Boston College Law Review

Volume 6 | Issue 1 Article 3

10-1-1964

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Lola Dickerman

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LOLA DICKERMAN*

INTRODUCTION

The purpose of this paper is to re-examine the cost limitation provisions in cost-type Government contracts. The standard inclusion of such clauses as contract "boiler-plate" has resulted in a folk-lore as to their meaning and significance which often clouds the contract. This paper will consider the following specific problems:

1. To what fee is the contractor entitled when the monies on the contract have been expended and the Government does not provide additional funds?
2. What obligation is there on the Government to provide funds to cover a Contractor's overrun of costs?
3. Who has title to the property generated by the overrun costs?
4. What is the interaction between the termination article and the cost limitation articles?

The crux of these problems is the inherently special nature of a cost-type contract; as in most such contracts, the Contractor agrees to fulfill the work statement although neither party is prepared to say what the total undertaking will cost.

In the case of fixed-price Government contracts the contract recites the total compensation to be paid.[1] The fee in cost reimbursement contracts is similarly recited in a total fixed amount.[2] The peculiar obligation undertaken by the Government to pay all allowable costs of performance in cost-type or "CPFF" contracts gives rise to the need for a limit on the amount which the Contractor may spend on the Government's account.

It is well settled that no Government contract may be made unless it is done pursuant to an appropriation adequate to its fulfillment.[3] The Supplemental Appropriation Act, 1955,[4] which treats of the recording and reporting of obligated funds, provides that no amount shall be recorded as an obligation of the Government of the United States unless it is supported by documentary evidence of a binding agreement in writing.

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* Graduate, Boston University Law School, 1947; admitted to practice before Massachusetts and Federal bars and the Court of Claims; member, National Panel of Arbitration, American Arbitration Association; presently in private practice in Boston, Mass., devoted entirely to the field of government contracts.

1 ASPR, 32 C.F.R. § 7.103-7 (1958).

2 ASPR, 32 C.F.R. § 7.203-4 (1959).

3 34 Stat. 255 (1906), 41 U.S.C. § 11 (1959).

4 68 Stat. 813 (1954), 31 U.S.C. § 200(a)(1) (1959).

The Armed Services Board of Contract Appeals (ASBCA) has said of CPFF contracts that as a

> general proposition the estimated cost is on the work required by the contract and that any work not included in the estimated cost is not included in the contract, although the accuracy of the estimated cost is not guaranteed . . . .[5]

In order, then, that the monetary obligation of the Government shall be so limited in accordance with the law, there is included in every CPFF supply contract, a clause known as "Limitation of Cost."

THE LIMITATION OF COST CLAUSE

The clause currently in use is set forth in the Armed Services Procurement Regulations (ASPR) at Section 7.203-3.

"LIMITATION OF COST" (OCT. 1953)[6]

> (a) It is estimated that the total cost to the Government, exclusive of any fixed fee, for the performance of this contract will not exceed the estimated cost set forth in the Schedule, and the Contractor agrees to use its best efforts to perform the work specified in the Schedule and all obligations under this contract within such estimated cost. If at any time the Contractor has reason to believe that the costs which it expects to incur in the performance of this contract in the next succeeding thirty (30) days, when added to all costs previously incurred, will exceed eighty-five percent (85%) of the estimated cost then set forth in the Schedule, or if at any time, the Contractor has reason to believe that the total cost to the Government, exclusive of any fixed fee, for the performance of this contract will be substantially greater or less than the then estimated cost thereof, the Contractor shall notify the Contracting Officer in writing to that effect, giving its revised estimate of such total cost for the performance of this contract.
>
> (b) The Government shall not be obligated to reimburse the Contractor for costs incurred in excess of the estimated cost set forth in the Schedule, and the Contractor shall not be obligated to continue performance under the contract or to incur costs in excess of the estimated cost set forth in the Schedule, unless and until the Contracting Officer shall have notified the Contractor in writing that such estimated cost has been increased and shall have specified in such notice a

[5] H. K. Ferguson Co., ASBCA No. 2826, 57-IBCA ¶ 1293 (1957).

[6] Other versions of the clause are found in ASPR, 32 C.F.R. § 7.402-2 (1959).

revised estimated cost which shall thereupon constitute the estimated cost of performance of this contract. When and to the extent that the estimated cost set forth in the Schedule has been increased, any costs incurred by the Contractor in excess of such estimated cost prior to the increase in estimated cost shall be allowable to the same extent as if such costs had been incurred after such increase in estimated cost.

THE NOTICE

The aforementioned clause places a duty on the Contractor to notify the Government when he has "reason to believe" he has reached the named 85% position. Neither party is, however, under obligation to the other for performance or payment when the "estimated cost" is expended. Lack of such notice was the issue in *PRD Electronics, Inc.*[7] The overrun included overhead, which appellant argued could not be determined with any degree of accuracy until the rate was negotiated at the end of the year. The appellant said further that the overhead factor made it impossible to determine where he stood with respect to the ceiling cost under the clause for notice purposes. The ASBCA found for the Government, pointing out that, as a matter of prudent business, the Contractor must or should have known what his actual situation was costwise at all times during performance.

