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ADMINISTERING SUBCONTRACTS AFTER A TERMINATION FOR CONVENIENCE

By Patricia A. Meagher and Greg S. Bingham

Although the Department of Defense has seen its budget grow by tens of billions of dollars under the Bush Administration, big-ticket major weapons programs are being scaled back or cancelled as technology and threat assessments change at unprecedented rates. In February 2004, the U.S. Army terminated for convenience the RAH-66 Comanche Stealth Helicopter program. Once regarded as

the cornerstone of the U.S. Army's aviation modernization plan, the Comanche joins another ill-fated multibillion dollar weapons program, the Crusader artillery system, which was terminated by the DOD in August 2002.

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On major Government programs such as these, it is common for a significant portion of the work to be accomplished by subcontractors. For example, significant portions of the \$39 billion Comanche contract¹ and the \$11 billion contract for development of the Crusader artillery system² had been assigned to subcontractors. The extent of subcontracting on the Navy's multibillion dollar A-12 attack aircraft program, terminated in 1991 for default rather than for the Government's convenience, was even more extensive.³

It therefore should not be surprising that some of the most complex and time-consuming

Patricia A. Meagher is a member of the San Francisco, California law firm of Rogers, Joseph, O'Donnell & Phillips. She is a member of the firm's Government Contracts and Construction Law Practice Groups. Greg S. Bingham is a Director in the Washington, D.C. office of the international consulting firm Navigant Consulting, Inc.

issues that a prime contractor must address after a termination for convenience relate to its terminated subcontracts.⁴ This is partially due to the hybrid nature of many subcontracts, especially lower-tier subcontracts, which are often a cross between a Government contract with the associated Federal Acquisition Regulation clauses and a commercial contract.⁵ Moreover, a prime contractor must “stand in the shoes” of the Government and protect the Government’s interests when dealing with subcontractors, even though most often this is done without the prime contractor having settlement authority. In addition, major subcontractors are often competitors of the prime contractor and, because of this, do not allow the prime contractor to gain access to sensitive accounting records that may be required to perform the necessary audits or reviews.

This BRIEFING PAPER discusses the issues faced by a prime contractor in administering subcontracts after a termination for the convenience of the Government. It addresses (1) how to inform subcontractors of the termination, (2) the issues that arise immediately after termination, (3) how to handle termination inventory, (4) the submission of subcontractor settlement proposals, (5) the review and negotiation of these proposals, (6) subcontractor settlements and payment, and (7) dispute avoidance and litigation. Although this PAPER is written from the perspective of advising the prime contractor, it applies equally to subcontractors that are faced with administering convenience terminations at the lower-tier subcontractor and supplier level.

Informing Subcontractors

■ Decision To Terminate Or Complete

It should not be a foregone conclusion that the prime contractor will terminate all of its subcontracts once it receives notice that the prime contract is being terminated for convenience. If a fixed-price subcontractor or supplier is very near completion of its assigned scope of work, it may actually be more expensive to terminate the subcontract for convenience than to allow the subcontractor to finish its work and pay it the subcontract price. For example, if a subcontract was 99% complete at the time it was terminated for convenience, the final termination settlement with that subcontractor may legitimately exceed the fixed contract price after taking into account the cost of preparing the settlement proposal, dealing with termination inventory, and completing other termination tasks. In such cases, a prime contractor may direct the subcontractor to complete its performance and deliver the items under the subcontract agreement, notwithstanding the Government’s termination of the prime contract for convenience. In such a situation, however, it is prudent to obtain the Government’s prior approval, if possible.

■ Notice

After receipt of a *written* notice from the Government that the prime contract has been terminated for convenience,⁶ you should provide each of your subcontractors and vendors with a similar notice of termination. This notice should provide the effective date of the termination and track the directions and instructions the



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Government has provided in its termination notice to you. In general, the notice should advise subcontractors to take the following actions:⁷

- (a) Stop all work under the subcontract and advise you promptly of any circumstance that precludes immediate stoppage of the work.
- (b) Place no further orders under the subcontract.
- (c) Terminate lower-tier subcontracts and cancel outstanding vendor orders.
- (d) Protect, preserve, and inventory all contract property.
- (e) Submit a termination settlement proposal to you as provided in the subcontract agreement (which ideally references FAR Part 49 and sets the submission deadline at six months after receipt of notice of termination).
- (f) Settle with lower-tier suppliers and subcontractors and request that they advise you promptly of any legal dispute.
- (g) Dispose of termination inventory as directed.

You should obtain a written acknowledgement of receipt of the notice of termination from each of your subcontractors.

Although a notice of termination may be supplemented by further instruction letters, a terminated subcontract cannot be unilaterally reinstated; any such reinstatement of a terminated subcontract must be by mutual agreement of the prime contractor and the subcontractor.

■ Partial Termination Notice

If the Government terminates the uncompleted work under your prime contract in part rather than in its entirety, it is referred to as a partial termination for convenience. In such cases, you must review the scope of work for each of your subcontracts and determine whether the work is (1) subject to the termination and therefore must stop, (2) not sub-

ject to the termination and therefore should continue, or (3) some mixture such that part of the subcontractor's work should be terminated while the remaining work should continue (e.g., partial termination). You must then communicate this determination to all affected subcontractors as promptly as possible.

Your notice to subcontractors informing them of the termination must be tailored to the scope of the Government's partial termination of the prime contract. For example, you may need to instruct your subcontractors to stop performance of certain tasks under the subcontract statement of work but continue with the performance of other tasks necessary for completion of the nonterminated portion of the prime contract. Similarly, there may be some purchase orders that your subcontractors will need to maintain, but others that should be cancelled. In addition, you will need to address what property will continue to be used by the subcontractor as well as what property should be subject to disposition as part of the partial termination. To the extent such decisions cannot be made at the time you provide your subcontractors with the notice of partial termination, you should send supplemental instruction letters to them as soon as possible.

A subcontractor whose work is subject to a partial termination for convenience is entitled to submit a termination settlement proposal for the terminated portion of the work. For the most part, the rules that apply to submission of a settlement proposal after a full termination apply to the submission of a settlement proposal after a partial termination. One important exception, however, is that a *fixed-priced* subcontractor is entitled to seek an equitable adjustment to the price of the *nonterminated* portion of the fixed-price work.⁸ You will need to address this issue of an equitable adjustment to the subcontract price of the continued portion of the fixed-price work before, or in conjunction with, the settlement of the subcontractor's partial termination. In this regard, you should ensure that no portion of the increase in the price of the nonterminated work is included in the subcontractor's termination settlement.⁹

■ WARN Act & Other Prior Notice Requirements

Under the Worker Adjustment and Retraining Notification (WARN) Act,¹⁰ a company that employs 100 or more employees must give 60-day notice of (a) a plant shut-down that will result in a loss of 50 or more employees or (b) a mass layoff of (1) 500 employees or (2) $\frac{1}{3}$ of the workforce and at least 50 employees. If you are advised in advance of a proposed termination for convenience of a major Government contract, it may trigger WARN Act obligations.

In addition, with regard to DOD contracts, a Contracting Officer must provide prior notice to a contractor that funding of a major defense program is likely to be terminated or substantially reduced.¹¹ DOD contractors, in turn, must provide similar notices to their employees (or their union representatives) within two weeks of receiving the Government notice.¹² DOD contractors must also provide notice to all first-tier subcontractors with a subcontract of \$500,000 or more no later than 60 days after the Government notice to the contractor. Each subcontractor must then give notice, and flow down the requirement, to all lower-tier subcontractors with subcontracts of \$100,000 or more under the program.¹³ It is incumbent upon the prime contractor and subcontractor to monitor lower-tier subcontractors after termination of a DOD program for compliance with these notice requirements.

Immediate Issues After Termination

■ Termination Team

As soon as possible after receipt of a notice of termination for the convenience of the Government, you should assemble a termination team to perform the various tasks required to properly administer the termination. Personnel from the following organizations are usually members of the termination team:

- (1) *Contract administration* personnel prepare the prime contract termination settlement proposal, negotiate various issues including settlement with the Government, and close out the terminated contract.

- (2) *Subcontract management* personnel direct subcontractors in the termination process, coordinate review and audit of subcontractor settlement proposals, negotiate various issues with subcontractors including provisional settlement, and close out the terminated subcontracts.
- (3) *Supplier management* personnel terminate or cancel smaller purchase orders or return goods to suppliers.
- (4) *Finance and accounting* personnel continue vouchering if appropriate, accumulate prime contract and subcontracts costs as necessary for the prime contract settlement proposal, review and provisionally approve partial payment requests from subcontractors, “roll up” these partial payment requests into the prime contractor’s submission to the Government, and support Defense Contract Audit Agency audit of the prime contractor settlement proposal.
- (5) *Internal audit, finance, or accounting* personnel review or audit subcontractor settlement proposal submissions.
- (6) *Property, plant clearance, or inventory management* personnel handle the disposition of both subcontract and prime contract termination inventory.
- (7) *Human resources* personnel address layoffs and WARN Act issues as well as monitor severance pay, retraining costs, and similar expenses that may be recoverable as part of the prime contract settlement proposal.

