THE NASH & CIBINIC REPORT

government contract analysis and advice monthly from professors ralph c. nash and john cibinic

Author: Ralph C. Nash, Professor Emeritus of Law, The George Washington University
Contributing Authors: Vernon J. Edwards and Nathaniel E. Castellano

OCTOBER 2024 | VOLUME 38 | ISSUE 10

¶ 57 POSTSCRIPT: FOLLOWING THE RULES ABOUT PERFORMANCE INCENTIVES

Vernon J. Edwards

In our September issue, Ralph wrote about the Armed Services Board of Contract Appeals' decision in the matter of *Red Bobtail Transportation*, ASBCA 63771, 24-1 BCA ¶ 38,591, 2024 WL 2873960. See *Performance Incentives: Follow the Rules*, 38 NCRNL ¶ 50. That case involved a firm-fixed-price "performance-based" contract for transportation services in Afghanistan that was awarded in 2014 by the United States Transportation Command (USTRANSCOM).

The contract was for transportation orders to various places in Afghanistan. Each order specified a required spot date (RSD), required load date (RLD), and required delivery date (RDD). As quoted by the board, the contract performance work statement provided as follows with respect to late deliveries:

> For each mission, missing RSD, RLD, or RDD (RDD when not exclusively caused by APPF [the Afghan military]) constitutes as one point each (each point earned is a 25% full pay reduction) resulting in a possible maximum of 75% full pay deduction for missing all three (RSD, RLD, and RDD). However, in the event the missed RDD was exclusively caused by APPF, in lieu of the 25% full pay reduction for missing the RDD provided above, the reduction for missing the RDD will be applied in the following manner:
>
> Cargo delivered one day beyond the RDD—the contractor's rate will be reduced by AFN [the Afghan currency] 3,190.00 per invoiced escorted mission unit. This reduction will be applied before any percentage reductions.
>
> Cargo delivered two or more days beyond the RDD—the contractor's rate will be reduced by AFN 6,380.00 per escorted mission unit. This reduction will be applied before any percentage reductions.
>
> In the event the contractor missed the RDD for a combination of reasons, of which one includes APPF, the AFN 3,190.00 or AFN 6,380.00 stated above no longer applies and the contractor shall receive a one point reduction (25%) for missing the RDD. It is the contractor's responsibility to prove to the Government's satisfaction that delays were caused solely by APPF and that delay was directly related to missing the RDD. If the contractor is unable to clearly demonstrate with adequate documentation that APPF was solely at fault for missing the RDD, a one point reduction (25% of the full pay) applies for missing the RDD.

> For example: Missing RSD, but meeting RLD and RDD equals 1 point. Missing RSD and RDD (not exclusively caused by APPF), but meeting RLD equals 2 points or a 50% full pay reduction). In the event the contractor misses RDD by one day exclusively caused by APPF and earns one point as described above, the AFN 3,190.00 shall first be subtracted from the total mission price prior to applying the percentage reduction.
>
> For example: Contractor A had a mission from ING to KIL for six (6) MUs valued at AFN 100,000.00. The mission was completed and the customer received their equipment in proper condition. Contractor A failed to meet RSD, but met RLD and RDD. For missing RSD, this is a Failed/Partial Pay mission and the Contractor has one (1) point. The Contractor will be paid AFN 75,000.00 (100,000 x 75%).

Hereinafter we will refer to that text as the *PWS deduction procedure*.

The Government ultimately deducted more than $100,000 from the contractor's invoices due to late deliveries (RDD). The contractor objected that the PWS deduction procedure was a liquidated damages provision and that the amounts deducted were not a reasonable measure of the Government's damages and thus were punitive. The contractor filed a claim and appealed to the ASBCA after the Contracting Officer's denial.

The Government argued that the PWS deduction procedure was not a liquidated damages provision, but a "negative performance incentive," as mentioned in Federal Acquisition Regulation 11.501 and 16.402-2. The board reviewed the PWS deduction procedure and the FAR provisions and, in a rather murky conclusion, ruled that the procedure was an "unenforceable penalty." A footnote to the decision stated: "To be clear, we are not holding that the challenged provisions of the PWS would be unallowable in all circumstances; merely that the arguments presented by the government here, in this non-precedential case, did not persuade us that the negative incentive was permissible."

What Are Negative Performance Incentives?