Some Government personnel are interpreting this statement quite literally, and *PRD Electronics* has quietly become support for the proposition that any overhead overrun, however innocently incurred, will be barred by a lack of timely notice. This writer feels, however, that such result was not intended by the *PRD* decision. The decision would be a shocking one indeed if it obliges a Contractor to know his overhead costs precisely on a day to day basis. The idea that the Contractor can be required to give notice of that which he truly does not know through no negligence of his own is hardly a familiar one either in the law generally, or in this particular field.

In 1956 the Comptroller General said of a subcontractor:

> However in connection with the responsibility to keep its costs from exceeding the actual cost limitation pending any negotiation for an increase in the amount of such limitation, the subcontractor could not reasonably have been expected to know precisely what its overhead costs were at any time during the course of performing the subcontract. Accordingly, the Comptroller approved the funding of the overrun.[8]

[7] ASBCA No. 7713, 1962 BCA ¶ 3282 (1962).

[8] Comp. Gen. Dec. No. B-127863 (June, 1956).

Also important on the notice issue is the recent decision in *Emerson Elec. Mfg. Co.*[9] In this case, the Board points out that although the Limitation of Cost clause requires the prime Contractor to notify the Government if his costs, including those of his subcontractors, are likely to exceed the cost limitation, no requirement for notice of a subcontractor's overrun exists.

The *Emerson* case is also illustrative of another doctrine which has grown up around the "Limitation of Cost" clause, the so-called "waiver" doctrine.

WAIVERS AND EXCEPTIONS TO THE CLAUSE

The "Limitation of Cost" clause is most often employed as a defense to a Contractor's request for overrun reimbursement. Since CPFF contracts do not contain a contract price as such, the amount which will ultimately be paid the Contractor for performance of the contract is not immutable. Obviously, if performance costs him less than the sums allotted, his allowable costs plus his fee will constitute the "price" (absent an incentive fee provision), and the "Limitation of Cost" clause will never be invoked.

Costs of performance are often underestimated, however, and Contractors will often incur costs in excess of the estimated cost set forth in the schedule. This occurs for a variety of reasons. Sometimes, a Contractor's bookkeeping is a week or more behind his expenditures; on other occasions, the Contractor merely incurs overruns in the hopeful expectation that he will be "covered" later.

The language of the ASBCA in the appeal of *American Hydromath Corp.*[10] typifies the result in these cases:

> Since the costs presently claimed are beyond any estimate of cost specified in the contract, and since no additional obligation to pay can be implied against the Government in the face of the express condition setting a limit to the Government's obligation, the Government never became and is not now obligated to pay those costs under the terms of the contract.

This case has often been cited for the proposition quoted, and it is clear that in the absence of unusual and compelling circumstances, Contractors will not recover unauthorized cost overruns.

A recent affirmation of this principle forms a portion of the Board's decision in *General Elec. Co.*,[11] in which a ceiling provision incorporated into the contract barred recovery of overrun expenses.

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9 ASBCA No. 8788, 1964 BCA ¶ 4070 (1964).
10 ASBCA No. 4505, 59-2 BCA ¶ 2465 (1959).
11 ASBCA No. 5897, 61-1 BCA ¶ 3038 (1961).

This decision illustrates the reasoning process employed in determining whether the "Limitation of Cost" clause will or will not prevent recovery of overrun costs:

> The Board has held that (the "Limitation of Cost" clause) is a bar to the Contractor's recovering overrun expenses where the Contractor could unquestionably have exercised the right to discontinue incurring expenses in excess of the maximum amount set forth.

The above language originally appeared in *Thiokol Chem. Corp.*,[12] and was cited later in the *General Elec. Co.* decision for the following converse proposition:

> This Board has held the Government liable for overrun expenses where action by the Government caused or induced the Contractor's continued expenditures beyond the maximum specified in the contract.[13]

The question appears to boil down to one of free and intelligent choice. That is, a Contractor cannot recover when he could, as quoted above, "unquestionably have exercised the right to discontinue incurring expenses" over and above the estimated cost set forth in the Schedule, but can and will recover when compelled or induced by the Government to exceed this maximum, *i.e.*, where the efficient cause of the overrun is some Government action.

Apparently, Contractors will be given the benefit of a retroactive interpretation of the conduct of the parties, provided that the Contractor's conduct and reliance were reasonable.

On the one hand, we have the situation in which the Government makes absolutely no representation, express or implied, that more funds will be allotted to the contract and where the only reasonable interpretation is that the Contractor, knowingly and deliberately, or negligently, proceeded at his own risk with merely a hope, not amounting to reasonable expectation, of reimbursement.

On the other hand, we have the situation which prevailed in *Thiokol,* where the Contractor was virtually impelled to continue performance despite exhaustion of funds and where "it is uncontroverted that the Government here would never have permitted appellant to discontinue performance of the contract."[14]

The *Thiokol* case involved a "crash" program for rocket engines. Manufacture and delivery of the engines was of paramount importance and the Contractor was spurred on to complete performance despite the

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12 ASBCA No. 5726, 60-2 BCA ¶ 2852 (1960).

13 General Elec. Co., supra note 11.

14 Thiokol Chem. Corp., supra note 12.

overrun situation, but reimbursement was later denied under the "Limitation of Cost" clause of the contract.

The Board there held that the literal language of the clause must be deemed a mere shadow of formality in the situation which obtained with respect to that contract. It said:

> Here the Government foreclosed appellant from the right to discontinue performance at any time prior to completion of work, but nevertheless now insists that the Government's own obligation to pay costs incurred by reason of uninterrupted performance, remains fixed and unchanged. To analogize, the Government cannot apply the whip and yank back on the bridle at the same time. Having insisted that appellant achieve sustained performance until delivery was made, the Government must pay the overrun costs incurred by reason of such insistence.

