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

#### The President's Column

#### Dear BCABA Members:

The Boards of Contract Appeals Bar Association web site includes a simple motto on the home page: "We are an association of judges, attorneys, legal assistants and other professionals dedicated to supporting and improving the practice of law before the Boards of Contract Appeals of the Federal Government." I think we are more than that.

This bar association is entirely a volunteer organization - lawyers and other legal professionals from the private and public sectors, and judges, donating substantial amounts of their time to share their expertise. The dedication of many of these volunteers continues to impress me. The egalitarian nature of this organization equally impresses me. Consider how closely board judges and practitioners from both sides work together for a common goal - improvement of litigation practice at the boards.

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# PRESIDENT'S COLUMN (cont'd)

Disparate groups working together to attain a mutual objective, without personal agendas, is rare. We should recognize the value of that great cooperation in BCABA.

The BCABA website motto also is too limiting. We certainly are not limited to federal government boards, and have a thriving DC government board component. Also missing, I think, is mention of the developmental element of BCABA. Some of our functions are geared towards newer attorneys or law students, to those new to the practice area, and to those looking for networking opportunities. I think BCABA's motto should mention our educational function – I learn something at every event. I suppose, however, if we listed every BCABA attribute in the motto, it would become unwieldy.

In the common collaborative interest I described, a leadership team and I continue to work towards an even closer relationship with board judges. We may be creating a Judicial Division within BCABA. I will report more about this as developments warrant.

Continuing to look forward, please consider attending BCABA's annual full-day conference, which has been scheduled for October 15, and will be held at the offices of Arnold & Porter, 555 12th St., NW, Washington, DC 20004 (corner of 12th & F Sts, Metro Center Station). Registration information will be posted soon on our web site, bcaba.org. Please also be alert for announcements about our executive policy forum, which we expect to conduct during the first week of December. Again, please visit bcaba.org for details as they develop. If you are a BCABA member, and have not registered in the BCABA directory, please go to the web site and follow the registration directions.

Hard as may be for me to believe, the next edition of the BCA Bar Journal will include my final President's Column. If you have not had an opportunity to meet me or the other BCABA officers, please introduce yourself during the October conference.

Best regards, Hon. Gary Shapiro President, BCABA, Inc.



# **CASE DIGESTS**

#### Edited by Heidi L. Osterhout

Case Digests offer snapshot summaries of the most interesting, topical, and hopefully useful decisions from the boards of contract appeals over the past three months.

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#### Notice: Changes to ASBCA Rules

The ASBCA published revised rules on July 21, 2014. The revised rules: (1) add addendums for Equal Access to Justice Act (EAJA) Procedures and Alternative Methods of Dispute Resolution; (2) account for changes in technology; (3) provide updated contact information; and (4) reorder the rules for clarity.

The ASBCA rules are available online at <a href="www.asbca.mil/Rules/rules.html">www.asbca.mil/Rules/rules.html</a>. Details of the recent changes are discussed in the Federal Register, available at <a href="https://www.federalregister.gov/articles/2014/07/21/2014-17056/defense-federal-acquisition-regulation-supplement-rules-of-the-armed-services-board-of-contract.">www.asbca.mil/Rules/rules.html</a>. Details of the recent changes are discussed in the Federal Register, available at <a href="https://www.federalregister.gov/articles/2014/07/21/2014-17056/defense-federal-acquisition-regulation-supplement-rules-of-the-armed-services-board-of-contract.">www.asbca.mil/Rules/rules.html</a>. A state of the recent changes are discussed in the Federal Register, available at <a href="https://www.federalregister.gov/articles/2014/07/21/2014-17056/defense-federal-acquisition-regulation-supplement-rules-of-the-armed-services-board-of-contract.">https://www.federalregister.gov/articles/2014/07/21/2014-17056/defense-federal-acquisition-regulation-supplement-rules-of-the-armed-services-board-of-contract.</a>



#### Muse Business Services, LLC, CBCA No. 3537

May 29, 2014 – Judge Drummond By Tara L. Ward, Wiley Rein LLP

The Civilian Board of Contract Appeals' ("CBCA" or "Board") dismissal of Muse Business Services, LLC's ("Muse") breach of contract action against the Office of the Comptroller of the Currency ("OCC" or "Agency")¹ for failure to state a claim confirms that blanket purchase agreements ("BPA") are not binding contracts subject to the Board's jurisdiction.

As a general matter, BPA holders cannot expect to be heard by the Board on a breach of contract action related to issues arising in the performance (or non-performance) of a BPA. The *Muse* decision further warns BPA holders that they incur readiness costs at their own risk: unlike requirements contracts, BPAs do not require the government to issue orders against the BPA such that a contractor's costs of preparing for future work are simply the "cost of doing business" with the government.

#### The BPA

In August 2010, the OCC established a five-year BPA with Muse and another provider for non-personal litigation support services. The BPA contemplated the OCC's issuance of task calls to BPA holders, who would then submit quotes for evaluation and possible acceptance by the Agency. The BPA estimated that the OCC would issue 20 task calls a year, but stated that the BPA "[did] not obligate any funds." The BPA did not require Muse to submit a quote in response to every task call, nor did the BPA guarantee that OCC would award an order to Muse.

From October 2010 through April 2013, the OCC issued three task calls requesting quotes from the two BPA holders. All three were awarded to the other service provider. In the intervening years, Muse took steps to ensure that it would be ready to submit a quote and ultimately perform any future task calls, primarily by complying with certain clauses in the BPA. For example, Muse incurred costs complying with the BPA's information security clause, which stated that the service provider "shall maintain a computing environment with adequate security at all times."

In June 2012, Muse requested that the OCC provide Muse with information

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<sup>&</sup>lt;sup>1</sup> The OCC is a bureau within the U.S. Department of the Treasury.



concerning future task call requirements. The OCC declined, noting that information regarding future task calls was being evaluated, but stated that the Agency would keep Muse apprised of any developments.

#### Muse's Certified Claim And Appeal

On April 29, 2013, Muse submitted a certified claim arguing that the OCC breached the BPA, and seeking \$333,672.89 for costs it incurred anticipating and preparing to perform orders. The OCC denied Muse's claim on the ground that the BPA was not a binding contract. Specifically, the OCC stated that the BPA did not include a guaranteed minimum quantity such that it was not a requirements contract nor was it an indefinite delivery, indefinite quantity ("IDIQ") type contract. In addition, the OCC stated that the BPA did not create any binding rights and obligations such that it could not be considered a binding contract.

Muse appealed the decision to the CBCA. As a threshold matter, Muse argued that the BPA was a binding contract because under its terms, the OCC was obligated to provide Muse "task order" opportunities and, in return, Muse and the other service provider were to provide quotes and be ready to perform future orders. Muse's complaint thus argued that the OCC breached the "contract" by issuing a bad faith estimate, and breached its covenant of good faith and fair dealing by refusing to provide Muse with information concerning future orders.

#### BPA Not a Binding Contract

Muse acknowledged that BPAs are generally not considered contracts, but argued that this BPA was different because it placed specific obligations on the parties. In particular, Muse asserted that the BPA obligated OCC to provide Muse (and others) with "task order" opportunities, and in return, Muse was required to be ready to perform the work. In support of its argument that the BPA was a contract, Muse cited *Ace-Federal Reporters, Inc. v. Barram*, 226 F.3d 1329 (Fed. Cir. 2000), in which the Court of Appeals for the Federal Circuit determined that a requirements contract was, in fact, a binding contract because consideration had been exchanged.

By contrast, the OCC argued—and the Board agreed—that the BPA lacked mutuality of intent and consideration and therefore was not a contract. The Board reasoned that unlike in *Ace-Federal*, the BPA at issue here was not a requirements contract and did not otherwise require either party to take any particular action: the



BPA did not require the OCC to issue task calls, nor did it require Muse to submit quotes in response to task calls. At bottom, the Board held that the BPA was not, in fact, a binding contract. *See Ridge Runner Forestry v. Veneman*, 278 F.3d 1058, 1062 (Fed. Cir. 2002) ("[A] valid contract cannot be based upon the illusory promise of one party, much less the illusory promise of both parties.").

The Board ultimately dismissed Muse's substantive claims for failure to state a claim because no breach action could lie where there was not a valid contract. According to the Board, it was Muse's *choice* to incur costs to prepare for future orders, that is, Muse "assumed the risk of not receiving task calls and the associated opportunity to recoup it costs." Thus, the costs Muse incurred to ensure its readiness were merely "the cost of doing business"—not the result of the Agency's having failed to perform an obligation under a contract.

As a general matter, this decision presents important lessons for all parties: BPA holders cannot expect to be heard by the Board on a breach of contract action related to issues arising in the performance (or non-performance) of a BPA. The *Muse* decision further cautions BPA holders that they incur readiness costs at their own risk: unlike requirements contracts, BPAs do not require the government to issue orders against the BPA such that a contractor's costs of preparing for future work are simply the "cost of doing business" with the government.



Kellogg Brown & Root Services, Inc., ASBCA Nos. 56358, 57151, 57327, 58559 Jun. 17, 2014 – Judge Freeman By Steven A. Neeley, Husch Blackwell LLP

In *Kellogg Brown & Root Services, Inc.*, ASBCA Nos. 56358, 57151, 57327, 5559, Jun. 17, 2014, the ASBCA held that Kellogg Brown & Root Services, Inc. ("KBR") was entitled to recover \$44 million in allegedly unallowable private security company ("PSC") costs incurred while providing the Army with logistical support in Iraq under the LOGCAP III contract. The Board also held that the Contract Disputes Act ("CDA") six-year limitation period on a government claim to recover amounts paid for allegedly unallowable costs begins to run on the date when the government first becomes aware that the contractor is incurring the costs.



#### The Facts

In March 2003, the Army issued several task orders to Kellogg Brown & Root Services, Inc. ("KBR") under the LOGCAP III contract for logistical and life-support services to support the Army's operations following the U.S. invasion of Iraq. The contract required that the government provide force protection to KBR employees and contractors that was "commensurate" with the threat and the level of protection afforded to Department of Defense ("DoD") civilians.

Due to resource constraints, the government was not able to fully protect KBR subcontractors' convoys as required under the contract. Attacks on KBR convoys started almost immediately after performance began in June 2003 and resulted in the death or injury of numerous KBR employees and subcontractors. In July 2003, the government acknowledged that its inability to provide force protection was significantly impacting KBR's mission and agreed to develop a revised statement of work to allow KBR's use of PSCs to provide the necessary security. Although the Army requested a contract modification to that effect, no such proposal was ever approved or implemented into the contract.

Because of the attacks, KBR subcontractors started using PSCs in 2003 and continued using them until the conclusion of the contracts in 2006. The government was aware of KBR's use of PSCs in early 2004 and was expressly advised of their use in June 2005 when an administrative contracting officer consented to the award of a KBR food services subcontract that contained an express pricing justification indicating that personnel would be moved using the services of a PSC.

In December 2005, U.S. Central Command ("CENTCOM") issued a statement of policy requiring CENTCOM authorization on a case-by-case basis for contractor use of PSCs in Iraq and Afghanistan. KBR received notice of the policy statement in December 2006 but there was no evidence that the statement was incorporated into KBR's contract. In February 2007, the Army notified KBR that it considered the costs of PSCs to be unallowable and was withholding more than \$19 million in payments to KBR as a result. The Army based its decision on the December 2005 CENTCOM policy statement and other provisions of the contract that, in the government's view, prohibited contractor use of PSCs. KBR disagreed and submitted a certified claim to recover the withheld amount in October 2007.

In August 2009, the Army revised its assessment and notified KBR that it



disapproved more than \$103 million of PSC costs billed to the contract. KBR submitted a \$22 million invoice later that month and the government withheld the entire amount as a partial effort to recoup the disapproved PSC costs. The Army withheld an additional \$2 million from KBR payments in March 2010. KBR submitted certified claims to recover all of those amounts in October 2009 and June 2010.

The Army did not respond to KBR's three certified claims so KBR appealed the deemed denials to the ASBCA. In January 2013, while KBR's appeals were pending, the Army issued a final decision finding \$55 million of the previously disapproved \$103 million in PSC costs to be unallowable under the contract. Finding that the government had already withheld \$44 million, the final decision asserted that KBR owed the government an additional \$11 million. KBR appealed the decision and the Board consolidated the appeal with KBR's other pending appeals.

# Government claim accrued on the date that it became aware of PSC costs being incurred and was therefore time-barred.

On appeal, KBR argued that the government's claim for the full \$55 million of unallowable costs was untimely because it was issued beyond the six-year limitations period provided in the CDA. Noting that the government failed to address KBR's argument in its reply brief, the ASBCA agreed and dismissed the claim for lack of jurisdiction. Citing FAR 33.201, the ASBCA explained that a claim accrues on "the date when all events, that fix the alleged liability of either the Government or the contractor and permit assertion of the claim, were known or should have been known." Based on the evidence at the hearing, the ASBCA reasoned that the government's claim for PSC costs accrued "no later than" June 2005, when an ACO approved the use of a food services subcontract acknowledging that personnel would be transported with PSC services. The government's claim in January 2013, nearly 8 years later, was therefore "untimely and thus invalid and a nullity."

#### PSC costs were reasonable and allowable.

The ASBCA also found that the \$44 million withheld by the government were reasonable and allowable costs that should be paid to KBR. The ASBCA affirmed its holding in earlier proceedings that nothing in the contract "categorically prohibited the use of PSCs," and found that the December 2005 CENTCOM policy statement was not applicable to existing contracts unless contractually incorporated into those contracts. Because there was no evidence to show that the CENTCOM policy had been



incorporated here, the ASBCA found that the government had not met its burden of establishing that the costs were unallowable under any specific contract provision or regulation.

The PSC costs were reasonable in amount, in the ASBCA's view, because they comprised only 2.32% of KBR's total billings and were substantially lower than the PSC costs incurred (12.5%) by Iraq Reconstruction contractors. The ASBCA also found the costs to be reasonably necessary because the evidence showed that the government did not provide force protection that was commensurate with the threat or the level of protection given to DoD civilians. The ASBCA rejected the government's counter argument that if the level of force protection was not adequate, KBR's exclusive remedy was to delay the support operations without cost to KBR. In so holding, the ASBCA noted that the contract was a rated order under the Defense Priority and Allocation Requirements clause (FAR 52.211-15) and that U.S. troops "depended on [KBR] and its subcontractors for their life-support and other logistical support services."

#### Use of PSCs is not a "political question."

The government also argued that KBR's claim was non-justiciable because assessing whether "the military force was inadequate and thus the PSCs were necessary . . . falls squarely within the political question doctrine" and is not a proper matter for the ASBCA to consider. The ASBCA disagreed and noted that the political question doctrine does not prevent a board or court from determining whether the government satisfied its contractual obligations under the CDA. The ASBCA also highlighted that "[i]n any event, there is no real question that the government did not provide force protection on a consistent basis.



**Temple Contract Station LC,** PSBCA Nos. 6430, 6488 July 16, 2014 – Judge Shapiro By Benjamin J. Kohr, Wiley Rein LLP

The Postal Service Board of Contract Appeals' ("PSBCA") ruling on Temple Contract Station LC's ("Temple") claim against the United States Postal Service confirmed that the Postal Service is not obligated to provide a contractor with advance warning of its termination over and above any contractually required notice. This case presents an important learning lesson: contractors are advised to review their



contractual termination rights and to make future business decisions in light of those rights.

#### The CPU Contract

Temple operated a contract postal unit ("CPU") for the Postal Service in Temple, Texas. The CPU contract contained a Contract Duration and Termination clause, which provided that the contract was for "an indefinite term" and could be terminated by either the Postal Service or Temple "upon 60 days' written notice." At the time of termination, Temple had performed under the "indefinite term" contract for nearly twenty years. The Postal Service's purchasing guidelines separately indicated that contracts were to be terminated consistent with the contract's termination provisions, but required that no contract exceeding \$1 million "may be terminated unless the [Vice President, Supply Management] has approved termination." These purchasing guidelines were not incorporated in the CPU contract.

#### CBA Agreement with Workers Union

In March 2011, the Postal Service and the American Postal Workers Union ("APWU") agreed to a four-and-a-half year collective bargaining agreement ("CBA") designed to address a number of Postal Service-wide labor issues. Among other requirements, the CBA incorporated a Memorandum of Understanding ("MOU") that required the Postal Service to close twenty CPUs, including the CPU in Temple, Texas. Unaware of the requirement to terminate its contract, Temple entered into a number of long-term financial commitments throughout 2011 in anticipation of the continued performance of the CPU contract through 2016. Temple asserted during the appeal that it would not have entered into these contracts—or at least not for the agreed upon periods of performance—had it known that the Postal Service planned to terminate the CPU contract.

#### **Termination**

The Contracting Officer ("CO") for Temple's CPU contract learned of the MOU for the first time in October 2011 when he was informed that it might require the termination of up to twenty CPUs. The CO reviewed the CBA, the MOU and the Temple CPU contract, and issued a termination letter to Temple on January 23, 2012. The letter indicated that the Postal Service was exercising its right to terminate the contract with 60 days written notice and that termination would become effective close



of business on March 30, 2012. The CO did not seek or receive the approval of the Vice President, Supply Management.

#### Temple's Claims

Temple appealed the termination to the PSBCA and separately filed a \$4.4 million certified claim seeking future expected profits for twenty years. The CO issued a final decision denying Temple's claim and Temple filed an appeal with the PSBCA that was consolidated with the termination appeal. Temple raised a number of allegations challenging the propriety of the termination, including: lack of changed circumstances, improper assignment, improper conduct by the CO, violation of the covenant of good faith and fair dealing, bad faith and bad policy.<sup>2</sup> The claims that PSBCA did not summarily dismiss are addressed below.

#### Changed Circumstances Not Required to Terminate for Convenience

Equating the termination to a termination for convenience, Temple argued that termination was only authorized where a substantial change had occurred in the circumstances under which the contract was made and, separately, that the termination was not in the best interest of the Postal Service. PSBCA rejected both arguments. The Federal Circuit has made clear that changed circumstances are not required before the government may terminate for convenience. In addition, the termination clause did not require a determination that the termination was in the best interest of the agency (in any event, the PSBCA will not substitute its judgment for the agency's).

#### *Improper Conduct by the CO*

The PSBCA rejected Temple's contention that termination required the approval of the Vice President of Supply Management per the Postal Service's purchasing guidelines. The Board chose not to address the question of the whether the purchasing guidelines—which were not explicitly incorporated—applied to the CPU contract. Rather, the PSBCA held that the approval was an internal approval procedure. It is well settled that internal approval procedures are intended only for the government's benefit, not that of contractors. Therefore, failure to comply with those internal requirements does not convey a cause of action. Because there was no evidence that the approval requirement was intended to benefit postal contractors, the Postal Service's

<sup>&</sup>lt;sup>2</sup> Temple also raised an allegation of superior knowledge; however, the PSBCA found that it did not provide a basis of relief independent of the covenant of good faith and fair dealing in this case.



failure to comply with the purchasing guidelines—even assuming they applied—did not provide Temple with a cause of action.

#### Good Faith and Fair Dealing

The implied covenant of good faith and fair dealing obligates parties not to interfere with each other's contract performance so as to destroy the reasonable expectations of the other party regarding the fruits of the contract. Temple argued that the Postal Service breached this implied duty by failing to inform the company of the intended termination. Had Temple been informed when the CBA was signed in March 2011, it would not have incurred any subsequent financial obligations. The PSBCA rejected this argument, holding that the implied duty cannot expand a party's contractual duties beyond those in the express contract. Here, the contract expressly granted either party the right to terminate the contract on 60 days' written notice. The implied covenant cannot be argued to impose a requirement for additional notice merely because the Postal Service was aware of the potential for termination prior to the January 2012 notice of termination. Further, the indefinite nature of the contract and the sixty-day notice requirement resulted in a contract that was perpetually at risk of termination with limited notice. Therefore, Temple could not have possessed a reasonable expectation—at any time—of continued performance for more than 60 days. Temple should have accounted for that risk in making its business decisions.

#### No Evidence of Bad Faith

Finally, Temple argued that the Postal Service acted in bad faith when it agreed to the CBA knowing that that the APWU's interests directly conflicted with Temple's. The PSBCA reiterated that the motivation at issue was the Postal Service's—not APWU's—and found no evidence in the record that the Postal Service entered into the CBA with the intent to injure Temple. Rather, the Postal Service was primarily motivated by a desire to resolve its service-wide labor issues. As the termination of the CPU contract was the ancillary result of the CBA, not its driver, there was no bad faith on the part of the Postal Service.

As a result of its findings, PSBCA denied Temple's appeals in their entirety. Temple has appealed the decision to the Federal Circuit (*Temple Contract Station LC v. USPS*, Case No. 14-1662).



#### Dissent

Administrative Judge Pontzer concurred with the majority's recitation of the law but disagreed with its application of the law to the facts of this case. Relying on *Krygoski Const. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996), Judge Pontzer argued that the Postal Service acted in bad faith by terminating the CPU contract solely "to acquire a better bargain from another source." Specifically, Judge Pontzer found that the Postal Service specifically targeted the Temple CPU in the CBA in order to obtain a better bargain from the APWU.

Judge Pontzer also disagreed with the majority's application of the implied covenant of good faith and fair dealing. Relying on *Free & Ben, Inc.,* Judge Pontzer argued that the key analysis under the implied covenant is the reasonableness of the government's actions rather than whether the allegations would impose obligations over and above those in the contract. ASBCA NO. 56129, 09-1 BCA ¶ 34,127 ("The gravamen of the . . . inquiry in cases involving a breach of the [covenant] is the reasonableness of the Government's actions considering all of the circumstances."). As the Postal Service knew of the termination as early as May 2011, Judge Pontzer found it unreasonable for it to wait until January 2012 to inform Temple.



## Brookwood Research Center, LLC, CBCA No. 3783

June 19, 2014 – Judge Goodman By Heidi L. Osterhout

In this case, the CBCA granted Appellant's appeal for \$11,958.14 plus interest under the Contract Disputes Act when the Appellant mailed a proper invoice and evidence of payment within the contractually required 60 calendar days even though the Government never received the mailed submission and did not receive an electronically mailed submission until well after the contractually required time period.

#### **Facts**

Appellant sought payment under the Tax Adjustment clause of the lease for real estate tax year 2012. The Tax Adjustment Clause required the lessor to furnish the contracting officer with tax adjustments for each year that real estate taxes were incurred during the lease. The clause specifically required the documents "within 10".



calendar days of receipt except that the proper invoice and evidence of payment shall be submitted within 60 calendar days after the date the tax payment is due from the Lessor to the taxing authority." In this case, for the real estate tax year 2012, 60 calendar days after the date the tax payment was due from the Lessor to the taxing authority was August 31, 2013.

Appellant alleged that it submitted a proper invoice and evidence of payment of the taxes by United States mail on June 20, 2013, before the expiration of the 60 calendar days. Appellant did not use certified mail, but did not receive the mail back for insufficient postage or an incorrect address and assumed it was delivered.

On October 2, 2013, appellant's representative contacted the respondent to ask why it had not yet received payment. Respondent searched the records but could not find the information. On October 24, 2013, the contracting officer responded by letter, denying the payment because the October 2, 2013, email message was after the 60 calendar days required by the contract. After further correspondence, the contracting officer issued a final decision denying the reimbursement claim and appellant appealed.

#### Discussion

The Board accepted that appellant submitted the letter in the United States mail based on a copy of the letter and an affidavit from the person who mailed the letter. The Board recognized that the respondent never received the letter, but help that "appellant's evidence establishes that the information was timely submitted as required by the lease. Whether appellant's mailing was lost before it arrived at its destination or thereafter does not negate appellant's timely submission."

In making its decision, the Board found "that it [was] more probable than not that the information was timely mailed." *See, eg.,* [sic] *Visutron, Inc., Security Electronics,* GSBCA 7139 84-1 BCA ¶ 17,022."





## Classic Site Solutions, Inc., ASBCA Nos. 58376, 58573 June 26, 2014 – Judge Clarke By Sonia Tabriz, Fox Rothschild LLP

The ASBCA's ruling on the parties' cross-motions for summary judgment included an important analysis regarding a contractor's burden of proving that it is entitled to submit a substitute item under FAR 52.236-5 (Material and Workmanship).

#### **Contract Requirements**

The U.S. Army Corps of Engineers (USACE) awarded a contract to Classic Site Solutions, Inc. (CSSI) to construct an automotive vehicle test and evaluation facility that included a paved test track. The contract specified the type of mix design required for the pavement:

#### 2.3 MIX DESIGN

a. HMA classified as Tank Mix shall be used for all bituminous concrete pavements. Tank Mix is used exclusively at Aberdeen Proving Ground for heavy-duty pavements, and has been locally available for several years. The nominal maximum aggregate size (NMAS) shall be 19.0 mm for the binder course and 12.5 mm for the wearing course. The Tank Mix producer shall have at least 5 years of experience in producing the submitted Tank Mix, and a record of successful production and use of such product on the APG Garrison. If Tank Mix is no longer locally available, then the Contractor shall develop the mix design as specified in Part b. or c., below.

Subparagraph b. provided that the contractor shall develop its own mix design in accordance with the guidance therein. Subparagraph c. allowed for the use of "MdDOT Superpave hot mix." The contract also incorporated FAR 52.236-5 (Material and Workmanship).



#### CSSI's Mix Design Submittals

After contract award, CSSI submitted its mix designs to USACE for approval. CSSI's original mix design was for the use of MdDOT Superpave hot mix, in accordance with subparagraph c. USACE disapproved this submittal, stating: "The specifications require that 'Tank Mix' hot mix asphalt be used by the contractor on this project, provided it is still locally available. To-date, this mix design is locally available from Independence [Construction] Materials, of Aberdeen, MD. Therefore, the contractor cannot exercise options 'B' or 'C' for this project."

CSSI then submitted two additional mix designs for approval by USACE. One submittal included the same mix design that CSSI originally submitted (and USACE disapproved). The second submittal offered the local Tank Mix formula from Independence Construction Materials (ICM). USACE disapproved the first submittal (again) and approved the second submittal. CSSI then submitted a certified claim for additional costs incurred due to USACE's direction to use ICM's local Tank Mix.

The claim was ultimately denied and CSSI submitted an appeal with the Armed Services Board of Contract Appeals (ASBCA, or the Board). The parties each moved for summary judgment regarding Paragraph 2.3, MIX DESIGN of the contract.

#### Parties' Cross-Motions

According to CSSI, USACE's demand that CSSI provide ICM's local Tank Mix constitutes a compensable change for three reasons. First, the contract allowed CSSI to provide one of three mix design options: local Tank Mix (subparagraph a.); its own mix design (subparagraph b.); or MdDOT approved Superpave hot mix (subparagraph c.). Second, local Tank Mix was not available. Third, CSSI provided a mix design that was "equal" to local Tank Mix pursuant to FAR 52.236-5 (Material and Workmanship).

CSSI also made an independent argument that USACE's specifications were too restrictive because they required the use of a proprietary mix design. The ASBCA did not address this argument, except to say that the remedy for overly restrictive specifications is the filing of a bid protest. CSSI did not file a bid protest, so the ASBCA did not have jurisdiction to make that determination.

In response to CSSI, USACE argued that the contract only allowed mix designs in accordance with subparagraph b. or c. if the local Tank Mix specified in



subparagraph a. was not available. Because local Tank Mix was available from ICM, CSSI was obligated to use that mix.

In reviewing the parties' cross-motions, the ASBCA only considered "minimum facts necessary" because "a motion for summary judgment based on an issue of contract interpretation may only be granted if there is no ambiguity requiring reliance on extrinsic evidence." Upon considering all arguments, the Board granted partial summary judgment in favor of USACE as to the interpretation of Paragraph 2.3, MIX DESIGN. The Board denied the remainder of USACE's motion and denied the entirety of CSSI's motion.

#### ASBCA's Holding

The ASBCA reviewed all three bases for CSSI's claim that it was entitled to a compensable change.

#### (1) Interpretation of Paragraph 2.3, MIX DESIGN

The ASBCA reviewed Paragraph 2.3, MIX DESIGN to determine whether CSSI could choose among all three options (subparagraph a., b., or c.). The Board concluded that the language was "clear and unambiguous and susceptible to only one reasonable interpretation." According to the Board, Paragraph 2.3, MIX DESIGN "create[d] a condition precedent to the use of subparagraph b. or c." Stated otherwise, the contractor could only submit mix designs pursuant to subparagraph b. or c. if local Tank Mix was unavailable under subparagraph a. Because local Tank Mix was available through ICM, CSSI was required to use it. The Board therefore granted summary judgment in favor of USACE on this point.

#### (2) Availability of Local Tank Mix

CSSI next argued that local Tank Mix was not available because it "does not meet the ATEF II Recipe." The "availability" of local Tank Mix is a disputed question of fact. Therefore, the ASBCA did not render a decision regarding this point on summary judgment.



#### (3) Material and Workmanship Clause

Lastly, CSSI argued that USACE should bear the cost of requiring CSSI to use ICM's local Tank Mix because CSSI offered a less expensive, functionally equivalent mix design. CSSI relied on FAR 52.236-5 (Material and Workmanship), which provides that identification by brand name (here, ICM) shall not limit competition.

The Material and Workmanship clause is an exception to the general rule that the government is entitled to strict compliance with technical requirements. A contractor can submit a substitute product – other than the proprietary item required by contract – if the contract does not contain a warning that only the proprietary item will be accepted. Simply requiring that a contractor "shall" use a specific brand name item is not an adequate warning. The contract must contain language such as "NOTWITHSTANDING" any other provision of the contract, no other product will be acceptable" to preclude the use of a functionally equivalent substitute.

USACE did not include any such a warning in Paragraph 2.3, MIX DESIGN. But to establish that it was entitled to submit a substitute mix design, CSSI first bears the burden of proving:

(1) the specifications are proprietary, (2) appellant submitted a substitute product along with sufficient information for the contracting officer to make an evaluation of the substitute, and (3) the proposed substitute meets the standard of quality represented by the specifications.

At the time, the record did not allow the ASBCA to conclude that CSSI had met that burden. Therefore, CSSI's motion on this point was denied as well.



*Tele-Consultants, Inc.*, ASBCA No. 58129 June 9, 2014 – Judge Melnick *By Laura Sherman, Wiley Rein LLP* 

In this case, the ASBCA declined to dismiss Tele-Consultants, Inc.'s ("TCI") appeal without prejudice under Rule 30 so that TCI could seek relief from Congress. TCI contended that its limited resources were better spent, at that time, pursuing other avenues of relief. The Board denied the motion and held that TCI had chosen to file the



appeal and, thus, did not have the right to make the Board or the government wait while it explored other options.

#### **Facts**

In June 2010, TCI, which subcontracted with Advanced Solutions for Tomorrow, Inc. ("ASFT") on a contract with the Department of the Navy for various technical tasks, filed an appeal seeking payment for work it had performed under the contract prior to ASFT being directed to stop work. The government moved to dismiss for lack of jurisdiction because TCI failed to prove that it entered into an implied-in-fact contract with the government. That motion was denied in *Tele-Consultants, Inc.*, ASBCA No. 58129, 13 BCA ¶ 35234 (holding that a claimant only need allege, not prove, existence of contract with the government). Following the denial of its motion to dismiss, the government moved for summary judgment, or in the alternative, for dismissal for failure to state a claim upon which relief can be granted.

