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2003 Government Contract Decisions of the Federal Circuit

Douglas L. Patin

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2003 GOVERNMENT CONTRACT DECISIONS OF THE FEDERAL CIRCUIT

DOUGLAS L. PATIN*

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* The author is a 1979 graduate of the *National Law Center, George Washington University*, and is a Partner in the Washington, D.C. law firm of Spriggs & Hollingsworth.

INTRODUCTION

In 2003, the Federal Circuit issued thirty five published opinions involving government contract law issues. For this article, the decisions have been grouped into the following subject matters: damages, default, costs, contract interpretation, duress, and bid protests. This article will emphasize those decisions which the author believes will most likely affect the greatest volume of future litigated cases. Among the various decisions handed down by the Federal Circuit in 2003, the court issued important precedential opinions regarding damages, default, and costs issues.

I. DAMAGES—THE EICHLEY DECISIONS

A. P.J. Dick Inc. v. Principi

The use of the Eichley formula to calculate unabsorbed home office overhead has been the subject of intense debate in the government contract arena.¹ Since the seminal decision of *C.B.C. Enterprises, Inc. v. United States*² in 1992 limiting the use of the Eichley formula to calculate unabsorbed home office overhead, the Federal Circuit has published fifteen decisions concerning its use—including three in 2003.³ Two of the 2003 “Eichley” decisions reflect the

1. See Ralph C. Nash & John Cibinic, *Unabsorbed Overhead and the “Eichley” Formula: Rampant Confusion*, 16 NASH & CIBINIC REP. ¶ 23 (2002) [hereinafter Nash & Cibinic, *Rampant Confusion*] (explaining that the Eichley formula produces significant complexities in pricing the claims of constructing contractors); Ralph C. Nash & John Cibinic, *Unabsorbed Overhead: Abandon Eichley*, 13 NASH & CIBINIC REP. ¶ 33 (1999) (arguing that the Federal Circuit should abandon the use of the Eichley formula and create a better means of calculating fixed-cost delay damages); David G. Anderson, *Practitioner’s Viewpoint: Federal Circuit Creates an Invalid Legal Test for Determining Entitlement to Unabsorbed Overhead*, 26 PUB. CONT. L.J. 353, 369, 371 (1997) (contending that the Eichley formula unfairly places the burden of proof on the government to show that the contractor was able to take on other work, thereby forcing the government to engage in lengthy and expensive discovery that may produce windfall recoveries for some contractors); Patrick A. McGeehin & Carleton O. Strauss, *Learning from Eichley: Unabsorbed Overhead Claims in State and Local Jurisdictions*, 25 PUB. CONT. L.J. 351, 353 (1996) (proposing that state and local jurisdictions adopt the principles of Eichley to provide a more uniform formula for computing unabsorbed overhead); Colonel Killham, *Federal Circuit Endorses Eichley*, ARMY LAW., July 1994, at 37 (stating that the Eichley formula can assist contracting officers by placing limits on contractors’ ability to increase overhead pools or allocation formulas); Major Tomanelli, *The Eichley Formula—Struggling to Survive*, ARMY LAW., Dec. 1993, at 46-48 (outlining three arguments that can limit the applicability of the Eichley formula so that contracting officers will not reimburse contractors unnecessarily).

2. 978 F.2d 669 (Fed. Cir. 1992).

3. P.J. Dick Inc. v. Principi, 324 F.3d 1364 (Fed. Cir. 2003); see also Charles G.

continuing difficulty created by the Federal Circuit's jurisprudence in this area, and mark important developments in the case law.

In *P.J. Dick Inc. v. Principi*,⁴ the contractor appealed the Department of Veterans Affairs Board of Contract Appeals decision denying P.J. Dick's ("PJD") claims for unabsorbed home office overhead damages. During performance of the construction contract, the government issued over 400 change orders, causing delays to various aspects of the project.⁵ The Board granted PJD a time extension and damages for field overhead costs.⁶ However, the Board denied PJD Eichleay unabsorbed home office overhead damages because PJD did not prove it was on "standby."⁷ The Board also ruled that a stipulation entered by the parties addressed only Eichleay quantum and not Eichleay entitlement.⁸ The Federal Circuit framed the unabsorbed overhead issues by stating that "[t]he primary issues here are whether the parties' stipulation entitled PJD to recovery of home office overhead *and, if not*, whether PJD had shown the [government] placed it on standby."⁹

Rather than first addressing the stipulation, the court instead addressed the standby issue.¹⁰ The court spent three pages clarifying ten years of Federal Circuit precedent on the standby requirement for an Eichleay recovery.¹¹ The analysis attempted to reconcile inconsistent language in earlier decisions that supported the position that suspension of work and idleness are not prerequisites for a standby finding.¹² Finding the standby inquiry multifaceted, the court explained that the standby element is met if the contracting officer

Williams Constr., Inc. v. White, 326 F.3d 1376 (Fed. Cir. 2003); *Nicon, Inc. v. United States*, 331 F.3d 878 (Fed. Cir. 2003); *Charles G. Williams Constr., Inc. v. White*, 271 F.3d 1055 (Fed. Cir. 2001); *Sauer, Inc. v. Danzig*, 224 F.3d 1340 (Fed. Cir. 2000); *Melka Marine, Inc. v. United States*, 187 F.3d 1370 (Fed. Cir. 1999); *E.R. Mitchell Constr. Co. v. Danzig*, 175 F.3d 1369 (Fed. Cir. 1999); *West v. All State Boiler, Inc.*, 146 F.3d 1368 (Fed. Cir. 1998); *Satellite Elec. Co. v. Dalton*, 105 F.3d 1418 (Fed. Cir. 1997); *Altmayer v. Johnson*, 79 F.3d 1129 (Fed. Cir. 1996); *Mech-Con Corp. v. West*, 61 F.3d 883 (Fed. Cir. 1995); *Wickham Contracting Co., Inc. v. Fischer*, 12 F.3d 1574 (Fed. Cir. 1994); *Interstate Gen. Gov't Contractors, Inc. v. West*, 12 F.3d 1053 (Fed. Cir. 1993); *Daly Constr., Inc. v. Garrett*, 5 F.3d 520 (Fed. Cir. 1993); *Cmty. Heating & Plumbing Co., Inc. v. Kelso*, 987 F.2d 1575 (Fed. Cir. 1993).

4. 324 F.3d 1364 (Fed. Cir. 2003).

5. *Id.* at 1368.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* at 1369 (emphasis added).

10. *Id.* at 1370. The Federal Circuit ruled later in the opinion that a stipulation between the parties regarding the damages calculations rendered unnecessary any proof of entitlement to Eichleay damages by the contractor. *Id.* at 1374.

11. *Id.* at 1371-73.

12. *Id.* at 1371-72.

has issued a written order: (1) suspending all work on the contract for an uncertain duration, and (2) requiring the contractor to resume work immediately or on short notice.¹³ Because many suspension orders likely will not state that the contractor must resume work immediately or on short notice, the Federal Circuit's discussion of how to prove standby status with indirect evidence will likely generate more "Eichleay" litigation in the future.¹⁴

Absent written orders containing the explicit directive referenced above, the Federal Circuit further explained that the contractor must prove standby with indirect evidence, including evidence that: (1) the substantial government-caused delay was of an indefinite duration; (2) during the delay the contractor had to be prepared to resume work immediately and at full speed; and (3) the contractor effectively suspended most or all of the contract work.¹⁵ Noting that case law has not addressed the second element of the standby test in detail,¹⁶ the court's discussion of this element in the context of (a) calculating a reasonable amount of time to remobilize, (b) remobilizing with a reduced work force, and (c) keeping some equipment and men at the work site¹⁷ will invite further disputes between contractors and the government.

It is difficult to understand why proof for an Eichleay claim should include the requirement that a contractor on standby must be prepared to resume work immediately and at full speed. If a suspension order tells a contractor to anticipate resuming work in three months, that advance notice does not make it any easier for the contractor to find replacement revenue for that three month period to absorb its project management personnel and bonding capacity than if no such notice was provided. A contractor will not find a new job for its management staff to replace the loss of revenue caused by the suspension simply because it knows that the suspension will end three months later. With or without notice that the suspended work will resume in three months, the contractor suffers the same loss of revenue stream to absorb overhead. If a contractor is told that the suspension will end two years later, this requirement may be reasonable because the contractor may have an opportunity to find substitute work. It is unreasonable if the contractor's bonding

13. *Id.* at 1371.