In the in-between "gray" area are the so-called inducements to continue performance, upon the promise, express or implied, that additional funds would be forthcoming, following requests or exhortations by Government personnel not to quit. The writer is inclined to believe that any such inducement, uttered by a Contracting Officer, upon which the Contractor relies, should support recovery of overrun expenses.

There is a time in these borderline situations during which the Contractor can make his decision to discontinue performance or continue at his own risk. Any conduct, by deeds or words, of the Contracting Officer which effectively motivates the Contractor to continue performance, or which can be reasonably construed as calculated to produce this effect, should support recovery of overrun costs. Even the most prudent Contractors may not then be in a good business position to "unquestionably" and unhesitatingly discontinue performance. In these cases, the Government should be prevented by its conduct from setting up the "Limitation of Cost" clause as a shield. Experience tells us that Contractors place great reliance on the words of the Contracting Officer. This word ought to be the Government's bond.

In *Acme Precision Prods., Inc.*,[15] the Army Panel of the Board summed up the problem as follows:

> There is no evidence that appellant was asked to continue performance by any Government representative who knew or had reason to know that contract funds were exhausted. A different case would be presented if a Government official acting within the scope of his authority had asked the

[15] ASBCA No. 6824, 61-1 BCA ¶ 3051 (1961).

Contractor to continue performance after being informed that the Contractor had incurred costs up to the ceiling specified in the contract.

Other cases in this area merit our attention. In *Ryan Aeronautical Co.*,[16] the "Limitation of Cost" clause invoked by the Government was countered by the fact that a change had been ordered, and under the "Changes" clause the Contractor was required to proceed with the changed work as ordered by the Government. The Contractor argued that "Limitation of Cost" clauses did not apply to costs in excess of the funds allotted, which costs were incurred in carrying out a change. The Board held that both interpretations were arguable, and thus an ambiguity resulted which was resolved by the conduct of the parties. Since the Government continued to exact performance and appellant continued to perform under the change long after the estimated costs set forth in the Schedule had been exceeded, the Contractor's appeal was sustained.

The Board also pointed out:

> This holding, even without the conduct of the parties, is in harmony with what we believe to be the consistent ruling of the Board that a fixed ceiling in a contract containing a price revision article has no application to a change which increases the costs under the contract.

In *Republic Aviation Corp.*,[17] the decision in favor of the Contractor hinged on the requirement in the "Limitation of Cost" clause that, upon making an increase, the Contracting Officer notify the Contractor in writing. The Board held that the clause does not require the writing to be in any particular form and found that the following writings sufficed to support overrun recovery. First, a supplemental agreement had been sent to the Contractor increasing the contract price. The Contractor had signed and returned it, but it had never been executed by the Government and thus did not become part of the contract. Second, the Government had sent the Contractor a letter stating that a second supplemental agreement increasing the contract price would be issued. In fact, it never was.

The Board regarded the two documents as notice and assurance to the Contractor that the contract funds would be increased, particularly since the Government was informed at a contemporaneous conference that appellant was performing with his own funds and obviously understood that it would continue to perform.

In the *Emerson*[18] case the Board speaks of cases wherein the

16 ASBCA No. 6244, 61-1 BCA ¶ 2911 (1961).

17 ASBCA No. 5729, 61-1 BCA ¶ 2950 (1961).

18 Emerson Elec. Mfg. Co., supra note 9.

Government had "constructively directed" a Contractor to proceed in spite of the cost limitation and then accepted delivery of the items produced. In the case of *Consolidated Electrodynamics Corp.*,[19] the Contractor had been led to believe that his request for funds was being processed. That case was likened by the Board to *Clevite Ordnance, Division of Clevite Corp.*,[20] where the parties had engaged in a long course of conduct in which overruns were funded after the fact.

To summarize, we have seen that the "Limitation of Cost" clause was designed to protect the Government against over-expenditure of appropriated funds, and that it will be invoked to prevent Contractors from recovering unauthorized cost overruns in the usual case. The principles of the clause are not inviolable, but are considered to be a "mere shadow of formality" in cases where the effective cause of the overrun was some action or inducement by the Government. Contractors must, however, beware of making value judgments in this area. The very fact that a Contractor, who finds himself in a potential overrun situation, weighs the language of the clause against the inducement offered betrays his awareness of the ramifications of his situation. Being thus able to make an intelligent decision before expenditure of funds in excess of the sums allotted to his contract, he is "unquestionably" in a position to cease performance; he cannot then place reliance on the inducement, and the Board will doubtless so hold.

Only those Contractors who believe, in utmost good faith, that they are proceeding under a firm reimbursement-supporting commitment can ever hope to recover overrun costs in the face of the "Limitation of Cost" clause. Too many Government Contractors have discovered too late the potentially disastrous effect of failure to heed that well-known but anonymous advice—"Get it in writing!"

