Volume XVII

No. 4

Summer 2007

The Clause

A Quarterly Publication of the Boards of Contract Appeals Bar Association

President's Message

by
Judge Richard Walters
CBCA

The BCABA program year has been going swimmingly. Our Spring BCABA/GW Colloquium, ***"Alternative Dispute Resolution in Government Procurement: New Horizons,"*** was held at the GW Law School Moot Court Room on April 19, 2007. The Colloquium was very well attended, and the program was superb. Moderated by GW Professors Yukins and Lees and Associate Dean Schooner, the panel of presenters included Civilian Board of Contract Appeals (CBCA) Board Judge Allan H. Goodman, Judge Marian Blank Horn of the U.S. Court of Federal Claims, and two former Board Judges of the Armed Services Board of Contract Appeals (ASBCA), Ruth C. Burg, a private mediator of considerable repute, and Donald P. Arnavas, who is now a Mediator/ Arbitrator with the McCammon Group. Program materials from the 2007 Colloquium are now posted on the Members Only page of our website.

The May 16, 2007 Annual BCA Judges' Reception, which BCABA co-sponsors each year, along with the D.C. Bar and Federal Bar Association, was thoroughly enjoyable, particularly the lively and enlightening discussion that was offered by the panelists, CBCA Chairman Stephen Daniels, CBCA Board Judges Anthony Borwick and Patricia Sheridan, ASBCA Vice Chairman Eunice Thomas, DCCAB Chairman Jonathan Zischkau, and Gibson and Dunn Partner Joseph West. Many thanks to our Board member Susan Warshaw Ebner for chairing and coordinating the whole event – something Susan has graciously done now for many years. The seminar and reception always proves to be a special program.

Below are some brief descriptions of what lies ahead for the balance of the year.

Executive Policy Forum

This summer, at a date we soon will schedule and announce, BCABA will have its Executive Policy Forum, a program open to our Gold Member Firm and Government agency lawyers. At this year's Forum, we hope to address, among other topics:

* Technology and Electronic Filing

Table of Contents

Two Important New Rules Affect Service Contractors by Christopher C. Bouquet and Richard B. Oliver — 4

Affirmative Misconduct As An Element of Estoppel Against the Government: A Different Point of View by Steven W. Feldman — 10

Plain Talk About Large Construction Project Disputes by Peter G. Merrill — 20

Progress Payment Perils by Christyne K. Brennan and Peter A. McDonald — 26

Viewpoint: DCAA Audit Guidance Conflicts With Pension Protection Act by Peter A. McDonald — 29

President's Message (cont'd):

* Lack of uniformity of rules between ASBCA and the CBCA
* Other ASBCA and CBCA Differences

2007 Annual Program

Please mark your calendars for our BCABA Annual Program, which we are planning for **Thursday, October 25, 2007**. We have reserved a wonderful space at the M Street Hotel, 1143 New Hampshire Avenue, NW, Washington, D.C., which has undergone a $20 million renovation and is now a truly first-class facility. This year's Program Chair (and our Vice President/President Elect) Mike Littlejohn and his Program Task Force are busy assembling terrific panels. This year's program promises to be among our very best, ever. Stay tuned for details.

The Clause

The Clause, BCABA's on-line publication, as you will see is truly remarkable for its depth and the wide variety of topics covered. Pete McDonald, the Editor, would like to remind you that, because we publish it online, there are no limitations imposed on article length or on the numbers of articles that can be included in an issue. The quality of our articles has been consistently good and, because of its web-based distribution, contributing an article for publication in ***The Clause*** is worthy of your serious consideration. Pete would also appreciate hearing from anyone who would like to assist in editing ***The Clause.*** Pete can be reached at pete.mcdonald@rsmi.com.

The BCABA Website

Please monitor the BCABA Website (http://www.bacaba.org) for information on all our future BCABA programs.

Our "user friendly" website has been further upgraded. Our **Members-Only Page** not only contains the online BCABA Directory, with the mailing and e-mail addresses and telephone and fax numbers for all of our members, but now holds all of our **archived issues** of ***The Clause,*** and a number of other helpful **resource links and documents**, including program materials from this year's Trial Practice Seminar and BCABA/GW Law Colloquium.

Membership in BCABA clearly has its advantages – and the price of membership is still unusually low ($45 for private sector members; $30 for Government members).

Quarterly Meetings

I invite you to join us at the remaining quarterly meetings of our BCABA Board of Governors, which are scheduled to be held at the offices of Holland & Knight LLP, 2099 Pennsylvania Avenue, N.W., Washington, D.C., on the following dates (both Thursdays): June 21, 2007; and September 20, 2007. Reservations are needed, so that we may make adequate arrangements for the numbers who will attend.