■ Inventory Disposition

Termination inventory is defined as “any property purchased, supplied, manufactured, furnished, or otherwise acquired for the performance of a contract subsequently terminated and properly allocable to the terminated portion of the contract.”¹⁴ The term includes Government-furnished property.¹⁵ It does not include special tooling, special test equipment, material, or facilities subject to a separate contract or a separate contract pro-

vision governing use or disposition.¹⁶ After receipt of a notice from the Government that your contract is terminated for convenience, you are obligated to dispose of termination inventory as directed by the Termination Contracting Officer.¹⁷ You therefore must clearly communicate with your subcontractors about their obligations with regard to termination inventory so that you can fulfill your obligations to the Government.

As a practical matter, it is frequently necessary to clear a plant or production area of termination inventory shortly after a termination for convenience so that the area can be used for other work. Prompt instruction to subcontractors on inventory disposition will avoid the loss, damage, or inadvertent destruction of termination inventory.

You should immediately instruct your subcontractors to segregate and move termination inventory to a termination area and to create a complete listing of all inventory involved. Your subcontractors should be directed to screen the termination inventory for possible diversion to other contracts or work that will remove items from the termination claim.¹⁸ In addition, if your contract was on a cost-reimbursement basis, you should advise your subcontractor that any diversion of inventory requires the prior approval of both yourself and the TCO.¹⁹

Although not specifically addressed in the regulatory guidance, it is important as a practical matter to “segregate” the termination inventory within a subcontractor’s electronic inventory control system. Many aerospace and manufacturing companies have integrated material requirements planning (MRP) and inventory control systems that allow inventory to be transferred from contract to contract rapidly and often. Within these integrated systems, the termination inventory can be designated as “available for transfer” so that the MRP system can automatically detect requirements for, and transfer, specific parts from termination inventory to other contracts. You need to ensure that your subcontractor’s contract cost records reflect that the cost of this inventory has been transferred to the receiving contract and removed from the terminated contract.

A further discussion of termination inventory is provided later in this PAPER.

■ Estimate Of Termination Settlement

The TCO generally requests, within 30 days of the Government’s issuance of a notice of termination of a prime contract, that you submit an estimate of the total amount of your termination settlement proposal.²⁰ (For this and other key dates in the termination process, see Appendix A at the end of this PAPER.) The estimate should include costs incurred before the termination as well as settlement expenses, continuing costs, and the cost of subcontractor settlements projected to be incurred in the future. It is unlikely that you can prepare a close-tolerance estimate in such a short period of time. Your “best efforts” toward a high-level estimate will suffice as long as you disclose your estimating methods to the Government so that the TCO and other Government officials are advised of the maturity of your estimate.

To prepare your estimate of your termination settlement proposal, you will need to obtain similar estimates from your subcontractors. It is therefore a best practice to send a request to your subcontractors, either in the termination notice or in a supplemental letter issued shortly thereafter, to submit an estimate of their termination settlement proposals within 15 days. As a practical matter, it will be helpful for you to instruct your subcontractors regarding the format for submission of the information you are requesting. For example, if you intend to provide the TCO with an estimate that segregates costs by month and by cost element, you should instruct your subcontractors to provide their estimated costs in a similarly segregated manner rather than on a lump-sum basis.

■ Continuing Work

An issue that may arise shortly after issuance of a notice of termination relates to continuing work. As discussed above, except where the termination is a partial termination, your notice to your subcontractors should direct the stoppage of all work and should instruct your subcontractors to notify you if work cannot be

stopped immediately. Thus, there may be occasions when a subcontractor notifies you of the need for some work to continue and asks for further instruction. Your response should consider that costs that are not discontinued immediately after the effective date of the termination (e.g., *continuing costs*) are recoverable *if all reasonable efforts are made to discontinue the costs and the costs are otherwise allowable*.²¹

Costs incurred in completing work-in-progress after the effective date of the termination have been allowed where completion was necessary to avert the total loss of the item, as would be the case, for example, where the item was in the midst of a heat treatment. The best practice, however, is for your subcontractors to request, and for you to obtain, authorization from the TCO to complete work-in-progress notwithstanding the notice of termination. Termination inventory, of which work-in-progress is a part, is often scrapped because it is not usable on other programs. For this reason, the TCO may instruct you to discontinue work on work-in-process even if it renders the inventory unusable.

Another example of a continuing cost is employee salaries. In general, some period of time lapses between the effective date of the termination and the reassignment of employees. Salaries during this stand-by period are allowable as long as all reasonable efforts are made to mitigate these costs.²² In other words, you should advise your subcontractors that this provision is by no means a “blank check” and that idle time charges will be closely scrutinized. You may wish to suggest to your subcontractors that they encourage affected employees to take accrued vacation time or time off without pay or perhaps to enroll in an educational or training course pending reassignment. Such actions demonstrate a subcontractor’s efforts to mitigate costs and increase the likelihood that the continuing costs that are incurred will be allowed.

■ Special Instructions On Vouchers

When a cost-reimbursement prime contract has been completely terminated, the prime contractor may (but is not required to) continue using vouchers until the last day of the

sixth month following the month in which the termination is effective.²³

In those instances where you continue to voucher, you should advise your cost-reimbursement subcontractors that they too are permitted to continue their normal vouchering process. You may wish to remind your subcontractors, however, that fee is not recoverable on settlement expenses or on lower-tier subcontractor settlement amounts other than continuing work and therefore fee on these costs should not be included in the voucher.²⁴ You should consider instructing your subcontractors to segregate the costs included in their vouchers into different categories to ensure that fee is only added to the appropriate categories of costs. You may also wish to instruct your subcontractors to submit more detailed cost records to support the subcontract vouchers so that you can perform a more detailed review or audit of the voucher costs than was necessary before the termination.

It is often the case that, before the termination, the subcontractor had a detailed scope of work against which you could measure progress and the reasonableness of the costs incurred (e.g., cost performance reporting). The post-termination work often is not as well-defined. Your subcontractor may be instructed to perform continuing work that necessarily has a more broadly defined scope of work. Accordingly, you should closely scrutinize the post-termination work from a cost and technical perspective to ensure that you allow payment only for progress made and work accomplished.

In addition, your subcontractors will likely include incurred *settlement expenses* in their vouchers. Settlement expenses must be closely monitored and reviewed or audited to ensure they are reasonable and allowable. The FAR cost principle governing termination costs provides as follows regarding the allowability of settlement expenses:²⁵

(1) Settlement expenses, including the following, are generally allowable:

(i) Accounting, legal, clerical, and similar costs reasonably necessary for—

(A) The preparation and presentation, including supporting data, of settlement claims to the contracting officer; and

(B) The termination and settlement of subcontracts.

(ii) Reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract.

(iii) *Indirect costs* related to *salary and wages* incurred as settlement expenses in (i) and (ii); normally, such indirect costs shall be *limited* to payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs.

Note that the regulations provide special instructions in paragraph (iii) regarding the allowability of indirect costs assigned to settlement expenses. As a practical matter, the method used to assign indirect costs to settlement expenses almost always differs from the method used to allocate indirect expenses to performance costs before the termination.

Finally, you should direct your cost-reimbursement subcontractors to identify their final voucher as their “completion voucher” and advise them of the need to be prepared for provisional audits of selected vouchers.²⁶

■ Conferences

The TCO commonly schedules a conference with the terminated contractor shortly after the termination.²⁷ The conference generally addresses issues such as those mentioned above as well as the responsibilities of the terminated contractor. In addition, the conference often results in a schedule for submission of the various termination forms, including the prime contract and major subcontract termination settlement proposals, as well as negotiation of the settlement.²⁸ With the TCO’s concurrence, you may wish to invite all subcontractors to this conference (or selected subcontractors for which there are more complicated termination issues or for which the dollar amount of the settlement may be significant). If this approach is not possible or desirable, you should consider scheduling a separate conference with all terminated subcontractors as promptly after the TCO conference as possible.

The conference is an excellent opportunity for companies involved in the terminated program to learn what is expected of them and to ask questions about continuing work, inventory disposition, settlement proposal preparation, the ratification or approval for proposed settlements with lower-tier subcontractors, access to books and records for audit, and settlement negotiations. Anticipated equitable adjustment to the price of the nonterminated work, outstanding change orders, and undefinitized work are often discussed as well. Attendance at the TCO’s conference is often most helpful to those subcontractors that are commercial firms or otherwise unfamiliar with the special rules and procedures associated with a termination for the convenience of the Government. In addition, as the termination process often takes much longer than initially anticipated by many subcontractors, the conference provides an opportunity for the various participants to become familiar with all the required steps. Finally, you may wish to distribute to your subcontractors copies of the applicable regulations and termination forms or a listing of the websites providing this information.²⁹

Termination Inventory

As discussed above, your termination team should include a member from your property, plant clearance, or inventory management groups since most terminated contracts included some items of termination inventory. This termination team member should be responsible for both the prime contract termination inventory and the subcontract termination inventory.

■ Schedules

At the time of the termination, it is likely that a number of your subcontractors will have in their possession property associated with the terminated work. For example, your subcontractors may have purchased parts, raw materials, work-in-process, finished components or finished product, and perhaps Government-furnished property. These items are part of

the termination inventory and require special treatment.

