COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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The Honorable John C. Stennis
Chairman, Committee on Armed Services
United States Senate

Dear Mr. Chairman:

As requested in your October 4, 1973, letter (see enc. I), we examined the use of the special termination costs clause in the Armed Services Procurement Regulation (ASPR), sections 8-712 and 7-108.3. (See enc. II.)

We obtained background from the Department of Defense's (DOD's) ASPR Committee and its special subcommittee which was recently established to review the clause. Procurement officials of the Army, Navy, and Air Force gave us data on use of the clause and reasons why it has not been used more extensively. We also obtained industry associations' views on the use and adequacy of the clause as now stated and recommendations for changes they feel are needed to make the clause more acceptable.

The clause has been used in contracts only to a limited extent by the services, primarily the Air Force. None of these contracts have been terminated, so we could not evaluate the clause's effectiveness.

The major obstacles to increased use of the clause appear to be the small number of contracts which meet the required dollar criteria as stated in ASPR and the possibility of violating the Antideficiency Act if funds are not available to pay termination costs.

## BACKGROUND

In early 1968 the Aerospace Industries Association recommended to DOD's ASPR Committee that a termination costs clause be established in ASPR. This clause would allow contractors to effectively use all money obligated to a program rather than having to limit their costs to maintain a reserve to cover potential termination costs. The Association suggested that the DOD establish a termination funding reserve account to pay termination costs. The amount of the account would be based on prior DOD experience and would total much less than the cumulative potential termination costs being reserved under individual contracts.

The ASPR Committee studied the recommendation and prepared a proposed special termination costs clause. The clause did not include the termination funding reserve account suggested by the association, but did include a maximum termination cost liability.

Industry associations felt that a maximum termination costs liability should not be included in the clause because the contractor's risks would

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be increased since the Government's liability would be limited to the negotiated amount. They also felt that the optional use of the clause should be extended to lower dollar value contracts--$5 million for research, development, test, and evaluation (RDT&E) contracts and $10 million for production contracts rather than the $25 million and $100 million levels proposed. Neither suggestion was included in the clause put into ASPR in early 1970. (See enc. II.)

In June 1973 the minimum limits for optional use of the clause were raised from $25 million to $50 million for RDT&E contracts and from $100 million to $200 million for production contracts. These new minimums were established to meet the funding level criteria which defines a major weapon system.

## DOD USE OF THE CLAUSE

As noted previously, the special termination costs clause has been used only in a limited number of contracts, none of which have been terminated.

The Air Force is using the clause on the Advanced Airborne Command Post, B-1, and AWACS contracts. It plans to use it on several other contracts, including the A-10, if the program is approved, and the STOL program. The Army is using the clause on the XM-1 tank program and plans to use it on SAM-D contracts. Other uses will be considered on a case-by-case basis. The Navy has not used the clause but plans to use it on the Trident program.

Officials of the services said the clause has not been used more often because:

--The clause is not authorized for use on the numerous RDT&E contracts under $50 million and production contracts under $200 million.

--Use of the clause was not justified on some RDT&E contracts because of low potential termination costs.

--The Antideficiency Act would be violated if funds were not available to pay termination costs (use of the clause does not automatically provide funds to pay termination costs).

The increased use, or planned use, of the clause appears to be the result of the Senate Armed Services Committee Report on the DOD Fiscal Year 1974 Procurement Authorization Bill (S. Rept. 93-385, Sept. 6, 1973) in which the committee suggested that the services use the clause more. Shortly after this report was issued, the Deputy Assistant Secretary of Defense (Procurement) requested that the ASPR Committee review ASPR 8-712 to see if any changes in the criteria for using this clause are warranted.

## PROPOSED CHANGES TO THE CLAUSE

In late 1973 an ASPR Subcommittee began reviewing the special termination costs clause to determine if changes were needed. We were informed that the Subcommittee plans to recommend that (1) the minimum contractual amount be reduced to the previous levels of $25 million for RDT&E contracts and $100 million for production contracts and (2) the clause not be used on contracts with minimal potential termination costs. The ASPR Committee will request comments on proposed changes from industry associations before formally revising the clause--tentatively scheduled for the end of 1974.