TCI, faced with the need to respond to the government's motions, maintained that it had insufficient resources to continue with the appeal and filed its own motion to dismiss under Board Rule 30. Board Rule 30 governs the suspension and dismissal of appeals without prejudice and its use is at the discretion of the Board. TCI stated that it intended to petition Congress for relief rather than continue at the Board. The government opposed TCI's motion and argued, among other things, that it was ready and able to defend the appeal and should not be required to face risks and interest accruals due to the passage of time requested by TCI.

The Board determined that a dismissal without prejudice was inappropriate because TCI did not have the right to require the government to wait while it pursued other avenues of relief. In particular, the Board found that because TCI had presented no evidence that its efforts to obtain relief from Congress had progressed or that it had a chance of success, TCI had provided no reason for the Board to conclude that if the appeal were dismissed that TCI would not seek to reinstate it later. Further, it noted that "TCI chose the file this appeal and must either timely litigate it or become subject to dismissal for failure to prosecute." The Board also noted that the government's arguments against pre-judgment interest and litigation risks such as the dulling of witness memories and their potential unavailability were persuasive. Accordingly, the Board ruled that the appeal would move forward and that TCI had 30 days to respond to the government's motions.



# BALANCING THE SCALES: APPLYING THE FAIR COMPENSATION PRINCIPLE TO DETERMINE RECOVERY FOR COMMERCIAL ITEM CONTRACTS TERMINATED FOR THE GOVERNMENT'S CONVENIENCE

By Major Phillip T. Korman\*

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#### I. Introduction

One lovely Monday morning, you return from physical training to find a voice-mail message from the contracting squadron requesting advice about a commercial items<sup>1</sup> contract terminated for the Air Force's convenience. Following up with the contracting officer, you learn that although the contract provided flight simulators for twelve months, the Air Force terminated it for convenience<sup>2</sup> after three months due to budget cuts. The contractor and contracting officer are at loggerheads over the entitled recovery under the Federal Acquisition Regulation (FAR).<sup>3</sup>

The contractor claims that the Air Force owes him a percentage of the contract price reflecting three months of performance, unamortized costs<sup>4</sup> incurred in manufacturing the simulators in anticipation of the year-long contract, post-termination settlement costs, and lost anticipated profit for the remaining nine months of the terminated contract. The contractor claims that, despite diligent efforts, he has been unable to contract out the simulators elsewhere. The contracting officer wants your advice before rejecting the contractor's settlement offer.

Hanging up the phone, you scramble to find FAR 52.212-4(l), the Termination for the Government's Convenience Clause,<sup>5</sup> included in the contract. You stare at its two-part recovery formula, which reads, "Subject to the terms of this contract, the Contractor shall be paid a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination, plus reasonable charges the Contractor can demonstrate ... have resulted from the termination." You are unsure about what encompasses "reasonable charges" but are encouraged to find detailed recovery guidelines for terminated traditional government contracts in FAR part 49.7 However, FAR 12.403(a) states that the "requirements of Part 49 do not apply" but that



"[c]ontracting officers may continue to use part 49 as guidance to the extent that part 49 does not conflict with this section and the language of the termination paragraphs in § 52.212-4," leaving you a bit puzzled. You vaguely recall from the Contracts course at The Judge Advocate General's Legal Center and School in Charlottesville, Virginia, that a dissatisfied contractor may appeal a contracting officer's final decision to either the Armed Services Board of Contract Appeals (ASBCA) or to the U.S. Court of Federal Claims (COFC) and wonder what you will tell the contracting officer.9

Given scant regulatory guidance and few board and court decisions, determining a contractor's entitled recovery can be daunting. Federal Acquisition Regulation 52.212-4(l)'s two-pronged recovery formula<sup>10</sup> for terminated commercial item contracts is short on details, leading to uncertainty over what is recoverable. Further, FAR 12.403(a) fails to define precisely which portions of FAR Part 49 can guide recovery determinations.

A logical, uniform approach to determining recovery for terminated commercial item contracts is especially necessary given the statutory preference for commercial item contracting.<sup>11</sup> With draw-downs in Afghanistan, automatic spending cuts,<sup>12</sup> and budget reductions<sup>13</sup> projected well into the future, more commercial item contract terminations and recovery disputes are foreseeable.

To help resolve this uncertainty over recovery, fair compensation should apply to FAR 52.212-4(l)'s recovery formula<sup>14</sup> and inform what constitutes "reasonable charges" resulting from the termination in a given case. Moreover, FAR Part 49 and, by extension, FAR Part 31 principles<sup>15</sup> consistent with FAR 12.403 and FAR 52.212-4(l) should guide recovery determinations if implicated by factual circumstances and necessary to achieve fair compensation.

This article begins with a background on terminations of traditional government contracts for the government's convenience, examines provisions to calculate recovery for terminated commercial items contracts, and surveys four views on determining contractor recovery. It next demonstrates from the history of fair compensation, FAR Part 12 itself, and sound public policy that contracting officers should adhere to the principle of fair compensation when determining recovery. This article asserts that contracting officers can and should rely on FAR Part 49 and FAR Part 31 principles consistent with FAR 52.212-4(l)'s recovery formula<sup>16</sup> as circumstances dictate to achieve fair compensation. Lastly, the article discusses potential problems with this approach and poses possible solutions.



#### II. Background

#### A. Termination for the Government's Convenience

The government has enjoyed a long-standing ability to terminate a contract based upon changes in the expectations in the parties, as happened at the conclusion of the Civil War.<sup>17</sup> The concept of termination for the government's convenience where there has been no fault or breach by the non-government party developed in military wartime procurement<sup>18</sup> during World War I, extended to peacetime military procurement in 1950, and ultimately expanded to peacetime civilian procurement today.<sup>19</sup>

The U.S. Court of Appeals for the Federal Circuit<sup>20</sup> has noted that the government's right to terminate a contract for its convenience is an exception to the common law's required mutuality of contract.<sup>21</sup> A cardinal change in the circumstances is not a prerequisite for a valid termination for the government's convenience.<sup>22</sup> Termination for the government's convenience reduces the government's liability by limiting recovery in comparison with damages for breaching a contract.<sup>23</sup>

Termination of a traditional government contract for the government's convenience transforms it into a cost-reimbursable contract under FAR 52.249-2's non-commercial item termination for convenience clause.<sup>24</sup> Federal Acquisition Regulation Part 49 regulates recovery for non-commercial item contracts, more often referred to as "traditional government contracts," terminated for the government's convenience.<sup>25</sup> A contractor whose traditional government fixed-price contract is terminated for the government's convenience is entitled to recover the following: (1) allowable costs incurred in the performance of the work; (2) costs allowable under a special termination cost principle set forth at FAR 31.205-42, including unamortized costs incurred prior to the termination, costs continuing after termination, and settlement expense; and (3) a reasonable profit on the above costs with the exception of settlement expense.<sup>26</sup> Recovery in such cases is subject to the fair compensation principle<sup>27</sup> and to the loss adjustment principle.<sup>28</sup>

#### B. The Recovery Formula for Terminated Commercial Items Contracts<sup>29</sup>

#### 1. FAR 52.212-4(l) and FAR 12.403(d)

In 1994, Congress passed the Federal Acquisition Streamlining Act (FASA, also known as FASA I)<sup>30</sup> to streamline the "acquisition laws of the federal government ... [to] facilitate the acquisition of *commercial* products, ... and increase the efficiency and



effectiveness of the laws governing the manner in which the government obtains goods and services."<sup>31</sup> The government then promulgated FAR 12.403 and FAR 52.212-4(l) to govern terminations of commercial item contracts for the government's convenience.<sup>32</sup>

The regulatory guidance for determining recovery for terminated commercial item<sup>33</sup> contracts is far less detailed than similar guidance for traditional government contracts.<sup>34</sup> Recovery is determined by a simple, two-pronged formula consisting of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination, plus reasonable charges the Contractor can demonstrate ... have resulted from the termination."<sup>35</sup> Unlike FAR Part 49, neither FAR 52.212-4(l) nor FAR 12.403 expressly mentions incurred costs, continuing costs, or reasonable profit.<sup>36</sup>

#### 2. The First Prong: Percentage Contract Price

A cursory examination of two board decisions addressing the first prong of the commercial recovery formula suggests that the percentage of the contract price reflecting the percentage of work performed generally refers to actual physical work performed.<sup>37</sup> For example, in *Red River Holdings*, the government terminated a commercial item contract requiring a U.S. flag vessel to perform charter services with just two months remaining on the fifty-nine month charter period.<sup>38</sup> The ASBCA stated that the "work" consisted of providing a suitable U.S. flag vessel for inspection, acceptance, and performance of the fifty-nine month charter.<sup>39</sup> The ASBCA indicated that the contractor would be entitled to 57 out of 59 months of the contract price under the first prong of the commercial item recovery formula.<sup>40</sup>

Similarly, the Civilian Board of Contract Appeals (CBCA) in *Corners & Edges* found that payment of the contract price for the months of actual courier service performed on a terminated commercial service contract reflected the percentage work physically completed prior to notice of termination.<sup>41</sup>

While these two cases are not intended to encompass all possible factual scenarios, they do illustrate an emerging understanding that "percentage of work performed" under the first prong of the commercial item recovery formula<sup>42</sup> frequently translates into the percentage of the contract physically completed.

#### 3. The Second Prong: Reasonable Charges Resulting from Termination

Focusing on the second prong of FAR 52.212-(4)(l)'s recovery formula,<sup>43</sup> this article reviews four differing perspectives of what constitutes "reasonable charges" resulting from termination and potential categories of recoverable costs. The ASBCA's



initial *Red River* ruling, the first view, limits the "reasonable charges" prong to settlement expenses.<sup>44</sup> In the opinion of the U.S. District Court, District of Maryland, the second view, the ""reasonable charges" prong expands to include costs or costs reasonably incurred in anticipation of contract performance, provided such costs are not adequately reflected as a percentage of the work performed, and provided such costs could not have been reasonably avoided.<sup>45</sup> In its *Russell Sand & Gravel* decision, the CBCA applied the cost-reimbursement construct in FAR Parts 49 and 31 and determined that "reasonable charges" included continuing costs and profits on such costs that could not be discontinued following termination, the third view.<sup>46</sup> Lastly, a noted legal commentator suggests that "reasonable charges" could even include lost anticipatory profit.<sup>47</sup>

#### a. ASBCA's Initial Red River Holdings Ruling

First, in the *Red River Holdings* decision, the ASBCA found that the "reasonable charges" prong consisted of mere settlement expenses.<sup>48</sup> There, the U.S. Navy had terminated a contract involving a chartered vessel two months prior to its completion date.<sup>49</sup> The contractor, who had taken out a loan to acquire and outfit the vessel, sought a portion of the loan costs and insurance premiums allocable to the final two months of the contract. Although he had been paid the portion of the contract price reflecting the period of performance on the contract, the contractor asserted that the unamortized loan and insurance premium costs allocable to the final two months of the contract were reasonably incurred in anticipation of full contract performance and resulted from the termination.<sup>50</sup>

In its analysis, the ASBCA emphasized the conceptual differences between the commercial item clause in FAR 52.212-4(l), with its two-pronged recovery formula,<sup>51</sup> and FAR 52.249-2's traditional termination for convenience clause,<sup>52</sup> which converts fixed price contracts to cost-reimbursable contracts. In denying the contractor's appeal, the ASBCA concluded that the loan costs and costs incurred in reflagging and modifying the vessel for contract performance were not recoverable under FAR 52.212-4(l)'s "percentage of work performed" prong and did not "result from" the termination of the commercial item contract.<sup>53</sup> While never expressly raising FAR Part 49's fair compensation principle, the ASBCA effectively rejected its applicability to terminated commercial item contracts.

#### b. The U.S. District Court's Red River Holdings Decision

Next, the U.S. District Court, District of Maryland, in reversing and remanding the ASBCA's decision, referenced "principles of fairness in the administration of



government contracts"<sup>54</sup> as applicable to FAR 52.212-4(l)'s recovery formula. The court reasoned that if "reasonable charges" were construed to include only settlement expenses from a termination, "monumental unfairness" could result if a contractor had incurred major preparatory costs in anticipation of full contract performance and the "percentage of the work performed prior to the notice of termination" failed to fully compensate the contractor's expenses.<sup>55</sup>

In the district court's view, recovery under FAR 52.212-4(l)'s second prong entitles a contractor to "payment as compensation for settlement costs or costs reasonably incurred in anticipation of contract performance, provided such costs are not adequately reflected as a percentage of the work performed, and provided such costs could not have been reasonably avoided."<sup>56</sup> The court stated that the second prong "generally does not contemplate additional allowances for profit," preventing recovery of profit on incurred costs.<sup>57</sup>

#### c. The CBCA's Decision in Russell Sand & Gravel

More recently, the CBCA relied upon FAR Part 49 and FAR Part 31 principles when determining "reasonable costs" where the International Boundary and Water Commission (IBWC) had terminated two delivery orders on a firm fixed price requirements contract, incorporating by reference FAR 52.212-4.<sup>58</sup>

In its analysis, the CBCA cited the fair compensation principle and reverted to the cost-reimbursement construct in FAR Parts 49 and 31 used for traditional government contracts to determine "reasonable charges" that resulted from the termination. Applying the cost principles in FAR 31.205-42(b), for example, the CBCA allowed recovery for continuing costs and profits on such costs that could not be discontinued following termination.<sup>59</sup> This CBCA decision exceeds the *Red River Holdings* ruling for its wholesale adoption of FAR Part 49's recovery scheme for traditional government contracts.

#### d. Recovery of Anticipated Profit Viewpoint

Lastly, a noted legal commentator suggests that recovery of anticipated profit fulfills FASA I's mandate that the federal acquisition regulation be consistent with standard commercial practice.<sup>60</sup> Section 8002(b)(1) of FASA I requires that the FAR include to the maximum extent practicable only clauses "(A) that are required to implement provisions of law or executive orders applicable to acquisitions of commercial items ...; or that are determined to be consistent with standard commercial practice."<sup>61</sup> Section 2-708(2) of the Uniform Commercial Code (UCC),<sup>62</sup> which allows



recovery of anticipatory profit, has been adopted by forty-nine states<sup>63</sup> and reflects standard commercial practice. Under this rationale, recognizing anticipatory profit as a "reasonable charge" under FAR 52.212-4(l) satisfies FASA I's mandate.<sup>64</sup>

#### III. Fair Compensation and Terminated Commercial Item Contracts

Having discussed the history of contract terminations, the two-pronged recovery formula for commercial items contracts, and competing perspectives on determining contractor recovery, this article next addresses the applicability of the fair compensation principle to commercial item contract terminations and analyzes FAR 52.212-4(l) and FAR 12.403. Lastly, the article presents a framework for determining recovery in such circumstances.

#### A. Historically, Fair Compensation Applied to Such Terminations

#### 1. Statutory and Regulatory History

The fair compensation principle, currently manifested in FAR 49.201(a), asserts that a "settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit." The fair compensation principle applied to terminated government contracts enjoys a rich statutory and regulatory history. During WWI, the Sixty-Fifth Congress passed legislation signed by the President that stated, "Whenever the United States shall cancel, modify, suspend or requisition any contract ... it shall make *just compensation* therefor ...." The Contract Settlement Act of 1944 decreed, "It is the policy of the Government ... to provide war contractors with speedy and *fair compensation* for the termination of any war contract ...." Later that year, the War and Navy Departments issued the Joint Termination Regulation, which authorized "fair compensation" for terminated contracts.

Moreover, FAR 49.201 echoes prior regulations, including the Defense Acquisition Regulation (DAR) 8-301<sup>69</sup> and the Federal Procurement Regulation (FPR) 1-8.301(a),<sup>70</sup> which provided fair compensation for the preparations made and the work completed.

#### 2. Case Law Supports the Fair Compensation Principle

A persuasive line of case law buttresses applying the fair compensation principle to terminated commercial item contracts. For example, when considering the recoverability of unabsorbed overhead in a traditional government contract, the Federal Circuit asserted that "the overall purpose of a termination for convenience settlement is



to fairly compensate the contractor and to make the contractor whole for the costs incurred in connection with the terminated work."<sup>71</sup> In a case involving a terminated development and construction contract, the Federal Circuit noted the following:

A contractor is not supposed to suffer as the result of a termination for convenience of the Government, nor to underwrite the Government's decision to terminate. If he has actually incurred costs ..., it is proper that he be reimbursed those costs when the Government terminates for convenience....<sup>72</sup>

Both a U.S. district court and the CBCA have acknowledged this long-standing fair compensation principle when determining recovery for terminated commercial item contracts.<sup>73</sup> While the fair compensation principle is not expressly mandated for terminated commercial item contracts by statute or regulation, out of respect for the long-standing practice and precedent, contracting officers should adhere to this venerable principle as a matter of course when deciding recovery for terminated commercial item contracts.

#### B. FAR 12.403(a) Allows Application of the Fair Compensation Principle

# 1. Fair Compensation Is Consistent with FAR 12.403(a) and FAR 52.212-4(l)

Notably, FAR 12.403 supports imposing the fair compensation principle currently embodied in FAR Part 49.201 onto commercial item contracts terminated for the government's convenience. Federal Acquisition Regulation 12.403(a) states that "[c]ontracting officers may continue to use part 49 as guidance to the extent that part 49 does not conflict with this section and language of the termination paragraphs in 52.212-4."<sup>74</sup> Further, FAR 49.201(b)'s directive that settlement proposals compensate the contractor fairly for the work done and for preparations made for the terminated portions of the contract is consistent with both FAR 12.403 and FAR 52.212-4(l).<sup>75</sup>

One might object that since FAR 12.403 and FAR 52.212-4(l) do not expressly mention the term "fair compensation," the principle does not apply to terminations of commercial item contracts. The FASA I,<sup>76</sup> FAR 12.403, and FAR 52.212-4(l), however, make no mention of abolishing the long-established fair compensation principle.<sup>77</sup> The statutory and regulatory silence on fair compensation should not be interpreted as intent to abolish the principle. Fair compensation does not conflict with either FAR 52.212-4(l) or FASA I. Indeed, the district court in *Red River Holdings* declined to find



that the drafters of FAR 52.212-4(l) intended to modify longstanding fairness principles and stated "that such a modification could well fail as an unreasonable interpretation of the statutory mandate set forth in the FASA ...." Federal Acquisition Regulation 12.403(a) empowers contracting officers to incorporate FAR 49.202's fair compensation principle into FAR 52.212-4(l).

#### 2. Recovery Formula of FAR 52.212-4(l) Enables Fair Compensation

When commercial item contracts are terminated, FAR 52.212-4(l)'s recovery formula provides the means to achieve fair compensation. By mandating payment of "a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination" and "reasonable charges the Contractor can demonstrate ... have resulted from the termination," FAR 52.212-4(l) provides a versatile formula capable of delivering a just settlement under a variety of factual circumstances.<sup>79</sup>

The formula's second prong, FAR 52.212-4(l)'s "reasonable charges" resulting from termination, serves as a vehicle to provide compensation extending beyond mere settlement costs. A proposed earlier version of the second prong did not use the phrase "reasonable charges," but, instead, referenced "actual direct costs that ... have resulted from the termination." One commentator has observed that the language of the final rule, "charges [that] have resulted from termination," envisions amounts that would not have been billed but for the termination, whereas the earlier "costs that ... have resulted from the termination" would have contemplated covering only amounts that would not have been incurred except for termination. The distinction between ""charges" and "costs" matters. The final rule, with its broader "charges" language, might cover costs incurred pre-termination but billed post-termination, while the earlier "cost" version could be construed to encompass only costs incurred post-termination, such as settlement costs. Since payment of such "reasonable charges" is mandatory under FAR 52.212-4(l), what constitutes "reasonable charges" under the second prong determines the government's liability.

The U.S. district court concluded that the drafters of FAR 52.2124(l) likely chose the "charges" terminology over "costs" to allow recovery of reasonable preparation costs and the like.<sup>84</sup> This court is not alone in concluding that "reasonable charges" could refer to more than just post-termination settlement costs incurred after termination. The General Services Board of Contract Appeals (GSBCA) awarded several pre-termination incurred costs in a terminated commercial item contract.<sup>85</sup> Moreover, the Agriculture Board of Contract Appeals noted that the termination clause's "reasonable charges" language in a commercial item contract could encompass the costs



reasonably incurred in anticipation of performing the contract but not fully reflected as a percentage of the work performed.<sup>86</sup>

#### 3. Fair Compensation Is Sound Policy

In addition to complying with long-standing practice, case law, and statutory and regulatory intent, fair compensation promotes sound policy. Why would a contractor expend resources competing for a commercial items contract just to face an unacceptable risk of being stuck with uncompensated costs should the government decide to terminate the contract for its convenience? Allocating a disproportionate share of the risk and financial burden onto the contractor's shoulders defeats FASA I's intent, thwarting competition rather than enhancing it. Further, small contractors, particularly sensitive to the current constrained fiscal environment, might be compelled to shutter their doors if forced to absorb unamortized costs reasonably incurred in anticipation of contract performance or other costs resulting from a contract termination.

Fair compensation, on the other hand, offers relief, lessening the disruption of termination, and ultimately promotes greater competition by creating a more secure contracting environment for companies. Fair compensation could preserve businesses in certain circumstances from closure following contract terminations and thereby sustain sources of goods or services the Department of Defense may need to tap for conflicts in the future. Further, fair compensation satisfies the government's obligation to manage limited public funds responsibly, prevents potential injustice, and follows the rule of law. Adhering to the time-tested fair compensation principle for terminated commercial item contracts promotes the national interest and serves as sound policy.

#### IV. FAR Part 49 and Recovery for Commercial Item Contracts

#### A. Consistent FAR Part 49 and FAR Part 31 Principles Are Advisory

Although FAR Part 49 was not promulgated to govern FAR Part 12 commercial item contract terminations, contracting officers may rely upon FAR Part 49, and, by extension, FAR Part 31 principles when consistent with FAR 12.403 and FAR 52.212-4(l) to determine "reasonable charges" resulting from termination. At the outset, FAR 49.002(a)(2)<sup>87</sup> asserts as a disclaimer that "[t]his part [FAR Part 49] does not apply to commercial item contracts awarded using part 12 procedures" and cites §12.403 for direction on termination policies for commercial item contract. Federal Acquisitions Regulation 49.002(a)(2) declares "for contracts for the acquisition of commercial items, this part provides administrative guidance which may be followed unless it is inconsistent with the requirements and procedures in 12.403 ...."<sup>88</sup> Federal Acquisition



Regulation 12.403(a) also states, "Contracting officers may continue to use part 49 as *guidance* to the extent that part 49 does not conflict with this section and the language of the termination paragraphs in 52.212-4."89

The portions of FAR Part 49 consistent with FAR 12.403 and FAR 52.212-4(l) can, on the should, inform FAR 52.212-4(l)'s two-pronged recovery formula. Under the recovery formula's second prong, contracting officers must pay "reasonable charges the Contractor can demonstrate ... have resulted from the termination." In the absence of any express mention of incurred cost, continuing cost, or reasonable profit in either FAR 12.403 or FAR 52.212-4(l), the salient question becomes which provisions of FAR Part 49 are considered consistent—and relevant—to a contracting officer's determination of "reasonable charges" resulting from termination.

Boards of review have frequently resorted to FAR Part 49 and to related FAR Part 31 principles for guidance when determining recovery of terminated commercial item contracts to the benefit of either contractors or the government. For example, the CBCA relied upon FAR 31.205-42(b)'s specific cost principle in awarding costs continuing after termination despite all reasonable efforts by the contractor to eliminate them.<sup>92</sup> The GSBCA referenced FAR 49.203(a)<sup>93</sup> and declined to award any profit claimed on termination costs where a loss would have been incurred, had the contract not been terminated.<sup>94</sup> Similarly, the ASBCA noted that the termination for convenience clause does not state whether or not profit is payable as a ""reasonable charge" and, "[i]n the absence of other guidance," decided to follow FAR 49.202(a)'s<sup>95</sup> language disallowing recovery of profit on settlement expenses.<sup>96</sup>

Bearing in mind the overarching principle of fair compensation, contracting officers should analyze FAR Part 49, and, by extension, the relevant FAR Part 31 provisions, and decide which principles are consistent with FAR 12.403 and FAR 52.212-4(l) and reasonably applicable to the particular facts of the case at hand. Elaborating on all the possible categories for recovery exceeds the scope of this article, but, as a boundary, a strong argument can be made that contractors cannot recover for lost anticipated profit for unperformed work on a terminated commercial item contract.<sup>97</sup> There may be instances where fair compensation implicates recovery based on FAR 31.205-42(b)'s costs continuing after termination principle.<sup>98</sup>

#### B. Potential Pitfalls and Possible Solutions

While contracting officers and boards have incorporated FAR Part 49 principles into their recovery calculations on occasion, potential pitfalls include uneven



application of FAR Part 49 principles by contracting officers and a lack of consensus among reviewing authorities on what categories of expenses are recoverable as "reasonable charges" under FAR 52.212-4(l)'s second prong. Also, FAR 12.403(a)'s discretionary grant to contracting officers on whether to follow consistent FAR Part 49 principles for recovery determinations could lead to their uneven application and to disparate outcomes.

A similar difficulty in this still-evolving area also occurs when boards and courts differ as to which FAR Part 49 provision and Part 31 cost principles apply to terminated commercial item contracts. For example, one commentator believes the district court's decision in *Red River Holdings* might preclude recovery of continuing costs and profits on incurred costs. <sup>102</sup> The CBCA, however, has allowed recovery for continuing costs and profits on such costs. <sup>103</sup> In the future, the Court of Federal Claims and ASBCA could potentially disagree on what costs are recoverable, inviting forum shopping.

While specific facts of a particular case are decisive in determining recovery, the Federal Circuit may ultimately resolve which FAR Part 49 and FAR Part 31 principles apply to terminated commercial item contracts. Congress could also pass legislation, or, more likely, the FAR Council could amend the FAR and specify which provisions of FAR Part 49 and FAR Part 31 apply to terminated commercial item contracts for recovery purposes. Other potential reforms include narrowing the definition of "commercial items" to exclude complex items more appropriate for FAR Part 49 governance. Given this dynamic legal terrain, contracting officers should consult their contracting attorney before conducting settlement negotiations.

#### V. Conclusion

Having advocated for an approach to determining recovery that fuses the fair compensation principle with FAR 52.212-4(l)'s two-part recovery formula and consistent FAR Part 49 principles when reasonably applicable, it is now appropriate to apply it. Returning to the article's opening scenario, the contracting attorney should advise the contracting officer that pursuant to FAR 52.212-4(l), the contractor is entitled to payment of the contract price reflecting three months of contract performance as well as settlement costs. While the *Red River Holdings* case is pending on remand with the ASBCA, in light of the district court's decision and the CBCA's *Russell Sand & Gravel* opinion, other costs beyond mere settlement costs not compensated for by a percentage of the contract price may be recoverable under FAR 52.2124(l)'s "reasonable charges" prong if the contractor can demonstrate they resulted from termination and could not be reasonably avoided. Additionally, FAR Part 49 and Part 31 principles deemed



consistent with FAR 12.403(a) and FAR 52.212-4(l) should be considered if relevant and necessary for fair compensation.

While fair compensation is a matter of judgment,<sup>108</sup> the contractor will have to provide satisfactory evidence to obtain recovery of costs incurred in anticipation of contract performance, and this proof requirement will undo an unsubstantiated claim. Following existing case law, the contracting attorney should advise the contracting officer to disallow recovery for lost anticipated profit.

This illustration is not merely an intellectual exercise but could prove useful in the future. Faced with historic fiscal pressure to reduce spending and a pending withdrawal from Afghanistan, the Department of Defense will inevitably resort to terminating commercial item contracts to comply with the Budget Control Act of 2011.<sup>109</sup> In all likelihood, recovery disputes will continue to arise over FAR 52.212-4(l)'s general two-pronged recovery formula.<sup>110</sup> In these fiscally challenging times, the long-established fair compensation principle should serve as a guidepost for determining recovery for terminated commercial item contracts.

Under the current regulatory scheme, FAR 52.212-4(l)'s two-pronged recovery formula<sup>111</sup> can accommodate a range of factual circumstances. While both prongs of the formula play important roles, the "reasonable charges" prong provides a flexible mechanism to incorporate consistent FAR Part 49 and FAR Part 31 principles, depending on the facts. Contracting officers must continue to use their judgment in looking to FAR Parts 49 and 31 for guidance and pursue fair compensation in their individual cases within the current matrix of board of review cases and court decisions.

#### Appendix: Recovery for Anticipated Profits Is Disallowed

While identifying all the FAR Part 49 and FAR Part 31 provisions relevant to terminated commercial item contracts exceeds the scope of this paper, a strong case can be made that anticipated profits should be disallowed. Federal Acquisition Regulation 49.202(a) states that "[a]nticipatory profits and consequential damages shall not be allowed."<sup>112</sup> The appropriate analysis asks whether this limiting provision is consistent with FAR 12.403 and FAR 52.212-4(l), and, therefore, able to guide contracting officers in determining recovery.<sup>113</sup>

In the analysis of FAR 52.212-4(l)'s clause, a basic principle of contract interpretation requires construing the "plain language" of the contract. This involves "giving the words of the agreement their ordinary meaning unless the parties mutually



intended and agreed to an alternative meaning."<sup>115</sup> The paragraph entitled "Termination for the Government's convenience" contained within FAR 52.212-4(l)'s Contract Terms and Conditions--Commercial Items<sup>116</sup> makes no express mention of recovery for lost anticipated profit or any hint of such recovery. On the contrary, if anything, FAR 52.212-4(l) affirms the traditional bar on recovery for lost anticipated profit. The clause's very title, "Termination for the Government's convenience," conveys meaning. The clause is not entitled "Breach of Contract for the Government's Convenience," which suggests intent to permit recovery of lost anticipated profit or consequential damages. Instead, the clause's opening words hearken to the government's long-held ability to terminate a contract for its convenience without incurring liability for lost anticipated profit.

Historically, termination of a contract for the government's convenience has disallowed recovery for lost anticipated profit on unperformed work as a unique sovereign benefit.<sup>117</sup> Within this context and in the absence of express statutory or regulatory language expressing intent to allow recovery for anticipated profits, the most logical conclusion is that the drafters did not intend the "reasonable charges" language of FAR 52.212-4(l) to include lost anticipated profits. Notwithstanding FASA I, Section 8002(b)(1)'s language favoring standard commercial practices,<sup>118</sup> there is no specific indication in FASA I or FAR 52.212-4(l) that Congress or the DAR Council intended to cede the government's long-standing civil immunity from lost anticipated profits during terminations for the government's convenience and bestow on contractors a gratuitous windfall. Surely Congress and the DAR Council would have more clearly provided for the recovery of anticipatory profits for terminated commercial item contracts had such a policy shift with its vast financial consequences been intended.

