Vol. 24

Issue No. 3

June 2014

BCA Bar Journal

The Clause

A Quarterly Publication of the Boards of Contract Appeals Bar Association, Inc.

The President's Column

Dear BCABA Members:

I can report several developments since my last President's Column. A leadership team and I have been working towards a closer collaboration with the BCA Judges Association. We continue to study various alternatives to achieve synergy.

You may notice that we are working towards transitioning from the historical name of this bar association publication – *The Clause* – to a name that is designed to attract more original content – tentatively, the BCA Bar Journal. Thanks to Skye Mathieson for the idea, and for his outstanding work as the new editor-in-chief.

Please consider attending BCABA's annual Colloquium on June 10 at 9:00 at the George Washington University Law School moot court room (2000 H St., NW, Lerner 101). This joint event between BCABA and GW's Government Procurement Law Program will discuss issues and challenges facing contractors doing business abroad. As always, it is free. My eternal thanks go to our own David Black and our friends at GW for this program. Please check our web site, bcaba.org for details.

(*continued on page 3*)

Table of Contents

Boards of Contract Appeals Bar Association, Inc.
Officers

President:
Hon. Gary Shapiro
PSBCA
2101 Wilson Boulevard, Ste. 600
Arlington, VA 22201
(w): 703-812-1900

Vice President:
Kristen Ittig
Arnold & Porter LLP
1600 Tysons Boulevard, Ste. 900
McLean, VA 22102
(w): 703-720-7035

Secretary:
Hon. Marc Loud
D.C. Contract Appeals Board
4421 North Street, NW, Ste. 250N
Washington, DC 20001
(w): 202-727-6957

Treasurer:
Thomas Gourlay
Army Corps of Engineers
441 G Street, NW
Washington, DC 20314
(w): 202-761-8542

Boards of Contract Appeals Bar Association, Inc.
Board of Directors

Anthony Palladino (2011-2014)
FAA Office of Dispute Resolution
for Acquisition
800 Independence Avenue, SW
Washington, DC 20591

David Edelestein (2012-2015)
Asmar, Schor & McKenna LLP
5335 Wisconsin Avenue, NW, Ste. 400
Washington, DC 20015

Katherine Allen (2011-2014)
Department of the Treasury
Bureau of Engraving & Printing
Washington, DC 20005

Ita Snyder (2012-2015)
General Electric Aviation
1299 Pennsylvania Ave., NW
Washington, DC 20004

Daniel Strouse (2012-2015)
Wittie, Letsche & Waldo LLP
915 15th Street, NW
Washington, DC 20005

Erin B. Sheppard (2011-2014)
McKenna, Long & Aldridge LLP
1900 K Street, NW
Washington, DC 20006

C. Scott Maravilla (2013-2016)
FAA Office of Dispute Resolution
For Acquisition
800 Independence Avenue, SW
Washington, DC 20591

William Wozniak (2012-2015)
Williams Mullen LLP
8300 Greensboro Drive, Ste. 1100
Tysons Corner, VA 22102

Jonathan DeMella (2011-2014)
Dorsey & Whitney, LLP
701 5th Avenue, Ste. 6100
Seattle, WA 98104

Immediate Past President:
Don M. Yenovkian
Fluor Government Group
100 Fluor Daniel Drive (HP03D)
Greenville, SC 29607

President's Column (cont'd):

Also check our website for information about BCABA board meetings, the upcoming summer judges reception and program, and other bar association events. We are trying to become more efficient with our information distribution by asking our members to check bcaba.org frequently. We hope that the web site soon will serve as the primary conduit of information. If you are a BCABA member, and have not registered for the BCABA directory, please go to the web site and follow the registration directions. Do not miss out on important announcements – please register in the directory. I ask that you help me spread that message to other members.

We also have scheduled BCABA's annual full-day conference. Please save the date – October 15. Watch this space and, of course, bcaba.org for details as they develop. I encourage anyone interested in donating some of their time, in any amount or capacity, to our volunteer organization which is dedicated to sharing information and improving the practice of law before the boards. Please contact me directly if interested. My contact information is available on bcaba.org.

Best regards,

Hon. Gary E. Shapiro
President
BCABA, Inc.

The Editor's Column

by
Skye Mathieson

This issue marks the return of the popular "Case Digests" section, which provides short summaries of noteworthy BCA decisions from the quarter. Our thanks go to Heidi Osterhout, Oliya Zamaray, Sonia Tabriz, and Michael Farr for their work in putting these digests together. We intend to have more case summaries in the next issue. Please let me and Heidi know if you are interested in becoming an Associate Editor. Our email addresses are: skye.mathieson@gmail.com and heidi.l.osterhout@gmail.com.

Leading this issue is an original article by Judge C. Scott Maravilla on the Buy American Act. The article analyzes GAO decisions and tries to bring clarity to when a U.S.-manufactured component comprised of foreign subcomponents constitutes a domestic component under the BAA. It is a great read on a hot-button issue in acquisition.

As our BCABA President, Judge Shapiro, wrote in the May 2014 issue, we want to transition the *BCA Bar Journal / The Clause* to print more original articles for our members. Judge Maravilla was the first to answer our call. We thank him, and we hope more will follow his lead. We know that you and your colleagues have great ideas that would make for fascinating articles. We want to read them. Please email your articles to me for publication.

We recognize that authors in any field want their articles to be widely read and cited by their peers. The BCABA's relatively broad membership, along with our diverse online readership, helps to satisfy the first criterion. The second criterion, citation by peers, appeared thornier with the opaque title *The Clause*.

After much thought, we decided to transition to a clearer, more descriptive, and more citation-friendly title: *BCA Bar Journal*. As we move to consecutive pagination, articles published in our journal would be cited to in accordance with Bluebook Rule 16.4 and T13. The format and font should be: Author's Name, *Article Title*, [Vol. #] BCA B.J. [page # of article's 1st page], [page-cite, if any] (Year).

At the end of the day, this publication is for you. If you have any questions or recommendations on how to improve it, please let Judge Shapiro and me know.

Reminder of Cheap Annual Dues

- Annual dues are extremely low: **$30** for government employees, and **$45** for all others.
- Dues notices will be emailed on or about **August 1st**.
- Dues payments are due NLT **September 30th**.
- There are no second notices.
- Gold Medal firms are those that have all their government contract practitioners as members.
- Members who fail to pay their dues by September 30th do not appear in the Directory.
- Members are responsible for the accuracy of their information in the Membership Directory, which is maintained on the website (bcaba.org).

Analyzing the Incorporation of Foreign Subcomponents under the Buy American Act

*By C. Scott Maravilla**

The Buy American Act (BAA) was promulgated in 1933 as a means to facilitate and protect American industry, workers, and capital during the Great Depression.[1] The BAA is intended to protect the interests of American workers, not serve as a protectionist measure for U.S. contractors.[2] However, it may be challenging to determine when a U.S.-manufactured component comprised of foreign subcomponents constitutes a domestic component incorporated into the end product satisfying the Buy American Act's 50 percent plus domestic components requirement.

There is no consistent criteria employed by the GAO to interpret the terms "manufacture," "end product," "component," or "system."[3] The Federal courts and Cibinic and Nash in their renowned treatise on the law of government contracts strongly criticize the GAO in failing to provide clear guidance on what constitutes an American manufactured component.[4] The U.S. Court of Appeals has even observed that "[t]he Comptroller General, with but limited success, has tried to provide general guidance regarding these terms and issues."[5]

There are, however, general guidelines provided by the GAO with regard to manufactured goods. In addition, the GAO has adopted a very broad definition of manufacturing.[6] Thus, an item will be considered a domestic end product when (1) the end product is manufactured in the United States, and (2) substantially all of the components directly incorporated into the end product have been mined, produced, or manufactured in the United States.[7]

U.S. Manufacturing of Components

Whether a component manufactured in the U.S. using foreign subcomponents constitutes an American-made component in order to meet the domestic component requirement in the end product is determined by an independent evaluation of the production processes and the particular facts of the case.[8] Proper analysis requires a comparison of domestic and total component costs, not the cost of foreign components as a percentage of total contract price.[9]

In determining whether a production process constitutes manufacturing of an altogether new component from foreign material, as opposed to merely serving as a step in the overall manufacturing of the end product where the foreign material is the component, the GAO uses the "basis test."[10] The basis test is that if processes performed on the foreign item create a basically new material or result in a substantial change in its physical character, the item constitutes a U.S. manufactured component.[11] It is not necessary for the manufacturing process undertaken in the United States to result in a substantial or fundamental change to the physical character of the foreign subcomponents to constitute a U.S. manufactured component.[12]

The application of the basis test has resulted in confusion and conflicting outcomes.[13] The GAO is actually more concise on what does not constitute manufacturing.[14]

The assembly of items or components to be incorporated directly into the end product from foreign-manufactured subcomponents may constitute a U.S.-manufactured component for BAA purposes.[15] In *General Kinetics*, the Pentagon procured two versions of a secure digital fax machine to be used with government-furnished cryptographic equipment, one with TEMPEST standard cryptographic equipment for limiting compromising emanations, and a second version without TEMPEST.[16]

In the ensuing protest, the GAO ruled that the fax machine component incorporating TEMPEST was sufficiently transformed to be considered manufactured in the United States. The Japanese commercial fax machine would conform to the specifications in the RFP only after replacing programmable read only memory chips, adding TEMPEST-required insulation to certain electronic subassemblies, removing insulated electronic subassemblies to the newly-added pedestal, and adding and integrating a protocol converter. The GAO reasoned that the "significance and necessity of those operations in making the fax machine conform to the specifications renders the fax machine a domestic component." Accordingly, the GAO found the TEMPEST system to satisfy the 50 percent plus component requirement.

The non-TEMPEST fax system, however, failed to satisfy the 50 percent plus domestic component requirement. The more limited domestic assembly and manufacturing operations performed on the non-TEMPEST fax system did not alter the essential nature of the fax machine component which was the core and essence of the end product being procured. In other words, the character of the Japanese-manufactured fax machine remained unchanged by the more limited domestic manufacturing operations performed on it.

Although the process is necessary to meet the specifications, the disassembly, removal of a circuit board, replacement of memory chips, and reassembly in the United States did not change its essential function as a basic fax machine. The GAO reasoned that this manufacturing process may not be used to circumvent the plain requirement of the BAA. Accordingly, the fax machine constituted a foreign component thereby making the overall cost of the domestic components directly incorporated into the end product less than the 50 percent plus requirement.

In *Rolm Corporation*, the GAO held that where a switch component of a telephone system was partially assembled in a foreign country but the manufacturing of the other subcomponents and final assembly of the switch is in the United States, the switch constitutes a domestic component for purposes of satisfying the BAA's 50 percent plus domestic component requirement incorporated in the end product.[17]

However, the mere reassembly of a foreign item or component, which had been disassembled for the purpose of shipment to the United States, does not constitute domestic manufacture of that component.[18] In *Ampex Corporation*, NASA entered into a contract with Sony Corporation for two video tape recorders.[19] The recorders were manufactured at Sony's California facility, however, the GAO held that the recorders were a foreign end product and not in compliance with the requirements of the BAA. The Comptroller stated that manufacturing an end product does not constitute a domestic-manufactured end product under the BAA. The cost of the domestic components directly incorporated into the end product, must satisfy the 50 percent plus requirement under the BAA. The base unit of the recorder is manufactured in Japan and directly incorporated into the video tape recorder making it a component of the end product. The fact that it is disassembled and reassembled during the manufacturing process does not materially alter its character to create a new item or change the fact that it was manufactured in Japan.