The major recommendation by the industry associations in their response to our inquiry (see enc. III) was to allow termination costs to exceed the maximum allowed by the clause if unused program funds are available to pay the additional costs.

## CONCLUSIONS

The availability of funds to cover potential terminations appears to be a major obstacle to the increased use of the special termination costs clause. The problem arises from the possibility of violating the Antideficiency Act, which prohibits the incurrence of contractual obligations in excess of authorized amounts.

When a contract using the clause is terminated, funding of termination costs can come from three sources: (1) residual program funds, (2) funds transferred from other programs (reprograming), and (3) funds received through a supplemental appropriation.

The first two sources are the most expedient means of paying termination costs when these funds are available. However, if a contract is terminated at or near the end of a fiscal year, unobligated funds from these sources may be limited. Requesting a supplemental appropriation would be a last resort.

As stated in the Senate Armed Services Report on the DOD Fiscal Year 1974 Procurement Authorization Bill, the risks of not having unobligated balances available in the appropriations to meet potential termination costs are minimal. From a purely legal viewpoint, however, use of the clause does not relieve procurement officials from the possibility of violating the Antideficiency Act because the availability of unobligated funds is not insured.

Alternative solutions to overcome this obstacle include (1) authorizing the incurrence of termination costs under this clause to insure that additional funds will be made available if unobligated appropriation balances are not sufficient to cover these costs (this approval could be included in the annual DOD appropriation authorization) or (2) legislation could be enacted to exempt costs incurred under the clause from the Antideficiency Act.

We have no objections to the ASPR Subcommittee's proposal to allow use of the clause on lower dollar value contracts ($25 million RDT&E and $100 million production) and to prohibit its use on contracts with minimal potential termination costs, such as research contracts consisting primarily of personal services.

The industry associations suggested that the clause be modified to permit the contractor's claim for termination costs, when added to all other costs incurred, not to exceed the sum of the funds allotted to the contract for performance plus the amount allowed by the clause.

We do not agree with this suggestion. We believe termination costs should not be permitted to exceed the maximum allowed by the clause even if unused program funds are available. Such a change could encourage the contractor to reserve funds by limiting costs incurred under the contract rather than to negotiate a higher termination costs ceiling. This would defeat the purpose of the clause.

We did not obtain formal comments from the Secretary of Defense on this report; however, the information contained herein was discussed with DOD officials during the review.

This report completes the work you requested. The reports dealing with (1) contractors' independent research and development, (2) incremental programing of RDT&E, and (3) development of major weapon systems under cost-type contracts were previously sent to you.

We plan no further distribution of this letter unless you agree or publicly announce its contents.

Sincerely yours,

Acting Comptroller General
of the United States

Enclosures - 3

ENCLOSURE I



United States Senate
COMMITTEE ON ARMED SERVICES
WASHINGTON, D.C. 20510

B-167034

October 4, 1973

Honorable Elmer B. Staats
Comptroller General of the United States
General Accounting Office
441 G Street, N. W.
Washington, DC 20548

Dear Mr. Staats:

The committee has completed and published its report (93-385) on the fiscal year 1974 procurement authorization bill.

There are a number of items in the report which involve actions to be taken by the General Accounting Office. Information on each of these items follows:

1. Independent Research and Development

Page 104 of the subject report states,

"While there is general satisfaction to date in the Department of Defense and in industry, additional time is needed to complete the implementing actions and acquire more experience as a basis for any changes which may be indicated as necessary to existing law. The General Accounting Office is in agreement with the need for additional time, and has expressed its intention to continue with the examination of this subject.

"The committee intends to follow these actions closely and consider the requirement for any possible further legislative actions in conjunction with the review of the fiscal year 1975 authorization request."

