remaining work, researching the market, and negotiating with potential bidders. Owners are also often faced with the difficult realities of picking-up the pieces after a contentious default termination such as conflicting subcontractor accounts (discrepancies with subcontract balances, changes and back-charges), insurance gaps, and warranty coverage.

Even where there is a performance bond, and the owner is theoretically protected from the financial implications and warranty questions in the aftermath of a default termination, reality may differ from paper promises. Sureties (although they will certainly never admit this truth)
will avoid responsibilities for technical failures to comply with bonds. Owners considering a
termination for default where a bond is in place must be assiduous to ensure that all conditions
are met (including all notices and meetings with the surety). Owners must then be ready for
delay associated with the surety’s investigation. Finally, owners must be prepared for the
intransigent or irresponsible surety.

Contractors terminating subcontractors face even more daunting obstacles because,
inevitably, owners do not relent in their demand for timely completion while the contractors are
addressing the fall-out from the terminated subcontractor and/or its bonding company. While
programs such as “SubGuard” have detractors and legitimate shortcomings, they at least provide
the contractor assurance that it can proceed as it sees fit to replace a defaulted subcontractor.

In short, wise commentators have counseled that the owner should only turn to
termination for cause/default as a last resort.\textsuperscript{113} We do not suggest otherwise.

\textbf{C. Advantages and disadvantages of termination for convenience}

The greatest benefit of a termination for convenience clause to the owner in the
government contracts setting is that the contractor generally can only recover “costs incurred,
profit on work done, and costs preparing the termination settlement proposal.”\textsuperscript{114} Significantly,
termination for convenience does not entitle the contractor to expectation damages, including
anticipatory profits.\textsuperscript{115} To determine these amounts, FAR 49.206-2(a) establishes the “inventory
basis” as the “preferred” method, which requires the contractor to prepare an itemization of its
costs for equipment, materials, work in process, third party charges, subcontractor settlements,
settlement with the owner, and “[o]ther proper charges.” Alternatively, the contractor may base
its settlement proposal on total cost “[w]hen use of the inventory basis is not practicable or will
unduly delay settlement . . . .”\textsuperscript{116}
Should the owner and the contractor on a government contract for construction fail to agree to a settlement based upon either approach described above, then FAR 52.249-2 Alternate I directs the contracting officer to pay the contractor the following amounts: (1) the costs of work performed; (2) the reasonable costs of settlement, which include necessary accounting, legal, clerical, storage, transportation, and other expenses, as well as the costs of terminating subcontracts; and (3) a “fair and reasonable” sum representing profit on work performed, unless “it appears that the Contractor would have sustained a loss on the entire contract had it been completed . . . .”

The AIA General Conditions likewise allow the contractor to recover its costs on work performed and its expenses in settling the termination for convenience with the owner.\textsuperscript{117} However, the AIA General Conditions depart from the FAR in one important respect by allowing the contractor to recover “reasonable overhead and profit on the Work not executed” as well.\textsuperscript{118} The AIA Commentary provides the following guidance on this departure:

This is one of the rare occasions when a contractor may be entitled to profit and overhead on work not performed. It is intended to compensate a contractor who is terminated solely for the owner’s convenience for the monies to which the contractor would have been entitled (less the actual costs of completing the work) had the termination not occurred.\textsuperscript{119}

The AIA General Conditions further discourage owners from using the termination for convenience provisions to cut the contractor out of the equation. For example, §14.4.2.3 requires the contractor to terminate all existing subcontracts and purchase orders. Thus, the owner cannot terminate for convenience and then take assignment of subcontracts – a protocol available in a termination for default under AIA Document A201-2007 §§14.2.2.2 and 5.4.1.1. If the owner intends to complete the work, and there are critical subcontractors involved in the completion, it has no assurance of keeping those subcontractors on if it terminates for convenience.
VI. CONVERSION OF AN IMPROPER TERMINATION FOR DEFAULT INTO A TERMINATION FOR CONVENIENCE

