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CONTINUING CONTRACTS CLAUSE IN FEDERAL PROJECTS

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By David J. Krebs and Harvey S. Bartlett¹

Picture this: As a surety, you have a principal engaged in a large construction contract administered by the U.S. Corps of Engineers (“COE”). The COE terminates your principal, claiming that the contractor defaulted; the contractor contests the alleged default, with some fairly solid reasons to mount the challenge. The COE then “de-obligates” the contract balance so that the funds can be available for use on other projects before the appropriation for the following fiscal year. Subsequently, the COE makes demand under the performance bond on you, the surety, requesting that you enter into a takeover agreement to complete the defaulted contractor’s work. You notice, however, that there are no contract proceeds since they have been de-obligated. The COE contracting officer tells you not to worry, that the COE can perform a little accounting magic called “reprogramming” to put the funds back into the contract. Stop. Go no further. Under recent legislation narrowing an exception to the Anti-Deficiency Act, the reprogramming proposed by the COE may be improper.

History of the continuing contracts clause

Large government construction contracts spread out over multiple appropriations cycles historically have presented a funding conundrum for the COE. Congress first addressed this conundrum when it authorized a “continuing contracts clause” solution in the Rivers and Harbors Act of 1922 (“RHA”). Upon finding abuse of the continuing contracts mechanism by the COE, however, Congress dramatically changed the continuing funding scheme in the Energy and Water Developments Appropriations Act of 2006 (“’06 E&WDA”). In the suretyship arena, these changes have created a need for special vigilance by sureties involved in potential takeovers of principals’ COE-administered contracts.

The continuing contracts clause is authorized by the RHA, as specifically codified at 33 USC § 621, which provides:

Any public work on canals, rivers, and harbors adopted by Congress may be prosecuted by direct appropriations, by continuing contracts, or by both direct appropriations and continuing contracts.

This provision was enacted as an exception to the Anti-Deficiency Act, which prohibits government employees from authorizing an obligation under any appropriation in excess

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of the amount of that appropriation, or in advance of the appropriation. 31 USC § 1341 (formerly, 31 USC § 665). The purpose of the exception to the Anti-Deficiency Act was to permit the COE to contract for large multi-year civil works projects without holding large balances of unexpended appropriations during the initial stages of the project.² Thus, a contract does not have to be fully funded before it is entered into by the COE.

The continuing contracts clause developed by the COE permits the government to periodically reserve appropriated funds, rather than dedicating the entire cost from the inception of the Project. The clause provides:

52.232-5001 CONTINUING CONTRACTS

(a) This is a continuing contract, as authorized by Section 10 of the River and Harbor Act of September 22, 1922 (33 U.S. Code 621). The Payment of some portion of the contract price is dependent upon reservations of funds from future appropriations, and from future contribution to the project having one or more non-federal project sponsors. The responsibilities of the Government are limited by this clause notwithstanding any contrary provision of the "Payments to Contractor" clause or any other clause of this contract.

(b) The sum of \$_____ has been reserved for this contract and is available for payments to the contractor during the current fiscal year. It is expected that Congress will make appropriations for future fiscal years from which additional funds together with funds provided by one or more non-federal project sponsors will be reserved for this contract.

(c) Failure to make payments in excess of the amount currently reserved, or that may be reserved from time to time, shall not entitle the contractor to a price adjustment under the terms of this contract except as specifically provided in paragraphs (f) and (i) below. No such failure shall constitute a breach of this contract, except that this provision shall not bar a breach-of-contract action if an amount finally determined to be due as a termination allowance remains unpaid for one year due solely to a failure to reserve sufficient additional funds therefore.

(d) The Government may at any time reserve additional funds

² See *In the Matter of the Army Corps of Engineers' Continuing Contracts*, 1977 WL 10467, 56 Comp. Gen. 437 (March 28, 1977).

for payments under the contract if there are funds available for such purpose. The contracting officer will promptly notify the contractor of any additional funds reserved for the contract by issuing an administrative modification to the contract.

(e) If earnings will be such that funds reserved for the contract will be exhausted before the end of any fiscal year, the contractor shall give written notice to the contracting officer of the estimated date of exhaustion and the amount of additional funds which will be needed to meet payments due or to become due under the contract during that fiscal year. This notice shall be given not less than 45 nor more than 60 days.

(f) No payments will be made after exhaustion of funds except to the extent that additional funds are reserved for the contract. The contractor shall be entitled to simple interest on any payment that the contracting officer determines was actually earned under the terms of the contract and would have been made except for exhaustion of funds. . .

(g) Any suspension, delay, or interruption of work arising from exhaustion or anticipated exhaustion of funds shall not constitute a breach of this contract and shall not entitle the contractor to any price adjustment under the "Suspension of Work" clause or in any other manner under this contract.