Request that the General Accounting Office conduct this further investigation including follow-up on the recommendations contained in your report B-167034, dated April 16, 1973. The opinions and recommendations of both the Department of Defense and appropriate industry associations should be obtained and reflected in your report. Discussions should be held with other governmental agencies such as the Department of Transportation, Atomic Energy Commission,

and the National Aeronautics and Space Administration, all of whom have substantial research and development programs to determine the desirability and practicability of extending the independent research and development policy to include their organizations on a uniform basis with the Department of Defense. The investigation of this subject also should include consideration of the possibility of broadening the definition and application of relevancy to include all Federal agencies while at the same time extending the IR&D provisions as represented in the applicable Military Procurement Authorization Acts to these various agencies. The results of these discussions together with appropriate recommendations also should be included in your report.

2. Incremental Programing of RDT&E

Pages 112-115 of the subject report cover this subject and set forth a consolidated and current policy statement, including definitions which resulted from the coordinated efforts of the committee staff, the Department of Defense, and the General Accounting Office. In fact, as the report states, the revised incremental programing policy was worked out to the mutual satisfaction of the committee and the Department of Defense. In accordance with the committee report, you are requested to continue with your review of the implementation of this policy as a follow-on to your earlier efforts as reported in General Accounting Office reports B-167034 of April 18, 1973, and May 15, 1973. Your study should include a reexamination of the Trident weapon system and such other major weapon systems which would represent an equitable sampling of the programs of each of the military departments. The extent to which first-tier subcontractors are being addressed should be made a matter of specific treatment since this is a new significant item covered under the revised policy. Comments should be submitted on the results of your findings together with any recommendations which you may deem appropriate.

3. Major Weapon Systems Developed Under Competitive Cost Reimbursement Type Contracts

This subject is covered on pages 115 and 116 of the committee report which includes an expression of the concern of the committee that there may be a need for the Department of Defense to examine the criteria, policy, and procedures contained in the Armed Services Procurement Regulations and other directives to insure that the source selection process is being uniformly applied and that the interests of all parties involved including the government are equitably considered and fully protected. The report requests that the Department of Defense conduct such an examination and advise the

committee what if any changes should be made as a result of the committee's views. As indicated in the report, the General Accounting Office is requested to participate in this review and submit its independent findings and recommendations to the committee.

4. Use of Special Termination Costs Clause on Certain Research and Development Contracts

On pages 118 and 119 of the committee report the committee explains the use of the special termination costs clause on research and development contracts and encourages the use of this clause to a greater extent by all of the military departments. The General Accounting Office is requested to examine the use of this clause to the extent that it has been included in recent contracts and obtain the opinions of the various industry associations and the Department of Defense on the wider application of this clause in future Department of Defense contracts. Comments with appropriate recommendations will be submitted to the committee.

Informal meetings have been held between the committee staff and the representatives of your agency to discuss each of the items contained in this letter. In order for your reports to be useful to the committee in its consideration of the fiscal year 1975 military procurement authorization request, such reports should be submitted by March 1, 1974.

Sincerely,

John C. Stennis
Chairman

## CONTRACT CLAUSES

7-108.3 *Special Termination Costs.* In accordance with 8-712, insert the following clause.

**SPECIAL TERMINATION COSTS (1970 FEB)**

(a) Notwithstanding the clause of this contract entitled "Limitation of Costs/Limitation of Funds," the Contractor shall not include in his estimate of costs incurred or to be incurred, or of the total amount payable by the Government, any amount for Special Termination Costs, as herein defined, to which the Contractor may be entitled in the event this contract is terminated for the convenience of the Government. The Contractor agrees to perform this contract in such a manner that its claim for such Special Termination Costs will not exceed $..... The Government shall have no obligation to pay the Contractor any amount for such Special Termination Costs in excess of such amount. Special Termination Costs for the purpose of this contract are defined as costs only in the following categories:

(i) severance pay as provided in ASPR 15-205.39(b)(ii);

(ii) reasonable post-termination plant maintenance and operation costs, if expressly made allowable under other provisions of this contract;

(iii) settlement expenses as provided in ASPR 15-205.42(f);

(iv) cost of return of field service personnel from sites;

(v) costs in categories (i), (ii), (iii), and (iv) above to which subcontractors may be entitled in the event of termination.