14. See Nash & Cibinic, *Rampant Confusion*, *supra* note 2, ¶ 23 (proposing two ways to simplify the calculation of damages and satisfying the standby requirement, which limit the amount of complex litigation).

15. *P.J. Dick Inc.*, 324 F.3d at 1371.

16. *Id.*

17. *Id.*

capacity is tied up during the two year work period by the suspended work. Thus, the court imposed another rigid requirement without regard to how the facts of a particular case should govern the award of damages.

Concerning the third element of the standby test, partial suspensions are more likely than total suspensions of work. In addition, a total suspension of a subcontractor's work is more likely than a total suspension of the general prime contract. Thus, the court's discussion of whether the continued performance involved "only insubstantial work on the contract"¹⁸ will likely face further litigation under this element of the standby test. The standby rule has nothing to do with the economics or accounting of unabsorbed overhead,¹⁹ and the standby requirements in *P.J. Dick* further complicate the analysis, likely engendering further litigation. Whether these new requirements sound the "death knell" of Eichleay,²⁰ they certainly make it much more difficult to recover Eichleay damages.

The Federal Circuit imposed a relatively simple, logical limitation of Eichleay in *C.B.C. Enterprises* by finding that Eichleay should not be applied automatically to all delays.²¹ The court ruled that Eichleay should only apply when the government suspends, disrupts, or delays a contract in a manner that imposes uncertainty on the contractor.²² Although the Eichleay formula is intended to simplify the calculation of overhead costs,²³ the Federal Circuit's requirements in *P.J. Dick* have not simplified the process:

In short, a court evaluating a contractor's claim for Eichleay damages should ask the following questions: (1) was there a government-caused delay that was not concurrent with another delay caused by some other source; (2) did the contractor demonstrate that it incurred additional overhead (*i.e.*, was the original time frame for completion extended or did the contractor satisfy the *Interstate* three-part test); (3) did the government

18. *Id.* at 1372.

19. Nash & Cibinic, *Rampant Confusion*, *supra* note 2, ¶ 23.

20. Ralph C. Nash & John Cibinic, *Postscript: Unabsorbed Overhead and the "Eichleay" Formula*, 17 NASH & CIBINIC REP. ¶¶ 33, 87 (2003) (arguing that the *P.J. Dick Inc.* decision severely diminishes the ability of contractors to recover unabsorbed overhead under the standby rule).

21. *C.B.C. Enters., Inc. v. United States*, 978 F.2d 669, 675 (Fed. Cir. 1992).

22. *Id.*

23. *Nicon, Inc. v. United States*, 331 F.3d 878, 889 (Fed. Cir. 2003) (Newman, J., concurring in part); *see also* Nash & Cibinic, *Rampant Confusion*, *supra* note 2, ¶ 23 (contending that although the calculation of Eichleay damages is not complex, recent court decisions and the standby requirement unnecessarily increase the complexity of litigation).

[contracting officer] issue a suspension or other order expressly putting the contractor on standby; (4) if not, can the contractor prove there was a delay of indefinite duration during which it could not bill substantial amounts of work on the contract *and* at the end of which it was required to be able to return to work on the contract at full speed and *immediately*; (5) can the government satisfy its burden of production showing that it was not impractical for the contractor to take on replacement work (*i.e.*, a new contract) and thereby mitigate its damages; and (6) if the government meets its burden of production, can the contractor satisfy its burden of persuasion that it was impractical for it to obtain sufficient replacement work. Only where the above exacting requirements can be satisfied will a contractor be entitled to Eichleay damages.²⁴

It is unlikely that a contractor could recover under these requirements given the facts in the numerous cases cited with approval in *C.B.C. Enterprises* where Eichleay damages were recovered.²⁵ The legal hurdles summarized in *P.J. Dick* are not linked to the practical accounting proof established in *C.B.C. Enterprises*, which required the contractor to prove that the government caused delays of uncertain length and reduced the contractor's flow of direct cost stream of revenue. Rather than making questions (2)-(6) in the *P.J. Dick* analysis legal requirements for recovery, they should serve as factors to consider in determining whether the evidence satisfies the two basic tests for entitlement under *C.B.C. Enterprises*: (1) did government-caused delay of an uncertain duration cause a reduction in the contractor's stream of direct costs, and (2) did the contractor mitigate or could have mitigated the unabsorbed overhead damages caused by the delay.

The *C.B.C. Enterprises* test is whether government-caused delay creates uncertainty which prevents the contractor from taking on more work to generate additional direct cost revenue to replace and

24. *P.J. Dick Inc.*, 324 F.3d at 1373 (emphasis in original).

25. "See, e.g., *Weaver-Bailey Contractors, Inc. v. United States*, 19 Cl. Ct. 474, 477 (1990); *A.A. Beiro Constr. Co.*, 91-3 B.C.A. (CCH) ¶ 24,149, ¶ 120,844 (ENGBCA 1991); *Cieszko Constr. Co.*, 88-1 B.C.A. (CCH) ¶ 20,223, ¶ 102,417 (ASBCA 1987); *Shirley Contracting Corp.*, 85-1 B.C.A. (CCH) ¶ 17,858, ¶¶ 89,399-400 (ABCA 1984); *Excavation-Constr., Inc.*, 82-1 B.C.A. (CCH) ¶ 15,770, ¶¶ 78,067-68 (ENGBCA 1982); *Savoy Constr. Co.*, 85-2 B.C.A. (CCH) ¶ 18,073, ¶ 90,723 (ASBCA 1985). See also *Williams Enters., Inc. v. Sherman R. Smoot Co.*, 938 F.2d 230 (D.C. Cir. 1991). In all these cases when disruption, suspension or delay caused by the government has reduced the stream of direct costs in a contract, it is appropriate to use the Eichleay formula to calculate extended home office overhead instead of the fixed percentage rate formula because the latter would not adequately compensate the contractor for extended home office overhead." *C.B.C. Enters., Inc.*, 978 F.2d at 674 (internal parentheticals eliminated).

absorb the delayed contract's share of home office overhead. The practical proof normally should be whether the contractor's bonding capacity, or key contract management, or equipment is tied up by the delayed contract preventing the contractor from replacing that contract's direct revenue stream with other work. The *P.J. Dick* "standby" requirements unnecessarily undermine the logic and rationale of *C.B.C. Enterprises*.

B. Charles G. Williams Construction, Inc. v. White

Twenty-five days after *P.J. Dick*, the Federal Circuit issued its decision in *Charles G. Williams Construction, Inc. v. White*.²⁶ This decision involved the second appeal of a contractor's claim for Eichleay damages. On the first appeal, the Federal Circuit vacated the decision by the Armed Services Board of Contract, which denied Williams' Eichleay claim, and remanded for the Board to discuss the two prerequisites a contractor must show to recover Eichleay damages: (1) the contractor was on standby during the delay, and (2) it was unable to take on other work during the delay.²⁷

On remand, the Board again denied the contractor's Eichleay claim, finding that Williams had not shown suspension or significant interruption of work performance during the period of delay involved.²⁸ The Board based its finding on a Defense Contract Auditor Agency auditor's report and credible testimony that Williams could not show it had a reduction in the flow of direct costs.²⁹ Rather, the contract continued to absorb its equitable share of general and administrative expenses.³⁰ The Federal Circuit rejected the contractor's assertion that Eichleay applies if government delay causes inefficient performance as continued performance permits the absorption of indirect costs.³¹

C. Nikon, Inc. v. United States

A month after *Charles G. Williams Construction*, the Federal Circuit issued *Nikon, Inc. v. United States*.³² In this case, the Army awarded Nikon a construction contract on March 30, 1998.³³ Subsequently, a different bidder protested the award and the Army instructed Nikon

26. 326 F.3d 1376 (Fed. Cir. 2003).

27. *Id.* at 1379-80.

28. *Id.* at 1378.

29. *Id.*

30. *Id.*

31. *Id.* at 1380-81.

32. 331 F.3d 878 (Fed. Cir. 2003).

