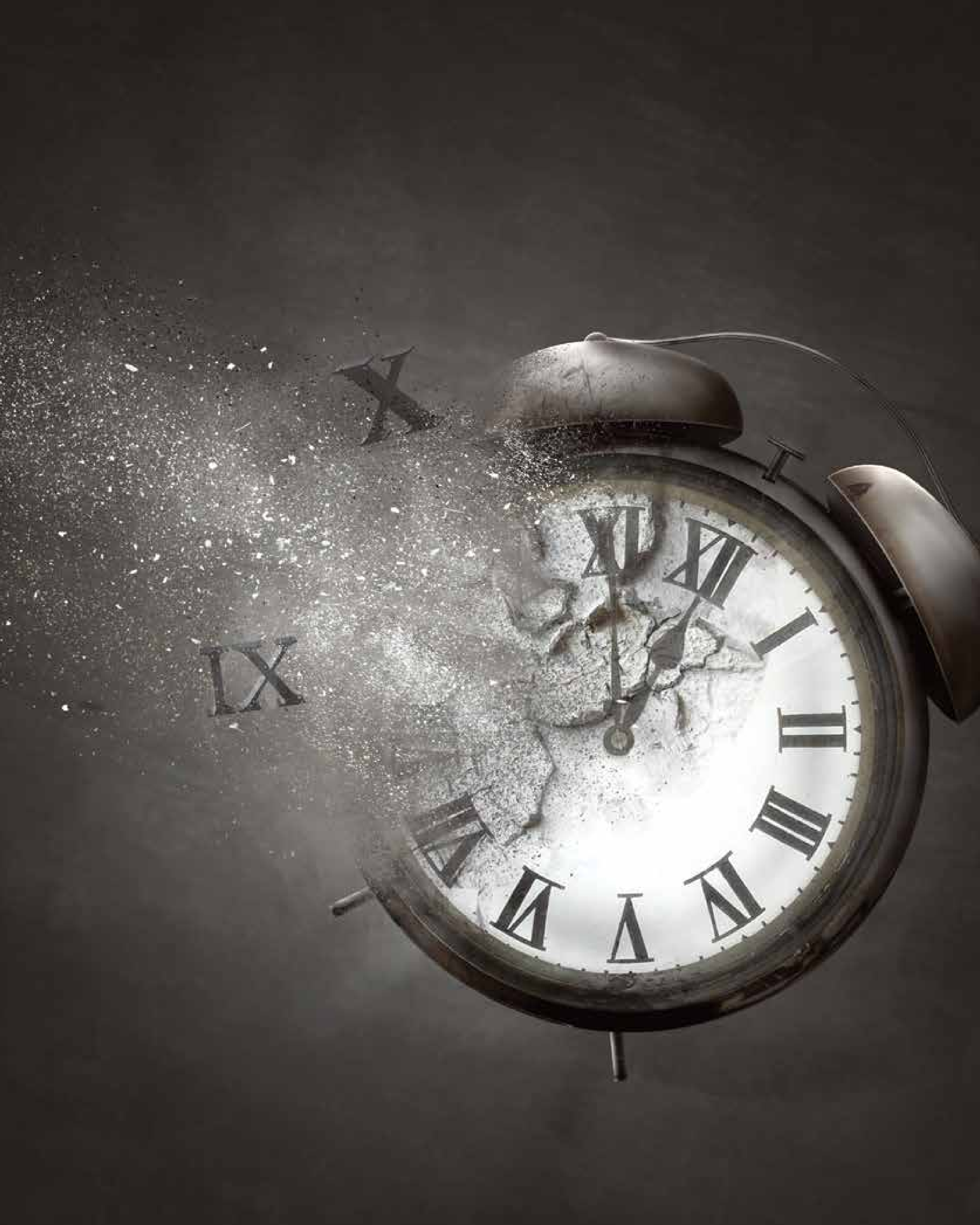

IT'S

Never Too Early

TO START THINKING ABOUT CONTRACT CLOSEOUT— AN ARGUMENT FOR DILIGENT

"Contract Hygiene"

By Jason N. Workmaster

In the life of a government contract, it is often the proposal/award phase that gets the most attention.

That phase is an exciting time, of course, as the offerors wait to learn whether they have won or lost the contract. Then, with the announcement of the award decision comes the question of whether any of the disappointed bidders will challenge the award by filing protests at either the Government Accountability Office or the U.S. Court of Federal Claims and, in so doing, further prolong the suspense.

Given this, it is perhaps not terribly surprising that, once the dust settles on the award and protest process, and the contractor and the government turn their attention to contract performance, it can seem a bit anti-climactic. And, regardless of whether performance begins immediately following award or after a knock-down-drag-out round of protests, how the contract will eventually be closed out is often the last thing on anyone's mind as performance kicks off. Indeed, from the vantage point of the early days of contract performance, closeout can seem an eternity away—like something that will take care of itself when the time comes.

As discussed in this article, prudent contractors will have started laying the groundwork for a successful closeout even *before* they learn that they have won the contract, whether the contract is fixed-price or cost-reimbursable. In so doing, contractors will maximize their recovery of cost overruns on their fixed-price contracts, minimize cost disallowances on their cost-reimbursable contracts, and reduce the risk of extended and contentious closeout processes.

Fixed-Price Contracts

It is axiomatic that, under a fixed-price contract, the contractor typically bears the risk of cost overruns that exceed the contract's fixed-price. As a consequence, often the best way for a contractor to minimize the risk that it will sustain a loss under a fixed-price contract is to develop and implement robust estimating and pricing processes and procedures that will help the contractor avoid overruns in the first place. These processes and procedures should be aimed at ensuring that the contractor's proposed prices for fixed-price contracts are based upon a complete understanding of the required work and the costs that the contractor will incur to perform it.