(b) In the event of termination for the convenience of the Government, the amount of such Special Termination Costs shall be determined in accordance with the provisions of the contract and this clause shall not be construed as affecting the allowability of such costs in any manner other than limiting the maximum amount payable therefor by the Government.

(c) This clause shall remain in full force and effect until this contract is fully funded.

## TERMINATION OF CONTRACTS

**8–712 Special Termination Costs Clause.**

(a) The clause set forth in 7–108.3 is authorized for use in fixed-price incentive contracts and incrementally funded cost-reimbursement contracts when:

(i) the contract term is two years or more; and

(ii) the contract is estimated to require total RDT&E financing in excess of $25 million, or total production investment in excess of $100 million; and

(iii) the use of the clause in the contract is approved by the Secretary of the Department concerned or his designee.

(b) The contractor and the contracting officer shall agree upon an amount that represents their best estimate of the total special termination costs to which the contractor would be entitled to in the event of termination of the contract. Such amount shall be inserted in the clause.

(c) A provision allowing for negotiated adjustments of the amount reserved for special termination costs may be inserted as paragraph (d) of the clause. Contract provisions for periodic adjustments by mutual agreement of the parties may be established based on, among other things, (i) set time periods within the contract, (ii) the Government's incremental assignment of funds to the contract, or (iii) the time when certain performance milestones are accomplished by the contractor. Provisions for such adjustments may be considered desirable in contracts containing unusually long production schedules, or in contracts where the contractor's cost risk in the event of Government termination fluctuates extensively over the period of the contract, depending on the scope of work to be performed during a certain period of the contract or the amount of funds to be assigned to the contract during any one increment.

ENCLOSURE III

# COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

WATERGATE SIX HUNDRED, SUITE 420
WASHINGTON D. C. 20037
(202) 338-6212 and 6213

February 21, 1974

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Harold H. Rubin, Deputy Director
U.S. General Accounting Office
Procurement and Systems Acquisition
Division, Technology Advancement
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Rubin:

This is in response to your letter of January 18, 1974, requesting the views of the Council of Defense and Space Industry Associations (CODSIA) concerning the Department of Defense's use of the special termination costs clause, Armed Services Procurement Regulation Section 8-712.

Because of the limited time afforded to respond, CODSIA has quickly checked with industry concerning the two questions mentioned in your letter. One question related to industry's experience following CODSIA's letter of September 22, 1969 to the ASPR Committee and since the clause was put into effect; the other requested any changes which industry believes are required to make the clause more acceptable.

Commenting on the first inquiry, it is noted that there has been little experience wherein the clause was actually required to be put into use. In other words, there have not been many major terminations in this time frame, which have involved this clause. This lack of experience limits our ability to discuss the use or adequacy of the clause as now stated.

Only one example of the clause becoming operative was discovered. In this instance, the final settlement fell within the dollar limitations set forth therein; therefore, no problem was confronted on allowable and allocable terminations costs being incurred beyond the dollars set forth in the clause.

There are companies which have current contracts that contain this clause. Several of these companies find it necessary to adjust the dollar limitations from time to time due to the fact potential termination costs are never static in an on-going contract. Such a right to do this is recognized within ASPR 8-712, but the clause itself, ASPR 7-108.3, does not recognize this aspect.

Industry concerns regarding the special terminations clause were expressed in our September 22, 1969 letter and again in the CODSIA study report of July, 1971, "Government Contract Terminations". The report had the following observations and recommendations:

- o "In this situation we have a double cost limitation -- a ceiling on these kinds of special costs plus a restriction a as to the kinds of costs that can be considered.

- o The purpose of the special termination costs clause can hardly be faulted -- to permit full utilization of contract funds for productive work and to exclude the Limitation of Cost Funds clause in the contract. However, it should be made more flexible.

  RECOMMENDATION

  Revise the special termination costs clause, ASPR 7-108.3, to provide more flexibility with the ceiling subject to upward as well as downward adjustment, and with the categories of costs broadened to include all post-termination costs, not just limited categories.

  (To assist you in your review, a copy of the CODSIA report of July, 1971 is attached - see pages 13 and 14.)