In 1925, the United States Supreme Court reached a conclusion in *College Point Boat Corp. v. United States*[^120] that, in retrospect, seems both obvious and logical:

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. He may, likewise, justify an asserted termination, rescission, or repudiation, of a contract by proving that there was, at the time, an adequate cause, although it did not become known to him until later.[^121]

Most modern courts have credited this holding as the legal foundation for the doctrine of conversion—that a termination for cause, improperly made, is automatically converted into a termination for convenience when the impropriety of that termination is proven.[^122] The doctrine follows the reasoning set forth by the court in *College Point Boat Corp.*: the government may justify a termination by proving that, while it had no right to terminate for cause, it had the right to terminate for convenience. The doctrine operates to limit the contractor's recovery such that the contractor only recovers what it would have recovered had the contract been terminated for convenience.[^123]

At least with respect to terminations governed by the FAR, there are limits on the government's power to invoke the conversion doctrine. Federal courts have recognized that the doctrine cannot be invoked if the contracting officer's decision to terminate was made in bad faith, or was a clear abuse of discretion.[^124] Despite these limits, the plain language of the contract is not necessarily a limit on the government's power to terminate for convenience. In *G. L. Christian & Associates v. United States*,[^125] the contract between the Corps of Engineers and the contractor did not contain a termination for convenience clause. The applicable Armed Services Procurement Regulations in effect at the time of contract required that a termination for

[^120]: *College Point Boat Corp. v. United States*
[^121]: 120
[^122]: 121
[^123]: 122
[^124]: 123
[^125]: 124
[^125]: 125
convenience clause be included in every contract of more than $1,000, and the contract at issue was admittedly for more than $1,000. After tracing the history of the termination for convenience provision, the court concluded "we believe that it is both fitting and legally sound to read the termination article required by the Procurement Regulations as necessarily applicable to the present contract and therefore as incorporated into it by operation of law." Thus was the *Christian* Doctrine born: the presumption that a termination for convenience clause is read into every government contract which the FAR would require to contain such a clause.  

In private contracts, a termination conversion clause will typically provide:

“If Owner terminates this Agreement for default, and it is later determined that the termination for default was not proper, then the termination shall be deemed a termination for convenience, and the parties’ rights shall be governed by Section XX.”

Of the contract families studied in this article, only ConsensusDOCs includes a termination conversion clause.

From an owner's perspective, including a conversion clause in the contract is a win-win. If the owner takes the drastic step of terminating the contractor for cause, and the contractor proves that termination was wrongful, the owner will only need to pay what it would have had to pay had it terminated the contractor for convenience, rather than the contractor's full breach of contract damages. In such a case, the formula for compensation provided in the termination for convenience provisions brings a set of rules to a process (formulating breach of contract damages) that often has very few firm rules. It is hard to envision any reason why an owner would not include a conversion clause when it has the power to do so.

For most of the same reasons, a conversion clause is not advantageous to a contractor. At a minimum, it empowers the owner to think more aggressively about a termination for cause, as
the downside to such a termination (the contractor becomes entitled to whatever damages a jury would believe) is eliminated.

VII. UNILATERAL DEDUCTIVE CHANGE ORDERS AND FUNCTIONAL TERMINATIONS FOR CONVENIENCE

A. Unilateral deductive change order

As an alternative to eliminating work through a partial termination for convenience, the owner may address the contractor’s unsatisfactory performance by simply deleting work through a unilateral change order pursuant to the Changes clause.128

1. The Changes clause

FAR 52.243-4 provides the Changes clause for fixed-price construction contracts.129 The Changes clause states at paragraph (a):

The Contracting Officer may, at any time, without notice to the sureties, if any, by written order designated or indicated to be a change order, make changes in the work within the general scope of the contract, including changes -
(1) In the specifications (including drawings and designs);
(2) In the method or manner of performance of the work;
(3) In the Government-furnished property or services; or
(4) Directing acceleration in the performance of the work.