Conclusion

A component may be considered a domestic component directly incorporated into the end product for purposes of the BAA when the manufacturing process involved has substantially materially altered the physical characteristics of the foreign subcomponents to create a basically new material.

---

* – C. Scott Maravilla is an Administrative Judge with the Federal Aviation Administration, Office of Dispute Resolution for Acquisition.

Endnotes

---

1. 76 Cong. Rec. 1896 (1933).
2. *Allis-Chalmers Corp., Hydro-Turbine Div. v. Friedkin*, 635 F.2d 248, 253 (3rd Cir. 1980).
3. *Textron, Inc., Bell Helicopter Textron Div. v. Adams*, 493 F. Supp. 824, 831 (D.D.C. 1980).
4. J. CIBINIC & R. NASH, FORMATION OF GOVERNMENT CONTRACTS 633 (1982); *see also United States v. Rule Indus., Inc.*, 878 F.2d 535, 539 (1st Cir. 1989); *A. Hirsh, Inc. v. United States*, 1991 WL 102984, at *2 (E.D. Pa. 1991) ("[T]he Comptroller General has adopted different, and sometimes conflicting, standards as to what constitutes 'manufacturing' under the Buy American Act.").
5. *Rule Indus.*, 878 F.2d at 539.
6. *Imperial Eastman Corp.*, B-177865, B-179812, Mar. 29, 1974, 74-1 CPD ¶ 153 (assembly of tool kits from individual component parts constituted manufacturing within the meaning of the BAA).
7. *Cincinnati Electronics Corp.*, 55 Comp. Gen. 1479, 76-2 CPD ¶ 286.
8. *Rule Indus.*, 878 F.2d at 541.
9. *Ampex Corp.*, B-203021, Feb. 24, 1982, 82-1 CPD ¶ 163.

10. CIBINIC & NASH, *supra* note 4, at 633; D. RILEY, FEDERAL CONTRACTS GRANTS & ASSISTANCES 11.07, at 556 (1983); *see also Orlite Eng'g Co.*, B-229615, Mar. 23, 1988, 88-1 CPD ¶ 300.
11. *Rule Indus.*, 878 F.2d at 535, 539 (process of converting steel ingots into billets constituted manufacturing within the meaning of the BAA); *Foreign Product Determination: Steel Reinforcing Bars*, B-158869, Apr. 27, 1966, 45 Comp. Gen. 658, 659-60; *Davis Walker*, B-184672, Aug. 23, 1976, 76-2 CPD ¶ 182 (cylinder liners are not domestic end products because they were made substantially from foreign components, *viz*., Japanese steel cylinder liner forging); *Becton Dickinson Acutecare*, B-238942, July 20, 1990, 90-2 CPD ¶ 55 (domestic components of suction sets are not substantially transformed in Mexico so as to make them products of Mexico); *Orlite Eng'g Co.*, B-229615, Mar. 23, 1988, 88-1 CPD ¶ 300 (cutting, molding, heating, bonding, trimming, drilling, painting, and applying a rubber edge constitute manufacturing within the meaning of the BAA).
12. *General Kinetics, Inc. v. Cryptek Div.*, B-242052.2, May 7, 1991, 91-1 CPD ¶ 445.
13. *A. Hirsh, Inc. v. United States*, 1991 WL 102984, at *2 (E.D. Pa. 1991) (*citing* CIBINIC & NASH, *supra* note 4, at 633 (1982) ("In applying [the basis test] to particular cases, the Comptroller General has drawn some fine distinctions which result in considerable confusion.").
14. *Marbex, Inc.*, B-225799, May 4, 1987, 87-1 CPD ¶ 468 (sterilization); *Foreign Product Determination: Packaging*, B-160627, May 9, 1967, 46 Comp. Gen. 784 (inspection or packaging); *Foreign Product Determination: Cylinder Liners*, B-166008, May 9, 1969, 48 Comp. Gen. 727 (testing or evaluation operations).
15. *Textron, Inc., Bell Helicopter Textron Div. v. Adams*, 493 F. Supp. 824, 831 (D.D.C. 1980).
16. *General Kinetics, Inc. v. Cryptek Div.*, B-242052.2, May 7, 1991, 91-1 CPD ¶ 445.
17. *Rolm Corp.*, B-200995, Aug. 7, 1981, 81-2 CPD ¶ 106.
18. *Textron/Bell Helicopter*, 493 F. Supp. at 831; *Bell Helicopter Textrou*, B-195268, Dec. 21, 1979, 79-2 CPD ¶ 431, 59 Comp. Gen. 158.
19. *Ampex Corp.*, B-203021, Feb. 24, 1982, 82-1 CPD ¶ 163.

<u>The Perils of Making Claims on U.S. Government Contracts (*Daewoo* Revisited)</u>

By David G. Anderson∗

[Originally published as the Feature Article in the January 2014 issue of the *Government Contract Costs, Pricing & Accounting Report*, Volume 9, Issue 1. © 2014 Thomson Reuters. Reprinted with permission.]

For contractors who understand and comply with its rules, the U.S. Government can be a very fair and equitable partner. It has deep pockets, pays timely or pays Prompt Payment Act interest, and seldom includes "No Damage for Delay" clauses or unfair notice provisions in its contracts. In contracting with the Government, however, a contractor must turn square corners, which means it must know and comply with Government rules.

Contractors who submit unsupported or false claims to the Government face a parade of horribles. Most contractors realize this. What they sometimes do not realize is the enormity of the penalties, and the high degree of truthfulness and attention to detail needed to avoid running afoul of the false claims laws.

To jumpstart its claim recovery effort, a contractor may submit its certified claim to the Government before completing any real investigation. Focusing on entitlement, the contractor estimates its damages on the high side, knowing that it can later, if need be, reduce its damages. The contractor does not falsify anything, but with little investigation makes key damage assumptions in its own favor. The contractor—used to the rough and tumble world of commercial negotiations, in which puffery, exaggeration, inattention to detail, and taking of extreme damage positions are not uncommon—fails to realize that in submitting a largely self-serving damage computation, it may have crossed the false claims line.

When it comes to claims, the Government is not just another commercial customer, as the contractor learned in *Daewoo Eng'g & Constr. Co. v. United States*., 73 Fed. Cl. 547 (2006), *aff'd* 557 F.3d 1332 (Fed. Cir. 2009). Daewoo Engineering and Construction Co. contracted with the Army Corps of Engineers to build a 53-mile road around a tropical island for $88 million.

During contract performance, Daewoo submitted a certified claim against the Corps, alleging defective specifications, breach of the duty to cooperate, and impossibility of performance within the originally scheduled time period. Daewoo sought $64 million, including $50.6 million in projected future damages, and a 928-day schedule extension. When the contracting officer denied Daewoo's claim, Daewoo filed suit in the U.S. Court of Federal Claims.

At trial, when Daewoo's proof of damages fell far short of the $64 million claimed, the Government was permitted to amend its answer to add counterclaims for fraud. Following a 13-week trial, the Court found that Daewoo's damage estimate of $50.6 million for future damages was fraudulent. As a result of this finding, Daewoo had to:

- Pay the Government a $50.6 million penalty for violating the "anti-fraud" provision of the Contract Disputes Act. The CDA, 41 U.S.C. § 7103(c)(2), provides,

  > Liability of contractor.—If a contractor is unable to support any part of his claim and it is determined that such inability is attributable to misrepresentation of fact or fraud on the part of the contractor he shall be liable to the Federal Government for an amount equal to the unsupported part of the claim plus all the Federal Government's costs attributable to reviewing the unsupported part of the claim.

  Although Daewoo's $50.6 million future cost estimate was, in part, supportable, the Court found its calculation to be fraudulent, justifying a $50.6 million penalty. Daewoo's exaggeration of its damages rendered its whole $50.6 million estimate fraudulent, not just the exaggeration.

- Pay the Government a $10,000 penalty for violating the False Claims Act, 31 U.S.C. §§ 3729–3733. For each false claim submitted, a contractor is now subject to an $11,000 FCA penalty (previously $10,000). The FCA also provides treble damages for money obtained fraudulently from the Government. Here, because Daewoo had not been paid any of its claim, the treble damages penalty did not apply.

- Forfeit its entire $64 million claim, including the non-fraudulent portion ($13.4 million), under the "Forfeiture Statute," 28 U.S.C. § 2514, which provides,

  > A claim against the United States shall be forfeited to the United States by any person who corruptly practices or attempts to practice any fraud against the United States in the proof, statement, establishment, or allowance thereof.

  Because part of Daewoo's claim was fraudulent (the $50.6 million future-damage calculation), Daewoo forfeited its entire $64 million claim. The forfeiture penalty is unique to litigation in federal court. In choosing to litigate in the COFC, rather than before a board of contract appeals, a contractor risks forfeiting its entire claim should a portion of its claim be deemed fraudulent.

Daewoo paid an enormous penalty for submitting a fraudulent damage calculation to the Government. Given the size of the penalty, it is noteworthy that Daewoo may not have understood that it was doing anything wrong. It appears that Daewoo was clueless—that it had no idea it was walking on the edge of a cliff.

Daewoo expected to negotiate a settlement with the U.S. and, for this reason, was more concerned about getting the Government's attention and establishing a favorable negotiating position than it was about ensuring the damages it claimed for negotiating purposes were in fact supportable.

Contractors often position themselves for negotiations by submitting a claim at the high end of the range of reasonableness, knowing that the owner, as a matter of course, will insist on decrementing the claim. Contractors also sometimes err in calculating damages. Neither circumstance ordinarily constitutes fraud.

Here, Daewoo, faced with tens of millions of dollars in losses, put together in a *summary fashion* its $64 million damage calculation, in the belief that the Government would negotiate it downward—in part by accepting a cheaper method of construction. Daewoo was prepared to reduce its claim for settlement purposes, but settlement proved elusive, and the case proceeded to trial.

At trial, Daewoo could not support its $50.6 million future cost calculation, and it acknowledged that the amount was developed for negotiation purposes, to indicate the seriousness of the situation and to get the Government's attention. Daewoo also conceded that $50.6 million exceeded what it believed the Government owed. Considering these facts, the Court held that the $50.6 million damage calculation was a negotiating ploy—the type of fraud Congress sought to prevent—and severe penalties followed.

Where did Daewoo go wrong? The Court found that:

- In its future cost calculation, Daewoo assumed that the Government was responsible for each day of additional performance beyond the original contract period, without considering whether there was any contractor-caused or other delay. (This is a typical contractor position at the start of negotiations. However, a contractor needs a rational basis for so claiming).

- Although Daewoo's damage expert testified at trial that the computed damages were $20 million less than Daewoo's certified claim and complaint, Daewoo failed to amend either. (In retrospect, it would have been prudent to amend both, but contractors reduce their damages all the time without recertifying their claim or amending their complaint).

- Daewoo made numerous incorrect assumptions and errors, all in its own favor. (Where unknowns exist, both contractors and the Government normally make assumptions in their own favor. A large, multi-year damage computation, consisting of thousands of individual cost elements, is rarely error-free. Early expert guidance, which Daewoo did not obtain, can significantly reduce error).
- Daewoo included in its damage calculation costs that the Defense Contract Audit Agency had rejected as unsupported or unallowable in an earlier claims audit. (This is not uncommon. Contractors frequently disagree with audit findings, but a

contractor who continues to include audit-questioned costs, without explaining in the claim why it is doing so, puts itself at risk).

- Daewoo used an equipment rate manual to price equipment, rather than using its lower actual costs. (When several ways of calculating a cost exist, contractors frequently opt for the one providing the higher return).