As the prime contractor, you are required to submit an inventory schedule to the TCO within 120 days from the effective date of the termination.³⁰ The Government expects to receive a schedule or set of schedules that includes all of the termination inventory whether it is in the prime contractor's physical possession or located at one of the subcontractors' facilities. Accordingly, you will need to obtain inventory schedules from your subcontractors to submit to the Government in connection with your own inventory schedules. Your notice of termination to your subcontractors should therefore direct the submission of inventory schedules to you within a shorter time period—perhaps 60 or 90 days after receipt of the notice of termination—as necessary to allow you to meet your 120-day deadline. Note, however, that any such direction should be consistent with any applicable subcontract provision.

Termination inventory is an important issue in administering a subcontractor termination for convenience. As the prime contractor, the Government will look to you directly for a full accounting of the termination inventory, even if the subcontractor has physical possession of the property or inventory. It is therefore important that you work with your subcontractors to ensure that the termination inventory is properly identified and segregated and that accurate and complete inventory schedules are submitted to you by your subcontractors.

There are several forms that a subcontractor may be required to submit.³¹ (For a complete listing of the FAR termination forms, including forms relating to inventory, see Appendix B to this PAPER.) The forms address different types of inventory that may be in the possession of the subcontractor at the time of the termination for convenience. For contracts awarded *before May 5, 2004*, the Standard Forms relating to termination inventory are the following:³²

- (a) SF 1426, Inventory Schedule A (used for metals in mill product form), and SF 1427, Continuation Sheet.

- (b) SF 1428, Inventory Schedule B (required for raw materials (other than metals), purchased parts, finished product, plant equipment, and finished components), and SF 1429, Continuation Sheet.
- (c) SF 1430, Inventory Schedule C (used for work-in-progress), and SF 1431, Continuation Sheet.
- (d) SF 1432, Inventory Schedule D (required for special tooling and special test equipment), and SF 1433, Continuation Sheet.
- (e) SF 1434, Inventory Schedule E (only form required if settlement is less than \$10,000).

Effective May 5, 2004, the *only* forms required are the *new SF 1428*, Inventory Disposal Schedule and *SF 1429*, Continuation Sheet. Note that a *separate inventory schedule* is now required for *each* of five different property classifications.³³

Significant time will be spent by your subcontractors (and you) in segregating inventory, verifying the accuracy of inventory records and completing the requisite forms. Such costs are allowable termination expenses if they are reasonable in amount. Although the above-listed Standard Forms are available for listings of termination inventory, a computer-generated printout will usually be acceptable as long as the certification from the inventory schedules is signed. (This is a good example of a topic to discuss with the TCO at the termination conference.) A practical solution used by many contractors is to complete the top part of the Standard Form, execute the required certification, attach a printout from the contractor's inventory control system, and then reference the attachment on that part of the Standard Form where the inventory is to be listed.

The Government inventory schedules, which are required even on a total cost basis settlement proposal (discussed below), have columns for cost information. Although many MRP and accounting systems are equipped to assign a cost to inventory, it is important that you disclose what cost elements are included in the cost of inventory. For example, you should dis-

close (a) whether the inventory cost shown includes direct material only or also includes overhead, (b) whether the cost of purchased parts is based on an average of many purchases over multiple contracts or is based on specific purchases on the terminated contract, and (c) whether direct labor is included.

■ Storage

The Government has the right to require the delivery of termination inventory. In practice, it may take some time—weeks if not months (or longer)—after the effective date of the termination for the Government to determine what, if any, termination inventory it would like to receive. In the interim, it is the contractor's responsibility to store the inventory in a secure location.

As a prime contractor, you must ensure that your subcontractors understand the obligation to store termination inventory in a secure location pending receipt of disposition instructions. Subcontractors should be warned of the likelihood that their settlement recovery will be reduced if termination inventory is lost, damaged, or destroyed. Subcontractors should be reminded that settlement expenses include reasonable storage costs.³⁴ They also should be reminded that subcontractors are entitled to a separate written storage agreement at the expiration of the *plant clearance period* for any items the Government does not remove.³⁵ The plant clearance period begins on the effective date of termination and ends 90 days after receipt by the TCO of acceptable inventory schedules.³⁶

■ Disposition

After submission of the inventory schedules, the prime contractor and the TCO (or the TCO's appointed plant clearance officer) will discuss the issue of disposition, and the TCO will provide direction to the prime contractor. The prime contractor, in turn, should provide direction to its subcontractors consistent with the TCO's direction. For termination inventory that the Government does not require to be delivered, disposition includes, in order of priority, purchase or retention at cost, return of property to the supplier, use within the Gov-

ernment, donation, sale, and then abandonment or destruction.³⁷

Accordingly, you have two responsibilities as a prime contractor. *First*, you must ensure that your subcontractors are aware of and comply with the instructions you receive from the TCO relating to the delivery of termination inventory. *Second*, you should work with your subcontractors to determine whether any of them wish to purchase termination inventory at cost.

Note that if an item of the termination inventory is a *common item*, the subcontractor is obligated to transfer the material to its own or another's use at cost, so long as this does not cause the subcontractor to sustain a loss.³⁸ But even if the material is not a common item, a subcontractor may wish to, and should be encouraged to, purchase the inventory at cost or make an offer to purchase inventory at less than its recorded cost. Since the Government does not always find an alternative use for the termination inventory, and often eventually directs the contractor to scrap some portion of the termination inventory, the most economical outcome for the Government and the subcontractor may be for the subcontractor to purchase any termination inventory for which it has even a marginal use. You will need to obtain the approval of the TCO, however, before selling any portion of the termination inventory at less than cost. Where the subcontractor transfers or purchases termination inventory, the subcontractor's settlement proposal amount should reflect a reduction. Termination inventory not retained by the subcontractor must be returned, sold, or otherwise disposed of as provided in the regulations. Subcontractors are entitled to recover as a termination cost all reasonable expenses incurred in returning, selling, or otherwise disposing of termination inventory.³⁹ Any revenue generated in disposition of the property is accounted for as a reduction on the subcontractor's termination settlement proposal.

As illustrated above, the goal of the regulations relating to termination inventory is to verify

that the inventory is accounted for, is segregated and protected, and was required for the terminated contract in the quantities purchased, and that common inventory has been transferred to other contracts along with the associated cost if such transfer does not cause the contractor to sustain a loss. The process described above, however, applies most often where the contractor and subcontractors do not necessarily have a Government-approved property system. There are shorter, more efficient, and less paper-oriented processes that often are allowed by the TCO under blanket authority when the particular contractor or subcontractor has a Government-approved property system. In at least two major terminations of which the authors of this PAPER are familiar, the prime contractors, and a number of subcontractors, had access to the Plant Clearance Automated Reutilization Screening System (PCARSS) and employed this system at the Government's direction to facilitate greatly the verification and disposition of termination inventory. In these instances, the PCARRS system was used in lieu of the inventory schedules described above and specified in the FAR.

Subcontractor Settlement Proposal Submission

Subcontractor settlement proposals, although handled separately from the prime contractor's own settlement proposal, are an essential part of the overall resolution of the termination. When a major prime contract is terminated, the result is often a chain reaction through several tiers of subcontractors. Each lower-tier subcontractor submits its settlement proposal to the contractor with whom it has privity of contract, and proposals are submitted back up the chain to eventually become embodied in the settlement proposal submitted by the prime contractor to the Government. Accordingly, clear communication and close coordination are necessary to ensure that the process is successful and that the rights of contractors at all tiers as well as the interests of the Government are protected.

■ Instructions To Subcontractors

A best practice for prime contractors is to prepare letters of instruction to subcontractors

addressing the submission of the termination settlement proposal, continued vouchering if applicable, termination of lower-tier subcontractors and suppliers, and the disposition of termination inventory. One letter should be prepared for fixed-price subcontractors. A separate letter should be prepared for cost-reimbursement subcontractors, which should then be tailored for time-and-materials or labor-hour subcontractors.

For *fixed-priced* subcontracts, there are three bases for preparing settlement proposals: (1) the *inventory basis* under which the contractor's costs are allocated to termination inventory items such as raw materials, purchased parts, work-in-progress, and finished components, (2) the *total cost basis* under which all costs incurred through the effective date of the termination as well as the continuing costs and termination settlement expenses are claimed as a lump sum (note that costed inventory schedules are also required when using the total cost basis settlement proposal forms), and (3) the *short form* (an abbreviated version of the inventory basis settlement proposal) for settlement proposals with a net payment requested of less than \$10,000.⁴⁰

You should advise your fixed-price subcontractors that settlement proposals *must* be submitted on the inventory basis *unless* the TCO approves in advance the use of the total cost method.⁴¹ Circumstances that may warrant the use of the total cost method include where the subcontractor has not commenced production, where inventory unit costs cannot readily be established under the subcontractor's accounting system, where the subcontract does not specify unit prices, or where the termination is complete and involves a letter contract.⁴² If a subcontractor requests your approval to use the total cost method, you should forward this request to the TCO and advise the subcontractor that, although it may proceed with preparation of its settlement proposal as it deems appropriate, unless and until the TCO approves of the use of the total cost method, any work on such a proposal is done at the subcontractor's own risk. If your subcontractor submits a settlement proposal on a total cost basis without the prior written consent of the TCO, you should (absent unique circumstances) reject it.