(h) An equitable adjustment in performance time shall be made for any increase in the time required for performance of any part of the work arising from exhaustion of funds or the reasonable anticipation of exhaustion of funds.

(i) If, upon the expiration of sixty (60) days after the beginning of the fiscal year following an exhaustion of funds, the Government has failed to reserve sufficient additional funds to cover payments otherwise due, the contractor, by written notice delivered to the contracting officer at any time before such additional funds are reserved, may elect to treat his right to proceed with work as having been terminated. Such a termination shall be considered a termination for convenience of the Government.

(j) If at any time it becomes apparent that the funds reserved for any fiscal year are in excess of the funds required to meet all payments due or to become due the contractor because of work performed and to be performed under the contract during

the fiscal year, the Government reserves the right, after notice to the contractor, to reduce said reservation by the amount of such excess.³

A problem arises for projects where the currently appropriated funds are exhausted more than sixty days prior to the end of the current fiscal year. Under the terms of the continuing contracts clause, the contractor could treat the exhaustion of funds as a termination for convenience. In order to manage funds among various continuing contracts projects as funds were either exhausted or left unexpended during a fiscal year, the COE would engage in reprogramming funds from one project to another, allowing for projects short on allocated funding to continue without subjecting the government to liability for interest on work performed after the exhaustion of funds, essentially creating IOUs against other projects with excess available funds for the fiscal year. See House Report 109-86, at 12-13 (May 18, 2005). As a corollary to this practice, in the interim period between the COE's default termination of a contractor and the execution of a takeover agreement with a surety, the COE may de-obligate or reprogram project funds for use on another project, and then seek to reprogram funds from another project back to the defaulted project at the time the takeover agreement is to take effect.

Propriety of de-obligation

Under 48 C.F.R. § 49.105-2, the COE is authorized to de-obligate excess funds upon the termination of a contract. However, the provision speaks in terms of keeping obligated the amount estimated to be necessary to "settle the termination," suggesting that the provision only addresses a termination for convenience and not a termination for default. Subsection (j) of the continuing contracts clause also allows the de-obligation of funds that will not be earned by the contractor in a fiscal year.

In a 1981 decision not involving a continuing contracts clause, the General Services Administration Board of Contract Appeals ("GSBCA") issued an opinion stating that the government should not de-obligate funds originally obligated for the defaulted contract where the contractor had appealed the default. The Board noted:

When a contract is terminated for default, the funds obligated for the contract generally remain available for a replacement contract whether awarded in the same or the following fiscal year. The obligation established for the original contract is not extinguished because the replacement contract is considered to represent a continuation of the original obligation rather than a new contract. . . . If all replacement contracts were treated as new contracts, an agency whose contractor defaults would be required to deobligate prior year's funds which support the

³ The fiscal year for the federal government is October 1 through September 30.

defaulted contract, and reprogram and obligate current year funds, even though the particular expenditure was budgeted for the prior year. Because contractor defaults can neither be anticipated nor controlled, a great deal of uncertainty would be introduced into the budgetary process.⁴

The GSBCA did, however, find that funds would be de-obligated if the contractor's appeal of the default were upheld before a replacement contract was awarded.

Using the GSBCA decision as a guide, a surety could assert that funds could not be de-obligated from a default-terminated contract where the termination is appealed, and that such de-obligation would impede any takeover agreement. The surety's right to application of the contract balance to completion of the work is well-recognized.⁵ In fact, under federal regulations applicable to the COE, "[a]ny takeover agreement must require the surety to complete the contract and the Government to pay the surety's costs and expenses up to the balance of the contract price unpaid at the time of default," subject to certain conditions. 48 C.F.R. § 49.404(e).

In another case not specifically confronting the continuing contracts clause, however, the GSBCA recognized the government's ability to reallocate funds or seek additional appropriations. In that case, the government argued that an order to the government to terminate a contract for convenience should be stayed as the order would result in the de-obligation of funds from the prior fiscal year, and there were not funds for the current fiscal year available to re-bid the contract. The Board rejected this notion, stating:

[W]e find . . . that even if fiscal year 1985 funds cannot be used to finance the given procurement once it is recompeted following the termination for convenience, that respondent possesses adequate funding to recompetete the procurement during fiscal year 1986. Funds would merely have to be reallocated with the respondent and/or the Army setting the priority for its various procurements. Additionally, nothing precludes the Army from seeking additional appropriations for the procurement if such is necessary.⁶

⁴ *Matter of Funding of Replacement Contracts*, 1981 WL 22547, 60 Comp. Gen. 591 (July 15, 1981).

⁵ 48 C.F.R. § 49.404(b); see *Insurance Co. of the West v. United States*, 243 F.3d 1367, 1370 (Fed. Cir. 2001) (noting that the surety is liable "for the government's costs in completing the contract which are in excess of the contract price.")