33. *Id.* at 881.

to suspend all work.³⁴ The protest was dismissed on July 15, 1988.³⁵ Despite Nikon's requests to proceed with the contract, the Army did not proceed with the contract and terminated it for convenience on January 12, 1999.³⁶ When Nikon submitted a termination settlement proposal, the contracting officer paid direct costs plus mark up, but denied a modified Eichleay claim for unabsorbed home office overhead.³⁷ Nikon filed suit in the Court of Federal Claims ("CFC").³⁸ The CFC granted summary judgment for the government because *Wickham Contracting Co. v. Fischer*³⁹ did not permit the court to accept a modified Eichleay formula.⁴⁰

The Federal Circuit vacated the CFC's decision and remanded the case to the CFC to determine whether there was government-caused delay of uncertain duration and whether Nikon was on standby during the period of delay.⁴¹ The Federal Circuit held that it could not apply the Eichleay formula for the relief sought because, absent any performance, it had no billings to apply in the formula.⁴² However, if contract performance has not begun, the Federal Circuit held the contractor may recover unabsorbed overhead costs in a termination for convenience settlement "if a reasonable method of allocation can be determined on the facts of the case and the contractor can otherwise satisfy the strict prerequisites for recovery of unabsorbed overhead costs."⁴³

The concurring opinion by Judge Newman disagreed about the inapplicability of Eichleay and suggested that a modified Eichleay formula may be appropriate.⁴⁴ Judge Newman's concurring opinion noted that:

The Eichleay formula is not a matter of legal entitlement; it is simply a mathematical equation for allocation of unreimbursed overhead costs. It is incorrect to promote it to a substantive entitlement limited to an inflexible formula If the formula does not precisely fit the circumstances, this does not warrant either dismissal of the claim or determination that the Eichleay

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* at 882.

38. *Id.*

39. 12 F.3d 1574 (Fed. Cir. 1994).

40. *Nicon, Inc.*, 331 F.3d at 887-88.

41. *Id.* at 887.

42. *Id.* at 884-85.

43. *Id.* at 888.

44. *Id.* at 889 (Newman, J., concurring in part) (observing that the court had previously recognized the potential application of close variations of the Eichleay formula).

formula is inapplicable; rather, it warrants adaptation, if such is needed, to the situation as it existed.⁴⁵

Elevating the Eichleay formula to a substantive entitlement limited to an inflexible formula is precisely what the Federal Circuit did in *Wickham Contracting Co., Inc. v. Fischer* and its progeny by insisting Eichleay is the *only* permissible calculation for determining claims of unabsorbed overhead.⁴⁶ In *Wickham Contracting Co.*, the Federal Circuit cited no empirical data to support its conclusion that Eichleay is the *only* means to fairly measure unabsorbed overhead. Although it is *an* equitable method, that does not mean it is the only method. Eichleay was devised to apply to construction contracts. It is not necessarily the appropriate measure for disruptions to a manufacturer's shop overhead or to other non-construction businesses. There are other methods available for evaluating unabsorbed overhead claims.⁴⁷ Whether they should be utilized or not should depend upon the facts of each case. However, by judicial fiat, the Federal Circuit declared that a contractor cannot use any other means to prove unabsorbed overhead damages, without any industry-accepted support that only the Eichleay formula can measure such damages in all cases. Reasonably limiting the application of Eichleay is one thing. Precluding contractors from proving unabsorbed overhead damages by any other reasonable means is quite another.

The trial court in *Nicon* had no option but to reject the contractor's unabsorbed overhead claims because Federal Circuit Eichleay jurisprudence prohibited the trial court from fairly addressing the contractor's claims through other methods of calculating damages.⁴⁸ Fortunately, the Federal Circuit's majority opinion allows some allocation method other than Eichleay in a very limited situation, i.e., where no work has been performed.⁴⁹ Judge Newman's concurring

45. *Id.* at 889-90.

46. *Wickham Contracting Co., Inc. v. Fischer*, 12 F.3d 1574, 1580-81 (Fed. Cir. 1994) (finding that the Eichleay formula provided an equitable means of calculating unabsorbed overhead damages without imposing additional costs on taxpayers and promoting its exclusive use where the Eichleay prerequisites are met).

47. See Patrick A. McGeehin, *Learning from Eichleay: Unabsorbed Overhead Claims in State and Local Jurisdictions*, 25 PUB. CONT. L.J. 351, 358-59 (1996) (providing examples of alternate approaches to calculating unabsorbed overhead claims).

48. See *Nash & Cibinic*, *supra* note 20, at 87 (arguing that courts should abandon the Eichleay formula and the stringent standby rule, which severely limits a contractor's ability to recover unabsorbed overhead, and gives contractors the burden of proof, but noting that Federal Circuit precedent prevents this approach).

49. See *Nicon, Inc.*, 331 F.3d at 888 (holding that in situations where contract performance has not yet begun, the contractor may recover unabsorbed overhead costs if a reasonable method of allocation may be determined on the facts of the case).

opinion in *Nicon* correctly argues that Eichleay should be a method of allocation—not a rule of law.⁵⁰ In any event, the opinions in *Nicon* provide a glimmer of hope that the Federal Circuit will eventually recognize that contractors should be allowed to prove their unabsorbed overhead damages claims by any evidence or formula which fairly measures the home office damage caused by government delays.

II. DAMAGES—MODIFIED TOTAL COST METHOD

*Propellex Corp. v. Brownlee*⁵¹ involved two fixed-price supply contracts for primers, a component of gun shells containing black powder.⁵² The contracts required submission of samples of primers to test the moisture content of the black powder,⁵³ and the Army subsequently determined that the moisture content of the primers was too high and rejected many primers.⁵⁴ During the following two years, the contractor conducted an investigation to determine the cause of the moisture and found no evidence that the moisture content exceeded the specified level.⁵⁵ During this two-year period, the contractor continued primer production, the government rejected three additional lots, and the contractor diverted production employees to investigate the moisture problem.⁵⁶

Subsequently, an observation team found defects in the government's testing procedure for the fifth lot of primers, and the Army eventually accepted all the primers produced by Propellex.⁵⁷ Propellex filed a claim for equitable adjustment for \$1.8 million using the modified total cost method for the costs it incurred by conducting the moisture investigation, as well as costs incurred by testing the moisture content of the primers prior to this delivery.⁵⁸ Although the contractor kept test records during the two-year investigative period, the records did not track the hours or materials spent investigating the moisture issue raised by the Army.⁵⁹ The contracting officer agreed that the Army erroneously tested the

50. *Id.* at 889 (Newman, J., concurring in part) (arguing that courts should be more flexible when determining whether the application of the Eichleay formula is appropriate).

51. 342 F.3d 1335 (Fed. Cir. 2003).

52. *Id.* at 1336.

53. *Id.*

54. *Id.* at 1337.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

samples, awarded \$77,325, and denied the balance of the claim based upon insufficient support for the additional costs claimed by Propellex.⁶⁰ Propellex appealed to the Armed Services Board of Contract Appeals, which awarded claim preparation and consulting expenses, but denied the balance of Propellex's claim for the moisture investigation for lack of proof of its modified total cost claim.⁶¹ While the contractor adjusted its claim by deducting amounts for bid errors and costs for which it admitted responsibility, the Board found that Propellex failed to establish two of the four requirements for the total cost method, i.e., the impracticability of directly proving its actual losses, and Propellex's lack of responsibility for the added costs.⁶²

The contractor appealed the Board's reasoning that it failed to prove all the prongs of the total cost method.⁶³ Since the Federal Circuit concluded that the Board correctly denied the claim for failure to show the impracticability of proving its actual losses directly, it did not address whether the contractor failed to prove lack of responsibility for the added costs.⁶⁴ The Federal Circuit affirmed,⁶⁵ thereby creating a decision which will make it more difficult for contractors to use the modified total cost or total cost methods to prove damages successfully.

In its decision, the Federal Circuit agreed that substantial evidence supported the Board's finding that Propellex failed to establish the impracticability of proving its actual costs directly.⁶⁶ While the contractor could have set up a cost code to segregate the costs of its moisture investigation, it did not do so.⁶⁷ Instead, the contractor believed itself responsible for the moisture problem, a belief which in the Federal Circuit's opinion made segregation of investigation costs from costs incurred under the Army's contracts all the more important.⁶⁸ The court stated that whether the contracts were fixed price was not important because "where a contractor can capture its

60. *Id.* at 1337-38.

61. *Id.* at 1338.

62. *Id.* The four elements are: (1) the impracticability of proving its actual losses directly; (2) the reasonableness of its bid; (3) the reasonableness of its actual costs; and (4) lack of responsibility for the added costs. *Id.*

63. *Id.* at 1340.

64. *Id.* *But see supra* note 10 and accompanying text (noting that in *P.J. Dick Inc.*, the Federal Circuit addressed the standby issue for Eichleay proof, even though the court's finding that the contractor did not need to prove legal entitlement to Eichleay damages rendered the standby discussion unnecessary).

65. *Propellex Corp.*, 342 F.3d at 1340.