In addition to the long-established association of the title ""Termination for the Government's Convenience" with excluding recovery of anticipated profits and the complete absence of language allowing recovery of anticipated profit, § 49.202(a)'s restriction<sup>119</sup> on recovering anticipated profits is consistent with § 12.403 and § 52.2124(l) and reasonably applicable under FAR 12.403(a).<sup>120</sup> Moreover, the Court of Federal Claims has found in *Praecomm* that anticipatory profits are not recoverable for such terminations of commercial item contracts.<sup>121</sup> Based upon practice, regulation, and case law, anticipatory profits are not recoverable under FAR 52.212-4(l)'s "Termination for the Government's Convenience" clause.<sup>122</sup>



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#### **ENDNOTES**

- 1. For purposes of this illustration, the flight simulators are "commercial items" as defined in FAR 2.101(b).
- 2. Reference to terminations of commercial item contracts will always refer to the convenience of the government unless otherwise stated.
- 3. The Federal Acquisition Regulation (FAR), issued as Chapter 1 of Title 48 C.F.R., serves as the primary regulation for all federal executive agencies in their acquisition of supplies and services with appropriated funds. It became effective on April 1, 1984. FAR 1.105-1(b) foreword (Mar. 2005).
- 4. Here, "unamortized costs" refers to costs incurred by the contractor in providing the simulators in anticipation of the full twelve months of performance but uncompensated for due to early termination.
- 5. FAR 52.212-4(l).
- 6. *Id.* A judge advocate facing a novel or unfamiliar contracting issue would be wise to consult more senior legal advisors, including AFLOA/JAQK (Contract Law Field Support Center). Contracting officers should be aware that the Defense Contracting Management Agency (DCMA) offers support through Termination Contracting Officers, whose sole purpose is to settle delegated contracts terminated for the convenience of the government. DEF. CONTRACT MGMT. AGENCY (DCMA) TERMINATIONS CTR., guidebook.dcma.mil/25/Terminations\_Customer\_Pamplet.doc (last visited June 10, 2014).
- 7. The FAR pt. 49.113 provides that "[t]he cost principles and procedures in the



applicable subpart of Part 31 shall, subject to the general principles in 49.201-(a) [b]e used in asserting, negotiating, or determining costs relevant to termination settlements under contracts with other than educational institutions ...." FAR 49.113(a) (2014). Section 31.205-42 lists numerous cost principles peculiar to termination situations, including initial costs and costs continuing after termination, among others. FAR 31.205-42.

- 8. FAR 12.403(a). Neither the mandated § 52.212-4(l) clause nor § 12.403 expressly recognizes the fair compensation principle or loss adjustment principle as applicable to commercial item contract terminations. FAR 52.212-4(l); FAR 12.403.
- 9. Under the Contract Disputes Act, a contractor may appeal a contracting officer's final decision to the Armed Services Board of Contract Appeals (ASBCA) or bring an action directly on the claim to the United States Court of Federal Claims. 41 U.S.C. § 7101, § 7104(a),(b)(1), § 7105(e)(1)(A) (2014) (granting the ASBCA jurisdiction to decide any appeal from a decision from a contract officer of the Department of Defense (DoD), the Department of the Army, the Department of the Navy, the Air Force, and the National Aeronautics and Space Administration regarding a contract administered by that agency). A contractor may appeal the decision of the ASBCA to the United States Court of Appeals for the Federal Circuit, which also has exclusive jurisdiction to hear an appeal from a final decision of the United States Court of Federal Claims. *Id.* § 7107(a)(1)(A). In maritime claims, United States district courts may also hear appeals from the ASBCA. *Id.* § 7102(d).
- 10. FAR 52.212-4(1).
- 11. 41 U.S.C. § 3307 (2011) (statutory subheading reads "Preference for commercial items").
- 12. The Budget Control Act of 2011, Pub. L. No. 112-25, 125 Stat. 240 (requiring total defense spending to decline by \$487 billion from FY 2012 through 2021). According to the DoD's Defense Budget Priorities and Choices-Fiscal Year 2014, if sequestration were allowed to continue, between 2010 and 2014, there would be an 18% decline in the inflation-adjusted defense base budget. Sequestration would further reduce average annual defense spending by more than \$50 billion each year through 2021. DEF. BUDGET PRIORITIES AND CHOICES-FISCAL YEAR 2014, www.defense.gov/pubs/DefenseBudgetPrioritiesChoicesFiscalYear. The National Defense Authorization Act for fiscal year 2014, which authorizes a DoD base budget of \$526 billion, however, offers a temporary reprieve from the full effect of



- sequestration for fiscal years 2014 and 2015. Ros Krasny, *Obama Signs Bipartisan Budget Deal, Annual Defense Bill*, REUTERS (Dec. 26, 2013), www.reuters.com/article/2013/12/26/us-usa-obama-idUSBRE9BP0HK20131226.
- 13. The DoD's baseline budget funding in fiscal year 2015 is currently constrained by law to \$496 billion. Daniel Wasserbly, *Pentagon Budget 2015: DoD Seeking Added Readiness Funding and Brac*, IHS JANE'S DEFENCE WKLY. (Feb. 23, 2014), www.janes.com/article/34523/pentagon-budget-2015-dod-seeking-added-readiness-fundingandBRAC-IHS Jane's 360. By way of comparison, the Pentagon's base-line budget for the 2013 National Defense Authorization Act was \$527.5 billion. Jim Garamone, *Obama Signs \$633 Billion Defense Authorization Act*, AM. FORCES PRESS SERV. (Jan. 3, 2013), www.defense.gov/news/newsarticle.aspx?id= 118913.
- 14. FAR 52.212-4(1).
- 15. FAR 31.205-42.
- 16. See supra note 14.
- 17. United States v. Corliss-Steam Eng. Co., 91 U.S. 321 (1876).
- 18. Torncello v. United States, 681 F.2d 756, 764-65 (Ct. Cl. 1982).
- 19. *Id.* (citing NASH & CIBINIC, FEDERAL PROCUREMENT LAW 1106-07 (3d ed. 1980)).
- 20. The United States Court of Appeals for the Federal Circuit has jurisdiction over an appeal from final decisions of the United States Court of Federal Claims and of an agency board of contract appeals. 28 U.S.C. § 1295(a)(3), (10) (2014).
- 21. Maxima Corp. v. United States, 847 F.2d 1549, 1552 (Fed. Cir. 1988) (noting that termination for convenience serves only the government).
- 22. T&M Distributors, Inc., v. United States, 185 F.3d 1279, 1284 (Fed. Cir. 1999).
- 23. *Maxima Corp.*, 847 F.2d at 1552.
- 24. FAR 52.249-2 (2014)
- 25. Id. § 49.002.
- 26. Paul Seidman, Termination for Convenience of FAR Part 12 Commercial Item Contracts: Is Fair Compensation Required, in 24 NASH & CIBINIC REP. no. 8, ¶ 37 (2010) (citing



- FAR 52.249-2, paras. (f), (g), (i); FAR 49.113, 49.201, 49.202, and 31.205-42).
- 27. The fair compensation principle, as stated in FAR 49.201(a), provides, "A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit." FAR 49.201(a) (2014).
- 28. The loss adjustment principle disallows recovery for profit if it appears that the contractor would have incurred a loss, had the entire contract been completed. *Id.* § 49.203.
- 29. For the remainder of this article, terminated commercial item contracts will refer to commercial item contracts terminated for the government's convenience.
- 30. The Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, 108 Stat. 3243 (codified in scattered sections of 10 U.S.C. and 41 U.S.C.).
- 31. S. REP. NO. 103-258, at 1-2 (1994), as reprinted in 1994 U.S.C.C.A.N. 2561, 2562 (emphasis added).
- 32. FAR 12.403; FAR 52.212-4(l). Federal Acquisition Regulation Part 12 makes no reference to the fair compensation principle or the loss adjustment principle for commercial item contracts.
- 33. As an introduction, FAR 2.101(b) defines "commercial items" to include, among other things, items of a type customarily used by the general public and sold, leased, or licensed to the general public as well as certain services. For the complete definition of "commercial items," see FAR 2.101(b).
- 34. Generally, the termination for convenience provision in FAR Part 12 is approximately 90 percent shorter than comparable termination for convenience provisions governing traditional government contracts. FEDERAL PUBLICATIONS LLC, COMMERCIAL ITEM ACQUISITION 9-37 (2007).
- 35. FAR 52.212-4(1).
- 36. *Id.*; FAR 12.403. Commercial item contracts are exempted from the Truth in Negotiations Act, thereby relieving contractors of the obligation to submit cost and pricing data to the government. National Defense Authorization Act for Fiscal Year 1996, Pub. L. No. 104-106, 110 Stat. 186. Similarly, a commercial items contractor is not required to comply with the cost accounting standards or with the contract cost principles of FAR Part 31 applicable to traditional government contracts. FAR



- 12.403(d)(ii) (2014).
- 37. PowerPoint Presentation of Paul J. Seidman, Seidman & Associates, P.C., ABA Section on Public Contract Law Committee on Commercial Items, "FAR Pt 12 Commercial Item Terminations for Convenience: Is Fair Compensation Required?" slide 6 (Oct 19, 2011), available at www.seidmanlaw.com/ Events/Far-PT-12-CommercialItem-Terminations-for-Convenience.pdf.
- 38. Red River Holdings, LLC, No. 56316, 2009 WL 3838891, at \*3-4 (Nov. 4, 2009).
- 39. *Id.* at \*7.
- 40. *Id.*
- 41. Corners & Edges, Inc. v. Dept. of Health & Human Servs., CBCA No. 693, 08-2 BCA ¶ 33,961.
- 42. FAR 52.212-4(l). What constitutes "work performed" under the first prong, with all the potential factual circumstances and complexities, exceeds the scope of this article. The author intends merely to familiarize the reader with the simplest of prong one circumstances and notes, for example, that neither of the two board cases mentioned concerned contract terminations for common, off-the-shelf stock items that could easily be placed back on the shelf for resale.
- 43. FAR 52.212-4(1).
- 44. Red River Holdings, LLC, 2009 WL 3838891, at \*7-8.
- 45. Red River Holdings, LLC v. United States, 802 F. Supp. 2d 648, 662 (D.Md. 2011).
- 46. Russell Sand & Gravel Co., Inc., No. 2235, 2013 WL 6144153, at \*5-10 (Nov. 6, 2013).
- 47. Ralph C. Nash & Paul J. Seidman, Postscript: Termination for Convenience of Part 12 Commercial Item Contracts, *in* 25 NASH & CIBINIC REP. NO. 8, ¶ 37 add (2011).
- 48. *Red River Holdings, LLC,* 2009 WL 3838891, at \*7.
- 49. *Id.* at \*3-4.
- 50. *Id.* at \*6-7.
- 51. FAR 52.212-4(1).
- 52. *Red River Holdings, LLC,* 2009 WL 3838891, at \*6-7; FAR 52.249-2 (2014).



- 53. *Red River Holdings, LLC,* 2009 WL 3838891, at \*6-7.
- 54. Red River Holdings, LLC v. United States, 802 F. Supp. 2d 648, 660 (D.Md. 2011).
- 55. *Id.* at 659.
- 56. *Id.* at 662. The court asserts that a contractor may not recover additional amounts, however reasonable or necessary, if already reflected in the percentage-of-work performed payment. *Id.* at 662 n.17.
- 57. *Id.* at 662 n.18.
- 58. Russell Sand & Gravel Co., Inc., No. 2235, 2013 WL 6144153, at \*2-3 (Nov. 6, 2013).
- 59. *Id.* at \*5-10.
- 60. Seidman, *supra* note 47, ¶ 37 add. Mr. Paul Seidman's impressive legal career includes service as Assistant Counsel for Contract Claims at Naval Sea Systems Command and as Assistant Chief Counsel for Procurement in the Office of the Chief Counsel for Advocacy at the SBA. Additionally, he has over three decades of experience as a private practitioner in government contract law. He has appeared as an expert witness on procurement-related issues at congressional hearings and drafted procurement-related legislation and regulations. A prolific writer, Mr. Seidman's works have been published in *The Briefing Papers*, *The Nash & Cibinic Report*, and *The Government Contractor*, among others. Elected a Fellow by the National Contract Management Association, Mr. Seidman has served on the Advisory Board of The Government Contractor and on the Data and Patent Rights Committee of the American Bar Association. www.seidmanlaw.com/Attorneys/ Paul-J-Seidman.shtml (last visited May 30, 2014).
- 61. The Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, § 8002(b)(1), 108 Stat. 3243 (codified 41 U.S.C. § 3307 (2014)) (emphasis added).
- 62. U.C.C. § 2-708(2) (2002) provides that "the measure of damages [for cancellation by the buyer includes] … the profit (including reasonable overhead) which the seller would have made from full performance by the buyer …." *Id.* § 2-708(2).
- 63. Seidman, *supra* note 47, ¶ 37 add.
- 64. *Id.*
- 65. FAR 49.201. Federal Acquisition Regulation 49.201 provides that "[f]air compensation is a matter of judgment and cannot be measured exactly. In a given



- case, various methods may be equally appropriate for arriving at fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement." *Id*
- 66. The Urgency Deficiency Appropriation Act, Pub. L. No. 65-23, 40 Stat. 182, 183 (1917) (emphasis added).
- 67. Contract Settlement Act of 1944, Pub. L. No. 78-395, 58 Stat 649, 652 (emphasis added).
- 68. Joint Termination Regulation, 9 Fed. Reg. 13,324 (Nov. 10, 1944).
- 69. Defense Acquisition Regulations, 32 C.F.R. § 8-301(a) (1984) ("A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including an allowance for profit thereon which is reasonable under the circumstances."); see Williams Alaska Petr., Inc. v. United States, 57 Fed. Cl. 789 n.7 (2003) (observing that the FAR resulted from an effort that culminated in 1983 to consolidate three separate systems of procurement regulations: the Federal Procurement Regulations, the Defense Acquisition Regulations, and the National Aeronautics and Space Administration Regulations).
- 70. Federal Procurement Regulations, 27 Fed. Reg. 11,583, 11,591 (Nov. 27, 1962) (later codified at 41 C.F.R. pt. 1-8.301 but now obsolete) ("A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including an allowance for profit thereon which is reasonable under the circumstances.").
- 71. Nicon, Inc., v. United States, 331 F.3d 878, 885 (Fed. Cir. 2003) (citing Freedom Elevator Corp., GSBCA No. 7259, 85-2 BCA ¶ 17,964). The Federal Circuit ruled that although FAR's "Termination for Convenience of the Government (Fixed-Price)" clause did not specifically mention unabsorbed overhead as one that would be paid under the settlement, as a matter of law, it could be recovered if properly allowed and allocable. *Id.* at 885.
- 72. Jacobs Eng'g Group, Inc., v. United States, 434 F.3d 1378, 1381 (Fed. Cir. 2006) (citing *In re* Kasler Elec. Co., DOTCAB No. 1425, 84-2 BCA ¶ 17374).
- 73. Red River Holdings, LLC v. United States, 802 F. Supp. 2d 648, 660 (D.Md. 2011); Russell Sand & Gravel Co., Inc., No. 2235, 2013 WL 6144153, at \*6 (Nov. 6, 2013).
- 74. FAR 12.403(a).



- 75. FAR 49.201(b) notes that the primary objective of the fair compensation principle is "to negotiate a settlement by agreement." The regulation does not require rigid cost and accounting data but recognizes that "[o]ther types of data, criteria, or standards may furnish equally reliable guides to fair compensation." FAR 49.201(c). Similarly, FAR Part 49.201(c) provides that "[t]he amount of recordkeeping, reporting, and accounting related to the settlement of terminated contracts should be kept to a minimum compatible with the reasonable protection of the public interest." *Id*.
- 76. The Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, § 8002(b)(1), 108 Stat. 3243 (codified 41 U.S.C. § 3307 (2014)).
- 77. FAR 12.403; id. § 52.212-4(1).
- 78. *Red River Holdings*, LLC, 802 F. Supp. 2d at 660 n.15.
- 79. FAR 52.212-4(1).
- 80. Federal Acquisition Regulations for the Acquisition of Commercial Items (Proposed Rule), 60 Fed. Reg. 11,198, 11,215-16 (Mar. 1, 1995).
- 81. Red River Holdings, LLC, 802 F. Supp. 2d at 661 n.16 (citing Seidman, supra note 26, ¶ 37) (emphasis added).
- 82. *Id.*
- 83. FAR 52.212-4(1).
- 84. *Red River Holdings, LLC,* 802 F. Supp. 2d, at 661 n.16. The district court in *Red River* concluded that the "reasonable charges" prong serves as a "safety valve" component to allow compensation for any reasonable, unavoidable costs not reflected in the first component. *Id.* at 662 n.18.
- 85. Divecon Servs., LP v. Dep't of Commerce, GSBCA No. 15997-COM, 04-2 BCA ¶ 32,656.
- 86. Jon Winter & Assocs., No. 2005-129-2, 2005 WL 1423636, at \*4 (June 20, 2005); see also Dehdari Gen. Trading & Contract'g, ASBCA No. 53987, 2003-1 BCA ¶ 32,249 (in a commercial items case, the ASBCA implied that a contractor would be entitled to pre-termination payments made to a supplier in anticipation of full contract performance if it had submitted evidence to support the alleged payments and proved that such costs could not have reasonably been avoided).



- 87. FAR 49.002(a)(2).
- 88. *Id.*
- 89. FAR 12.403(a) (emphasis added).
- 90. Id.
- 91. FAR 52.212-4(1).
- 92. Russell Sand & Gravel Co., Inc., No. 2235, 2013 WL 6144153, at \*8 (Nov. 6, 2013).
- 93. FAR 49.203 (a) states, "In the negotiation or determination of any settlement, the [termination contracting officer] (TCO) shall not allow profit if it appears that the contractor would have incurred a loss had the entire contract been completed." FAR 49.203 (a).
- 94. Divecon Servs., LP v. Dep't of Commerce, GSBCA No. 15997-COM, 04-2 BCA ¶ 32,656. Relying upon FAR 49.202(a), the GSBCA disallowed recovery for anticipated but unearned profit on work not performed. *Id*.
- 95. FAR 49.202(a) precludes recovery of profit on settlement expenses, lost profit, and consequential damages. FAR 49.202(a).
- 96. Appeals of Alkai Consult., LLC, ASBCA No. 56792, 10-2 BCA ¶ 34,493.
- 97. See infra Appendix.
- 98. FAR 31.205-42(b) provides in part, "Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable." FAR 31.205-42(b).
- 99. Red River Holdings, LLC, No. 56316, 2009 WL 56316 at \*7-8 (Nov. 4, 2009) (limiting recovery under FAR 52.212-4(l)'s "reasonable charges" prong to settlement expenses); Red River Holdings, LLC v. United States, 802 F. Supp. 2d 648, 662 (D.Md. 2011) (allowing recovery for settlement costs reasonably incurred in anticipation of contract performance if such costs are not adequately reflected as a percentage of the work performed and could not be reasonably avoided); Russell Sand & Gravel Co., Inc., No. 2235, 2013 WL 6144153 at \*8-11 (Nov. 6, 2013) (recovery for "reasonable charges" under FAR 52.212-4(l) included costs incurred, profits on cost incurred, costs continuing after termination, and profit on such continuing costs).



- 100. FAR 52.212-4(1).
- 101. FAR 12.403(a).
- 102. Seidman, *supra* note 47,  $\P$  37 add.
- 103. *Russell Sand & Gravel Co., Inc.,* 2013 WL 6144153, at \*8-11.
- 104. Parties could consider tailoring termination clauses specifying which costs are recoverable.
- 105. FAR 52.212-4(l). This vignette presupposes consultation with higher headquarters.
- 106. The ASBCA has yet to publish a response to the district court's reversal. Red River Holdings, LLC v. United States, 802 F. Supp. 2d 648, 662 (D.Md. 2011). Although the Federal Circuit has not ruled on this issue, the CBCA found that more than settlement expenses can be recovered where the government terminates a commercial item contract for its convenience under FAR 52.212-4(l). *Russell Sand & Gravel Co., Inc.*, 2013 WL 6144153, at \*8-11.
- 107. FAR 52.212-4(1).
- 108. FAR 49.201(a).
- 109. The Budget Control Act of 2011, Pub. L. No. 112-25, 125 Stat. 240.
- 110. FAR 52.212-4(l).
- 111. *Id*.
- 112. FAR 49.202(a).
- 113. FAR 12.403(a).
- 114. McAbee Constr., Inc. v. United States, 97 F.3d 1431, 1435 (Fed. Cir. 1996).
- 115. Harris v. Dep't of Veterans Affairs, 142 F.3d 1463, 1467 (Fed. Cir. 1996).
- 116. FAR 52.212-4(l).
- 117. Marc Pederson, *Rethinking the Termination for Convenience Clause in Federal Contracts*, 31 CONT. L.J. 83, 86-87 (2001) (reviewing the historical development of the government's sovereign ability to terminate contracts without facing common law breach damages).
- 118. The Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355,



- § 8002(b)(1), 108 Stat. 3243 (codified 41 U.S.C. § 3307 (2014)).
- 119. FAR 49.202 (2014) precludes a terminated contractor from recovering anticipatory profit.
- 120. FAR 12.403(a).
- 121. Praecomm, Inc. v. United States, 78 Fed. Cl. 5, 12 (2007) (citing Int'l Data Prods. Corp. v. United States, 492 F.3d 1317, 1323-24 (Fed. Cir. 2007)).
- 122. FAR 52.212-4(1).



# EFFECTIVE CONSTRUCTION CLAIM RESOLUTION: UNDERSTANDING DCAA

By David G. Anderson\*

[Reprinted with permission of the Public Contract Law Journal. David Anderson, *Effective Construction Claim Resolution: Understanding DCAA*, 43:2 Pub. Cont. L.J. 165 (2013)].

Give me six hours to chop down a tree and I will spend the first four sharpening the axe.

- Abraham Lincoln

#### I. INTRODUCTION

"The U.S. Government has been and, for the foreseeable future, will continue to be the largest purchaser of construction services in the world." Competition for government construction contracts is fierce, in part due to the continuing slump in the construction industry. The U.S. Government, in many respects, is an extremely fair and equitable construction partner. Unlike the typical owner, rarely does the U.S. Government include draconian notice provisions or "No Damage for Delay" clauses in its construction contracts. When contracting with the U.S. Government, however, one "must turn square corners." In addition, one must comply with government regulations, laws, and unique contract requirements, which may include an audit of claims by the Defense Contract Audit Agency (DCAA).

Construction rarely proceeds exactly as planned.<sup>5</sup> When things do not go as planned, claims arise. The U.S. Government takes contractor claims seriously. To help ensure that the government does not overpay, contractor requests for equitable adjustment (REAs) and claims, where significant, are audited by DCAA.

Disputes exist due to factual uncertainty and, to a lesser extent, legal uncertainty. No one wants or can afford to bear a large loss--not the construction contractor, not its subcontractors, not its vendors, and not the government. For this reason, when substantial uncertainty exists, settlement may be difficult or impossible to obtain. Discovery is one vehicle for reducing factual uncertainty. Audit is another.

Damages are typically the area where the greatest uncertainty exists for the government.<sup>6</sup> Like the construction contractor, the government "lives" the project. Government people are usually physically present at the job site, observe construction



firsthand, and work directly with the contractor to resolve problems as they arise. As a result, the government normally has a fairly good understanding of the liability-causing event and the degree to which each party is responsible. Indeed, regarding liability, the government's knowledge may approximate the contractor's. By contrast, the government has little visibility into the contractor's damages or costs. It is in the damage area where the government needs the most help. DCAA often can provide that help.<sup>7</sup>

Because many construction contractors and their attorneys (and even some government attorneys) are unfamiliar with DCAA, this Article will present basic information about the agency and the audit process. The Article will then examine recent Boards of Contract Appeals and court decisions concerning construction claims and determine the role DCAA has played. Following that discussion of recent case law, this Article will analyze a DCAA audit from the following perspectives: (1) the Contracting Officer (CO) and government attorney defending a construction claim and (2) the construction contractor and its attorney. Finally, the Article will discuss recent troubles at DCAA and will offer recommendations for working effectively with DCAA.

#### II. ABOUT DCAA

DCAA performs all contract auditing for Department of Defense (DoD) contracts and subcontracts, including all audits of construction claims.<sup>8</sup> Additionally, DCAA audits contractor and subcontractor claims for other government agencies.<sup>9</sup>

DCAA is a separate agency of the DoD and is independent of the CO, the trial attorney, and even the contracting government entity. DCAA has over 5000 employees located at more than 300 field audit offices throughout the United States, Europe, and the Pacific. A substantial percentage of the DCAA workforce are certified public accountants and an even higher percentage have advanced degrees.

The DCAA auditor has an advisory role.<sup>13</sup> DCAA advises the CO, who has "sole authority to legally bind the government to contracts and contract modifications."<sup>14</sup> The CO is "allowed wide latitude to exercise business judgment"<sup>15</sup> and is required to "[e]nsure that contractors receive impartial, fair, and equitable treatment."<sup>16</sup> What this means is that the CO can disregard the findings, opinions, and recommendations of the auditor. A CO, however, normally will follow the auditor's lead on damages, unless credible evidence is brought to the CO's attention demonstrating that the auditor's concerns are unfounded or insufficient to preclude recovery.



#### A. The Audit

The auditor's report is the "principal means of conveying ... audit results to contracting officers and other interested parties." The purpose of the DCAA audit is to express an opinion on the costs and estimates contained in the construction contractor's REA or claim. To express a valid opinion, the auditor must physically examine and test the contractor's records, including, inter alia, job cost records and indirect cost rates. In short, the auditor verifies the costs asserted in the REA or claim by tracking them back to source documents, such as timesheets and vendor invoices. The auditor seeks to ascertain whether the claimed costs are

- (1) reasonable as to nature and amount;
- (2) allocable, and measurable by the application of duly promulgated cost accounting standards;
- (3) [in accordance with] generally accepted accounting practices and principles applicable to the particular circumstances; and
- (4) in accordance with applicable cost limitations or exclusions as stated in the contract or in FAR.<sup>20</sup>

In performing the audit, the auditor is guided by the DCAA Contract Audit Manual (DCAAM), an official publication of DCAA.<sup>21</sup> The DCAAM provides "technical audit guidance, audit techniques, audit standards, and technical policies and procedures."<sup>22</sup> Because DCAA has placed the DCAAM online for reference,<sup>23</sup> the construction contractor and its attorney can promptly access and review the HQ DCAA guidance to the auditor.

The Government Accountability Office (GAO) issues Generally Accepted Government Auditing Standards (GAGAS) for each government audit organization to follow, including DCAA.<sup>24</sup> The DCAA auditor must strictly adhere to GAGAS while performing his or her audit duties.<sup>25</sup>

Auditing standards address audit *quality*.<sup>26</sup> The value of an audit lies in the *credibility* of the information it provides decision makers.<sup>27</sup> GAGAS "provide a framework for conducting high quality audits with competence, integrity, objectivity, and independence."<sup>28</sup> Per GAGAS, an audit should be conducted with integrity, which



"includes auditors conducting their work with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' report."<sup>29</sup>

Independence is a core government audit standard.<sup>30</sup> As stated in the DCAAM, "the auditor's effectiveness depends upon the ability to develop and evaluate facts and arrive at sound conclusions objectively (based on unbiased judgments) and independently (not influenced or controlled by others)."<sup>31</sup> Independence, however, does not mean isolation.<sup>32</sup> For example, an auditor can develop an independent conclusion, after discussing potential findings with contractor personnel, while also objectively considering their comments.<sup>33</sup>

Another audit standard is proper supervision.<sup>34</sup> The supervisory auditors and field audit office managers provide this necessary oversight.<sup>35</sup> Before a construction claim audit begins, "the supervisory auditor must ensure that the audit team understands clearly the purpose and scope of the audit."<sup>36</sup> During the audit, the supervisory auditor provides the auditor with "technical guidance on audit or accounting problems, … coordinate[s] on any major changes the auditor proposes to make to the audit program or time budget, and … perform[s] interim reviews" of the audit.<sup>37</sup> At completion of the audit, the supervisory auditor reviews "the working papers and the report draft for compliance with GAGAS, professional quality, accuracy, and responsiveness to the audit request."<sup>38</sup> If the audit report is "significant," the field audit office manager provides a second review.<sup>39</sup>

### B. Communicating with the Contractor

DCAA strongly encourages the auditor to keep the contractor apprised of the audit and the auditor's findings.<sup>40</sup> Indeed, in an April 30, 2013, memorandum, DCAA stressed the importance of this communication.<sup>41</sup> Communications with the contractor are to start at the very beginning of the audit and continue through the exit conference.<sup>42</sup>

The auditor must "hold an entrance conference with the contractor's designated representative(s)."<sup>43</sup> Here, the auditor is to explain "the purpose of the audit, the overall plan for its performance, including the estimated duration, and generally the types of books, records," and other data needed.<sup>44</sup> At this time, the auditor should also arrange with the contractor for any "necessary work space and administrative support" and "[a]sk the contractor to designate primary and alternate officials with whom audit matters are to be discussed during" the audit.<sup>45</sup> The auditor should also ask the



contractor for a "walk-through" of its REA or claim, i.e., to fully explain it and answer questions to ensure that the audit team fully understands the contractor's assertions.<sup>46</sup>

The DCAAM instructs the auditor to discuss matters with the contractor, throughout the audit, "as necessary to obtain a full understanding of the basis" of each item of cost.<sup>47</sup> The auditor should disclose to the contractor "any factual duplications, omissions, or other mistakes noted in the contractor's assertion, records, or supporting data."<sup>48</sup> The auditor should "discuss preliminary audit findings ... with the contractor to ensure conclusions are based on a complete understanding of all pertinent facts."<sup>49</sup> These discussions "are generally necessary to obtain sufficient evidence to support audit conclusions."<sup>50</sup> The auditor should also inform the contractor of any "significant understatements" in the REA or claim that are the clear result of an oversight, such as a mathematical error.<sup>51</sup>

Upon completion of the field work, the auditor "should hold an exit conference with the contractor's designated representative" to discuss the audit results and obtain the contractor's views concerning the audit findings, conclusions, and recommendations.<sup>52</sup>

Auditor communications, however, can be limited by the CO. The auditor cannot "reveal the audit conclusions or recommendations to the … contractor without obtaining the concurrence of the [CO]."<sup>53</sup> Auditor communications also can be limited by the government trial attorney. For audit work performed at the request of the government trial attorney in support of ongoing or anticipated litigation: "[a]uditors must request and follow counsel advice on such matters as … whether and how to discuss factual aspects of the ongoing audit with the auditee …. An exit conference will not be held unless the [g]overnment trial attorney expressly approves it and its scope in writing."<sup>54</sup>

# C. Responsibility for Detecting Fraud

"Government auditing standards require auditors to design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, or illegal acts that could ... significantly affect the [claim being audited]." The DCAAM instructs:

Under the concept of professional skepticism, an auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, an auditor recognizes that conditions observed and evidential



matter obtained ... need to be objectively evaluated to determine if contractor financial representations are free of material misstatements.<sup>56</sup>

Per the DCAAM, "[a]uditors are not trained to conduct investigations of illegal acts. This is the responsibility of investigators or law enforcement authorities." When an auditor obtains information raising "a reasonable suspicion of fraud," the auditor is to initiate an "investigative referral." <sup>58</sup>

Issuance of an investigative referral should not be deferred until completion of the audit. Neither should it necessarily take place as soon as the auditor is confronted with a fraud indicator. The auditor should follow up on the fraud indicator until he or she is satisfied either that an innocent explanation of irregularity is not likely or no further relevant information can be obtained through audit techniques.<sup>59</sup>

The auditor is not required "to prove the existence of fraud ... in order to submit a referral"; indeed, encountering evidence raising a ""reasonable suspicion" of fraud is sufficient.<sup>60</sup> The preferred method of submission is a DCAA Suspected Irregularity Referral Form (DCAAF 2000), but the auditor may also utilize the DoD Hotline.<sup>61</sup> On DCAAF 2000, the auditor is to "fully describe the fraudulent condition" and include information on "contractor efforts to hinder or obstruct audit work which uncovered the suspected fraud."<sup>62</sup> "The auditor's responsibility for detecting fraud ends with submission of a Form 2000 or Hotline referral."<sup>63</sup>

### III. RECENT CONSTRUCTION CASES INVOLVING DCAA

To determine the role DCAA currently plays in federal court and Boards of Contract Appeals cases, the author reviewed ten years of reported decisions.<sup>64</sup> A brief examination of the most significant or interesting construction cases follows.