Likewise, the AIA General Conditions also provide a standard Changes clause for private sector construction contracts:

Changes in the Work may be accomplished after execution of the Contract, and without invalidating the Contract, by Change Order, Construction Change Directive or order for a minor change in the Work, subject to the limitations stated in this Article 7 [governing Changes in the Work] and elsewhere in the Contract Documents.130

2. Determining when the Owner must terminate for convenience rather than order a unilateral deductive change

Courts and boards have imposed limitations on when the owner may choose to deduct the contractor’s work via a unilateral change order instead of a partial termination for convenience. In J. W. Bateson Co. v. United States,131 for example, the 5th Circuit affirmed the district court’s
following statements about determining whether an owner may affect a unilateral change order instead of a partial termination for convenience:

“‘It is obvious that there can be no hard and fast line between a ‘termination’ and a ‘change’ . . . . By a shift of circumstances, the two words may be made to verge on each other, or, on the other hand, may be made to stand far apart. Anybody would readily agree that when a contract for 430 buildings is cut down to 81 buildings, there has been a partial termination, and there would be the same unanimity in saying that the use of a shingle roof in place of a composition roof on a house would be a change rather than a termination, yet if a contract for a dwelling and basement has the basement eliminated, there would be a borderline picture, and that fairly could be called a change as readily as a partial termination. The long and short of it is that the 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.”

The dispositive inquiry for whether an owner must exercise a partial termination for convenience to deduct the contractor’s work is thus whether “major portions of the work are deleted and no additional work is substituted.” Otherwise, the owner is free to elect between either the Changes or Termination for Convenience clauses to delete work. Courts addressing this issue in the private contracts setting have upheld and applied this analysis.

3. **Requirements of unilateral deductive change orders**

FAR 49.243-4(a) states that change orders must be in writing. However, paragraph (b) of FAR 49.243-4 allows for oral change orders to become binding on the owner and the contractor, “provided, that the Contractor gives the Contracting Officer written notice stating (1) the date, circumstances, and source of the order and (2) that the Contractor regards the order as a change order.” Otherwise, “no order, statement, or conduct of the Contracting Officer shall be treated as a change under this clause or entitle the Contractor to an equitable adjustment.” Standard Form 30 represents the proper form for the issuance of any unilateral or bilateral change order, although courts have upheld the binding effect of written change orders that did not utilize the standard form template.
Likewise, the AIA General Conditions also require that a unilateral change order be in writing. However, the AIA General Conditions impose the additional requirement of having both the owner and the architect for the construction project sign the unilateral change order. In addition, the standard Changes clause contained in the AIA General Conditions imposes an obligation upon the contractor to “promptly proceed with the change in the Work involved . . .”

4. Advantages and disadvantages of unilateral deductive change orders

Both the FAR and the AIA General Conditions allow the owner to charge a credit against the contractor for what it saved on deleted work. Therefore, a major benefit of utilizing a unilateral deductive change order is that the owner may receive a downward equitable adjustment for the deleted work as identified by the owner. In the government contracts setting, courts and boards generally price the amount of this downward equitable adjustment on the basis of what the project would have cost the contractor should the work at issue not have been deleted. Conversely, the AIA General Conditions limit the amount of the downward equitable adjustment the owner may receive to “actual net cost,” which the AIA Commentary explains is “the cost that would have been incurred in executing the change by the contractor without decreasing the contractor’s overhead and profit.” Note that his provision is frequently modified by owners to require reductions in profit, overhead and/or other mark-ups in connection with deductive changes.

In the private contracts setting, Sections 7.3.5 and 7.3.7 of the AIA General Conditions allow the contractor to appeal to the architect for a determination of a reasonable amount covering the resulting price adjustment. Only once the contractor and owner agree on the
architect’s determination, or on some other amount reached by mutual consent, does the final amount of the price adjustment become binding on the parties to the construction contract.  