66. *Id.*

67. *Id.* at 1342.

68. *Id.*

increased costs . . . it should do so regardless of whether its contract is a fixed price contract. This is good business practice, and fosters accountable and efficient contract performance.⁶⁹

This reasoning is troublesome for several reasons. There seems to be little logical basis to conclude that a fixed-price contractor should segregate costs relating to self-imposed problems.⁷⁰ The contractor was entitled to be paid for supplies delivered—not for costs incurred. Whether the contract is a fixed-price contract or a cost-reimbursement contract makes all the difference in determining how to account for costs during performance. Fixed-price contractors have fewer overhead accounting costs because they spend less time tracking and documenting costs than cost-reimbursement contractors. There are good reasons for the significant differences in how fixed-priced contractors and cost-reimbursement contractors track costs.

In dismissing the fixed-price contract argument, the Federal Circuit observed the “good business practice” inherent in segregating increased costs for problems that the contractor believes itself responsible, even under a fixed-price contract.⁷¹ The Federal Circuit cited no evidence to support that conclusion. The Federal Circuit also stated that regardless of whether it is a fixed-price contract, segregating costs for contractor problems on fixed-price contracts “fosters accountable and efficient contract performance.”⁷² If the Federal Acquisition Regulations (“FAR”), the contract, or general accounting principles do not require fixed-price contractors to segregate increased costs due to *contractor-caused* problems, it is difficult to understand why the Federal Circuit should impose such accounting practices. It is one thing to penalize a contractor for failing to track increased costs due to government-caused problems when the contractor has reason and it is normal practice to do so. It is another to penalize a contractor for failing to separately track costs under a fixed-price contract when it does not believe the government is responsible for them.

The contractor also argued that the Board improperly cited the contractor’s ability to satisfy the fourth element of the total cost test as proof that it was practicable to satisfy the first element of the test, i.e., to estimate costs for the government-caused problems.⁷³ The

69. *Id.* at 1342 n.3.

70. *Id.* at 1342.

71. *Id.* at 1342 n.3.

72. *Id.*

73. *Id.* at 1343.

contractor argued that the Board's logic essentially did away with a contractor's ability to recover under a modified total cost approach, as the contractor's deduction for non-government-caused problems will always be cited as proof that it could segregate costs for government-caused problems.⁷⁴ In rejecting this argument, the Federal Circuit reasoned as a matter of law that a contractor will still be able to establish that its ability to segregate some costs does not automatically disprove the impracticability of proving the contractor's losses directly.⁷⁵ The problem with this legal conclusion is that, as a *factual* matter, the evidence cited to support the Board's conclusion that the contractor could estimate costs for the government-caused moisture problem was the estimation and deduction of contractor-caused extra costs by the contractor's expert in the modified total cost claim.⁷⁶ Ultimately, the Federal Circuit found that the Board correctly relied on Propellex's calculations of costs unrelated to the moisture problem as evidence that it was not impracticable for Propellex to prove its losses directly.⁷⁷ It is not clear how a contractor will be able to meet the first element of the test if the Board or court may factually defeat that element by pointing to the contractor's ability to deduct contractor-caused costs. Although a contractor can estimate and segregate contractor-caused extra costs, it does not necessarily mean it can do the same for government-caused extra costs. This reasoning will only encourage the government to reject modified total costs claims whenever contractors do the right thing and deduct contractor-caused extra costs from the total cost claim.

Propellex also argued that *Servidone Construction Corp. v. United States*⁷⁸ supported Propellex's claim since the volume of work in Propellex's contract (number of primers supplied) did not increase, just as the volume of dirt to be excavated in *Servidone Construction Corp.* did not increase.⁷⁹ In both cases, the "extra work" claims produced the same volume of work required under the contract. In rejecting this argument, the Federal Circuit reasoned that in *Servidone Construction Corp.*, there was no way for the contractor to segregate its extra costs, while Propellex could have tracked its extra costs.⁸⁰

74. *Id.* at 1340.

75. *Id.* at 1343.

76. *Id.* at 1342 n.4.

77. *Id.* at 1343.

78. 931 F.2d 860 (Fed. Cir. 1991).

79. *Propellex Corp.*, 342 F.3d at 1343. *See Servidone Constr. Corp.*, 931 F.2d at 862 (granting the contractor recovery under a modified total cost method).

80. *Propellex Corp.*, 342 F.3d at 1343-44.

The *Propellex* decision will encourage further litigation over modified total cost claims. The mere fact that a contractor deducts contractor-caused extra costs from its modified total cost claim should not be sufficient evidence to support the conclusion that it could have segregated the government-caused extra costs. Nor should the Federal Circuit attempt to establish standards for proper accounting practices for contractors that are not reflected in FAR, general accounting principles, or the contract in question.

III. DAMAGES—LOST PROFITS

In *Rumsfeld v. Applied Companies, Inc.*,⁸¹ the Defense Logistic Agency (“DLA”) breached its requirements contract with Applied Companies, Inc. (“Applied”). DLA issued a request for proposals (“RFP”) to provide, among other things, cylinders to store refrigerants.⁸² The RFP estimated the DLA’s requirements to be 120,000 cylinders of refrigerants during the term of the one-year contract.⁸³ Prior to contract award, DLA determined that it would need only one-tenth of the estimated quantity.⁸⁴ However, DLA did not notify the offerors of this change, and the notice of award to Applied included the estimate contained in the RFP.⁸⁵ DLA did not inform Applied of the faulty estimate until one month into contract performance.⁸⁶ DLA eventually ordered a total of 11,950 cylinders and sought to modify the contract to a new contract price.⁸⁷ When Applied declined to supply at the government’s price, the government terminated the contract for convenience.⁸⁸ None of the quantities were delivered.⁸⁹ The contracting officer denied Applied’s claim for breach of contract and determined that DLA’s failure to exercise due care in preparation of its estimates gave rise to a constructive change entitling Applied only to an equitable adjustment.⁹⁰ Applied appealed to the Board, which held that the DLA’s actions constituted a breach of contract that entitled Applied to compensatory damages and noted in passing that while its decision only addressed entitlement to breach, the contractor’s damages may

81. 325 F.3d 1328 (Fed. Cir. 2003).

82. *Id.* at 1331.

83. *Id.*

84. *Id.*

85. *Id.* at 1332.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

include anticipated profits.⁹¹ In a decision issued on December 10, 2002, the Federal Circuit affirmed the Board's entitlement decision, finding that negligently prepared estimates may form the basis for a claim of breach of a requirements contract.⁹² On April 2, 2003, the Federal Circuit granted a Petition for Rehearing to correct factual misstatements in its previous decision, withdrew that opinion, and substituted a corrected opinion.⁹³ The new opinion contained no substantive changes from the prior opinion.

While the Board did not reach a decision on quantum, the Federal Circuit decided to provide guidance on the lost profits claim, given the Board's passing comments on that issue.⁹⁴ This case represented a first impression issue of whether lost profits under a requirements contract are recoverable on negligently prepared estimates, where none of the requirements were diverted to a third party. Prior decisions addressing lost profits for breaches of requirements contracts involved diversion of requirements to third parties⁹⁵ and approaching such awards in this manner provided the proof needed to meet the requirements of lost profits set forth in *California Federal Bank v. United States*.⁹⁶ The Federal Circuit in *Applied Companies* concluded that an award of lost profits for all of the estimated 120,000 cylinders would convert the contract from a requirements contract, where the government only orders its actual needs, to a guaranteed quantity contract.⁹⁷ In addition, the Federal Circuit held that in this case the contractor could not establish that it would have made a profit had DLA issued proper estimates or told bidders that its estimates were inaccurate.⁹⁸

The Federal Circuit also concluded that lost profits in this case would allow the contractor to profit from DLA's breach, because the

91. *Id.* at 1333, 1335.

92. *Rumsfeld v. Applied Cos., Inc.*, 318 F.3d 1317, 1330 (Fed. Cir. 2002).

93. *Applied Cos., Inc.*, 325 F.3d at 1329-30.

94. *Id.* at 1335.

95. *See Ace-Federal Reporters, Inc. v. Barram*, 226 F.3d 1329, 1332 (Fed. Cir. 2000) (reaffirming the availability of lost profits compensation when the government procures goods or services from a third party, thereby breaching a requirements contract); *Torncello v. United States*, 681 F.2d 756, 771 (Ct. Cl. 1982) (asserting that under a requirements contract, the termination for convenience clause does not permit the government to breach its only meaningful obligation by diverting business away from a contractor); *Locke v. United States*, 283 F.2d 521, 523 (Ct. Cl. 1960) (holding that the claimant was entitled to compensation for its projected share of business stemming from a breached requirements contract).