### A. Reliance on Audit Testimony

A very high percentage of the time, the court or board decision accepted the DCAA audit finding at issue. DCAA's determination of actual labor hours, labor rates, field overhead, home office overhead, material costs, payments to subcontractors, actual equipment costs, and bond rates were, in most cases, readily accepted.<sup>65</sup>

On the other hand, where the contractor presented *credible evidence* contradicting DCAA, the contractor usually prevailed.<sup>66</sup> For example, in *States Roofing*, DCAA used



\$14.00 per hour for labor because the contractor had priced some changes at \$14.00 per hour.<sup>67</sup> The contractor's expert successfully challenged the DCAA finding by using the contractor's job cost report and identification of specific individuals to show that the contractor's actual labor rate was \$16.62 per hour.<sup>68</sup> The Board adopted the contractor's \$16.62 per hour rate.<sup>69</sup>

## 1. Weight to Be Given DCAA Auditor Testimony

A DCAA audit report is just evidence, not an admission by the government.<sup>70</sup> In *Orlosky Inc. v. United States*, Judge Christine Odell Cook Miller comprehensively analyzed the case law on the weight to be given a DCAA audit.<sup>71</sup> DCAA had accepted Orlosky's computation of unabsorbed home office overhead.<sup>72</sup> Orlosky, however, had varied from the *Eichleay* formula,<sup>73</sup> the exclusive formula per *Nicon*, *Inc. v. United States* for calculating unabsorbed home office overhead.<sup>74</sup> After explaining that a DCAA audit is considered evidence and not an admission by the government, the court denied Orlosky's unabsorbed home office overhead claim in its entirety for failure to adhere strictly to the *Eichleay* formula.<sup>75</sup> The court held that "[w]hile the DCAA ultimately accepted plaintiff 's methods, the court is not bound to do so."<sup>76</sup>

In *Charles G. Williams Construction v. White*, the Court of Appeals for the Federal Circuit (Federal Circuit) held that the board must decide important cost issues, not the auditor.<sup>77</sup> It stated:

The [b]oard's function in this case was itself to determine whether Williams had established its case for *Eichleay* damages, not to determine whether the auditor's "finding" that Williams had not done so was supported by the record. *The [b]oard was entitled to give the auditor's evidence and testimony, like that of any other evidence, whatever weight it concluded it should have.* Under the Contracts (sic) Disputes Act, however, it is the function and responsibility of the [b]oard, and not of the auditor, to decide questions of entitlement.<sup>78</sup>

Despite the fact that "the *Eichleay* claim was the largest element of damages" requested by Williams and the most significant issue in the case, the board's ""sole discussion" regarding the *Eichleay* claim was a "[nine] line passage" reciting the auditor's findings.<sup>79</sup> According to the court:

[O]ne would have expected that the [b]oard would have made its own



finding to that effect, rather than merely stating that the auditor had so found. One would also have expected the [b]oard to discuss the underlying evidence relating to that issue. The [b]oard's treatment of the issue created uncertainty about what the [b]oard actually found and the basis of its finding.<sup>80</sup>

The case returned to the Federal Circuit after the board, on remand, again denied Williams's *Eichleay* claim. <sup>81</sup> The board's decision this time, however, was supported by "an additional [eleven] detailed findings on the claim, followed by a brief discussion, in the 'DECISION' section of its opinion." <sup>82</sup> The court noted that "[u]nlike [the board's] earlier opinion, in which it merely had reviewed the auditor's decision, on the remand the [b]oard itself determined [the entitlement to *Eichleay* damages] issue." <sup>83</sup> The board found "[t]he auditor's report and testimony were credible, corroborated by the daily reports, the scope of the contract modifications, and the data in [the contractor's] termination settlement claim and were unrebutted by any credible evidence [by the contractor]." <sup>84</sup>

In reconciling its prior opinion with the weight the board subsequently gave the DCAA audit report on remand, the court stated:

To be sure, the [b]oard gave significant weight to the "auditor's report and testimony," but in our prior opinion, we recognized that the [b]oard could give such evidence and testimony "whatever weight it concluded it should have." The [b]oard also gave weight to the other evidence in the record to which it referred.<sup>85</sup>

# 2. Withholding Final Decision on a Claim Awaiting the DCAA Audit

How long can a CO reasonably withhold a final decision on a claim waiting for the DCAA audit report? Probably no more than nine months according to the Armed Services Board of Contract Appeals (ASBCA) in *Kelly-Ryan*, *Inc.*<sup>86</sup>

The U.S. Army Corps of Engineers awarded a \$19,729,300 contract to Kelly-Ryan (KRI) for improvements to False Pass Harbor, Alaska.<sup>87</sup> On November 24, 2009, KRI submitted a \$36,231,321 claim.<sup>88</sup> The claim document was 3546 pages and failed to include a schedule analysis apportioning responsibility for the delay.<sup>89</sup> The CO notified KRI that, due to the claim's complexity, he would issue his final decision by November 24, 2010.<sup>90</sup> On March 4, 2010, KRI appealed to the ASBCA.<sup>91</sup> The government moved to



dismiss for lack of jurisdiction (asserting the appeal was premature in the absence of a final decision) or to stay the proceedings until November 24, 2010, when the final decision would be issued. On September 13, 2010, the CO extended the date by which the final decision would be issued to January 14, 2011, due to a delay in completing the DCAA audit. On September 13, 2010, the CO extended the date by which the final decision would be issued to January 14, 2011, due to a delay in completing the DCAA audit.

Although reasonableness is a case-by-case determination, rarely will a board allow a CO more than nine months to render a final decision. Even under the extreme facts of this case, the board held one year to be an unreasonable period. The board did not find the need to complete a DCAA audit persuasive and denied the government's motion to dismiss for lack of jurisdiction. The board also denied the government's motion to stay the proceedings, agreeing with KRI that "the appeal should go forward and the government can continue its audit and analysis during the discovery phase of the appeal."

The facts in *Kelly-Ryan--*a \$36 million claim, 3546 pages long, and lacking a schedule analysis apportioning delay--are such that it reasonably could have taken a year or more to analyze and audit the claim.<sup>97</sup> The board, however, was reluctant to delay the contractor's right of appeal for more than nine months, even when the CO needed a DCAA audit to assess the contractor's claims.<sup>98</sup> The board reasoned that the audit could continue while the appeal proceeded.<sup>99</sup>

There is a price, however, to proceeding with litigation before the audit is complete. The audit could provide sufficient certainty to enable settlement, saving both the contractor and the government unnecessary litigation costs.

*Kelly-Ryan* demonstrates that should the CO need a DCAA audit to render a final decision, the government must get the DCAA audit started and completed within a three-to-nine-month window, depending upon the complexity of the case.<sup>100</sup>

# 3. Ability to Preclude DCAA Auditor Testimony

A contractor cannot prevent the DCAA auditor from testifying about the audit findings. A contractor can, however, often prevent the DCAA auditor from testifying as an expert.

In Contract Management, Inc. v. Babcock & Wilcox Technical Services Y-12, LLC, the District Court for the Eastern District of Tennessee denied Contract Management, Inc.



(CMI)'s motion in limine to preclude DCAA auditor testimony.<sup>101</sup> CMI sought to preclude auditor testimony on three grounds. First, "the audit was 'prepared as a basis for settlement negotiations"D' and hence should "be excluded from evidence under [Federal Rule of Evidence 408], as "conduct or a statement made during compromise negotiations about the claim."'<sup>102</sup> Second, the auditor was not involved in the project until "fifteen months after the Plaintiff had completed its work" and, therefore, was not a fact witness.<sup>103</sup> Third, the auditor failed to demonstrate that she possessed the "'knowledge, skill, experience, training, or education' through disclosure of curriculum vitae, resume, or other statement of qualifications" to qualify as an expert under the *Daubert* standard.<sup>104</sup>

The DCAA notification letter stated the audit is "to determine if the claimed costs are acceptable as a basis for settlement." <sup>105</sup> The court, however, found "no case law to support the proposition that DCAA audits, despite what their introductory letters may say, are instruments of compromise negotiations, per se." <sup>106</sup>

The court's decision is obviously correct. A ruling that the DCAA audit is part of settlement negotiations and is therefore inadmissible at trial would have far-reaching negative implications. Essentially, it would mean that the audit could be used for either settlement or trial purposes but not both. The need for factual information for settlement purposes does not eliminate the need for factual information for trial purposes or make the DCAA audit into "an instrument of compromise" under Rule 408.107

CMI next argued that the auditor should be precluded from testifying because she was not a fact witness to the project's completion, was not involved in the project's performance, and only became involved during the review of CMI's claims fifteen months after CMI had completed its work.<sup>108</sup> The defendant, Babcock & Wilcox Technical Services Y-12, LLC (Babcock), responded that "DCAA's internal regulations ... classify the persons who perform audits as witnesses of fact and persons who testify generally about costs as expert witnesses."<sup>109</sup> Babcock additionally cited *United States v. Rigas*<sup>110</sup> for the proposition that:

a witness's specialized knowledge, or the fact that he was chosen to carry out an investigation because of this knowledge, does not render his testimony expert as long as it was based on his investigation and reflected his investigatory findings and conclusions, and was not rooted exclusively in his expertise ....<sup>111</sup>



The court denied CMI's motion and found that the auditor's testimony as "regarding her own observations and basic financial reasoning known to everyday persons is either fact testimony or lay opinion testimony given pursuant to Rule 701."<sup>112</sup> The court, however, held that auditor testimony regarding "whether the practices, actions, or facts she may have observed are "reasonable' or 'allowable' based on her specialized knowledge as an accountant and as a person with potentially special knowledge of government contracting, is expert testimony" under Rule 702.<sup>113</sup>

# B. Recovery in Cases Where DCAA Questioned Contract Damages

Where DCAA questioned the entirety of the construction contractor's damages as being unsupported, the contractor often still recovered at least in part. Where entitlement was clear, the board or court frequently found a way to compensate the contractor despite DCAA questioning the entire amount claimed as unsupported. That is not to say that the contractor did not suffer for the lack of documentary support. To counter the uncertainty caused by the lack of documentary support or the contractor's use of estimates (when actual costs could have been segregated), the board or court often decremented the contractor's recovery so that the contractor, not the government, bore the risk of that uncertainty. On the other hand, when entitlement was questionable, DCAA's questioning of the entire amount of damages significantly increased the likelihood of the claim being denied.

## 1. Cases Allowing Recovery

C.H. Hyperbarics, Inc. involved a Navy contract for "design and installation of hyperbaric piping and instrumentation for the Army Special Forces Training Facility, Fleming Key, Key West, Florida."<sup>114</sup> The contractor, C.H. Hyperbarics, Inc. (CHHI), failed to segregate its labor hours for added work.<sup>115</sup> As a result, DCAA could not determine from CHHI's "records that the labor costs claimed were incurred" and questioned all labor.<sup>116</sup> The board, however, held that the audit report and the auditor's testimony "reflect only that CHHI's assignment of labor hours to the additional tasks lacks documentary support."<sup>117</sup> The board found that CHHI's estimates had a "reasonable basis in fact and constitute[d] sufficient evidence" to allow the board "to make a fair and reasonable approximation of the damages."<sup>118</sup> The board noted that "[t]he government could have made its own [technical] analysis of the direct labor estimated to have been incurred for the additional tasks. The government's principal witness … was familiar with all the problems that arose on the project, but provided no estimates in rebuttal."<sup>119</sup> The DCAA audit report, showing that the contractor's costs



were unsupported because the contractor did not segregate its costs, was insufficient to defeat the contractor's damage claim.<sup>120</sup> The government needed to prepare a rebuttal estimate of the added labor hours.<sup>121</sup> Although the board did not deny all recovery, CHHI did pay a price for not segregating its costs. CHHI's use of estimates, rather than actual labor costs, to price the changes created uncertainty.<sup>122</sup> The board reduced that uncertainty by decrementing CHHI's estimate by over twenty percent.<sup>123</sup>

In contrast, when DCAA identified a specific rather than a general problem, the board reduced CHHI's claim accordingly. For example, when DCAA identified that CHHI had reclassified overhead (e.g., typist, project director, and project manager costs) as direct labor in pricing the added work, the board reduced CHHI's claim accordingly.<sup>124</sup>

DCAA's questioning of a cost in its entirety was persuasive when uncertainty existed as to whether the cost was real. For example, CHHI claimed an increase in material and freight costs "due to the increased thickness and weight" of the material. DCAA questioned certain of these costs because no invoice or liability was recorded in the accounting records for the vendor at issue. If CHHI had incurred added freight, an invoice or documentation should exist. On these facts, the board denied recovery.

In *Reliable Contracting Group*, the government contracted for the "design and construction of a new utility plant and electrical distribution system at the [Veterans Administration (VA)] Medical Center in Miami, Florida." Reliable Contracting Group's (Reliable) subcontractor sought over \$1.3 million for upgrades to the electrical equipment for the backup emergency generator. The parties stipulated to entitlement but could not agree on quantum. According to the audit, Reliable's subcontractor "did not properly identify materials and did not segregate costs claimed." The subcontractor estimated its costs before the work was performed but failed to track the actual costs of performance. The VA alleged that the subcontractor could have easily tracked actual costs but simply failed to do so. 133

The board, however, did not find the subcontractor's failure to track actual costs to be fatal.<sup>134</sup> The board was influenced by the facts that (1) the subcontractor actually performed the added work, (2) the VA had accepted the subcontractor's estimates on other modifications, and (3) the VA failed to show where and how the subcontractor's estimates were excessive.<sup>135</sup> Also, the board noted that the auditor was not called to testify at trial.<sup>136</sup>



As this case shows, the government's defense cannot rely solely on DCAA's questioning of an entire category of costs due to missing support when it is clear that the contractor has performed the change, at a substantial cost, and is due something. In these situations, the government should prepare a rebuttal estimate of the costs incurred.

This case may be an anomaly. Often, a construction contractor's actual cost for performing changed work is lower than its pre-work estimate, sometimes significantly.<sup>137</sup> If the contractor performs the changed work before an agreement on price can be reached, the contractor is entitled to recover its actual costs. It is not entitled to recover its pre-work estimate; only its actual costs. Failure to price at actual costs, when actual costs were easily obtainable, particularly on major changes, generally raises a red flag and not just to DCAA. The contractor who fails to use actual costs is unlikely to get the full benefit of the doubt as Reliable did.

States Roofing Corp. was one of five ASBCA decisions concerning a Navy contract for repairs and work at the naval operating base at Norfolk, Virginia. States Roofing Corp. (SRC) claimed \$2535 to replace two broken skylights but proved entitlement for replacing only one of the two skylights. DCAA questioned the \$40 claimed for plywood because SRC did not provide an invoice for this cost. The board permitted SRC to recover the full \$20 claimed for plywood (for one skylight) because there was no dispute that plywood was used in repair of the broken skylight. The amount questioned was small. But the case illustrates that the board is sometimes unwilling to wholly deny a cost where entitlement exists and it is certain that some cost was incurred, simply because DCAA found the cost to be unsupported by documentation. In such situations, the board may decide to adopt the contractor's estimate unless the government credibly challenges it.

In *States Roofing Corp. III*, another of the five ASBCA Norfolk naval base decisions, the board resolved SRC's \$41,762 claim for proposal preparation costs.<sup>142</sup> DCAA questioned in-house labor in its entirety<sup>143</sup> because SRC had not segregated the in-house labor hours charged to proposal preparation.<sup>144</sup> The board noted "that the record contain[ed] sufficient evidence to award some of these costs to SRC" and, via jury verdict, awarded SRC \$5000 in lieu of the approximately \$30,000 claimed.<sup>145</sup>

In *Versar, Inc.*, the Air Force issued a contract for "heating, ventilation, and air conditioning" replacement at a DoD elementary school at Fort Jackson, South Carolina. Although DCAA questioned Versar's entire \$115,593 claim due to lack of



documentation, the board found partial entitlement and awarded Versar \$59,536.<sup>147</sup> The board denied the remainder of the claim, finding there was no evidence to support that Versar had paid its subcontractor for particular work and services.<sup>148</sup> The Air Force moved for reconsideration because the board seemingly had ignored the DCAA audit finding that the claim documentation was inadequate.<sup>149</sup> On reconsideration, the board stated that DCAA's findings on the adequacy of documentation were "not dispositive of [Versar's] right to recover its claims costs."<sup>150</sup> The board had considered DCAA's evidence but found an exchange containing notation supporting \$64,986 in costs and suggesting the work had been performed.<sup>151</sup> The \$59,536 awarded was supported by this documentation,<sup>152</sup> and the board reaffirmed its prior decision.<sup>153</sup>

The lesson from *Versar* is that where entitlement exists and costs were definitely incurred, the board will take a hard look at the evidence before concluding that no recovery is possible.

# 2. Cases Denying the Claim in Its Entirety

In *Beyley Construction Group Corp.*, the contractor sought an equitable adjustment for changed conditions on an Army grounds maintenance contract at Fort Buchanan, Puerto Rico.<sup>154</sup> DCAA found that the contractor "was unable to demonstrate that the costs claimed" were incurred.<sup>155</sup> On a written record, without a hearing, under Rule 11, the board denied the claim on damages alone, *without deciding entitlement*.<sup>156</sup>

The \$130,923 claim was supported only by estimates prepared at the time the changed conditions occurred.<sup>157</sup> The estimates "lacked the necessary foundation" for the board to conclude that the amounts claimed were commensurate with the damages suffered.<sup>158</sup> The contractor provided no evidence identifying who had developed the estimates and whether the calculated amounts reasonably reflected the claimed additional work.<sup>159</sup> The board found that, without testimony, the formulas used to develop the contractor's damages were "incomprehensible."<sup>160</sup>

In Management Resources Associates, Inc., the Navy entered into a \$165,000 contract with the contractor for boiler repair and replacement, painting, and other miscellaneous construction work at Oceana Naval Air Station, Virginia Beach.<sup>161</sup> The contractor, Management Resources Associates (MRA), claimed \$506,689 for delay and added work.<sup>162</sup> DCAA "questioned all but \$18,315 of the claimed incurred costs." <sup>163</sup> "The DCAA audit report stated, and the auditor testified at the hearing, that the cost and pricing data submitted in support of the claim were 'not adequate' because MRA did



not provide verifiable source documentation to which its claimed costs could be traced and shown to have in fact occurred."<sup>164</sup> The board denied the appeal based on both DCAA's findings and MRA's failure to prove entitlement.<sup>165</sup>

In *Nu-Way Concrete Co.*, the contractor sought "reimbursement for additional expenses incurred during the deactivation of travel trailers and mobile homes" in support of disaster operations for the Federal Emergency Management Agency (FEMA) in Florida. The CO rejected Nu-Way's claim, stating, "DCAA was unable to audit [the] claim since [the] cost data was essentially non-existent and completely inadequate." The CO's request for supporting documentation was "met with a package of cancelled checks without any explanation as to how they related to [the] contract or to Nu-Way's claim." Nu-Way also failed to provide receipts documenting its costs to the CO until the first day of trial. Moreover, its receipts spanned from 2005 to 2007, even though the claim stated that the costs were incurred in 2005. The board denied Nu-Way's claim, finding its "calculation of costs [to be] inconsistent, incredible, and incomprehensible." The board denied Nu-Way's claim, finding its "calculation of costs [to be] inconsistent, incredible, and incomprehensible."

In *Renda Marine, Inc. v. United States*, the contractor, Renda Marine, Inc. (RMI), entered into a contract with the Army Corps of Engineers to dredge a portion of the Houston-Galveston Navigation Channel.<sup>172</sup> RMI alleged a number of differing site conditions, including one of \$789,600 for realignment of a levee.<sup>173</sup>

DCAA questioned this \$789,600 claim in its entirety because RMI failed to provide adequate support.<sup>174</sup> Indeed, "[i]n what appeared to the court to be an effort to mask or minimize any problem with its proof of damages, [RFI] attempted to recast its ... claim."<sup>175</sup> As the court noted, however, RFI did not revise the amount of damages. The court ultimately denied RMI's claim for failure to prove entitlement, <sup>176</sup> but had it survived entitlement, it appears the court would have given the DCAA audit great weight.

*R.L. Bates General Contractor Paving & Associates, Inc.* involved a contract to maintain and repair roads and parking areas at the West Point Military Academy.<sup>177</sup> The contractor allegedly performed the contract at a loss and subsequently brought a series of added-work claims totaling \$3,891,403.<sup>178</sup> The DCAA audit report noted that deficiencies in the contractor's accounting system left DCAA unable to rely on the contractor's cost information, and that DCAA had found no other documentation supporting the alleged costs.<sup>179</sup> DCAA could not verify through source documents that the restoration costs were incurred.<sup>180</sup> The board denied the contractor's claims on both



entitlement and quantum grounds.181

### C. Overreliance on DCAA as an Expert

Being a DCAA auditor does not make one an expert. The DCAA auditor functions as a fact witness. The auditor's job is to ascertain whether the costs claimed are properly supported by documentary proof and then to report his or her findings in an audit report. Few auditors, however, possess the educational background and experience to qualify as an expert in judicial proceedings. The following case illustrates the dangers of using a DCAA auditor as an expert witness if the auditor does not possess the qualifications.

Fireman's Fund Insurance Co. v. United States involved a U.S. Army Corps of Engineers contract to construct a large dam and the contractor's claim of defective concrete specifications.<sup>184</sup> As is often the case, the contractor presented its proof of damages at trial through a damages expert.<sup>185</sup> The court's opinion contrasts the expert with the DCAA auditor, stating that:

[the contractor's expert was] a persuasive damages expert, convincing and resilient on cross-examination. He favorably contrasted with [the] DCAA supervisory auditor, who testified without objection as defendant's expert in the field of cost accounting. [The DCAA auditor] endeavored to discredit the extended overhead and equipment costs developed by [plaintiff 's expert], but she was tasked beyond her capabilities. Cross examination sufficiently discredited the timeliness of her data, the validity of her assumptions, the sufficiency of her records, and the thoroughness of her analysis.<sup>186</sup>

The court also noted that it "would not have qualified [the DCAA auditor] to give expert testimony under" Evidence Rule 702.<sup>187</sup> The contractor ultimately prevailed on damages: not necessarily because it was correct, but rather because the government trial attorney did not have a credible rebuttal expert.<sup>188</sup>

#### IV. DCAA FROM THE GOVERNMENT TRIAL ATTORNEY'S PERSPECTIVE

### A. Importance of the DCAA Audit

The only general comment I have is that the audit is a place for the contractors to show that their cost submission is real and not some highly questionable thing. As a trial attorney, I quickly got a feel from the auditor if the claim amount is fluff or not.<sup>189</sup>



I am not going to settle the case without an audit. The question about what the case is worth needs to be answered.<sup>190</sup>

We can't perform our jobs if DCAA doesn't perform its job. The biggest problem is that DCAA is so far behind.<sup>191</sup>

These three quotes came from senior government contract trial attorneys and demonstrate just how important the DCAA audit is to the government and to the trial attorney. A construction contractor's damages are an area of great uncertainty for the government. On a large construction claim, questions abound. What are the contractor's actual costs? To what extent did the contractor mitigate its damages? Did the number of changes cause a ripple effect, thereby reducing productivity on the unchanged work, or did they enable the contractor to greatly increase its anticipated profit? Is the contractor correctly pricing the changed work or is it seeking a "pound of flesh" on each change? The government does not know. It looks to DCAA and the audit.<sup>192</sup>

Discovery is not a substitute for a DCAA audit. Unlike the government trial attorney, the DCAA auditor can contemporaneously query the contractor's staff to obtain explanations and needed feedback. The audit is conducted in the contractor's office, where the contractor is present to answer the auditor's questions, verify assumptions, present explanations, and locate supplemental documentation or state it does not exist. Moreover, the auditor has the experience and expertise to navigate the contractor's cost records. Obtaining cost records during discovery does an attorney little good unless he or she can meaningfully relate them back to the claim. Finally, the auditor can take the witness stand. Having a credible witness testify that the contractor's records fail to substantiate its claim is critical. Even the rare government trial attorney who possesses superior contracting and auditing expertise cannot testify at trial.<sup>193</sup>

Disputes exist, in a majority of cases, because of factual uncertainty. <sup>194</sup> The DCAA audit often eliminates much of that uncertainty for the government trial attorney and helps shape the attorney's strategy. If the audit confirms the amount of the contractor's claimed loss, a major question has been answered and the parties can now focus on the government's proper share of that loss. An audit confirming the contractor's loss protects the government decision makers, who are stewards of the public's money, from criticism should they opt to settle. Conversely, when the audit questions certain costs, the attorney can seek concessions from the contractor. If the contractor rejects an



audit finding, the parties now know where the battle lies.

The Honorable Paul Williams, chairman of the ASBCA, stresses the importance of DCAA in helping the parties to narrow the scope of litigation, which allows the trial attorneys to focus on the critical issues in contention. Judge Williams illustrated DCAA's importance with the "Big Dig" in Boston. The "Big Dig" generated unusually massive and complex construction claims. Per Judge Williams, the dispute resolution process was unsuccessful until after DCAA audited the "Big Dig" contractors' claims. Although the construction contractors disputed many of DCAA's audit findings, the audits both reduced and defined the areas of contention, thereby promoting a mediated settlement.

#### B. Limits to Reliance on the DCAA Audit

While the DCAA plays a vital role, relying solely on the audit for damage analysis is a mistake. The audit report plays a specific role in damage analysis--not an all-encompassing one. When asked how much the trial attorney can rely on DCAA, one senior Department of Justice trial attorney responded, ""Not very much."<sup>200</sup> He explained:

DCAA is generally good at verifying costs incurred, but they seem entirely unequipped to understand what cost/damage information is useful to a trial attorney and how to assist the trial attorney in understanding weak points in the damages claim, or even more importantly, in the entire claim/liability/damages web[,] something a good [CPA claims expert] can perceive and assist the attorney in understanding and counteracting.<sup>201</sup>

Although the DCAA audit sheds light on the contractor's damages, that light is limited by the auditor's claims expertise and project knowledge, both of which are often narrow.<sup>202</sup>

Best practice calls for the government trial attorney to couple a strong DCAA audit with a damages expert, and then conduct damage discovery with the assistance of that expert. DCAA and the damages expert are complementary, not duplicative.<sup>203</sup> Utilizing both a damages expert and DCAA early in a case can pay big dividends.<sup>204</sup>

To accurately measure damages, one must correctly visualize the damage-



causing event, and DCAA has little factual knowledge of the project.<sup>205</sup> Generally, DCAA compares a contractor's REA to the contractor's cost records and focuses on the cost details.<sup>206</sup> But DCAA often does not examine the pricing method to determine whether it is appropriate. Such an examination requires an in-depth understanding of both the pricing method and the project facts, neither of which is typically possessed by the auditor.

The government's attorney who relies solely on DCAA can be at a severe disadvantage if he or she is facing a contractor-hired damages expert with decades of claims experience, as noted in *Fireman's Fund*.<sup>207</sup> The DCAA auditor is not typically an expert on claims, construction, or the project. The auditor may (1) never have audited a claim, let alone a construction claim;<sup>208</sup> (2) have limited familiarity with the pricing methods used and limited knowledge of construction (making it more difficult to understand causation and cost measurement); (3) be unfamiliar with the construction contractor, its records, and its people (in many instances, this will be the first time the contractor has been audited); and (4) be unfamiliar with the pricing history of the project.<sup>209</sup> Moreover, the DCAA auditor is working under time constraints. Unfamiliarity with the subject matter and the environment, coupled with time constraints, can make it difficult for the auditor to see, let alone tackle, the more challenging aspects of damages.

Correctly dissecting damages on any large claim is no easy task and usually takes time to ascertain. For example, the alleged loss may have occurred but may be attributed only in part to the entitlement issues identified by the contractor. DCAA excels at verifying whether the contractor's records show that the "claimed" costs were incurred; however, other damages issues exist. Such issues include the following:

- What are the disconnects between entitlement and quantum?
- Is there evidence in the accounting records of contractor-caused damages that offset or mitigate government-caused damages?
- What is being priced? Is the contractor pricing the right item and the right time period?
- Is the pricing method permitted by and consistent with the contract terms, and is it being correctly applied?



- Does the pricing method, *given the facts*, correctly measure the government-caused costs?
- What assumptions does this pricing method make? Do those assumptions exist here?
- Is a more precise pricing method available? If so, why is it not being used?
- Did the contractor also use other pricing methods on this project? If so, does double-counting exist?
- Is the contractor's use of the current pricing method consistent with its use of earlier pricing methods on this project? Is it consistent with prior releases?

Answering these questions requires a command of the facts of the case, the contract terms and conditions, the claim, and the pricing methods.

Significantly, government trial attorneys often fail to recognize that DCAA's role in damage analysis is not all-encompassing. As one interviewee stated, "The government trial attorney's number one mistake is over reliance on DCAA."<sup>210</sup> Indeed, this sentiment was a recurring theme voiced by many interviewed for this Article. Most respected DCAA and its role but believed government trial attorneys frequently failed to seek, or waited too long to seek, needed damage assistance in addition to DCAA. This failure results in a hole in the government's damage position and permits the contractor to prevail on damage issues when it should not.<sup>211</sup>

To contest damages successfully, the government trial attorney needs to (1) invest a substantial amount of his or her own time, (2) get DCAA audits, and (3) normally obtain a damages expert. DCAA is only part of a successful damage defense. Damages are complicated and, perhaps for this reason, often neglected or addressed last. The combination of DCAA, the trial attorney, and a damages expert--each playing his or her part to unravel damages--normally will pay for itself many times over.

