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The Clause

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The President's Column

David Nadler

Dear BCABA Members:

My thanks to Pete McDonald (our *Editor for Life*) for bringing together another interesting and informative collection of articles for this edition of *The Clause*. We expect to issue two more editions of our excellent journal this year and welcome submissions from members on topics of interest to the government contracts community.

We are moving forward with our agenda of increasing membership, particularly among the younger members of the government contracts bar and are reaching out to our government colleagues, particularly those that work for agencies that are presently not well represented in the BCABA. We are also looking at President Obama's stimulus plan and other regulatory and legislative initiatives that impact the government and its contractors, and will weigh-in on issues of relevance to our members. For example, the BCABA has been invited to provide comments on the proposed changes to Rules of Procedure for the Postal Service Board of Contract Appeals which were recently published in the Federal Register.

We are also evaluating proposals for a redesign of the BCABA website that will be more user-friendly and an improved resource for our

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President's Column (cont'd):

member on government contracts law and practice. We expect to select a vendor shortly and to begin the web development effort.

We have a number of upcoming events. The Colloquium will be held on April 23, 2009 at George Washington University Law School. We will also feature our Trial Advocacy Program, Executive Policy Forum (May 27, 2009), BCA Judges Reception, and the Annual Program (in October) so please watch your e-mail for further details.

Our next meeting will be on March 26, 2009 (**note the date change**), and will be held at the office of Dickstein Shapiro LLP, 1825 Eye Street NW, Washington, DC 20006.

I look forward to seeing everyone then.

Best regards,

Dave Nadler
President

**Bored of Contract Appeals
(a.k.a. The Editor's Column)**

by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

Leading this issue is a rarely seen article on collecting attorney's fees under the Miller Act, followed by Chris Bouquet's heads-up about recent DCAA activity regarding lobbying costs. Finally, I co-authored an article about some of the more significant changes government contractors can expect with the new Obama Administration.

On an unrelated matter, I appreciate Dave Nadler's kind words, but I am really not the *Editor for Life*. In fact, I am willing allow anyone else who is willing to volunteer be the editor.

The Clause will reprint, with permission, previously published articles. We are also receptive to original articles that may be of interest to government contracts practitioners. But listen, everybody: Don't take all this government contract stuff too seriously. We again received some articles that were just not suitable for publication, such as: "Pete Submits Second Highest Bid for Illinois Senate Seat!"; "Jury Finds Pete Not Guilty — But Wants Him Punished Anyway!!"; and "BCAJA Holds Blowout Annual Meeting in Vegas — 3 Arrested!!!"

Beating *Rich*: Three Ways to Recover Attorney's Fees in Miller Act Cases

by
Steven J. Koprince*

[Note: Reprinted with permission from the Federal Bar Association, *The Federal Lawyer*, Vol. 56, No.2, February 2009.]

Introduction

Miller Act¹ plaintiffs are often small subcontractors and suppliers, for whom the costs of litigation may be particularly burdensome. But the Miller Act does not provide a statutory right to recover attorney's fees and costs, and any possibility that the courts might construe the Miller Act to include the recovery of attorney's fees seemed to vanish in 1974, when the Supreme Court issued its ruling in *F.D. Rich Co. v. United States ex. rel. Industrial Lumber Co.*² In *F.D. Rich*, the Court considered an appeal from a Miller Act decision issued by the Ninth Circuit Court of Appeals. The Ninth Circuit had awarded attorney's fees to a Miller Act plaintiff, reasoning that because the Miller Act "was intended to substitute for the unavailable state remedy of the [mechanic's] lien," therefore, "if state [law] allows a supplier on private projects to recover such fees, there is no reason for a different rule to apply to federal projects."³ Because California law entitled a successful mechanic's lien plaintiff to recover its attorney's fees and costs, the Ninth Circuit awarded attorney's fees to the Miller Act plaintiff.⁴

The Supreme Court held that the Ninth Circuit had erred by awarding attorney's fees. The Court wrote that there was no "evidence of congressional intent to incorporate state law to govern such an important element of Miller Act litigation as liability for attorney's fees."⁵ Instead, the Supreme Court held, the "American Rule" of attorney's fees, under which each party typically pays its own fees and costs, applies in Miller Act cases. The court wrote that adopting the American Rule as a "rule of uniform national application" under the Miller Act "avoids many of the pitfalls which have already manifested themselves using state law referents."⁶ The court noted that many federal contracts "involve construction in more than one State," and that parties may have "little or no contract, other than the contract itself, with the State in which the Project is located."⁷ In addition, the "rule of uniform national application" envisioned by the Court would "extricate the federal courts from the morass of trying to divine a 'state policy' as to the award of attorney's fees" when state law was unclear.⁸ The Court reversed the Ninth Circuit's award of attorney's fees.⁹

Citing *F.D. Rich*, a number of courts have rejected attempts by subcontractors and suppliers to recover fees under the Miller Act. For example, in *United States f/u/b/o Vulcan Materials v. Volpe Construction*,¹⁰ the Fifth Circuit upheld the district court's denial of fees to a prevailing Miller Act plaintiff, stating that Florida law "provides no authority for the award of attorney's fees under the Miller Act bond".¹¹

But despite the absence of a fee-shifting provision in the Miller Act, and in spite of *F.D. Rich*, attorney's fees are sometimes awarded to prevailing Miller Act plaintiffs. This article
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Beating Rich (cont'd):

discusses the three main theories upon which prevailing Miller Act plaintiffs recover their attorney's fees: (1) pursuant to contractual fee-shifting provisions; (2) under claims of bad-faith behavior by the general contractor and/or surety; and (3) pursuant to state law, which at least one circuit continues to rely upon to award fees in what it admits to be a "sidestep" of *F.D. Rich*.

A. Recovery of Attorney's Fees Pursuant to Contract

Contractual fee-shifting provisions are a well-recognized exception to the American Rule. In *F.D. Rich*, the Supreme Court noted that the American Rule is not "an absolute bar to the shifting of attorney's fees" and that under the American Rule, fees may be recovered under a "statute or enforceable contract providing therefor."¹² The *F.D. Rich* court, therefore, appeared to contemplate the award of attorney's fees in a Miller Act case pursuant to a contractual fee-shifting provision.

But does a contractual fee-shifting provision square with the language of the Miller Act? After all, the Miller Act surety is supposed to reimburse a plaintiff for the unpaid value of "labor or material" provided to the project.¹³ Would holding a surety liable for attorney's fees impermissibly expand the surety's liability beyond "labor or material"? The courts have answered this question with a resounding "no." Notwithstanding the Miller Act's use of the term "labor or material," courts have routinely required Miller Act sureties to cover attorney's fees and costs where a fee-shifting provision is include in the bond principal's contract with a subcontractor.¹⁴

For example, in *United States ex. rel. Noyes v. Kimberly Constr. Inc.*,¹⁵ the Tenth Circuit awarded a prevailing Miller Act plaintiff its attorney's fees, writing "[a]lthough the Miller Act itself does not provide for attorney's fees, when they are provided for by contract, the fees are routinely awarded and the contract is enforced according to its terms."¹⁶ A number of other circuits have reached similar conclusions.¹⁷

Surprisingly, few courts have addressed how an award fees and costs comport with the Miller Act's language regarding "labor or material." However, an answer is suggested by a Fourth Circuit case, *United States ex rel. Woodington Electric Co. v. United Pacific Insurance Co.*¹⁸ In *Woodington*, a surety was held liable for costs under its principal's profit-sharing provision, even though the costs were not "labor or material." The Fourth Circuit held that the "surety is liable for the subcontract price," and is "obligated to pay the compensation to which the parties have agreed, although this amount exceeds the cost of labor, materials, and overhead."¹⁹ The *Woodington* court's measure of the surety's liability by the subcontract price (regardless of whether the price includes things other than "labor or material") is the most likely rationale for holding a Miller Act surety liable for fees and costs provided for by contract.