Use of a unilateral deductive change order is not wholly without risk – it could adversely impact the owner. For example, a unilateral deductive change order could result in an upward equitable price adjustment for the contractor when it can show that the change at issue actually increased its costs of performance, even when the deductive change decreased the costs contemplated in the contract price.

2. Correction or completion by supplemental contractors

As discussed above, the owner in exercising its termination for cause/default rights may correct or complete the contractor’s unsatisfactory performance through alternative means. Specifically, the FAR allows the owner to “take over the work and complete it by contract or otherwise” and to charge the contractor and its sureties for the resulting costs. Similarly, the Inspection clause for government construction contracts allows the Government to replace or correct the contractor’s defective work and charge the contractor in lieu of terminating the contractor for default. The AIA General Conditions also allow the owner to complete or correct the defaulting contractor’s work “by whatever reasonable means available,” including the hiring of supplemental contractors, and to provide the contractor “a detailed accounting of the costs incurred by the Owner in finishing the Work” that the owner may seek to recover. Relative to the other methods available to the owner to address the contractor’s unsatisfactory performance, little case law exists limiting or defining the parameters of the owner’s right to correct or complete by supplemental contractors. Nevertheless, one overriding consideration

Bruner & O’Connor on Construction Law has highlighted is that the hiring of supplemental contractors must conform to the traditional contract law doctrine of mitigation of damages.
VIII. CONCLUSION

Termination for convenience clauses are under-valued and under-utilized tools for avoiding and resolving disputes after construction has begun. A termination for convenience is less adversarial, far less prone to spawn litigation, and much more predictable than a termination for default. Different form families, and different governmental regulatory schemes, treat terminations for convenience in very different ways. As with many aspects of construction law, the practitioner's mantra must be: read the contract.

The practitioner can also add substantial value in the contract drafting phase. There are many variables that must be taken into account when drafting a termination for convenience clause. Is the contractor to be paid based on its costs, or based on the contractual value of the work? If the former, how are those costs to be proven? Is the contractor to be paid profit, and if so, on what work, and how much? Is the contractor to be paid for overhead? For non-conforming work? The list of questions can be as detailed as the drafter and the client wish, and the questions create a clause that is increasingly specific and predictable.

The purpose of this article has been to focus the reader's attention on the major issues surrounding terminations for convenience, and to explore the common contractual and regulatory schemes governing such terminations. It is the authors' hope that this article will serve not only as a convenient reference, but also as a basis for further thought on the part of our practitioner friends. As the construction industry moves towards collaboration, and away from traditional (and adversarial) delivery methods, the importance of terminations for convenience, and the clauses drafted to govern them, will only increase. While perhaps less lucrative for construction lawyers, this can and should be beneficial to the industry as a whole.
Leo Tolstoy opened *Anna Karenina* by proclaiming "All happy families are similar; every unhappy family is unhappy in its own way." Or, more precisely, Tolstoy proclaimed "Все счастливые семьи похожи друг на друга, каждая несчастливая семья несчастлива по-своему." An accepted English translation is included here based on the authors' assumptions about the audience for this article.