BCABA programming continues to be first rate. I invite you all not only to participate in our stimulating activities but to become more involved in their planning. Your ideas and your help are always welcome. Feel free to get in touch with me or with any of our officers. My new e-mail address at the new Civilian Board of Contract Appeals is Richard.Walters@gsa.gov. Let me hear from you.

Best regards,

Hon. Richard C. Walters
President

Boards of Contract Appeals Bar Association
Board of Governors

Robert J. Brown (2007-2009)
Department of Housing & Urban Development
751 7th Street, SW
Washington, DC 20410
(w): 202-708-0622, ext. 2223

Frederick (Rick) W. Claybrook, Jr. (2007-2009)
Crowell & Moring LLP
1001 Pennsylvania Avenue, NW
Washington, DC 20004
(w): 202 624-2695

Susan Warshaw Ebner (2006-2008)
Buchanan Ingersoll, PC
1776 K Street, NW
Washington, DC 20006
(w): 202-452-7995

Shelly L. Ewald (2007-2009)
Watt, Tieder, Hoffar & Fitzgerald, LLP
8405 Greensboro Drive, Suite 100
McLean, VA 22102
(w): 703-749-1093

John A. Howell (2007-2009)
McKenna Long & Aldridge, LLP
1900 K Street, NW
Washington, DC 20006
(w): 202-496-7476

John A. Dietrich (2006-2008)
Department of the Navy
Office of the General Counsel
720 Kennon Street, SE
Washington Navy Yard, DC 20374
(w): 202-685-7000

Anne M. Donohue (2007-2009)
SRA International, Inc.
4300 Fair Lakes Court
Fairfax, VA 22033
(w): 703-227-7062

Lynda Troutman O'Sullivan (2006-2008)
Department of the Air Force
Office of General Counsel
1777 Kent Street, Suite 11500
Roslyn, VA 22209
(w): 703-588-2210

Jennifer S. Zucker (2006-2008)
Patton Boggs
2550 M Street, NW
Washington, DC 20037-1350
(w): 202-457-6000

Officers
of the
Boards of Contract Appeals Bar Association

President:
Hon. Richard C. Walters
CBCA
1800 M Street, NW
Washington, DC 20036
(w): 202-606-8814

Vice President:
Michael Littlejohn
Akerman Senterfitt Wickwire Gavin
8100 Boone Boulevard
Vienna, VA 22182
(w): 703-790-8750

Secretary:
David M. Nadler
Dickstein Shapiro LLP
1825 Eye Street, NW
Washington, DC 20006
(w): 202-420-2281

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

Two Important New Rules Affect Service Contractors

by
Christopher C. Bouquet
and
Richard B. Oliver*

[Note: "Two Important New Rules Affect Service Contractors" by Christopher C. Bouquet and Richard B. Oliver, published in *The Procurement Lawyer*, Volume 42, No. 3, Spring 2007. Copyright © 2007 by the American Bar Association. Reprinted with permission.]

Procurement lawyers concerned with contracting for services with federal agencies should take heed of two new rules that will affect time and materials (T&M) and labor-hour contracts. One of the rules concerns T&M and labor-hour contracts for "commercial services,"[1] i.e., services that meet the definition of a "commercial item" set forth in Federal Acquisition Regulation (FAR) 2.101.[2] The other rule primarily concerns T&M and labor-hour contracts for "noncommercial services."[3] This article summarizes key features of these rules, which became effective for new acquisitions on February 12, 2007.[4]

Background

T&M contracts typically provide for the acquisition of direct labors at specified fixed hourly rates and for materials at cost.[5] Labor-hour contracts also provide for acquiring direct labor hours at fixed rates, but the contractor does not supply materials.[6] In a recent study of contracting practices in the commercial marketplace, the Office of Federal Procurement Policy (OFPP) made three main findings concerning these types of contracts. First, companies commonly sell services on a T&M and labor-hour basis when the customer has not been able to define its requirements in detail and has determined that the risk of contracting on a T&M or labor-hour basis is manageable through oversight of company invoicing and performance. Second, companies also commonly sell these same services on a fixed-price basis. Third, a limited number of types of services are sold in the commercial marketplace predominantly on a T&M and labor-hour basis, e.g., emergency repair services. The OFPP study found that the nature of emergency repair services makes them "difficult to capture in a well-defined scope of work." Therefore, OFPP found that these types of services "are not generally conducive to purchase on a fixed-price basis."[7] Based on these findings, the drafters of these new rules decided not to limit the application of T&M contracts to particular categories of services, but to make the use of T&M contracts available to any type of service.[8]

T&M and labor-hour contracts are increasingly popular in the government marketplace. Indeed, federal dollars obligated to T&M contracts increased from $6.6 billion in fiscal year (FY) 1999 to $16 billion in FY 2005.[9] The Federal Government's increasing use of T&M contracts has been controversial because many believe that this contract type is "extremely disadvantageous" to the Government.[10] The FAR officially acknowledges these disadvantages, stating that a T&M contract "provides no positive profit incentive to the contractor for cost control or labor efficiency. Therefore appropriate government surveillance of contractor performance is required to give reasonable assurance that efficient methods and effective cost controls are being used."[11] Despite these disadvantages, in these days of the global war on terror when government requirements are constantly evolving to meet rapidly changing threats, T&M and labor-hour contracts offer the Government badly needed flexibility to acquire critical services from the private sector.