INTERIM FUNDING CLAUSES

In some situations, the Services find that the total funds estimated to perform the contract are not available. As a result, they have developed time-phased or interim funding arrangements. Examples of the clauses used to limit the Contractor to the available funds are those set forth in the Air Force Procurement Instructions at Section 7-4054. These clauses limit the Government's obligation to reimburse the Contractor to the amount which has been allotted to the contract; *i.e.*, an amount less than the estimated cost. The most significant feature of interim funding clauses is that the dollar limit includes the amount which will be payable not only for the Contractor's costs, but also, in the event of termination, the amount which will be payable in respect

19 ASBCA No. 6732, 1963 BCA ¶ 3806 (1963).
20 ASBCA No. 5859, 1962 BCA ¶ 3330 (1962).

to subcontracts, termination settlement costs, and fee. Thus the Contractor who may be terminated at any time must, each day, on a continuing basis, know what it will cost to perform or to be terminated, and must provide appropriate notice to the Government based on this knowledge.

It is interesting that the Air Force interim funding clauses *specifically provide* that if the Government does not provide additional monies when they are needed, the Contracting Officer will terminate the contract under the termination provisions.

Since the termination provisions relate fee earned to percentage of completion, it is plain that the Government, under these clauses, will pay the agreed fixed fee only in the case of complete performance. The Government, by its decision not to fund the contract to the estimated amount, is now in a position to reduce the Contractor's profit.

It is clearly in the public interest that the Government have the right to terminate contracts for military items. Contractors for the defense establishment have always taken the risk that if the items being produced were no longer wanted, they would be paid a profit only for the work accomplished. By interim funding clauses, this risk is now enlarged to include loss of fee in the situation where the Government in its budget machinations cannot or does not choose to obligate the money originally known to be required.

FAILURE TO INCREASE ESTIMATE OF COSTS— "LIMITATION OF COST" ARTICLE

Unlike the interim funding clauses referred to in the last section, the "Limitation of Cost" article does not provide that a failure to increase the estimated costs shall be a termination for the convenience of the Government.

The "Limitation of Cost" clause limits the Contractor's obligation to perform and incur costs to the limit of the monies available in the contract. To avoid the abortion of a procurement for which funds are obtainable, the "Limitation of Cost" clause creates a unilateral option in the Government by which it may increase the estimated cost.

It is generally understood that if the fee, which is computed initially as a percentage of estimated costs, were to increase commensurately with the increase in estimated costs, the statutory prohibition against cost plus percentage of costs contracts would then be violated.[21] The "Limitation of Cost" clause is silent on the matter of fee in this situation, but it is accepted practice that Contractors will not be entitled to fee increases when additional sums are allotted to

[21] 72 Stat. 1457 (1958), 10 U.S.C. § 2306 (1959).

the contract. This view presumes that a CPFF Contractor's undertaking is to complete the work.

The "Limitation of Cost" clause permits the Contractor to stop work when funds have been exhausted, unless the Government exercises its option to provide additional funds. In cases where the sums allotted have been expended and the Government decides not to provide additional funds, it generally invokes the machinery of the "Terminations" clause of the contract, on the theory that the Contractor has not completed performance. Under the termination procedure, the Contractor is paid a percentage of the fee equivalent to the percentage of completion of the work contemplated by the contract.[22]

It is therefore important to determine what work was contemplated by the contract. We must examine not only the physical work described in the work statement, which is often immutable, but more important, we must look to the contract to discover what it is exactly that the Contractor has agreed to do.

Generally, the Contractor's commitment with respect to the work called for under the contract is unequivocal. That is, for the fee, he commits himself to perform the contract work by the contract due date. The effect of the "Limitation of Cost" clause on the obligation is that if the Contractor has used his best efforts to perform within the estimated cost but has nevertheless failed to complete performance for this sum, he will not be amenable to default action. In effect, he has completed his performance and discharged his obligation to work. However, if the Government exercises its option to fund, he must continue in accordance with his agreement.

In order that we may determine what the Contractor's fee should be when the funds are depleted and no further monies are forthcoming, we should pause to examine two types of cost contracts, the unequivocal obligation and the obligation which is limited as to time.

DISTINCTION BETWEEN TERM-TYPE COST CONTRACTS AND NON TERM-TYPE COST CONTRACTS

Sometimes the parties contemplate that the work may not be capable of performance. This is particularly true in research contracts, where the undertaking is a venture into the unknown. In these situations it is proper for the contract to provide that the Contractor shall use his best efforts to accomplish the result being sought during a limited period of time. This type of contract often contains an expiration date, at which point the Contractor will have earned the entire fee, provided that he has applied his best efforts to the task.

While the option granted by the "Limitation of Cost" clause to

[22] ASPR, 32 C.F.R. § 8.702(e)(1)(D)(I) (1959).

provide additional funds has the same effect in both unequivocal and term-type contracts before expiration of the contemplated time for performance, there is a marked distinction in treatment once the due date or expiration date is reached. In the former type of contract, a default situation exists, absent excusable delays; whereas in the latter, the Contractor has fully performed and is entitled to the full amount of the fee.

Should a contract of the unequivocal type be terminated for default, a fee is paid only with respect to supplies delivered and accepted. The Contractor is obliged to continue performance beyond the delivery date if the Government does not terminate. If the Government desires to continue performance toward the goal after the expiration date in a term-type contract, it must provide additional fee as well as costs.

DETERMINATION OF FEE WHEN GOVERNMENT DOES NOT FUND OVERRUN

If the Contractor cannot complete the work under the contract within the estimated cost and the Government elects not to provide additional funds, the question arises as to the amount of fixed fee to which the Contractor is entitled. In the infrequent case where the Air Force "Limitation of Government's Obligation" clause is applicable, this matter is explicitly covered by the language of the clause—the fee paid is based upon the percentage of completion of the work. If that clause is not applicable, however, this question is not so easy to decide.