Cost-reimbursement subcontractors should use the settlement proposal form for cost-reimbursement-type contracts (SF 1437). As with the total cost basis settlement proposal form for fixed-price contracts (SF 1436), the completion of SF 1437 primarily requires the accumulation of costs from the accounting books and records of the terminated subcontractor.

As discussed above, you should instruct your subcontractors to submit a final settlement proposal no later than six months after the effective date of the termination. You should also encourage your subcontractors to submit final settlement proposals earlier than this deadline, which would provide the opportunity for you to obtain corrections and clarification of the submission from the subcontractor.

■ Settlement Proposal Forms

You should instruct your *fixed-price* subcontractors to submit their termination settlement proposal on SF 1435, Settlement Proposal (Inventory Basis), along with SF 1439, Schedule of Accounting Information.⁴³ Fixed-price subcontractors given prior approval for submission on a total cost basis should be instructed to submit Standard Form 1436, Settlement Proposal (Total Cost Basis), rather than Standard Form 1435.⁴⁴ Subcontractors with a termination settlement claim of less than \$10,000 may use the short form, SF 1438, Settlement Proposal (Short Form).⁴⁵

You should instruct your *cost-reimbursement* subcontractors to submit their termination settlement proposal using SF 1437.⁴⁶

Many prime contractors find it helpful and efficient to direct their subcontractors to submit both paper and electronic revisions of their settlement proposals. You may wish to advise your subcontractors that an electronic version of the termination forms can be obtained from the General Service Administration's Forms Library available at <http://www.acqnet.gov/far/>.

For a complete listing of the FAR termination forms for each type of settlement proposal see Appendix B at the end of this PAPER.

■ Certifications

Each settlement proposal form includes a certificate that the contractor is required to execute to certify that its settlement proposal and supporting schedules (a) were prepared from the books of account and records of the contractor in accordance with recognized commercial accounting practices, (b) include only those charges allocable to the termination portion of the contract, (c) were prepared with knowledge that they may be used as the basis for the settlement of a claim against the United States, and (d) state only fair and reasonable charges.⁴⁷

In addition, the contractor must certify, with regard to its subcontractors' charges, that (1) it has adequately examined the termination proposals of its immediate subcontractors; (2) the settlements of immediate subcontractors' charges (a) are fair and reasonable, (b) are allocable to the terminated portion of the contract, and (c) were negotiated in good faith and are not more favorable to the immediate subcontractors because reimbursement by the Government is involved; (3) it has received executed and appropriate certificates from subcontractors with respect to their proposals; and (4) it has no information leading it to doubt either the reasonableness of the settlements with more remote subcontractors or that the charges for them are allocable to the contract. The contractor is also required to certify that, immediately upon receipt of amounts covering settlement with its immediate subcontractors, it will pay or credit subcontractors the appropriate amount.⁴⁸

Accordingly, as prime contractor, you are required to certify both your own settlement charges and those of your immediate subcontractors, although the terms of the certification are somewhat different. Also, you need to ensure that your immediate subcontractors provide you with the requisite certifications for their own settlement proposals as well as the settlement proposals of lower-tier subcontractors and suppliers.

Subcontractor Settlement Proposal Review

■ Initial Steps

To prepare for your review of subcontractor termination settlement proposals, it is helpful to have check lists of the mandatory forms and items that are required to be submitted as part of the termination settlement proposal as well as the steps you plan to take to review, negotiate, and settle the termination proposals. A separate check list should be prepared for each type of subcontract proposal—fixed price, cost-reimbursement, or short form—that you will be required to review.

Upon receipt of a subcontractor's termination settlement proposal, you should review the proposal and supporting schedules for completeness. Specifically, you should determine whether all of the required forms have been submitted (a listing of the required forms is provided in Appendix B at the end of this PAPER), whether the proposal forms have been properly prepared with all applicable blocks filled in and all questions answered, whether the required certifications have been signed and submitted, and whether the supporting schedules are in accord with the proposal. You should also check the mathematical computations of the settlement proposal for accuracy.

Assuming the subcontractor's termination settlement proposal is complete, there are three major areas for you to review. First, a *technical review* of the proposal information should be conducted. This review would include a review of the work the subcontractor claims to have performed before receipt of the notice of termination as well as any continuing work. You will need to determine, for example, that all work performed was within the scope of the subcontract agreement and that the labor hours incurred and material charges appear reasonable. The technical review also may determine the estimate to complete and the percentage of completion at the time of termination.

The second major area for review is *cost*. Most of the cost issues faced by terminated subcontractors are the same as those faced by the terminated prime contractor. The primary

issues relate to the different roles and responsibilities of the prime contractor as both a *seller* of goods and services to the Government and a *buyer* of goods and services from subcontractors. As a terminated seller, you accumulate and report cost information to your customer, the Government. As the buyer of goods and services from terminated subcontractors, you are responsible for overseeing the subcontractors and evaluating the cost information submitted to you. It is important that you consistently and fairly treat various cost issues, or that you understand and can articulate why you accepted a subcontractor's treatment of a particular cost in its proposal even though it may not have been consistent with the treatment you gave a similar cost in your prime contractor termination proposal. Some of the more important cost issues to initially investigate include the following:

(a) *Mathematical Consistency*—Ensure the numbers “flow” correctly from the subsidiary schedules up to the summary termination schedules. For example, on an inventory basis settlement proposal, the total cost of Purchased Parts shown on Inventory Schedule B (SF 1428) should “flow” up to line 3, Purchased Parts, on the Settlement Proposal summary form (SF 1435). Also ensure that the amounts shown on the settlement proposal are consistent with records of costs incurred by the subcontractor. For example, review the last cost performance report (if applicable) you received from a cost-reimbursement subcontractor to see if the actual cost of work performed just before the termination, plus any vouchered cost, is approximately the same as the amount included on the settlement proposal.

(b) *Loss Contracts*—On fixed-price contracts, the FAR provides that the TCO will not allow profit if it appears that the contractor would have incurred a loss had the entire contract been completed. Moreover, the TCO will reduce the settlement to reflect the indicated rate of loss.⁴⁹ These provisions have a large impact on the final settlement if the subcontractor was in a loss position. Partially because of this, there is often disagreement over whether or not the subcontractor would have incurred a loss. To fully investigate this issue, it is usu-

ally necessary to obtain the subcontractor's cost estimate-at-completion from just before or just after the termination and to compare this estimate-at-completion to the subcontract value. Note that the subcontractor's answers provided on the Schedule of Accounting Information (SF 1439) to Question 12 are designed to assist you in this investigation.

(c) *Completion Percentage*—The loss adjustment provision discussed above does not apply to cost-reimbursement contracts. If a cost-reimbursement contract is terminated for convenience the subcontractor is allowed to recover its reasonable, allowable, and allocable costs (up to the cost ceiling), settlement expenses, and a percentage of the fee equal to the percentage of work completed.⁵⁰ The initial investigation of terminated cost-reimbursement subcontracts should include a review of the cost ceiling to determine if it will limit the recovery of costs to the subcontractor as well as the subcontractor's completion percentage since the fee received will be based on this completion percentage.

(d) *Profit/Fee*—You should ensure that profit or fee has not been added to settlement expenses or based on settlements with lower-tier subcontractors or suppliers.⁵¹ The profit allowed on a fixed-price subcontract should be based, to the extent possible, on the nine factors listed in the FAR.⁵² Although some of these nine factors may not apply to your particular situation, you should be able to obtain information on at least a few of these factors (e.g., profit rate included in the original subcontract proposal and profit the subcontractor was projected to earn if not terminated and allowed to complete the subcontract).

A recent decision by the Armed Services Board of Contract Appeals affects the fee that a cost-reimbursement prime contractor can recover on cost-reimbursement subcontracts under somewhat limited circumstances.⁵³ The board in that case held that on fixed-price contracts, the FAR specifically permits fee on completed subcontractor work. The board pointed out that, by contrast, the FAR language relating to cost-reimbursement contracts does not have an exception for completed work.⁵⁴ The FAR states simply that the

“contractor's adjusted fee shall not include an allowance for fee for subcontract effort included in subcontractors' settlement proposals.”⁵⁵ The case makes clear that while the prime contractor is not entitled to recover fee on subcontractor cost included in subcontractors' settlement proposals, the prime is entitled to recover fee on subcontractor costs that were vouchered.

(d) *Reclassification of Costs*—It is not uncommon for terminations to give rise to situations where it is necessary to modify the treatment of costs such that costs normally treated as indirect costs become direct costs assignable directly to the terminated subcontract.⁵⁶ You should investigate the circumstances involved to ensure that the reclassification was proper and that the reclassification does not cause some elements of cost to be “double-counted” (e.g., counted as both a direct cost and as part of an indirect allocation). Note that the subcontractor's answers provided on the Schedule of Accounting Information (SF 1439) are designed to assist you in this investigation.

The third major area of review of a subcontractors termination settlement proposal is *property*. You should ensure that your instructions were followed by the subcontractor, that the subcontractor's Government property list was received and reviewed, that retained parts were shipped as directed, and that the proposal reflects the proper credit for scrapped or sold items.

■ Audit

It is the responsibility of the prime contractor to perform all necessary *accounting reviews* and *field audits* of subcontractor settlement proposals.⁵⁷ Each subcontractor settlement must be supported by sufficient financial information to permit adequate Government review since in many instances the DCAA or other audit agency also reviews these settlement proposals and provides findings to the TCO.