Rule Concerning Commercial Services Contracts

The new rule concerning commercial services contracts implements certain provisions of the Services Acquisition Reform Act (SARA)[12] that expressly authorize federal agencies to use T&M and labor-hour

(*continued on next page*)

Two Important New Rules Affect Service Contractors (cont'd):

contracts to acquire "commercial services." Prior to the issuance of the rule, agencies were required to use firm fixed price (FFP) contracts for the acquisition of commercial services. The new rule adds provisions to FAR 12.207 that permit federal agencies to use T&M and labor-hour contracts to procure commercial services under certain circumstances. A key precondition to the use of this authority is the cognizant contracting officer's (CO's) execution of certain determinations and findings (D&Fs) stating that an FFP arrangement is not appropriate because it is not possible to accurately estimate the extent or duration of the work or to anticipate costs with any reasonable degree of certainty. Another key precondition is that the agency uses a competitive process to award the contract or task order.[13]

The implementation of SARA is significant because it should make the government marketplace more attractive to commercial services contractors who have previously been unwilling to run the risk of cost overruns, losses, and costly disputes on FFP contracts where government requirements were poorly defined. The streamlined acquisition procedures available for commercial items acquisitions may offer additional incentives to such contractors. For existing government contractors, the authorization to use T&M and labor-hour contract types also should open up new opportunities for less risky work. Although use of the new authority is ultimately up to the discretion of the Government, companies can promote its use in at least two ways: (1) in exchanges with federal agencies prior to the issuance of solicitations that are conducted in accordance with FAR 15.201 and (2) in commenting on draft solicitations issued by agencies for industry comment that do not reflect use of the authority. Of course, any recommendation for use of the authority should be accompanied by an explanation of how the agency can satisfy the regulatory preconditions for its use, including the D&Fs that the CO must make.

In addition to implementing SARA, the rule addresses the Government's audit rights under T&M and labor-hour contracts for commercial services. Under the rule, the CO not only will have access to time records, but also may interview employees whose time has been included in invoices, for the purpose of verifying that the employees have worked the hours shown on the invoice. The government contracting community has criticized this new provision as an "unprecedented," "unreasonable," and "intrusive" expansion of the Government's traditional audit rights.[14] The community has also stated that this type of audit right is contrary to customary commercial practice. Although not denying that the new rule is contrary to commercial practice, the Government believes that it has the right to interview employees under noncommercial T&M and labor-hour contracts.15 Accordingly, the Government disagrees that the new rule involves an expansion of its audit rights.

Finally, the rule contains detailed prescriptions for pricing and payment under T&M and labor-hour contracts for commercial services. One of these new rules requires that the CO specifically list in T&M contracts each element of "other direct costs" (e.g., travel and computer usage charges) that will be reimbursed. If an element is not listed, the Government will not reimburse the contractor for that type of cost.[16] Another rule concerns indirect costs such as material handling and subcontractor administration costs, providing that the contractor must charge the Government a fixed price for indirect costs. This price may be invoiced on a pro-rata basis over the period of contract performance.17 The rule drafters adopted this rule because they were concerned that a fixed rate would violate the statutory prohibition against cost-plus-a-percentage-of cost contracting.[18]

In summary, although the new rule provides new business opportunities, it also may open contractors up to new audit scrutiny.

Rule Concerning Noncommercial Services Contracts

This new rule primarily concerns how service contractors price and are paid on T&M and labor-hour

(*continued on next page*)

Two Important New Rules Affect Service Contractors (cont'd):

Contracts for "noncommercial services." The key changes affect pricing and payment for labor supplied by subcontractors and for materials.[19]

Subcontract Labor

The rule adds new instructions for pricing and payment of subcontract labor.