96. 245 F.3d 1342 (Fed. Cir. 2001) (requiring a definite determination that the contractor would have made a profit, the amount of which may be reasonably estimated, and a showing that the lost profits were the proximate result of the breach).

97. *Applied Cos., Inc.*, 325 F.3d at 1339.

98. *Id.* at 1340.

contractor would have earned a profit on the cylinders sold, or it would not have bid at all if the government had provided a reasonable estimate.⁹⁹ To allow recovery on the full 120,000 estimated quantity would place the contractor in a better position than if the DLA had never breached the contract by negligently providing the estimates.¹⁰⁰ Thus, the contractor's recovery is limited to an equitable adjustment in price of units delivered,¹⁰¹ or it is limited to a recovery for termination for convenience costs if the contractor did not deliver any cylinders.¹⁰²

The dissenting opinion by Judge Dyk presented a classic "Contracts 101" debate over the standard of proof for an award of lost profits. Judge Dyk noted that in none of the negligent misrepresentation precedents cited by the majority did the contractor seek lost profits.¹⁰³ Citing the general law of contracts allowing lost profits based on the amounts of likely purchases, the dissent was particularly disturbed by the majority's failure to provide the contractor an opportunity to prove foreseeability of likely purchases.¹⁰⁴ The dissent argued that the majority decision will effectively permit the government to misrepresent its requirements without consequences in situations where the misrepresentation does not cause the contractor an increase in costs.¹⁰⁵

IV. DEFAULT

Several important decisions were issued in 2003, which defined standards of review to be utilized in reviewing the propriety of terminations for default.

A. *McDonnell Douglas v. United States*

In *McDonnell Douglas v. United States*,¹⁰⁶ the Federal Circuit issued its second opinion in the twelve years of litigation for this termination for default dispute.¹⁰⁷ The first Federal Circuit opinion¹⁰⁸ reversed the Court of Federal Claim's ("CFC") ruling that the Navy did not base its

99. *Id.*

100. *Id.*

101. *Id.* at 1341.

102. *Id.* at 1342.

103. *Id.* at 1342-45 (Dyk, J., concurring in part and dissenting in part).

104. *Id.* at 1345.

105. *Id.*

106. 323 F.3d 1006 (Fed. Cir. 2003).

107. *See id.* at 1010 (noting that this case arose in 1991 when the government defaulted on a contract with McDonnell Douglas for the development of a carrier-based stealth aircraft).

108. *McDonnell Douglas Corp. v. United States*, 182 F.3d 1319 (Fed. Cir. 1999).

decision to terminate on the contractor's performance.¹⁰⁹ The CFC misapplied *Schlesinger v. United States*,¹¹⁰ which barred default termination only where the termination had no connection to the contractor's performance.¹¹¹ Since the termination in this case related to the contractor's performance, the Federal Circuit ordered a remand to determine if the contractor was in default.¹¹²

On the first remand, the CFC sustained the trial court's finding of default termination solely on the contractor's failure to meet performance deadlines.¹¹³ The trial court improperly interpreted the Federal Circuit's first decision as requiring the trial court to sustain the default as long as the delivery date was reasonable.¹¹⁴ The Federal Circuit rejected both parties' plea to rule on the default termination and end the litigation on appeal, because the CFC record did not contain adequate factual findings to establish whether the contractor was in default.¹¹⁵ This second opinion provides guidance for applying the standard in *Lisbon Contractors, Inc. v. United States*¹¹⁶ for reviewing default termination.

The Federal Circuit rejected the contractor's position that the standard FAR default language, which permits default termination if the contractor "fails to . . . [p]rosecute the work so as to endanger performance of this contract,"¹¹⁷ allows for default termination only for absolute impossibility of performance or complete repudiation or abandonment by the contractor.¹¹⁸ Nor did the Federal Circuit accept the government's position that prior default precedents did not apply, and that default termination is appropriate when a contractor expresses a concern that it may not be able to comply with a schedule milestone or specification requirements.¹¹⁹ The Federal

109. *Id.* at 1326-27.

110. 390 F.2d 702 (1968) (finding that the government's failure to provide constructive notice under a contract's default termination provision rendered the government's termination one of convenience, even though the termination occurred after the supplier failed to perform adequately under the contract).

111. *McDonnell Douglas*, 323 F.3d at 1013.

112. *McDonnell Douglas*, 182 F.3d at 1329.

113. *McDonnell Douglas*, 323 F.3d at 1011 (reiterating the CFC's refusal to base its determination of justified default on the contractor's alleged inability to perform the contract, anticipatory repudiation, or failure to comply with specific requirements).

114. *See id.* at 1012-13 (recalling that in its remand order, the Federal Circuit required the CFC to determine whether the government established default by the contractor, in which case the validity of the default termination should be upheld and the contractors would not recover under a convenience termination claim).

115. *Id.* at 1014.

116. 828 F.2d 759 (Fed. Cir. 1987). *See infra* note 121 and accompanying text for discussion of the *Lisbon Contractors, Inc.* standard.

117. 48 C.F.R. § 52.249-9(a)(1)(ii) (1984).

118. *McDonnell Douglas*, 323 F.3d at 1014-15.

119. *Id.* at 1015.

Circuit held that interpretation of the FAR default provision requires a compromise between judicial aversion to default terminations and the government's right to performance under the contract.¹²⁰ It reaffirmed the "pragmatic approach" adopted in *Lisbon Contractors, Inc.*, which requires the government to establish a reasonable belief that the contractor could not complete contract performance, with any reasonable likelihood, within the time remaining under the contract.¹²¹ A showing that the contractor fell behind schedule does not satisfy the government's burden.¹²² There should be tangible, direct evidence showing objective factors to make this determination, such as: testimony from the contracting officer; contemporaneous documents; a comparison of percentage of unfinished work to time left under the contract; a showing that the contractor failed to meet project milestones; and any relevant information about the contractor's financial position and performance history.¹²³

In language which will often be quoted for what the government does *not* need to prove, the Federal Circuit held that the contracting officer does not have to prove he was in fact correct.¹²⁴ The standard is whether the contracting officer was "justifiably insecure about the contract's timely completion."¹²⁵ In doing so, the focus is on whether the contracting officer had a reasonable belief based upon facts leading up to the time of the default decision—not whether the decision was correct based on hindsight and post-termination facts.¹²⁶ The Federal Circuit remanded for a determination of whether the government proved that the contracting officer reasonably believed that there was no reasonable likelihood that the contractor could complete contract performance within the allotted time.¹²⁷

The Federal Circuit also ruled that the CFC correctly found the government's unilateral imposition of a revised schedule to be reasonable based upon the methodical, comprehensive inquiry conducted by the Navy, taking into account all the issues and information available.¹²⁸ This finding does not require an examination of the amount of unfinished work as of the date of issue of the unilateral schedule, or an analysis of how long it would take

120. *Id.*

121. *Id.* at 1015-16.

122. *Id.* at 1016.

123. *Id.* at 1016-17.

124. *Id.* at 1017.

125. *Id.* at 1017 (citing *Discount Co. v. United States*, 554 F.2d 435, 441 (Fed. Cir. 1997)).

126. *Id.*

127. *Id.* at 1018.

128. *Id.* at 1019.

the contractor to complete the work given its capacity.¹²⁹ Although useful, such inquiries are not required to meet a reasonableness determination¹³⁰ under *DeVito v. United States*.¹³¹

The Federal Circuit rejected an “objective achievability” analysis since it would require a departure from the case law, and “would compel the government to have perfect prescience and be infallible in its decision.”¹³² Since the government conducted a methodical inquiry before imposing the new schedule on the contractor and “[took] into account all the issues and information then available to him,” including performance problems and the contractor’s track record and progress, the CFC properly found the revised date to be reasonable.¹³³ Respected commentators contend that this decision is a significant departure from the case law because the trial court does not have to make an independent analysis of the facts.¹³⁴ Rather, the new rule is whether the revised date is subjectively reasonable in the government’s view.

The Federal Circuit’s reluctance to impose an “objective achievability” analysis on a unique major weapons contract is understandable given the lack of prior experience producing the deliverables. However, the vast majority of default terminations involve more mundane construction and supply contracts where reliable, comparable contractor and industry performance experiences exist for an objective analysis of whether a revised schedule is reasonable or not. Judges in future litigation over the more typical default terminations involving unilateral revised schedules will have to decide whether such objective data should have been considered by the contracting officer in unilaterally establishing a revised schedule.