The FAR does not mandate the type of audit that you must conduct. Rather, the type of audit to be performed on a subcontractor's termination settlement proposal is a matter for

the prime contractor to determine and will depend on a number of factors including the dollar value of the settlement proposal, whether the proposal is on the inventory basis or the total cost basis, whether the subcontractor has a Government-approved accounting system, and the perceived level of risk involved.

The *DCAA Contract Audit Manual* addresses in detail the steps the DCAA believes are required for a proper convenience termination audit. While not binding on the prime contractor, the *Contract Audit Manual* provides guidance for the contractor in conducting subcontract termination audits.⁵⁸ This same material is addressed in the format of an Audit Program with specific audit steps available at the DCAA's website at <http://www.dcaa.mil/>. Both the *DCAA Contract Audit Manual* and the various Audit Programs address the full range of audit review that may be required—from the desk review of a low-risk voucher to the full audit, including site visit, of a complex and high-value termination settlement proposal package.

On large termination actions, it is often efficient to create various thresholds and decision rules specifying the types of audits or reviews that will be conducted for different categories of the subcontractors. This allows audit resources to be prioritized and expended on the riskier areas. For example, short-form settlement proposals of under \$10,000 would be reviewed in accordance with an abbreviated desk review procedure; for settlement proposals of between \$10,000 and \$100,000, a desk review would be conducted including a review of documents from the subcontractor and a telephonic question-and-answer dialogue between the prime contractor and the subcontractor. For settlement proposals of over \$100,000, all of the steps described above would be followed as well as one or more visits to the subcontractor's site to test accounting and inventory records. You should not adhere to thresholds such as the ones described above too rigorously, however, since there may be exceptional cases that would warrant a higher standard of review (e.g., a significant risk of overpayment on a low-value settlement proposal).

For *cost-reimbursement type* contracts, the audit procedures are very similar to those estab-

lished for a normal incurred cost audit, which are addressed in Chapter Six of the *DCAA Contract Audit Manual*. If the goal is to settle the termination *and* close the subcontract, there will typically be two separate audit actions required: (1) preparation of a contract audit closing statement addressing costs that were vouchered after the termination and possibly before the termination, and (2) preparation of an audit report addressing the final settlement proposal.⁵⁹

As for the audit of a terminated *fixed-price* contract, the *DCCA Contract Audit Manual* describes the two acceptable settlement proposal bases—inventory basis and total cost basis. Regarding inventory basis settlement proposals, the *Manual* notes that the “inventory basis requires that the contractor directly associate the costs and profit in the settlement proposal with units or services terminated. It limits the proposal to those items which are residual due to the termination action. Using the inventory basis for submitting settlement proposals is the method preferred by the government.”⁶⁰ Regarding total cost basis settlement proposals, the *Manual* notes that “[i]n contrast, a settlement proposal on a total cost basis is for total costs incurred under the entire contract until termination, by elements such as labor, material, and indirect costs plus settlement expenses and profit, less the contract price of delivered items. The auditor's main interest in the termination inventory is not its value, but whether all inventory items are properly identified and made available to the government....The government normally gives approval to use the total cost basis only when the inventory basis is not feasible or would unduly delay the settlement.”⁶¹

Under certain circumstances, the Government may assist the prime contractor in conducting an accounting review or audit of subcontractor settlement proposals. Most commonly, a TCO may request that the Government audit agency perform the accounting review where the subcontractor is a competitor of the prime contractor and therefore objects to the prime contractor reviewing its accounting records. Many TCOs, however, will restrict the referral to competitively sensitive information—for example, overhead rates—and require that the prime contractor conduct its own accounting review of

those areas that are not competitively sensitive. Other circumstances that warrant the Government conducting the accounting review of the subcontractor's settlement proposal include where the Government is currently performing audit work at the subcontractor's facility, where audit by the Government is necessary for consistency in audit treatment, and where the prime contractor has a substantial financial interest in the subcontractor.⁶² As in other areas, while the TCO is responsible for determining whether the Government should audit the subcontractor's proposal, the criteria provided in the DCAA Audit Manual as well as the judgment and experience of the auditor determines the scope of the audit once the referral is made.⁶³

You should note that the regulations instruct the TCO to request that the Government audit agency periodically examine the contractor's procedures for conducting accounting review of subcontractor termination settlement proposals and thereafter provide comments and recommendations to the TCO concerning the contractor's procedures.⁶⁴

If it is necessary for amounts previously claimed by the subcontractor to be modified during the audit and evaluation process, consider whether the cost is justified to have the subcontractor update and resubmit the termination forms. Each time this is done the subcontractor's settlement expenses may increase. Another alternative is to edit the earlier forms or handle the changes on a separate spreadsheet or letter.

A negotiated subcontractor settlement that is submitted by the prime contractor for TCO approval will be subject to Government audit when (a) the amount exceeds \$100,000 or (b) the TCO desires an accounting review.⁶⁵ This Government audit, however, does not relieve the prime contractor from its own obligation to conduct an appropriate review or audit of the subcontractor's proposal before negotiations.⁶⁶

Negotiation Of Subcontractor Settlement Proposal

■ Preparing For Negotiations

The subcontract termination file should be standardized and completed before the com-

mencement of negotiations. At a minimum, it should include the following items:

- (1) Subcontract and modifications.
- (2) Correspondence relating to the termination.
- (3) Subcontract summary sheet.
- (4) Settlement proposals (interim and final).
- (5) Technical review report.
- (6) Audit or accounting review.

■ Special Considerations For Fixed-Price Subcontracts

With regard to negotiations with terminated fixed-price subcontractors, your responsibility is to negotiate a fair and equitable settlement. In this regard, the policy and procedures of FAR Subpart 49.2 should govern your negotiations, including the following often-quoted provision:⁶⁷

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.

In negotiating a settlement with a terminated fixed-price subcontractor, you may agree upon the total dollar amount or *lump-sum* payment to be made as a result of the termination. Agreement or segregation of particular elements of costs or profit is not required.⁶⁸ Furthermore, you should regard cost and accounting data as providing *guidance* rather than establishing rigid measures for determining what compensation is fair under the circumstances. An estimation of costs is acceptable, and the subcontractor's books and records need only be reliable and sufficient so as to be "compatible with the reasonable protection of the public interest."⁶⁹ The prime contractor must generally conform to the FAR termination principles in settling with its subcontractors.⁷⁰

Note that the FAR provisions summarized above are not wholly consistent with other FAR

provisions that require the strict application of the cost principles to termination settlements. For instance, the “Termination for Convenience” clauses for fixed-price and cost-reimbursement contracts state that the FAR cost principles and procedures “shall govern all costs claimed, agreed to, or determined under this clause.”⁷¹ The FAR provides that the cost principles are to be incorporated into contracts as the basis for “[p]roposing, negotiating, or determining costs under terminated contracts,” but that this is subject to the general principles of fairness described above.⁷² The FAR also directs the application of the cost principles in bottom-line settlements of cost-reimbursement contracts, stating that an “overall settlement shall not include costs that are clearly not allowable under the terms of the contract.”⁷³ Furthermore, the FAR clearly advises prime contractors that the Government will not pay the prime contractor any amount for a terminated subcontractor’s claim of loss of anticipatory profits or consequential damages.⁷⁴

■ Delay Or Impasse

In those instances, where, despite your best efforts, settlement negotiations with a subcontractor have reached an impasse, there generally are several options. The exact options available to you in dealing with a particular subcontractor will depend on the terms and conditions of your subcontract agreement and the willingness of the TCO to intervene.

First, assuming the termination clause in your subcontract agreement tracks the FAR “Termination for Convenience” clause for fixed-price⁷⁵ or cost-reimbursement contracts,⁷⁶ the prime contractor has the ability to issue a unilateral determination of the amount due the subcontractor if the prime contractor and the subcontractor fail to agree on the amount of the termination settlement or if the subcontractor fails to submit a termination proposal. The unilateral determination of the amount due the subcontractor should be based on the information available to the prime contractor and should represent a reasonable settlement amount (rather than, for example, an assessment of the minimum amount arguably due). Again depending on the language of the subcontract’s termina-

tion clause, the subcontractor would have the right to accept or reject the unilateral determination of the amount due. It also may have the right to be paid the amount set forth in the unilateral determination even if the subcontractor decides to reject the unilateral determination amount and commence litigation.