2. See also *United States v. Speed*, 75 U.S. (8 Wall. 77) 77, 82-83 (1868) (discussing Civil War Army regulation providing for termination for convenience and stating that the regulation was “required because the post or force to be supplied may be suddenly removed or greatly diminished”).
3. Cibinic et al., *supra* at 1050.
11. 16 Ct. Cl. 528, 542-43 (1880).
13. ASBCA No. 13739, 70-1 BCA ¶ 13739.
14. *Id.*
15. DAR 8-701-705 (1950).
19. Cibinic et al., *supra* at 1050.
20. *Kalvar Corp.*, 543 F.2d at 1302 (quoting *Knotts v. United States*, 147 Ct. Cl. 605, 612 (1959)).
22. 96 Ct. Cl. 186, 222 (1942).
23. See also *Hoel-Steffen Constr. Co. v. United States*, 684 F.2d 843, 847-50 (Ct. Cl. 1982) (finding Government acted in bad faith by arbitrarily refusing to grant approval even though clause required contractor to obtain approval); *Schlesinger v. United States*, 390 F.2d 702, 708-709 (Ct. Cl. 1968) (finding governmental abuse of discretion when contracting officer terminated contractor for default without making a judgment on the merits of the case).
24. 681 F.2d 756, 768-72 (Ct. Cl. 1982).
25. 681 F.2d at 768.
26. *Id.* at 769.
27. *Id.* at 771.
32 Id.
33 94 F.3d 1537 (Fed. Cir. 1996).
34 94 F.3d at 1545.
35 Id. at 1542, 1545.
37 Id. at 1542-44.
38 Cibinic et al., supra at 1067 (citing T&M Distrib., Inc. v. United States, 185 F.3d 1279 (Fed. Cir. 1999); Charles G. Williams Constr., Inc., ABSCA No. 49775, 00-2 BCA ¶ 31,047, vacated and remanded on other grounds, 271 F.3d 1055 (Fed. Cir. 2001); Max S. Castle, AGBCA No. 97-137-1, 00-1 BCA ¶ 30,871, recons. denied, 03-2 BCA ¶ 32,270).
40 Id. at 769 (internal citations omitted) (emphasis added).
41 978 A.2d 651, 669-70 (Md. 2009).
42 Id. at 670.
43 Id. at 672.
44 Id.
45 Id. at 674.
46 978 A.2d at 673.
47 Id.
48 978 A.2d at 669-70.
49 127 S.W.3d 579, 585 (Ky. 2003).
50 RAM Eng’g & Const., Inc., 127 S.W. at 585.
51 Id. at 586.
53 Sylvan Crest Sand & Gravel Co. v. United States, 150 F.2d 642, 643-45 (2d Cir. 1945);
55 EDO Corp., 977 F.2d at 1453.
56 See Torncello, 681 F.2d at 770 n.10 (citing Sylvan, 150 F.2d at 642) (“[W]e would question whether it is sufficient to support a contract merely that one party promise to the other to tell him that he is walking away before he does so.”).
57 911 F.2d 1447, 1453 (10th Cir. 1990).
58 EDO Corp., 911 F.2d at 1453.
60 See 48 CFR § 49.002(a)(2), recognizing that Subpart 49 is inapplicable to commercial acquisitions, and 48 CFR § 12.403, which governs the termination for convenience of a commercial items contract.
61 48 CFR § 49.108-3. The TCO can also give authorization to the prime contractor to finalize settlements without the TCO's approval, in limited instances, per 48 CFR § 49.108-4.
62 48 CFR § 49.201(a).
64 49 CFR § 49.206-2(b).
65 49 CFR § 49.206-2(c).
66 49 CFR § 49.202(a).
67 49 CFR § 49.203(a).

R&G Gewachungs GmbH, ASBCA No. 42214, 93-2 BCA ¶ 25,105.

Astro Dynamics, Inc., ASBCA No. 41825, 91-2 BCA ¶ 23,807; Scope Electronics, Inc., ASBCA No. 20359, 77-1 BCA ¶ 12,404, mot. for recon. denied, 77-2 BCA ¶ 12,586.

Best Foam Fabricators, Inc. v. United States, 38 Fed.Cl. at 640 (quotation and citation omitted).

New York Shipbuilding, supra, 73-1 B.C.A. at 46,019. See also Best Foam Fabricators, Inc., supra, 38 Fed.Cl. at 640 (adopting the rule on the part of the Federal Court of Claims); Caskel Forge, supra, 1962 B.C.A. at 17,109 (contractor should be reimbursed unless defects resulted from its “fault or folly or careless conduct of the work or other disregard of its contractual duties”); Morton–Thiokol, Inc., ASBCA No. 32629, 90–3 B.C.A. ¶ 23,207 at 116,471–72 (absent showing of gross misconduct, government must reimburse costs of producing defective work under cost reimbursement contract); John Cibinic, Jr. & Ralph C. Nash, Jr., Administration of Government Contracts, p. 1118 (3d ed. 1995) (“Allowable costs include those costs incurred in producing defective material ... as long as the amount of defective material is not unreasonable”).