- When Daewoo certified its claim, it believed that it was owed a lesser amount. (This makes the certification false—but not the whole claim. One should never falsely certify. This said, a contractor's desire to fudge a bit is high. A little leeway makes the Government's insistence on an unfounded 10- to 20-percent decrement to settle much easier to swallow).

Daewoo's mistake was treating the Government as if it were a commercial entity. Daewoo incorrectly believed that, for negotiating purposes, it could submit an imprecise, largely unsupported damage calculation, certify it, and then, if the case actually went to trial, present something defendable there. Daewoo did not understand that if the damage calculation for its certified claim (the initial damage amount) was found to be baseless at trial, its claim might be deemed fraudulent with disastrous results.

Daewoo could not afford to wait, as it did, until after it was certain that the case would go to trial to examine the supportability of its damages. Even so, Daewoo might have escaped disaster had it employed better trial tactics—making it absolutely clear from the preliminary trial brief onward that, based on new analysis, it was no longer claiming $50.6 million in future costs, but instead a lesser, supportable amount.

In summary, as the *Daewoo* case illustrates, making a claim against the Government is a serious business matter, requiring careful oversight. Contractors who fail to appreciate the perils of making and certifying claims against the Government risk enormous penalties. Large, self-serving damage calculations are particularly problematic. When making a claim against the Government, a contractor should ensure that both entitlement and damages are well supported before submitting its claim. On larger, more complicated claims, a contractor normally will want to employ a damage expert at the beginning of the claim preparation process.

---

* – David G. Anderson is an attorney in the Albany, N.Y. office of Couch White, LLP. He is also a certified public accountant. His practice focuses on construction and government contract law. In addition, he serves as an expert witness on government contract costs and damages.

Reforming the False Claims Act for the 21st Century

By David W. Ogden and Jonathan G. Cedarbaum***

[Originally published in the May 2014 issue of *Contract Management Magazine*.

Originally enacted during the American Civil War, the False Claims Act (FCA)[1] is one of the most venerable statutes in the U.S. federal code. A century and a half later, after a series of amendments in the last 30 years, it has become a very important tool for redressing fraud in U.S. federal contracting (and other dealings with the U.S. federal government) and a vehicle for significant recoveries of funds to the U.S. Treasury.

The FCA authorizes huge penalties—larger in proportion to the commerce at issue even than the treble damages authorized by the antitrust laws. Yet central to its operation is the incentivizing of private citizens—so called "*qui tam* relators"—to come forward with evidence of fraud, permitting them to bring enforcement actions in the government's name and to retain sometimes enormous shares of the government's recovery. The FCA has promoted an increasing tidal wave of claims and litigation, and federal officials often trumpet the size of recoveries under the FCA as signs of its success. But as now constituted, the FCA's unique features have unintended harmful consequences, and it fails to realize its potential to stop fraud before it happens.

Relatively modest adjustments could preserve the FCA's incentives to come forward with evidence of fraud while promoting more effective compliance. This will mean less fraud and thus less need for litigation that distracts both the government and the companies that contract with it from efficiently serving the needs of the American people. The authors of this article helped design amendments to the FCA, recently proposed by the U.S. Chamber Institute for Legal Reform (ILM), which would strengthen the FCA's core fraud-fighting purposes while promoting the highest levels of compliance by those who deal with the federal government. We describe a number of them in this article and the problems they are designed to remedy.

The FCA Should Reward Companies that Do Everything They Can to Comply with the Law in the First Place

What's Wrong?

As structured and interpreted today, the FCA prioritizes the filing of lawsuits—often weak or meritless ones—over encouraging and rewarding effective corporate efforts to avoid and root out fraud internally. Most of the hundreds of new FCA suits filed each year are filed by relators—private citizens who are required to share their allegations and evidence with the government. The government then decides whether to intervene and join the litigation or decline intervention and leave the case to be pursued by the relator. Ninety percent of the cases in which the government declines to intervene are dismissed or abandoned, reflecting the fact that most of the hundreds of new *qui tam* suits filed each year are meritless.[2]

But defending against those meritless claims imposes real, and unnecessary, costs on private enterprise. Many of the proposed reforms by the ILR are designed to:

- Reduce the number of meritless FCA suits,
- Improve incentives and protections for genuine whistleblowers, and
- Ensure that FCA litigation is focused on genuine cases of fraud rather than statutory and regulatory defaults that do not involve fraud and have their own enforcement mechanisms.

Even more important, nothing in the FCA (apart from the sort of generalized deterrence that any punitive statute may bring) encourages companies to develop the most sophisticated kinds of compliance systems or encourages the employees of companies to help them comply with the law. Compliance—not after-the-fact, jackpot recoveries for employees who run to the government rather than fixing the problem before it starts—should be the first line of defense against fraud in government programs.

As Stuart F. Delery, the head of the Justice Department's Civil Division, explained recently, "Litigation to recover the costs of fraud is a far inferior option to preventing fraud in the first place."[3] Businesses should adopt "forward-looking compliance measures,"[4] he urged, and "join with the [government] in establishing structures that help prevent fraud—and the need for lawsuits to combat it—in the first instance."[5] We agree completely.

<u>How Can We Fix the Problem?</u>

The FCA should encourage companies to adopt effective compliance programs that encourage early detection and prompt internal reporting of potential fraud. Companies that adopt independently certified, state-of-the-art compliance programs would get the benefit of the package of reforms that are outlined as follows.

➢ Jurisdictional Bar on *Qui tam* Actions after a Defendant's Disclosure to the Government

Under the current FCA, a *qui tam* plaintiff who files suit after the defendant has already disclosed the same conduct to an agency inspector general is still entitled to proceed with the suit and receive a full bounty. This possibility exists even though the disclosure has been made to the government authority responsible for investigating fraud and even though the party making the disclosure is typically required to cooperate fully in the investigation. When a corporation has made a disclosure of fraud to an agency inspector general or other investigative office, *qui tam* actions based on the same allegations of fraud should be foreclosed.

The self-disclosure provision advocated here would not foreclose actions filed by whistleblowers who provide the government with information about fraud before a corporation makes a self-disclosure.

➢ Incentives for Potential Relators to Report Internally to their Employers

The FCA currently provides no incentive for employees to report concerns about potential fraud to their employers. To the contrary, the FCA contains a structural disincentive to internal reporting in the form of the "first-to-file" bar, which specifies that only the first relator who files suit is eligible for a bounty. This provision creates a "race to the courthouse," with the problematic effect that a potential relator has no incentive to take the extra step of reporting internally first since doing so might reveal information to other employees, one of whom might beat the initial discoverer of the problem to court. The FCA thus encourages employees to "circumvent internal reporting channels altogether."[6]

The FCA's disincentives for prompt internal reporting are out of sync with modern statutory and regulatory mechanisms that encourage internal reporting and more robust corporate compliance programs. If an employee of a company with a certified compliance program (or any other individual with a contractual or legal obligation to make reports to such a company) fails to report the alleged misconduct internally at least 180 days before filing a *qui tam* suit, the ILR proposes that the court would be required to dismiss the action. The 180-day window would afford the employer sufficient time to investigate the allegations and make a determination whether to disclose a violation to the government itself and/or take corrective action.

In order to ensure that a person who uses the internal reporting mechanism is not disadvantaged, the reforms would also provide that a person who reports internally and triggers a prompt disclosure by the company to the government would still be eligible for up to 10 percent of any government recovery that results from the company's disclosure. If the whistleblower reports internally, but the company does not promptly self-disclose and the whistleblower proceeds with a *qui tam* action, then the whistleblower would be deemed to have filed an action for purposes of the FCA's "first-to-file" bar dating back to the time of the internal report.

➢ No Mandatory or Permissive Exclusion or Debarment

For government contractors, the threat of suspension or debarment based on FCA violations has become a tool for pressuring companies into substantial settlements. In 2011 alone, over 3,300 federal contractors were suspended or debarred as a result of increased contract monitoring by federal agencies.[7]

Exclusion or debarment may be necessary to protect federal programs from entities or individuals who present a particularly high risk of recidivism. But when a company has implemented a certified compliance program, the rationale for exclusion or debarment no longer applies. ILR has proposed eliminating the threat of exclusion for such companies. Doing so would create a powerful incentive for companies to adopt state-of-the-art compliance programs while also affording such companies the ability, where appropriate, to seek the guidance and protection of the courts.

The Disconnect Between Actual Harm or Culpability and the FCA's Enormous Monetary Sanctions and Pressured Settlements Rather Than Court-Tested Evidence and Development of the Law

What's Wrong?

One fundamental problem with practice under the FCA today is the huge discrepancies it often creates between the amount of actual harm caused to the government by the conduct of investigated companies and the enormous financial penalties companies are compelled to pay. Two elements of the FCA, more than any others, contribute to these irrational and unjust outcomes.

First, the FCA requires *both* treble damages—themselves three times the harm actually done to the public fisc—*and* civil penalties without regard to the extent of actual damages in a range currently set at $5,500–$11,000 per "claim." Second, courts have interpreted a "claim," for purposes of the penalty provision, as each invoice or request for payment submitted to the government, even if there was only one arguably false statement made to the government and even if each request for payment was for a small sum. Thus, an invoice for, say, an individual pharmaceutical prescription or a part in a complex good worth just $20 could bring a mandatory penalty of $11,000, and 5,000 such invoices with a total value of just $100,000 could generate a mandatory fine, over and above treble damages, of more than $50 million.

The risk of facing treble damages plus exorbitant penalties deters virtually every company threatened with an FCA suit from taking the government to court, even when the claims are weak or meritless. Especially with the government's and relators' increasing reliance on false certification theories, liability can turn on the meaning of ambiguously worded regulations or contractual provisions. Thus, companies often feel almost irresistible pressure to settle, even when their odds of ultimate success may be substantial.

The rising frequency of settlements not only exacts a financial toll on the settling companies. By keeping cases out of court, settlements spare the government the effort of testing its evidence in front of a detached judge. Also, settlements frustrate the development of the clearer legal rules that emerge through frequent interpretation of a statute in light of different sets of facts.

The prospect of large penalties, coupled with the increasing frequency of suits, has led companies to settle FCA claims rather than contest them. As one court explained, "[b]ecause the risk of loss in [an FCA] case carries potentially devastating penalties, unlike most litigation or even an administrative recoupment action,"[8] companies are discouraged from even attempting to defend themselves in court.

Conversely:

> *Qui tam* relators are also incentivized to file suit even if their case is weak and unlikely to succeed at trial. FCA suits frequently end in settlement because of the heavy penalties and potential for disqualification from federally funded programs…. The potential for the imposition of significant penalties is enough to cause many defendants to think twice about taking a case to trial, even if the plaintiff's case is unlikely to succeed. Thus, many *qui tam* cases are not adjudicated before a judge, but decided in negotiations between lawyers….[9]

The result is that companies "lack the benefit of precedent and reliable information on which to base decisions about the legitimacy of the [Department of Justice's] use of the [FCA against them]."[10]

How Can We Fix the Problem?

Several simple changes in the FCA could help bring its sanctions back in line with the harm actually suffered by the government and the culpability of investigated parties. Companies that adopt effective compliance programs should get the benefit of these changes. First, rather than tripling damages in every case, the statute should calibrate the damages multiplier to the defendant's culpability. A defendant would be liable for treble damages only when it acted with specific intent to defraud; double damages when it acted with knowledge, reckless disregard, or deliberate ignorance; and a maximum of 1.5 times damages when it made a disclosure to the government of the conduct. This would bring the FCA in line with other fraud statutes, which recognize gradations of punishment based on the defendant's level of culpability.