Another interesting question arises when a sub-subcontractor or supplier attempts to recover attorney's fees from a Miller Act surety on the basis of a fee-shifting provision in a
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Beating Rich (cont'd):

second-tier subcontract. Under common law suretyship principles, a surety's liability is generally coextensive with that of its principal.²⁰ Under the common law, therefore, one would expect that a Miller Act surety would not be responsible for attorney's fees owed to a sub-subcontractor or supplier by virtue of a fee-shifting provision in a sub-subcontract, because the surety's principal—the general contractor—is not a party to the sub-subcontract and is not liable for the fees.

But the common law of suretyship appears to have been trumped by the Miller Act. Reasoning that attorney's fees are "justly due" under a sub-subcontract containing a fee-shifting provision, a number of courts have held that a sub-subcontractor or supplier can recover attorney's fees from a Miller Act surety on the basis of the fee-shifting provision—even though the general contractor was not a party to the contract. In *United States f/u/b/o Carter Equipment co. v. H.R. Morgan, Inc.*,²¹ the Fifth Circuit held that a supplier was entitled to recover fees pursuant to a fee-shifting provision in its contract with a subcontractor. The court reasoned that fee-shifting provisions are enforceable in Miller Act cases, and that "there appears to be no statutory basis for distinguishing between the recovery allowed to the supplier of a subcontractor and that of a person dealing directly with the general contractor." Several other courts have also permitted a Miller Act supplier to recover attorney's fees pursuant to a fee-shifting provision in the supplier's contract with a subcontractor.²²

It should be noted, however, that when a sub-subcontractor or supplier makes a Miller Act claim, fees cannot be awarded on the basis of a fee-shifting provision contained in the contract between the general contractor and subcontractor. In *United States f/u/b/o American Bank v. C.I.T. Construction, Inc. of Texas*,²³ a supplier brought a Miller Act claim against a general contractor's surety and sued the general contractor in quantum meruit. When the supplier's Miller Act claim was dismissed for failing to meet the one-year limitations period, the general contractor argued that it should be entitled to recover fees because its contract with the subcontractor contained a fee-shifting provision. The court declined to enforce this provision against the supplier, holding that "[t]he contract does not impose liability on any party other than . . . the subcontractor."²⁴ Although the case involved an attempt by a general contractor to recover fees, the court's reasoning strongly suggests that the same result would have occurred had a sub-subcontractor or supplier sought to recover fees based upon a fee-shifting provision in the contract between the general contractor and subcontractor.

Many subcontractors and suppliers will argue that, from a practical perspective, they will generally be unable to negotiate attorney's fees provisions with more powerful higher-tier contractors. In a number of states, one potential way around this problem is state "reciprocal attorney's fees" statutes. Under these statutes, if a contract provides that one party, but not the other, is entitled to a fee recovery if it prevails in litigation, the court is to treat the fee provision as "reciprocal," and award fees to the other party if it prevails.²⁵ Wily subcontractors and suppliers may be able to take advantage of reciprocal attorney's fees statutes by agreeing to unilateral attorney's fees provisions favoring the higher-tier contractor, with the knowledge that the court will treat the provision as bilateral.

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Beating Rich (cont'd):

The effect of a reciprocal attorney's fees statute on a purported unilateral fee agreement in a Miller Act case is demonstrated by the Ninth Circuit's ruling in *United States ex rel. Reed v. Callahan*.²⁶ In *Reed*, the contract between a general contractor and subcontractor provided that the general contractor (but not the subcontractor) was entitled to fees if it prevailed in litigation. Although the subcontractor prevailed in the district court, the court relied upon the contractual clause to deny the subcontractor its attorney's fees. The Ninth Circuit reversed. It held that California law "converts a one-way attorneys' fees clause into a two-way avenue of opportunity" and that the statute applies "no matter how unilateral the wording of the contract."²⁷ Under the law, "the fact that the subcontract expressly limits the availability of fees to the contractor is of no effect."²⁸ The Ninth Circuit remanded to the district court with an order to award fees to the prevailing subcontractor.

Obviously, before agreeing to a unilateral attorney's fee provision, a subcontractor or supplier should be absolutely sure that the applicable state law provides for reciprocity. Subcontractors and suppliers should be aware that some state statutes *require* courts to treat attorney's fees provisions as reciprocal, while others merely *permit* courts to deem a unilateral fee provision to be reciprocal.²⁹ Nevertheless, the fact remains that in true "reciprocal" attorney's fees jurisdictions, a subcontractor or supplier who wishes to preserve the ability to recover fees on its Miller Act claim would be well-served to accept a purportedly "unilateral" fee provision. After all, as several California courts have written, reciprocal attorney's fees statutes have been adopted to protect those, who—like many subcontractors and suppliers—"may be in a disadvantageous bargaining position."³⁰

B. Recovery of Attorney's Fees Because of Bad Faith

Although a fee-shifting provision is the most effective way for a subcontractor or supplier to recover fees in a Miller Act case, the practical reality is that fee-shifting provisions will not always be available to Miller Act plaintiffs. In many cases, the higher-tier contractor is in a stronger bargaining position and will refuse to permit a subcontractor or supplier to include a reciprocal fee-shifting provision in the contract. Many states do not offer the reciprocal attorney's fees provisions described above, and even in those that do, a higher-tier contractor may not be so easily lured into accepting a purported "unilateral" fee provision. But even in the absence of a fee-shifting provision, there are at least two potential avenues for a Miller Act subcontractor or supplier to recover fees. One of these is the "bad faith exception" to the American Rule.

The bad faith exception is exactly what its name suggests: an exception to the American Rule, allowing for the prevailing party to recover its attorney's fees when the other party has acted in bad faith. Several courts have applied the bad faith exception to permit a subcontractor or supplier to recover attorney's fees in Miller Act cases. For example, in *Horst Masonry Construction, Inc. v. ProControls Corp.*,³¹ the Eighth Circuit upheld a district court decision awarding attorneys fees to the subcontractor where (1) the surety failed to properly investigate the claim; and (2) the general contractor and the surety defended the Miller Act claim using a

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Beating Rich (cont'd):

recoupment defense they knew to be without merit. Similarly, in *United States f/u/b/o Treat Brothers Co. v. Fidelity & Deposit Co.*,³² the Seventh Circuit upheld the district court's award of attorney's fees to a subcontractor where the general contractor had imposed groundless back charges and unrealistic estimates for incomplete work in a bad faith effort to avoid liability.