The "Limitation of Cost" clause does not contain language covering the payment of fee. It is therefore of no use in deciding the amount of fee to be paid in this situation. Another clause specified for use in all cost plus fixed fee contracts, "Allowable Cost, Fixed Fee, and Payment," does contain the following language covering fee:

> (a) For the performance of this contract, the Government shall pay to the Contractor—
>
> (i) the cost thereof . . .
>
> . . . .
>
> (ii) such fixed fee, if any, as may be provided for in the Schedule.[23]

The clause goes on to state procedures to be followed including the requirement that a portion of the fixed fee be withheld, and then continues:

> (e) On receipt and approval of the invoice or voucher designated by the Contractor as the "completion invoice" or

[23] ASPR, 32 C.F.R. § 7-203.4 (1959).

> "completion voucher" and upon compliance by the Contractor with all of the provisions of this contract . . . the Government shall promptly pay to the Contractor any balance of allowable cost, and any part of the fixed fee, which has been withheld pursuant to (c) above or otherwise not paid to the Contractor. The completion invoice or voucher shall be submitted by the Contractor promptly following completion of the work under this contract but in no event later than one (1) year . . . from the date of such completion.[24]

Although this clause does not deal directly with the problem at hand, it does contain some language that needs interpretation in this regard. For instance, it says in paragraph (a), above, that the Government shall pay the fixed fee "for the performance of this contract." It also says, in paragraph (e), that the withheld portion of the fee will be paid upon submission of an invoice promptly following completion of the work under the contract. There is the implication that such an invoice would be submitted when the funds ran out as well as when the work was physically completed, since this is the only means provided by the contract language to close out the contract. Thus, this language can be interpreted as saying that the fixed fee will be paid when the contract is completed or performed. The language does not, however, provide satisfactory guidance on what will constitute completion or performance.

In spite of the lack of specific language covering this question in cost plus fixed fee contracts, as a matter of actual practice, the Contracting Officer usually asks for and receives a reduction of fee at the time the funds run out before the work has been completed. This procedure is based on the opinion of the Government that the situation is governed by the provisions of the "Termination" clause. Since the work had not been completed, the Government would have the right to terminate the contract at its convenience. Thus, the negotiation of a reduction of fee is merely a method of simplifying the termination procedure.

Is this, however, a proper interpretation of the "Termination" clause? That clause provides:

> (a) The performance of work under the contract may be terminated by the Government in accordance with this clause in whole, or from time to time in part:
>
> . . . .
>
> (2) Whenever for any reason the Contracting Officer

24 Ibid.

> shall determine that such termination is in the best interest of the Government.
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> Any such termination shall be effected by delivery to the Contractor of a Notice of Termination specifying whether termination is for the default of the Contractor or for the convenience of the Government, the extent to which performance of work under the contract is terminated, and the date upon which such termination becomes effective.[25]

This clause contemplates action by the Contracting Officer during the performance of the contract, not after the Contractor has completed performance. The whole tenor of the clause is in terms of actions of the parties when work is stopped during performance. In the case of a Contractor who reaches the cost estimate and has not completed the work, however, the "Limitation of Cost" clause contains its own provisions relating to the action of the parties. Thus, the clause specifically relieves the Contractor of any obligation to continue the work after the funds have been exhausted. The issuance of a notice of termination for the covenience of the Government, after the Contractor has stopped work pursuant to the terms of another clause of the contract, would be a meaningless act.

It can thus be argued that the two clauses are mutually exclusive in this area, for they provide alternate procedures, with the "Limitation of Cost" clause clearly taking priority at the time the Contractor reaches the estimated cost of the contract. This point was well and succinctly made in the case of *General Electronic Labs., Inc.*[26] The issue in that case was whether compensation under a terminated cost-reimbursement type contract was limited to the contract's estimated cost, where the Contractor elected to settle a termination claim on the inventory basis and where the Government demanded delivery of the inventory. The cost of the inventory resulted in an overrun of the cost estimate.

In finding for the appellant the Board said:

> Upon all the evidence, we conclude that the Government intended to demand and acquire the fruits of all of appellant's work and intended to pay for it, and chose the termination route to effectuate this intent. The Government argues that the Limitation of Cost clause is a contractual impediment to such effectuation. The short answer to this argument is that we find the Government's intent, as expressed through the Termination Contracting Officer, acting by direction of the cognizant technical personnel, included

[25] ASPR, 32 C.F.R. § 7.203-10 (1959) referring to ASPR, 32 C.F.R. § 8.702 (1959).
[26] ASBCA No. 8097, 1963 BCA ¶ 3921 (1963).

