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**DoD contract termination liability: an analysis  
of the special termination cost clause (STCC)**

Rendon, Rene G.; Mutty, John

Monterey, California. Naval Postgraduate School.

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## ACQUISITION RESEARCH SPONSORED REPORT

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**DoD Contract Termination Liability:  
An Analysis of the Special Termination Cost Clause (STCC)**

**30 September 2006**

**by**

**Dr. Rene G. Rendon, Lecturer, Naval Postgraduate School**

**John Mutty, Senior Lecturer, Naval Postgraduate School**

Approved for public release, distribution unlimited.

Prepared for: Naval Postgraduate School. Monterey. California 93943



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# Abstract

This research paper explores the Department of Defense (DoD) policies and practices for managing contract termination liability. The specific purpose of the research is to review current policies, practices, and procedures for funding and managing contract termination liability within the DoD. The research proposes alternative approaches for improving the DoD's ability to manage contract termination liability and discusses the resulting effect of each alternative on defense acquisition practices. First, we provide a brief review of regulatory and policy guidance on contract termination liability as reflected in the *Federal Acquisition Regulation (FAR)* and the *Financial Management Regulations (FMR)*. We then discuss the current practices and procedures for funding and managing contract termination liability and identify results from interviews and document reviews with various Air Force, Navy, Army, and other DoD agencies. Next, we present program management challenges and preliminary observations and findings based on our research of current contract termination liability policies and real-world practices. A discussion of alternative approaches to funding contract termination liability is then presented, including the use of Special Termination Cost Clauses (STCC). Finally, this research concludes with a summary and recommendations on how the DoD can improve the policies and practices for managing contract termination liability.

**Key Words:** contract management, contract termination liability, termination liability funding.



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Disclaimer: The views represented in this report are those of the authors and do not reflect the official policy position of the Navy, the Department of Defense, or the Federal Government.



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# Executive Summary

This research paper explores the Department of Defense (DoD) policies and practices for managing contract termination liability. The specific purpose of the research is to review current policies, practices, and procedures for funding and managing contract termination liability within the DoD. The research then proposes alternative approaches for improving the DoD's ability to manage contract termination liability and discusses the resulting effect of each alternative on defense acquisition practices. Finally, this research concludes with a summary and recommendations on how the DoD can improve the policies and practices for managing contract termination liability.

This research found that the regulations and policies pertaining to the management and funding of contract termination liability are inconsistent and subject to interpretation. Program managers, finance and budget managers, and contracting officers have differing interpretations of the requirement for funding contract termination liability. Furthermore, the practices and procedures used in defense acquisition program offices reflect this inconsistency.

A review of current practices and procedures for funding and managing contract termination liability and historical data of past contract terminations found that the probability of a contract termination for convenience is very small, and program managers' approaches to managing contract termination liability reflects this probability. The normal procedure for handling the potential liability associated with a contract terminated for convenience is to "budget" for the liability. Then, in coordination with the contractor, the required amount of funding is tracked on a regular basis. In this case, budgeting for Termination Liability does not mean obligating funds specifically for that purpose.

Interviews with various acquisition program offices indicate that program managers are generally satisfied with the current method for managing contract



termination liability because the procedure they currently use to handle contract termination liability allows them to keep all of the funding appropriated for their program. Furthermore, program managers are not in favor of a “tax” that would negate the requirement to budget for contract termination liability. A tax would deprive them of funds that they currently have at their disposal. Additionally, if all programs were taxed, there is a general concern that the pooled funds would likely be lost—either the military Departments (or DoD) would use them to solve other problems if they were not required to cover a liability, or Congress would look upon the funds that had been set aside as a “slush fund,” making them tempting for other uses.

Interviews also indicated that support for increased use of STCCs is not evident, either at the program level or the OMB or Congressional level. Congress has expressed its concern through report language. OMB correspondence has indicated that support for more than one STCC per service is unlikely. However, it should be noted that those programs that have significant funding problems and/or are concerned about the possibilities of termination do support additional use of STCCs. In fact, these programs would prefer to have a STCC that covers more cost elements than the standard STCC.

Finally, this research concluded with the following recommendations for the DoD’s management of contract termination liability: 1. Remove the ambiguity and improve the consistency in the regulations pertaining to the management of contract termination liability; 2. Refrain from imposing a tax system to provide funding for potential contract termination liability; and, 3. Continue to use STCCs for the larger programs with funding or longevity concerns.



# Introduction

The purpose of this research is to explore current Department of Defense mechanisms for addressing contract termination liability, review current practices and procedures for funding and managing Termination Liability, and propose alternative approaches to improve the DoD's ability to manage Termination Liability and its effect on defense acquisition programs. First, a review of regulatory and policy guidance on contract termination liability is presented. Next, a review of current practices and procedures for funding and managing Termination Liability is discussed, based on interviews and document reviews with various Air Force, Navy, and other DoD agencies. Program management challenges and preliminary observations and findings are then presented. Alternative approaches to funding Termination Liability are discussed, including the use of Special Termination Cost Clauses (STCC).<sup>1</sup> Finally, a summary and recommendations are presented.

## Regulatory and Policy Guidance

This section of the research report focuses on the regulatory and policy guidance on Termination Liability and the Special Termination Cost Clause (STCC). The regulatory and policy guidance covering Termination Liability (and, specifically, Special Termination Cost Clauses (STCC)) is found in the DoD *Financial Management Regulation (FMR)* and the *Defense Federal Acquisition Regulation Supplement (DFARS)*. In addition, the Air Force *Financial Management Regulation* is also discussed as an example of Agency-specific guidance on contingent liability.

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<sup>1</sup> DoD *FAR* Parts 249.50170 and 252.249-7000 permit the use of Special Termination Cost Clauses (STCC) in fixed-price incentive contracts and incrementally funded cost reimbursement contracts. If contracts containing a STCC are terminated before completion, the special termination charges are covered by the unobligated balance of the applicable appropriation, subject to any congressional approval required for reprogramming. The extent to which the STCC can be used is limited to the ability of the Service or Agency to cover expected termination costs from unobligated balances. All STCCs, regardless of dollar amount, require prior notification of the House and Senate Appropriations Committees.