Second, statutory penalties should be available only when no damages are awarded. There is no reason to impose penalties when the defendant has already been assessed damages times a multiplier. Application of the multiplier already serves the purposes of the penalty: to punish the defendant and to ensure that there is a sufficient financial liability to deter future misconduct.

Third, penalties should be capped at an "amount equal to the sum sought in the claim in addition to all costs to the government attributable to reviewing the claim."[11] The proposed cap is designed to permit an appropriate punishment, and to provide compensation for any harm suffered by the government, but to avoid the possibility of penalty awards that are so excessive as to violate the Eighth Amendment. The proposed cap is loosely derived from the antifraud provision in the Contract Disputes Act,[12] which provides that the penalty for submission of a false claim is an "amount equal to the unsupported part of the claim plus the federal government's costs attributable to reviewing the unsupported part of the claim."[13]

Turning Regulatory or Contractual Breaches into Frauds

What's Wrong?

One of the most controversial expansions of FCA liability in the past two decades has been the court-created "false certification" theory of liability, and especially the notion of *implied* false certification. Under the false certification theory, violation of any fine-print regulatory requirement can provide a basis for treble damages and penalties. And under the *implied* false certification theory, the regulatory requirement need not even be stated in the contract or invoice. It may simply be found somewhere in the government program's regulations, with the contractor's promise to avoid any defaults taken to be implicit in its participation in the government program. But, as the Seventh Circuit has explained, "the FCA is not an appropriate vehicle for policing technical compliance with administrative regulations. The FCA is a fraud prevention statute."[14] Violations of federal regulations should not be treated as fraud "unless the violator knowingly lies to the government about them."[15] Still, many courts have permitted FCA liability without such clear, knowing falsehoods.

Premising FCA liability on technical violations, rather than on falsely seeking payments for goods or services not provided as promised, relieves relators of the need to prove, or even to allege, actual falsity in a claim for payment submitted in connection with providing goods or services. This is particularly troubling because of the large and rising number of potential regulatory requirements that may be used to ground false certification claims:

> Government contractors…are required to submit certifications related to everything from how they dispose of hazardous materials to their affirmative action plan, and they frequently enter into contracts requiring compliance with other statutory and regulatory provisions.[16]

How Can We Fix the Problem?

Liability for false certifications should only be permissible if the triggering certification is clearly and expressly stated and if compliance with it is explicitly identified as a condition of the government's paying on the contract. The first of these requirements is a matter of simple fairness: It ensures that the contracting party knows the promises for which it may be held accountable. The second goes to the basic purpose of the FCA. If the requirement at issue would have made no difference in the government's paying, then any noncompliance caused no economic harm to the government.

To ensure that the statute remains focused on true fraud on the government, ILR proposes a new definition of "false or fraudulent claim" that would impose FCA liability only when a claim is "materially false or fraudulent on its face," or when a claim is presented or made "when the claimant has knowingly violated a requirement that is expressly stated by contract, regulation, or statute to be a condition of payment of the claim."[17] Liability could be based on a false "certification" only when "the claimant has violated a requirement that is expressly stated by contract, regulation, or statute to be a condition of payment of the claim."[18] This approach would reserve FCA liability for true frauds on the government and not apply them to contractual, regulatory, or statutory violations that do not rise to that level. Of course, such violations would be punishable under existing administrative or judicial regimes that establish proportional and appropriate penalties for such violations.

Conclusion

The FCA is an essential tool for fighting fraud in government contracting—a goal that is all the more urgent at a time of enormous federal deficits. But as currently drafted and enforced, the FCA is much less effective at preventing and thus reducing fraud than it could be, while it imposes unfair and unnecessary costs on companies that are trying to do the right thing. Commonsense reforms of the sort described in this article can and should make the FCA both fairer and more effective.

---

* – David W. Ogden is the chair of Wilmer-Hale's Government and Regulatory Litigation Group. He served as the deputy attorney general of the United States from 2009-2010 and assistant attorney general for the Civil Division, U.S. Department of Justice, from 1999-2001. He and Jonathan G. Cedarbaum, along with Peter Hutt and Anna Dolinsky of Akin Gump, authored "Fixing the False Claims Act: The Case for Compliance-Focused Reforms," issued by the U.S. Chamber of Commerce's Institute of Legal Reform in October 2013.

** – Jonathan G. Cedarbaum is a partner in WilmerHale's Government and Regulatory Litigation Group. He served as acting assistant attorney general for the Office of Legal Counsel, U.S. Department of Justice, from 2010-2011.

Endnotes

---

1. 31 U.S.C. §§ 3729–3733.
2. *See* U.S. DEPT. OF JUSTICE, "Fraud Statistics Overview" (Nov. 23, 2010), *available at* www.taf.org/FCA-stats-2010.pdf.
3. Stuart F. Delery, Acting Assistant Attorney General, U.S. Department of Justice, "Acting Assistant Attorney General Stuart F. Delery Speaks at the American Bar Association's Ninth National Institute on the Civil False Claims Act and Qui Tam Enforcement" (June 7, 2012), *available at* www.justice.gov/iso/opa/civil/speeches/2012/civ-speech-1206071.html.
4. *Id.*
5. *Id.*

6. Michael D. Greenberg, RAND Corp., "For Whom the Whistle Blows: Advancing Corporate Compliance and Integrity Efforts in the Era of Dodd-Frank," at 18 (2011), *available at* www.rand.org/pubs/conf_proceedings/CF290.html.
7. "Suspensions, Debarments Jump 73 Percent in Federal Contracting in 2011," WASH. POST (Sept. 30, 2012), *available at* http://articles.washingtonpost.com/ 2012-09-30/business/35497386_1_professional-servicescouncil-countractors-federal-agencies.
8. *Ohio Hosp. Ass'n v. Shalala*, 978 F. Supp. 735, 740 n.6 (N.D. Ohio 1997), *aff'd in part, rev'd in part*, 201 F.3d 418 (6th Cir. 1999) (litigating in court "is a risk the hospitals feel they cannot take—even if they believe their chances of prevailing would be great").
9. Sharon Finegan, "The False Claims Act and Corporate Criminal Liability: *Qui Tam* Actions, Corporate Integrity Agreements, and the Overlap of Criminal and Civil Law," 111 PENN STATE L. REV. 625 (2007).
10. Vicki W. Girard, "Punishing Pharmaceutical Companies for Unlawful Promotion of Approved Drugs: Why the False Claims Act Is the Wrong Rx," 12 JOURNAL OF HEALTHCARE LAW & POLICY 119 (2009).
11. U.S. CHAMBER INST. FOR LEGAL REFORM, "Fixing the False Claims Act: The Case for Compliance-Focused Reforms," at 4, 40 (Oct. 2013).
12. 41 U.S.C. § 7103.
13. 41 U.S.C. § 7103(c)(2).
14. *U.S. ex rel. Lamers v. City of Green Bay*, 168 F.3d 1013, 1020 (7th Cir. 1999).
15. *Id.*
16. "Brief of The Chamber of Commerce of the United States of America, *et al.* as Amici Curiae Supporting Petitioner [in *Schindler Elevator Corp. v. U.S. ex rel. Kirk*, slip. op. No. 10-188 (S. Ct. 2011)]," at 20 (2011); *see, e.g.*, 40 U.S.C. § 3142 (requiring companies that contract with the government for construction projects to pay their workers according to a wage schedule set by the Department of Labor); 29 U.S.C. § 793 (requiring companies doing business with the government to take "affirmative action" to employ disabled individuals).
17. *See* U.S. CHAMBER, *supra* note 11, at 30-33.
18. *Id.*

The Government's Non-Bankruptcy Rights for Debt Collection: Reconciling the Administrative Law of Contractual Withholdings and Setoffs

By C. S. Maravilla and David Schneider***

[Originally published in the December 2013 issue of the *Federal Circuit Bar Journal*, Volume 23, Number 2, ©2013 *Federal Circuit Bar Journal*. Reprinted with permission.]

Introduction

It is well established that the government, like any other creditor, has a common law right to offset (or "setoff") a debt owed to it from other obligations it owes the debtor.[1,2,3] In the realm of public contract law, the government's right to offset debt owed to it has branched into two distinct lines of government action: withholding progress payments on a government contract[4] and offsetting overpayments made by the government or money owed to the government from money owed the contractor.[5] The former is referred to as a withholding and the latter is called a setoff.[6]

However, the terms withholding and setoff have been loosely defined and used interchangeably by courts, boards and the Government Accountability Office ("GAO").[7] The blurred distinction has created much confusion in this area of law.[8] Some courts have attempted to reconcile these terms by calling such actions a "recoupment."[9] Another approach has been to define a withholding as "an intra-contractual right that allows the Government to refuse payment to which the contractor is not entitled."[10] In turn, a setoff has been defined as a circumstance where "the Government refuses to pay amounts due under a contract as a means of collecting sums improperly paid to the contractor on *another contract or unrelated transaction*."[11]

However useful and insightful these definitions are, they tend toward a more formalistic and narrow approach to defining withholdings and setoffs. It is possible for a contractor to hold only a single contract with the government in which an overpayment is made.[12] In this situation, if the government seeks to recover its overpayment by deducting that sum from future payments on the same contract, that would formally be considered a withholding because the deduction was made under a single contract but substantively would be considered a classic case of setoff. In other words, the government is recovering its overpayment through a single contract rather than multiple contracts, which would render what was otherwise a setoff for overpayment a withholding.[13]

As the case law shows, a withholding is an action of contract administration applied to progress payments.[14] Thus, the more formal definition focusing on whether the right is exercised intra- or inter-contractually establishes a "no man's land" where an action is neither a withholding nor a setoff, but perhaps both.[15] This Article seeks to provide an alternate basis for defining and distinguishing withholdings and setoffs by focusing on the case law. A withholding should be considered a situation in which the contracting officer withholds progress payments under a single contract[16] as a matter of contract administration.[17] A setoff should be considered strictly a method of debt collection in which the government offsets the debt owed to it from other monies owed to the contractor across contracts.[18]

For purposes of this Article, the focus on debt will be from a public procurement law perspective as opposed to broader perspective of debt owed to the government, which would include liability from federal tax owed. Contractual debt is defined in the relevant federal regulations.[19] The Federal Acquisition Regulations ("FAR") specify that "[c]ontract debts include, but are not limited to"[20] the following items:

> (1) Billing and price reductions resulting from contract terms for price redetermination or for determination of prices under incentive type contracts.
>
> (2) Price or cost reductions for defective cost or pricing data.
>
> (3) Financing payments determined to be in excess of the contract limitations at 52.232-16(a)(7), Progress Payments, or 52.232-32(d)(2), Performance-Based Payments, or any contract clause for commercial item financing.
>
> (4) Increases to financing payment liquidation rates.
>
> (5) Overpayments disclosed by quarterly statements required under price redetermination or incentive contracts.
>
> (6) Price adjustments resulting from Cost Accounting Standards (CAS) noncompliances or changes in cost accounting practice.
>
> (7) Reinspection costs for nonconforming supplies or services.
>
> (8) Duplicate or erroneous payments.
>
> (9) Damages or excess costs related to defaults in performance.
>
> (10) Breach of contract obligations concerning progress payments, performance-based payments, advance payments, commercial item financing, or Government-furnished property.
>
> (11) Government expense of correcting defects.
>
> (12) Overpayments related to errors in quantity or billing or deficiencies in quality.[21]

Contractors are required under the FAR to remit overpayments back to the government.[22]

To illustrate these more functional definitions of withholding and offsetting debt owed to the government under a public procurement contract, this Article will: (1) discuss the case law on withholdings; and (2) discuss the cases on setoff using the substantive case law to more clearly define these terms.