> either abrogation of the Limitation of Cost clause, or invocation of the last sentence thereof. Nor is a specific finding of such intent necessary.
>
> The Limitation of Cost Clause is, by its terms, applicable to the cost 'for the performance' of a contract. All of its provisions point to a procedure looking toward active performance and continuance of a contract, rather than terminating work. Compliance with its provisions becomes impossible once a termination notice has been issued. For example, how can a contractor notify the Government that costs to be incurred in PERFORMING the contract will exceed 85% of the cost estimate in the ensuing 30 days of termination procedures? We conclude that this clause has no application to, nor effect upon the Termination clause and its consequent procedures.
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> The Termination clause in cost-reimbursement type contracts contains no delimiting language regarding total payments. Compare this with the clause for fixed-price contracts which limits the total settlement to the contract price. ASPR 8-701 (a), Subclause (e). We regard this difference as significant, and probably inherent in the philosophy underlying cost-reimbursement type contracts.[27]

To what fee is the Contractor entitled if the Government does not provide the additional funds necessary to complete the work? In one case before the Armed Services Board of Contract Appeals, the Contractor was held to be entitled to the full fee called for by the contract. In this case, *American Hydromath Corp.,*[28] the Contractor stopped work when the funds ran out, and the Contracting Officer decided not to provide additional funds. The Contracting Officer then refused to pay the withheld portion of the fee (which was 20% of the total fee) on the ground that there had been no satisfactory completion of the contract. The contract contained the following language governing the payment of the fee: "A final payment . . . of the fixed fee shall be made to the contractor upon the satisfactory completion of this contract." The Board noted the distinction between completion of the work under the contract and completion of the contract itself. In the instant case it was found that there was no further obligation on the part of the Contractor (in accordance with the contract language, which was substantially the same as the terms of the "Limitation of Cost" clause), and that the work which had been done had been accepted as satisfactory by the Government. The Board there-

27 Ibid.

28 ASBCA No. 3127, 56-2 BCA ¶ 1149 (1956).

fore felt that the Contractor had met the contract requirement of "satisfactory completion of the contract" and was entitled to the full fee. It might be noted that the Board pointed out that the Government was free to draft contract language requiring pro-rata fee adjustments, but that the language in the contract in question would not be so interpreted.

In the only other case bearing on this issue, the opposite result was reached. In that case, *Sterling Precision Corp.*,[29] when the funds ran out, the Contracting Officer took a different course of action than had his counterpart in *American Hydromath.* In the *Sterling* case the contract was terminated for default. This, of course, resulted in no fee being paid to the Contractor. The Board found that the Contractor had been behind schedule at the time the funds ran out, but that he was making progress, and that the proximate cause of his failure to complete the work was the failure of the Government to provide additional funds in the contract. Thus, the Board found, generally, that the provisions of the "Limitation of Cost" clause will excuse a Contractor from performance under the provisions of the "Excusable Delays" clause of the contract. The Board converted the termination to a termination for the convenience of the Government, in accordance with the generally accepted interpretation of paragraph (a) of the "Termination" clause.[30] The Contractor was therefore awarded a percentage of the contract fee equivalent to the percentage of completion of the work under the contract, as called for by the "Termination" clause in the case of convenience terminations. The Board did not consider whether the Contracting Officer had the right to issue any type of termination after the funds had run out. Evidently this question was not raised by the parties. On its face, however, *Sterling* would indicate that the Contracting Officer has such a right.

On the surface, these two cases would seem to indicate that the determination of fee in such a situation is based on the action which

[29] ASBCA No. 4646, 59-2 BCA ¶ 2371 (1959).

[30] The clause contains the following language in the last sentence of paragraph (a):

> If, after notice of termination of this contract for default under (i) above, it is determined that the Contractor's failure to perform or to make progress in performance is due to causes beyond the control and without the fault or negligence of the Contractor pursuant to the provisions of the clause of this contract relating to excusable delays, the Notice of Termination shall be deemed to have been issued under (ii) above, and the rights and obligations of the parties hereto shall in such event be governed accordingly.

In the *Sterling* case, the Board relied on this language, although there was actually no default by either failure to perform or failure to make progress and thus the termination could not be converted to a termination for the convenience of the Government in accordance with this language. See Klein v. United States, 152 Ct. Cl. 221, 285 F.2d 778 (1961), where the Court of Claims held that the Government could not convert a default termination to a convenience termination under similar circumstances.

the Contracting Officer takes at the time the funds run out. If he withholds the remaining fee, the Contractor may recover the full fee; but if he issues a termination notice, the Contractor may only recover a portion of the fee. Such an interpretation, however, would not make sense, since the rights of the parties should not be so sensitive to change by their procedural actions after the Contractor's substantive obligations have ended. It is therefore proposed that the interpretation in the *American Hydromath* case is the more sound, and the one which should be followed whether or not a termination notice is issued after the funds run out.

This raises the question of whether it would be inequitable for the Contractor to get the full fee when he had not performed the entire job called for by the contract.[31] This, of course, depends on the bargain which the parties have made. In the case of a term-type contract, where the parties explicitly bargain for a certain amount of engineering time rather than the completion of a task, the fee is clearly earned when the time has been expended. What is the bargain in a contract calling for the completion of a task of work? It can be argued that it is one in which the Contractor undertakes at the option of the Government to: (a) perform all of the work within the delivery schedule, so long as the Government provides the necessary funds; or (b) perform in a satisfactory manner the work which is possible until the funds run out. This interpretation is borne out by the language of the "Limitation of Cost" clause, which gives the Government the alternative rights of increasing the estimated cost of the contract or of not increasing the estimated cost, but which nowhere gives the Government the right to reduce the fee of the Contractor in the event it chooses not to increase the estimated cost.