⁶ *Protest of System Automation Corp.*, 1986 WL 19604, GSBCA No. 8204-P-R (January 3, 1986).

The '06 E&WDA as a barrier to reprogramming

However, the continued viability of continuing contracts – through the employment of reprogramming and de-obligations – is questionable in light of recent legislation. The '06 E&WDA, which effected COE appropriations for the fiscal year ending September 30, 2006, provided, in Section 108:

None of the funds made available in title I of this Act may be used to award any continuing contract or to make modifications to any existing continuing contract that commits an amount for a project in excess of the amount appropriated for such project pursuant to this Act; *Provided*, That the amounts appropriated in this Act may be modified pursuant to the authorities provided in section 101 of this Act or through the application of unobligated balances for such project.

In the '06 E&WDA, Congress sought to cut down on “just-in-time” accounting by placing restrictions on the use of continuing contracts and on the previously unfettered use of reprogramming. P.L. 109-103. Section 101(a)(5) of the Act requires the approval of both the House and Senate appropriations committees before reprogramming of funds to augment existing programs by more than \$2 million:

Under Section 101 (a) (5) of the '06 E&WDA:

SEC. 101.(a) None of the funds provided in title I of this Act, or provided by previous appropriations Acts to the agencies or entities funded in title I of this Act that remain available for obligation or expenditure in fiscal year 2006, shall be available for obligation of expenditure through a reprogramming of funds that –

* * *

(5) augments existing programs, projects or activities in excess of \$2,000,000 or 50 percent, which ever is less, unless prior approval is received from the House and Senate Committees on Appropriations[.]

The legislation is vague as to what happens to existing continuing contracts where sufficient funds have not been obligated. What is clear is that the de-obligation of funds for a project calls into question the COE's ability to re-obligate funds to the project following execution of a takeover agreement. Given the ambiguity of the language, sureties should be concerned about the propriety of funding for COE-administered projects when negotiating a takeover agreement.

When Congress constructed the '06 E&WDA, it was not just large-scale programs with which it was concerned regarding the transfer of funds by the COE, but all project-level fund movements: "By the Corps' own admission, each year there may be as many as 20,000 transfers of funds among only 2,000 **projects**. . . . The GAO has informed the Committee that the Corps has moved millions of dollars set aside for **specific projects** and has expended them on other activities, without the knowledge of approval of the Committee on Appropriations." House Rep. 109-86, at 12-13 (May 18, 2005) (emphases added).

Indeed, the House Report specifically recognized the COE's affinity for often characterizing project-level "reprogrammings" under different names, so as to avoid triggering the notification requirements to the appropriations committees. See *id.*, at 13. Accordingly, it was Congress's express intent in passing the '06 E&WDA to address all project-level shifting of funds, regardless of characterization, and to make clear that they should be treated as "reprogrammings" subject to the Appropriation Committee notice requirements:

The Committee believes the Corps' execution of Congressionally directed projects through its liberal use of reprogramming actions and its unbalanced emphasis on annual expenditures exhibit ongoing disregard of the **specific program and project allocations** provided by the Congress each year in report language.

Id. (emphasis added). Congress left little doubt that its restriction of the movement of reserved funds within the COE applies on an individual contract basis:

The Corps abrogates its management responsibilities and improperly intrudes upon Congressional prerogatives in determining annual appropriations levels when the Corps reserves insufficient funds to cover the work performed each fiscal year through the duration of **the contract** or when it makes available funds, through reprogramming, in excess of the amounts **reserved in such contracts** or appropriated in any fiscal year because of unbudgeted accelerated contractor earnings.

Id., at 15 (emphasis added).

The restrictions on reprogrammings have been carried through with minor modifications in subsequent Energy and Water Development Appropriations bills, the most recent being that contained in the 2008 Omnibus Appropriations Bill. In Division C of that Bill, regarding E&WDA projects, section 101(a) sets thresholds for reprogrammings. For investigations, reprogramming is allowed of 25 percent of project funds, up to \$150,000;

for construction projects, reprogramming is allowed of 15 percent of project funds, up to \$3 million; for operations and maintenance, reprogramming is unlimited for emergency response activities (a byproduct of Hurricane Katrina activities), but is limited to 15 percent of base funds, up to \$ 5 million. Continuing contracts remain highly disfavored under the '08 E&WDA, however: "None of the funds made available in this title may be used to award any continuing contract or make modifications to any existing continuing contract that commits an amount for a project in excess of amounts appropriated for that project that remain unobligated, except that such amounts may include any funds that have been made available through reprogramming to that project pursuant to section 101 of this Act."