Unfortunately for subcontractors and suppliers, several courts have placed an important limit the bad faith exception, holding that it applies only to bad faith conduct occurring during litigation, not to actions taken before litigation began. *Towerridge, Inc. v. T.A.O., Inc.*³³ is typical of decisions refusing to award attorney's fees on the basis of alleged pre-litigation bad faith. In *Towerridge*, the district court found that the general contractor had acted in bad faith during the course of the project, and awarded the subcontractor attorney's fees. The Tenth Circuit reversed. It found that the bad faith exception had been created to sanction abuses of the judicial process, not punish conduct occurring before the litigation commenced. The court wrote that were attorney's fees to be awarded on the basis of pre-litigation conduct, the bad faith exception "risks swallowing" the American Rule.³⁴ The *Towerridge* decision concurs with the Fifth Circuit's earlier ruling in *Tacon Mechanical Contractors, Inc. v. Aetna Casualty & Surety Co.*³⁵ In *Tacon*, as in *Towerridge*, the court refused to award attorney's fees for alleged bad faith conduct that occurred before litigation, stating that the court's ability to award attorneys' fees stems "not from any substantive provision of the Miller Act" but from the court's "inherent power to sanction abusive and egregious behavior by a litigant."³⁶

The Sixth Circuit, however, has rejected the argument that pre-litigation conduct cannot form the basis of an award of attorney's fees. In *Yonker Construction Co. v. Western Contracting Corp.*,³⁷ the court held that pre-litigation conduct could form the basis of a fee award in a Miller Act case. The argument that fees should only apply to postlitigation conduct "is meritless," the court wrote.³⁸ "Bad faith may occur during either contract performance or litigation."³⁹ The court upheld an award of attorney's fees based on a jury's finding that the general contractor had acted in bad faith during the performance of the contract.⁴⁰

Subcontractors and suppliers considering a bad faith claim for attorney's fees should determine whether their jurisdiction permits claims based upon pre-litigation conduct. If not, all is not necessarily lost, as the line between pre-litigation conduct and conduct occurring during litigation is not always a bright one. In *Towerridge*, the Tenth Circuit withheld judgment on whether a bad faith claim may rely on both pre-litigation conduct and conduct occurring during the litigation, writing "we merely hold the award of fees may not be premised solely upon prelitigation abusive conduct."⁴¹ Artful pleading, together with the court's desire to do equity, may enable a subcontractor or supplier to cast its bad faith claim as not being "solely" based upon pre-litigation conduct. For example, if a surety, acting in bad faith, fails to properly investigate a claim, the pleadings subsequently filed by the surety may rely upon the improper investigation to defend the claim. By knowingly imposing defenses based on a bad faith investigation, the surety arguably again acts in bad faith, this time during the course of the litigation.

C. Recovery of Attorney's Fees Under State Law

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The Supreme Court's ruling in *F.D. Rich* seemed to be the last word on whether state law could form the basis of an attorney's fee award in a Miller Act case. In reversing a Ninth Circuit decision awarding fees based upon California law, the *F.D. Rich* court touted the importance of a "rule of uniform national application."⁴² But in one circuit, more than 35 years after *F.D. Rich*, state law remains a fertile basis for the recovery of attorney's fees in Miller Act cases, and other courts may be inclined to follow that court's lead.

The Fifth Circuit has interpreted *F.D. Rich* merely as precluding the award of attorney's fees under the Miller Act itself, but not as prohibiting the award of attorney's fees to a Miller Act plaintiff when the fees are awarded pursuant to a supplemental state law claim. According to the Fifth Circuit, the *F.D. Rich* court "announced only that Miller Act claims do not incorporate state law remedies such as attorney's fees; it did not read the Act to preclude the pursuit of state causes of action for fees in addition to Miller Act claims."⁴³ The Fifth Circuit has acknowledged that its holdings may circumvent the spirit of the *F.D. Rich* ruling, writing that "[a]dmittedly, in many Miller Act cases supplemental jurisdiction offers a neat sidestep to the broad policy statements of *F.D. Rich*." However, the court held that "the sidestep is available . . . because Congress has by separate statute . . . made possible simultaneous prosecution of Miller Act and state law claims."⁴⁴

The Fifth Circuit's ruling in *United States ex rel. Cal's A/C & Electric v. Famous Constr. Corp.*⁴⁵ is one of several cases in which the court awarded attorney's fees to a Miller Act plaintiff by relying on the plaintiff's state law claim. In *Cal's A/C & Electric*, a subcontractor, concurrently with its Miller Act claim, brought a state law claim for breach of Louisiana's Prompt Payment Act. Under the Louisiana Prompt Payment Act, a subcontractor or supplier can recover fees where payment is withheld for more than 14 days without reasonable cause.⁴⁶ The District Court held that the Miller Act precluded supplemental jurisdiction over the state law claim for fees. The Fifth Circuit reversed, holding that "*F.D. Rich* did not preclude state-based actions for attorney's fees to accompany Miller Act claims."⁴⁷

The Fifth Circuit's willingness to allow supplemental state law claims for attorney's fees is subject to an important limitation: the fees are only recoverable against the general contractor, not the Miller Act surety. In *United States f/u/b/o Howell Crane Service v. U.S. Fidelity & Guaranty Co.*,⁴⁸ relying on a Texas statute providing for attorney's fees in contract actions, the district court held that a Miller Act plaintiff was entitled to an award of fees against both the general contractor and the Miller Act surety. The Fifth Circuit reversed in part, holding that the fees could not be recovered against the surety. Citing *F.D. Rich*, the court wrote: "USF&G's only involvement with Howell was its Miller Act bond. No state law claim was asserted by Howell against USF&G. Thus, there is no basis for a pendant jurisdiction award" of attorney's fees against the surety.⁴⁹ The *Cal's Electric* court reached the same conclusion, holding that the subcontractor could recover its fees from the general contractor, but not from the surety.⁵⁰

Will courts other than the Fifth Circuit permit Miller Act plaintiffs to recover fees for supplemental state law claims? The Ninth Circuit has strongly suggested that it would follow the Fifth Circuit's lead. In *United States ex rel. Leno v. Summit Construction Co.*,⁵¹ the court declined to permit a plaintiff to recover its fees, noting that "the district court found only Miller Act jurisdiction" over the plaintiff's claims.⁵² However, the court wrote that "unless there is a
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Beating Rich (cont'd):

separate state claim at the trial level," attorney's fees are not available to a Miller Act plaintiff—suggesting that if there had been a separate claim, attorney's fees would have been awardable. This view appears to have been confirmed in *Tapat v. Sandwich Islands Construction, Ltd.* In *Tapat*,⁵³ the Ninth Circuit refused to permit a Miller Act plaintiff to recover fees for its claim, but applied a Hawaii statute to allow the plaintiff to recover fees incurred in successfully defending the general contractor's counterclaim, writing that "[b]ecause the district court assumed pendent jurisdiction over the counterclaim, state law governs the availability of attorney's fees."⁵⁴

Maine's District Court has issued a decision suggesting that it may not be open to awarding attorney's fees under supplemental state law claims in Miller Act cases. In *United States ex rel. Great Wall Construction, Inc. v. Mattie & O'Brien Mechanical Contracting Co.*,⁵⁵ the Miller Act plaintiff argued that under a state unfair settlement practices statute, it was entitled to attorney's fees because the surety had unfairly refused to settle the claim. The court rejected the claim, finding that it was "an attempted expansion of the Miller Act remedy in the exact manner than *F.D. Rich* forbids . . ." The court wrote that state law claims should proceed in Miller Act cases "only when those claims are not used to expand the Miller Act remedies."⁵⁶

