UNILATERAL MODIFICATION OF FUNDING CLAUSE BY AGENCY IS A BREACH OF CONTRACT, NOT A PROPER CHANGE ORDER

This blog recently discussed the limits of the use of the Changes Clause in a contract, noting that the clauses at Federal Acquisition Regulation ("FAR") 52.243-1 through FAR 52.243-7 (Changes) are limited to the specific changed situations described in each clause, and *cannot* be used to change terms and conditions, including the payment clause of the contract. See "Changes Clause Can't Be Used To Change terms and Conditions, Including Payment Clause" (Nov. 6, 2017). Now comes a later case where the Armed Services Board of Contract Appeals ("ASBCA" or "Board") clearly states that an agency's unilateral modification of a contract's funding clause constitutes a breach of the contract. *Kelly-Ryan, Inc.*, ASBCA No. 57168, Dec. 5, 2017.

Kelly-Ryan was awarded a contract by the U.S. Army Corps of Engineers ("Corps") to construct harbor improvements (civil works) at a remote location in Alaska. The contract included a payment clause known as the "Continuing Funding Clause" (EFARS 52.232-5001) that permitted the contractor to work beyond the funds actually allotted for a fiscal year. The clause stated that "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….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."

After the Contract had been awarded, the Congress enacted the Energy and Water Development Appropriations Act of 2006, Pub. Law No. 109-103, which included new legal limitations that severely constrained many of the Corps' procedures used in the execution of the contract, including the Continuing Funding Clause. The Corps Headquarters advised its staff that with respect to existing continuing contracts, there was a "bilateral agreement" with contractors based on the Continuing Funding Clause, and the Corps could not unilaterally modify existing contracts to require contractors to work within funds reserved in compliance with the new limitations contained in Pub. L. No.109-103. The Corps Headquarters directed contracting officers to negotiate with the contractors and reach agreement to modify the contracts to limit the Government's liability to funds currently available in FY 2006. The Corps noted that limiting the Government's liability in this manner would increase the contractor's risk and, therefore, was likely to increase the cost of the contract and could create schedule problems. The Corps directed the contracting officers to work this issue out with the contractor, and if not possible, to terminate the contract.

As part of the change required by Pub. Law 109-103, the Corps drafted an Incremental Funding Clause to replace the Continuing Funding Clause. The Incremental clause does not permit the contractor to work beyond the amount reserved and expressly requires the contractor to stop working when funds are exhausted. Since the clause limits the amount payable to the contractor and requires the contractor to stop work, contractors' estimates were expected to increase their prices in order to account for this increase in risk. Under the Incremental Funding Clause, the

government's liability for termination costs was limited to the amount reserved on the contract. In contrast, under the Continuing Funding Clause, the government was responsible for all costs pursuant to the termination for convenience clause regardless of the amount reserved on the contract.

Instead of negotiating with Kelly-Ryan, Inc. to make the switch to the Incremental Funding Clause, the Contracting Officer used a unilateral modification, without the agreement of the contractor. Kelly-Ryan sought approximately $30 million in a claim for delay and cost overruns in the planning and construction of the harbor improvements. When the Corps denied the claim, Kelly-Ryan appealed to the ASBCA, asserting that the Corps had breached the contract.

The Board held that there were very significant differences between the Continuing Funding Clause and the Incremental Funding Clause that replaced it. When the contracting officer made the switch without attempting to negotiate a bilateral modification, the Corps reduced its own contractual obligation without giving any valuable consideration in return to Kelly-Ryan. This was, according to the board, "the very definition of a material breach of an express term of the contract." In addition, the Board's change in the clause breached the Corps' implied duty of good faith and fair dealing because the Corps was aware of the need for a change in policy regarding the funding of the continuing contracts *before it awarded Kelly-Ryan's contract*, but never so advised the contractor. The Board called this a "bait and switch" tactic which was a breach of the implied duty of good faith and fair dealing. Ultimately, the Board awarded Kelly-Ryan $20.7 million in breach damages, based on "restitution" (giving the contractor the benefit of the bargain).

Takeaway: Two thoughts:
(1) Contracting Officers should advise contractors during the bidding phases of *reasonably expected* changes in the law or policy, so there is no need for "bait and switch" after the contract is awarded; and
(2) Changes in the payment terms of a contract cannot be made by unilateral change order—they must be made through a bilateral process that gives the contractor an opportunity to seek consideration (payment) where their payment rights are significantly affected. No contracting officer should issue unilateral change orders *except* in areas where the clause in the contract discussing such orders explicitly permits a change. And payments are not included in the modification clauses at FAR 52.243-1 through FAR 52.243-7.