Second, you can request that the Government provide assistance to you in the settlement of a particular subcontract. You could request, for example, that the TCO attend a negotiation session with the subcontractor or send another Government representative such as a DCAA auditor. In this way, the subcontractor would learn “first hand” the Government’s view on the issues that it has not been able to resolve in discussions with the prime contractor. Whether the Government is willing to provide such assistance varies from TCO to TCO and case to case. Under the FAR, such settlement assistance may be provided in “unusual cases” and where the TCO determines it is in the best interests of the Government.⁷⁷ In addition, where the Government provides such assistance, the settlement is entered into by three parties—the Government, the prime contractor, and the subcontractor—but the subcontractor settlement is paid through the prime contractor as part of the overall Government’s termination settlement with the prime contractor.⁷⁸

Third, although not specifically addressed in the regulations, the following approach may provide a practical solution to an impasse. Where you are unable to reach agreement with your subcontractor, you may be able to submit the matter to the TCO for determination. Under this approach, the package forwarded to the TCO by the prime contractor would include the prime contractor’s recommended proposed settlement amount with supporting justification, but also would include information from the subcontractor about the reasons why the subcontractor disagrees with the prime contractor’s settlement recommendation. The TCO would then make a determination whether to adopt the prime contractor’s position or the subcontractor’s position on the issue. Note that there is no obligation on the part of the TCO to agree to such a procedure; indeed, some TCOs may view this procedure as inconsistent

with the obligation of the prime contractor to reach an agreement with their subcontractors on the amount due as a result of the termination. But in those instances where the disputed issue is limited, and both the prime contractor and subcontractor believe strongly in the validity of their positions, intervention by the TCO—who must ultimately approve any settlement between the prime contractor and the subcontractor on the termination—may be the most efficient and practical means of resolution.

Finally, where none of the alternative approaches discussed above is feasible, and your inability to settle with the subcontractor is delaying your own settlement with the Government, you should consider submitting a request to the TCO that the TCO settle the prime contract termination with you, excepting the subcontractor settlement proposal from your own settlement and reserving the rights of the Government with the prime contractor with respect to that subcontractor proposal.⁷⁹

Submission Of Proposed Subcontractor Settlements

As noted, all termination settlements with subcontractors are subject to the review and approval of the Government. The only exception is where the prime contractor has been delegated settlement authority to settle with subcontractors for amounts less than \$100,000.⁸⁰

■ Certification

As noted earlier in this PAPER, as the prime contractor, you must certify that you have reviewed the subcontractor's termination settlement proposal, that the costs are allocable to the terminated portion of the contract, and that the settlement agreed to between you and the subcontractor is fair and reasonable, was negotiated in good faith, and is not more favorable to the subcontractor than if the Government were not involved.⁸¹

As for lower-tier subcontractors, you are not directly responsible for reviewing their claims or settling their termination settlement proposals. This, of course, is the responsibility of the subcontractor that issued the con-

tract or purchase order to the lower-tier subcontractor or vendor. But you are responsible for certifying that you have no information leading you to doubt the reasonableness or allocability of the settlements with lower-tier subcontractors.⁸² Accordingly, it is highly recommended that you conduct a review of the settlements and verify that the negotiations were conducted in good faith.

You should note that the Truth in Negotiations Act, which requires the disclosure of cost or pricing data, applies to termination actions. For termination settlement proposals exceeding \$550,000, the contractor must certify that the cost or pricing data submitted was accurate, complete, and current as of the date of agreement on the settlement.⁸³

■ Government Approval

As noted above, the TCO is required to refer subcontract settlements received for approval or ratification to the appropriate Government audit agency when (a) the amount of the proposed settlement exceeds \$100,000, or (b) a complete or partial accounting review is warranted.⁸⁴

In some instances, the TCO may authorize you to settle with your subcontractors if the amount involved is \$100,000 or less. The authorization, however, is not available if the settlement would be with a related corporate entity. The grant of this authority is discretionary and varies from TCO to TCO. If the authority is granted, however, it will relieve some of the administrative burden imposed on the TCO to review and approve subcontractor settlements. In addition, if the TCO finds the prime contractor procedures or its negotiations with subcontractors are inadequate, the authority may be revoked by the TCO.⁸⁵

You should advise your subcontractors in writing, and then remind them periodically, that any settlement reached on their termination proposal is subject to the approval or ratification of the TCO. A common practice followed by prime contractors is to advise subcontractors in writing that the settlement is contingent upon Government approval, and if the TCO

disapproves of the settlement reached between the prime contractor and the subcontractor for any reason, the settlement is void and must be renegotiated. Some prime contractors also advise that if the TCO specifies the basis for the TCO's disapproval, only those items specifically disapproved by the TCO need be renegotiated (assuming the settlement was on an item-by-item basis). This practice protects the prime contractor in that it is not liable to the subcontractor for the negotiated settlement amount in the event the TCO disallows all or part of the settlement. At the same time, the subcontractors need not worry that all items will be reopened if the TCO disapproves only a part of the proposed settlement.

The TCO is obligated to review each subcontract settlement to confirm that the subcontract was terminated as a result of the prime contract termination, that the settlement negotiations were conducted in good faith, and that the subcontract settlement is allocable and reasonable in amount. Once the review is completed, the TCO advises the prime contractor in writing that the settlement is approved or ratified *or* that the settlement is not approved. If the TCO fails to approve the settlement, the TCO must advise the prime contractor of the reasons for the disapproval.⁸⁶

Subcontractor Payments

■ Before Settlement

Often more than one year lapses between notice of termination and final settlement of a contract termination for convenience proposal. For many companies, especially small businesses, it is difficult to weather such an extended period without payment. There are, however, two avenues available to contractors and subcontractors to minimize the adverse affect a termination may have on a contractor's cash flow—(1) vouchers and (2) partial payment.

■ Vouchers

The best opportunity to continue the flow of contract payments is afforded cost-reimbursement subcontractors under a cost-reimbursement prime contract. As discussed above, after

a full termination for convenience, both the cost-reimbursement prime contractor and its cost-reimbursement subcontractors may continue to voucher for costs for a period up to six months after the termination.⁸⁷ If your terminated prime contract is on a cost-reimbursement basis, you should take full advantage of the vouchering-out period and strongly encourage your cost-reimbursement subcontractors to do the same.

Unvouchered costs and the fee adjustment are submitted as part of the settlement proposal. As discussed below, partial payments may be made on the settlement proposal, thus providing another avenue for payment.

■ Partial Payment

Fixed-price subcontractors are not eligible for the voucher process. But a fixed-price subcontractor can, and should be advised to, submit a partial payment application at the time it submits its termination settlement proposal. In most cases, this application provides the vehicle for significant payment to the subcontractor pending final settlement of the termination for convenience. In addition, the subcontractor has the option of submitting an interim settlement proposal—a proposal that is submitted in good faith but is not final—along with a request for partial payment. Note, however, that all partial payments to a subcontractor are made through you, as prime contractor, and only after you have submitted your own interim or final settlement proposal. In addition, you must attach your own invoice and recommendation to any partial payment request that you forward to the Government on behalf of a subcontractor.⁸⁸

Partial payments are discretionary with the TCO. If authorized by the TCO, partial payments may be made for (a) up to 100% of the contract price (less undelivered acceptable items), (b) up to 100% of subcontractor settlements approved by the TCO and paid by the prime contractor, (c) up to 90% of the direct costs of the termination inventory, (d) up to 90% of other allowable costs, and (e) up to 100% of partial payments made to subcontractors.⁸⁹

Partial payment is not allowed for profit or fee except for undelivered acceptable finished product.⁹⁰ In addition, deduction should

be made in computing the amount of partial payment for unliquidated progress or advanced payments and the amount of all applicable credits.⁹¹ The aggregate amount of partial payments may not exceed the amount the TCO believes will be due the contractor upon settlement of the termination.⁹²

Note that cost-reimbursement subcontractors are also entitled to submit partial payment requests.

■ Final Payment & Subcontract Closeout

Issuing final payment to a terminated subcontractor and closing out the subcontract are welcomed events. In most instances, final payment is made after the TCO approves the termination settlement with the subcontractor and you issue the final modification to the subcontract agreement reflecting the approved settlement. Final settlement requires the execution of SF 30, Amendment of Solicitation/Modification of Contract, or its equivalent, and may reflect any offsets you may have against your subcontractor. Any issues that are reserved or excepted from the settlement should be specified in the modification to the subcontract incorporating the TCO—approved termination settlement.⁹³

As discussed above, in accordance with TINA, the subcontractor must certify that the cost or pricing data submitted was *accurate, complete, and current* as of the date of agreement on the settlement, if the settlement amount exceeds \$550,000.⁹⁴ To comply with the requirement that the data submitted be *current* as of the date of the agreement, the subcontractor will likely update its cost and pricing data just before the final settlement.

After payment of the final invoice and assuming no outstanding issues, the subcontract can be closed in accordance with your standard company procedure.

With regard to your cost-reimbursement subcontractors, it is possible to agree to the overhead rate to apply to the termination settlement in lieu of waiting for fixed negotiated overhead rates.⁹⁵

Disputes

■ Avoiding Litigation

There are many opportunities after a termination for convenience for a dispute to arise between you and your subcontractors. Disagreements may occur over a myriad of issues including title to property used in performance of the contract, whether certain costs are properly chargeable to the termination, or the reasonableness of costs incurred.

One of the best methods of avoiding litigation with your subcontractors is to have competent, well-trained subcontract administrators responsible for negotiating and settling subcontractor settlement proposals. Subcontract administrators should be knowledgeable of the requirements of FAR Part 49 for contract terminations and have a general understanding of the type of work that the subcontractor was performing before the termination (or at a minimum ready access to someone who does). The subcontract administrator should have the authority to refer a proposal to the technical team member for review and to the cost team member for audit. The subcontract administrator should also have authority to negotiate with the subcontractor and to reach a settlement pending, of course, appropriate management review and TCO approval or ratification.