However, it is almost inevitable that even the most sophisticated contractors, with the most state-of-the-art estimating and pricing systems, will experience cost overruns. The key to ensuring that such overruns will not adversely affect and delay contract closeout is to identify them (and the causes for them) in real-time to the greatest extent possible. This means that contract administrators, as well as the responsible program and project managers, should be carefully monitoring at least two things:

- Any government-directed changes to the agreed-upon scope of work (often referred to as "scope creep"); and
- Any material deviations between the contractor's incurred cost to perform and the cost estimate upon which it based its proposed price.

However, while both of these things should be monitored, the actions to be taken in response to identified scope creep versus an identified deviation from the cost estimate may vary. If a change to the scope of work is identified, it is then typically best practice to establish a charge code to specifically track the costs resulting from the change. This will enable the contractor to determine if the change has a material cost impact that is worth attempting to recover through the request for equitable adjustment and/or claims process. It will also help the contractor avoid the need to estimate the cost associated with the change at some point in the future, and the associated risk that the government will reject such an estimate. The contractor will also want to assess the strength of its position that the identified scope creep actually constitutes a change to the contract, which could involve complicated questions of contract interpretation that require the contractor to review its bid and proposal files. It is thus critical that the contractor develop complete, well-organized files during the bid and proposal process, and that it retains those files throughout performance.

In contrast, if a material deviation from the cost estimate is identified and the reasons for it are not apparent, the next step is likely to be an investigation to determine the cause of the overrun. In this regard, the contractor will want to ascertain whether the overrun results from an unexpected event, a mistake it made in its cost estimate, a government-directed change, etc. Once the cause of the overrun is determined, the contractor can then assess whether or not there are any legal doctrines that would entitle it to pursue recovery of the overrun. This could also involve review of the company's bid and proposal files so, again, retaining those records is of key importance.

Regardless of how a contractor first becomes aware of a potential change or overrun, it will almost always be advisable to engage the government on the issue as soon as possible. Even if the government disagrees with the contractor's position, early discussion with the government increases the likelihood that the dispute will be resolved in time for the contract to be closed out in due course at the end of performance. In contrast, issues that are allowed to fester can result in contracts being kept open long after performance on them has been completed. This increases the chance that key witnesses—on both the government and contractor sides—will move on to new responsibilities, or entirely new jobs, which can significantly impair the parties' ability to bring the issues to a successful resolution.

Cost-Reimbursable Contracts

Under cost-reimbursable contracts (unlike fixed-price contracts), the contractor does not, in general, bear the risk of cost overruns. Rather, subject to certain potential limitations that are beyond the scope of this article, the government bears that risk and is responsible for paying the contractor all of its allowable and allocable costs.[1] At the same time, however, the government possesses broad audit rights, including the right to audit the contractor's incurred costs on a fiscal year basis.[2] In such an incurred cost audit, government auditors can question both direct and indirect costs and recommend that the contracting officer disallow them. If the auditors do so, it can have a significant impact on the parties' ability to timely close out the contract at the end of performance. So, to ensure a speedy closeout process for contractors' cost-reimbursable contracts, it is vital that they have in place processes and procedures designed to minimize questioned/disallowed costs to the greatest extent possible. In this author's experience, this has become increasingly true with respect to costs questioned/disallowed on the basis of "reasonableness."

To be allowable, a given cost must satisfy certain criteria.[3] One such criterion is "reasonableness"—a concept that is not well-defined in either the *Federal Acquisition Regulation* (*FAR*) or the case law. And, over the last decade or so, the government audit community has demonstrated an increased willingness to question costs for failing to satisfy this criterion. For example, in several cases with which this author is familiar, government auditors have challenged the reasonableness of a price to which a government prime contractor has agreed with one of its subcontractors. In each of those cases, the prime contractor had a government-approved purchasing system and was not required to seek and obtain government permission to agree to the price in question, and so did not do so. The auditors then, years later, reviewed the prime contractor's decision to agree to the price at issue and alleged that the agreed-upon price was "unreasonable" and so should not be considered an allowable cost chargeable to the government. In response, the contractor was then forced to try to justify pricing decisions it had made long before, under an unclear legal standard that imposed the burden of proof on the contractor.[4]

It is beyond the purview of this article to address how a contractor can, after-the-fact, demonstrate the reasonableness of a given cost. For current purposes, however, it is sufficient to note that doing so is laborious and fact-intensive, and that tribunals routinely rule in the government's favor on this issue. Rather, the principal takeaway here is that even contractors that have approved purchasing systems should seriously consider seeking government approval for any significant procurement actions. And, if the government refuses to either approve or disapprove of the cost in question, the contractor should consider at least notifying the government—in real time—of all the material facts supporting its pricing decision. This should help mitigate the risk that government auditors will later allege that the contractor acted unreasonably, and so the cost should be disallowed. In turn, this should help the parties avoid cost disallowance issues that could delay contract closeout at the end of performance.

Conclusion

There are many issues that can affect the closeout of a contract, but the two specifically addressed here—cost overruns on fixed-priced contracts and cost disallowances under cost-reimbursable contracts—are ones that routinely result in a drawn-out process that is frustrating to both parties. However, this risk can be significantly mitigated through good "contract hygiene" throughout the procurement life cycle—especially diligent recordkeeping, careful monitoring, and active engagement. CM

ENDNOTES

1. *See Federal Acquisition Regulation* (*FAR*) 52.216-7 (the standard payments clause for cost-reimbursement contracts).
2. *See* FAR 52.216-7(d).
3. *See* FAR 31.201-2(a).
4. *See*, *generally*, FAR 31.201-3(a).

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