FAR Subpart 16.4 addresses incentive contracts. It distinguishes subjective ("award fee") and objective ("predetermined, formula-type") incentives. Among predetermined formula-type incentives, the FAR further distinguishes among cost incentives, performance incentives, and delivery incentives. FAR 16.402-2, *Performance incentives*, states:

> (a) Performance incentives may be considered in connection with specific product characteristics (*e.g.*, a missile range, an aircraft speed, an engine thrust, or a vehicle maneuverability) or other specific elements of the contractor's performance. These incentives should be designed to relate profit or fee to results achieved by the contractor, compared with specified targets.
>
> (b) To the maximum extent practicable, positive and negative performance incentives shall be considered in connection with service contracts for performance of objectively measurable tasks when quality of performance is critical and incentives are likely to motivate the contractor.

FAR 16.402-3, *Delivery incentives*, states:

> (a) Delivery incentives should be considered when improvement from a required delivery schedule is a significant Government objective. It is important to determine the Government's primary objectives in a given contract (*e.g.*, earliest possible delivery or earliest quantity production).
>
> (b) Incentive arrangements on delivery should specify the application of *the reward-penalty structure* in the event of Government-caused delays or other delays beyond the control, and without the fault or negligence, of the contractor or subcontractor. [Emphasis added.]

The distinction in FAR 16.402 between performance and delivery incentives is not sharp, since a performance incentive could apply to (a) "product characteristics" or (b) "other specific elements of the contractor's performance," the latter of which might conceivably include timeliness of delivery. But the incentives described in FAR Subpart 16.4 are profit or fee incentives. They do not involve deductions from a contractor's invoices due to unacceptable performance or late delivery, which are different matters. The *Red Bobtail* contract made no mention of an incentive, and the "negative performance incentive" defense seems to have been a case of grasping at straws. In any case, it is not clear why the Government did not argue that the PWS deduction procedure was a delivery incentive rather than a performance incentive, since it applied to delivery and FAR 16.402-3(b) clearly refers to a reward/penalty arrangement in delivery incentives.

How Do Negative Incentives Work?

One can find references to negative incentives in a number of fields of interest. An AI app defined "negative incentive" as follows:

> A negative incentive is a consequence *or penalty* designed to discourage specific behaviors or actions. It often involves the imposition of a cost or a loss that follows a particular decision, prompting individuals or organizations to avoid undesirable actions in order to escape the negative outcome. Examples of negative incentives include fines for violating laws, increased taxes for certain behaviors, or loss of privileges for breaking rules. [Emphasis added.]

Mention of "negative performance incentives" was added to the FAR in 1997, Federal Acquisition Circular (FAC) 97-01, 62 Fed. Reg. 44813 (Aug. 22, 1997), but without description or explanation, and the FAR had to be amended in 2000 to make it clear that negative performance incentives are not liquidated damages, FAC 97-19, 65 Fed. Reg. 46064 (July 26, 2000). See FAR 11.501(b).

How do negative performance incentives work? Since the 1980s, the Air Force, the National Aeronautics and Space Administration, and the National Oceanic and Atmospheric Administration have used negative performance incentives in contracts for satellites. See Government Accountability Office, *Satellite Acquisitions: Agencies May Recover a Limited Portion of Contract Value When Satellites Fail*, GAO-17-490 (June 9, 2017), which describes one positive-negative orbital incentive as follows:

> On-orbit incentives are typically documented in a satellite contract's fee plans or in contract clauses. There are generally three mechanisms for on-orbit performance incentives: negative incentives, positive incentives, and withholding of milestone payments. Agencies can use a combination of these when designing on-orbit incentives, which are generally tied to objective performance criteria, such as successfully getting into the right orbit and achieving critical performance parameters once there.
>
> When using negative incentives, the government generally pays the contractor incentives as the contractor completes work during the development or production phase. The contractor would have to pay back some or all of the incentives if the satellite fails to meet on-orbit performance parameters. With positive incentives, the government assesses satellite performance in any given period, such as 6 or 12 months, to determine how much the contractor earns for that period. The amount at risk for the contractor could be the same for a positive incentive or a negative incentive.
>
> Firm-fixed-price contracts for satellite programs may have progress or performance-based payment plans that require fixed payments to be made upon successful completion of milestones, such as preliminary design review, final system test, and successful on-orbit check-out. If a satellite fails prior to checkout, the government may withhold the final milestone payment from the contractor.
>
> * * *
>
> The WGS [Wideband Global SATCOM] Block II and Block II follow-on contracts have a unique on-orbit

incentive structure that includes a 10-year negative incentive followed by a 4-year positive incentive for the satellite's 14-year mission life. The negative incentive includes calculations to determine how much money the contractor has to pay the government if its satellite fails to meet performance requirements during the first 10 years. The positive incentive, starting at year 11 of the satellite's mission life, allows the contractor to offset any negative incentives assessed during that satellite's first 10 years. At the end of 14 years, the government adds up the positive and negative incentive amounts to determine what, if anything, the contractor has to pay back.