Obviously, the decision to obtain an expert requires a cost-benefit analysis.<sup>212</sup> Experts are expensive, but if the government faces a \$10 million claim, even a two percent difference (\$200,000) easily covers the expert's cost. When asked how much a government trial attorney gives up by relying solely on DCAA for damages, one expert responded:



[I]t all depends upon the individual [auditor]. DCAA has some of the best, most experienced auditors in the country. DCAA also has some of the worst and least experienced auditors in the country. Of course, the same can be said for any large audit organization. As Forrest Gump would say, "[Y]ou never know what you are going to get." In contrast, with a damages expert, the government trial attorney has a pretty good idea of what he or she is getting. At a minimum, the trial attorney gives up expert witness experience. [W]hile there are some very good DCAA auditors, few have much experience in testifying and withstanding the rigors of [cross-examination]. Whether ... accurate or not, the general perception is that DCAA is biased toward the government. So, an independent C.P.A. usually looks more objective.<sup>213</sup>

By relying solely on DCAA for damages, the government trial attorney also gives up a resource--typically a person with an extensive record for making a substantial impact in more challenging cases. An expert is not just another set of hands for the trial attorney, but rather an individual who can help the trial attorney conceptualize the issues and pull the damage case together. The expert can assist with discovery and cross-examination.

For these reasons, on larger, more complicated cases where success is critical and where the contactor will employ an expert, the government trial attorney should strongly consider hiring a damages expert to augment DCAA.

# C. Trial Attorney Communications with the Auditor May Be Discoverable

The DCAAM states that audit work "performed at the request of [g]overnment trial attorney in support of ongoing or anticipated contract litigation" is privileged.<sup>214</sup> The DCAAM, however, is not the controlling authority regarding privilege and the attorney should be aware that communications with the DCAA auditor--particularly before the audit report is issued--may be discoverable.<sup>215</sup> Although the government will fight to prevent such disclosure, the auditor is performing an *independent* and *objective* audit that the attorney may need to use as evidence at trial.

DCAA auditors typically record all communications that relate to the audit, including communications with counsel.<sup>216</sup> Audit working papers are generally discoverable and often obtained by the contractor's attorney during discovery.<sup>217</sup> For this reason, the government trial attorney should exercise care in communicating with the DCAA auditor, particularly during the audit phase.



# D. Resolving Conflicts with the DCAA Auditor

The government trial attorney and the auditor occasionally see damages differently.<sup>218</sup> If so, the attorney must remember that (1) the DCAA auditor is a professional, (2) the DCAA auditor is not only entitled to his or her own opinion but is required to exercise independent judgment, and (3) the audit report is the auditor's product--not the attorney's (even if a finding hurts the government and the trial attorney believes it to be incorrect).<sup>219</sup>

When the attorney differs with the auditor, the auditor must exercise extreme caution. The government's case will not be advanced by the auditor's testimony, at deposition or trial, that the auditor did not really understand or agree with the ultimate audit finding but went along with it to appease the government trial attorney or the auditor's supervisor.

The audit change, if any, must be made because the *auditor* wants to make the change because the change truly represents the *auditor's* opinion.<sup>220</sup> The trial attorney cannot permit the auditor (even if the auditor is amenable) to substitute the trial attorney's opinion for the auditor's.<sup>221</sup> The trial attorney must make it very clear that the auditor is expected to maintain professional independence and the trial attorney is simply pointing out facts that the auditor may or may not want to consider in rendering that opinion.

Independence, however, does not mean isolation. The auditor should consider all the facts in coming to an independent and objective decision.<sup>222</sup> The auditor normally is attentive to both the government trial attorney's and the contractor's concerns but will steadfastly resist attempts by either to substitute their judgment for the auditor's. The auditor truly wants the audit findings to be correct. So if the trial attorney or the contractor identifies information that will enable the auditor to be correct, the auditor is likely to consider that information.

If DCAA declines to correct an error, a government trial attorney should consider hiring an expert to testify on that issue. Another option, which this author has successfully used, is to obtain agreement from opposing counsel that DCAA erred. If the issue is significant and the conflict with DCAA cannot be resolved, the government trial attorney can and should contest the audit finding at trial.



# E. What the Government Trial Attorney Can Do to Make Audits More Meaningful

Communication between the government trial attorney and the auditor is critical to a meaningful audit. The auditor knows little about the litigation or the issues. Without communication, the government trial attorney's needs and the audit report will likely take different directions.<sup>223</sup> The government trial attorney has a number of vehicles, both formal and informal, with which to communicate with the auditor, including:

- (1) *Audit request*. Use the audit request to identify and explain the specific areas to be audited and any particular concerns.<sup>224</sup>
- (2) *Pre-audit conference*. The trial attorney can request a conference with the auditor in order to explain the case and bring specific damage issues to the auditor's attention for possible review. This is also an ideal time to interview the auditor to ascertain the level of experience he or she has with contract litigation, the contractor, claims, construction, and the pricing methods being used.
- (3) *Audit leads*. Audit leads are a vehicle for informing the DCAA auditor of facts and issues to consider in the audit. As a government trial attorney's knowledge of the case evolves through document discovery, witness interviews, depositions, and consultation with experts, the attorney should communicate with the auditor. When issues or facts arise that the government trial attorney would like the DCAA auditor to consider, the trial attorney should send an audit lead to the DCAA auditor.
- (4) *Draft audit report*. The attorney should obtain a copy of the draft audit report and carefully review it to ascertain whether it (a) addresses the key damage issues and (b) contains any errors. At this stage, the auditor can timely and efficiently consider an omitted issue and correct errors.
- (5) Supplemental audit. Where the construction contractor's claims were audited prior to the government trial attorney's involvement and a final audit report has been issued, the trial attorney can ask DCAA to perform an updated or supplemental audit. A supplemental audit is a vehicle for DCAA to address concerns and issues arising during discovery or areas where the final audit report appears to be at odds with the facts now known.<sup>225</sup>



### F. What the Government Trial Attorney Can Do to Make Audits More Timely

Audits now are taking longer to initiate and even longer to complete.<sup>226</sup> Timeliness is a great concern for the government trial attorney. As one former Air Force Trial Team Division Chief put it: "DCAA is a service organization. The audit has to be right and timely. If not timely, it's of little help."<sup>227</sup> Audit untimeliness hurts the government trial attorney in a number of ways.

First, audit untimeliness delays claim resolution. The government trial attorney must prepare the case for resolution and the audit provides factual information needed to resolve the claim. Getting the necessary information early, rather than late, allows the trial attorney time to absorb and fully use the new information. Also, resolving claims promptly, while the facts are relatively fresh and witnesses still available, reduces costs and increases the likelihood of a fair resolution.

Second, audit untimeliness creates unnecessary litigation expense. Such untimeliness can cause discovery to begin prematurely before the parties truly know whether litigation is necessary. Without the audit report, the government is generally unwilling to negotiate a settlement.<sup>228</sup> The construction contractor, by contrast, typically wants to enter into settlement discussions within a month or two of REA submission. Needing payment, the construction contractor is unwilling to push off settlement discussions for a year or more while the parties await audit completion. Indeed, to quicken the pace, the contractor often asks the judge for a firm trial date and a discovery schedule. The government trial attorney, knowing that once the audit is received a strong likelihood of settlement exists, pleads with DCAA to complete the audit, while trying to convince the judge and the contractor that it is wasteful to begin discovery before even knowing if a dispute exists. The government trial attorney, however, can only stave off discovery temporarily.

Finally, audit untimeliness makes discovery more difficult. The audit helps to define the areas in dispute. Effective litigation requires focused and efficient discovery. The audit report gives the government trial attorney a better grasp of both what is in dispute and its dollar magnitude. For these reasons, the government trial attorney wants a timely audit report. The government trial attorney can hasten completion of the audit by:

1. Requesting the audit as early as possible. This is key. Promptly after receipt of an REA, the government should request the audit from DCAA. Waiting for the



government to complete its technical evaluation before requesting the audit serves little purpose. The audit and the technical evaluation can be done simultaneously rather than sequentially. If the technical evaluation identifies an issue that requires DCAA's attention, the government trial attorney can promptly send DCAA an audit lead.

- 2. Telling DCAA that timeliness is critical. DCAA should be told in the initial audit request that timeliness is crucial and the reason why. Then, in the initial meeting with the auditor and the auditor's supervisor, the attorney should explain the importance of timeliness and its impact upon the case. The attorney should try to get a commitment from the auditor and her supervisor to complete the audit by a certain date.
- 3. Meeting with the auditor and her supervisor at the beginning of the engagement. The purpose of the meeting is to ascertain the auditor's experience level and to better focus the audit. The government trial attorney must avoid the nightmare situation where the audit not only takes a long time to complete but also provides little useful information.<sup>229</sup> For this reason, the government trial attorney will want to discover whether the auditor has ever audited a claim, testified, or been deposed. The government trial attorney will also want to discover what the auditor knows about the contractor, the construction, the claims, the pricing methods used by the contractor, and the auditor's experience regarding damages. If the auditor seems a particularly poor fit, the attorney should consider asking DCAA to reassign the audit to a more qualified auditor.
- 4. Following up with the DCAA auditor at regular intervals to ensure the audit is on schedule. If the government trial attorney does not stay on top of the amount of time the audit is taking, the audit may delay the entire litigation process. The government trial attorney cannot let what should be a six-month audit turn into a fifteen-month audit. Communication with DCAA during the audit will give the attorney a chance to assist the auditor with impediments or, if the delay is unavoidable, give the attorney advanced notice.
- 5. Employing a damages expert. A damages expert can analyze the damages, identify areas of concern, and provide audit leads to help the auditor better understand the claim. The damages expert can sometimes serve as an alternative to DCAA, allowing the attorney to narrow the audit request to core DCAA functions, such as verifying claimed costs.<sup>230</sup>



- 6. Encouraging the contractor to cooperate fully with DCAA. The government trial attorney should discuss the audit with opposing counsel to elicit support in expediting the audit.<sup>231</sup> If opposing counsel views the audit as an unfair means for the government to obtain "free discovery," the contractor may seek to frustrate the audit, slowing its completion. But if opposing counsel views the audit as a chance for the contractor to show the merits of its claim and explains to his or her client that cooperation with the auditor will speed the audit and perhaps payment to the contractor, the contractor is more likely to cooperate with DCAA, allowing a faster audit.
- 7. Using an entity other than DCAA to perform the audit. Federal agencies outside the DoD are not required to use DCAA.<sup>232</sup> A number of public accounting firms have auditors (sometimes former DCAA auditors) who are experienced with government costs. An outside accounting firm may have the capacity to complete the audit quickly.

#### V. DCAA FROM THE CONSTRUCTION CONTRACTOR'S PERSPECTIVE

#### A. Construction Contractors Tend to Distrust DCAA

After having read [the audit], I feel our Company has been the victim of a smear campaign. Although we have never been involved in a DCAA audit before, I am still amazed at how one can create such a misleading and incomplete report.<sup>233</sup>

It seems the objective of the DCAA audit is to tear down a claim .... I would be surprised to learn that any DCAA auditor has ever concluded an audit with no questions, satisfied that the claim is accurate. Has there ever been one?<sup>234</sup>

The [audit] process is cumbersome and unwieldy. It is unconscionable that DCAA audits become the critical path in REA/Claim resolution, yet there is no way to influence the speed of the audit process. If it were in my power to do so, I would decree that DCAA audits must be completed in good faith within six months, or the claim is deemed valid as stated .... [W]e saw the contractor claims age interminably on account of the DCAA audit process.<sup>235</sup>

DCAA is set up for auditing manufacturing projects and those with repetitious activities and/or [Cost Accounting Standard (CAS)-covered] contracts. Most DCAA auditors do not seem to understand construction accounting. As an example, we had a project that



had many change orders and cost accounts. DCAA insisted that every employee not only complete their own timecard but also cost code it. This would have been difficult enough for a cost accountant, let alone an unskilled laborer who would not normally be exposed to knowing and understanding the multitude of cost accounts.<sup>236</sup>

These quotes, while far from a scientific poll, illustrate the degree to which many construction contractors dislike the DCAA audit. The quotes come from construction contractors and/or their attorneys, who see DCAA as obstructing rather than facilitating dispute resolution. Construction contractors, however, are a diverse group. Many construction contractors price claims conservatively (below actual cost), while others price claims aggressively; some construction contractors pride themselves on having never brought a lawsuit, while others are very litigious. Despite this diversity, construction contractors have a shared interest in being paid promptly and fairly for the very real risks taken, costs incurred, and work performed.

## B. Does DCAA Impede Dispute Resolution?

From a construction contractor's perspective, DCAA generally does impede dispute resolution. The length of time it takes DCAA to audit a construction claim is unacceptable to the contractor. The contractor funded the change; it paid for the labor, supervision, materials, and equipment.<sup>237</sup> The contractor is not a bank; it is unwilling to give DCAA a year or more to complete an audit, then permit the government two months to interpret the audit, and then another month to obtain settlement authority, before finally meeting to discuss settlement.<sup>238</sup> The contractor would prefer to have an agreement on price before the work is performed; however, the realities of construction often make this impractical.<sup>239</sup> Thus, while the government enjoys its new facility, the contractor is often left waiting to be paid on its claims, with the perception that it alone is concerned with the slow pace of the resolution process.

A DCAA audit, when it belatedly comes out, often is viewed by the contractor as a disaster. An audit often does not verify the contractor's claims but rather adds new areas of contention. For example, instead of confirming the contractor's claim, the audit may question all labor hours because the contractor failed to follow timesheet procedures common in manufacturing plants, but which the contractor has never followed and views as impractical for construction contractors. In addition, the contractor may view negative audit findings as auditor error rather than accurate information regarding contractor costs.



# C. Despite the Construction Contractor's Negative Perception of DCAA, the Audit Often Benefits the Construction Contractor

The audit is a vehicle for the contractor to show the extent of its damages. Often the audit proves the contractor's case. If the audit verifies damages, it puts the contractor in a stronger position to either settle or litigate successfully with the government. The audit answers questions. Certainty is valuable both in the courtroom and at the settlement table.

The audit often expedites recovery. The DCAA audit can give the government and contractor the information needed to settle a claim quickly without discovery or trial. The audit provides the government information and insight otherwise obtainable only through discovery.<sup>240</sup> On a large construction claim, discovery can take years to complete and be very expensive.<sup>241</sup> Rather than fighting the audit, in most instances, the contractor would be better off pushing the government to promptly start and complete the audit.

Although the DCAA audit is not free, it is inexpensive compared to the cost of discovery. Moreover, the government pays DCAA's costs, not the contractor. The contractor's costs are limited to preparing for the audit, having its office staff assist the auditor during the initial fieldwork, and participating in an exit conference.

## D. Why Few Construction Contractors Appreciate the Value of the DCAA Audit

There are at least six reasons contractors do not appreciate the value of a DCAA audit. First, contractors tend to view the audit as a tool to defeat their claim. In the contractor's experience, most owners seek to minimalize contractor recovery on claims regardless of their merits. Contractors often see the DCAA auditor as a government henchman, hired to challenge the contractor's claim. Unlike major defense contractors, who possess considerable knowledge and experience in the field of federal procurement, construction contractors typically know little about federal procurement, let alone DCAA. The audit at issue is often the construction contractor's first exposure to DCAA. The construction contractor is unlikely to have audited rates for labor, overhead, or other costs. The average construction contractor--having never been audited by DCAA and being unfamiliar with the cost principles--is likely to be less disciplined in its pricing than a frequently audited major defense contractor. Hence, the typical construction claim offers a rich target for DCAA.



Second, construction contractors are frustrated with the time it takes to complete an audit. As discussed above, construction contractors resent any significant delay in payment; they are typically undercapitalized and need cash flow, particularly after a project on which they suffered a significant loss. The construction contractor finds it incredible that, after supplying labor, materials, and equipment for a project on which it was held to a "time is of the essence" standard,<sup>242</sup> now that the contract has been completed, the government allows the dispute resolution process, which relies heavily on the audit, to drag out interminably.

Third, many contractors do not view DCAA as objective and neutral but instead unpredictable and unreasonable.<sup>243</sup> The distrust, in part, derives from DCAA's focus on internal controls, which the construction contractor may not have implemented. For example, DCAA will often question all craft labor cost because a supervisor rather than the individual workers filled out the timesheets. The contractor sees this as unjust, pointing out that it has never had individual craft employees fill out timesheets, believing this practice to be impracticable, and that the contract gave no notice of this requirement.

The construction contractor's distrust is also driven in part by a failure to communicate.<sup>244</sup> DCAA, for example, may find that certain construction costs are unsupported. The construction contractor may have cost records that support those costs but did not give them to DCAA because DCAA did not push the issue. In the contractor's view, if DCAA had given the contractor a copy of the draft audit report or explained that DCAA was going to question all these costs for lack of support, the contractor would have provided additional support. The contractor feels betrayed by what it perceives as the auditor's failure to follow up with the contractor on such a crucial issue or tell the contractor that unless it produced additional support, the auditor would question the entire category of costs.

Fourth, some contractors believe that DCAA is only marginally competent. Throughout the audit, the construction contractor had to educate the auditor. Understandably, the auditor was unfamiliar with the contractor, its accounting system, and the project. But also, the auditor is typically unfamiliar with construction, claims, and some of the REA pricing methods.<sup>245</sup> This unfamiliarity increases the likelihood of audit error and undercuts the contractor's confidence in the auditor.

Fifth, contractors dislike DCAA's requests for documents that were already given to other government personnel. Many construction contractors incorrectly view



the CO, the government trial attorney, and the auditor from DCAA as a single entity.<sup>246</sup> For this reason, once it has given cost documents to the auditor, the CO, or the government trial attorney, the contractor often objects to producing them a second time. In its view, DCAA should obtain those documents already provided to the CO or the government trial attorney from the government rather than bothering the contractor.

Finally, the contractor often views the audit as free discovery by the government. The audit, however, is not "discovery" pursuant to the Federal Rules of Civil Procedure (FRCP).<sup>247</sup> Document production, interrogatories, and depositions are all rights granted under the FRCP.<sup>248</sup> In contrast, the right to audit the contractor's claim is not a litigation right but rather a contractual right.<sup>249</sup> Although not ""discovery," the DCAA audit can seem like discovery as it allows the government to gather information concerning the contractor's claim. The audit clause requires the contractor to provide information and documentation to the DCAA irrespective of the contractor's ability to request documents from the government.<sup>250</sup> Construction contractors often resent disclosing information about a claim before they can compel the government to disclose information.

Active dislike of the DCAA audit process can impede effective or speedy claim resolution and is thus counterproductive. As Judge Paul Williams warned: "Contractor, don't make DCAA your enemy ... [it] is [neither] your enemy [nor] incompetent. Kicking DCAA is not the solution." For the construction contractor, the best approach is to accept the audit as a requirement of doing business with the government and prepare its REAs and claims to withstand audit scrutiny.

#### E. Contractor Keys to a Successful DCAA Audit

A contractor is not a passive participant in the audit.<sup>252</sup> Its actions directly affect audit accuracy and timeliness.<sup>253</sup> A construction contractor can substantially benefit itself by complying with the following nine actions.

# 1. Before the Project Even Starts, Prepare for Both Claims and the Audit

The reality is that claims are a way of life in our business, the business of supplying goods and services to the U.S. Government. Claims should come as no surprise, but yet the parties wait until one ... asserts a claim before they start thinking about the validity of the claim.... I think the claims' process starts way before the actual assertion of a claim.<sup>254</sup>



The contractor knows in advance of the contract that (1) claims are likely to occur, (2) the government expects each claim to be fully supported by cost records, and (3) a large claim will probably be audited. The contractor also knows that the DCAA audit will evaluate the nature and quality of its supporting records. In many ways, DCAA is simply the messenger. A proactive contractor can increase the likelihood that DCAA's final audit report will support its claim.<sup>255</sup>

Poor project documentation impairs a contractor's ability to provide the support needed to substantiate claims. The key to making the audit better for the contractor is for it to develop the management and accounting controls necessary to timely *identify* out-of-scope work and accurately *track* its costs, and then be disciplined enough to use these controls so that its claims can withstand audit scrutiny.<sup>256</sup>

The contractor needs not only to retain the source documents supporting its claim, but also to be able upon request to provide those documents promptly to the auditor. A record retention system, which includes record identification and location logs, is needed to enable the contractor to retrieve project records quickly and easily.<sup>257</sup> A poor record retention system makes supporting a claim difficult. Many construction contractors, at the project's end, box their project documents and ship them to an off-site storage facility where, although out of the way, they are difficult to find. Moreover, once found, it can be difficult to identify the project box that contains the requested documents.

# 2. Timely Submit the REA

The contractor starts the dispute resolution process and, in many ways, sets its pace.<sup>258</sup> The sooner the REA is submitted, the sooner the audit can be completed. An REA submitted a year to eighteen months after the project is completed signals to the government both that the REA has problems and that the contractor can wait. If the REA was well-founded and time-sensitive, it seemingly would have been submitted earlier, at least within six months after project completion.<sup>259</sup> A year to eighteen months after project completion, the events giving rise to the claim will be less clear, even to the contractor.<sup>260</sup> For these reasons, late submittal of an REA typically increases the amount of time it takes DCAA and the government to evaluate the claim.

### 3. Segregate the Claim Documents

The purpose of the DCAA audit is to verify the damages sought in the claim or



REA. The auditor will start with the claim and work backwards, following each element of damages to the project's job cost record and then back to source documents such as purchase orders, payroll records, timesheets, invoices, etc.<sup>261</sup> Thus, in anticipation of the audit, the contractor should gather the source documents supporting its REA or claim so that they are readily available when requested by the auditor.<sup>262</sup>

### 4. Immediately Request an Audit

The contractor needs to push REA resolution at every opportunity. This includes asking the trial attorney or CO to start the audit as soon as possible. The sooner the audit starts, the sooner the REA can be negotiated. On a large REA, the contractor loses nothing by asking the government to start the audit promptly; the audit will be performed regardless.

#### 5. Maximize the Entrance Conference

The auditor is required to "hold an entrance conference with the contractor's designated representative at the start of each separate audit assignment."<sup>263</sup> The auditor will use the entrance conference to learn about the construction contractor, its accounting records, and staff and to make necessary work arrangements.<sup>264</sup>

The entrance conference, however, is the contractor's opportunity to (1) encourage open communications, (2) voice its desire to cooperate, (3) establish reasonable ground rules for the audit (i.e., designating a contractor contact point to limit workplace disruption), (4) discuss the expected duration of the audit, (5) ask the auditor to bring potential negative audit findings immediately to the company's attention, (6) ask the auditor to bring any delays in completing the audit or in obtaining needed documents immediately to the company's attention, and (7) ask the auditor to start as soon as possible. At the entrance conference, the contractor should volunteer to explain the claim to the auditor and answer any questions.<sup>265</sup>

#### 6. Be Responsive to the Auditor

When preparing its REA, the construction contractor should put together its costs and support for those costs in a manner that makes the REA easy to audit.<sup>266</sup> The contractor should cooperate with the auditor, and give the auditor the requested information and support as promptly as possible.<sup>267</sup> Arguing with the auditor about what the auditor needs to complete the audit will not advance dispute resolution, but



rather will increase the auditor's professional skepticism.<sup>268</sup>

Frequently, the construction contractor's office is not located near a DCAA branch office. This means that the auditor will gather documents at the contractor's office to take back to the audit office for analysis. If the contractor is not highly responsive when the auditor is present at the contractor's facility, the auditor may need additional trips to the contractor's office, resulting in delay. The goal is to get the auditor in and out, not to have the audit continue indefinitely.<sup>269</sup>

Finally, the contractor should be patient. The auditor has a lot to learn: the REA, the project, the project records, and the contractor's accounting system. The auditor may, at least initially, require significant contractor assistance.

## 7. Review Preliminary Audit Findings as the Audit Progresses

Errors are easier to correct before DCAA issues its final audit report. DCAA shares the contractor's interest in having the audit free of error or misunderstandings.<sup>270</sup> Auditing is an interactive process. The auditor requests information and documents; the contractor supplies them; the auditor asks questions; the contractor responds; the auditor draws preliminary conclusions and then typically seeks contractor confirmation. To optimize this interaction, the DCAAM strongly encourages interim conferences with the contractor throughout the audit.<sup>271</sup>

The contractor should request auditor feedback on each major damage area immediately following the audit fieldwork in that area.<sup>272</sup> Contemporaneous communication alerts the contractor to potential problems and creates an early opportunity to provide the auditor with reliable supporting information or explain why the factual finding is incorrect.

Limits exist, however, on DCAA's ability to communicate findings to the contractor. The FAR prohibits the auditor from revealing "the audit conclusions or recommendations to the ... contractor without obtaining the concurrence of the [C]ontracting [O]fficer. However, the auditor may discuss statements of fact with the contractor."

DCAA will normally seek the CO's permission to discuss audit conclusions and recommendations with the contractor on a "real time" basis. Such sharing of information can reduce audit misunderstandings and speed dispute resolution. Even



when the CO prefers that the auditor not share audit conclusions and recommendations with the contractor, DCAA can still discuss statements of fact with the contractor and it makes sense from an audit quality perspective for the auditor to do so.

For audits performed at the request of government counsel, the DCAA auditor may hesitate to communicate findings with the contractor for fear of compromising the attorney work product privilege. As a result, the construction contractor may receive little, if any, auditor feedback, thereby increasing the likelihood of auditor error or misunderstanding. To preclude noncommunication, before the audit begins, the contractor's attorney should ask the government counsel to consent to normal audit procedures, including the auditor discussing statements of fact, findings, and preliminary audit conclusions with the contractor during the audit. The construction contractor's attorney should emphasize that such communication represents best practice (as noted in the DCAAM), and will promote a better and more efficient audit containing the contractor's reasoned reaction to each audit finding.

#### 8. Avoid Mid-Audit Revisions to the Claim

When DCAA learns that the contractor intends to revise the pricing of its REA significantly, it typically stops the audit. When months later, after the claim has been revised, the audit resumes, it is sometimes with a different auditor, which can further delay dispute resolution. Rather than make significant changes midstream, the better practice is to wait for DCAA to complete the audit before making changes. The changes can then be made in response to the DCAA audit or the government's technical evaluation.

#### 9. Obtain a Draft Audit Report and a Meaningful Exit Conference

The contractor should ask DCAA for both a copy of the draft audit report and an exit conference. A copy of the draft audit report allows the contractor a preview of the report that DCAA plans to issue. A copy of the draft audit report gives the contractor an opportunity to identify audit errors and provide DCAA, where appropriate, additional reliable information. The DCAAM encourages DCAA to provide the draft audit report to the contractor, or "at a minimum, the results of the audit section of the draft report."<sup>278</sup>

An exit conference allows the contractor to hear DCAA explain the audit results and provide a contractor response to the audit findings, conclusions, and



recommendations for inclusion in the report.<sup>279</sup> As such, the exit conference is a key audit procedure.<sup>280</sup> Although the DCAAM encourages exit conferences,<sup>281</sup> it cautions that "[a]n exit conference may not be appropriate when the audit is performed in support of litigation" and requires the DCAA auditor to obtain litigation counsel's written consent prior to holding such a conference.<sup>282</sup>

Prior to the exit conference, the contractor should check with DCAA to ascertain whether it will receive a copy of the draft report or at least be told the dollar amount of individual findings. If DCAA intends to restrict the exit conference, the contractor should consider asking its attorney to discuss a more appropriate exit conference with the government attorney.

#### F. Subcontractor Audits

A construction contractor often asserts claims on behalf of its subcontractors, as well as itself. If the subcontractors' claims are significant, the government will likely audit them. The DCAA branch office auditing the contractor's claim may ask another DCAA branch office--perhaps closer to the subcontractor's home office--to audit the subcontractor's claim. To ensure that subcontractor audits do not delay claim resolution, the construction contractor should actively encourage its subcontractors to cooperate fully with DCAA.

#### G. What to Do When DCAA Incorrectly Questions a Cost

If DCAA incorrectly questions a cost, the contractor has three opportunities for correction: (1) with DCAA, (2) with the CO and government counsel, or (3) with the trier of fact.

The contractor should start with DCAA.<sup>283</sup> How does one approach DCAA? Anger, outrage, and attempts at bullying DCAA are rarely effective.<sup>284</sup> They end communication and the contractor's best opportunity for correction. The best approach is to focus on what DCAA wants-- that the audit report be correct. The contractor should ask DCAA to explain the basis of the challenged finding. If the basis is incorrect, the contractor should promptly provide DCAA factual evidence (e.g., invoices, receipts, timesheets) showing audit error. Even if DCAA remains steadfast, the auditor will include the contractor's dissent in the audit report, thus ensuring that the contractor's argument is part of the record.



Next, if DCAA is unwilling to modify its report, the contractor should address the issue with the CO during negotiations. The CO is required to "[e]nsure that contractors receive impartial, fair, and equitable treatment."<sup>285</sup> The DCAA audit is advisory<sup>286</sup> and the FAR grants the CO discretion to exercise judgment.<sup>287</sup> A CO, however, is unlikely to vary from the DCAA audit unless good cause exists (e.g., DCAA error or credible evidence supporting the questioned cost).<sup>288</sup> Assume a DCAA audit report correctly questioned the costs of materials for added work because the contractor lacked invoices to support the cost. In response to the DCAA audit, the contractor might measure the added work, identify the materials, price them with its supplier, and submit a cost breakout to the CO.<sup>289</sup>

If the CO is unresponsive and the cost is significant, then the contractor should, if it has not already done so, consider hiring an expert to rebut the DCAA finding. The expert will draw the DCAA error to the attention of the government trial attorney. The government trial attorney must prepare for trial. She or he will take a new look at the issue and may agree with the contractor.

If the contractor cannot convince DCAA, the CO, or the government trial attorney, it will have the opportunity to show a board or court the merits of its case. Normally, the contractor will need an expert to testify on the damage areas questioned by DCAA. If the contractor is correct, the trier of fact is likely to find for the contractor.<sup>290</sup>

# H. Recognize That Some DCAA Findings Are More Significant Than Others

When DCAA questions an entire cost category for lack of documentation or effective internal controls, that does not tell the CO or the government trial attorney that the costs were not incurred or are unrecoverable. It merely warns the government that certain accounting safeguards are missing and raises questions about the validity of the claimed costs.

For example, construction claims frequently involve delay, including extended field overhead.<sup>291</sup> Extended field overhead consists, inter alia, of the contractor's on-site office staff--typically salaried employees. The contractor's practice may be to require timesheets for hourly workers but not for its salaried employees. Because timesheets do not exist for the salaried office staff, the DCAA audit may question all extended salary costs for those individuals. That DCAA questioned these costs does not mean they were not incurred or are not recoverable in settlement or at trial. It simply means that DCAA



could not, based on the contractor's records, ascertain that these salaried employees each worked exclusively on the project during the extended period.

Should DCAA have questioned these costs? Absolutely. The CO and the trial attorney need to know that the contractor's onsite office staff did not fill out timesheets, verifying that they worked full time on this project during the delay period. As a result of the audit, the government trial attorney may seek to depose several of these onsite employees to verify that they did not work on other projects, take a training class, or use vacation time during the delay. DCAA has identified an area of uncertainty.