## Termination Liability

The DoD *Financial Management Regulation (FMR)* defines Termination Liability as:

The amount of prepayments that cover payments required by the contract, and any damages and costs that may accrue from the cancellation of such contract. Funds prepaid for Termination Liability will convert to cover actual expenditures in the event that the contract not be terminated prior to performance completion. Termination Liability may not apply to articles/services provided under other authorities of the Foreign Assistance Act or AECA. (DoD, 2006c, Vol. 15)

The *Financial Management Regulation (FMR)* categorizes Contingent Liabilities (CLs) as probable, possible, or remote (DoD, 2006c). The terms probable, reasonably possible, and remote identify three areas within that range as follows:

1. Probable: The future event or events are likely to occur.
2. Reasonably possible: The chance of the future event or events occurring is more than remote but less than likely.
3. Remote: The chance of the future event or events occurring is slight.

Probable CLs must be covered by a commitment of funds. Probable CLs are most likely to become actual liabilities. Commitments are not required for possible CLs and should not be established for remote CLs (DoD, 2006c, Vol. 4, Ch. 13, pp. 241-242).

The budgeting for Contingent Liabilities is discussed in the following excerpts taken from the DoD *Financial Management Regulation*:

### Special Provisions for Determining the Amounts of Commitments

Contingent Liabilities Remaining under Outstanding Contracts. There are contingent liabilities for price or quantity increases or other variables that cannot be recorded as valid obligations in the cases of (1) outstanding fixed-price contracts containing escalation, price redetermination, or incentive clauses, or (2) contracts authorizing variations in quantities to be delivered, or (3) contracts where allowable interest may become payable by the US Government on contractor claims supported by written appeals pursuant to



the “Disputes” clause contained in the contract (see subparagraph 080202.D, below). Amounts to cover these contingent liabilities should be carried as outstanding commitments pending determination of actual obligations. The amounts of such contingent liabilities, however, need not be recorded at the maximum or ceiling prices under the contracts. Rather, amounts should be committed that are estimated conservatively to be sufficient to cover the additional obligations that probably will materialize, based upon judgment and experience. In determining the amount to be committed, allowances may be made for the possibility of downward price revisions and quantity underruns. Each contingent liability shall be supported by sufficient detail to facilitate audit. (DoD, 2006c, Vol. 3, Ch. 8, para. 080202)

### **Budgeting for Termination Liability on Incrementally Funded RDT&E Contracts**

The legal requirements of the *Anti-deficiency Act* and the long-standing policy of not committing a successor Congress to a course of action both make it necessary that the unliquidated obligation for an incrementally funded, multiple-year contract be sufficient at all times to cover the cost of terminating that contract for the convenience of the Government.

Budgeting to cover Termination Liability will not increase the total amount budgeted for the program. It will require that the distribution of funds by fiscal year be shifted more towards the earlier years of the contract than if funds had been budgeted only to cover the actual bill to be paid each year. The distribution of funds by fiscal year shall be such that, if a contract is terminated at any point during the fiscal year, all termination costs can be financed from the unliquidated obligation on the contract without recourse to reprogramming of funds, supplemental appropriations, or awaiting the appropriation of funds for the succeeding fiscal year’s funding increment. All programs shall adhere to this policy with the following two exceptions, both of which are to be used rarely.

- a. Special Termination Cost Clause (STCC). DoD *FAR* Parts 249.50170 and 252.249-7000 permit the use of STCC in fixed-price incentive contracts and incrementally funded cost reimbursement contracts. If contracts containing an STCC are terminated before completion, the special termination charges are covered by the unobligated balance of the applicable appropriation, subject to any congressional approval required for reprogramming. The extent to which the STCC can be



used is limited to the ability of the Service or Agency to cover expected termination costs from unobligated balances. A recordable obligation under the STCC arises when the contract is actually terminated. If a proposed STCC would require an above-threshold reprogramming action when a program is terminated, the approval to use the STCC shall be obtained from the USD (Comptroller) before the contract or contract modification is awarded. All STCCs, regardless of dollar amount, require prior notification of the House and Senate Appropriations Committees.

- b. Statutory Waivers. The Department is not required to budget for, or obligate funds sufficient to cover, Termination Liability in connection with an incrementally funded RDT&E contract if Congress has expressly exempted the program or contract from that requirement. When this situation arises, however, the budget exhibits for the program shall clearly indicate the value of the unfunded Termination Liability by year for the current year, budget year, and the outyears covered by the FYDP. (DoD, 2006c, Vol. 2A, Ch. 1, para. 010214)

Termination Liability is considered a contingent liability since adequate funds must be committed to cover the liabilities resulting from the termination of contracts, including any potential or Contingent Liabilities (Gill, 2003).

The DoD *FMR* explains Contingent Liabilities as follows:

Contingent Liability—The term has two meanings. As a budgetary term, it represents variables that cannot be recorded as valid obligations. Such variables include (1) outstanding fixed-price contracts containing escalation, price redetermination, or incentive clauses, or (2) contracts authorizing variations on quantities to be delivered, or (3) contracts where allowable interest may become payable by the US Government on contractor claims supported by written appeals pursuant to the "DISPUTES" clause contained in the contract. As a proprietary accounting term, it represents an obligation, relating to a past transaction or other event or condition that may arise in consequence, as a future event now deemed possible but not probable. When the liability is determined to be possible, but not probable, the potential liability is disclosed as a footnote to the financial statements. When the potential liability becomes probable, it is recorded in the accounts as a current liability or a reduction of an asset. The budget definition is the preferred usage. (DoD, 2006c, Vol. 15)

Thus, according to DoD *FMR*, Volume 2A, Chapter 1, "all termination costs can be financed from the unliquidated obligation on the contract without recourse to



reprogramming of funds, supplemental appropriations, or awaiting the appropriation of funds for the succeeding fiscal year's funding increment" (2006c). The two exemptions to this are a Special Termination Cost Clause (STCC) and a Statutory Waiver.

In addition, Volume 3, Chapter 8, Section 080512 of the DoD *FMR* states that in the case of termination of a contract, the contract shall be decreased to an amount that is sufficient to meet the settlement costs under the termination.