Thus, the court imposed, both for the default termination decision and for the unilateral imposition of a revised schedule decision, that

129. *Id.* (stating that such a finding is based on what the government knew or should have known at the time it adopted the unilateral schedule).

130. *Id.*

131. 413 F.2d 1147, 1154 (Ct. Cl. 1969) (stating that where the government unilaterally sets a new date for performance, such date must be “both reasonable and specific from the standpoint of the performance capabilities of the contractor at the time notice is given.”).

132. *McDonnell Douglas*, 323 F.3d at 1019.

133. *Id.*

134. See Ralph C. Nash & John Cibinic, *Postscript II: The “A-12” Default Termination*, 17 NASH & CIBINIC REP. ¶ 38, at 74 (2003) (observing that judges in the past have conducted an independent assessment of the facts when determining whether a new date, independently imposed by the government, is objectively reasonable based on the contractor’s capabilities and what the government knew or should have known).

the standard of review should be based on whether the contracting officer reasonably utilized objective data to reach those decisions.

The Federal Circuit also agreed that the contractor's superior knowledge defense to the default should be dismissed, because it required discovery of information protected by the Military and States Secrets privilege, which the government properly invoked.¹³⁵ Similarly, the Fifth Amendment Due Process Clause argument raised by the contractors was rejected¹³⁶ based on the Supreme Court's findings in *United States v. Reynolds*.¹³⁷

B. Johnson v. All-State Construction

In *Johnson v. All-State Construction*,¹³⁸ the Navy appealed the decision of the Armed Services Board of Contract Appeals that the Navy breached its contract with All-State Construction by withholding progress payments to offset liquidated damages.¹³⁹ In granting summary judgment on the contractor's breach of contract claim, the Board held that FAR 52.232-5(d) limited the amount of progress payments that the government could retain to a maximum of ten percent of the payment amount.¹⁴⁰ As such, the Board found that the Navy's retention of thirty-eight percent of All-State's progress payments breached the contract, and the Board converted the default termination to one for convenience.¹⁴¹

The Federal Circuit held that, absent a contract clause permitting the government to retain progress payments in anticipation of default termination, the Navy may not retain payments over and above the ten percent retainage right under FAR 52.232-5(d).¹⁴² However, the government may exercise its common law right of set-off to retain payments to cover the liquidated damages due the government.¹⁴³

135. *McDonnell Douglas*, 323 F.3d at 1020-21 (noting that the Military and States Secrets privilege can preclude discovery of information that might adversely affect national security).

136. *Id.* at 1023 (rejecting the contractor's argument that the Fifth Amendment Due Process Clause trumps the Military and State Secrets privilege and requires the government either to disclose the classified information or to forego the default termination action).

137. 345 U.S. 1 (1953) (finding that in a civil matter, the government's invocation of a privilege does not disadvantage the opposing party in the same way that such a privilege deprives a criminal defendant of information necessary to his defense, especially since the government was also responsible for raising the criminal charges in the first place).

138. 329 F.3d 848 (Fed. Cir. 2003).

139. *Id.* at 850.

140. *Id.* at 851.

141. *Id.* at 851.

142. *Id.* at 851-52.

143. *Id.* at 852.

This right of set-off is not limited by the retainage clause, FAR 52.232-5(d), or the set-off clause in the contract, because the contract provisions do not contain specific language defeating the government's right to set-off.¹⁴⁴ Reciting the set-off requirements of *Citizens Bank of Maryland v. Strumpf*,¹⁴⁵ the Federal Circuit held that the government properly exercised its right to set-off by taking the following steps: "(i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff."¹⁴⁶ Finally, the court found that the Navy may demand liquidated damages pursuant to set-off rights prior to making a final decision to terminate the contract even though the contractor is still performing under the contract.¹⁴⁷

C. Copeland v. Secretary of Agriculture

In *Copeland v. Secretary of Agriculture*,¹⁴⁸ the contractor's employees reported \$37,905 in Davis Bacon Act ("DBA") violations to the Forest Service's contracting officer.¹⁴⁹ The contracting officer withheld and delayed payment of progress payments based on the possible DBA violations.¹⁵⁰ Copeland's performance was delayed and the government eventually terminated both contracts for default.¹⁵¹ Copeland appealed to the Board of Contract Appeals, which dismissed the appeal based on a pending decision of Copeland's DBA violations by a Department of Labor ("DOL") administrative law judge ("ALJ").¹⁵² Five years after Copeland's default terminations, the ALJ dismissed the DBA charges based on the DOL's original delay in prosecuting the violations.¹⁵³ The government appealed, and the ALJ held that Copeland violated the DBA in the amount of \$3,951, but dismissed the charges based on the DOL's administrative delay.¹⁵⁴ Subsequently, Copeland appealed the default terminations to the Board. The Board held that absent a showing that the Forest Service inappropriately withheld payments, Copeland did not demonstrate cause for altering the Forest Service's default termination.¹⁵⁵

144. *Id.* at 853-54.

145. 516 U.S. 16, 19 (1995).

146. *Johnson*, 329 F.3d at 854.

147. *Id.* at 855.

148. 350 F.3d 1230 (Fed. Cir. 2003).

149. *Id.* at 1231.

150. *Id.* at 1231-32.

151. *Id.* at 1232.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* at 1232-33 (citing Bill Copeland, AGBCA Nos. 1999-182-1 to -187-1, 2000-147-1 to -148-1, 02-2 B.C.A. (CCH) ¶¶ 32,049, 158,404 (2002)).

Copeland contended that its performance on the contracts was delayed based on the government's excessive withholding of progress payments.¹⁵⁶ The Federal Circuit ruled that a different standard is applied to DBA withholdings than withholdings for set-offs.¹⁵⁷ While set-off withholdings are only proper if the set-off amount is properly calculated, DBA withholdings are "proper as long as the amount withheld depended on a reasonable judgment of the contracting officer that the withheld amounts were needed to protect the employees' interests."¹⁵⁸ Notwithstanding the long delay in DOL proceedings, the burden remained on the contractor to prove that its delay in performance due to the improper DBA withholdings was excusable, largely because the contractor had "ample opportunity" to prove the DBA violations false or owed in a lesser amount.¹⁵⁹ The Federal Circuit noted that given the extraordinary delay in the DOL decision-making process, if the contractor could have asked the contracting officer to release the funds with documentation to support his position that proper withholdings were made, the result of this case would have been different.¹⁶⁰

V. COSTS

The Federal Circuit issued two significant cost decisions in 2003 interpreting (1) the interplay between FAR and cost accounting standards principles on asset write-up allowability, and (2) the recovery of defense legal costs under FAR.

A. *Kearfott Guidance & Navigation Corp. v. Secretary of Defense*

In *Kearfott Guidance & Navigation Corp. v. Secretary of Defense*,¹⁶¹ the contractor submitted progress payment requests to the Navy, which included costs attributable to an increase in valuation of its assets during another company's purchase of Kearfott.¹⁶² The Navy contended the amounts attributable to the asset write-up were not allowable.¹⁶³ Kearfott appealed to the Armed Services Board of Contract Appeals, which held that FAR 31.205-52 barred Kearfott from recovering its costs associated with the increased asset

156. *Id.* at 1233.

157. *Id.* at 1234.

158. *Id.*

159. *Id.* at 1234-35.

160. *Id.* at 1235.

161. 320 F.3d 1369 (Fed. Cir. 2003).

162. *Id.* at 1371-72.