It is also important for the subcontract administrators to have access to legal and accounting experts, either in-house or outside consultants. Legal and accounting experts assist the subcontract administrators in the review of the subcontractor settlement proposals, and advise as to the allowability, allocability, or reasonableness of the costs claimed by subcontractors. The reasonable costs of legal and accounting services in conjunction with termination settlement are allowable termination costs.

Finally, it is imperative to designate a manager to be responsible for ensuring that subcontract issues are dealt with consistently among the subcontract administrators and, wherever possible, with the prime contract itself.

■ Dispute Process

The subcontractor's right to appeal or challenge a unilateral determination by a prime contractor of the amount due will be governed by the terms of the subcontract agreement. The subcontractor has no right or remedy against the Government. Because the dispute between a prime contract and a subcontractor is a private matter, the subcontract agreement may allow the subcontractor to bring a lawsuit in state court or file an arbitration claim.

Alternatively, where the basis for the dispute is the Government's refusal to recognize the cost as part of the subcontractor's termination settlement, the prime contractor may agree to "sponsor" the subcontractor's claim. Under the sponsorship approach—also referred to as an indirect appeal—the prime contractor agrees to file an appeal from the final decision of the contracting officer in its own name but on behalf of the subcontractor. The subcontractor then prosecutes the appeal (albeit in the name of the prime contractor) and appears before the agency board of contract appeals or the Court of Federal Claims as the real party-in-interest.

■ Subcontractor Judgments

On occasion, a terminated subcontractor may successfully pursue litigation or arbitration against the prime contractor. The amount of the judgment or arbitration award is treated as a cost of

the prime contractor's termination settlement if the following five conditions are met.⁹⁶ *First*, as the prime contractor, you must have made "reasonable efforts" to include in the subcontract agreement a FAR-type termination clause or other provision excluding the recovery of anticipatory profits or consequential damages. Note that the requirement is not that you successfully negotiated for the inclusion of such a provision but only that you made reasonable efforts to do so. *Second*, the termination provisions of the subcontract must be "fair and reasonable" and cannot "unreasonably increase the common law rights of the subcontractor." *Third*, you must have made reasonable efforts to settle with the subcontractor. *Fourth*, you must have given prompt notice to the TCO of the subcontractor's lawsuit or demand for arbitration. You also must not have refused to give the Government control of the defense of the proceedings. *Finally*, you must have diligently defended the suit or, if the Government assumed control of the defense of the proceedings, rendered reasonable assistance as requested by the Government.

If any one of these five conditions is *not* met, the TCO is not required to recognize as allowable the full amount of the court judgment or arbitration award against you as a result of the subcontract termination. Rather, the TCO has the discretion to allow that part of the court judgment or arbitration award he or she considers fair for settling the subcontract settlement proposal.⁹⁷

GUIDELINES

These *Guidelines* are designed to assist you in administering your subcontracts after your contract has been terminated for convenience by the Government. They are not, however, a substitute for professional representation in any particular situation.

1. Notify your subcontractors *immediately* after receipt of a notice that your prime contract has been terminated for the convenience of the Government. Oral notification of the termination of the prime contract should be followed promptly by a *written notice to each subcontractor*. In general, your notification should follow the Government's

notice of termination, which is based on FAR 49.102, and include a direction to subcontractors to *stop work*.

2. Where your prime contract is subject to a *partial* rather than full termination, make sure you fully understand the *extent* of the Government's partial termination before terminating a subcontract for convenience. While the scope of a partial convenience termination can be expanded unilaterally to eliminate additional work (i.e., a second partial termination for convenience), terminated work can be *reinstated* only by *mutual agreement*.

3. After determining the extent to which subcontract work is subject to the termination for convenience, you should issue a *letter of instructions* to each of your subcontractors. One letter of instructions should be prepared and transmitted to terminated *fixed-price subcontractors*. A *separate* letter of instructions should be prepared and transmitted to terminated *cost-reimbursement contractors* (and appropriately tailored for time-and-material subcontractors).

4. Before *completing* any work-in-progress after receipt of a notice of termination, you should at a minimum *notify* the TCO of your intent to complete the work and, whenever possible, obtain the TCO's *prior approval* or *consent*. This applies to completion of work by you as prime contractor as well as by any of your subcontractors whose work is subject to the termination notice.

5. Assemble your *termination team* and meet with the TCO as soon as possible after the notice of termination, preferably in person and with as many of the subcontractors represented as possible. The conference agenda should include a review of the status of the work at the time of termination as well as any continuing work, the protection, disposition and possible transfer of termination inventory to the Government, the termination settlement proposal forms, an accounting review and audit of termination settlement proposals, partial payments, and a tentative time schedule for negotiation of the termination settlement proposal.

6. Designate a *company representative* to be the *point of contact* for the TCO. A company representative should also be appointed as the contact point for the DCAA and for each of your *subcontractors*. Emphasize to these appointed company representatives the need to cooperate, coordinate, and keep the lines of communication open.

7. Clarify with your subcontractors their obligations with regard to *termination inventory* and advise them that their termination settlement recovery will be *adjusted downward* if inventory is lost, damaged, destroyed, or improperly diverted to other contracts.

8. Consider submitting a *written request* to the TCO for authority to conclude subcontractor settlements *without* TCO approval or ratification when the amount of the settlement is *\$100,000 or less*.

9. If you are a *cost-reimbursement* prime contractor, you and your cost-reimbursement subcontractors should take full advantage of the ability to *continue using vouchers* until the last day of the sixth month following the month in which the termination is effective.

10. If the terminated contract authorized *partial payments* on settlement proposals before final settlement, you should consider submitting a request for partial payment with the submission of any interim or final termination settlement proposal. More than one partial payment request may be submitted pending final settlement of the termination proposal, but the total amount of all partial payments cannot exceed the amount that the TCO believes you are due as a result of the termination. You should advise your *subcontractors* that the opportunity to submit a partial payment request along with an interim or final settlement proposal is available to them as well. Any partial payment to a subcontractor will be made through you as prime contractor.

11. With the TCO's *consent*, you may wish to use, and have your subcontractors use, the electronic version of the *FAR termination forms* that can be found at <http://www.acqnet.gov/far>.

12. Advise the TCO whenever an *impasse* is reached in negotiations with subcontractor. Discuss with the TCO various solutions, including issuing a unilateral determination of the amount due the subcontractor, Government assistance in reaching a settlement, submission of the disputed issue to the TCO for determination, or excepting the subcontractor's settlement proposal from the prime contractor's termination settlement. Notify the TCO of any *judgments* in favor of subcontractors or of any *legal proceedings* instituted by or against a subcontractor.

13. When negotiating with the subcontractor the amount due under its termination settlement proposal, keep in mind that your objective is to

negotiate a fair and prompt settlement. Strict application of accounting principles is not required, but the proposed settlement amount must be appropriate under *FAR Part 49* and supported by *adequate documentation and analysis*. No TCO will approve or ratify a proposed subcontract termination settlement that is not adequately justified or has

the appearance of a *sweetheart* deal. More importantly, an improper or inadequately justified proposed subcontractor settlement will reflect poorly on you and your ability to execute your post-termination subcontract obligations, which is a consideration in determining the *fee* or *profit* award under your termination settlement proposal.

★ REFERENCES ★

- 1/ See Merle, "Comanche Cancellation May Reshape Industry," Wash. Post, Feb. 25, 2004, at E4; see also Merle, "Army Scraps \$39 Billion Helicopter," Wash. Post, Feb. 24, 2004, at A1; Statement of M.E. Rhett Flater, Executive Director, American Helicopter Society International, Before the Subcomm. on Tactical Air and Land Forces of the House Armed Services Comm. (Mar. 4, 2004) ("Let there be no question. The Army's termination of the Comanche will directly impact a large portion of the rotorcraft industrial base, more than 300 subcontractors, in addition to Sikorsky Aircraft and Boeing and engine manufacturers Rolls-Royce and Honeywell.").
- 2/ See Pincus, "Rumsfeld Defends Decision To Recommend Killing Crusader," Wash. Post, May 17, 2002, at A11; see also Cruz & Diaz, "Crusader Counter Attack; United Defense Industries Launched an All-Out Offensive To Save Its Endangered Artillery System," Star Trib. (Minn.), June 7, 2002, at D1 ("If the program is cut, more than 800 people could lose their jobs in Fridley as well as an additional 1,400 employees at Crusader subcontractors nationwide. About 32 other companies in Minnesota are subcontractors for the Crusader program, almost all of them in the Twin Cities suburbs.").
- 3/ See "MDC Raises A-12 Loss Estimate to \$1 Billion," 159 Aerospace Daily 301 (Aug. 23, 1991) ("McDonnell Douglas raised its estimate of potential losses on the A-12 attack plane program to \$1 billion because it's costing the company more than expected to terminate the hundreds of different subcontractors on the program, the company reported."); "GD, McDonnell Douglas Stop Payments to A-12 Subcontractors," Associated Press (Ft. Worth, Tex.), Jan. 11, 1991 ("Subcontractors of the program were located in 42 states and some of the companies have begun layoffs, The Dallas Morning News reported in today's editions.... About 10,000 employees worked on the A-12 program at subcontractor and supplier companies, McDonnell Douglas said.").
- 4/ See generally Seidman & Banfield, "Preparing Termination for Convenience Settlement Proposals for Fixed-Price Contracts," Briefing Papers No. 97-11 (Oct. 1997); Seidman & Banfield, "Maximizing Termination for Convenience Settlements," Briefing Papers No. 95-5 (Apr. 1995).
- 5/ See generally Perry & Victorino, "Practical Tips & Considerations for Subcontract Negotiations: A Subcontractor's Perspective," Briefing Papers No. 03-9 (Aug. 2003); Feldman, "Subcontractors in Federal Procurement: Roles, Rights & Responsibilities," Briefing Papers No. 03-3 (Feb. 2003); Healy, "Subcontractor Claims: Strategies for the Prime," Briefing Papers No. 95-7 (June 1995).
- 6/ FAR 49.102.
- 7/ FAR 49.104.
- 8/ FAR 49.208.
- 9/ FAR 49.208(b).