The Air Force Material Command (AFMC) *Financial Management Reference System* (2005, February) provided more detailed guidance on funding termination costs. The AFMC *FMRS* states the following concerning funding termination costs:

The funded activity should commit the estimated funds to cover the expected contingent liability (CL). This estimated CL amount is in excess of the contract awarded amount recorded as an obligation. The financial manager must record commitments for CLs against the applicable FY and appropriation cited on the contract. Normally, funds for CLs are maintained locally. Funds are committed for a contingent liability at the time of contract award, based on the amount provided by the contracting officer [...]. Commitments are not recorded for STCC or contingent termination liabilities. Obligations are recorded when the action to terminate is taken. (Air Force, 2005, February)

The AFMC *FMRS* further states that funds are committed for all "probable" CLs (funding for "possible" or "remote" CLs is not necessary) as defined in a matrix. "The CL Matrix is used to identify, categorize according to probability, and track CLs throughout the life of a contract [...] must be reported to SAF/FM semi-annually" (AFMC, 2005, February).

As indicated above, the DoD *FMR* refers to two exceptions to the policy of budgeting for Termination Liability. These include the Special Termination Cost Clause (STCC) and the Statutory Waiver. These will be discussed below.



## **Special Termination Cost Clause (STCC)**

Regulatory and policy guidance related to the use of Special Termination Cost Clauses is found in the DoD *FMR* (“Budgeting for Termination Liability on Incrementally Funded RDT&E Contracts,” p. 3) and the DoD *FAR*.

Although the *Federal Acquisition Regulation (FAR)* Part 49 provides guidance on contract terminations, the *Defense FAR Supplement (DFARS)* provides the guidance and prescribes the clause specifically for Special Termination Costs. The *DFARS* guidance at 249.501-70 states the following:

### **249.501-70 Special Termination Costs.**

- (a) The clause at 252.249-7000, Special Termination Costs, may be used in an incrementally funded contract when its use is approved by the agency head.
- (b) The clause is authorized when—
  - (1) The contract term is two years or more;
  - (2) The contract is estimated to require—
    - (i) Total RDT&E financing in excess of \$25 million; or
    - (ii) Total production investment in excess of \$100 million; and
  - (3) Adequate funds are available to cover the contingent reserve liability for special termination costs.
- (c) The contractor and the contracting officer must agree upon an amount that represents their best estimate of the total special termination costs to which the contractor would be entitled in the event of termination of the contract. Insert this amount in paragraph I of the clause.
- (d) (1) Consider substituting an alternate paragraph I for paragraph I of the basic clause when—
  - (i) The contract covers an unusually long performance period; or



- (ii) The contractor's cost risk associated with contingent special termination costs is expected to fluctuate extensively over the period of the contract.
- (2) The alternate paragraph I should provide for periodic negotiation and adjustment of the amount reserved for special termination costs. Occasions for periodic adjustment may include—
- (i) The Government's incremental assignment of funds to the contract;
  - (ii) The time when certain performance milestones are accomplished by the contractor; or
  - (iii) Other specific time periods agreed upon by the contracting officer and the contractor.

A review of the *DFARS* clause reveals that the clause may be used on incrementally funded contracts when: the contract term is two years or longer and is estimated to require in excess of \$25 million of Research, Development, Test, and Evaluation (RDT&E) funds, or a total of over \$100 million of production investment.

Incrementally funded contracts are those contracts in which funds are incrementally obligated throughout the period of performance. Typically, cost reimbursement RDT&E contracts are incrementally funded and require the use of the Limitation of Funds Clause at *FAR* 52.232-22. This clause requires the contractor to notify the Contracting Officer in writing whenever it has reason to believe the cost it expects to incur in the next 60 days, when added to all costs previously incurred, will exceed 75% of the total amount allotted on the contract (DoD, 2006b, 52.232-22).

Another requirement of the Special Termination Cost Clause (STCC) is that there will be adequate funds available to cover the contingent reserve liability for special termination costs.

In addition, the clause states that the contractor and the contracting officer must agree upon an amount that represents their best estimate of the total special termination costs to which the contractor would be entitled in the event of termination



of the contract. These special termination costs are identified within the *DFARS* in the actual Special Termination Costs clause as follows:

**252.249-7000 Special Termination Costs.**

As prescribed in 249.501-70, use the following clause:

**SPECIAL TERMINATION COSTS (DEC 1991)**

- (a) *Definition.* "Special termination costs," as used in this clause, means only costs in the following categories as defined in Part 31 of the *Federal Acquisition Regulation (FAR)*—
- (1) Severance pay, as provided in *FAR* 31.205-6(g);
  - (2) Reasonable costs continuing after termination, as provided in *FAR* 31.205-42(b);
  - (3) Settlement of expenses, as provided in *FAR* 31.205-42(g);
  - (4) Costs of return of field service personnel from sites, as provided in *FAR* 31.205-35 and *FAR* 31.205-46l; and
  - (5) Costs in paragraphs (a)(1), (2), (3), and (4) of this clause to which subcontractors may be entitled in the event of termination.
- (b) Notwithstanding the Limitation of Cost/Limitation of Funds clause of this contract, the Contractor shall not include in its estimate of costs incurred or to be incurred, any amount for special termination costs to which the Contractor may be entitled in the event this contract is terminated for the convenience of the Government.
- (c) The Contractor agrees to perform this contract in such a manner that the Contractor's claim for special termination costs will not exceed \$\_\_\_\_\_. The Government shall have no obligation to pay the Contractor any amount for the special termination costs in excess of this amount.
- (d) In the event of termination for the convenience of the Government, this clause shall not be construed as affecting the allowability of special termination costs in any manner other than limiting the maximum amount of the costs payable by the Government.



(e) This clause shall remain in full force and effect until this contract is fully funded.

(End of clause)(DoD, 2006a, 252.249-7000)

Thus, the Special Termination Cost Clause limits the amount of special termination (as agreed between the government and the contractor) costs that the Government is liable for in a Termination for Convenience. It should be noted that the STC clause does not apply to the regular termination costs as outlined in *FAR* 31.205-42.

### **Agency Approval for STCC**

As stated in the *DFARS* clause, the use of the STC clause is subject to approval of the agency head. A review of the various agency *FAR* supplements provides some perspective on how this approval is obtained.