To the extent that *Mattie & O'Brien* is read as prohibiting supplemental state law claims for attorney's fees against Miller Act sureties (rather than against general contractors), it is in harmony with the Fifth Circuit decisions. But the *Mattie & O'Brien* court went further, writing that the plaintiff did not assert an "additional and separate claim" and did "not seek any substantive relief under Maine law."⁵⁷ The notion that the plaintiff did not seek substantive relief under state law does not comport with the language of the applicable state statute, which expressly provides that a person whose insurer unfairly refuses to settle a claim "may bring a civil action and recover damages, together with costs and disbursements, reasonable attorney's fees and interest . . ."⁵⁸ In the face of this clear statutory right, the court's refusal to consider the plaintiff's state law request as one for substantive relief may reflect the court's opinion that state law claims ought not to be "tacked on" to Miller Act claims for the sole purpose of seeking attorney's fees. If this is the case, a supplemental state law claim for fees may not be successful in a Miller Act case in Maine, even against a general contractor.

A final notable case regarding state law claims for attorney's fees under the Miller Act is the Western District of Louisiana's opinion in *United States ex rel. Cal's A/C & Electric v. The Famous Construction Corp.*⁵⁹ In that case, the court held that the 1988 amendments to the Prompt Payment Act,⁶⁰ effectively superseded *F.D. Rich*. The applicable section of the Prompt Payment Act provides that it "shall not limit or impair" any remedies otherwise available to a contractor or subcontractor involved in a dispute over late payment or nonpayment.⁶¹ The court found that the language "shall not limit or impair" applied not only to Prompt Payment claims, but also the Miller Act. Accordingly, the *F.D. Rich* decision, which was a "limit" or "impairment" of the right to seek state remedies, was no longer good law.

On appeal, however, the Fifth Circuit overruled the district court's decision. Although

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Beating *Rich* (cont'd):

the Fifth Circuit allowed the subcontractor to recover attorney's fees on a supplemental state law claim, as described above, it held that "[t]his result is not, however, mandated by the Prompt Payment Act Amendments of 1988."⁶² The court explained that "the text [of the 1988 amendments] plainly limits itself to one particular section of the Prompt Payment Act. Any bars to additional remedies erected by the Miller Act are left untouched . . ."⁶³ The Ninth Circuit has also rejected the Western District of Louisiana's holding. In *Didomenico v. North American Construction Corp.*,⁶⁴ the Ninth Circuit denied a Miller Act plaintiff's claim for attorney's fees, holding that the "plaint language" of the 1998 amendments to the Prompt Payment Act "does not incorporate state law remedies into the Prompt Payment Act or Miller Act as Miller Act remedies that can be recovered from the surety or Miller Act bond."⁶⁵

The interpretation of Section 3905(j) of the Prompt Payment Act offered by the Fifth and Ninth Circuits will likely prove persuasive to other courts to decide the issue. Nevertheless, the Western District of Louisiana's decision in *Cal's A/C & Electric* may provide a subcontractor or supplier in another jurisdiction an additional argument in favor of an attorney's fees award, albeit an argument whose odds of success are likely very long.

For Miller Act plaintiffs, state law may offer an alternative means of recovering attorney's fees. A Miller Act plaintiff considering seeking fees under state law should (1) carefully plead its claim for fees under state law as separate and independent of its Miller Act claim; (2) bring its claim for fees against the general contractor, not the surety; and (3) ask the federal court to assert supplemental jurisdiction over the claim under 28 U.S.C. §1367. In addition, recalling *Tapat*, Miller Act plaintiffs should also be aware that state law may entitle them to recover fees accrued in defending any counterclaim filed by the defendants.

Conclusion

Even after *F.D. Rich*, creative Miller Act plaintiffs still have at least three potential ways of recovering their attorney's fees and costs. First, if costs and fees are provided for by contract, they are recoverable under the Miller Act, even though they are not for "labor" or "material." Suppliers can recover fees from the Miller Act surety based upon a provision in their contract with a subcontractor, even though the general contractor was not a party to the subcontract. And in some jurisdictions, a subcontractor or supplier may be able to recover fees under a purportedly "unilateral" fee provision pursuant to a state reciprocal attorney's fees statute.

Second, attorney's fees are recoverable when the general contractor or surety has acted in bad faith. In some jurisdictions, allegations of bad faith are limited to the defendants' actions in defending the Miller Act claim. But in others, the general contractor's pre-litigation bad faith can also entitle a Miller Act plaintiff to recover attorney's fees. Even where the jurisdiction does not permit claims based upon pre-litigation bad faith, the line between "pre-litigation" and "during litigation" may not be clear.

Third, despite *F.D. Rich*, attorney's fees may be recoverable pursuant to state law. In

Beating Rich (cont'd):

jurisdictions where such claims have been successful, the plaintiff has "sidestepped" *F.D. Rich* by bringing its attorney's fees claim as a supplemental state law claim against the general contractor, not the surety. Plaintiffs bringing supplemental state law claims must carefully plead their cause of action as separate and independent of the Miller Act.

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- - Steven J. Koprince is an attorney with Piliero Mazza PLLC in Washington, D.C. He welcomes questions and comments about this article to skoprince@pilieromazza.com.
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Endnotes