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| <p>10/ 29 U.S.C. § 2101 et seq.; 20 C.F.R. pt. 639.</p> | <p>24/ FAR 49.202(a), 49.305-1(a).</p> |
| <p>11/ DFARS 249.7003(b)(2).</p> | <p>25/ See FAR 31.205-42(g) (emphasis added).</p> |
| <p>12/ DFARS 252.249-7002, para. (c).</p> | <p>26/ See DCAA Contract Audit Manual ¶¶ 12-402, 12-404, 10-900 (Jan. 2004) (addressing completion vouchers, final vouchers, and the contract closeout process).</p> |
| <p>13/ DFARS 252.249-7002, para. (d).</p> | <p>27/ FAR 49.105(c).</p> |
| <p>14/ FAR 2.101.</p> | <p>28/ FAR 49.105(c).</p> |
| <p>15/ FAR 2.101.</p> | <p>29/ The FAR and agency supplements (e.g., DOD FAR Supplement) are available at http://farsite.hill.af.mil/ and at http://www.acqnet.gov/far/. Electronic versions of the applicable termination forms are available from the GSA's Forms Library at http://www.acqnet.gov/far/.</p> |
| <p>16/ FAR 2.101.</p> | <p>30/ FAR 49.206-3, 49.303-2.</p> |
| <p>17/ FAR 49.104(i).</p> | <p>31/ FAR 45.606-5 (prior to amendment by 69 Fed. Reg. 17,741 (Apr. 5, 2004) (effective May 5, 2004)).</p> |
| <p>18/ See FAR 31.205-42 (a) ("Common Items").</p> | <p>32/ For form illustrations, see FAR 53.301-1426 to -1434 (prior to amendment by 69 Fed. Reg. 17,741 (Apr. 5, 2004) (effective May 5, 2004)).</p> |
| <p>19/ FAR 52.245-5, para. (i); see FAR 45.502(d); see also FAR 45.510, 49.108-3(b).</p> | <p>33/ 69 Fed. Reg. 17,741 (Apr. 5, 2004) (amending FAR pts. 45, 49, 52, 53).</p> |
| <p>20/ See FAR 49.105-2.</p> | <p>34/ FAR 31.205-42(g)(1)(ii).</p> |
| <p>21/ FAR 31.205-42(b) ("Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable.").</p> | <p>35/ FAR 52.249-2, para. (d).</p> |
| <p>22/ See FAR 31.205-42(b).</p> | <p>36/ FAR 49.001.</p> |
| <p>23/ FAR 49.302.</p> | |

37/ FAR 45.603 (prior to amendment by 69 Fed. Reg. 17,741 (Apr. 5, 2004) (effective May 5, 2004) (amending FAR pts. 45, 49, 52, 53)).

53/ Lockheed Martin Corp., Naval Elecs. & Surveillance Sys.—Surface Sys., ASBCA No. 53032 et. al., 2004 WL 483235 (Mar. 10, 2004).

38/ FAR 31.205-42(a).

54/ Compare FAR 49.202(a) (fixed-price contracts) with FAR 49.305(a) (cost-reimbursement contracts).

39/ FAR 31.205-42(g)(1)(ii).

55/ FAR 49.305-1(a).

40/ FAR 49.206-2, 49.206-1(d).

56/ FAR 31.205-42.

41/ FAR 49.206-2(b).

57/ FAR 49.107.

42/ FAR 49.206-2(b).

58/ See DCAA Contract Audit Manual ¶¶ 12-101 to 12-408.

43/ FAR 49.602-1(a), 49.602-3.

59/ DCAA Contract Audit Manual ¶¶ 12-402, 6-711.2, 6-711.3.

44/ FAR 49.602-1(b).

60/ DCAA Contract Audit Manual ¶ 12-301.1.

45/ FAR 49.602-1(d).

61/ DCAA Contract Audit Manual ¶ 12-301.2.

46/ FAR 49.602-1(c).

62/ FAR 49.107(c)(1).

47/ E.g., SF 1435.

63/ See DCAA Contract Audit Manual ¶ 12-202.

48/ E.g., SF 1435.

49/ FAR 49.203.

64/ FAR 49.107(c)(2).

50/ See FAR subpt. 49.3.

51/ FAR 49.202(a), 49.305-1(a).

65/ FAR 49.107(b).

52/ FAR 49.202(b).

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| <p>66/ FAR 49.107(b).</p> <p>67/ FAR 49.201(a).</p> <p>68/ See FAR 49.201(b).</p> <p>69/ See FAR 49.201(c).</p> <p>70/ See FAR 49.108-2(b).</p> <p>71/ FAR 52.249-2, para. (i), 52.249-6, para. (i).</p> <p>72/ FAR 31.103(b), 49.113; see FAR 49.201.</p> <p>73/ FAR 49.303-5(d).</p> <p>74/ FAR 49.202(a).</p> <p>75/ FAR 52.249-2.</p> <p>76/ FAR 52.249-6.</p> <p>77/ FAR 48.108-7.</p> <p>78/ FAR 48.108-7.</p> <p>79/ FAR 48.108-6.</p> <p>80/ FAR 49.108-4.</p> <p>81/ SF 1435; SF 1436; SF 1437.</p> | <p>82/ SF 1435; SF 1436; SF 1437.</p> <p>83/ 10 U.S.C. § 2306a; 41 U.S.C. § 254b; FAR 15.403-4, 15.406-2.</p> <p>84/ FAR 49.107(b).</p> <p>85/ FAR 49.108-4(c); DCAA Contract Audit Manual ¶ 12-310c.</p> <p>86/ FAR 49.108-3(c).</p> <p>87/ See FAR 302.</p> <p>88/ FAR 49.112-1(a).</p> <p>89/ FAR 49.112-1(b).</p> <p>90/ FAR 49.112-1(a).</p> <p>91/ FAR 49.112-1(e).</p> <p>92/ FAR 49.112-1(f).</p> <p>93/ FAR 109-2.</p> <p>94/ 10 U.S.C. § 2306a; 41 U.S.C. § 254b; FAR 15.403-4, 15.406-2.</p> <p>95/ FAR 49.303-3, 42.708 (quick-closeout procedure).</p> <p>96/ FAR 49.108-5(a), (c).</p> <p>97/ FAR 49.108-5(b), (c).</p> |
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Appendix A—Key Dates in Termination Process

Topic	FAR Reference	Post Termination
Funding Requirements	FAR 49.105-2	30 Days
Inventory Schedules	FAR 49.206-3, 49.303-2	120 Days
Vouchering Period	FAR 49.302	First Month End After Six Months
Submission of Final Termination Settlement Proposal by Prime Contractor to Government	Author Recommended	Six Months
Submission of Final Termination Settlement Proposal by Prime Contractor to Government	FAR 49.206-1, 49.303-1	One Year
Partial Payments (SF 1440)	FAR 49.112-1	After Submission Of Interim or Final Termination Settlement Proposal
Final Settlement	N/A	Expect > One Year After Submission of Termination Settlement Proposal

Appendix B—Contract Termination Forms & Formats (FAR Subpart 49.6)

Form	Form Number	Cost Type	Fixed Price		
			Short Form	Inventory Basis	Total Cost Basis
Amendment of Solicitation/ Contract Modification	SF 30	X	X	X	X
INVENTORY SCHEDULES FOR CONTRACTS AWARDED BEFORE MAY 5, 2004*					
Inventory Schedule A for Metals in Mill Product Form	SF 1426/27	X		X	X
Inventory Schedule B	SF 1428/29	X		X	X
Inventory Schedule C for Work-In-Progress	SF 1430/31	X		X	X
Inventory Schedule D for Dies, Jigs, Fixtures, and Special Tools	SF 1432/33	X		X	X
Inventory Schedule E for Use With Short Form Settlements	SF 1434		X		
SETTLEMENT PROPOSAL FORMS					
Inventory Basis Settlement Proposal	SF 1435			X	
Total Cost Basis Settlement Proposal	SF 1436				X
Cost-Reimbursement Settlement Proposal	SF 1437	X			
Short Form Settlement Proposal	SF 1438		X		
Schedule of Accounting Information	SF 1439	X		X	X
Partial Payment Request	SF 1440	X	X	X	X

* Effective May 5, 2004, the only form required is the new SF 1428, Inventory Disposal Schedule, and SF 1429, Continuation Sheet. Note that a separate inventory schedule is now required for each of the five different property classifications. 69 Fed. Reg. 17,741 (Apr. 5, 2004) (amending FAR pts. 45, 49, 52, 53).

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