Charles G. Williams Constr., Inc. v. White, 271 F.3d 1055, 1058 (Fed. Cir. 2001).


As established in Eichleay Corp., 60-2 BCA (CCH) ¶ 2688, at 13,568 (ASBCA, July 29, 1960).

Nicon, Inc. v. United States, 331 F.3d 878, 884 (Fed. Cir. 2003); Melka Marine, Inc. v. United States, 187 F.3d 1370, 1347-75 (Fed. Cir. 1999); Wickham Contracting Co. v. Fischer, 12 F.3d 1574, 1575 (Fed. Cir. 1994).

331 F.3d 878 (Fed. Cir. 2003).

Id. at 886-887.

As discussed above in the analysis of FAR, this is not without limits. Dramatic or widespread departure from the contract documents will result in non-payment, even under the FAR.


681 F.2d 756 (Ct. Cl. 1982).

Id. at 760.

This issue is discussed at length in Section III of this article, discussing limitations on the government’s power to terminate for convenience under the FAR.

49 CFR § 49.203.
87 49 CFR § 49.206-2(b).
88 49 CFR § 49.206-2(c).
89 Bruner & O’Connor on Construction Law § 18:33.
91 See FAR 52.249-10.
93 Bruner & O’Connor on Construction Law § 18:39 (citations omitted).
95 See Cibinic et al., supra at 889-940; Bruner & O’Connor on Construction Law §§ 18:22-31.
96 CJP Contractors, Inc., 45 Fed. Cl. at 371. AIA Document A201-2007 § 14.2.2; AIA Document A201-2007 § 15.2. AIA Document A201-2007 § 14.2.2 also provides that the Owner obtain “certification by the Initial Decision Maker that sufficient cause exists to justify” termination for cause. According to the AIA General Conditions, “[t]he purpose of the initial decision maker is to provide a mechanisms that will allow claims to be resolved without resorting to more formal dispute resolution proceedings that will inevitably delay the project.” The AIA General Conditions provide that either the architect for the project or a third party agreed upon by the Owner and Contract should serve as the Initial Decision Maker. Id.
97 See, e.g., McClain v. Kimbrough Constr. Co., 806 S.W.2d 194, 198-99 (Tenn. Ct. App. 1990). See FAR 49.402-3 (requiring 10-day cure notice prior to default termination for fixed-price contracts); FAR 49.607 (providing text of standard cure notice as well as optional show cause notice); see also FAR 52.249-10(b)(1) (stating that contractor shall not be terminated for default if “within 10 days from the beginning of any delay . . . [the contractor] notifies the Contracting Officer in writing of the causes of delay”).
99 See Phila. Regent Builders, Inc. v. United States, 634 F.2d 569, 572-73 (Ct. Cl. 1980). The Court of Claims in Philadelphia Regent Builders, Inc. v. United States, 634 F.2d 569, 572-73 (Ct. Cl. 1980), found that the technical defects of the Government’s default termination notice at issue, such as the fact that the notice did not contain proper contract numbers or dates, did not cause any harm to the contractor. The court cited to Bostwick-Batterson Co. v. United States, 283 F.2d 956, 958-59 (Ct. Cl. 1960) – which involved a Contracting Officer’s failure to notify a contractor of its right to appeal, thus causing the contractor to fail to appeal within the prescribed 30-day time period – as an example of when a notice defect causes actionable prejudice to a contractor. See Phila. Regent Builders, Inc., 634 F.2d at 572-73.
100 AIA Document A201-2007 § 14.2.3.
102 Id.
103 Id.
104 Rayco, Inc., Eng. BCA 4792, 88-2 BCA ¶ 20,671.
105 Cascade Pac. Int’l, 773 F.2d at 294.
Id.