I. Withholdings

Distinguishing a withholding by simply counting the number of contracts involved provides little guidance. The Federal Circuit, in *Allied Signal, Inc. v. United States*,[23] provided a better guide to be used in analyzing this branch of government's ability to characterize a withholding. The Court analyzed withholding within the realm of progress payments.[24]

Allied Signal, Inc. ("Allied") was awarded a multi-year fixed price contract to develop and produce a trainer aircraft engine.[25] The contract included a Defense Acquisition Regulation ("DAR") Progress Payment clause and an Economic Price Adjustment ("EPA") clause that "allowed for adjustment of the target cost and ceiling values, within specified parameters . . . ."[26] The Air Force contracting officer reduced the contract price according the government's interpretation of the EPA clause.[27] The contracting officer subsequently refused to pay two of Allied's requests for progress payments because the reduction in the contract price resulted in overpayments by the progress payments already made.[28]

The Federal Circuit held that the government's withholding of progress payments was not a "collection of debt" as laid out in the Debt Collection Act ("DCA") and DAR.[29] The court agreed with the Armed Services Board of Contract Appeals ("ASBCA") in reasoning "the withholding of progress payments was an act of contract administration rather than collection of a debt as contemplated by the DCA and DAR provisions."[30] The Federal Circuit noted further that "one can consider Allied's continued entitlement to the progress payments an implied condition precedent to the Government's obligation to continue making those payments."[31]

The Federal Circuit, quoting the ASBCA, demonstrated that withholding a progress payment has a completely separate legal significance than does setting off an overpayment.[32] The Federal Circuit explained, "[h]ad the Government [already paid the full amount], it would be in a position where it would have to seek recovery of overpayments by requesting return of the funds or administrative offset against money payable to appellant. Under those circumstances, the [DCA and DAR provisions] would apply."[33] To invoke the DCA in a situation like this would "add a new procedural matrix to every contract," and without explicit statutory language the courts will not infer such a drastic "expansion of procedural requirements in contract administration."[34]

Although the government's right to withhold is considered contract administration, the right is not without limitation. The Federal Circuit in *Copeland v. Veneman*[35] addressed the issue of whether the amount in question regarding a government withholding was excessive.[36] The Federal Circuit stated: "Ordinarily, if the government withholds amounts from progress payments as a set-off, the withholding is proper only if the amount of the set-off is found to have been properly computed."[37] However, *Copeland* involved money withheld pursuant to a Davis Bacon Act ("DBA")[38] violation, which employs a different standard.[39] When progress payments have been withheld because of a possible DBA violation, the withholding is proper as long as the amount withheld depended on a reasonable judgment interpretation by the contracting officer that the withheld amounts were needed to protect the employees' interests.[40] In such instances it is the Department of Labor ("DOL") that makes the final decision on DBA violations.[41] However, the "Withholding of Funds" clause of the FAR "authorizes a contracting officer upon its own action or upon request by the DOL to 'withhold or cause to be withheld from the Contractor . . . so much of the accrued payments or advances as may be considered necessary to pay laborers.'"[42]

The government is not only limited by the amount it can withhold; it is also limited in the manner in which it may withhold. The government cannot use its power to withhold as a sword to control a contractor; rather, it can only use the power to shield itself. In *Rumsfeld v. Freedom NY, Inc.*,[43] Freedom Industries, Inc., the predecessor of Freedom New York, Inc., was awarded a contract to process, assemble, and package Meals Ready to Eat ("MREs").[44] The contractor missed many deadlines and claimed this was due to the government's repeated late progress payments.[45] Even though both parties signed a modification, the government continued to refuse to pay a progress payment of $700,000 until the contractor agreed to sign another modification.[46]

The Federal Circuit found that the second modification was signed under duress and, thus, not valid.[47] The contract did give the government the right to withhold payments.[48] However, it "did not allow the government to withhold progress payments simply to pressure the contractor into giving up its rights under the contract."[49] The court reasoned that this was because "[t]he government could not have had a good-faith belief that withholding for this purpose was permissible under the contract."[50]

In *Johnson v. All-State Construction, Inc.*,[51] the Federal Circuit again restricted the government from abusing its right to withhold when the government tried to withhold progress payments as a form of indemnity.[52] The issue in *Johnson* was whether the Navy's failure to make progress payments operated "as a breach of contract because the amount withheld was more than ten percent of the amount earned."[53] The Navy awarded All-State a contract for the construction of a hazardous waste storage facility.[54] The Navy granted an extension to the period of completion because the site was unavailable for part of the contracted term.[55] All-State failed to complete the task by the new extended date, which eventually resulted in termination of the contract.[56] All-State submitted an invoice for $120,878.67 for the 34% completion of the project it had completed before termination less the amount already received.[57] The government had a pending claim for $180,900 in liquidated damages.[58]

The ASBCA granted summary judgment to All-State finding the Navy breached the contract by retaining 38% of the amount All-State earned.[59] The ASBCA reasoned that FAR 52.232-5(d) "as incorporated in the contract limited the permissible retention of progress payments to 10 percent of the amount earned."[60]

The Navy had claimed its right to withhold progress payments on the following grounds: "(1) that the government is entitled to withhold progress payments when a default termination is imminent; and (2) that the government is entitled to withhold progress payments pursuant to its common-law right of set-off and also pursuant to section 1.12.2.b. of the contract."[61]

The Federal Circuit reversed the ASBCA's decision based on the Navy's second justification.[62] The Federal Circuit held that the Navy's first justification was not valid because the "Navy does not cite any provision of the contract or regulation as authorizing it to withhold the progress payment in anticipation of a default determination."[63] The Federal Circuit relied upon the holding in *Pigeon v. United States*,[64] where a contracting officer withheld progress payments "upon the ground that the work was not progressing as it should, and that he would retain not only the [ten] per cent but the compensation for the work as an indemnity to the defendants for the faithful performance of the agreement."[65] The Court of Claims in *Pigeon* held that the contracting officer's actions to "secure indemnity for the Government against the chances of probable failure upon the part of the contractor" was improper and breached the contract."[66]

II. Setoffs

The government's right to setoff differs from its right to withhold progress payments. Unlike withholding progress payments, the right to setoff is not a contract claim governed by the CDA. The Federal Circuit discussed this distinction in *Applied Cos. v. United States*.[67] In that case, the government sought to recover overpayments to Applied Companies ("Applied") totaling $1,399,005.19.[68] Applied had entered into multiple contracts with the government to supply air conditioning units.[69] Applied proposed to have the government exercise its right to setoff the debt against obligations the government owed Applied on different contracts.[70] The government rejected the setoff proposal, and, instead, elected to setoff the amount it was owed pursuant to a settlement agreement for another contract that was terminated for convenience.[71] The parties had negotiated a settlement agreement for $2,818,931.34, yet the government had only paid $911,604.11.[72]

The Federal Circuit affirmed the lower court's holding that "the termination settlement agreement did not bar the setoff, because nothing in the agreement deprived the government of its common law setoff right."[73] Applied tried to argue that it had satisfied its debt before the setoff, but the Federal Circuit found that Applied failed to demonstrate sufficient evidence that it had actually taken a setoff.[74] The Federal Circuit looked to the Supreme Court, which had previously explained that a "valid setoff requires: '(i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff.'"[75]

Applied also argued that the government's action was contrary to the Federal Acquisition Regulations and therefore invalid.[76] The FAR state that a termination of a settlement agreement "shall cover any setoffs that the government has against the contractor that may be applied against the terminated contract."[77] The Federal Circuit held that the FAR provision at issue "is meant to refer only to setoffs of sums under the terminated contract, rather than to any setoff that the government may have against the contractor, from whatever source."[78]

The Federal Circuit also affirmed the holding reached in the Court of Federal Claims—that Applied was not protected under the Assignment of Claims Act because Applied was the assignor and the benefits asserted under the Assignment of Claims Act only run to the assignee.[79] Finally, Applied argued that the government's action violated the Contracts Dispute Act because a contracting officer had not entered a final decision.[80] The Federal Circuit stated that before deciding if the government violated the Contracts Dispute Act it "must decide whether the setoff to recoup the erroneous overpayment can fairly be characterized as a claim 'relating to a contract.'"[81] The Court held that the setoff could not be characterized as a claim relating to a contract for purposes of the CDA.[82]

Although not governed by the CDA, the government's right to setoff shares some limitations with the right to withhold. The Federal Circuit in *Johnson v. All-State Construction, Inc*., held that the government, as in the case with withholding, could not use its ability to setoff a previous debt as insurance or to indemnify.[83]

In *Johnson*, the Federal Circuit reversed a ASBCA decision upholding a claim by the Navy that the government has a common law right to setoff.[84] All-State argued that the government's setoff right was defeated by the Retainage Clause of the FAR, which reads:

> If the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, the Contracting Officer shall authorize payment to be made in full. *However, if satisfactory progress has not been made, the Contracting Officer may retain a maximum of 10 percent of the amount of the payment until satisfactory progress is achieved.* When the work is substantially complete, the Contracting Officer may retain from previously withheld funds and future progress payments that amount the Contracting Officer considers adequate for protection of the Government and shall release to the Contractor all the remaining withheld funds. Also, on completion and acceptance of each separate building, public work, or other division of the contract, for which the price is stated separately in the contract, payment shall be made for the completed work without retention of a percentage.[85]

The Federal Circuit held in *Applied* that the government's right to setoff could only be defeated by explicit statutory language.[86] In *Johnson*, the Federal Circuit held that the Retainage Clause "does not contain explicit language defeating the government's common law setoff right, but rather narrowly limits the scope of the government's retainage rights."[87] The Federal Circuit reasoned that the common law right to set off has an entirely different purpose than retentions.[88] Setoffs are "to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him."[89] FAR 32.611 provides the government with a regulatory right to setoff, stating:

> If a disbursing officer is the responsible official for collection of a contract debt, or is notified of the debt by the responsible official and has contractor invoices on hand for payment, the disbursing officer shall make an appropriate setoff. The disbursing officer shall give the contractor an explanation of the setoff. To the extent that the setoff reduces the debt, the explanation shall replace the demand prescribed in 32.610.[90]

The Federal Circuit articulated that "[t]he set-off right is not an indemnity against a possible future breach, but rather offsets a current payable debt."[91]

The issue in *Bonneville Power Administration*[92] was whether the government could set off the payment on a contract to an assignee, even where the contract included a no setoff provision.[93] The U.S. Forest Service awarded a contract to Crow Rock Products, Inc. ("Crow") "for the construction of access roads and right-of-way for power transmission facilities through an area including national forest lands in the state of Washington."[94] A forest fire occurred while Sverdsten Logging Company, one of Crow's subcontractors, was working, costing the Forest Service $36,989.41.[95] The case also included a "purported notice of an alleged assignment" by Poppie Corporation of the payments under the contract with Crow to the First Bank of Troy Idaho ("Bank").[96] First Bank asserted that Poppie Corporation was the new corporate name of Crow.[97]

The Comptroller General held that the common law of assignments "governs the relative priorities of the parties."[98] Thus, the government may setoff against an assignee any claims that have matured prior to the assignment.[99] The Board reasoned that the right to setoff is inherent in the United States, and it covers separate and independent transactions when a debt is owed to the government.[100] The Board explained that the priority and right of setoff is determined by the type of assignment:

> A surety which completes the contract under a performance bond becomes subrogated to the rights of the Government and is entitled to any withheld funds. It is well settled, however, that a payment bond surety which pays the contractor's laborers and materialmen is merely a subrogee of the contractor and a creditor of the Government. The Government may, of course, setoff claims against its creditors.[101]

If an entity is both a creditor and debtor to the government, an accounting officer is required by law to "consider both the debts and credits and set off one indebtedness against the other."[102]

The ASBCA also addressed the issue of setting off an overpayment when there has been an assignment in *Kearfott Guidance & Navigation Corp.*[103] The issue in

Kearfott Guidance was whether a release signed by the assignor applied to the assignee's contract in which there was an overpayment corrected through a setoff and whether the contracting officer must issue a final decision for a lawful setoff.[104] In this case, the Air Force awarded a contract to Singer Company ("Singer"), and Singer in turn sold its business to Kearfott Guidance and Navigation Division.[105] The Air Force overpaid over $2,000,000 on the contract and recouped the amount through a setoff against other contracts held by Kearfott.[106] Among its claims, Kearfott asserted that the setoff was unlawful because the Air Force failed to comply with Section 605(a) of the Contracts Dispute Act and FAR 32.608(c).[107] Kearfott contended that the letters they received notifying them of the overpayments and the setoff were not final decisions of the contracting officer.[108]

The ASBCA upheld the setoff because the Release at issue did not apply to the specific contract involving the overpayments.[109] The ASBCA rejected Kearfott's claim that a final decision by the contracting officer under the CDA was necessary before the government could exercise its right to setoff.[110] The ASBCA reasoned that "since neither the CDA nor FAR 32.608(c) explicitly bars the Government's exercise of its common law right of setoff, the contracting officer was not required to issue a final decision under the CDA before collecting the amount due."[111]

In *Bluebird Forms, Inc.*,[112] the Government Printing Office Board of Contract Appeals addressed the contractor's untimely filing of its complaint regarding the setoff of alleged overpayments made by the government.[113] Bluebird Forms, Inc. ("Bluebird") was awarded a contract by the Government Printing Office ("GPO") for the production of standard forms.[114] From 1990–1992, Bluebird submitted vouchers and received payments without issue.[115] In 1993, however, Bluebird prepared a voucher for a print order that required parallel and right angle folds.[116] Bluebird billed for both types of folds at the contract price for "continuous fold," which included $14,800 for the right angle folds.[117] The GPO paid the voucher without question, but Bluebird became aware that it had not previously charged for right angle folds because right angle folds were not authorized under the contract.[118]

Bluebird prepared new vouchers for all prior folding work not yet invoiced to the GPO.[119] The government then believed that there was an overpayment of $20,748 for "films and folding charges not authorized," and recouped the amount "through offset against other contract payments owed to Bluebird."[120] The GPO asserted that Bluebird's claim was barred because it had failed to provide written objection to the setoff within sixty days, as required by the contract.[121] The ASBCA found that Bluebird's claim was time barred,[122] reasoning that "where the debt giving rise to the setoffs arose out of a GPO contract, [the setoff] is entirely consistent with the purpose and intent of the clause."[123] The ASBCA made reference to the final payment clause of the contract, which required the contractor to take exception within sixty days of payment, as the basis for its decision.[124]

In *Custodial Guidance Systems, Inc.*,[125] the contractor was awarded a contract for custodial and landscape services at the United States Customs Service and Interstate

Commerce Commission Buildings.[126] The contract had a specific provision that provided if the contractor did not perform a satisfactory job or failed to perform, "a deduction, in the nature of an assessment of liquidated damages, may be taken from the amounts to be paid it on its invoices for services rendered."[127] Pursuant to this provision, the contracting officer sent letters proposing deductions totaling $7,777.54 based on unsatisfactory inspection reports.[128] The Board of Contract Appeals held that there is no legal significance to the contracting officer's late issuance of formally assessed deductions.[129] The Board reasoned that because the government already had the money and Custodial showed no impairment in its ability to contest the deductions, it was not prejudiced.[130]

Conclusion

As demonstrated in the case law, the definitions of withholdings and setoffs have generally led to blurred distinctions between the two. In reviewing the cases themselves, a less formalistic definition of intra- and inter-contractual rights does not work. The cases support a clearer definition of withholding as a situation where the contracting officer withholds progress payments under a single contractual obligation as part of the contract administration. In this regard, the right can only be intra-contractual. In contrast, a setoff is best understood as a method of non-bankruptcy debt collection in which the debt owed the government is offset from money owed to the contractor.

---

* – Judge Christopher Scott Maravilla is an Administrative Judge at the Federal Aviation Administration Office of Dispute Resolution for Acquisition. He is an elected member of the American Law Institute and graduated with a JD in 2000 from the Georgetown University Law Center. The opinions in this Article are solely those of the author and do not reflect the positions of the FAA, the ODRA, or any other organization.

** – David I. Schneider is an associate in the Northern Virginia Litigation Group of Holland & Knight LLP. He graduated from Emory University School of Law and upon graduation, was honored with induction to The Order of Barristers, a national scholastic Order which recognizes excellence in oral advocacy. He earned his Bachelor of Arts in English at Tufts University, where he graduated magna cum laude. He is a former intern of the Federal Aviation Administration's Office of Dispute Resolution for Acquisition, and would like to thank Judge Maravilla for all of his help and guidance. He would also like to thank Judge Maravilla for asking him to co-author this piece.

Endnotes

---

1. *See, e.g.*, *United States v. Munsey Trust Co.*, 332 U.S. 234, 239 (1947).
2. "The government's right of setoff, although broad, is not unlimited. In order for the government to invoke its right of setoff, there must be mutuality of debt between the parties." *Marré v. United States*, 117 F.3d 297, 303 (5th Cir. 1997); *accord United States*

v. 717.42 Acres of Land, 955 F.2d 376, 381 (5th Cir. 1992); *Capuano v. United States*, 955 F.2d 1427, 1429–30 (11th Cir. 1992). The court in Marré defines mutuality as requiring "that the judgment creditor must be the same person (in the view of the law) as the party who owes the debt to be collected, and the government must be the same person to whom the debt is owed." *Marré*, 117 F.3d at 303 (*quoting Mr. Alan I. Saltman*, B-259532, 1995 WL 905738, at *2 (Mar. 6, 1995)).

3. The Federal Contracting Corporation ("FCC") entered into six contracts with the United States government in 1940 to paint and repair federal buildings. *Munsey Trust*, 332 U.S. at 236. Pursuant to statutory requirements, two sureties were designated. *Id.* The first surety guaranteed the completion of the work and the second covered the payment of laborers and materialmen. *Id.* The FCC did not pay the laborers and materialmen, and, accordingly, the second surety paid the FCC's obligations. *See id.* at 237. The government retained percentages of the progress payments due to the FCC, which totaled $12,445.03. *Id.*

On October 18, 1940, the FCC successfully bid for a painting job with the government. *Id.* However, the job had to be completed by a replacement contractor because the FCC failed to actually enter into the contract. *Id.* The government ended up spending $6,731.50 more than the FCC's proposed price as a direct result of the FCC's failure to enter into the contract. *See id.* The General Accounting Office ("GAO") deducted $12,445.03 held by the government as retained money to offset the government's claim of $6,731.50 against the FCC. *Id.* at 238. The GAO returned the remaining $5,712.53 to the FCC. *Id.*

The Supreme Court held that "[t]he government has the same right 'which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him.'" *Id.* at 239 (*quoting Gratiot v. United States*, 40 U.S. 336, 372 (1841)). Thus, in that case, "the government properly used its right to set off its independent claim." *Id.* at 244. Justice Jackson, writing for the majority, stated that the Court had no reason to increase the government's risks when the surety is required to bear such risk. *See id.* When a contractor does not complete its job the government must spend its own money to complete the job. Therefore, the government must be permitted to claim damages for the additional amount it had to pay as a result of the contractor's default. *Id.* The bond that was created for the payment of the laborers and materialmen was not formed to cause a loss for the government, but rather in order to protect the interests of the laborers and materialmen. *See id.* The government also lowered its safeguards for itself against the FCC because the sureties gave their assurances that they would pay the obligations to the laborers and materialmen. *See id.*

4. *See Great Am. Ins. Co. v. United States*, 203 Ct. Cl. 754, 754-55 (1974).

5. *See Applied Cos. v. United States*, 144 F.3d 1470, 1472 (Fed. Cir. 1998).

6. *See, e.g.*, *Great Am. Ins. Co.*, 203 Ct. Cl. at 754-55; *Applied Cos.*, 144 F.3d at 1472.

7. RALPH C. NASH, JR. & JOHN CIBINIC, JR., ADMINISTRATION OF GOVERNMENT CONTRACTS 1172 (3d ed. 1995). One of the reasons this may be the case is that the government's right to setoff is broad and used in other areas such as recovering taxes owed. *Marré*, 117 F.3d at 302. Richard L. Marré and Agritech Enterprises, Inc. ("Agritech"), Marré's wholly owned company, won $215,000 in damages from the government due to wrongful disclosures of his tax return information. *Id.* at 299. The

government assessed tax penalties of $2,010,733.40 against Marré and Agritech. *Id.* at 302. The district court held that the government could not setoff the damages against the tax penalties. *Id.* The government has the power to setoff damages with plaintiffs' tax liabilities. *Id.* at 303. As will be discussed further in Part 2, *infra*, this Article is only concerned with the government's right to setoff as applied to overpayments on government contracts.

8. NASH & CIBINIC, *supra* note 7, at 1172.

9. *See United States v. Dewey Freight Sys., Inc*., 31 F.3d 620, 622-23 (8th Cir. 1994). In other words, recoupment is "an equitable principle that allows a creditor in bankruptcy 'to show that because of matters arising out of the transaction sued on, he or she is not liable in full for the [debtor's] claim.'" *Id.* (*quoting* COLLIER ON BANKRUPTCY ¶ 553.03, at 553-17 (15th ed. 1994)).

10. *Id.*

11. *Id.* at 1176 (emphasis added).

12. *See Cecile Indus., Inc. v. Cheney*, 995 F.2d 1052, 1053 (Fed. Cir. 1993).

13. *See Campbell Keypunch Serv*., GSBCA No. 3123, 71-1 BCA ¶ 8800, at 40,882. In *Campbell Keypunch*, Campbell challenged a Contracting Officer's decision to setoff payments for future deliveries under its contract with the government against an alleged overpayment made on the contract. *Id.* at 40,881-82. The contract at issue was for key-punching and verifying services on IBM computer cards used for inputting data into GSA computers. *Id.* at 40,881. Campbell had listed the prices for punching, but not for verifying. *Id.* at 40,882. The bid schedule had "clearly required the Appellant to state a combined price for punching and verifying." *Id.* at 40,883. The Board of Contract Appeals upheld the setoff. *Id.* The Board held that the Contracting Officer was required to continue payments until the overpayments were settled. *Id.*

14. *Allied Signal v. United States*, 941 F.2d 1194, 1195 (Fed. Cir. 1991).

15. Some courts have attempted to establish a third way by defining this situation as a recoupment. *See United States v. Dewey Freight Sys., Inc*., 31 F.3d 620, 622-23 (8th Cir. 1994) (discussing the applicability of the recoupment doctrine in a government contracting setting). However, the boards repeatedly use recoupment in its common usage. Thus, this approach creates even more confusion.

16. In this regard, the right can only be intra-contractual.

17. *See, e.g.*, *Allied Signal*, 941 F.2d at 1195.