Besides FAR 16.402-2, the only other provisions in the entire FAR System (48 CFR) that mention negative performance incentives are in the NASA FAR Supplement (NFS) at NFS 1816.402-270, 1852.216-85, and 1852.216-88. According to NFS 1816.402-270:

(a)…*Performance incentives, which are objective and measure performance after delivery and acceptance, are separate from other incentives, such as cost or delivery incentives*.

(b) When a performance incentive is used, it shall be structured to be both positive and negative based on performance after acceptance, unless the contract type requires complete contractor liability for product performance (*e.g.*, fixed price). In this latter case, a negative incentive is not required. In structuring the incentives, the contract shall establish a standard level of performance based on the salient performance requirement. This standard performance level is normally the contract's target level of performance. No performance incentive amount is earned at this standard performance level. Discrete units of measurement based on the same performance parameter shall be identified for performance above and, when a negative incentive is used, below the standard.…

(c) The final calculation of the performance incentive shall be done when performance, as defined in the contract, ceases or when the maximum positive incentive is reached. When performance ceases below the standard established in the contract and a negative incentive is included, the Government shall calculate the amount due and the contractor shall pay the Government that amount.…[Emphasis added.]

See also Space and Missile Systems Center (SMC) Incentive Guide 42 (Mar. 7, 2007), https://www.dau.edu/sites/default/files/Migrated/CopDocuments/SMC%20Incentives%20Guide%207Mar07a.doc;

Schedule can be incentivized as either a negative or positive incentive. A pool of money can be provided as a reward for completing a task or tasks early. Early completion needs to be in the Government's best interest, have some distinct benefit, and be achievable. A cost/benefit analysis should be performed if reward dollars are to be provided for early delivery (*i.e.*, benefit of early delivery outweigh the dollars). Money can be withheld or reduced for late performance or delivery.

Negative Incentives? Damages? Penalties?

Here is a simple proposition. A contract specifies the rights and obligations of the contracting parties. Broadly, failure to fulfill one's obligations without contractual excuse is breach of contract. If the breach is material, then the injured party may be discharged from its obligations and may seek damages. Damages must be reasonable, not punitive. See Restatement (Second) of Contracts § 355 (1981). So far, so good.

In Government contracting a "negative performance incentive," as referred to in FAR 16.402, should motivate a contractor to perform above the level of minimally acceptable performance by offering more money for a better outcome. The ASBCA's *Red Bobtail* decision raises the question: *When is a negative incentive really an impermissible penalty?* See Farnsworth on Contracts 4th ed., at 811: "To what degree is the law of remedies for breach of contract amenable to contrary agreements by the parties? Compared with the extensive power that contracting parties have to bargain over the substantive contract rights and duties, their power to bargain over their remedial rights is surprisingly limited."

First, it seems to us that an incentive should function only within a range of acceptable performance. See FAR 46.501, *Acceptability*: "Acceptance constitutes acknowledgment that the supplies or services conform with applicable contract quality and quantity requirements, except as provided in this subpart and subject to other terms and conditions of the contract." We do not think a negative incentive should apply to any performance that fails to conform to a contract requirement. It should not be designed to be a remedy. It should not involve invoice deductions or paybacks. Rather, a negative incentive should be a lost opportunity. It should deprive the contractor of the chance to earn more money, either a higher price under a firm-fixed-price contract or a higher fee under a cost-reimbursement contract.

Second, the incentive payoff should be structured as a function of performance within a range running from that which is acceptable to that which is maximally beneficial to the Government, while being both cost effective and feasibly achievable. Structured in that way the incentive will be both positive and negative depending on the performance trend. The incentive should not involve deductions from invoices or paybacks. When used in a firm-fixed-price contract, the incentive could be structured as a scale of prices, running from a low price set for minimally acceptable performance through a series of price increases leading to a maximum price for the best desired performance. Such a scheme would constitute a positive/negative performance incentive as we envision it. Failure to perform at a higher level would negate the opportunity to make more money.

Conclusion

We could use some clarification of the concept of negative incentives in contracts. But they have been in use in various forms and guises for decades without causing much trouble, and the FAR councils are so overwhelmed with pending FAR changes that they are unlikely to devote any time to it, even if they were capable. Besides, the FAR is not a textbook. Any agency that plans to include any kind of negative incentive in a contract should do some thinking in light of the general prohibition against penalties provisions in contracts. Any incentive that provides for deductions from amounts claimed due by a contractor based on performance or delivery shortfalls may be vulnerable to challenge. *VJE*