COE guidance on the '06 E&WDA

On December 31, 2005, the COE issued Engineering Circular 11-2-189, "to ensure that execution of [FY] 2006 annual appropriations is conducted in accordance with [the '06 E&WDA]." EC 11-2-189, para. 1. On April 22, 2006, the COE issued a *Memorandum for Commanders/Directors* that further bolstered the guidance in the Engineering Circular. In its Engineering Circular, the COE noted that, "[t]o ensure adherence to the directions of Congress, the Corps must substantially change its Civil Works business processes." EC 11-2-189, para. 5. Accordingly, "reprogrammings will not exceed the limits established by P.L. 109-103(a)(5) . . . without prior notification of the House and Senate Committees on Appropriations." *Id.* at para. 5.b; *see also id.* at para. 10.d.6 (acknowledging \$2 million limit to unauthorized reprogrammings). The COE expressed no doubt as to the impact of the '06 E&WDA on projects already in existence: "This guidance replaces the past practice of allowing temporary 'cash flow' reprogrammings from PPAs that will require the funds some time later, and is effective for all reprogrammings that have been accomplished since enactment of P.L. 109-103 (19 November 2005)." *Id.* at para. 10.a; *see also id.* at para. 11.a.2. ("[T]he Corps can not . . . reserve an additional amount in an **existing** continuing contract in excess of the amount appropriated for the project in P.L. 109-103, plus any permitted reprogramming This restriction on the use of the continuing contract applies to both new awards **and existing continuing contracts.**") (emphasis added).

In its April 22, 2006 *Memorandum*, the COE was even more adamant about the effect of the '06 E&WDA on existing continuing contracts: "In light of the legal restrictions on continuing contracts, the Corps must change its implementation of existing continuing contracts." *Memorandum*, at para. 2.b. The COE set out three options where fiscal year funds will be exhausted for existing contracts using the true continuing contracts clause, in order of precedence: (1) negotiation of a contract modification to limit the government's liability to available fiscal year funds, (2) "seek[ing] approval to reprogram and add additional funds to the project, . . . [as] limited by Section 101 of P.L. 109-103[.]" and (3) termination and reprourement as a fully funded contract. *Memorandum*, at para. 4.a. Because the first option would change the risks to the contractor by eliminating the assurances of the old true continuing contracts clause, that option requires negotiation of a bilateral modification; the *Memorandum* specifically prohibits replacing the 52.232-5001 clause through unilateral modification. *Id.* at para. 4.d (providing that the Continuing Contracts clause "must be replaced through a bilateral modification; a unilateral

modification is not sufficient.”). Further, Section 4(c) of the Memorandum directs the Corps that “unless you have approval to continue the contract as a continuing contract pursuant to paragraph 5c of the EC, you **must delete the continuing contract clause from the contract.**” [Emphasis added].

Accordingly, no longer can the COE reprogram funding for a contract at a level of more than \$2 million by a unilateral contract modification, without approval by the House and Senate appropriations committees, as required by the ‘06 E&WDA, the Engineering Circular, and the *Memorandum*. Nevertheless, in some post-‘06 E&WDA contracts, the COE has insisted that it has the right for individual contracts within one larger general appropriation line-item to conduct a unilateral modification beyond this threshold, “pursuant to 52.232-5001” – the very continuing contracts clause that the COE has determined may no longer be relied upon in light of the ‘06 E&WDA. Indeed, the provision in 52.232-5001 that allows for reprogramming, subsection (d), allows for such unilateral reprogramming only upon notification of the contractor by the contracting officer. This runs afoul of the directive in the ‘06 E&WDA that reprogramming of amounts more than \$2 million must also have the approval of the appropriations committees. If such approval is lacking, the COE’s reprogramming beyond the \$2 million threshold falls outside the now-narrowed exception to the Antideficiency Act.

The COE has attempted to get around the requirements for either Congressional approval or bilateral modification through categorizing the shifting of funds among contracts within a single appropriation line-item as mere “reallocation.” The COE’s own guidance on implementation of the ‘06 E&WDA, however, refutes the attempt to distinguish a “reallocation” from a “reprogramming” subject to the Act’s restrictions: “Reprogramming is **any reallocation** of funds into or from a [program, project, or activity]. There are no distinctions made for prior year restorations or revocations. **All are considered reprogramming actions.**” Engineering Circular No. 11-2-189, at ¶ 10.b.3 (Dec. 31, 2005) (emphases added).

Accordingly, when engaged in takeover agreement negotiations on COE-administered contracts, sureties should be vigilant with regard to the following conditions: (1) whether the COE has de-obligated funds from the contract during the current fiscal year; and (2) whether there are sufficient contract funds to complete the work required for the current fiscal year without the COE engaging in a “reprogramming” or a “reallocation” of funds beyond the \$2 million threshold established in the ‘06 E&WDA.