- 1 - See 40 U.S.C. §3133(b)(1).
 - 2 - *F.D. Rich Co. v. United States ex. rel. Indus. Lumber Co.*, 417 U.S. 116 (1974).
 - 3 - *United States ex rel. Indus. Lumber Co. v. F.D. Rich Co.*, 473 F.2d 720, 727 (9th Cir. 1973).
 - 4 - *Id.* The Ninth Circuit's ruling was consistent with earlier decisions of the Fifth and Tenth Circuits, both of which had held that attorney's fees could be awarded under the Miller Act if attorney's fees were available under applicable state law. See, e.g., *Arnold v. United States f/u/b/o Bowman Mech. Contractors, Inc.*, 470 F.2d 243 (10th Cir. 1972).
 - 5 - *F.D. Rich Co.*, 417 U.S. at 127.
 - 6 - *Id.*
 - 7 - *Id.*
 - 8 - *Id.* at 128.
 - 9 - *Id.* at 131.
 - 10 - *United States f/u/b/o Volpe Constr.*, 622 F.2d 880 (5th Cir. 1980).
 - 11 - *Id.* at 887.
 - 12 - *F.D. Rich Co.*, 417 U.S. at 126 & 129.
 - 13 - 40 U.S.C. §3133(b)(1).
 - 14 - Although this article focuses on the ability of a successful Miller Act plaintiff to recover attorney's fees, it should be noted that fee-shifting provisions can also allow Miller Act defendants to recover their fees. See, e.g., *United States ex rel. U.S. Prefab, Inc. v. Norquay Constr., Inc.*, 2008 WL 2026360 (D.Ariz. 2008) (where parties' contract contained a fee-shifting clause, general contractor and surety who successfully defended Miller Act claim were entitled to a fee award).
 - 15 - *United States ex. rel. Noyes v. Kimberly Constr. Inc.*, 43 Fed. Appx. 283 (10th Cir. 2002) (internal citations omitted).
 - 16 - *Id.* at 288.
 - 17 - See *Drill South, Inc. v. Int'l Fidelity Ins. Co.*, 234 F.3d 1232 (11th Cir. 2000) (awarding successful Miller Act plaintiff its attorneys' fees pursuant to a contractual provision); *GE Supply v. C&G Enters., Inc.*, 212 F.3d 14 (1st Cir. 2000) (awarding attorney's fees to Miller Act plaintiff where plaintiff's invoices contained a fee-shifting provision); *United States f/u/b/o Micro-King Co. v. Community Science Tech. Inc.*, 574 F.2d 1292 (5th Cir. 1978) (awarding attorney's fees pursuant to contractual fee-shifting provision), *D&L Constr. Co. v. Triangle Elec. Supply Co.*, 332 F.2d 1009 (8th Cir. 1964) (similar).
 - 18 - *United States ex rel. Woodington Elec. Co. v. United Pacific Ins. Co.*, 545 F.2d 1381 (4th Cir. 1976).
 - 19 - *Id.* at 1383.
 - 20 - RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY, §§ 19 & 34; see also Philip L. Bruner & Patrick J. O'Connor, Jr., 3 BRUNER & O'CONNOR ON CONSTRUCTION LAW § 8:50 ("It is a fundamental principle of suretyship that the surety, as the secondary obligor, is liable to the obligee to no greater extent than that of the principal obligor. Stated another way, the surety is entitled to assert against the obligee all the defenses, with the exception of personal defenses such as insolvency, that its principal possesses.")
 - 21 - *United States f/u/b/o Carter Equip. Co. v. H.R. Morgan, Inc.*, 554 F.2d 164 (5th Cir. 1977).
- (continued on next page)

Beating Rich (cont'd):

- 22 - See, e.g., *United States ex rel. Maddux Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 86 F.3d 332 (4th Cir. 1996) and *United States ex rel. Southeastern Municipal Supply Co., Inc. v. Nat'l Union Fire Ins. Co.*, 876 F.2d 92 (11th Cir. 1989); *United States f/u/b/o Capps v. Fidelity and Deposit Co. of Maryland*, 875 F.Supp. 803 (M.D. Ala. 1995), and *United States ex rel. Casa Redimix Concrete Corp. v. Luvin Constr. Corp.*, 2001 WL 506227 (S.D.N.Y. 2001).
- 23 - *United States f/u/b/o Am. Bank v. C.I.T. Constr., Inc. of Texas*, 944 F.2d 253 (5th Cir 1991).
- 24 - *Id.* at 256.
- 25 - See, e.g., CAL. CIV. CODE § 1717 and MONT. CODE ANN. § 28-3-704.
- 26 - *United States ex rel. Reed v. Callahan*, 884 F.2d 1180 (9th Cir. 1989).
- 27 - *Id.* at 1185.
- 28 - *Id.*
- 29 - Compare CAL. CIV. CODE § 1717 (requiring courts to treat unilateral fee provisions as reciprocal) with FLA. STAT. ANN. § 57.105(7) (permitting courts to treat unilateral fee provisions as reciprocal).
- 30 - *Int'l Billing Servs., Inc. v. Emigh*, 101 Cal.Rptr.2d 532, 540 (Cal. Ct. App. 2000), citing *Coast Bank v. Holmes*, 97 Cal. Rptr. 30, 39 (Cal. Ct. App. 1971).
- 31 - *Horst Masonry Constr., Inc. v. ProControls Corp.*, 208 F.3d 218 (8th Cir. 2000).
- 32 - *United States f/u/b/o Treat Bros. Co. v. Fid. & Deposit Co.*, 986 F.2d 1110 (7th Cir. 1993).
- 33 - *Towerridge, Inc. v. T.A.O., Inc.*, 111 F.3d 758 (10th Cir. 1997).
- 34 - *Id.* at 769.
- 35 - *Tacon Mech. Contractors, Inc. v. Aetna Cas. & Sur. Co.*, 65 F.3d 486 (5th Cir. 1995).
- 36 - *Id.* at 489.
- 37 - *Yonker Constr. Co. v. Western Contracting Corp.*, 935 F.2d 936 (6th Cir. 1991).
- 38 - *Id.* at 942.
- 39 - *Id.*
- 40 - *Id.* at 943.
- 41 - *Towerridge*, 111 F.3d at 767, n.6 (emphasis in original).
- 42 - *F.D. Rich Co. v. United States ex. rel. Indus. Lumber Co.*, 417 U.S. 116, 127 (1974).
- 43 - *United States ex rel. Cal's A/C & Elec. v. Famous Constr. Corp.*, 220 F.3d 326, 327 (5th Cir. 2000) (emphasis in original).
- 44 - *United States f/u/b/o Varco Pruden Bldgs. v. Reid & Gary Strickland Co.*, 161 F.3d 915, 919 (5th Cir. 1998).
- 45 - *Cal's A/C & Elec.*, 220 F.3d at 326.
- 46 - LA. REV. STAT ANN. § 9:2784(C).
- 47 - *Cal's A/C & Elec.*, 220 F.3d at 328.
- 48 - *United States f/u/b/o Howell Crane Serv. v. U.S. Fidelity & Guar. Co.*, 861 F.2d 110 (5th Cir. 1988).
- 49 - *Id.* at 113.
- 50 - *Cal's A/C & Elec.*, 220 F.3d at 329.
- 51 - *United States ex rel. Leno v. Summit Constr. Co.*, 892 F.2d 788 (9th Cir. 1989).
- 52 - *Id.* at 791.
- 53 - *Tapat v. Sandwich Islands Constr., Ltd.*, 942 F.2d 794 (9th Cir. 1991).
- 54 - *Id.* at *1.
- 55 - *United States ex rel. Great Wall Constr., Inc. v. Mattie & O'Brien Mech. Contracting Co.*, 2001 WL 127663 (D.Me. 2001).
- 56 - *Id.* at *2.
- 57 - *Id.*
- 58 - ME. REV. STAT. ANN. 24-A § 2436-A.
- 59 - *United States ex rel. Cal's A/C & Elec. v. The Famous Constr. Corp.*, 34 F.Supp.2d 1042 (W.D. La. 1999).
- 60 - 31 U.S.C. § 3905(j).
- 61 - *Id.*
- 62 - *United States ex rel. Cal's A/C & Elec. v. Famous Constr. Corp.*, 220 F.3d 326, 328 (5th Cir. 2000).
- 63 - *Id.*
- 64 - *Didomenico v. N. Am. Constr. Corp.*, 94 Fed.Appx. 598 (2004).
- 65 - *Id.* at 599-600. The Massachusetts District Court has also rejected the decision issued by the Western District of Louisiana, holding that the 1988 amendments to the Prompt Payment Act "in no way limits the holding of *F.D. Rich.*" *United States ex rel. Metric Elec., Inc. v. Enviroserve, Inc.*, 301 F.Supp.2d 56, 73 n. 10 (D. Mass. 2003).