163. *Id.* at 1372.

valuation.¹⁶⁴ The Board held that the FAR language applied to Kearfott's business combination and did not conflict with Cost Accounting Standards ("CAS"), because the FAR language governed allowability and not allocability.¹⁶⁵

The Federal Circuit upheld the Board's decision and determined that FAR 31.205-52 is an allowability provision and does not conflict with CAS allocability principles.¹⁶⁶ Kearfott argued that the 1990 FAR regulation did not apply retroactively to a 1988 business transaction.¹⁶⁷ The Federal Circuit disagreed with Kearfott's retroactivity rationale and held that the critical date for determining the regulation's applicability is the cost claim's submission date.¹⁶⁸ Moreover, the Federal Circuit held that Kearfott's interpretation would create an "anomalous and cumbersome two-tiered system of cost accounting."¹⁶⁹ The asset write-up limitations would govern businesses that combined after the 1990 FAR Regulation while excluding earlier business combinations, even if the government contract in such earlier instances was executed after 1990.¹⁷⁰ Thus, the FAR regulation covers business combinations prior to 1990. The Federal Circuit also reasoned that the application of FAR 31.205-52 did not affect Kearfott's vested rights, and therefore, created no retroactivity problem.¹⁷¹

Kearfott also contended that the application of the FAR regulation to the business combination causes the FAR regulation to conflict with CAS 404 and 409.¹⁷² The Federal Circuit rejected Kearfott's interpretation because it would lead to the invalidation of the FAR regulation pre-1995 when the CAS provisions were modified to comport with the FAR regulation.¹⁷³ Kearfott argued that the FAR regulation operates as an allocability rule and where FAR and CAS conflict regarding allocability, CAS governs.¹⁷⁴ The government contended that the FAR regulation operates like a Defense Acquisition Regulation provision which requires that general and administrative expenses be allocated to individual costs in the G&A

164. *Id.*

165. *Id.*

166. *Id.* at 1377.

167. *Id.* at 1374-75.

168. *Id.* at 1373.

169. *Id.* at 1374.

170. *Id.*

171. *Id.* at 1375.

172. *Id.*

173. *Id.*

174. *Id.*

base and which was held to be an allowability provision.¹⁷⁵ Thus, the Federal Circuit determined that the success of Kearfott's argument rested on whether the FAR regulation is an allocability or allowability regulation.¹⁷⁶ It determined that the FAR regulation was an allowability regulation and held that:

Nothing in FAR 31.205-52 precludes contractors from measuring and allocating their costs pursuant to the protocol set forth in the pertinent CAS provisions. The FAR provision therefore has no impact on the measurement and assignment of costs under CAS to a contractor's commercial contracts. Rather, the FAR provision merely operates as an after-the-fact ceiling on the extent to which certain costs will be allowed once they have been allocated among the acquired asset values under the CAS provisions.¹⁷⁷

Relying on the administrative history of the FAR regulation, the Federal Circuit held that the FAR functioned as an allowability rule, which did not conflict with CAS.¹⁷⁸ Therefore, Kearfott's costs for asset write-ups were not recoverable.¹⁷⁹

B. *Brownlee v. DynCorp*

In *Brownlee v. DynCorp*,¹⁸⁰ the contractor, DynCorp, won a cost-plus-award-fee contract for base support services from the Army.¹⁸¹ Soon thereafter, the government began to investigate criminal allegations against DynCorp, including recording of false data, fraudulent documentation, and fraudulent use of government credit cards.¹⁸² DynCorp expended legal fees to defend itself and its employees, which concluded in a plea agreement by its branch manager.¹⁸³ DynCorp submitted a claim to the government for its defense costs, which excluded those costs specifically expended in defending the branch manager.¹⁸⁴ The government denied DynCorp's claim, and it appealed to the Armed Services Board of Contract Appeals.¹⁸⁵ The Board accepted the government's argument that, pursuant to FAR 31.205-47(b), a contractor could not recover defense costs when a proceeding resulted in the conviction of an agent or employee of the

175. *Id.* at 1376.

176. *See id.* at 1375-76.

177. *Id.* at 1377.

178. *Id.*

179. *Id.*

180. 349 F.3d 1343 (Fed. Cir. 2003).

181. *Id.* at 1345.

182. *Id.* at 1346.

183. *Id.*

184. *Id.*

185. *Id.*

contractor but not the contractor itself.¹⁸⁶ However, the Board found the regulation was inconsistent with the Major Fraud Act of 1988,¹⁸⁷ which makes contractor costs allowable in part.¹⁸⁸ Therefore, the regulation was a “nullity.”¹⁸⁹ The Board remanded the case to determine quantum in DynCorp’s favor.¹⁹⁰

In defending the Board’s decision, DynCorp contended that (1) the FAR provision should not apply when only the employee, not the contractor, is convicted, and (2) if the Federal Circuit construes the FAR provision to disallow recovery of defense costs associated with employee convictions, the regulation is invalid in light of the Major Fraud Act of 1988, which makes “contractor” costs allowable in part.¹⁹¹ The Federal Circuit rejected DynCorp’s interpretation of the regulation and held that FAR 31.205-47(b) defines the term “contractor” to include both the contractor and its employees.¹⁹² Thus, the FAR regulation disallows not only the cost of defending the employee, but all costs of the proceeding, including the cost of defending the contractor, even though the contractor itself was not convicted.¹⁹³

In addressing the contractor’s second argument, the Federal Circuit found that the Major Fraud Act was ambiguous, and that legislative history did not resolve the ambiguity in favor of the contractor’s interpretation.¹⁹⁴ Turning to the analysis under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,¹⁹⁵ the court found that the FAR regulations should be afforded deference under *Chevron* and concluded that FAR 31.205-47(b) specifically, given its reasonable interpretation, was entitled to the same deference and was binding.¹⁹⁶ Even if the statutory term “contractor” could be construed to exclude employees, the Federal Circuit held the Secretary of Defense was authorized to adopt supplemental cost disallowance rules going beyond the statute to include the contractor’s agents or

186. *Id.*

187. *Id.*

188. See 10 U.S.C. § 2324 (2004) (explaining circumstances under which contractors may recover costs).

189. *Brownlee*, 349 F.3d at 1346.

190. *Id.*

191. *Id.* at 1352.

192. *Id.*

193. *Id.*

194. *Id.* at 1352-53.

195. 467 U.S. 837, 842-43 (1984) (holding that a review of an agency’s statutory interpretation requires an analysis of whether the precise question has been directly addressed by Congress, and where such is not the case, whether the agency employed a permissible statutory construction).

196. *Brownlee*, 349 F.3d at 1354-55.

employees.¹⁹⁷ The Federal Circuit held that the 1988 Act did not change that approach, because the Act allowed defense costs in part, where there was no conviction, but only if allowable under the FAR.¹⁹⁸

The Federal Circuit remanded the case to determine whether the costs were incurred in a separate proceeding from that which DynCorp's branch manager plead guilty and whether they involved the same misconduct.¹⁹⁹

VI. CONTRACT INTERPRETATION

The decisions in 2003 further reflect the Federal Circuit's strong preference for the plain meaning approach to contract interpretation.

A. WDC W. Carthage Associates v. United States

WDC W. Carthage Associates v. United States,²⁰⁰ involved a military housing lease providing that the contractor/developer will repair any damages, beyond normal wear and tear, caused by the government or occupant.²⁰¹ The "cost of such repairs" would be paid by the government.²⁰² Although the government initially paid the full invoiced charges for carpet replacements due to damage beyond normal wear and tear, after several years, the government announced it would only pay the replacement cost less a prorated amount for normal wear and tear on the carpets.²⁰³

The Court of Federal Claims ("CFC") agreed with the government's contract interpretation on a motion for summary judgment. The Federal Circuit reversed, rejecting the CFC's reliance on landlord-tenant case law to interpret the lease's meaning since none of those cases dealt with the specific contract language at hand.²⁰⁴ Instead, it found that the "plain terms" of the leases required the government to pay the full cost of carpet replacements made necessary by damage beyond normal wear and tear, without any allowance for depreciation.²⁰⁵ The Federal Circuit rejected the government's "economic windfall" argument, that full reimbursement for replacement carpeting prior to the end of the

197. *Id.* at 1355.

198. *Id.*

199. *Id.* at 1356.

200. 324 F.3d 1359 (Fed. Cir. 2003).

201. *Id.* at 1360.

202. *Id.*

203. *Id.* at 1361.

204. *Id.* at 1362-63.

205. *Id.* at 1363.

carpet's useful life gives the contractors an economic windfall, since it was not the court's duty to rewrite the terms of the lease.²⁰⁶ The court also relied on the parties' past conduct, specifically, the government's initial payment of full replacement cost, as evidence of the proper construction of the leases.²⁰⁷ The rejection of the government's economic windfall argument is particularly noteworthy in this decision.

