

Managing the Effects of Inflation with Existing Fixed-Price Contracts: Extraordinary Circumstances, Extraordinary Relief

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Monetary inflation effectively imposes a tax on just about everything we purchase. But for many years, inflation was so muted and gradual that the economy could manage it with minimal disruption or personal hardship. Recently, and for reasons that are both controversial and beyond the scope of this article, the American economy has been suffering an inflationary fever affecting individuals and businesses alike. This includes Government contractors performing fixed-price contracts. For a time, it was unclear whether high inflation would be just a transitory spike, or something longer-lasting.

During this period of uncertainty, the U.S. Department of Defense (DOD), as recently as May 2022, took a hard line against inflation relief for contractors signed up to firm fixed-price (FFP) contracts:

Unlike contractors performing under [flexibly-priced contracts], contractors performing under firm-fixed-price (FFP) contracts generally must bear the risk of cost increases, including those due to inflation. In the absence of an applicable contract clause, such as an [economic price adjustment (EPA)] clause authorizing a contract price adjustment as a result of inflation, there is no authority for providing contractual relief for unanticipated inflation under an FFP contract.

(Memo, May 25, 2022, Principal Director, Defense Pricing and Contracting (DPC).)

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Something has changed. As reported in a recent Wiley Alert, DOD may be softening this strict stance. Perhaps due to prolonged inflationary pressure, by a policy change embodied in another DPC guidance memo issued on September 9, DOD signaled a change of course. In this latter memo, DPC said that “there may be circumstances where an accommodation can be reached by mutual agreement of the contracting parties, perhaps to address acute impacts on small business and other suppliers.” DPC suggested “schedule relief” as one such “accommodation.” The efficacy of such relief to dampen inflationary impacts seems unclear. But the memo noted, more helpfully – and provocatively – that for “extraordinary circumstances where contractors have sought or may seek an upward adjustment to the price of an existing firm-fixed-price contract to account for current economic conditions,” the military departments can provide extraordinary relief. The memo says that such relief is available under Public Law 85-804, as implemented by the Federal Acquisition Regulation (FAR) Part 50 and the DOD FAR Supplement (DFARS).

Typically used to mitigate elevated risks for certain types of contracts (such as those involving ultra-hazardous work or cutting-edge anti-terrorism technology), Public Law 85-804 gives DOD power “to enter into, amend, and modify contracts, without regard to other provisions of law related to making, performing, amending, or modifying contracts, whenever the President considers that such action would facilitate the national defense.” Executive Order 10789 delegates this authority to various agencies, including DOD. FAR 50.101-1(a)-(b).

This all sounds good, but use of this relief to mitigate the effects of inflation will doubtless seem to Government personnel to be uncharted waters, and money is never plentiful enough to meet all needs. Also, agency officials know that their actions are open to second-guessing, audit, and criticism. Finally, contract price relief must be approved at the secretarial level. FAR 50.102-1(c). So we should therefore expect program and contracting officials to act warily.

How can a contractor get relief? To start, a request for it should have at least as much support as any certified claim. Most long-term contractors know how to file a claim. But to best position yourself to get a piece of the extraordinary relief pie, there are several unique, important considerations:

- **Know the Rules.** Each agency has its own way to process 85-804 requests. For DOD overall, that is PGI 250.1, and the military departments each have their own processes, to include departmental “contract adjustment boards” to make recommendations to service secretaries. Learn the rules and draft the request to fit them. Make the deciding officials’ jobs easier.
- **National Defense Must Be the Reason.** Regardless of how meritorious a contractor’s request may be from an economic hardship standpoint, agencies may only approve extraordinary relief that “will facilitate the national defense.” FAR 50.102-3(b)(1). That is an easier argument to make when seeking relief from extreme economic risk from highly hazardous work such as in the nuclear, biological, and chemical fields. Not so easy for an IT services contract. We hope there will be guidance from DOD to help understand what the interests of national defense are in the context of less hazardous contracts. But in the meantime, potential requesters should think about how to justify relief as “facilitat[ing] the national defense.” Some considerations may include preservation of competition within the industrial base, or the ability to continue important research and development work.

- **Cause and Effect.** Even for seemingly worthy cases, agencies are unlikely to support requests based on a “total cost” quantum – i.e., one which assumes, without support, that all losses or cost increases are due to inflation. So make sure, and be ready to show, that the economic harm or overrun is actually traceable to elevated inflation, rather than “bid-misses” in the proposal, failure to perform efficiently, or to some other cause unrelated to inflation.
- **It Must Be a Last Resort.** Before seeking relief, the requester must analyze the contract for other possible means to address the problem, to make sure that no “other adequate legal authority exists within the agency.” FAR 50.101-2. These could include contract rescission, or reformation for mutual mistake through a certified claim under the Disputes Clause.
- **Make Haste Slowly.** Companies are feeling the inflationary pressure and need to act quickly. But agency officials will be cautious. So it is best to at least have informal talks with key agency contacts as soon as possible, to assess the customer’s openness to giving relief and the available resources.
- **Brace for a Rigorous Audit.** Finally, contractors should assume that the Defense Contract Audit Agency (DCAA) will aggressively and intrusively audit any Public Law 85-804 requests. For such requests, the DCAA Contract Audit Manual (CAM) provides 10 additional factors *beyond those normally considered for claims*. CAM § 12-900 Section 9. These include, for example, the contractor’s overall financial position, its net working capital changes since contract start, and the compensation paid to key personnel. Know what the auditors will want to see; use the knowledge to assess the merits of the request; and, if submitted, include relevant information up front if appropriate.

It’s difficult to say how long high inflation will persist. Beyond extraordinary relief for current contracts, when competing for new contracts, offerors should more carefully consider year-over-year cost escalation, and more rigorously document any assumptions about inflation in proposals and proposal backup. But for contractors feeling a major inflationary pinch, especially those for whom inflation-impacted projects might represent a life-or-death matter for the company, DOD’s change of course may offer hope. It will likely, however, only help those who understand the process for seeking relief and do the hard work to prove that their cases are truly “extraordinary.”