The Air Force *FAR* supplement at *AFFARS* 5349.501-70 provides additional and specific policy related to the use of the Special Termination Cost Clause. *AFFARS* 5349.501-70 specifically states the following:

#### **5349.501-70 Special termination costs.**

- (a) Contracting officers shall refer to Volume 2A, Chapter 1, Section 010213, paragraph C.2 of DoD 7000.14-R, DoD *Financial Management Regulation*, for Congressional notification and additional approval requirements for Special Termination Cost Clauses (STCCs). Because STCCs require special notification to Congress and entail a long approval process over which the Air Force has little control, the contracting officer should allow SAF/AQCK sufficient time to process requests to use *DFARS* 252.249-7000, Special Termination Costs (i.e., not less than 90 days prior to contract award). The request shall include the following:
- (i) A detailed breakdown of applicable cost categories in the clause at *DFARS* 252.249-7000 (a)(1) through (5), which includes the reasons for the anticipated incurrence of the costs in each category;
  - (ii) Information on the financial and program need for the clause, including an assessment of the contractor's financial position and the impact of a failure to receive authority to use the clause; and





(iii) Clear evidence that only costs that arise directly from a termination would be compensated under the clause. Costs that would be incurred by the Government, regardless of whether a termination occurs, shall not be covered by an STCC.

(b) The contracting officer shall obtain SAF/FM approval prior to authorizing any increase in the Government's maximum liability under the clause. (Air Force, 2006, 5349.501-70)

The *AFFARS* is the only agency-level *FAR* guidance that gives more specific instruction on the coordination and review process, as well as the Congressional notification requirement for the use of STCCs. This guidance also identifies the requirement for referencing the DoD *Financial Management Regulations (FMR)* for specific notification and approval requirements.

### **Statutory Waiver**

The second exception to the Termination Liability funding policy is the Statutory Waiver. This exception is explained in the *FMR* as follows:

Statutory Waivers. If a program is exempted by Public Law from the requirement to budget for Termination Liability, the fiscal year increments may be budgeted on a pay-as-you-go basis, providing only sufficient funds to cover the disbursements expected to be made in that fiscal year. When this situation arises, however, the budget exhibits for the program shall clearly indicate the value of the unfunded Termination Liability by year for the current year, budget year, and the outyears covered by the FYDP. (DoD, 2006c)

As can be seen from the above discussion, the regulatory and policy guidance pertaining to the funding of Termination Liability and the use of STCCs is found in two different functionally oriented regulations—the *Financial Management Regulation (FMR)* and the *Federal Acquisition Regulation (FAR)*. This regulatory guidance on budgeting for contract termination liability from two different functional areas of DoD acquisition increases the potential for different interpretations or even misinterpretation of the DoD policy. These differences in policy interpretation are reflected in the practices and procedures used by the various DoD services. This evident discrepancy will be discussed next in the review of current practices and procedures for managing contract termination liability.



# Review of Current Practices and Procedures

## Air Force Space and Missile Systems Center

Interviews were conducted with contracting and financial management officials for various System Program Offices (SPOs) at the Air Force Space and Missile Systems Center. See Attachment 1 for a list of interview questions. The following SPOs were interviewed in respect to their contracts requiring Termination Liability, and the use of an STCC: SBIRS, STSS, and the Launch Vehicle program office.

### **1. Space Based Infrared Systems (SBIRS):**

The SBIRS contract (F04701-95-C—0017) requires the funding of Termination Liability (TL). The contract previously contained the *DFARS* clause 252.249-7000, Special Termination Costs (1991), but this clause was removed on 12 August 2005 with P00313 of the contract. Currently, the contract does not contain the STC clause, and the TL funds are not exclusively “fenced” apart from the obligated contract funds. In addition, the Air Force relies on the contractor to ensure that sufficient funds are available in the event of a termination.

### **2. Space Tracking and Surveillance System (STSS):**

The STSS is a Missile Defense Agency program with the contract executed by the Air Force Space and Missile Systems Center. The STSS contract does not require the funding of Termination Liability; however, it does not contain an STC clause. The obligated funds for TL are not fenced apart from the other program funds. The system program office maintains periodic communication between the PCO and the Contractor to estimate current TL requirements. In addition, the system program office uses the Contract Funds Status Report (CFSR), as one method for monitoring the amount of funds needed for Termination Liability.



### **3. Launch Vehicle Programs:**

The Launch Vehicle program contracts do require the funding of Termination Liability; however, they do not contain an STC clause. The obligated funds for TL are not fenced apart from the other program funds. The system program office maintains periodic communication between the PCO and the Contractor to estimate current TL requirements.

#### Joint Strike Fighter (JSF) Program:

The JSF program was directed to seek a waiver of Termination Liability at Milestone B. The Office of Management and Budget (OMB) refused to support a waiver of all Termination Liability but indicated that it would support an STCC.

Preparation of the STCC proved to be a fairly labor-intensive process. The estimates for those items that are allowable under an STCC are a subset of what is covered normally under Termination Liability. Both the program office and the contractor found that an STCC required calculations outside of the “norm.” The JSF program currently maintains an STCC clause.

#### Naval Sea Systems Command (NAVSEASYS COM)

The Naval Sea Systems Command has no programs with an STCC. Current practice entails the tracking of potential Termination Liability by both the program offices and the contractors on a periodic basis. Funds are identified within the contract to ensure that sufficient funding exists at all times to cover Termination Liability in the event a Termination for Convenience of the government should occur. However, funds are not set aside (committed) solely for that purpose.



## Naval Air Systems Command (NAVAIRSYSCOM)

The Naval Air Systems Command has no programs using an STCC. There is a feeling that, generally, the Comptroller is not in favor of STCCs. Current practice entails the tracking of potential Termination Liability by both the program offices and the contractors on a periodic basis. Funds are identified within the contract to ensure that sufficient funding exists at all times to cover Termination Liability in the event a Termination for Convenience of the government should occur. However, funds are not set aside (committed) solely for that purpose.

## United States Marine Corps

Our research indicated that the Marine Corps has no acquisition programs containing a STCC.

## Missile Defense Agency (MDA)/Defense Acquisition Challenge Program (DACP)

There is no clear policy as to who is responsible for the determination of a program's likelihood of termination, i.e., probable, possible, or remote possibility.