If, then, this is the proper interpretation of the bargain which the parties have made, the Contractor has completely fulfilled his obligations under the contract when the funds run out and the Government elects to provide no additional money. In such case, he is entitled to the full fee. The final argument in favor of this interpretation is that the contract is drafted by the Government and therefore is construed against the Government when ambiguities occur. In this case, the language is clearly ambiguous at best and therefore should be

[31] See Navy Contract Law, § 8.36, where it is indicated that the Government must be satisfied that the Contractor has "earned" the fee before it can be paid. This section further points out that "nothing short of the completion of the task will satisfy the performance requirements and earn the full amount of the fee" in a contract calling for a task to be completed. It is interesting to note that this section also contains the following sentence: "Since the Limitation of Cost clause is silent on the matter of fee, it may be well to have the fee provisions specifically call for an equitable adjustment under such circumstances." The circumstances referred to occur when the Contracting Officer decides not to fund an impending overrun.

construed in favor of the Contractor. This is certainly true on these facts, where it would be very simple for the Government to draft these "boilerplate" clauses to state clearly that the fee would be reduced, in the event the Government elects not to provide additional funds and the work is not completed.

TITLE TO PROPERTY

As we have seen, it frequently happens that in addition to having expended all Government funds allotted to the contract, a Contractor will have spent some of his own money. Where the cost overrun is not recoverable, the question of what is to be done with equipment produced with combined funds still remains.

This treatment of the problem should be prefaced by a quote from *Republic Aviation Corp.*:[32]

> With respect to this claimed right of the Government to take the termination inventory and then not pay all of the incurred performance costs, the following colloquy took place between the hearing member and counsel for the Government.
>
> > "Lt. Col. Hand: . . . but is the Government entitled to take what the contractor obtained with these reimbursable costs? That's my question.
> >
> > "Mr. Smolka: The contractor was simply continuing his performance under the contract which he had a right to do, and as and to the extent that the contractor performed, the Government was, under the contract, entitled to accept the benefit of this performance.
> >
> > "Lt. Col. Hand: You mean the Government is entitled to accept the benefits even though the benefits are tendered and made possible because of overrun costs?
> >
> > "Mr. Smolka: Yes, sir.
> >
> > "Lt. Col. Hand: That is your position?
> >
> > "Mr. Smolka: Yes, sir."
>
> And at another time:
>
> > "Lt. Col. Hand: You mean you are going to keep the airplanes and not pay for them?"

Government counsel replied that the consideration flowing to the Contractor under a CPFF contract is the money he receives under the cost method plus his fee. If the Government is unwilling to increase the estimated cost, he has a right to discontinue performance where

[32] Republic Aviation Corp., supra note 17.

the estimated cost has been reached. The consideration in effect is stated in the contract and the Contractor is not to exceed the estimated cost except at his own risk.

The Government counsel said since this was the bargain, and since the contractor had been paid according to this bargain, the fact that the contractor would not receive a direct recoupment for his later production would still not lead to the conclusion that the Government was not paying him for his performance.

As stated earlier in this paper, the *Republic Aviation* decision was in fact based upon different grounds, but this question remains. Can the Government accept the benefits of performance and not pay for them even though it never induced the Contractor to continue performance after exhaustion of funds?

The Board, in *Republic,* said:

> This finding that appellant had in fact been adequately notified under the Payment's Article that the funds on the contract had been increased eliminates the necessity of our making any determination concerning the legal effect of the Government taking all of the termination inventory, even though at least part of the termination inventory had been created by the alleged overrun costs. In passing this point we note, however, that this action of the T.C.O. was consistent with an adequately funded contract and the argument of the appellant that the Government's right to the termination inventory was limited by the language in the Termination Article to that portion of the inventory *"for the costs of which the contractor has been or will be reimbursed under this contract."* (Emphasis supplied.)

This language indicates that if there is a termination for convenience of the Government, and if the Government wants the termination inventory, the Contractor will be entitled to reimbursement of overrun costs expended in producing this equipment.

It is conceivable that the Government will not want the equipment and that the Contractor will therefore have built it for his own account. It commonly happens that an equipment is started with funds allotted to the contract and completed with overrun funds. This occurs particularly in contracts for few but expensive equipments. The problem is compounded when considerable labor and materials have been poured into the production of this end item and each party has contributed funds.

If termination is not proper when contract funds are exhausted, we no longer have the benefit of the "Termination" clause referred to in the *Republic* case to aid in determining who will bear the cost of the equipment built with both Government and Contractor's funds. Resort to the "Limitation of Cost" clause in this situation does not tell us anything about the title situation on an equipment in which mixed monies are invested. The "Limitation of Cost" clause is little more than a device to control expenditure of Government money in cost reimbursement contracts.

Although the "Limitation of Cost" clause, which provides the necessary control is quite reasonable, nonetheless a contracting party should not be permitted to reap benefits for which he is not required to pay. The clause was not intended to achieve this result. If the Government takes equipment constructed wholly or partially with overrun funds, it should be compelled to reimburse the Contractor for his allowable costs.

Contractual support for this proposition is found in the "Government Property" clause, in which there appears the following sentence:

> Title to all property purchased by the contractor for the cost of which the contractor is entitled to be reimbursed as a direct item of cost under this contract, shall pass to and vest in the Government upon delivery of such property by the vendor.

This language is similar to the language of the "Termination" article, quoted by Lt. Col. Hand in the *Republic Aviation* decision.