18. *See, e.g.*, *United States v. Munsey Trust Co*., 332 U.S. 234, 243-44 (1947).

19. *See* FAR 32.601 (2009).

20. FAR 32.601(b).

21. *Id.*

22. FAR 3.1003(a)(3) (2009) ("The Payment clauses at FAR 52.212-4(i)(5), 52.232-25(d), 52.232-26(c), and 52.232- 27(l) require that, if the contractor becomes aware that the Government has overpaid on a contract financing or invoice payment, the contractor shall remit the overpayment amount to the Government. A contractor may be suspended and/or debarred for knowing failure by a principal to timely disclose credible evidence of a significant overpayment, other than overpayments resulting from contract financing payments as defined in 32.001.").

According to FAR 9.406-2(b)(1):

> Knowing failure by a principal, until 3 years after final payment on any Government contract awarded to the contractor, to timely disclose to the Government, in connection with the award, performance, or closeout of the contract or a subcontract thereunder, credible evidence of—(A) Violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; (B) Violation of the civil False Claims Act (31 U.S.C. 3729-3733); or (C) Significant overpayment(s) on the contract, other than overpayments resulting from contract financing payments as defined in 32.001.

See also FAR 12.215 (2005) ("If the contractor notifies the contracting officer of a duplicate payment or that the Government has otherwise overpaid, the contracting officer shall follow the procedures at 32.604."); FAR 15.407-1(b)(7)(i) (2005) ("In addition to the price adjustment, the Government is entitled to recovery of any overpayment plus interest on the overpayments.").

The Defense Federal Acquisition Regulations ("DFAR") at 232.605 (2005) defines an "overpayment" as follows:

> Disbursing officers are those officials designated to make payments under a contract or to receive payments of amounts due under a contract. The disbursing officer is responsible for determining the amount and collecting contract debts whenever overpayments or erroneous payments have been made. The disbursing officer also has primary responsibility when the amounts due and dates for payment are contained in the contract, and a copy of the contract has been furnished to the disbursing officer with notice to collect as amounts become due.

23. 941 F.2d 1194 (Fed. Cir. 1991).
24. *See id.* at 1194.
25. *Id.*
26. *Id.*
27. *Id.* at 1194-95.
28. *Id.* at 1195.
29. *Id.* at 1198.
30. *Id.* at 1195; *see also Fairchild Republic Co.* (*Fairchild I*), ASBCA No. 29385, 85-2 BCA ¶ 18,047, *amended by* ASBCA No. 29385, 86-1 BCA ¶ 18,608 (*Fairchild II*), *appeal dismissed*, 810 F.2d 1123 (Fed. Cir. 1987) (*Fairchild III*)).
31. 941 F.2d at 1198.
32. *See id.* at 1197-98.
33. *Id.* (*quoting Fairchild I*, ASBCA No. 29385, 85-2 BCA ¶ 18,047 at 90,600).
34. *Avco Corp. v. United States*, 10 Cl. Ct. 665, 667 (1986).
35. 350 F.3d 1230 (Fed. Cir. 2003).
36. *Id.* at 1234-35.
37. *Id.* at 1234 (*citing Johnson v. All-State Constr., Inc.*, 329 F.3d 848 (Fed. Cir. 2003)).
38. *Id.* at 1231. The DBA sets wage and payment guidelines for federal contractors in contracts valued over $2000. *Id.*
39. *Id.* at 1234.

---

40. *Id.*; *see also Monarch Enters., Inc.*, VABCA Nos. 2239, 2296, 86-3 BCA ¶ 19,281 at 97,483.
41. *Copeland*, 350 F.3d. at 1234.
42. *Id.*; FAR 52.222-7 (2012).
43. 329 F.3d 1320 (Fed. Cir. 2003).
44. *Id.* at 1322-23.
45. *Id.* at 1323.
46. *Id.* at 1324.
47. *Id.* at 1329.
48. *See id.* at 1331.
49. *Id.*
50. *Id.*
51. 329 F.3d 848 (Fed. Cir. 2003).
52. *See id.* at 850.
53. *Id.* at 851.
54. *Id.* at 850.
55. *Id.*
56. *Id.* at 850-51.
57. *Id.* at 850.
58. *See id.*
59. *Id.* at 851
60. *Id.*
61. *Id.* at 850.
62. *Id.*
63. *Id.* at 851.
64. 27 Ct. Cl. 167 (1892).
65. *Johnson*, 329 F.3d at 852 (*quoting Pigeon*, 27 Ct. Cl. at 173).
66. *Id.* (*quoting Pigeon*, 27 Ct. Cl. at 175).
67. 144 F.3d 1470 (Fed. Cir. 1998).
68. *Id.* at 1473.
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.* The amount was paid to Comerica bank, to which Applied had assigned its settlement award as collateral for a loan. *Id.*
73. *Id.*
74. *Id.*
75. *Id.* at 1474 (*quoting Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 19 (1995)).
76. *Id.* at 1475.
77. *Id.*; *see also* FAR 49.109-1 (2012).
78. *Applied Cos.*, 144 F.3d at 1475.
79. *See id.* at 1476-77.
80. *Id.* at 1477.
81. *Id.* at 1477-78.
82. *Id.* at 1478.

83. *See Johnson v. All-State Constr., Inc*., 329 F.3d 848, 851 (Fed. Cir. 2003).
84. *Id.* at 855.
85. FAR 52.232-5(e) (2005).
86. *Applied Cos.*, 144 F.3d at 1476.
87. *Johnson*, 329 F.3d. at 854.
88. *See id.*
89. *Id.* (*quoting Gratiot v. United States*, 40 U.S. 336, 370 (1841)).
90. FAR 32.611 (2012).
91. *Johnson*, 329 F.3d at 850.
92. *Bonneville Power Admin*., B-188473, Aug. 3, 1977, 77-2 CPD ¶ 74.
93. *See id.* at 1.
94. *Id.*
95. *Id.*
96. *Id.* at 2.
97. *Id.*
98. *Id.* at 4.
99. *Id.* at 3; *see also South Side Bank & Trust Co. v. United States*, 221 F.2d 813, 814 (7th Cir. 1955).
100. *Id.* at 3.
101. *Id.* at 5.
102. *Id.* at 3.
103. ASBCA No. 49263, 99-2 BCA ¶ 30,518 at 150,696.
104. *Id.* at 150,695.
105. *Id.* at 150,693.
106. *See id.* at 150,693-94.
107. *Id.* at 150,695.
108. *Id.*
109. *See id.*
110. *Id.* at 150,696.
111. *Id.*
112. GPOBCA No. 27-95, 1998 GPOBCA LEXIS 9 (Aug. 20, 1998).
113. *See id.* at *3.
114. *Id.* at *1.
115. *Id.*
116. *Id.* at *1-2.
117. *Id.* at *2.
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.* at *3.
122. *See id.* at *17.
123. *Id.* at *9.
124. *Id.* at *6-7, *10-11.
125. GSBCA No. 6952, 82-3 BCA ¶ 16,749 at 83,281.
126. *Id.*

127. *Id.* at 83,282.
128. *Id.* at 83,281-82.
129. *Id.* at 83,283.
130. *Id.*

Case Digests

Edited by
Heidi Osterhout

Back by popular demand after a short hiatus, the Case Digest section of the *BCA Bar Journal* offers a snapshot summary of the most interesting and relevant substantive decisions from the boards of contract appeals. Below you will find summaries of a few appeals decided from March to May 2014. We intend to do more write-ups in the next issue. Please let us know if you are interested in becoming an Associate Editor and writing for us:

skye.mathieson@gmail.com
heidi.l.osterhout@gmail.com

American General Trading & Contracting, WLL

ASBCA No. 56758, April 23, 2014 – Judge Melnick
By Oliya S. Zamaray, Rogers Joseph O'Donnell, P.C.

The ASBCA's ruling on the parties' second set of cross-motions for summary judgment included interesting analysis of negligent estimates and implied-in-fact contracts.

The Facts

Prior to the 2003 invasion of Iraq, the U.S. Army awarded American General Trading & Contracting, WLL ("AGT") a laundry services contract at five military camps operating in Kuwait. The firm-fixed unit-priced contract contained a total item numbers adjustment; thus, AGT's payment depended on the actual number of items laundered. The contract estimated the average number of soldiers in each camp and the number of items to be laundered, but did not contain either the FAR 52.216-21 Requirements clause or the FAR 52.216-22, Indefinite Quantity clause. Between February and March 2003, AGT performed laundry services called for by the contract, invoiced for its services, and was paid by the Army. On March 20, 2003, the United States invaded Iraq and the Kuwaiti camps were virtually emptied, leading AGT to allege that the Army was negligent in estimating its laundry needs.

A series of verbal and electronic exchanges in June 2003 would lead to AGT's claim of an implied-in-fact contract. Specifically, the Army Contracting Officer ("CO") in Kuwait contacted AGT's president and asked AGT to establish laundry facilities at two additional camps, Victory and 35th Brigade. AGT responded with pricing only for Camp Victory – noting it was higher than the pricing on the original contract – and the CO verbally instructed AGT to proceed. AGT emailed the CO to request a written notice to proceed and the CO replied that AGT should "keep proceeding with [its] efforts" but that she was in the process of preparing a change order to be completed later in the week. Though AGT proceeded with the procurements and mobilization for Camp Victory, no modification was sent. Later, the CO emailed AGT to inquire about full-service laundry at 35th Brigade and AGT responded that service could be available in July, depending on when the CO issued the notice to proceed; AGT again noted that pricing would be higher than on the original contract. The CO issued a notice to proceed, but requested documentation regarding the price increase. AGT built and operated laundry facilities at both camps, but did not invoice the Army for those services at the rates quoted, using instead the lower rates in effect on the original contract.

In its certified claim, AGT alleged first that the Army had been negligent in estimating its laundry needs under the original contract. AGT next argued that the Army breached an implied-in-fact contract to pay for laundry services at two other Kuwaiti camps. After the CO denied its claim, AGT appealed to the ASBCA. Regarding the first claim the ASBCA denied the Army's motion and deferred ruling on AGT's motion until completion of discovery. The ASBCA granted the Army's motion for summary judgment regarding the second claim.

Negligent Estimates in Other Than Requirements Contracts

When estimates are placed in certain types of contract solicitations, contractors are entitled to rely upon them; "a negligent estimate as to a material matter is a breach of contract." The ASBCA clarified that indefinite-quantity contracts are not subject to such claims, but agreed with the parties that the original contract was not such a contract (it did not contain the Indefinite Quantity clause or commit the Army to purchase a minimum quantity of services, a key characteristic of such a contract). The ASBCA then noted that requirements contracts are subject to negligent estimate claims because they commit the government to fill all or some particularly defined need within a specified period using a particular contractor. The ASBCA agreed with the Army that the original contract was also not a requirements contract (it did not contain the Requirements clause and did not make AGT the exclusive source of laundry services). The ASBCA concluded that because the Army was not obligated to take any ascertainable quantity of laundry services, the original contract was therefore not enforceable at its inception. However, the contract became valid and binding to the extent that it was performed. As a binding contract, the original agreement was subject to a claim for breach.

The ASBCA looked to Federal Circuit precedent and concluded that what mattered was not the type of contract but whether "estimates … are material to the contract." It concluded that the government's estimates were material to the subject contract. The solicitation expressly directed AGT to bid based on certain estimates and AGT demonstrated to the board that it relied on the Army's estimates to establish rates. Thus, if estimates in the original contract had been negligently prepared, and AGT reasonably relied on them, there was "no reason" AGT cannot pursue a claim based on that negligence. The ASBCA denied the Army's motion for summary judgment, concluding only that the contract was not immune from a negligent estimate claim as a matter of law. The ASBCA deferred ruling on AGT's motion until completion of discovery.