Defense Contract Audit Agency Shines Spotlight on Lobbying Costs

by
Christopher C. Bouquet*

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In recent years, scrutiny of special interest lobbying of Congress has become fashionable. Despite the old adage that "there are two things you don't want to see being made—sausage and legislation,"¹ the media, government watchdog organizations, and some politicians seem determined to shine a spotlight on this process.² These groups appear particularly concerned about legislative "earmarking," the process by which legislators insert language in funding bills or reports that curtails the ability of the executive branch to control critical aspects of the funds allocation process.³ For government contracts, earmarks typically direct a specified amount of money to a particular contractor or project in a legislator's home state or district. The critics complain that by circumventing established merit- based or competitive funding allocation processes, such earmarks serve special interests and not the public interest. One critic has even alleged that earmarks for contracts associated with the war on terror have damaged national security.⁴ It appears that the election of President Obama will not change the trend towards increased scrutiny of lobbying. Indeed, he has promised to "shine the light on Washington lobbying."⁵

The various laws and regulations that govern the enterprise of lobbying the government fall into three broad categories: 1) rules requiring public disclosure of lobbying activities⁶; 2) rules governing the tax deductibility of lobbying costs⁷; and 3) government contracting rules governing accounting for the costs of lobbying.⁸ Not surprisingly, the recent scrutiny of special interest lobbying in the "public square" has led to increased auditing of contractor compliance with these rules. Indeed, the Defense Contract Audit Agency (DCAA) has recently stepped up its auditing of contractors' compliance with the lobbying cost accounting rules. To assist contractors' preparations to withstand such audits, this article provides an overview of the lobbying cost accounting rules and discusses a DCAA audit alert issued last year that instructs auditors to pay special attention to contractors' accounting for the costs of lobbying for earmarks.

Overview of the Lobbying Cost Accounting Rules

There are two major sets of government contracting rules applicable to accounting for lobbying costs: 1) the so called "Byrd Amendment" rules governing accounting for the funds used to pay for lobbying for government contract awards,⁹ and 2) the principles set forth in Federal Acquisition Regulation (FAR) Part 31 concerning accounting for lobbying costs (the "cost principles").¹⁰

The Byrd Amendment Rules

The Byrd Amendment rules prohibit recipients of appropriated federal funds from using those funds to pay persons or organizations to lobby Congress or an executive agency in
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connection with the award, extension, or modification of a contract, grant, or other funding instrument (“covered federal action”).¹¹ The Byrd Amendment rules require contractors to track separately and to pay for the costs of covered lobbying activities out of funds that are not considered “federal.” The implementing regulations, however, specify that profits and fees from government contracts are not considered federal funds and may be used to pay for covered lobbying.¹² Moreover, as long as a contractor can demonstrate that it has sufficient funds, other than federal funds, to cover the costs of its lobbying, there is a presumption that the contractor used these other monies.¹³

The Byrd Amendment rules are far-reaching. In particular:

- They preclude the use of federal funds to pay for the making, with the intent to influence, of any communication to or appearance before an officer or employee of any executive agency, a member of Congress, an officer or employee of Congress, or an employee of a member of Congress in connection with any covered federal action.¹⁴
 - While there is no definition in the rules, the “making” of a communication arguably includes activities preparatory to the communication, such as the preparation of position papers and presentation slides, and follow-up activities, such as the development of conference notes or debriefings of individuals who were not in attendance at a meeting.
 - The rules cover not only the costs of activities of outside consultants and lobbyists, but also cover the costs of efforts by a contractor’s officers, directors, or employees to influence a transaction.¹⁵
 - The rules cover the costs of activities to influence the earmarking of funds for specific covered federal actions.¹⁶

The Byrd Amendment prohibitions do not apply to reasonable compensation paid to employees of the contractor for providing information specifically requested by Congress or an agency, or for agency and legislative liaison activities not directly related to a covered federal action, such as holding discussions with an agency regarding product capabilities, or adaptation of products for particular uses, that occur prior to the issuance of a solicitation.¹⁷ The Act also does not prohibit using appropriated funds to pay persons, including consultants, for “professional and technical services” provided directly in connection with the preparation, submission, or negotiation of any proposal for an award or for meeting requirements of the law pertaining to the award. Such services are limited to advice and analysis directly applying a professional or technical discipline to the proposal effort. If the services involve lobbying, then their costs are not allowable.¹⁸

Solicitations for contracts expected to exceed \$100,000 in value include FAR provisions stating that, by signing or submitting its offer, the contractor is certifying that, to the best of its knowledge and belief, no federal appropriated funds have been paid or will be paid for covered lobbying activities in connection with the contract.¹⁹ Prime contractors and subcontractors must obtain this certification from subcontractors that will receive subcontracts expected to exceed \$100,000 in value.²⁰ Moreover, all prime government contracts expected to exceed this amount include FAR provisions requiring compliance with the Byrd Amendment rules during the term
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DCAA Shines Spotlight on Lobbying Costs (cont'd):

of the contract, including the rules prohibiting use of federal funds to influence the extension or other modification of the contract.²¹ These provisions must be flowed down to subcontracts exceeding \$100,000 in value at all tiers.²²

To meet the requirement to demonstrate that they have sufficient funds, other than appropriated federal funds, to cover the costs of their lobbying activities, contractors must identify and segregate these costs. Moreover, the costs must be excluded from contractor invoices under cost-reimbursable-type contracts or other claims for payment based on costs incurred. Such costs must also be excluded from cost estimates used to develop or support proposed prices for fixed-price contracts. In other words, the costs of covered lobbying activities must be treated as “unallowable costs” under government contracts. If they are not treated in this manner, then contractors will be vulnerable to allegations that federal funds were, in fact, used to pay for the costs in violation of the Byrd Amendment rules. Failure to comply with the Byrd Amendment rules can lead to significant legal liability. Under the Act, civil penalties between \$10,000 and \$100,000 may be imposed for each violation.²³ Moreover, contractors that are not compliant with the Byrd Amendment rules risk significant liability under the False Statements and False Claims Acts simply by submitting their proposals, because each such submission carries with it a certification of compliance with the rules.²⁴

The Cost Principles

The principles in FAR Part 31 govern the allowability (i.e., recoverability) of costs under cost-reimbursement-type contracts.²⁵ They are also used in the pricing of fixed-price contracts when (a) the procurement involves government analysis of estimated costs submitted by the contractor in support of the reasonableness of the fixed price, or (b) a contract clause requires the determination or negotiation of costs (e.g., when the fixed price is redetermined during or after performance based on costs incurred).²⁶ When a cost is unallowable under FAR Part 31, its “directly associated” costs are also unallowable. In this context, a directly associated cost is any cost that a contractor incurs solely as a result of incurring an unallowable cost, and that would not have been incurred had the unallowable cost not been incurred.²⁷

The cost principles make unallowable the costs of lobbying concerning the introduction, enactment, or modification of federal, state, or local legislation on any topic, including program earmarks, taxes, environmental regulations, and particular government contract awards.²⁸ Under the cost principles, the costs of legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when carried on in preparation for or support of lobbying for legislation, are also unallowable.²⁹ There are exceptions to the cost principles on lobbying costs. In particular, costs of the following activities are allowable if they are reasonable:

- providing to the Congress or a state legislature certain technical and factual presentations on topics directly related to the performance of a contract in response to a documented request;
- state/local legislative lobbying to directly reduce contract costs or to avoid material impairment of the contractor’s ability to perform the contract; and