In such a situation, the construction contractor will want to show that its accounting practice is not to require its salaried employees to keep timesheets and that the contract does not require they keep timesheets. The contractor may also wish to show that its salaried staff were onsite and not assigned other work during the extended period. An affidavit from each of the salaried staff members detailing what he or she was doing during the delay might be convincing.

#### VI. TROUBLE AT DCAA

DCAA has been sharply criticized by GAO and the DoD Inspector General (DoD IG). In July 2008, a GAO report confirmed allegations that DCAA management had become complacent at three locations and the contractors being audited had improperly influenced the audit scope, conclusions, and opinions in the contractors' favor.<sup>292</sup>

On August 25, 2009, the DoD IG informed DCAA that its 2007 "adequate" opinion of DCAA would expire on August 26, 2009.<sup>293</sup> Under GAGAS, an audit organization must obtain a peer review at least every three years confirming that its "system of quality control [was] suitably designed" and that "the audit organization is complying."<sup>294</sup> An external peer review assures that the audit organization is meeting professional standards.<sup>295</sup>

In September 2009, GAO issued a second report severely criticizing DCAA.<sup>296</sup> Whereas the July 2008 report only found problems with DCAA's audit quality at three locations, the September 2009 report found serious audit quality issues at DCAA offices nationwide.<sup>297</sup> GAO found serious deficiencies in sixty-five of the sixty-nine audits reviewed, "including compromise of auditor independence, insufficient audit testing, and inadequate planning and supervision."<sup>298</sup> GAO recommended that DCAA fundamentally change its structure and culture.<sup>299</sup>



In March 2013, the DoD IG issued a third, highly critical report.<sup>300</sup> The DoD IG found "DCAA did not exercise professional judgment in performing [thirty-seven] of the [fifty] FY 2010 assignments reviewed."<sup>301</sup> The report identified significant quality issues, including "external impairments to independence, inadequate planning, poor communications with the requester and contractor, insufficient evidence, unsupported or untimely reports, poor documentation, and ineffective supervision and quality control."<sup>302</sup>

In response to the GAO reports, and in an effort to regain its "adequate" opinion on external peer review, DCAA changed its focus from the quantity and timeliness of audits to their quality. DCAA's initiatives for improved working paper documentation and sampling of low-risk transactions resulted in a 400% reduction in the number of audits performed by DCAA from 2008 to 2011.<sup>303</sup> In FY 2008, DCAA performed 30,352 audits.<sup>304</sup> By contrast, in FY 2011, DCAA performed only 7390 audits.<sup>305</sup> In FY 2012, DCAA "issued over [6700] audit reports."<sup>306</sup> Fundamental changes in operations and culture are difficult to implement, particularly when imposed from outside the organization. These forced changes undoubtedly lowered DCAA auditor morale and are likely a contributing cause for the drop in audit productivity.<sup>307</sup>

The government's need for audit reports, however, did not diminish.<sup>308</sup> In a May 2012 article, Professor Richard C. Loeb noted that "the productivity of DCAA auditors appears to be at an all-time low" and asked:

Did DCAA need such a drastic overhaul that it no longer has time to complete thousands of required audits, or did the agency respond to the GAO reviews by going overboard and spending an inordinate amount of time on working paper documentation to ensure that GAO and the Department of Defense inspector general would not find fault with any working papers, all the while letting billions of contract costs go unaudited?<sup>309</sup>

The 400% drop in DCAA productivity has "result[ed] in a massive backlog of audits awaiting completion."<sup>310</sup> Federal agencies and contractors are aware that once an audit is initiated, it can now take months longer for the auditor to complete the audit and for it to pass DCAA muster.<sup>311</sup> As of August 2011, the unaudited backlog was reported at \$558 billion and is expected to exceed \$1 trillion by 2016.<sup>312</sup>

Professor Loeb asserts that the "clericalization" of DCAA--the quest for perfect



working papers and other niceties at the price of leaving many hundreds of billions of costs unaudited--is a major error requiring immediate correction.<sup>313</sup> Because DCAA's focus on the more trivial aspects of GAGAS is driven by GAO and the DoD IG, Professor Loeb recommends that DCAA, GAO, and the DoD IG convene and resolve the GAGAS compliance issues.<sup>314</sup> As Professor Loeb stated: "Taxpayers, [g]overnment agencies, and contractors cannot afford the luxury of having DCAA perform audits that far exceed GAGAS requirements but do not yield any tangible benefit."<sup>315</sup>

Patrick Fitzgerald, director of DCAA, countered Professor Loeb's criticisms of DCAA's effectiveness and productivity.<sup>316</sup> Mr. Fitzgerald noted that "doing more audits does not automatically result in more savings .... Choosing the right audits and doing them comprehensively is more effective and beneficial than simply completing more audits."<sup>317</sup> Mr. Fitzgerald contrasted FY 2003 with FY 2011.<sup>318</sup> In FY 2003, DCAA "examined \$265 billion, questioned \$8 billion ([three] percent) of costs and issued over 29,000 audit reports."<sup>319</sup> In FY 2011, DCAA "examined \$128 billion, questioned \$11.9 billion ([nine] percent) of costs and issued about [7000] reports."<sup>320</sup> Moreover, the 2011 net savings totaled \$3.5 billion--the highest net savings in ten years.<sup>321</sup> DCAA attributed the high net savings to its use of a new "risk-based approach," focusing its resources on "higher payback audits" rather than the number of audits.<sup>322</sup>

Mr. Fitzgerald acknowledged that DCAA has a current backlog of unaudited "incurred cost' audits of \$570 billion, of which \$170 billion is 'normal current inventory.'"<sup>323</sup> He also noted a boost in DCAA auditor morale, pointing to a 2011 Office of Personnel Management (OPM) employee satisfaction survey.<sup>324</sup> The 2012 OPM survey also showed an "improvement in [DCAA] employee satisfaction."<sup>325</sup>

Mr. Fitzgerald characterized the DoD IG's 2013 report on audits completed in 2010 as a rehashing of old news.<sup>326</sup> The problems identified by GAO in its September 29, 2009, report had already triggered wide-ranging DCAA policy changes to improve audit quality.<sup>327</sup> He did consider the report, with its focus on audit work performed prior to or immediately following GAO's 2009 report, as meaningfully measuring the quality of the audit work DCAA has since performed or is now performing.<sup>328</sup>

What does all this mean for the construction bar? The large backlog at DCAA means difficulty in resolving REAs and claims on government projects. Construction claims that took one year to resolve in the past may now take eighteen months or longer to resolve. Audits of construction claims have been, and for the foreseeable future will be, more difficult to schedule; moreover, once initiated, they may take months longer to



complete.

Notably, DoD IG and GAO criticisms of DCAA as an agency, even where valid, are unlikely to undercut a specific DCAA auditor's findings before the boards or courts.<sup>329</sup> The merit of an individual audit finding depends upon the facts of the case and not the criticism of the agency. Construction costs are either supported by the documents or they are not. There is little to gain by detailing DCAA's internal problems during litigation. To prevail, a contractor must focus on presenting factual support for the DCAA-questioned costs.<sup>330</sup>

#### VII. CONCLUSION

DCAA has come under significant fire in recent years from GAO and the DoD IG. In response, DCAA is working to improve the quality of its audits. This effort has decreased the number of audits, creating a large backlog. As a result, many claim audits are taking longer to start and, once started, longer to complete. Improved audit timeliness is critical. The dispute resolution process is a long, often torturous path that poorly tolerates the added cost of substantial audit delay.

DCAA plays a critical role in dispute resolution. The audit provides transparency for the government in an area of the contractor's claim where the government typically has the least insight.<sup>331</sup> An audit should not impede or delay claim resolution but instead should be a powerful tool for the construction contractor and the government alike.

To resolve a claim effectively, one must properly prepare--in President Lincoln's words, "sharpen the axe." The construction contractor can make the audit report a strength rather than a weakness by anticipating, before the project even begins, the questions and requests for documentation that will inevitably come. Investing in the internal controls and practices that allow prompt identification of extra-contractual work and segregation of costs, as well as a record retention system that safeguards and allows ready access to documents, will allow the audit to communicate that the contractor's claim is well supported.

The government trial attorney can make the audit a better dispute resolution tool by encouraging DCAA to give the contractor a copy of the draft audit report and hold a meaningful exit interview with the contractor. If the process is more open, the auditor is more likely to be considered objective and neutral, thereby making it more likely that



the audit results will be accepted. Government trial attorneys should also understand DCAA's limitations--that the typical auditor is not an expert on construction, claims, contract damages, or the project. A damages expert is normally needed to help the government trial attorney unravel a complex damage claim and promote a more meaningful DCAA audit.

DCAA also can make the audit a better dispute resolution tool. Construction contractors tend to be unfamiliar with DCAA. In its notification letter to contractors audited for the first time or audited infrequently, DCAA should briefly explain (1) what DCAA is, (2) that the audit is a critical step in resolving the REA, (3) that DCAA will perform the audit in accordance with GAGAS (i.e., with independence and objectivity), and (4) that the contractor is encouraged to access DCAA's website to learn more about the audit process.

Additionally, DCAA should improve its communications with the construction contractor. Although DCAA discusses preliminary audit findings with the contractor, the contractor sometimes misunderstands the significance of the findings. If the auditor believes that a particular cost is inadequately supported, the auditor should promptly communicate this concern to the contractor. Concurrently, and in a nonthreatening way, the auditor should ensure that the contractor understands that if additional support is not furnished, the audit report will question the recovery of that cost in its entirety for lack of support. This extra step will incentivize the contractor to provide additional support, resulting in a better audit, and help prevent contractor disbelief and anger when the report is issued.

In addition, DCAA should establish a group of auditors whose sole task is to audit claims. Specialization would reduce audit error and, crucially, increase the likelihood of a truly meaningful audit. Specialization would decrease the amount of new information an auditor must learn to perform the audit, allow a more focused and timely audit, reduce "handholding" by the construction contractor, and increase construction contractor confidence that the auditor is qualified and competent.

The challenge is how to make the audit a better tool for dispute resolution. A meaningful, timely DCAA audit goes a long way toward providing the visibility and assurance the government needs to effectively resolve complex construction claims. The key to making the audit a less frustrating and more efficient dispute resolution tool is a better understanding by all the stakeholders of DCAA and the audit process.



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## **ENDNOTES**

- 1. MICHAEL A. BRANCA ET AL., FEDERAL GOVERNMENT CONSTRUCTION CONTRACTS xxxix (Adrian L. Bastianelli III et al. eds., 2d ed. 2010).
- 2. See Brandon Butler, Crowded Market: With the Construction Sector Still on Life Support, Competition Is Fierce for Government Contracts, WORCESTER BUS. J. ONLINE, www.wbjournal.com/article/20100830/PRINTEDITION/308309978 (last updated Mar. 25, 2012).
- 3. See generally Scott Wolfe Jr., No Damages for Delay Clauses, CONSTR. L. MONITOR (Feb. 14, 2008), www.constructionlawmonitor.com/2008/02/no-damages-for-delay-clauses/.
- 4. United States v. Wunderlich, 342 U.S. 98, 101 (1951) (Douglas, J., dissenting).
- 5. See, e.g., JOHN CIBINIC ET AL., ADMINISTRATION OF GOVERNMENT CONTRACTS 483 (4th ed. 2006) (explaining that a "major risk[] of a construction project is the type of subsurface or other latent physical conditions that may be encountered").
- 6. See BRANCA ET AL., supra note 1, at 572 ("Perhaps the most difficult element in pricing a construction claim is proving that the claimant is entitled to receive the damages it is requesting.").
- 7. See DCAA CONTRACT AUDIT MANUAL § 12-704.2 (2013) [hereinafter DCAAM] (one audit objective is to "[d]etermine if proposed or claimed costs are acceptable as a basis for negotiation or settlement").
- 8. *See id.* § 1-102(a).



- 9. *Id*.
- 10. *Id.* §§ 1-103, 1-403.1(b) ("Organizationally, DCAA is separate and independent from acquisition components of the DoD.").
- 11. DEF. CONTRACT AUDIT AGENCY, 2012 YEAR IN REVIEW 3 (2013) [hereinafter 2012 DCAA YEAR IN REVIEW].
- 12. *Id.* at 4. As of February 2013, DCAA had a total workforce of 5181, including 4492 auditors, 1611 employees with advanced degrees, and 1272 CPAs. *Id.*
- 13. DCAAM, *supra* note 7, §§ 1-102(b), 1-104.2(c).
- 14. FAR 1.602-1; CIBINIC ET AL., *supra* note 5, at 31.
- 15. FAR 1.602-2.
- 16. FAR 1.602-2(b).
- 17. DCAAM, *supra* note 7, § 10-102.
- 18. See id. § 9-305(c).
- 19. *See id.* § 4-602.8(c)(1) (listing sample items that may be examined).
- 20. *Id.* § 1-104.2(b).
- 21. Patrick J. Fitzgerald, *Foreword to DCAAM*, *supra* note 7, at 3.
- 22. DCAAM, *supra* note 7, § 0-002(a). For example, when auditing a construction contractor's delay and lost productivity claim, the auditor for guidance will turn to DCAAM, chapter 12 section 8, "Auditing Delay/Disruption Proposals or Claims." *See generally id.* § 12-800.
- 23. A current copy of the DCAAM is available at DCAA's website: http://www.dcaa.mil/cam.html.
- 24. The current version of Generally Accepted Government Auditing Standards (GAGAS)--the 2011 revision--can be accessed at http://www.gao.gov/yellowbook.
- 25. The DCAAM devotes an entire chapter to auditing standards. *See generally* DCAAM, *supra* note 7, § 2-000. See *id*. § 10-103 for the requirement that the audit report comply with GAGAS.
- 26. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-331G, GOVERNMENT



# AUDITING STANDARDS § 1.05 (2011) [hereinafter GAGAS].

- 27. See id. § 3.01 ("These general standards ... establish a foundation for the credibility of auditors' work.").
- 28. Id. § 1.04.
- 29. Id. § 1.17.
- 30. *Id.* § 3.02.
- 31. DCAAM, *supra* note 7, § 2-203(a).
- 32. See generally id. § 4-300 (describing the various conferences between the auditor and contractor that take place during an audit assignment).
- 33. See id. § 4-304.1.
- 34. GAGAS, *supra* note 26, § 6.53 ("Audit supervisors or those designated to supervise auditors must properly supervise audit staff.").
- 35. DCAAM, *supra* note 7, § 2-302.2.
- 36. *Id.* § 2-302.2(h).
- 37. *Id.* § 2-302.2(i).
- 38. *Id.* § 2-302.2(j).
- 39. *Id.* § 2-302.2(n).
- 40. See generally id. § 4-300 (governing conferences with the contractor on audit plans and results).
- 41. Def. Contract Audit Agency Memorandum, PAS 730.3.B.2.4, Audit Alert on Auditor Communications ("The Rules of Engagement") (Apr. 30, 2013) ("As required by auditing standards, it is essential that auditors communicate with the contractor and the [C]ontracting [O]fficer during all phases of the audit. The communication stipulated by this guidance does not impair auditor independence.").
- 42. *See* DCAAM, *supra* note 7, § 4-301(a).
- 43. *Id.*
- 44. *Id.* § 4-302.1(b).



- 45. *Id.* § 4-302.1(b)(1)-(2).
- 46. *See id.* § 4-302.1(c).
- 47. *Id.* § 4-303.1(a).
- 48. *Id.*
- 49. *Id.* § 4-303.1(b).
- 50. *Id.*
- 51. See id. § 4-303.1(d).
- 52. *Id.* § 4-304.1(a).
- 53. FAR 15.404-2(c)(1)(i).
- 54. DCAAM, *supra* note 7, § 15-503(c) (emphasis added).
- 55. *Id.* § 4-702.2(a)(2).
- 56. *Id.*
- 57. *Id.* § 4-702.2(b).
- 58. *Id.*
- 59. *Id.* § 4-702.2(c).
- 60. *Id.* § 4-702.4(a).
- 61. *Id.* § 4-702.4(a)(1).
- 62. *Id.* § 4-702.4(a)(2).
- 63. *Id.* § 4-702.6
- 64. For purposes of this Article, the author reviewed every board and federal court decision that included both the words "DCAA" and "construction" between January 1, 2003, and April 30, 2013. Of the decisions reviewed, the author found forty-six to be relevant.
- 65. For example, the DCAA's findings were accepted over the contractor's claim in the following: Ace Constructors v. United States, 70 Fed. Cl. 253, 276, 280 (2006), aff'd, 499 F.3d 1357 (Fed. Cir. 2007) (labor burden 31.8%, not 40%; bond rate 0.65%, not 0.84%); AEI Pac., Inc., ASBCA No. 53806, 08-1 BCA ¶ 33792, at 131-34, 163-64



(G&A 10.5%, not 15%; bond 0.75%, not 1.75%; labor hours 29,064, not 33,119); Alfair Dev. Co., ASBCA No. 53120, 05-2 BCA ¶ 32,990, at 36-40 (project manager allocation 93.6%, not 100%; labor burden \$104,989, not \$117,291); Charles G. Williams Constr., ASBCA No. 49775, 00-2 BCA ¶ 31,047, at 153,321, vacated and remanded on other grounds, 271 F.3d 1055 (Fed Cir. 2001) (home office overhead 14.12%, not 15%); C.H. Hyperbarics, Inc., ASBCA No. 49375, 04-1 BCA ¶ 32,568, at 161,155-56, 161,158 (overhead rate 46.9%, not 52.53%; added vendor material and freight costs \$0, not \$2638; attorney costs \$4274, not \$5376); Clark Constr. Grp., CAB No. 2003-1, 2004 GAOCAB LEXIS 2, at 460-62, 493-95, 643-44, 649-50 (subsidiary not allowed overhead/profit where parent added its own overhead/profit to subsidiary's costs; claimed management cost duplicated in overhead; labor burden 14.43%, not 23%; field overhead outside compensable period); George Sollitt Constr. Co. v. United States, 64 Fed. Cl. 229, 300 (2005) (claimed direct cost duplicated in field overhead); M.E.S., Inc., ASBCA No. 56149, 2012 ASBCA LEXIS 15, at \*7 (bond rate 0%, not 2%); MIG Corp., ASBCA No. 54451, 05-2 BCA ¶ 32,979, at 163,383-87 (G&A incurred outside the recoverable period); States Roofing Corp., ASBCA No. 55506, 08-2 BCA ¶ 33,970, at 168,036-39 (labor hours; labor rate \$10.52, not \$12.17; equipment double-counted as a direct cost and as field overhead); States Roofing Corp., ASBCA No. 54860, 10-1 BCA ¶ 34,356, at 169,659 (overstated field overhead costs); Sunshine Constr. & Eng'g, Inc. v. United States, 64 Fed. Cl. 346, 367-68, 379 (2005) (G&A rate 5.9%, not 11.44%; daily field overhead rate \$553, not \$738); White Buffalo Constr. v. United States, 101 Fed. Cl. 1 (2011) (labor \$127,463, not \$128,478). Similarly, the ASBCA accepted DCAA's findings over the government's contrary position in *Packard Constr. Corp.*, ASBCA No. 55383, 09-2 BCA ¶ 55,383, at 169,201-02 (field overhead at DCAA's daily rate of \$786, not the government's estimated daily rate of \$308.89).

- 66. See, e.g., Fireman's Fund Ins. Co. v. United States, 92 Fed. Cl. 598, 699 (2010) (disputed evidence regarding extended field overhead and equipment costs); C.H. Hyperbarics, Inc., 04-1 BCA ¶ 32,568, at 161,158-59 (disputed evidence regarding per diem, labor hours); States Roofing Corp., 08-2 BCA ¶ 33,912, at 167,799 (foreman labor rate \$16.62, not \$14.00); States Roofing Corp., ASBCA No. 55500, 09-1 BCA ¶ 34,036, at 168,349-50 (material cost).
- 67. *States Roofing Corp.*, 08-2 BCA ¶ 33,912, at 167,799.
- 68. *Id.*
- 69. Id.



- 70. *See* Orlosky Inc. v. United States, 68 Fed. Cl. 296, 317 (2005) (citing Raytheon Co. v. White, 305 F.3d 1354 (Fed. Cir. 2002); A.C. Ball Co. v. United States, 531 F.2d 993, 1005 (Ct. Cl. 1976)).
- 71. *Id.* at 317-18.
- 72. *See id.* at 318.
- 73. *Id*.
- 74. 331 F.3d 878, 882-83 (Fed. Cir. 2003) ("The *Eichleay* formula is used to equitably determine allocation of unabsorbed overhead to allow fair compensation of a contractor for government delay." (internal quotation marks omitted)).
- 75. *Orlosky*, 68 Fed. Cl. at 317-18.
- 76. *Id.* at 318.
- 77. Charles G. Williams Constr., Inc. v. White (*Williams I*), 271 F.3d 1055, 1059 (Fed. Cir. 2001).
- 78. *Id.* (emphasis added).
- 79. *Id.*
- 80. *Id.*
- 81. Charles G. Williams Constr., Inc. v. White (*Williams II*), 326 F.3d 1376, 1378 (Fed. Cir. 2003).
- 82. *Id.* at 1378
- 83. *Id.* at 1380 (internal quotation marks omitted).
- 84. *Id.* at 1379 (internal quotation marks omitted).
- 85. *Id.* at 1380.
- 86. ASBCA No. 57168, 11-1 BCA ¶ 34,629, at 170,634 ("We have found no Board cases, nor have we been cited to any by the parties, that have held more than [nine] months to be a reasonable period of time within which to issue a [Contracting Officer's] final decision.").
- 87. *Id.* at 170,631.
- 88. *Id.* at 170,632.



- 89. Id.
- 90. Id.
- 91. *Id.* at 170,633.
- 92. Id.
- 93. *Id.*
- 94. *Id.* at 170,635.
- 95. Id.
- 96. Id.
- 97. *Id.* at 170,632.
- 98. *Id.* at 170,634-35.
- 99. Id.
- 100. Id.
- 101. No. 3:10-CV-110, 2012 WL 1144022, at \*7 (E.D. Tenn. Apr. 4, 2012). Contract Management claimed \$767,992 in damages on a contract to clean and line potable water piping at a Department of Energy facility in Oak Ridge, Tennessee. *Id.* at \*1.
- 102. *Id.* at \*2.
- 103. Id. at \*6.
- 104. *Id.* (citing Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579 (1993)).
- 105. *Id.* at \*4 (internal quotation marks omitted).
- 106. *Id.* The court's research "revealed no cases in which a DCAA audit ha[d] been excluded from evidence based upon any part of Rule 408." *Id.* The court's research identified many cases weighing DCAA audits as "part of the evidence" without any indication of the audit being inadmissible under Rule 408. *Id.* Construction Management did not direct the court to any letter by the defendant or its counsel indicating that the audit was part of compromise negotiations. *Id.* Moreover, the subcontract granted the right to audit. *Id.* at \*5. Hence, "Plaintiff 's acquiescence to the audit was already legally required." *Id.*
- 107. FED. R. EVID. 408 (banning admission of evidence of compromise offers or



- negotiations); Contract Mgmt., Inc., 2012 WL 1144022, at \*4.
- 108. Contract Mgmt., Inc., 2012 WL 1144022, at \*6.
- 109. *Id.*; see also DCAAM, supra note 7, § 15-506.6 ("The auditor who performed the original audit or his supervisor will normally be the DCAA factual witness."). In addition to the DCAA auditor fact witness, "[g]overnment trial attorneys sometimes request expert witnesses to testify in the areas of cost accounting standards, [g]overnment procurement regulations, generally accepted accounting principles, and generally accepted auditing standards." *Id.* § 15-505.3. The DCAAM states that most DCAA regional audit managers, some DCAA field audit office managers, and some DCAA field supervisors would qualify as experts. *Id.*
- 110. 490 F.3d 208, 224 (2d Cir. 2007).
- 111. Contract Mgmt., Inc., 2012 WL 1144022, at \*6 (quoting Rigas, 490 F.3d at 224 (internal quotation marks omitted)).
- 112. *Id.* at \*7.
- 113. *Id.* Unless the auditor qualified as an expert, the court would have precluded her from testifying on cost reasonableness or allowability. The defendant, however, did not try to qualify the auditor as an expert, but instead agreed that she would not testify on cost reasonableness or allowability. *Id.*
- 114. ASBCA No. 49,375, 04-1 BCA ¶ 32,568, at 161,112 (2005).
- 115. *Id.* at 161,156-57.
- 116. Id. at 161,154.
- 117. *Id.* at 161,159 (emphasis added).
- 118. Id.
- 119. *Id.*
- 120. *Id.* at 161,156-57, 161,159.
- 121. *Id.* at 161,159.
- 122. *See id.* at 161,155-57.
- 123. With little discussion, the board held that the costs (over twenty percent) that the contractor added later to its contemporaneous estimates were less credible. *Id.* at



161,159.

- 124. *Id.* at 161,155, 161,159.
- 125. Id. at 161,156.
- 126. Id.
- 127. Id.
- 128. Reliable Contracting Grp., LLC v. Dep't of Veterans Affairs, CBCA No. 1539, 11-2 BCA ¶ 34,882, at 171,554.
- 129. *Id.* at 171,558.
- 130. Id. at 171,560.
- 131. *Id.* at 171,559.
- 132. *See id.* at 171,561 ("The [Veterans Administration] posits that since work has been performed, making the actual costs available, [the claimant's] estimates of costs should be rejected.").
- 133. Id.
- 134. *Id.* at 171,562-64 (awarding claimant \$719,259 in major equipment costs; \$13,885 for miscellaneous materials; \$143,583 in labor costs; a markup for subcontractor overhead and profit; bond costs; and a markup for the prime contractor's overhead and profit).
- 135. Id. at 171,556.
- 136. *Id.* at 171,559.
- 137. In noncompetitive situations, contractors have little incentive to take risks-meaning that their pricing is likely to be at the high end of the range of reasonableness. As a result, the contractor is likely to perform the change at significantly less than the pre-work estimate it gave to the government.
- 138. ASBCA No. 55500, 09-1 BCA ¶ 34,036, at 168,343.
- 139. *Id.* at 168,349.
- 140. Id.
- 141. Id.



- 142. States Roofing Corp. (*States Roofing Corp. III*), ASBCA No. 55504, 10-1 BCA ¶ 34,360, at 169,684, 169,686.
- 143. *Id.* at 169,686.
- 144. *Id.* at 169,686-87.
- 145. Id at 169,689.
- 146. ASBCA No. 56857, 12-1 BCA ¶ 35,025, at 172,091, 172,095.
- 147. *Id.* at 172,099, 172,116, 172,120-21.
- 148. *Id.* at 172,120-21.
- 149. Versar, Inc., ASBCA No. 56857, 12-2 BCA ¶ 35,126, at 172,456.
- 150. *Id.* at 172,458.
- 151. Id.
- 152. *Id.* at 172,455, 172,458.
- 153. See id. at 172,459.
- 154. ASBCA No. 55692, 08-2 BCA ¶ 33,999, at 168,128.
- 155. *Id.* at 168,141.
- 156. *Id.* at 168,128, 168,141.
- 157. Id. at 168,141.
- 158. *Id.* at 168,140-41.
- 159. *Id.* at 168,140.
- 160. Id.
- 161. ASBCA No. 49457, 03-1 BCA ¶ 32,141, at 158,921.
- 162. *Id.* at 158,925.
- 163. Id.
- 164. Id.
- 165. *Id.* at 158,933-34.



- 166. Nu-Way Concrete Co. v. Dep't of Homeland Sec., CBCA No. 1411, 11-1 BCA ¶ 34,636, at 170,691.
- 167. Id. at 170,694.
- 168. *Id*.
- 169. Id. at 170,695.
- 170. Id.
- 171. Id. at 170,698.
- 172. 66 Fed. Cl. 639, 642-43 & n.5, 705 (2005), aff'd, 509 F.3d 1372 (Fed. Cir. 2007).
- 173. Id. at 705.
- 174. Id.
- 175. Id.
- 176. *Id.* at 705, 721.
- 177. ASBCA No. 53641, 10-1 BCA ¶ 34,328, at 169,538.
- 178. Id.
- 179. *Id.* at 169,544-45.
- 180. *Id.* at 169,544-45, 169,547.
- 181. *Id.* at 169,551 (allowing only the claim for interest on wrongful invoice deductions).
- 182. DCAAM, supra note 7, § 15-506.6.
- 183. See id. §§ 1-104.2(a)-(b), (d), 10-000.
- 184. 92 Fed. Cl. 598, 602 (2010).
- 185. See id. at 699.
- 186. *Id.* (citations omitted).
- 187. Id. at 699 n.113.
- 188. See id. at 699-700, 710.



- 189. E-mail from Tedd Shimp, former senior Air Force trial attorney, to David G. Anderson, Counsel, Couch White LLP (Dec. 17, 2012) (on file with author).
- 190. Telephone Interview with a senior Air Force trial attorney (Dec. 5, 2012).
- 191. Telephone Interview with a senior Army trial attorney (Dec. 11, 2012).
- 192. See DCAAM, supra note 7, § 1-104.2(a) ("The purpose of contract auditing is to assist in achieving prudent contracting by providing those responsible for [g]overnment procurement with financial information and advice relating to contractual matters and the effectiveness, efficiency, and economy of contractors' operations.").
- 193. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 3.7(a) (2012).
- 194. See supra Part I.
- 195. Telephone Interview with the Honorable Paul Williams, Chairman, ASBCA (Dec. 13, 2012).
- 196. Id.
- 197. The "Big Dig" was a \$14.7 billion Central Artery/Tunnel Project in Boston, Massachusetts. See Kurt L. Dettman & Martin J. Harty, Mediators as Settlement Process Chaperones: A New Approach to Resolving Complex, Multi-Party Disputes, ADR Q., July 2008, at 1 (Alternate Dispute Resolution Section of the State Bar of Michigan). The Big Dig produced disputes and claims "from the dozens of prime contracts and hundreds of subcontracts that were used" during the fifteen-year construction period. Id. Given the sheer size and complexity of the disputes, traditional ADR procedures would not work. Id. For this reason, project management set up a global mediation framework. Id. The ASBCA helped to mediate this massive, complex dispute. Id.
- 198. Telephone Interview with the Honorable Paul Williams, *supra* note 195.
- 199. *Id.*; Dettman & Harty, supra note 197, at 2.
- 200. E-mail from senior Dep't of Justice trial attorney (Mar. 27, 2013).
- 201. *Id.* (emphasis added).
- 202. See discussion supra Part III.A.3.
- 203. See discussion supra Part III.C.