STCCs are used on a very limited basis. Partly, because there is limited experience with STCCs, the process seems long and complicated. Most program managers and contractors will be going through the process for the first and only time.

The contractor's cost-accounting system determines TL. Because a STCC covers only certain items associated with TL, the figures are not those that are normally calculated and available to the contractor/program manager.

## MDA

Boeing resisted use of STCCs with MDA initially. Program managers didn't know how to evaluate parameters (e.g., 3-6 months severance pay); however, once



such calculations were completed, the company became a supporter. The program saw an initial gain of about \$300M in available monies to run the MDA.

OSD GC's opinion was that while there is nothing statutory regarding Termination Liability, the interpretation has been that by not setting aside funds to cover TL, there is a risk that termination of a program without those funds, in essence, is committing a future Congress to spend money.

The authors' recommendation in the case of MDA is: Because large programs have multiple contracts, why not allow the program manager determine how TL will be covered rather than mandating that each contract cover its own portion?

### **Future Combat System (FCS)**

Boeing is quite enthusiastic about the STCC in the FCS program. Regarding FCS, both Boeing and the program manager would be in favor of including all TL costs—not just those included in the STCC.

Discussion items included the benefits that large development contracts would derive from an STCC. Congressional reluctance to approve STCCs does not seem to be supported by the limited frequency of program terminations. Budgeting for TL at the project level seems less efficient than at the headquarters level.

### **OSD Office of the General Counsel**

In the last three years, the USAF has drafted the most STCCs. No Navy programs utilize them, and the only Army program that the OSD Office of the General Counsel had worked on was the Comanche.

The Office cited that one major “roadblock” is the reluctance of Congress to approve an STCC.



## Summary:

Interviews with representatives from all of the services seemed to indicate levels of support for increased use of the Special Termination Cost Clause (STCC) that ranged from enthusiastic to indifferent.

For those programs that had gone through the STCC process, the support was generally quite favorable; in fact, PMs also generally favored an expansion of the cost items covered. Expanded coverage would, in turn, release more money for program execution. They were also unanimous in their observations of the difficulty of establishing a STCC both from the workload (paperwork) level to the time required to get the paperwork through the OSD, OMB and Congress.

For those activities without an STCC, there was a general indifference toward the use of such a clause. Our research did not detect a major concern for the requirement to identify funds for the possibility of funding TL. Most programs do not have a separate line-item for TL. The amount that would be required to fund TL is identified by both the program office and the contractor. That amount is compared to what is currently obligated and unobligated, and adjustments are made accordingly. Negotiations with the contractor appear to result in a “dual use” for the funds. As long as there is no indication that a termination is likely, the funds that would be needed for termination are used for program execution. In the unlikely event of a termination, the funds will be pulled back and reapplied for the contract termination.

Funding TL at the project level, especially for the programs with multiple contracts, was looked upon as overkill. It was felt that the program manager should have the flexibility to move money between contracts, as required, for those programs that were not line-item funded.

Our research/interviews identified some program management challenges pertaining to managing Termination Liability and the use of STCCs. This will be discussed in the next section.



## Program Management Challenges:

A defense acquisition Program Manager faces multiple challenges when considering the issue of Termination Liability, including determining:

- How much should be budgeted for Termination Liability?
- How should the Program Manager account for Termination Liability?
- If funding is set aside (committed) for Termination Liability, how should a program be managed with less money available than was budgeted for and appropriated by Congress?
- How should the PM determine the likelihood of a need for Termination Liability (what is the probability of the program being terminated)?
- How should a Program Manager decide whether to seek a waiver for funding Termination Liability or apply for a Special Termination Cost Clause (STCC)?

### 1. How much should be budgeted for Termination Liability?

While certain sections of the *FMR* and *FAR* would seem to leave little doubt that a program manager must budget for Termination Liability to avoid possible violation of the *Anti-deficiency Act*, it is less clear that these regulations require the actual commitment of funds solely for the purpose of assuring coverage of TL. For example, the section of the *FMR* that discusses Contingent Liabilities (see above), would lead one to the conclusion that a program with only a possible or remote chance of termination need not commit funds to cover the possibility of termination. Even though the requirement to avoid violation of the *Anti-deficiency Act* remains, there appears to be recognition that a healthy program can accommodate that statute. A PM can assure his/her program can do so through a practical accounting of funds available to manage a program, recognizing that there is only a remote chance that the program will need the same funds for a different purpose. For a program with a greater chance of termination, the program manager seems to be facing a “Catch 22.” To ensure the survivability of a weak program, every dollar available could best be used for execution of the program; yet, money is required to be committed for the possibility of program termination, thereby making it more likely



that the program will be terminated—i.e., committing funds for Termination Liability makes them unavailable for program execution at the time they are most needed.

The amount required to be committed depends on both the program manager's best estimates and the contractor's estimates. During the life of the program, the estimates will change and likely diminish as the program matures and work is performed and products or services are delivered.

## **2. How should the Program Manager account for the funding of Termination Liability?**

As the ultimate result of a budget submitted by the program manager, Congress appropriates money for a program with standard restrictions as to Purpose, Time, and Amount. These restrictions require the program manager to spend the funds for those items specified by Congress within the time limits imposed by the applicable appropriation, and in an amount not to exceed the appropriation. Congress does not provide additional funding to cover the potential liability that would occur for a program terminated for the convenience of the government. For that reason, committing funds specifically to address Termination Liability imposes a restraint on a program not envisioned by Congress. Several options would seem to exist for the PM. Funds may be committed for TL with the attendant restrictions on program execution, or the PM may track the potential requirement for TL without specifically committing funds. The latter approach provides more flexibility and allows the PM to execute his/her program in a manner consistent with both the contractor's and Congress' expectations as reflected in the budget.

## **3. If funding is set aside (committed) for Termination Liability, how should a program be managed with less money available than was budgeted for and appropriated by Congress?**

Before a budget is submitted to Congress it will already have been scrubbed, reviewed, and approved at multiple levels. The purpose of those reviews is to ensure that the program is executable and funded at the minimum level required. Unless a program manager is very lucky, little management reserve will be left by the time





his/her budget goes forward. Congress has also been known to trim money from programs for a variety of reasons, especially those programs that are considered at risk. When money is appropriated, the amount of funding is determined by the scrubbed budget. Routinely, programs are “taxed” by higher levels. Therefore, it is normal for a PM to have little flexibility in program execution. Because Congress does not appropriate additional monies to fund Termination Liability, by definition, committing funds to cover TL will leave a program short of funds.