In line with the thought expressed above, and addressing specifically the subject of changes believed essential to make the clause more acceptable, the following changes are offered for consideration:

1. Within the clause (ASPR 7-108.3), lines 4 and 5 are the words, "...in the event this contract is terminated for convenience of the Government ..." It is strongly believed the words "for the convenience of the Government," should be revised to read "for the convenience of the Government on fixed price contracts and for convenience of the Government or default on cost reimbursement contracts." A similar treatment of these words is also required in paragraph (b) of this clause.

   REASON: The sole purpose of this clause is to permit full use of incremental contract funds for productive work. This is primarily for the benefit of the Government. The clause is not intended to cause the contractor to assume additional risk by not holding the normal reserve of contract funds against a possible termination as he would do if this clause were not used. Nevertheless, there is always the risk, however remote, of a default termination. In the case of a cost reimbursement contract the allowability of termination costs for either default or convenience is basically the same, subject only to availability of contract funds. It is therefore apparent that in the cost reimbursement case the special termination costs

clause, as currently limited to a convenience termination, imposes additional risk of loss to the contractor in the event of a default termination. In all fairness this limitation should be eliminated to enhance the use of the clause and to preclude the clause from being self-defeating.

2. The "Recommendation" cited above and contained in the reference CODSIA study report suggested that the categories of costs defined in ASPR 7-108.3 be broadened to include all post-termination costs and not be limited to the categories currently covered in the clause. It is recommended that the clause be revised by eliminating the limited categories and adding after the words "are defined as costs", the following: "are defined as costs as covered by ASPR 15-205.12 (b) (ii) Idle Facilities, ASPR 15-205.39 (b) (ii) Severance Pay, and ASPR 15.205.42, Termination Costs."

   REASON: Because the present clause covers only limited types of post-termination costs, it is incumbent upon a prudent contractor to hold a termination reserve for all categories of termination and post-termination costs not now listed in the clause but otherwise allowable under ASPR Section XV. The wording of the present special termination costs clause therefore, partially defeats the intended purpose of the clause. As the Committee on Armed Services of the U.S. Senate recognized (Report No. 93385 dated September 6, 1973, pages 118 and 119), the purpose of the clause is to enable the contractor to more fully utilize contract funds without the need for a reserve against possible termination.

3. In addition to eliminating the restrictive list of types of termination costs, ASPR 7-108.3 should be further modified by changing the second sentence thereof to read: "The contractor agrees to perform this contract in such a manner that its claim for termination costs, when added to all other costs incurred, will not exceed the sum of the funds allotted to this contract for performance plus $--------- covered by the Special Termination Costs clause."

   REASON: Without such a change, the clause has the characteristic of an advance understanding and limitation on termination costs even if, at the time of termination, the funds allotted to the contract were not exhausted. This is not the purpose for which the clause is intended. Such clarification will not increase the Government's liability but it will eliminate potential administrative confusion.

4. As will be noted in the CODSIA study report of July, 1971, as well as in CODSIA's letter of September, 1969 to the ASPR

Committee, industry did not then, nor does it now, take issue with the purpose of the clause, but it must be recognized that it creates concern as to whether the dollar limitation will be adequate as the contract progresses. In this respect it is recommended that a paragraph (d) be added to the ASPR clause 7-108.3 (as Permitted by ASPR 8-721 (c)) to provide for periodic adjustment by mutual agreement of the parties.

In closing, we wish to express our appreciation for the opportunity to provide these comments as the consensus of the opinions expressed by the member associations of CODSIA and trust that they will receive due consideration in the course of your review. We would welcome the opportunity to have our representatives discuss with you in greater detail the views and recommendations which have been presented here.

Sincerely,

J. A. Caffiaux
Staff Vice-President
Electronic Industries Assn.

Joseph M. Lyle
President
National Security Industrial Assn.

Francis P. Rooney, Manager
Defense Liaison Department
Motor Vehicles Manufacturers Assn.

Karl G. Harr, Jr.
President
Aerospace Industries Assn.

Robert E. Lee
President
National AeroSpace Services Assn.

Edwin M. Hood
President
Shipbuilders Council of America

John C. Beckett
WEMA

Attachment