- 204. Cost records help tell what happened, which is key not just to damages but also to entitlement. For example, costs may not have been segregated because the contractor contemporaneously saw the event as contractor-caused. Equally as important, when the government mounts an early challenge to both entitlement and damages, early settlement becomes more likely.
- 205. See, e.g., discussion supra Part III.A.3.
- 206. *See* DCAAM, *supra* note 7, §§ 6-102.1, 6-102.2(d).
- 207. See discussion supra Part III.C.
- 208. Claim audits make up less than five percent of DCAA's workload. In 2012, DCAA examined \$154 billion of contractor costs. 2012 DCAA YEAR IN REVIEW, *supra* note 11, at 3. Equitable adjustment and termination claims audits made up \$6.4 billion of that amount. *Id.* at 5. If \$5 billion of this \$6.4 billion was for equitable adjustments, then equitable adjustment audits make up 3.2% of the DCAA audits dollar-wise
- 209. Construction claims are factually complex. Over the life of the project, there may be hundreds of changes and resulting claims. The contractor may have used a myriad of potentially overlapping pricing methods.
- 210. Telephone Interview with Stephen Mabie (Dec. 2012). Mr. Mabie did not intend his comment as a criticism of DCAA, but rather of the system. *Id.* He saw the government repeatedly injured by its trial attorneys' reluctance to augment DCAA with an outside damages expert. *Id.* For over twenty years, Mr. Mabie (now retired) served almost continuously as a litigation consultant and advisor to Air Force, Army, and Justice Department trial attorneys on a host of cases ranging in value from \$30 million to \$2.2 billion. *Id*
- 211. *See, e.g.,* discussion *supra* Part III.C.
- 212. For a discussion of the costs and benefits in selecting a damages expert, see Stephen D. Easton, *Damages: Expert Witnesses*, 2004 J. DISP. RESOL. 37.
- 213. E-mail from David L. Cotton, C.P.A., Chairman of Cotton & Company, LLP, to David G. Anderson, Counsel, Couch White LLP (Feb. 13, 2012) (on file with author).
- 214. DCAAM, *supra* note 7, § 15-503(c).
- 215. See Robert T. Peacock, Discovery Before Boards of Contract Appeals, 13 PUB. CONT.



- L.J. 1, 45 & n.241 (1982).
- 216. See DCAAM, supra note 7, § 4-401.
- 217. *See* Peacock, *supra* note 215, at 57-58.
- 218. See DCAAM, supra note 7, § 1-403.3 (addressing resolution of disagreement by Contracting Officer (CO) with audit recommendations).
- 219. See id. § 1-403.1(b) (emphasizing that the auditor is "expected to exercise independent judgment in planning the type and extent of audit testing ... [and] in the formulation of audit opinions, recommendations, and conclusions contained in audit reports").
- 220. See id. §§ 2-203, 15-503(c).
- 221. See id.
- 222. See id. § 2-203 ("[T]he auditor's effectiveness depends on the ability to develop and evaluate facts and arrive at sound conclusions objectively ... and independently....").
- 223. From author's experience and opinion.
- 224. See, e.g., Request an Audit, DCAA, http://www.dcaa.mil/request\_an\_ audit.html (last visited Dec. 1, 2013).
- 225. See DCAAM, supra note 7, § 10-214.1(a).
- 226. See, e.g., Pratap Chatterjee, Better Auditing for Better Contracting, CTR. FOR AM. PROGRESS, Mar. 2012, at 4; Lack of Resources Delaying Audits of USAID Afghanistan Awards, SIGAR Says, 54 GOV'T CONTRACTOR ¶ 146, at 8-9 (2012).
- 227. Telephone Interview with Michael J. Renner, Colonel, U.S. Air Force (retired) (Mar. 29, 2013).
- 228. See the quotes from senior government trial attorneys, *supra* Part IV.
- 229. If the audit takes a long time to complete and provides little useful information, the government trial attorney is not prepared to litigate and has expended perhaps all the time available to obtain useful information.
- 230. See discussion supra Part IV.B.
- 231. This discussion can pay dividends in both expediting the audit and showing



- opposing counsel that the government attorney is committed to timely claim resolution.
- 232. *See* DCAAM, *supra* note 7, § 1-102(a) (specifying that DCAA was primarily established to serve DoD).
- 233. E-mail from contracting company owner to a CO (2011) (on file with author) (regarding the DCAA audit of a construction claim.)
- 234. E-mail from senior construction attorney to David G. Anderson, Counsel, Couch White LLP (on file with author). For the purposes of this Article, the author asked a number of senior contractor construction attorneys for their views on DCAA. Several declined to respond. But the comments received were overwhelmingly negative.
- 235. E-mail from senior construction attorney to David G. Anderson, Counsel, Couch White LLP (on file with author).
- 236. *Id.*
- 237. The construction contractor, however, rarely pays its subcontractors their claim costs before being paid for those claims by the government. Thus, the prime contractor is subject to continual pressure by its subcontractors, who may have performed the majority of the work, for status reports and action on their claims.
- 238. Many, if not most, construction contractors are closely held, owner-operated, corporations with relatively little cash resources. They need the government to timely pay what it owes so they can fund the next project, buy equipment, pay down debt, and obtain bonding. Cash flow is a significant issue.
- 239. *See* FAR 43.201(b) (the contractor must continue performance of the contract as changed, and payment for the change is negotiated after).
- 240. See DCAAM, supra note 7, § 1-504.1(a) (noting that mandatory clause FAR 52.215-2 gives auditors access to contractor records--records normally accessible only through discovery). Like discovery, the audit is a vehicle for reducing and hopefully eliminating factual uncertainty as to the contractor's damages. The audit provides transparency for the government. Ideally, it tells the government what the contractor is saying--I incurred these costs.
- 241. See Donald P. Arnavas & Louis D. Victorino, Litigation or ADR: Choosing the Right Dispute Resolution Process, BRIEFING PAPERS, July 2009, at 4.



- 242. The "time is of the essence" requirement appears in virtually every construction contract.
- 243. DCAA's objectivity (or rather lack of objectivity) was raised by each of the accounting experts interviewed for this Article. DCAA defines its success in terms of net savings. See DEF. CONTRACT AUDIT AGENCY, 2011 YEAR IN REVIEW (2012); 2012 DCAA YEAR IN REVIEW, supra note 11, at 3. Is DCAA's use of ""net savings," as the measure of its value to the taxpayers, consistent with auditor objectivity? If DCAA's mission is to generate net savings, the concern is that the audit will be conducted as a "witch hunt," rather than as a balanced review of costs.
- 244. But see DCAAM, supra note 7, § 4-303.1(a) (stating that "[t]hrough-out the audit, the auditor should discuss matters with the contractor").
- 245. See discussion supra Part IV.B.
- 246. *But cf.* DCAAM, *supra* note 7, § 1-103. In fact, the DCAA auditor, the government trial attorney, and the CO are rarely co-located and speak infrequently.
- 247. FED. R. CIV. P. 26-37.
- 248. FED. R. CIV. P. 28, 33-34.
- 249. FAR 52.214-26.
- 250. Id.
- 251. Telephone Interview with the Honorable Paul Williams, *supra* note 195.
- 252. See generally CHARLES L. WILKINS, 10 KEYS TO A SUCCESSFUL DCAA AUDIT.
- 253. Id.
- 254. E-mail from Charles L. Wilkins, Exec. Dir., Gov't Contract Compliance, KPMG, LLP (Apr. 12, 2013) (on file with author). Wilkins offers contractors additional guidance in his booklet, 10 Keys to a Successful DCAA Audit, such as (1) "[i]nsist on an entrance conference"; (2) "[a]ppoint an internal liaison"; (3) "[a]ssemble a management team"; (4) "[e]stablish an accurate, accessible record-keeping system"; (5) "[b]e responsive"; (6) ""[m]aintain a detailed log"; (7) "[d]o not allow the audit to exceed the agreed scope"; (8) ask for "a list of required interviews"; (9) "[r]eview the preliminary findings at the function/department level"; and (10)



- "[i]nsist on an exit conference at the company level." *See generally* WILKINS, *supra* note 252.
- 255. WILKINS, supra note 252.
- 256. Id.
- 257. Id.
- 258. See FAR 43.204 (indicating that the equitable adjustment process does not begin until the contractor submits a claim).
- 259. The claim-causing condition typically surfaces early in the project, the key witnesses are contractor employees, the claimed costs were or should have been contemporaneously recorded, and the contractor possesses intimate knowledge of the project and its own accounting records.
- 260. Key employees leave, forget, or become consumed in demanding new construction projects. By twelve to eighteen months after project completion, the government also will have largely or completely disbanded its project team.
- 261. WILKINS, supra note 252.
- 262. The process of gathering and organizing the pertinent source documents should begin immediately upon discovery of the out-of-scope work. After-the-fact efforts to locate relevant source documents are time-consuming and problematic and can delay completion of the audit.
- 263. DCAAM, *supra* note 7, § 4-302.1(a)-(b) ("As a minimum, [the auditor is to] explain the purpose of the audit, the overall plan for its performance including the expected duration, and generally the types of books, records, and operations data with which the auditor will be concerned.").
- 264. See id. § 4-302.1(b); see also discussion supra Part II.B.
- 265. See DCAAM, supra note 7, § 4-302.1(c).
- 266. See WILKINS, supra note 252.
- 267. Id.
- 268. "In my experience, there is a proportional relationship between the speciousness of the claim and the obstructiveness of the contractor in the audit process. Where a contractor is confident that its claim is valid and has a sound foundation, the



- contractor goes out of its way to assist the auditor." E-mail from David L. Cotton, C.P.A., Chairman of Cotton & Company, LLP, to David G. Anderson, Counsel, Couch White LLP (May 28, 2013) (on file with author).
- 269. See WILKINS, supra note 252.
- 270. *See* DCAAM, *supra* note 7, § 4-105(a) (encouraging continuous communication as issues arise); *id.* § 4-303.1(a) (noting the auditor should disclose to the contractor any omissions, mistakes, or duplications in data).
- 271. *Id.* § 4-303.1, "General Procedures for Interim Conferences," provides:
  - a) Through-out the audit, the auditor should discuss matters with the contractor as necessary to obtain a full understanding of the basis for each item in the contractor's [damages]. Disclose to the contractor any duplications, omissions, or other mistakes as noted in the contractor's assertion, records or supporting data.
    - b) The auditor should discuss preliminary audit findings ... with the contractor to ensure conclusions are based on a complete understanding of all pertinent facts. These types of discussions do not impair auditor independence and are generally necessary to obtain sufficient evidence to support audit conclusions.
- 272. For example, labor is normally a construction contractor's largest cost. After the auditor has examined labor costs, the contractor's designated representative should ask the auditor for an oral summary of the auditor's preliminary factual findings and conclusions regarding labor. Similar requests should be made following the audit field work for other major cost elements such as materials, equipment, subcontract costs, and home office overhead. *See* WILKINS, *supra* note 252.
- 273. See FAR 15.404-2(c)(1)(i).
- 274. Id.
- 275. See DCAAM, supra note 7, §§ 4-304.7(a), 15-503(c).
- 276. See, e.g., id. §§ 4-303.1(a), 4-304.1(a), 4-304.7(a). DCAA wants a high-quality audit. DCAA understands that interim conferences (and communications) are needed to help support audit findings and reduce audit errors and misunderstandings. DCAA's normal practice is to discuss its preliminary findings and conclusions with the contractor as the audit progresses. With this in mind, if government litigation counsel appears reluctant to allow such communication, the construction contractor may want to suggest that government litigation counsel



- check with DCAA to see if DCAA has a preference before deciding. See id.
- 277. The contractor's attorney should affirmatively represent that he or she will not communicate with the auditor without going through government litigation counsel.
- 278. DCAAM, *supra* note 7, § 4-304.1(e).
- 279. *Id.* § 4-304.1(a).
- 280. *See id.*; *id.* § 4-304.1(c) (expressing how the exit conference "is an important part of sound contractor relations").
- 281. *Id.* § 4-304.1(a).
- 282. *Id.* §§ 4-304.1(c), 4-304.7. The DCAAM states:
  - Audit work is privileged when performed at the request of [g]overnment litigation counsel in support of an ongoing or anticipated litigation.... [A]n exit interview could compromise the privilege. When audit work is covered by the attorney work product privilege, the auditor should explain the importance of the exit conference in resolving audit issues and avoiding errors and attempt to obtain permission [from government litigation counsel] to hold an exit conference. However, to prevent inadvertent compromise of the attorney work product privilege, an exit conference must not be held without litigation counsel's written consent and coordination on the matters to be discussed. Id. § 4-304.7(a) (emphasis added).
- 283. See id. § 4-304.1(d) (noting that the auditor must "[c]onfirm or follow up on requests for the contractor's reaction to any audit exceptions for inclusion in the audit report").
- 284. Such tactics do not work for the CO or the government trial attorney either.
- 285. FAR 1.602-2(b).
- 286. *See* DCAAM, *supra* note 7, § 1-102(b).
- 287. FAR 1.602-2.
- 288. See discussion supra Part II.
- 289. Usually, the best way to get rebuttal information to the CO is to present it to DCAA during the audit. In the example above, even with the cost breakout, the DCAA auditor will almost certainly question the cost. But DCAA will now



- include in its audit report the contractor's reaction to the audit finding (the cost breakout), which, via the audit report, will then find its way to the CO.
- 290. See discussion supra Part III.B.1.
- 291. See, e.g., Fireman's Fund Ins. Co. v. United States, 92 Fed. Cl. 598, 703 (2010).
- 292. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-857, DCAA AUDITS: ALLEGATIONS THAT CERTAIN AUDITS AT THREE LOCATIONS DID NOT MEET PROFESSIONAL STANDARDS WERE SUBSTANTIATED, 4 (2008).
- 293. Memorandum from April G. Stephenson to All DCAA Employees on the Modified GAGAS Statement Due to Expiration of DoD IG Opinion on DCAA's Quality Control Program (Aug. 26, 2009).
- 294. GAGAS, supra note 26, § 3.96.
- 295. Id.
- 296. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-468, DCAA AUDITS: WIDESPREAD PROBLEMS WITH AUDIT QUALITY REQUIRE SIGNIFICANT REFORM 14 (2009).
- 297. Id.
- 298. Id.
- 299. Id. at 70-72.
- 300. INSPECTOR GEN., U.S. DEP'T OF DEF., DODIG-2013-044, MONITORING OF THE QUALITY OF DEFENSE CONTRACT AUDIT AGENCY FY 2010 AUDITS i (2013).
- 301. Id.
- 302. Id.
- 303. Richard C. Loeb, *DCAA--Is Anyone Home?*, 7 COSTS, PRICING & ACCT. REP. ¶ 24, at 3 (2012).
- 304. Id.
- 305. Id.
- 306. 2012 DCAA YEAR IN REVIEW, supra note 11, at 1.



- 307. See, e.g., Bryan Rahija, Backlog of Unaudited Pentagon Contract Costs Could Reach \$1 Trillion, PROJECT ON GOV'T OVERSIGHT (May 23, 2012), www.pogo.org/ blog/2012/05/potential-backlog-of-unaudited-pentagon-contract-costs-could-reach-1-trillion.html. DCAA auditor blogs show an alarming anger and lack of faith in DCAA management and the changes being implemented. The bloggers indicate that DCAA auditor morale is at an all-time low and many of DCAA's better auditors are leaving the agency. See, e.g., id. Morale issues and loss of experienced auditors are such that they were one of the first things mentioned when, for purposes of this Article, the author discussed DCAA with knowledgeable persons outside DCAA. The first thing mentioned was how long it now takes to get an audit completed. This said, the author worked with DCAA on two very significant sets of claims from 2009 through 2011. Over the course of this work, the author read fifteen to twenty DCAA audit reports and worked to varying degrees with more than ten DCAA auditors. At no time did he see evidence of low morale. It did, however, take a very long time to get some of the audit reports.
- 308. Loeb, *supra* note 303, at 3 ("It is almost incomprehensible how DCAA could just stop performing so many audits, especially as contracting actions and dollars awarded have not decreased in any material way.").
- 309. Id.
- 310. Id. at 4.
- 311. See id.
- 312. Id.
- 313. *Id.* at 5-6.
- 314. *Id* at 6-7.
- 315. Id. at 6.
- 316. *See* Patrick Fitzgerald, Letter to the Editor, FED. TIMES (June 17, 2012, 2:17 PM), http://www.federaltimes.com/article/20120617/ADOP07/306170002/Letter-Editor.
- 317. *Id.* Following the two Government Accountability Office reports discussed above, Fitzgerald replaced April Stevenson as director of DCAA. Fitzgerald was brought in from the Army Audit Agency (where he served as director) to lead the reform efforts at DCAA.
- 318. Id.



- 319. Id.
- 320. Id.
- 321. *Id.* DCAA's reported net savings for FY 2012 were even higher; they totaled \$4.2 billion. 2012 DCAA YEAR IN REVIEW, *supra* note 11, at 3.
- 322. Fitzgerald, supra note 316.
- 323. Charles S. Clark, *Triaging Audits*, GOV'T EXEC., Oct. 2012, at 14.
- 324. Id.
- 325. 2012 DCAA YEAR IN REVIEW, supra note 11, at 27.
- 326. See Dietrich Knauth, DCAA Defends Audit Reforms After Critical Watchdog Report, LAW 360 (Mar. 11, 2013, 8:36 PM), http://www.law360.com/articles/422583/dcaa-defends-auditreformsafter-critical-watchdog-report. See generally DODIG-2013-044, supra note 300.
- 327. See Knauth, supra note 326; see also DODIG-2013-044, supra note 300, at 4.
- 328. See, e.g., Knauth, supra note 326.
- 329. See discussion supra Part III.
- 330. See discussion supra Part V.G.
- 331. See supra Part I.



# HOW PUBLIC AGENCIES MAY (OR MAY NOT) TERMINATE CONTRACTS

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#### I. Introduction

This article discusses how state and local governments may, or may not, terminate their contracts. As with many issues, the first place to look is the contract itself. State statutes and regulations and local charters, ordinances, and codes may provide additional rights or impose additional restrictions on the ability to terminate. Finally, common law and equity may impact a public agency's ability to terminate.

State and local government contracts typically include termination provisions. They almost always include a provision that permits the public agency to terminate the contract for cause (often referred to as a "termination for default"). Many also provide that the public agency may terminate without cause (often referred to as a "termination for convenience"). Some also provide for cancellation, which is typically a termination without cause early in the project or for some specific, anticipated possible event (for example, a failure to obtain project funding or contractor bankruptcy).

Public agencies often use, or at least borrow from, the Federal Acquisition Regulation (FAR) standard termination clauses. Most of the law on terminations of public contracts is concerned with the federal government's termination of prime contractors. Where there are no state law decisions that directly involve the termination of contractors by public agencies, state courts will likely find federal decisions persuasive.<sup>2</sup>

Common law and equity will limit the enforceability of some termination provisions. For example, terminations for default are considered forfeitures, to be avoided wherever possible.<sup>3</sup> Termination for convenience provisions may be considered illusory.<sup>4</sup> And equity will allow rescission under certain circumstances, regardless of what the contract provides.<sup>5</sup>



# **II. Typical Contract Provisions:**

# A. Terminations for Default:

State and local government contracts typically permit the public agency to terminate a contract based on the contractor's default,<sup>6</sup> and many also provide for termination based on the occurrence of specified contingencies, such as contractor bankruptcy or insolvency.<sup>7</sup>

A typical default termination clause will provide that the agency may terminate on a specified number of days written notice if the contractor: (1) repeatedly refuses or fails to supply sufficient skilled workers or materials; (2) fails to pay its subcontractors; (3) violates applicable laws; or (4) substantially breaches the contract documents, including failing to meet the schedule or comply with specifications.<sup>8</sup> The agency typically may also exclude the contractor from the site; take possession of all materials, equipment, tools, and equipment and machinery owned by the contractor; accept assignment of any subcontracts that it desires to keep;<sup>9</sup> and finish the work by whatever reasonable method it deems expedient.<sup>10</sup>

When a contract is terminated for default, the government may be entitled to recover from the contractor a variety of damages resulting from the contractor's failure to perform its contractual obligations. These include excess reprocurement costs, delay damages, and unliquidated progress payments, among others.<sup>11</sup> Moreover, the contractor may also incur poor performance evaluations and negative responsibility determinations that may affect the contractor's ability to obtain additional work in the future, not to mention litigation costs in defending against the government's decision to terminate.

The government may withhold sufficient amounts to protect itself from loss due to its costs to complete performance. If the government's cost to complete the procurement is less than the outstanding contract balance with the terminated contractor, then the contractor will be entitled to payment of the remaining amount; if the costs of finishing the work exceed the unpaid balance, then the contractor must pay the difference to the government.<sup>12</sup>

#### **B.** Terminations for Convenience:

Many state and local government contracts also permit public agencies to terminate a contract for convenience.<sup>13</sup> Where a contract so provides, the public agency



typically must provide specified written notice of the termination for convenience to the contractor. <sup>14</sup> If it does, the contractor has several important obligations. The most important among these obligations are to stop work and to notify all subcontractors that the government has terminated the prime contract and to instruct the subcontractors to stop work, protect and preserve work-in-progress, terminate existing lower-tier subcontracts and supply orders, and not enter into any new subcontracts or orders for the project. <sup>15</sup>

The contractor, under a typical provision, will be entitled to some form of recovery if the agency terminates the prime contract. The contract will typically provide a deadline for the terminated contractor to submit claims for reimbursement in accordance with the termination provisions. Among the costs the contractor typically may recover are its settlement expenses, which typically will include post-termination costs incurred in terminating and settling its subcontracts.<sup>16</sup>

# III. Public Agency's Right to Terminate the Contractor:

#### A. Terminations for Default:

Typical default termination language will allow the public agency to terminate based on a material breach by the contractor and a failure to cure that breach within a specified time period after notice is given by the public agency. Some state and local government contracts also allow termination for specific breaches, such as failures to acquire required insurance or bonds and contractor bankruptcy.

Material Breach Requirement. A material breach is generally required before the government may terminate a contractor for default.<sup>17</sup> The types of material breaches that may warrant a default termination are sometimes, but not always, set forth in the default clause. While some courts will not permit a default termination for any reason that is not specified in the contract clause,<sup>18</sup> the more common approach is to allow default termination for any material breach.<sup>19</sup> The clause may, for example, include as material breaches: defective or nonconforming work, failure to pay subcontractors or suppliers, or violation of applicable law. Additional material breaches that commonly result in default terminations include anticipatory repudiation<sup>20</sup> and abandonment of the contract.<sup>21</sup> State courts will typically consider the following five factors to determine whether a breach is material: (1) the amount of the benefit lost to the injured party; (2) the adequacy of compensation to the injured party; (3) the amount of forfeiture by the breaching party; (4) the likelihood that the breaching party will cure; and (5) the breaching party's good faith.<sup>22</sup>



Notice and Opportunity to Cure Requirement. In many situations, as a condition to a default termination, the government must provide the contractor with a cure notice. State courts will typically require strict compliance with such notice requirements.<sup>23</sup> Failure to provide notice and a cure period may itself be a material breach by the government.<sup>24</sup> Where the government provides the notice, and the contractor takes sufficient action to cure, the government may not terminate for default.<sup>25</sup>

# Challenges to Default Termination: Standard to justify; default as forfeiture.

A default involves very serious consequences for a contractor. For example, a default may exclude the contractor from the competition for the reprocurement contract, and terminations for default on prior similar contracts may be considered in assessing past performance or responsibility on future procurements. Therefore, state courts should adhere to the principle, oft stated in federal contract termination decisions, that a default termination is a drastic sanction akin to a forfeiture, which imposes on a prime contractor strict accountability for its actions.

Due to the serious implications of a default termination, the government in most instances has the burden of sustaining its contention that the prime contractor was not in compliance with the contract requirements. There are exceptions to this general policy, such as the prime contractor's burden of showing that its untimely performance was attributable to excusable delay. State courts will typically place the burden of proof on the party alleging a breach, which would typically be the defaulted contractor seeking recompense for its termination.<sup>26</sup> Only if a public agency counter-claims would it then bear the burden of proving that the contractor was at fault.<sup>27</sup> However, the general concept of a termination for default as a forfeiture is an important foundation in examining the rights of the public agency and the contractor with respect to termination for default.

**Bases for default.** Under typical clauses, state and local government agencies will have the right to terminate for default on the following bases:

Failure to Meet Schedule Deadline. For federal contracts, if the government can show that the contractor failed to deliver or to perform services in the time specified, then it may terminate without issuing a 10-day cure notice or giving a contractor the opportunity to cure under the default clause.<sup>28</sup> Other contracts often contain similar provisions.<sup>29</sup>



Failure to Meet Specifications. For federal contracts, absent unusual facts and circumstances, the government is entitled to insist on strict compliance with all contract provisions.<sup>30</sup> Such provisions are rare, but not unheard of, in nonfederal government contracts.<sup>31</sup>

Failure to Make Progress. A contractor's failure to make progress is a separate basis for default and may occur when the contractor fails to progress satisfactorily toward the completion of performance, despite the fact that the final performance date has not yet arrived.<sup>32</sup> Cases involving failure to make progress generally fall into two categories: (1) the contractor is so far behind schedule that timely completion is unlikely; or (2) a failure to make progress because of defective work.<sup>33</sup> When addressing an allegation of failure to make progress, the question has traditionally been whether or not the contractor's performance has progressed in such a way to permit the contractor to meet the end-item delivery date. Typically, a cure notice is required before termination is allowed.

Failure to Meet Other Contract Requirements. Under federal law, in addition to providing for default for failure to make progress or failure to meet specifications, the default clause provides the government with the right to terminate the contract in whole or in part for the failure to perform any other provision of the contract that is not cured after due notice.<sup>34</sup> As with a termination for failure to make progress, a cure notice is required for a default termination based on failure to perform other provisions of the contract.<sup>35</sup> Such a provision is less common in nonfederal contracts. Some courts have held, however, that even in the absence of such a provision a default termination may be justified where the contractor's breach is sufficiently material.<sup>36</sup>

Anticipatory Breach. A termination for anticipatory breach or repudiation of the contract has traditionally been found to exist in two situations: (1) where it is evident from the circumstances that the contractor is unable to perform although willing to do so; or (2) where a contractor makes a positive, definite, unconditional, and unequivocal statement, before contract performance is due, that it will not perform in accordance with the contract's terms.<sup>37</sup>

Abandonment. Abandonment occurs when the contractor simply performs no further work on the contract but does not state its reasons for doing so.<sup>38</sup> In cases of true abandonment, a default termination may be valid even without a cure notice. Whether there has been an abandonment of performance depends upon the totality of the contractor's conduct.



Contractor defenses; excusable delay. When there is a default termination, the contractor may be able to assert the defense of "excusable delay." A delay is typically excusable where it is caused either by the government or its agents or by forces not within either the government's or the contractor's control, e.g., force majeure.

A delay is generally not excusable where it is caused by one of the contractor's subcontractors or suppliers. This is so because the prime contractor is generally responsible to the government for the conduct of its subcontractors and suppliers.<sup>39</sup> As a consequence, the government may choose to terminate a prime contractor for default even where the basis for the termination lies solely with a subcontractor or supplier. Hutton Contr. Co. v. City of Coffeyville, while not a termination case, is instructive. 40 There, the plaintiff contractor sued the defendant city under Kansas law to obtain the unpaid amount of a contract to construct a power line and a fiber-optic line. After a jury trial, the district court ordered the city to pay the contractor \$24,659.47--the retainage of \$110,159.47 minus \$85,500 in liquidated damages to which the city was entitled. On appeal, the contractor unsuccessfully challenged the district court's rejection of the contractor's contention that it should have been excused for all delays caused by its suppliers or subcontractors, at least when those delays arose without its fault and were beyond its control. The court ruled that the contractor was responsible to the city for its supplier's delays when those delays were not themselves excused by a force majeure.<sup>41</sup> These same principles would apply in a termination for default based on a prime contractor's failure to deliver on schedule or failure to make progress--i.e., that the prime's delays were caused by one of its subcontractors or suppliers would not render its termination improper.

This rule was applied to a state agency default termination in *Excell Constr., Inc. v. Michigan State Univ. Bd. of Trustees.*<sup>42</sup> In that case, the defendant university awarded the plaintiff general contractor a construction contract for defendant's Swine Teaching and Research Center. After the university terminated the contractor for failure to meet the contract schedule, the contractor sued for breach of contract, claiming the termination was improper. The trial court granted the university summary judgment, finding that the contract was terminated because of the undisputed delays that were the result of the contractor's failure to coordinate and adequately manage its subcontractors. The appellate court affirmed.

An issue that sometimes arises is whether a government agency, where it designates a particular subcontractor as a sole source, necessarily warrants the performance by that subcontractor, such that the failure of that subcontractor to



perform will not serve as a ground for terminating the prime contractor. State courts have generally declined to shift responsibility for subcontractor performance from the prime contractor to the government simply because the latter directed use of that particular subcontractor.<sup>43</sup> For example, in *Barham Constr., Inc. v. City of Riverbank*, Barham, a general contractor, sued the city to recover the balance due on a contract for the construction of a skate park. The city had withheld certain amounts from its payments to Barham as liquidated damages for delays in completion of the project. After a court trial, judgment was entered in favor of Barham on its complaint against the city. The appellate court reversed and remanded that judgment, in part because it disagreed with the trial court's conclusion that the city was responsible for delays caused by a bathroom supplier that it specified in the contract.<sup>44</sup> This rule, applied to a default termination, would mean that, where a sole-source subcontractor or supplier causes the prime contractor's default, the agency may terminate for default under a typical termination clause, even though the agency specified that sole-source subcontractor or supplier.

Contractor defenses; waiver of schedule deadline. Another defense to a default termination is that the public agency elected to waive the delivery date, permitting a contractor to continue with performance despite the fact that the contractor will not be able to deliver on time. If subsequently terminated for default, the contractor may then raise such a waiver as a defense if it can demonstrate that it relied on the government's election and actually continued to perform. Once waived, the right of the government to terminate for default can only be revived by establishing a new delivery schedule.<sup>45</sup>

For example, in *State of California v. Lockheed Martin IMS*, the court rejected the state's contention that "the referee erred in finding the cure notice waived past [delays], arguing that the cure notice did not include an express waiver as required by the terms of the deadlines contract" and agreed with Lockheed's contention that "the plain language of the cure notice constitutes a waiver of past delays."<sup>46</sup> It found that, despite the absence of the term "waive" in the state's cure notice, the notice indicated the state's clear intent to waive past deadlines because it promised that the state would proceed with the contract if Lockheed "cured the correctable deficiencies within the specified time and provided adequate assurances of its future ability to perform." Since a past deadline is a past event that cannot be corrected and the state did not reserve the right to terminate the contract for past delays, the cure notice was "a conditional waiver that clearly expressed the State's intention to go forward with the contract and forgive past deadlines if [Lockheed] met the specified conditions." Lockheed was entitled to rely, and did rely, on the state's promise to proceed, and "the State waived any breaches by



[Lockheed] involving previously missed deadlines."47

Contractor defenses; impossibility. Where the contract specifications are impossible to perform, delay caused by that impossibility will be excused, and the contractor even has a right to stop work. Default termination by the government under these circumstances would be improper and a breach of contract. That said, impossibility is an affirmative defense and is very difficult for a contractor to prove. For a contractor to prove impossibility, so that its failure to perform under the contract is excused, it must prove that the industry as a whole would find the specifications impossible to meet.<sup>48</sup>

When a contractor points out a specification deficiency, the government has the obligation to give the contractor proper direction and correct any deficiencies, rather than terminate the contract. If a contractor discovers a defective specification, it may not suspend work unless and until it promptly gives notice of the perceived defect to the government. Suspending work without providing this notice may justify a default termination, even where the contractor can show the suspension was caused by a defect in the government's specification.