#### **4. How should the PM determine the likelihood of a need for Termination Liability (what is the probability of the program being terminated)?**

The probability of terminating a program for convenience of the government has historically been quite low. (This will be discussed later in this report.) Most programs have gone through an intensive justification and approval process before they make it into a Service’s budget. Prior to receiving funding, they are reviewed and approved at the OSD and Congressional levels. Because of the stiff competition for resources, a program manager will normally have sufficient reason to believe that his/her program will survive if milestones are met, budgets are adhered to, and priorities don’t change. Additionally, there is sufficient evidence to support the fact that the likelihood of termination is small—even if the aforementioned qualifications are not met. Many programs that have missed their milestones repeatedly, greatly exceeded their budgets, or have transferred from the spotlight to the shadows have been continued. Therefore, only those programs in the direst straights with a lack of Congressional support would qualify for the “probable” category when considering the need to budget for Termination Liability. Program managers and contractors have a vested interest in continuing their programs and, as advocates, are perhaps not the best qualified to make a “health” decision for a program. Someone at the MDA or PEO level may be better qualified to make an unbiased appraisal.



## **5. How should a Program Manager decide whether to seek a waiver for funding Termination Liability or apply for a Special Termination Cost Clause (STCC)?**

If a Program Manager is required to set aside funds to cover Termination Liability, a waiver of that requirement would be the most useful. An STCC which eliminates the requirement for the funding of a subset of the items associated with Termination Liability would be the next most useful outcome. In both cases, the financial pressures on the program will be significantly reduced in that all funding associated with the program can be used for execution of the program. Once again, the Program Manager is the victim of a conundrum. Congress has shown a distinct lack of enthusiasm for STCCs and an even greater distaste for the waiver of funding for Termination Liability. Those feelings have been mirrored by the Office of Management and Budget (OMB) in that it, too, has evidenced a bias against STCCs and blanket waivers. Additionally, those programs in the greatest need are the ones least likely to obtain approval.

### Probability of Termination for Convenience

In an attempt to determine the probability of a contract being terminated for the convenience of the government, this research accessed data from the Defense Contract Management Agency (DCMA). A sample of contracts administered by the DCMA was analyzed to determine what percentage of those contracts were cost-type contracts, and then to determine what percentage of those cost-type contracts were terminated for the convenience of the government. Since budgeting for Termination Liability applies to incrementally funded cost-type contracts, this research focused only on cost-type contracts. Some assumptions in this method were that all cost-type contracts were incrementally funded and that these contracts required the funding of Termination Liability. The limitation of this analysis was based on the shortcomings of the DCMA database in particular and on the DoD as a whole. The DoD database does not capture data relating to the funding of Termination Liability, nor does it capture data on the amount of TL funding on each contract.



The DCMA's in Atlanta, Georgia, and in Los Angeles, California, were each asked to provide data on cost-type contracts. Data from Atlanta included contracts for the period FY1998 to FY2005. The period covered in the Los Angeles data was from FY1995 to FY2006. (See Attachment 2 for the DCMA data.)

## **Data Analysis**

### **1. DCMA Atlanta**

During the period of analysis, the DCMA had 325,000 open contracts. Of these contracts, the DCMA had 518 contracts terminated *for convenience* out of a total 10,901 total terminations. That means that the probability of a contract being terminated for convenience is 0.16% (518/325,000). During this same period, of the 10,901 contract terminations in the DCMA database, 306 are cost-type contracts. That means that cost-type contracts represent approximately 2.8% of the terminated contracts.

Thus, the probability that a contract will be terminated for convenience and that the contract will also be a cost-type contract are approximately .0045% (518 X .028)/325,000).

From a dollar perspective, DCMA is responsible for \$852B in contracts. For all terminated contracts, the dollar value is \$8.16B. From a dollar perspective, it would appear that the potential liability is greater than that based solely on the number of contracts and contract terminations. That is, using dollar value as a criterion, it would appear that the probability of a termination is approximately .95% (8.16/852). The dollar value of the terminated cost type contracts is \$1.29B. That would mean that from a dollar perspective, the probability of a termination is approximately .15% (1.29/852).



## **2. DCMA Los Angeles**

The data from DCMA Los Angeles included information from Palmdale, Santa Ana, Los Angeles, Boeing Seattle, Seattle, Boeing Long Beach, Northrop Grumman El Segundo, San Diego, Pratt & Whitney, Northern California, Lockheed Sunnyvale and Northrop Grumman Redondo Beach. While not all locations' data spanned the entire period (e.g., Santa Ana data are from 2 January 2002), the number of contracts and terminations covered are considered representative.

During this period of analysis, DCMA Los Angeles managed 3159 cost-type contracts. Of these 3159 cost-type contracts, there were 10 terminations for the convenience of the government, or .31% (10/3159). The total value of the contracts was \$64.4B. The value of the terminated contracts was \$440M. From a dollar perspective, the risk of a termination for a cost-type contract was .68%.

### **Data Comparison**

It was anticipated that the data from DCMA Atlanta and DCMA Los Angeles would be comparable in that one is a subset of the other. While the values do vary from one site to the other, what is apparent is the small likelihood of the termination for convenience of a cost-type contract. When looked at as a percentage of the number of contracts, it is significantly less than 1%. Perhaps the dollar value of the terminated contracts should be perceived as the most critical indicator because the liability of the government is measured in dollars, not numbers of contracts. Although the data would seem to indicate that higher-dollar-value contracts are the most susceptible to termination, the risk of termination based on dollar criteria is still less than 1%.

It should be noted that data not available for analysis was the cost of terminations incurred by the government. (Figures of 10% of the contract value or less were provided as anecdotal estimates by several interviewees.)