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DCAA Shines Spotlight on Lobbying Costs (cont'd):

- any activity specifically authorized by statute to be undertaken with funds from the contract.³⁰

As with the Byrd Amendment rules, failure to comply with the cost principles can lead to significant legal liability. Inclusion of unallowable costs in proposals or claims can result in the imposition of administrative penalties under the FAR.³¹ Moreover, contractors that are not compliant with the cost principles risk significant liability under the False Statements and False Claims Acts simply by submitting their proposals or invoices because each such submission might be considered to include a material falsity, i.e., a claim of entitlement to payment of amounts that are not recoverable under the regulations.³²

Some lobbying costs that are unallowable under the Byrd Amendment rules, such as lobbying for earmarks for specific covered federal actions in legislation, are also unallowable under the cost principles on lobbying costs. In addition, some lobbying costs that are unallowable under the Byrd Amendment rules, such as the costs of lobbying that strictly concerns executive branch decision making on contracting actions, are not made unallowable by the cost principles. Furthermore, some lobbying costs that are not made unallowable by the Byrd Amendment rules, such as lobbying concerning tax laws, are unallowable under the cost principles. Compliance with both sets of rules requires design and implementation of a comprehensive internal control system that identifies and segregates unallowable lobbying costs and directly associated costs. A key task in implementing such a system is the inclusion in all lobbying and consulting agreements of provisions requiring the maintenance of adequate records concerning the amount of effort spent on unallowable lobbying activities in each month that the lobbyist or consultant does any work for the company, in relation to the total effort spent by the lobbyist or consultant on all company activities in that month. It also requires training and educating of employees to identify and separately record the time they spend on lobbying activities covered by the rules.

The DCAA Audit Alert

As mentioned above, DCAA has increased its scrutiny of contractors' compliance with the lobbying cost accounting rules. Indeed, on April 24, 2008, DCAA's assistant director of policy and plans issued an audit alert instructing auditors to pay special attention to contractors' accounting for the costs of lobbying for earmarks.³³ The audit alert instructs auditors, as part of routine audits of contractor costs, to review certain databases that identify recipients of earmarks. If the auditors find a "significant" earmark to the contractor, auditors are to make inquiries to the contractor to determine the procedures the contractor uses to identify and collect the costs related to pursuing earmarks.

DCAA's inquiries are to include interviews with "responsible contractor personnel to ascertain the nature and extent of effort provided to support the identified earmark."³⁴ According to the audit alert, DCAA is interested in determining whether contractor effort to support lobbying for earmarks extends beyond company lobbyists and executives to include program management, contracting, public relations, consultants, and technical personnel. If the effort extends to a larger group, DCAA will want to determine whether everyone is recording time to an unallowable charge code. In addition, DCAA will scrutinize costs that are
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DCAA Shines Spotlight on Lobbying Costs (cont'd):

“directly associated” with unallowable lobbying costs, e.g., travel and meeting expenses. The audit alert states that “many significant earmarks . . . require contracting personnel to attend meetings with congressional members or their staff to pursue earmark funding.”³⁵ Thus, contractors should expect more questions about the purpose of travel to government facilities, especially those that are in the Washington, D.C., area. The audit alert states that additional guidance addressing audits of earmarks will be issued in the “near future.”

Conclusion

Through its stepped-up auditing activities, including the recently issued audit alert, DCAA is shining a spotlight on contractors’ lobbying costs. Contractors should prepare themselves to withstand DCAA audits of such costs by designing and implementing robust internal control systems that identify and segregate unallowable lobbying costs and directly associated costs.

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Endnotes

1. This adage has been attributed to German Chancellor Otto Von Bismark (1815-1898). *See, e.g.*, Alan Rosenthal, *The Legislature as Sausage Factory: It’s About Time We Examine This Metaphor*, AM. POL. SCI. ASS’N LEGIS. STUD. SEC. NEWSL., Vol. 25, No. 1 (Jan. 2002) at www.apsanet.org/~lss/Newsletter/Jan02/sausage.htm.
2. *See, e.g.*, Marilyn W. Thompson and Ron Nixon, *Even Cut 50 Percent, Earmarks Clog Military Bill*, N.Y. TIMES, (Nov. 4, 2007) at <http://www.nytimes.com/2007/11/04/washington/04earmarks.html>; Citizens Against Government Waste, 2008 CONGRESSIONAL PIG BOOK SUMMARY at www.cagw.org; John McCain 2008, “Ethics Reform” at www.johnmccain.com/Informing/issues/.
3. *See* Office of Management and Budget, “OMB Guidance to Agencies on Definition of Earmarks” at http://earmarks.omb.gov/earmarks_definition.html.
4. Eric Eglad, *Earmark Folly: Damaging U.S. National Security*, WASH. TIMES (July 2, 2008) at www.washingtontimes.com/news/2008/jul/02/earmark-folly.
5. “Plan to Change Washington” at <http://www.barackobama.com/issues/ethics/>.
6. *See, e.g.*, Lobbying Disclosure Act as amended by the Honest Leadership and Open Government Act of 2007, 2 U.S.C. §§1601 *et seq.* (Cornell Univ. Law School, Legal Information Institution through 2008).
7. *See, e.g.*, 26 U.S.C. §162(e).
8. *See, e.g.*, 31 U.S.C. §1352; 48 C.F.R. §52.203-12 (2008); 48 C.F.R. §31.205-22.
9. 31 U.S.C. §1352; 48 C.F.R. §52.203-12. These rules also mandate that contractors make certain disclosures of lobbying contacts.
10. 48 C.F.R. §31.205-22.
11. 31 U.S.C. §1352(a)(1); 48 C.F.R. §52.203-12(b).
12. 48 C.F.R. §52.203-12(b)(1).
13. *Id.* at §52.203-12(b)(2).
14. *Id.* at §52.203-12(a) and (b).
15. *Id.*
16. *See* 55 Fed. Reg. 24,540 (June 15, 1990).
17. 48 C.F.R. §52.203-12(c)(1).
18. *Id.* at §52.203-12(c)(2).
19. 48 C.F.R. §3.808(a); 48 C.F.R. §52.203-11; 48 C.F.R. §52.212-3(e).
20. 48 C.F.R. §52.203-12(g).