Contractor defenses; substantial completion. Contractors may also avoid default when they have substantially completed the required work.<sup>49</sup> To determine whether substantial completion has been reached, a court will examine both: (1) the quantity of work left to be done and (2) the extent to which the ""unfinished" project is capable of serving its intended use.

In order to rely on a substantial completion defense, a contractor must first show that the work performed is near total completion. Although no fixed percentages can be relied on with confidence, substantial completion will not be found where large portions of work remain unfinished. In addition, even where a high percentage of the work has been accomplished, substantial completion will not be found if a project cannot be put to its intended use.

For example, in *Norberto & Sons, Inc. v. County of Nassau*, a general contractor had been awarded a contract by the county government to renovate and construct a public swimming pool. The general contractor hired a subcontractor to perform some work. Under the subcontract, the subcontractor was to furnish all material, labor, equipment, plant, and services to construct new pools and renovate existing pools at a facility. By letter, the general contractor declared the subcontractor in default of the contract. As a



result, the subcontractor filed an action to recover the balance it alleged it was due under the subcontract. The court found that the subcontractor had substantially performed its obligations under the subcontract, and, as such, the general contractor improperly declared the subcontractor in default and terminated the subcontractor from the job. An engineer from the county testified that, at the time the subcontractor was declared in default, 95 percent of the work required under the subcontract had been completed. Because the general contractor breached the subcontract, it was not entitled to liquidated damages.<sup>50</sup>

Once found, substantial completion does not operate to discharge all subsequent obligations of the contractor. If the contractor is ordered to complete or correct work that is practical to perform, and if it fails to do so, the government may terminate for default, assess costs of completion, or reduce the contract price through equitable adjustment.

#### **B.** Terminations for Convenience:

Many state and local government contracts also allow the public agency to terminate for convenience. These provisions will generally be enforced.<sup>51</sup> Where such clauses are not included, the courts generally will not imply a convenience termination right.<sup>52</sup> Convenience termination provisions are more variable than those for default and often depend on the agency and type of project.

Limitations on Ability to Terminate for Convenience. Most convenience termination clauses give public agencies extremely broad rights to terminate.<sup>53</sup> But even under the broadest of provisions, there are limitations on the government's ability to terminate without cause. Most jurisdictions prohibit convenience terminations made in bad faith.<sup>54</sup> This limitation is very narrow and difficult to prove, such that contractor challenges of convenience terminations are rarely successful. For example, in *Vila & Son Landscaping Corp. v. Posen Constr., Inc.,* the court held that a contractor may terminate a subcontract for convenience in order to enter into another subcontract with a different subcontractor at a lower price, finding that such a termination does not constitute bad faith. The court rejected the subcontractor's argument that interpreting the prime's termination rights so broadly would render the subcontract illusory, holding that the prime provided valid consideration because it was bound by the termination for convenience provision's written notice requirement.<sup>55</sup>

In *Handi-Van, Inc. v. Broward County,* a Florida court of appeal noted that a public entity's discretion to terminate for convenience, where its contract so allows, is even



broader where the contract's convenience termination clause was not required by law.<sup>56</sup> This case, decided under Florida law, provides a good discussion of the history of convenience terminations and federal decisions on improper terminations from Colonial Metals Co. v. United States<sup>57</sup> (termination to get better price is not improper, even where government may have known about the availability of the lower price when it made the award), to Torncello v. United States<sup>58</sup> (termination, even when not in bad faith, is improper absent changed circumstances since award), to Krygoski Constr. Co. v. United States<sup>59</sup> (limiting Torncello's "changed circumstances" requirement to cases in which the government knew at award that it had no intention of performing the contract).60 In Handi-Van, the court affirmed summary judgment for the county in the contractors' challenge of the terminations for convenience of their paratransit services contracts. The court stated that federal case law was inapposite because, unlike federal procurement contracts in which the FAR requires inclusion of a termination for convenience clause, county rules did not require such a clause in the contracts at issue.<sup>61</sup> As such, the parties were free to negotiate whether to include a termination for convenience clause, and, having agreed to one, it was not for the court to undo the bargain struck. The court also held that the termination for convenience clause was not illusory because it contained a notice requirement.<sup>62</sup> Finally, even if federal law were applied, the termination passed muster: changed circumstances are not required and in any event were present, and there was no evidence of bad faith, which the court equated to intent to injure the terminated contractors.63

Some challenges of convenience terminations have succeeded under state law, even where a bad faith standard is applied. For example, in *Questar Builders, Inc. v. CB Flooring, LLC*, a general contractor terminated its carpeting installer for convenience before it started work at the project based on changes to the interior design plans and the subcontractor's proposed change order increasing the contract price by an amount the prime considered excessive. The prime terminated and obtained the work from a substitute subcontractor at a lower price. The terminated subcontractor sued for wrongful termination, prevailed at trial, and was awarded its expectation damages. On appeal, the appellate court held that an implied obligation of good faith and fair dealing limits a terminating party's discretion to terminate for convenience and affirmed the trial court's finding that the prime breached this obligation.<sup>64</sup>

Other courts have been more restrictive regarding the ability to terminate for convenience, requiring a change in circumstances to justify termination.<sup>65</sup> For example, in *Ram Eng'g & Constr., Inc. v. Univ. of Louisville*, a protest challenged award of the contract for site preparation for construction of a football stadium. The university and



the protester entered into a stipulated dismissal of the protest that called for the project to be re-bid, and the contract was terminated for convenience. On re-bid, the awardee again won and sued for the difference between its original price and its revised lower price in the resolicitation. The Kentucky Supreme Court held that, since a contract issued under the Kentucky Model Procurement Code was subject to the obligation of both parties to perform the contract in good faith, a convenience termination could only be justified by a change in circumstances and that the stipulated dismissal did not qualify as such a change.<sup>66</sup>

Terminations for Convenience by Operation of Law. In addition to terminations for convenience following formal written notice, a convenience termination may arise by operation of law where a court converts an erroneous default termination. State and local government contracts sometimes expressly provide that, where the government improperly terminates a contractor for default, that termination will be converted to one for convenience. *R&J Constr. Corp. v. E.W. Howell Co., Inc.*, although it involved termination of a subcontract, is illustrative. In that case, the terminated subcontract provided that, if the prime "wrongfully" terminated for default, its liability to the subcontractor would be the same as it would be had the prime terminated for convenience.<sup>67</sup> The court enforced that provision.<sup>68</sup>

Some courts have implied a termination conversion provision in subcontracts based on an express provision to that effect in the prime contract and on the prime's ability to terminate for convenience. In *Rogerson Aircraft Corp. v. Fairchild Industries, Inc.,* however, the court held that, where the default termination clause contained in a subcontract did not provide for the automatic conversion of an improper default termination to one for convenience, the subcontract's convenience termination clause did not apply, and, as a result, a subcontractor was entitled to breach of contract damages for an improper termination for default.<sup>69</sup>

**Termination Procedures.** While some state and local government contracts provide procedures for how and when the prime contractor may terminate for convenience, they do not typically provide the same level of detail as do federal procurement contracts. Most require the public agency to give some kind of notice to the contractor. If they follow the federal government model, they will require the notice to state whether any portion of the contract is to be continued, provide the effective date of the termination, and instruct the contractor to (1) stop all work; (2) terminate subcontractors; and (3) place no further orders except those necessary to perform any unterminated portion of the contract.<sup>70</sup>



A Contractor's Recovery from the Public Agency. Once the agency has effectively noticed the termination for convenience of the contract, the parties must determine the recovery to which the contractor is entitled, if any. If the contractor has not incurred costs pertaining to the terminated portion of the contract or agrees to waive its costs, and if no costs are due the agency under the contract, then the parties may execute a no-cost settlement agreement.

More commonly, a termination for convenience will entitle the contractor to a monetary recovery. The typical procedure for achieving this recovery is that the contractor will prepare and submit a termination settlement proposal to the public agency, and the parties will then attempt to negotiate a settlement. If successful, the parties will enter into a settlement agreement and close out the contract. If not, the agency will pay the contractor what the agency determines to be due under the contract convenience termination provision, if anything, and the contractor will either accept that determination and payment or sue for breach of the contract.

Most state and local government contract clauses for termination for convenience provide that, in the event of such a termination, the contractor is entitled to the following: (1) payment at the contract price for completed or accepted work as of the termination; (2) costs incurred for work-in-progress at termination, plus a reasonable profit (or loss) on that work; and (3) settlement expenses.<sup>71</sup> They typically preclude recovery of anticipated profits on the unexecuted, i.e., terminated, work.<sup>72</sup> Some clauses provide for different or more limited contractor recovery.<sup>73</sup>

The most complicated element of a contractor's recovery, and often the most significant, is its costs incurred for work-in-progress at termination, plus a reasonable profit (or loss) on that work. The costs may under certain circumstances include performance costs incurred prior to the effective date of the termination. All credits to the public agency, such as pretermination progress payments and disposal credits, must be deducted.<sup>74</sup> The agency also may be able to deduct costs it has incurred due to breaches by the contractor.

The contractor also may incur post-termination costs to which the contractor necessarily committed itself but which, due to the termination, it is prevented from absorbing through payments under the contract. Examples include (1) costs continuing after termination; (2) loss of useful value of special equipment; and (3) rental cost under unexpired leases. Each of these costs arises out of commitments necessary to perform the contract. These costs generally will be recoverable under most convenience



#### termination clauses.

An express or implied term of the contract convenience termination provision is that the contractor has a duty to mitigate these costs.<sup>75</sup> This requires the contractor to act quickly and diligently to stop work, cancel orders, and terminate its subcontracts and equipment leases. It also requires the contractor to dispose of its "termination inventory," such as unused materials and equipment and work-in-progress, so as to minimize the costs it passes on to the public agency as part of its termination claim. If the contractor fails to meet any of these obligations, the agency will be entitled to reduce its settlement payment by deducting the claimed costs that it can prove the contractor would not have incurred had it done so.

Some state and local government contract clauses will cap or otherwise limit the contractor's recovery for a convenience termination. For example, many contracts, including those adopting federal requirements, do not allow the contractor's termination recovery to exceed the total contract value or to include consequential damages.<sup>76</sup> Such provisions are generally enforced, unless they are not sufficiently specific.<sup>77</sup>

Some courts have refused to apply to subcontracts the recovery limitations in the prime contract based on general flow-down provisions; rather, they will only do so where the subcontract specifically incorporates those limitations. For example, in *Encon* Utah, LLC v. Fluor Ames Kraemer, LLC, a subcontract incorporated prime contract terms "as applicable to the Scope of Work" of the subcontractor. The prime terminated the subcontractor for convenience and sought to limit the subcontractor's recovery to "the value of work performed" as provided in the prime contract terms. The court rejected the prime's argument, finding that the prime contract termination clause was not applicable to the subcontractor's scope of work, and holding that the subcontractor's recovery would be determined by the convenience termination clause in the subcontract. That clause did not limit recovery to the value of work performed; rather, it allowed the subcontractor to recover "the actual costs of all such Work satisfactorily executed to the date of termination, plus an allowance for reasonable overhead and profit on such costs incurred prior to termination (but not to exceed a pro rata portion of such Contract Price for such Work based on the percentage of Work properly completed to the date of termination), together with termination costs." The court interpreted this to apply the pro-rata limitation only to overhead and profit and not to direct costs incurred.78



Most state and local government contract termination for convenience provisions entitle the terminated contractor to recover its reasonable settlement expenses. These may include the following: (1) accounting, legal, clerical, and similar costs reasonably necessary for preparation and presentation of settlement claims and the termination and settlement of subcontracts; (2) reasonable costs for the storage, transportation, protection, and disposition of termination inventory; and (3) indirect costs related to salary and wages incurred as settlement expenses.

Finally, the prime must take reasonable steps to ensure that its termination claim is true and correct before submitting it to the government. In many states, if the contractor includes amounts in its termination settlement proposal to which it is not entitled, it may be liable under false claims laws.<sup>79</sup>

#### **IV. Conclusion:**

As with any state and local government contracting issue, the law of terminations will vary by jurisdiction, locality, and even agency. State and local public contracts almost always contain default termination provisions and are much more commonly including convenience termination provisions as well. Typical contract clauses vary somewhat for terminations for default, much more so for terminations for convenience. In all cases, counsel should look both to the contract itself and to applicable law, regulation, and agency policy. Often, counsel will find little or no law in the applicable jurisdiction and so should look to law on analogous subjects (such as material breach, forfeiture, and equity) and terminations law from other jurisdictions, including federal common law.

Despite the variation, several common themes exist. As with default terminations of federal government contracts, state and local public contracts typically require agencies to provide pre-termination notices, with opportunities to cure, for most types of default, and the burden on the agency to justify any termination is high. Where it validly terminates, the agency will be entitled to recover its cost of cover (i.e., its excess reprocurement costs). For convenience terminations, typical provisions give the agency extremely broad discretion to terminate, and the burden on the contractor to overturn a termination is extremely high. Contractor recovery usually, but not always, consists of payment at the contract price for completed work, pre-termination costs plus a reasonable profit (or less any loss), and post-termination costs to close out the contract (and subcontracts) and settle the termination; the contractor rarely gets to recover its anticipated profit on the terminated work.



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# **ENDNOTES**

- 1. FAR 52.249-1 through FAR 52.249-12.
- 2. See, e.g., Pacific Architects Collaborative v. State of California, 100 Cal. App. 3d 110, 125 (1979) ("We are strongly persuaded by decisions relating to federal procurement bidding.").
- 3. Lisbon Contractors, Inc. v. United States, 828 F.2d 759, 765 (Fed. Cir. 1987); B.V. Constr., Inc., ASBCA Nos. 47766, et al., 2004-1 BCA ¶ 32,604, at 161,350. The scope of this rule is being tested in a pending appeal in California. Dep't of Water Resources v. Whitaker Contractors, Inc., Cal. Ct. App. No. C069248, 3d App. Dist., filed Sept. 16, 2011.
- 4. Questar Builders, Inc. v. CB Flooring, LLC, 978 A.2d 651 (Md. 2009).
- 5. *See, e.g.,* Tolboe Constr. Co. v. Staker Paving & Constr. Co., 682 P.2d 843, 847 (Utah 1984); Lakeside Pump & Equipment, Inc. v. Austin Constr. Co., 576 P.2d 392, 396-97 (Wash. 1978).
- 6. See, e.g., State of California's General Provisions--Information Technology (GPIT), Form GSPD-401IT, at ¶ 23, available at http://tinyurl.com/l32thk6; Maine Dept. of Transportation (MDOT) Standard Specifications Highways and Bridges, General Condition (Jan. 2001), §§ 112.1.1, 112.1.2, 12.2.1; State of Maine Standard General Conditions and Contract Work on State Projects (Nov. 22, 1993), Art. 22; see also ABA 2000 Model Procurement Code for State and Local Governments (MPC), §§ 5-401(3)(c), 6-101(3)(c).
- 7. See, e.g., MDOT Std Specs, supra, § 112.1.1; Maine Std. GCs, Art. 22.
- 8. *See, e.g.*, Cal. GPIT, *supra*, at ¶ 23.a), b); MDOT Std Specs, *supra*, § § 112.1.1, 112.1.2, 12.2.1; Maine Std. GCs, Art. 22.
- 9. *See, e.g.*, Bolt Electric, Inc. v. City of New York, 53 F.3d 465 (2d Cir. 1995).



- 10. *See, e.g.*, Cal. GPIT, *supra*, at ¶ 23.d); MDOT Std. Specs. §§ 112.1.2, 112.2.1; Maine Std. GCs, Art. 22.
- 11. See, e.g., Cal. GPIT, supra, at ¶ 23.c); MDOT Std. Specs. § 112.2.1; Maine Std. GCs, Art. 22.
- 12. *See, e.g., id.* at ¶ 23.e).
- 13. *See, e.g.*, Cal. GPIT, *supra*, ¶ 22; MDOT Std Specs, *supra*, § 112.2.2; *see also* ABA 2000 MPC, §§ 5-401(3)(d), 6-101(3)(d).
- 14. *See, e.g.,* Cal. GPIT, *supra*, ¶ 22.a); MDOT Std Specs, *supra*, § 112.2.2.
- 15. *See, e.g.,* Cal. GPIT, *supra*, ¶ 22.b).
- 16. *See, e.g.*, Cal. GPIT, *supra*, at ¶ 22.c), d); MDOT Std Specs, *supra*, § 112.2.2.
- 17. *See, e.g.,* California GPIT, Form GSPD-401IT, ¶ 23.b), *supra* ("The State's right to terminate this Contract under sub-section a) above, may be exercised if the failure constitutes a *material breach* of this Contract ….") (emphasis added).
- 18. *See, e.g.*, County of La Paz v. Yakima Compost Co., 224 Ariz. 590, 601-02, 233 P.3d 1169, 1180-81, 585 Ariz. Adv. Rep. 13 (Ariz. Ct. App. 2010).
- See, e.g., Pettinelli Elec. Co. Inv. v. Board of Ed. of City of New York, 56 A.D.2d 520, 391 N.Y.S.2d 118 (1st Dept. 1977), order aff'd, 43 N.Y.2d 760, 401 N.Y.S.2d 1011, 372 N.E.2d 799 (1977).
- 20. *See, e.g.,* Mometal Structures, Inc. v. T.A. Ahern Contrs. Corp., 2013 U.S. Dist. LEXIS 27797 (E.D.N.Y. Feb. 28, 2013) (applying New York law).
- 21. See, e.g., BloomSouth Flooring Corp. v. Boys' & Girls' Club of Taunton, 800 N.E.2d 1038 (Mass. 2003).
- 22. *See, e.g.*, L.L. Lewis Constr., L.L.C. v. Adrian, 142 S.W.3d 255, 260 (Mo. Ct. App. 2004).
- 23. *See, e.g.*, Allstate Contractors v. Marriott Corp., 652 N.E.2d 1113, 1119 (Ill. App. Ct. 1st Dist. 1995).
- 24. McClain v. Kimbrough Constr. Co., 806 S.W.2d 194, 198-99 (Tenn. Ct. App. 1990).
- 25. *County of La Paz*, 224 Ariz. at 600-02, 233 P.3d at 1179-81, 585 Ariz. Adv. Rep. 13.
- 26. See, e.g., Collins/Snoops Assocs. v. CJF, LLC, 988 A.2d 49, 57-58 (Md. App. 2010).



- 27. *Id*.
- 28. FAR 52.249-8(a)(1)(i).
- 29. *See, e.g.*, Excell Constr., Inc. v. Michigan State Univ. Bd. of Trustees, 2003 Mich. App. LEXIS 59 (Mich. Ct. App. Jan. 14, 2003).
- 30. FAR 52.249-8(a)(1)(i); Dimarco Corp., ASBCA 29870, 87-1 BCA ¶ 19,456; R.B. Wright Constr. Co. v. United States, 919 F.2d 1569 (Fed. Cir. 1990), *aff'g* R.B. Wright Constr. Co., ASBCA 31967, *et al.*, 90-1 BCA ¶ 22,364.
- 31. See, e.g., Cal. GPIT, supra.
- 32. FAR 52.249-8(a)(1)(ii).
- 33. Hannon Elec. Co. v. United States, 31 Fed. Cl. 135, 143 (1994); California Dep't of Water Resources v. Whitaker (decision pending).
- 34. FAR 52.249-8(a)(1)(iii).
- 35. Paine, ASBCA No. 41273, 95-2 BCA ¶ 27,896.
- 36. *Pettinelli Elec.*, 56 A.D.2d 520, 391 N.Y.S.2d 118, order aff'd, 43 N.Y.2d 760, 401 N.Y.S.2d 1011, 372 N.E.2d 799.
- 37. Mometal Structures, 2013 U.S. Dist. LEXIS 27797.
- 38. See, e.g., BloomSouth Flooring, 800 N.E.2d 1038.
- 39. See, e.g., Continental Mach. Tool Co. v. Aircraft Welding & Mfg. Co., 1996 Conn. Super. LEXIS 2015, at \*9-\*10 (Conn. Super. Ct. July 24, 1996); Hutton Contr. Co. v. City of Coffeyville, 487 F.3d 772, 779 (10th Cir. 2007).
- 40. 487 F.3d 772.
- 41. *Id.*
- 42. *Supra*, note 29, 2003 Mich. App. LEXIS 59 (Jan. 14, 2003).
- 43. *See, e.g.*, Barham Constr. v. City of Riverbank, 2011 Cal. App. Unpub. LEXIS 5959, at \*26-\*28, \*35-\*39 (Aug. 8, 2011); *see also Collins/Snoops Assocs.*, 988 A.2d at 51 (County terminated prime contractor even after replacing defaulted subcontractor).
- 44. 2011 Cal. App. Unpub. LEXIS 5959, at \*26-\*28, \*35-\*39.
- 45. State of California v. Lockheed Martin IMS, 2002 Cal. App. Unpub. LEXIS 4548, at



- \*46-\*56 (Jan. 25, 2002).
- 46. *Id.*
- 47. *Id.* at \*50-\*53.
- 48. Evan Johnson & Sons Const., Inc. v. State, 877 So. 2d 360, 366-67 (Miss. 2004).
- 49. Norberto & Sons, Inc. v. County of Nassau, 16 A.D.3d 642, 643 (N.Y. App. Div. 2005).
- 50. 16 A.D.3d at 643.
- 51. See, e.g., York Eng'g Co., Inc. v. City of Montgomery, 374 So. 2d 884 (Ala. 1979).
- 52. See, e.g., Baker v. State, 77 A.D. 528, 78 N.Y.S. 922 (3d Dept. 1902).
- 53. See, e.g., G & R Elec. Contractors, Inc. v. State, 130 Misc. 661, 663, 665, 496 N.Y.S.2d 898, 900, 902 (Ct. Cl. 1985); Subsurface Technologies, Inc., MSBCA 2801 (Apr. 2013); compare La. Civ. Code, Art. 2765 (2011) (gives owner absolute right to terminate, even without cause, but then requires it to pay the contractor its costs incurred as of the termination, plus any damages caused).
- 54. See, e.g., Questar Builders, Inc., 978 A.2d 651; Capital Safety, Inc. v. State Div. of Bldgs. and Const., 848 A.2d 863 (N.J. App. 2004); Ram Eng'g & Constr., Inc. v. Univ. of Louisville, 127 S.W.3d 579 (Ky. 2003); Harris Corp. v. Giesting & Assocs., Inc., 297 F.3d 1270, 1272-73 (11th Cir. 2002) (applying Florida law); A.J. Temple Marble & Tile, Inc. v. Long Island R.R., 659 N.Y.S.2d 412 (1997); EDO Corp. v. Beech Aircraft Corp., 911 F.2d 1447 (10th Cir. 1990) (applying Kansas law).
- 55. 99 So. 3d 563 (Fla. Dist. Ct. App. 2d Dist. 2012).
- 56. 116 So. 3d 530 (Fla. Dist. Ct. App. 4th Dist. 2013).
- 57. 494 F.2d 1355 (Ct. Cl. 1974).
- 58. 681 F.2d 756 (Ct. Cl. 1982).
- 59. 94 F.3d 1537, 1543-44 (Fed. Cir. 1996).
- 60. 116 So. 3d at 535-38.
- 61. *Id.* at 539.
- 62. *Id*.



- 63. *Id.* at 540-41.
- 64. 978 A.2d 651 (Md. 2009).
- 65. Ram Eng'g & Constr., Inc., 127 S.W.3d 579; Linan-Faye Constr. Co. v. Housing Auth., 49 F. 3d 915 (3rd Cir. 1995). See also Smart, Inc. v. Virgin Islands Housing Auth., 320 F. Supp. 2d 332 (D. V.I. 2004) (constructive termination for convenience limited to changed circumstances).
- 66. Ram Eng'g & Constr., Inc., 127 S.W.3d 579.
- 67. 239 N.Y.L.J. 123 (Sup. Ct. 2008).
- 68. *Id.*
- 69. 632 F. Supp. 1494 (C.D. Cal. 1986) (applying California law); see also Westinghouse Elec. Corp. v. Garrett Corp., 437 F. Supp. 1301 (D. Md. 1977); Coleman Eng'g Co. v. North American Aviation, Inc., 65 Cal. 2d 396 (1966); MLK, Inc. v. Univ. of Kansas, 940 P.2d 1158. 23 Kan. App. 2d 876 (Kan. App. 1997).
- 70. FAR 49.102.
- 71. See, e.g., Cal. GPIT, supra, ¶ 22.c); compare FAR 52.249-2, ¶ (g); see also Clingerman, MSBCA 2002, 5 MSBCA ¶ 431 (1998); G & R Elec., 130 Misc. at 663, 496 N.Y.S.2d at 900.
- 72. See, e.g., G & R Elec., 130 Misc. at 663, 496 N.Y.S.2d at 900; Affirmative Pipe Cleaning, Inc./Edenwald Contracting Co., Inc. v. City of New York, 159 A.D.2d 417, 553 N.Y.S.2d 324 (1st Dept. 1990); Subsurface Technologies, Inc., SHA Contract Nos. AX8565149, AX8565159, MSBCA 2801 (Apr. 2013) (citing Delle Data Systems, Inc., MSBCA 2146, ¶ 493 (2001)).
- 73. See, e.g., Affirmative Pipe Cleaning, 159 A.D.2d 417, 553 N.Y.S.2d 324 (based on percent complete on unit priced contract); Encon Utah, LLC v. Fluor Ames Kraemer, LLC, 210 P.3d 263 (Utah. Sup. Ct. 2009) (prime contract limited contractor's recovery to "the value of work performed").
- 74. See, e.g., Appeal of M&M Hunting Preserve, No. 1279 (MSBCA, March 30, 1987).
- 75. See, e.g., G & R Elec., 130 Misc. at 663, 665, 496 N.Y.S.2d at 900, 902.
- 76. See, e.g., Cal. GPIT, supra, ¶ 22 ("in no event will total payments exceed the amount payable to the Contractor if the Contract had been fully performed"); Appeal of



M&M Hunting Preserve, No. 1279 (MSBCA, March 30, 1987); *compare* FAR 49.202(a), 49.207; Okaw Industries, Inc., ASBCA No. 17863, 17864, 75-1 BCA ¶ 11,321, *reconsid. denied*, 75-2 BCA ¶ 11,571.

- 77. Dept. of Transp. v. Arapahoe Constr., Inc., 357 S.E.2d 593 (Ga. 1987).
- 78. 210 P.3d 263 (Utah. Sup. Ct. 2009).
- 79. For a link to 29 states' false claims laws go to: False Claims Act Resource Center, website at http://tinyurl.com/lzrdhke.



#### PAYMENT OF FIXED FEE UNDER CPFF CONTRACTS

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According to Federal Acquisition Regulation 16.306(d), a "cost-plus-fixed-fee contract may take one of two basic forms – completion or term." The FAR describes both forms and gives examples of how the fixed fee should be paid.

The "completion form" cost-plus-fixed-fee (CPFF) contract "describes the scope of work by stating a definite goal or target and specifying an end product." FAR 16.306(d)(1). A completion form CPFF contract generally requires the contractor to complete and deliver the "specified end product (e.g., a final report of research accomplishing the goal or target) within the estimated cost, if possible, as a condition for payment of the entire fixed fee." The "term form" CPFF contract "describes the scope of work in general terms and obligates the contractor to devote a specified level of effort for a stated time period." FAR 16.306(d)(2). Under the term form CPFF contract, if the government finds the contractor's performance satisfactory, the fixed fee is payable at the end of the agreed time period, "upon contractor statement that the level of effort specified in the contract has been expended in performing the contract work." The FAR also states that the completion form contract is preferred over the term form "whenever the work, or specific milestones for the work, can be defined well enough to permit development of estimates within which the contractor can be expected to complete the work." FAR 16.306(d)(3). In fact, the FAR prohibits use of the term form CPFF contract, "unless the contractor is obligated by the contract to provide a specific level of effort within a definite time period." FAR 16.306(d)(4). Sounds simple, right?

A January 2014 decision by the Armed Services Board of Contract Appeals shows that applying these basic principles can be tricky.

In *Teledyne Brown Engineering, Inc.*, ASBCA No. 58636, Jan. 6, 2014, a contractor appealed the deemed denial of a claim against the Army seeking a greater fixed fee under an indefinite delivery/indefinite quantity CPFF contract. The Army had paid \$416,480 in fixed fee but Teledyne sought an additional \$406,565 to achieve the full fixed fee under the contract.



Teledyne argued that it was entitled to the full fixed fee because it completed all work under the contract. The Army moved for summary judgment and argued that the total cost ceiling in the contract was not reached, so Teledyne was not entitled to the full fixed fee. The Army argued that the contract was only funded to 50.6 percent of the cost ceiling so, logically, only 50.6 percent of the work anticipated under the contract could have been performed by Teledyne. And, only 50.6 percent of the full fixed fee could be paid to Teledyne. The Army asserted that the contract was a term form CPFF contract under which Teledyne only would be entitled to its full fixed fee if it performed the agreed-upon level of effort for the agreed-upon time period, but here the agreed-upon level of effort was never fully funded. Thus, argued the Army, Teledyne did not fully perform the agreed level of effort and the full fixed fee was not payable.

In *Teledyne*, there were lots of disagreements over basic facts. Significantly, the parties could not even agree on which form of CPFF contract was involved. Apparently, the Teledyne contract did not identify which form of CPFF contract or which FAR clause controlled the fixed fee determination. Moreover, the contract had the hallmarks of both forms of CPFF contracts. The ASBCA noted that the contract appears to be consistent with the term form contract because the contract stated a "specified level of effort for a stated" period of time that is characteristic of a contract under FAR 16.306(d)(2). But the parties also agreed in a contract modification that Teledyne would "produce 360 armor plates by the specified delivery date." That requirement was noted to be consistent with the preferred completion form CPFF contract under FAR 16.306(d)(1). Obviously, on this record, the ASBCA denied the Army's motion for summary judgment.

The ASBCA also introduced a new wrinkle when it suggested that the Army's interpretation of the contract "would result in a prohibited cost-plus-a-percentage-of-cost contract." See 10 U.S.C. § 2306(a); 41 U.S.C. § 3905(a); and FAR 16.102(c). That issue may control the ultimate outcome of the case and points to a favorable outcome for Teledyne. Or maybe not. The ASBCA decision contemplates the development of a fuller record through the discovery process—including both documents and depositions. Some of the points that the ASBCA wants to be developed include what was the parties' contemporaneous interpretation of the contract at issue.

Note that the dispute in Teledyne was only about how much of the fixed-fee the contractor was entitled to receive, not about whether the contractor had performed adequately. It is indisputable that, under a cost-type contract, the government generally is not contracting for a finished product or service. If, despite its best efforts, the contractor cannot meet the contractual requirements, the government has obtained precisely what it



bargained for—namely, the contractor's best efforts.

In conclusion, a word to the wise: it's always better to resolve these types of issues on the front end before all the work is performed and before there is any dispute over how much fee should be paid. That avoids disappointing results and sets realistic expectations as to just how much of the fixed fee a contractor is entitled to under the contract. It also avoids the messy dispute after the fact and all the expenses that go along with it.

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