B. *Forman v. United States*

In *Forman v. United States*,²⁰⁸ Forman sought reimbursement of expenses allegedly incurred pursuant to a pre-indictment plea agreement with the Federal Bureau of Investigations ("FBI").²⁰⁹ Under that agreement, Forman pledged to cooperate in the establishment of a textile company, which would facilitate the FBI's investigation of a long-time clothing industry consultant.²¹⁰ The FBI, in turn, agreed to reimburse Forman for certain expenses and to allow Forman to keep any profits arising from the legitimate operation of the business.²¹¹ Forman submitted a reimbursement request, which the FBI denied on the grounds that Forman had failed to obtain FBI authorization prior to incurring the expenses.²¹² Forman filed suit in the CFC, which granted summary judgment in the government's favor because Forman failed to obtain FBI approval prior to incurring the expenses as required by their agreement.²¹³

The Federal Circuit rejected the government's contention that the contract required Forman to obtain express or "specific" pre-approval before incurring reimbursable expenses.²¹⁴ Rather, the plain language required Forman to consult with an FBI representative prior to incurring expenses as to the nature and purpose of the expenses.²¹⁵ The agreement provided that the FBI would instruct Forman not to proceed if the FBI determined the expenses unnecessary for its goals.²¹⁶

206. *Id.*

207. *Id.*

208. 329 F.3d 837 (Fed. Cir. 2003).

209. *Id.* at 839-41.

210. *Id.* at 840.

211. *Id.* at 839-40.

212. *Id.* at 840-41.

213. *Id.* at 841.

214. *Id.* at 843.

215. *Id.*

216. *Id.*

C. Rumsfeld v. Freedom NY, Inc.

In *Rumsfeld v. Freedom NY, Inc.*,²¹⁷ the United States appealed a decision of the Armed Services Board of Contract Appeals finding invalid the contractor's release of potential claims against the government contained in two modifications to a contract.²¹⁸ The supply contract involved Meal, Ready to Eat ("MRE") combat rations for the Defense Logistics Agency.²¹⁹ When the contractor repeatedly missed deadlines for delivery of MREs, the government terminated the contract for default.²²⁰ The contractor brought a claim for breach of contract, constructive change, and improper default termination in 1991.²²¹

Prior to termination of the contract, the parties entered into contract modifications extending delivery dates and making a price adjustment, in exchange for the release of claims.²²² For one of the modifications, the contractor claimed, and the government denied, the existence of a side agreement with the government to negotiate a contract for the supply of additional MREs beginning in 1987.²²³ The Board found that a valid side agreement existed based upon the contractor's letters sent before the execution of the modification and the fact that the contracting officer never objected to the contents of the letters at the time.²²⁴ The contract contained an integration clause, and the Board found that the side agreement was a part of the modification, despite contrary testimony from the contracting officer, which the Board did not find credible.²²⁵ Therefore, the contractor's release of claims against the government contained in the modification could not be enforced due to the government's breach of the modification.

The Federal Circuit reversed, strongly endorsing the FAR's policy of settling disputes through modifications, which should be enforced "absent a clear showing of invalidity."²²⁶ The parole evidence rule does not apply to allow the inclusion of additional terms when the modification is completely integrated.²²⁷ Integration clauses, while not dispositive, create a strong presumption of a fully-integrated

217. 329 F.3d 1320 (Fed. Cir. 2003).

218. *Id.* at 1323-26.

219. *Id.* at 1322.

220. *Id.* at 1324.

221. *Id.*

222. *Id.* at 1323-24.

223. *Id.*

224. *Id.* at 1325.

225. *Id.*

226. *Id.* at 1327.

227. *Id.* at 1328.

agreement.²²⁸ Use of extrinsic evidence with an integration clause should be “extremely limited,”²²⁹ such as when the document is obviously incomplete, or the merger clause was induced by fraud, mistakes or other reasons to set aside the contract.²³⁰ If there was a side agreement, the contractor should have stricken or modified the integration clause.²³¹ The court held that the modification was an integrated document, and therefore the parole evidence rule did not allow the inclusion of additional terms.²³²

In a *per curiam* decision on a petition for panel rehearing and rehearing *en banc*,²³³ the Federal Circuit affirmed its prior decision and rejected Freedom’s argument that the side agreement was integrated into the modification by virtue of a letter attached to the modification containing the agreement.²³⁴ The court on re-hearing also reaffirmed that mere attachment cannot bind a party.²³⁵ Rather, documents must clearly indicate that the attachments are to be considered part of the contract.²³⁶

This decision provides clear guidance and warning for unwary contractors signing contract modifications. If there is an integration clause in the modification, it will be enforced. If the parties did not intend the modification’s release language to cover impact or delay damages, one cannot rely on parole evidence, such as prior letters or discussions, or post-modification conduct to argue different intent to avoid the effect of the release language when the contract contains an integration clause.

VII. DURESS

In the initial *Freedom NY, Inc.* case discussed above, the Federal Circuit affirmed the Board’s finding that the modification’s release was unenforceable because of duress.²³⁷ Citing the standard three part test for duress,²³⁸ the government withheld a \$700,000 progress

228. *Id.*

229. *Id.*

230. *Id.* at 1328-29 (citing JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 3.2(a) (4th ed. 1998)).

231. *Freedom NY, Inc.*, 329 F.3d at 1329.

232. *Id.*

233. *Rumsfeld v. Freedom NY, Inc.*, 346 F.3d 1359 (Fed Cir. 2003) (*per curiam*).

234. *Id.* at 1361.

235. *See id.* (explaining that both parties must agree what documents constitute a single contract).

236. *Id.*

237. *Freedom NY, Inc.*, 329 F.3d at 1329.

238. *Id.* (stating that to prove duress, a party must establish: (1) involuntary acceptance of the other party’s terms, (2) a lack of alternatives under the circumstances, and (3) that the other party’s coercive act created such

payment, which the parties agreed caused the contractor to sign the modification with the release.²³⁹ A coercive act need not be illegal.²⁴⁰ Coercion may be shown by breach of an express contract term without a good faith belief the action is permissible under the contract.²⁴¹ Here, the government withheld the approved progress payment for the sole purpose of pressuring the contractor to sign the modification, which was not a reason listed under the contract for withholding a payment.²⁴² Thus, the government did not have a good faith belief that such a withholding was permissible.²⁴³ In an important amplification of case law, the Federal Circuit rejected the government's argument that it withheld the payment in good faith due to the government's belief that the contractor defaulted, as this justification was made after-the-fact.²⁴⁴ The wrongfulness of the government's action must be judged at the time it was taken.²⁴⁵

VIII. BID PROTESTS

The issue of clarifications and discussions often arise in bid protests involving negotiated procurements. In *Information Technology & Applications Corp. v. United States*,²⁴⁶ the protestor appealed from the decision of the CFC denying its post-award bid protest. The protestor complained, in part, that the Air Force violated 41 U.S.C. § 253b and 48 C.F.R. § 15.306, by conducting "discussions" with another bidder ("RSIS") and not with it ("ITAC"). According to ITAC, the discussions were in the form of evaluation notices ("ENs") to RSIS that revealed past performance deficiencies and requested additional information regarding performance. The CFC held that the ENs were not "discussions" within the meaning of FAR 15.306(d) because the agency had not made a determination of the competitive range or allowed the offerors to correct deficiencies by revising their proposals.

The Federal Circuit affirmed, citing revised regulatory language to distinguish between "discussions" and "clarifications." The Federal Circuit held that ENs were not "discussions" because RSIS did not have the opportunity to revise its proposal. The court held ENs were

circumstances).

239. *Id.* at 1324.

240. *Id.* at 1330.

241. *Id.*

242. *Id.* at 1331.

243. *Id.*

244. *Id.*

245. *Pigeon v. United States*, 27 Ct. Cl. 167, 175 (1892).

246. 316 F.3d 1312 (Fed. Cir. 2003).

requests for clarification under 48 C.F.R. § 15.306(a)(2) which provides that offerors “may be given the opportunity to clarify certain aspects of proposals” and one aspect being described as “an offer’s past performance information.” The ENs issued to RSIS sought additional information to verify relevant past performance of subcontractors and, thus, were clarifications. Rejecting the use of dictionary definitions to interpret the statute, the Federal Circuit gave deference to FAR definitions of the terms,²⁴⁷ as they represented “a reasonable interpretation of the statutory terms.”²⁴⁸ The Federal Circuit also rejected ITAC’s argument that ENs were not clarifications because they requested additional information. Any meaningful clarification requires the offeror provide additional information to the agency.²⁴⁹

CONCLUSION

The government contract decisions issued in 2003 reflect important developments in damages and default case law. The Boards of Contract Appeals and the Court of Federal Claims will have difficulty in uniformly applying these precedents. The Eichleay and modified total cost decisions discussed herein reflect the Federal Circuit’s continuing difficulty in applying rather simple damages principles to the practical realities of doing business with the government.

247. *Id.* at 1320-21.

248. *Id.* at 1322.

249. *Id.* at 1324.