## Observations and Findings

This research included a review of the regulatory and policy guidance on Termination Liability found in the *Financial Management Regulation (FMR)* and the *Federal Acquisition Regulation (FAR)*. In addition, the researchers conducted interviews with various DoD program management offices and analyzed samples of DoD contracts related to the management of Termination Liability. Based on these reviews, interviews, and analyses, the research team identified the following observations and findings:

### 1. Inconsistent Approach

There is an inconsistent approach among the various military and DoD agencies to managing Termination Liability funds on contracts. Although all program offices that were interviewed in this research manage Termination Liability based on the funds obligated on contract, the procedures used for ensuring the obligated funds are adequate and sufficient to cover Termination Liability expense at any point during the contract period of performance varied. Some program offices maintained close coordination with their contractors to monitor and ensure sufficient obligated funds to cover estimated Termination Liability expenses throughout the contract period, while other program offices depended solely on the contractor to monitor the obligated funds to ensure sufficient coverage for Termination Liability. Some program offices conducted periodical “budget drills” to determine if the amount of obligated funds at any given time would be sufficient to cover the estimated Termination Liability at that point in time. Some program offices used the Contractor Funds Status Report (CFSR) as an aid in monitoring the estimated Termination Liability expenses.



## **2. Diffused Guidance**

The regulatory and policy guidance pertaining to Termination Liability are diffused between the Federal Management Regulation (*FMR*) and the Federal Acquisition Regulation (*FAR*). The *FMR* is the main source of financial management policy and guidance used by DoD financial and budget managers, while the *FAR* is the main source for contract management policy and guidance used almost exclusively by DoD contracting officers. These two functionally based regulations lead to differing interpretations of policy, guidance, and procedures related to the management of Termination Liability by the financial-management and contract-management functional areas.

## **3. Insufficient Databases**

There is no DoD-wide, Service-wide, Command-wide, or Center-wide database; yet, one is needed to conduct a proper analysis to determine the total number of contracts that require funding for Termination Liability, the total amount of Termination Liability funding on these contracts, the total number of contracts containing a Special Termination Cost (STC) clause, and the total amount of estimated Termination Liability expenses being managed at the Service levels because of these STC clauses. These databases would provide the data that would be considered a critical part of the business case needed to calculate the extent of the funding being budgeted for Termination Liability expenses.

## **4. Declining Acceptability of Special Termination Cost Clause**

Because of the current acquisition climate of defense acquisition program cost overruns and schedule delays, the increased use of the current Special Termination Cost Clause (STCC) would not be well received by the Congress or the Office of Management and Budget (OMB). Furthermore, program managers are not necessarily receptive to requesting approval of an STCC from their higher headquarters.



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# Alternative Approaches to Funding Termination Liability

Our research identified the following alternative approaches to managing and funding contract termination Liability.

## **1. Impose a “Tax” on All Programs Subject to Termination Liability for the Purpose of Establishing an Insurance Fund to Cover Termination Liability.**

The advantages of this alternative include the benefit for program managers of not having to commit funds to cover TL, thus allowing better use of funds for program execution. Additionally, since the required Termination Liability funds would be identified prior to any termination, any concerns for possible *Anti-deficiency Act* violations should subside. Finally, for the military departments, significantly fewer dollars would be tied up unproductively for TL and would be available for program execution.

The disadvantages of this option include the fact that those programs not at risk for termination would have to pay this TL tax, thus decreasing their amount of budget for executing the program. For not-at-risk programs, this tax would make program management more difficult. The dollars associated with this tax would not be available until late in the fiscal year if they were not used to cover a termination; if they were used to cover a termination, the program would lose the money permanently—presenting a lose-lose proposition for the program manager. Finally, another disadvantage would be that at-risk programs would not have the funds required to pay for the tax available for program execution, thus, putting these programs at an increased disadvantage.

Some of the potential questions related to this alternative include the following:

- Who determines the “tax”? Those programs at greatest risk should logically be taxed more than those programs not at risk.





- Who determines the risk of a possible program termination?
- Would the insurance fund provide an attractive target for Congressional rescissions as well as Department reprogrammings?
- When and how would the unused portion of the funds be returned to the programs?

## **2. Allow Coverage of Termination Liability to be Assumed at the Major Command or PEO Level.**

One advantage of this alternative is that program managers could use all of the funds appropriated for their programs for program execution. Additionally, the use of STCCs with the associated Congressional notification would not be required. Another advantage of this approach is that the uncertainty of fund availability (as opposed to the tax approach) would be eliminated. Finally, there would not be a pot of funds to be targeted by Congress or the Department.

The disadvantages of this option include the fact that this approach is similar to the STCC approach—which has not enjoyed strong support from OMB or the Congress. Additionally, concerns regarding possible *Anti-deficiency Act* violations would likely increase. Finally, another disadvantage would include the fact that paying for a program’s termination costs would likely adversely impact other programs.

Some of the potential issues related to this alternative include the following:

- This approach would appear to OMB and Congress as an attempt to forego budgeting for Termination Liability.
- A program termination late in the fiscal year could be difficult to fund. Above-threshold reprogramming requests are rarely certain or timely.

## **3. Increase the Use of Special Termination Cost Clauses (STCC)**

The advantages of this alternative include the benefit that program managers would be able to use all of the funds appropriated for their programs for program



execution. The uncertainty of fund availability (as opposed to the tax approach) would be eliminated for program managers.

The disadvantages of this option include the fact that Congress and the OMB have already exhibited a lack of enthusiasm for the increased use of STCCs. Additionally, the paperwork involved with STCCs is considered onerous by the programs that have completed it.



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# Recommendations

Based on the research finding and conclusions, the following recommendations are provided.

## **1. Remove ambiguity and improve consistency in the regulations.**

The current regulations pertaining to the management of contract termination lend themselves to differing and inconsistent interpretations among the Services and functional areas (program management, financial management, and contract management). If the “liberal” interpretation of current regulations is different from what is desired or is the intent of the agencies, these regulations should be revised to remove any ambiguity and to improve the consistency between the functional areas.

## **2. Do not impose a tax system to provide funding for potential Termination Liability.**

The taxing of program offices for the purpose of generating a pool of funds to use for Termination Liability results in a lose-lose proposition for program offices and may result in more disadvantages than advantages. In addition, the potential issues related to this alternative would require additional research and analysis.

## **3. Continue to use STCCs for the larger programs with funding or longevity concerns.**

For larger, major defense acquisition programs that have a lower probability of termination due to visibility, political ties, or urgency of need, the DoD should continue to support the use of STCCs to allow for greater use of program funds for program execution.