See id. at 810-11 (discussing adverse consequences of default termination on Government).

See Bruner & O’Connor on Construction Law § 18:38 (“Enforcement of termination clauses is subject to strong public policy constraints arising out of judicial recognition of termination for cause as a forfeiture provision to be strictly construed.”)

Cibinic et al., supra at 1049.


FAR 49-206-2(b).

AIA Document A201-2007 § 14.4.3.

Id.

Id.

Cmt. to AIA Document A201-2007 § 14.4.3.

College Point Boat Corp. v. United States, 267 U.S. 12; 45 S.Ct. 199; 69 L.Ed. 490 (1925) (footnotes omitted).

Id. at 267 U.S. 15-16.

See, e.g., John Reiner & Co. v. United States, 325 F.2d 438, 443 (Cl. Ct. 1963), cert. denied, 377 U.S. 931 (1964) (identifying College Point Boat Corp. as the source of the doctrine of conversion).


312 F.2d 418 (Cl. Ct. 1963), aff’d on reh’g, 320 F.2d 345 (Cl. Ct. 1963).

Id. at 427.


See FAR 43.205(d).

AIA Document A201-2007 § 7.1.1. Instead of the terms “bilateral change order” and “unilateral change order” as used in the government contracts setting, see Cibinic et al., supra at 401-405, the AIA General Conditions use the terms “Change Order” and “Construction Change Directive,” respectively. See AIA Document A201-2007 §7.1.2 (“A Change Order shall be based upon agreement among the Owner, the Contractor and Architect; a Construction Change Directive requires agreement by the Owner and Architect and may or may not be agreed to by the Contractor; an order for a minor change in the Work may be issued by the Architect alone.”).

308 F.2d 510, 513 (5th Cir. 1962).

Id. (quoting Dooley, J.) (emphasis added).

Cibinic et al., supra at 1071; see id. at 1072 (stating J. W. Bateson Co., 308 F.2d at 513, “is the leading case for the rule that major deletions may not be accomplished under the Changes clause”).
See **Nager Elec. Co. v. United States**, 442 F.2d 936, 950 (Ct. Cl. 1971) (citing *J. W. Bateson*, 308 F.2d at 512-13) (stating that factual situations do not “always demand the exclusive use of either the termination for convenience or the changes clause to the exclusion of the other”).


FAR 49.243-4(c).

See FAR 43.301.


AIA Document A201-2007 § 7.3.1.

*Id.*

*Id.* § 7.3.5.

See FAR 52.243-4(d); AIA Document A201-2007 § 7.3.8.


Cmt. to *id*.

AIA Document A201-2007 § 7.3.10.

*See B-E-C-K-Christensen Raber-Keif & Assocs.*, ASBCA 16467, 73-1 BCA ¶ 9884 (finding contractor entitled to upward price adjustment when a deductive change resulted in the contractor incurring higher wage costs that it could have avoided if the deleted work was never included in the contract in the first instance).

*See infra* Part A. 1.c.

FAR 52.249-10(a).

FAR 52.246-12(g); *see Jiminez, Inc.*, VA BCA 6351, 02-2 BCA ¶ 32,019 (rejecting contractor’s argument that Government should have effectuated a termination for convenience to delete work from the contract rather than correcting the defective work with another contractor on the basis of the Inspection clause).

*See AIA Document A201-2007 §§ 14.2.1, 14.2.4.

*See Bruner & O’Connor on Construction Law* § 18:43 (citing Rest. (2d), Contracts (1979) § 350); *see also Sergeant Co. v. Pickett*, 401 A.2d 651, 659-60 (holding that burden was on breaching contractor to show owner had adequately mitigated its damages in hiring supplemental contractors to complete the work on a construction project).