Proving an Implied-In-Fact Contract

With regard to its implied-in-fact contract claim, AGT argued that the CO agreed to compensate AGT for laundry services at the higher rates it quoted the Army (but did not use in invoicing). The Army replied that there was no evidence that the parties formed an implied-in-fact contract obligating the Army to pay rates higher than those in the original contract. The ASBCA explained that, to prove an implied-in-fact contract, AGT would have to demonstrate the party acting for the Army had contracting authority, and then facts showing mutuality of intent, consideration, and lack of ambiguity in offer and acceptance.

Even assuming that the Army CO had authority to bind the Army for camps Victory and 35th Brigade, there was no evidence that the Army agreed to pay all of AGT's costs. The board then reviewed the facts in evidence, including the CO's requests for documentation supporting the higher rates and the fact that AGT invoiced the Army at the lower, original rates (which the Army paid). While the record showed that AGT proposed new, higher item prices, there was nothing to show "an unambiguous promise" by the Army to pay them. The board surmised that AGT was aware of this and did not invoice the Army at the higher rates. AGT's argument that the dispute was the CO's "fault" because she failed to issue a modification approving the higher prices confirmed for the ASBCA that there had been no meeting of the minds on this question. Thus, the board granted the Army's motion for summary judgment on AGT's second claim.

Appeal of Marilyn Laney
PSBCA No. 6487, June 2014 – Judge Shapiro
By Sonia Tabriz, Fox Rothschild LLP

The PSBCA's ruling on Ms. Marilyn Laney's claim against the United States Postal Service confirmed that the Postal Service cannot invoke a retroactive termination date where the contract terms expressly require one day notice to terminate the contract.

The CPU Contract

On September 26, 2002, Ms. Marilyn Laney was awarded a contract by the United States Postal Service to operate a contract postal unit ("CPU") in Lamoille, Nevada. The contract provided a fixed annual price of $19,392 to be paid automatically in 12 equal monthly installments. The Postal Service issued the monthly payments in the first week of the following month.

The contract term began on October 1, 2002, and was to continue for "an indefinite term," subject to each party's right to terminate as set forth in the contract. The termination clause provided that: "This contract may be terminated by either the Postal Service [C]ontracting [O]fficer or the contractor upon 60 day's written notice. The [C]ontracting [O]fficer may terminate the contract upon one day's written notice if necessary to protect the Postal Service's interest."

Termination of the CPU Contract

On August 1, 2012, the Postal Service issued Ms. Laney the $1,616 contract payment for the month of July 2012. The July 2012 payment was the last payment made by the Postal Service under the contract. Days later on August 3, 2012, the Postal Service's Contracting Officer ("CO") issued Modification 1, which suspended the CPU contract as of July 26, 2012, pending the outcome of an investigation regarding Ms. Laney's contract performance.

On August 10, 2012, the Postal Service's Office of Inspector General ("OIG") issued a report concerning Ms. Laney's misconduct in operating the CPU. After receiving the OIG's report in late August, the CO issued Modification 2 on September 13, 2012. Modification 2 stated: "This is your 1 day written notice that this contract will terminate in its entirety at close of business 08/22/2012. Termination is in the best interest of the Postal Service due to the results of an investigation conducted by the Office of Inspector General."

Ms. Laney's Claim

In response, Ms. Laney sent two letters to the Postal Service presenting a $3,298 claim consisting of: $1,616 for the September 2002 contract payment; $1,616 for the August 2012 contract payment; and $66 for a "filing fee." The CO issued a final decision denying all three components of Ms. Laney's claim and Ms. Laney filed an appeal with the Postal Service Board of Contract Appeals (PSBCA). Ms. Laney also filed a separate small claims lawsuit concerning its dispute with the Postal Service in a local Nevada court. The court entered default judgment against the Postal Service, which was vacated by the U.S. District Court for the District of Nevada.

The September 2002 Contract Payment

The PSBCA lacked jurisdiction to consider Ms. Laney's claim for the September 2002 contract payment of $1,616. The Contract Disputes Act ("CDA") provides that all claims must be submitted within six years after accrual. Ms. Laney admitted to knowing the basis for her September 2002 contract payment claim in 2002. Therefore, she was required to submit that claim no later than 2008. Ms. Laney failed to file the claim until 2012. Therefore, that component of Ms. Laney's claim was dismissed pursuant to the CDA's statute of limitations.

The Filing Fee

With regards to Ms. Laney's claim for a $66 filing fee – presumably associated with her small claims lawsuit filed in a Nevada court – Ms. Laney did not provide the PSBCA with any evidence that she paid a filing fee. Nor did Ms. Laney establish that she is entitled to recovery for the fee under her contract with the Postal Services. Therefore, that component of Ms. Laney's claim was denied by the PSBCA.

The August 2012 Contract Payment

What remained was Ms. Laney's claim for a $1,616 contract payment for the month of August 2012, which would have been paid to Ms. Laney in the first week of September 2012. This claim was timely filed under the CDA because Ms. Laney learned of the basis for her claim in 2012 and filed her claim in the same year. Therefore, the PSBCA addressed the merits of the claim.

Ms. Laney's contract with the Postal Service permitted the Postal Service to terminate the contract with one day's written notice if necessary to protect the Postal Service's interest. The CO provided Ms. Laney with this notice on September 13, 2012. According to the PSBCA, "that one-day notice would have been effective one day later, on September 14, 2012."

The Postal Service's attempt at retroactively invoking an earlier termination date of August 22, 2012, is not supported by the contract terms or by relevant case law. Specifically, the PSBCA cited to *Hector Rivera Ruiz*, PSBCA No. 1756, 88-3 BCA ¶ 20,829 – a case with facts very similar to those here. In *Ruiz*, the PSBCA held that the Postal Service's retroactive termination of a CPU contract was impermissible because the contract's termination clause provided only for a one-day or thirty-day termination notice. The same applies here.

The PSBCA was also unconvinced by the Postal Service's argument that its previous suspension of Ms. Laney's contract in Modification 1 eliminated its obligation to issue contract payments thereafter. The contract terms did not provide the Postal Service with this authority, and the contract remained in full force until either party exercised its right pursuant to the termination clause.

The Postal Service exercised its right to terminate by giving Ms. Laney one-day notice on September 13, 2012. The termination was therefore effective on September 14, 2012. Thus, Ms. Laney was entitled to the contract payment for August 2012 and the PSBCA granted her claim for $1,616.

Eyak Services, LLC (ESL)
ASBCA Nos. 58556 and 58557, Apr. 1, 2014 – Judge Melnick
– and –
Eyak Technology, LLC (EyakTek)
ASBCA Nos. 58552, 58553, 58554, and 58555, 1 Apr. 1, 2014 – Judge Melnick
By Michael J. Farr, Headquarters Air Force Acquisition and Litigation Directorate

In *Eyak Services, LLC*, ASBCA Nos. 58556 and 58557, 1 Apr 2014, and *Eyak Technology*, *LLC*, ASBCA Nos. 58552, 58553, 58554, and 58555, 1 Apr 2014, the ASBCA denied the Appellants' motions for summary judgment and to dismiss, which contended that the Government's claims for overpayment during contract performance improperly asserted fraud.

The Facts

In these cases, two sister companies, Eyak Services LLC (ESL) and Eyak Technology, LLC (EyakTek), appealed contracting officer final decisions seeking to recover overpayments, respectively, of $3.05 million and $29.4 million on U.S. Army Corps of Engineers (Corps) contracts. The overpayments resulted from a fraudulent scheme masterminded by a Corps employee, and involved an EyakTek employee and various subcontractors. Under the scheme, two Corps contracting officials facilitated the award of subcontracts to corrupt companies in return for their payments, and the subcontractors then included false or inflated amounts in their invoices to the Corps' prime contractors (ESL and EyakTek), which were then forwarded to the two Corps officials for payment approval.

ESL and EyakTek argued that because of the statutory prohibition on agencies settling or compromising fraud claims on their own, the final decisions were a nullity because they were based on the fraudulent conduct of certain individuals. Alternatively, ESL and EyakTek contended that the Government's claims should be dismissed to avoid the possibility of inconsistent decisions between the ASBCA and the forums adjudicating the fraud.

Contracting Officer May Assert Claims for Overpayment Even When Fraud is the Reason for Overpayment

In addressing these arguments, the ASBCA first emphasized that the Contract Disputes Act (CDA) forbids agencies from relying on it "to settle, compromise, pay, or otherwise adjust any claim involving fraud. 41 U.S.C. § 7103(c)(1). This prohibits contracting officers from pursuing claims for penalties or forfeitures arising from fraud in their final decisions, and deprives the ASBCA of jurisdiction over appeals involving such claims.

ESL and EyakTek contended that the Government's claims involved fraud because they arose from its criminal prosecution of the conspirators and involved their false subcontractor charges. They also asserted that the Government did not have a contractual basis for its claims because it did not allege that it paid ESL and EyakTek more than the fixed prices of their delivery orders.

The ASBCA disagreed, finding that the Government's claims against ESL and EyakTek arose not from any alleged fraud committed by ESL and EyakTek, but instead, from an established, fraudulent conspiracy by others, including Government, contractor, and subcontractor personnel, and sought the return of alleged overpayments the Government claimed ESL and EyakTek were not entitled to receive. The ASBCA further observed that the fact that ESL and EyakTek were the subjects of a Department of Justice fraud investigation was irrelevant, since regardless of the outcome of that investigation, the Government's claims were not based on fraud.

Contrary to ESL's and EyakTek's arguments, the ASBCA found that the Government's claims asserted a non-fraud basis for recovery based upon the established doctrine that the Government is required to recover amounts paid to a contractor that the contractor was not entitled to, over which it had jurisdiction. The ASBCA found that the Government's claims that it paid ESL and EyakTek more than they were entitled to receive due to the fraudulent acts of others implicated the parties' contract rights, not whether ESL and EyakTek committed fraud.

The ASBCA also disagreed with ESL's and EyakTek's contentions that the Government's claims should be dismissed to avoid the possibility of inconsistent decisions between the ASBCA and the actions of the Department of Justice or other tribunals concerning the civil fraud investigations ESL and EyakTek were undergoing. With ESL and EyakTek merely under investigation, with no proceedings ongoing at that time in another court or forum, the ASBCA found no basis to suspend its proceedings.

In an attempt to expand on their inconsistency argument as a basis for dismissal, ESL and EyakTek suggested there could be a conflict between the Government's claims and the restitution awards the Government had already obtained against the individual conspirators. ESL and EyakTek contended that since the restitution awards already compensated the Government for the overcharges it sought, the present claims proceedings could lead to a double recovery.

The ASBCA disagreed that the double recovery concern restricted its jurisdiction, observing that this concern potentially related to the merits of the Government's claims, and that the Government's ultimate entitlement to recovery was governed by equitable principles applied in a "case-by-case" determination designed to avoid injustice. The ASBCA further noted that such a review would require the development of a thorough record, which also made resolution of the case by summary judgment inappropriate.

Key Learning Point

In both cases, the Board held that even though the fraudulent conduct of others resulted in an overpayment to the contractor, that did not deprive the ASBCA of jurisdiction over a claim to collect the overpayment, where the Government's claim has a contractual basis and is not based on fraud committed by the contractor.