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## Summary and Conclusion

The purpose of this research was to explore current Department of Defense mechanisms for addressing contract termination liability, review current practices and procedures for funding and managing Termination Liability, and propose alternative approaches to improve the DoD's ability to manage Termination Liability and its effect on defense acquisition programs. This research reviewed the regulatory and policy guidance on contract termination liability. A review of current practices and procedures for funding and managing Termination Liability was conducted based on interviews and document reviews with the Air Force, the Navy, and other various DoD agencies. Program management challenges and preliminary observations and findings were then presented. A discussion of alternative approaches to funding Termination Liability was discussed, including the use of Special Termination Cost Clauses (STCC). Finally, recommendations were presented.

The regulations and policies pertaining to the management and funding of contract termination liability are inconsistent and subject to interpretation. Program managers, finance and budget managers, and contracting officers have differing interpretations of the requirement for funding Termination Liability. Furthermore, the practices and procedures used in defense acquisition program offices reflect this inconsistency.

In addition, the probability that a government contract will be terminated for convenience is very small. Program managers and contractors are aware of the statistics, and their approach to Termination Liability reflects that knowledge. The normal procedure for handling the potential liability associated with a contract terminated for convenience is to "budget" for the liability. Then, in coordination with the contractor, the required amount of funding is tracked on a regular basis. In this case, budgeting for Termination Liability does not mean obligating funds specifically for that purpose.



Additionally, program managers are not in favor of a “tax” that would negate the requirement to budget for TL. For the most part, they are satisfied with the status quo because the procedure they currently use to handle TL allows them to keep all of the funding appropriated for their program. A tax would deprive them of funds that they currently have at their disposal. In fact, a program that has funding problems could be put in jeopardy by having to relinquish funding to pay for a tax. Program managers feel as though the statistics support their current approach.

Furthermore, if all programs were taxed, there is a general concern that the pooled funds would likely be lost for good—either the military Departments (or DoD) would use them to solve other problems if they were not required to cover a liability, or Congress would look upon the funds that had been set aside as a “slush fund” and be tempted to use them elsewhere.

Also, support for increased use of STCCs is not evident, either at the program level or the OMB or Congressional level. Congress has expressed its concern regarding STCCs through report language. OMB correspondence has indicated that support for more than one STCC per service is unlikely. However, it should be noted that those programs that have significant funding problems and/or are concerned about the possibilities of termination do support additional use of STCCs. In fact, these programs would prefer to have an STCC that covers more cost elements than the standard STCC.

Finally, this research recommended that the Department of Defense: remove the ambiguity and improve the consistency in the regulations pertaining to the management of Termination Liability, not impose a tax system to provide funding for potential Termination Liability, and continue to use STCCs for the larger programs with funding or longevity concerns.



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# Attachment 1. Termination Liability Interview Questions

In incrementally funded contracts (See DoD, 2006a, 249.501), there is a requirement to identify funds to cover the contingent liability for termination. These funds are set aside for this purpose and may not be used to pay costs for work being performed on the contract.

- Question: Which programs in the Center are required to have funded Termination Liability on their contracts?
- Question: What is the total value of funded Termination Liability for the Center?
- Question: Has any program with funded Termination Liability been terminated?
- Question: Has the requirement to fund Termination Liability caused any difficulties with managing any other aspects of the program?

Program managers can apply for a Special Termination Cost Clause (STCC) that will waive the requirement for funding and budgeting for Termination Liability on the contract. If the program has an approved STCC clause, the Agency guarantees it will find the necessary funds to cover the Termination Liability in the event of a termination.

- Question: Which programs have an approved STCC clause?  
May we have access to STCC clauses (Section H clauses)?
- Question: What is the total value of funds identified on programs with STCC clauses at the Center?
- Question: What is the process for requesting an STCC clause?  
Who coordinates at the Center? Contracts, FM, Legal?  
Who coordinates at the MAJCOM? Contracts, FM, Legal?  
Who coordinates at HQ level? Contracts, FM, Legal?



How is Congressional approval for the STCC clause obtained?

What is included in the STCC package?

Is a program risk (cost, schedule and performance) assessment conducted as part of the STCC package? If so, who conducts that risk assessment?

Question: Has any program with an approved STCC clause been terminated?

If the program has an approved STCC clause, the Agency guarantees that it will find the necessary funds to cover the Termination Liability.

Question: How does the Agency estimate the amount of term liability it needs to cover all of the programs with approved STCCs?

How does the Agency fund for term liability programs that have an approved STCC clause and that have been terminated?

How does the Agency keep track of those programs (under its control) that have approved STCC clauses?

Does the Agency track the status of previously approved STCC programs to monitor those programs' risk for termination?

One of the outcomes of this research will be recommendations on potential changes to the current system of funding Termination Liability.

Question: Given your experience with Termination Liability, what changes to the process, if any, would you recommend?

Question: Would a program "tax" to cover Termination Liability for a number of programs be acceptable, assuming that the "tax" is less than the funding required for Termination Liability for your program?



## Attachment 2A

Cost Type Contracts, Los Angeles 1-1-95 to 8-17-06

## Attachment 2B

Closed Dockets, Los Angeles 1-1-95 to 9-30-05

## Attachment 2C

Closed Dockets, Los Angeles 10-1-05 to 9-30-06

## Attachment 2D

Cost Type Contracts, Atlanta 1-4-82 to 4-1-05

## Attachment 2E

Analysis of Cost Type Contracts, Atlanta

Please contact Karey Shaffer at [klshaffe@nps.edu](mailto:klshaffe@nps.edu) to request a copy of the complete attachments associated with this sponsored report.



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- Acquisitions via leasing: MPS case
- Special Termination Liability in MDAPs

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- ASDS Product Support Analysis
- Analysis of LAV Depot Maintenance
- Diffusion/Variability on Vendor Performance Evaluation
- Optimizing CIWS Life Cycle Support (LCS)

## **Program Management**

- Building Collaborative Capacity
- Knowledge, Responsibilities and Decision Rights in MDAPs
- KVA Applied to Aegis and SSDS
- Business Process Reengineering (BPR) for LCS Mission Module Acquisition
- Terminating Your Own Program
- Collaborative IT Tools Leveraging Competence

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