Under the "Government Property" clause, then, the Government's right to take property produced under the contract is limited to the property for the cost of which the Contractor is entitled to be reimbursed. When the Government takes possession (and hence title), it is required to reimburse the Contractor for costs he has invested in the equipment, be they contract or overrun funds. This result does not do violence to any equitable or contractual principles.

In keeping with the equitable and contractual principles which do and should govern contracts between the citizen and his Government, it is here proposed that when the Government, with knowledge of the existence of an overrun situation, permits the Contractor to continue performance, it should be required to pay for this performance, whether or not it wishes to accept the equipment.

This situation resembles an acceptance by silence,[88] wherein one party, with reasonable opportunity to reject offered services, takes the benefit of them under circumstances which would indicate to a reasonable man that they were offered with the expectation of compensation. Failure to seasonably decline the proffered services in these cases is an acceptance.

[88] Restatement, Contracts, § 72 (1932).

Remember, too, that the Government is an active participant in contract performance. It is in constant contact with its Contractors by virtue of a host of administrative requirements and through the presence of Government inspectors at the Contractor's plant.

In conclusion of this part, and by way of summation, Contractors who pour overrun funds into a product should be reimbursed, when the Government, with or without original knowledge of the overrun, takes equipment produced with the Contractor's own money; or when the Government, with original knowledge of the overrun, does not wish to accept the equipment, but silently stands by and permits the Contractor to spend his own money completing it, knowing full well that the Contractor was not expecting to work gratuitously.

COST CEILING CLAUSES

The *General Electric* case referred to earlier,[34] provides a framework for the consideration of cost ceilings. The cost plus fixed fee contract involved in that case was in a "maximum amount" which the Contracting Officer could increase at his option. Failing such increase, the Contractor was not obliged to continue performance.

The Board held that certain contract language established similar "maximums" for each intra-company order. The intra-company order in question had a maximum amount of $199,850, which was increased by the Contracting Officer's letter to a maximum of $238,850. The Board concluded that General Electric had a right to stop work at the $238,850 expenditure point and the appeal for the recovery of the overrun of costs beyond this amount was denied.

The first problem is one of definition. Is a "maximum" which can be increased at the option of the Contracting Officer and beyond which the Contractor may discontinue performance a "ceiling"? The Board begins its decision by pointing out that attorneys for both parties agreed that the prime issue in the case was whether the intra-company order contained a ceiling limitation on expenditures. In the writer's opinion, the "ceiling" concept is badly handled in the above decision. A ceiling on costs, to be distinguished from a limit on costs, should be confined to an agreement by which the Contractor agrees *to complete* an undertaking for which he is to be paid no more than the ceiling amount.

Using this definition, then, the maximum cost clauses in General Electric's contract are not ceilings on costs but limits on costs. In fact, the Contracting Officer in a letter did increase the limit on the purchase order. If the order had contained a ceiling, the Contracting Officer would have had no right to increase the dollars, on the principle

[34] General Elec. Co., supra note 11.

that the Government was receiving no consideration for the increase, being already entitled to complete performance.

In the letter increasing the limit the Contracting Officer said:

> This approval is granted on the condition that there be incorporated into Purchase Order NPD-3082 a provision to the effect that notwithstanding any provision to the contrary all existing requirements thereunder will be *completed* at cost, as defined in the contract, plus the fixed fee. This results in a total estimated cost for Purchase Order NPD-3082 of $239,850 including a fixed fee of $10,290. (Emphasis supplied.)[35]

If this language, which calls for completed work at a cost no greater than $238,850 imposes a ceiling, as it seems to do, then the Board is not correct in saying that General Electric had an option to discontinue the work when it had incurred costs in the ceiling amount. By agreeing to the Contracting Officer's letter (through words or conduct) the Contractor has agreed to complete the work, no matter what the cost to him.

CEILINGS ON COST ELEMENTS

For many years, it was quite customary for the parties to a Government cost-type contract to include in the contract a predetermined fixed overhead rate in the form of a percentage of direct labor costs for an agreed period. In 1956 the Comptroller General held that these predetermined fixed rates were illegal, as a violation of the prohibition against cost plus a percentage of cost system of contracting.

Cost sharing arrangements in which the Government's obligation to pay any cost is fixed by the contract at less than actual costs are neither illegal nor unknown. Thus, a contract may impose ceilings on any cost element, whether direct or indirect.

One of the main reasons for the existence of the fixed predetermined overhead rate was that it gave the Contractor knowledge in advance of the exact rate at which he would be reimbursed. Today, the use of provisional rates which are adjusted post-audit to actual costs, leaves the Contractor in a position where he does not always know the rate at which he is incurring overhead costs. Yet the "Limitation of Cost" article requires that he provide the Contracting Officer with notice at the 85% point.[36]

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35 Ibid.

36 PRD Electronics, Inc., supra note 7.

THE BUSINESS PROBLEM

In conclusion, no paper on the subject of cost limits can be complete without some mention of the serious business problems which arise from these clauses. It is a simple matter for an attorney to advise a client to stop work when the money is expended. It is not, however, such a simple decision for the businessman. If he has a large work force on hand, this alternative may not be a realistic one. It is understandable that in this situation the businessman will not infrequently rely on the good faith efforts of the Contracting Officer to obtain retroactive funding. On the other hand, all too many businessmen are careless of the notice requirement in the limitation clauses. It is the duty of the business manager to send a timely notice, and to keep the Contracting Officer advised of expenditures beyond the limit. Government personnel resent the "surprise overrun," and well they should.