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Endnotes (cont'd)

21. 48 C.F.R. §3.808(b); 48 C.F.R §52.203-12; 48 C.F.R §52.212-4(r).
22. 48 C.F.R. §52.203-12(g). FAR §52.203-12 is not listed in FAR §52.244-6, Subcontracts for Commercial Items, or FAR §52.212-5(e), Terms and Conditions Required to Implement Statutes or Executive Orders Commercial Items, as a mandatory flow-down to subcontracts for “commercial items.” However, it should nonetheless be flowed down to all subcontracts exceeding \$100,000 because the statute applies to all such subcontracts.
23. 31 U.S.C. §1352(c).
24. 18 U.S.C. §287; 18 U.S.C. §1001; 31 U.S.C. §§3729 *et seq.*
25. 48 C.F.R. §31.103(b)(1).
26. 48 C.F.R. §31.102.
27. 48 C.F.R. §31.201-6.
28. 48 C.F.R. §31.205-22(a)(3). FAR §31.205-22(a)(1), (2), (4) and (6) also make unallowable the costs of certain political activities and attempts to influence executive branch employees to act regarding a contract on any basis other than the merits.
29. *Id.* at §31.205-22(a)(5). When a contractor seeks reimbursement for indirect costs, total unallowable lobbying costs must be separately identified in the indirect cost rate proposal and thereafter treated as other unallowable activity costs. *Id.* at §31.205-22(c).
30. *Id.* at §31.205-22(b). To be allowable, these costs must meet the general allowability criteria in FAR §31.201-2.
31. 48 C.F.R. §52.215-10, Price Reduction for Defective Cost or Pricing Data; 48 C.F.R. §52.242-3, Penalties for Unallowable Costs.
32. 18 U.S.C. §287; 18 U.S.C. §1001; 31U.S.C. §§3729 *et seq.*
33. Memorandum from assistant director of policy and plans, Defense Contract Audit Agency, to regional directors and director, Field Detachment (April 24, 2008) (*available at* www.dcaa.mil).
34. Whether DCAA has contractual authority to interview contractor personnel has been the subject of considerable debate.
35. Memorandum from assistant director of policy and plans, *supra*, note 33.

**Preparing for Change:
The Obama Administration's Effect on Government Contractors**

by
Gregory A. Garrett
and
Peter A. McDonald*

[Note: Reprinted with permission from the National Contract Management Association, *Contract Management*, February 2009.]

With the incoming Obama administration, government contractors are likely to see substantial changes, with increased focus on performance results, controlling costs, competition, transparency, oversight, and ethics/compliance programs. While the Bush administration largely focused on making government agencies more accountable, it is widely believed the new Obama administration will be heavily focused on industry—primarily improving government contractor performance.

For example, both the Democratic Congress and the new administration perceive that there has been too much coddling of government contractors, especially large defense contractors. To address this concern, the heavily Democratic congress is expected to significantly increase government contractor audits and special investigations to be conducted by the Defense Contract Audit Agency (DCAA), Government Accountability Office (GAO), Defense Contract Management Agency (DCMA), and various department Inspector General (IG) offices. Toward that end, the 2008 Defense Appropriations Act already requires new audits of coalition logistical support and reconstruction contracts. Along the same lines, the interim report by the congressional Commission on Wartime Contracting, which was due at the end of January 2009, can be expected to highlight perceived instances of waste and mismanagement.

Controlling Costs and Increasing Competition on Government Contracts

During the presidential campaign, Senator Obama announced a number of initiatives regarding the importance of controlling costs and increasing competition on government contracts. One suggested approach was to prohibit contractors with tax delinquencies from receiving government contracts. Also, both Obama and McCain supported the reduction or even elimination of cost-plus contracts in favor of fixed-price contracts in an effort to control the costs of large complex programs. One reform that already made it to the 2009 Defense Appropriations Act requires sole source awards based on “unusual and compelling urgency” to be limited in duration, but in no event to exceed one year. Complementing this requirement, the Obama administration is also likely to require all agencies to separately justify their non-competitive awards to the Office of Management and Budget (OMB), Office of Federal Procurement Policy. It is widely expected there will be an across the board initiative to increase competition on all contracts, with the emphasis on fixed-price contracts. It is expected that the Obama administration will reinforce the need and value of performance-based contracting, with the appropriate and intelligent use of contract incentives and award fees.

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In an effort to support the incoming Obama administration, the GAO has created a Web site, www.gao.gov/transition_2009, which includes a list of 13 urgent issues facing the new administration and the 111th Congress. The GAO Web site lists numerous opportunities to cut government costs, such as improving the Department of Defense (DOD) weapons systems acquisition process, applying best practices to strategic sourcing, promoting competition for contracts, improving the use of award fees and incentives, improving the Department of Homeland Security (DHS) acquisition management, improving oversight of oil and gas royalties, reducing improper federal payments, and owning instead of leasing property.

The Need for Transparency

Another Obama administration reform expected to widely affect government contractors will be the movement toward “greater transparency.” In brief, this means more government oversight of contractors, both on an individual and organizational basis, via the increased focus on the potential for personal conflicts of interest (PCI) and organizational conflicts of interest (OCI). Plus, greater transparency will include more reviews and audits by government agencies on government contractors, including: contractor purchasing system reviews (CPSRs); earned value management systems (EVMS); integrated baseline reviews (IBRs); cost estimating and accounting system reviews; government property (GP) management systems reviews, DCAA audits, IG inspections, and so on. Effective December 12, 2008, there are new requirements for government contractors contained within the Federal Acquisition Regulation (FAR). The new regulations require government contractors to do the following:

- Provide timely disclosure to the government of certain violations of criminal law, False Claims Act violations, and any significant overpayment by the government;
- Have a written code of business ethics and conduct and provide education and training to its employees; and
- Establish specific internal controls to prevent and detect improper conduct in connection with government contracts.

For this reason, compliance programs will become even more important for government contractors.

What to Expect

Apart from the heightened scrutiny for all government contractors, we expect an intense focus on major defense and homeland security contractors. Clearly, defense and homeland security spending is likely to experience significant programmatic changes as the new Obama administration addresses domestic concerns, as well as the global financial crisis. Accordingly, defense and homeland security programs will be forced to adjust to budget Realignments and force structure trade-offs (some programs may be cancelled outright). Moreover, the DOD and DHS will not be the only agencies to undergo internal competition for diminished budget resources. In short, there will probably be an increase in terminations for convenience, especially in the Departments of Defense, Homeland Security, Energy, and NASA, where the majority of funding is spent acquiring products, services, and integrated solutions from government contractors. In addition, we expect the Obama administration
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to focus on rebuilding the federal government's workforce, thus, reducing the practice of competitive sourcing which is currently implemented via the OMB Circular A-76. Further, we expect the Obama administration to expand the definition of the term *inherently governmental function* to include key acquisition workforce functions such as: acquisition planning, strategic sourcing, source selection, contract administration, project planning, system engineering, cost/price analysis, contract auditing, and program management. Currently, tens of thousands of government contractors are filling these key acquisition roles, because the government does not have the expertise required to get the needed work accomplished. Therefore, we expect the Obama administration to focus on significantly increasing the hiring, training, and retaining of federal government employees across the civilian service system, with special emphasis on key acquisition positions that perform inherently governmental functions.

Preparing for the Obama Administration

As the saying goes, "It is best to live in interesting times," clearly the next four years will be very interesting times for government contractors, especially for major defense contractors. Accordingly, we suggest government contractors focus on the following five actions to prepare for the upcoming Obama administration:

- 1 | Improve performance results on government contracts and programs, especially on-time delivery within budget, and meet or exceed government requirements;
- 2 | Be well prepared for increased government oversight on all business systems, policies, and practices;
- 3 | Increase the use of competition in internal purchasing system and practices;
- 4 | Enhance ethics and compliance programs, especially PCI and OCI aspects; and
- 5 | Improve the education and training of accounting, contract management, pricing, supply chain management, and project/program management personnel to address the requirements and elevated scrutiny from government agencies and Congress.

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Endnotes

¹ - *The Change We Need In Washington*, October 2008. Web site: www.barackobama.com/issues/fiscal.

² - *Ibid.*