Pricing Instructions. On acquisitions of "noncommercial items" that are based on adequate price competition,[20] offerors may propose labor rates in one of three ways. First, offerors may propose "blended" (i.e., composite) rates under which labor hours will be paid at the same rate, regardless of whether the individual performing the labor works for the prime contractor; a division, subsidiary or affiliate of the prime contractor under common control ("affiliate"); or a subcontractor. Second, offerors may propose different sets of rates for individuals employed by the offeror, affiliates and subcontractors. Third, offerors may propose any combination of separate and blended rates for each category of labor to be provided. If authorized by agency procedures, the CO may mandate a single method from among these three options.[21]

By mandating that proposals contain separate fixed hourly rates for the offeror, affiliates and subcontractors, agencies can eliminate the risk of bad publicity that might result from permitting prime contractors to bill the government for subcontract labor at blended rates that are significantly more expensive than the rate at which the prime contractor pays the subcontractor. Indeed, the Department of Defense (DoD) has already issued such a mandate for all acquisitions of noncommercial items that are based on adequate price competition. DoD indicated that it selected this option because of recent "significant" oversight activities and the high dollar value of DoD's T&M and labor-hour contracts.[22] In addition, DoD believes that most of its contractors already have the necessary systems to establish separate rates without "undue administrative burden."[23] Apparently, the high visibility of its T&M and labor-hour contracts has made DoD procurement officials quite sensitive to the risk of bad publicity. Given that adequate price competition typically produces a reasonable price to the government, it could be argued that DoD's global mandate was an overreaction.

On acquisitions not based on adequate price competition, offerors have no options; they must propose separate individual labor hour rates for prime contractor employees, employees of each subcontractor and employees of affiliates.[24] The fixed hourly rates for services of affiliates that meet the definition of commercial item at FAR 2.101 may be the established catalog or market rate when (1) it is the established practice of the transferring affiliate organization to price inter-organizational transfers at other than cost for commercial work of the contractor or any affiliate and (2) the CO has not determined the price to be unreasonable. Otherwise, the fixed hourly rates for services of affiliates may not include profit for the transferring organization (but may include profit for the prime contractor).[25]

Payment Instructions. In addition to the changes described above, FAR 52.232-7, Payment Under Time and Material and Labor-Hour Contracts, has been revised to specify that the appropriate fixed hourly rates in the contract "shall be paid for all labor performed on the contract that meets the labor qualifications specified in the contract."[26] This provision clarifies that, regardless of whether an individual is an employee of the prime contractor, a subcontractor or an affiliate, the government must pay for his labor at the appropriate fixed hourly rate specified in the contract, rather than simply a pass-through of the prime contractor's cost.

For example, assume that an agency awards a contract based on adequate price competition and that the prime contractor offered a single "blended rate" covering prime contractor and subcontractor labor supplied for the "Network Specialist" labor category. As long as subcontractor personnel meet the specified

(*continued on next page*)

Two Important New Rules Affect Service Contractors (cont'd):

labor category qualification criteria (e.g., concerning required education, experience and certifications), the Government must pay for their labor at the fixed hourly rate specified for Network Specialists, even if the subcontractor charges the prime considerably less than the prime charges the government for that labor. However, if the agency did not obtain adequate price competition (e.g., in the case of a sole source award based on "urgent and compelling" circumstances), the contract would contain separate rates for Network Specialists provided by the prime contractor, affiliates of the prime and each subcontractor.

T&M contracts containing separate labor rates for contractors, subcontractors and affiliates will present certain contract administration challenges to the parties. As performance proceeds, prime contractors often need new subcontractors that were not anticipated at the time the proposal was submitted. For contracts requiring separate hourly rates for each subcontractor named in the proposal, there would not be "appropriate" labor categories for employees of the new subcontractor. Thus, the contract would need to be modified to establish new billing rates. As the promulgation comments for the rule indicate, it is within the Government's sole discretion to issue such modifications.[27]

Despite these challenges, these changes concerning the pricing and payment of subcontract labor provide additional clarity to a clause that a distinguished professor in government contract law had described as "problematical at best."[28] Prior to the change, there was a controversy among procurement lawyers concerning whether prime contractors should be paid for subcontractor labor at the fixed hourly rates for the appropriate labor category or at the rates charged to the prime by the subcontractor. Some maintained that the former clause permitted payment to the prime contractor of the fixed hourly rate for all subcontract labor. Others, including the Defense Contract Audit Agency,[29] maintained that the former clause only permitted payment to the prime at the rates charged to the prime by its subcontractors. To the relief of many practitioners, the new rule has ended this controversy.

Materials

Another key change involves the pricing and invoicing for materials under T&M contracts for non-commercial services. The rule changes the FAR to specify that COs must include FAR 52.216-7, the Allowable Cost and Payment Clause, in such contracts. That clause, which provides that the Government will only pay the contractor in amounts that are allowable under the contract and the "cost principles" set forth in FAR Subpart 31.2, is only applicable to the portion of the contract that provides for reimbursement of "materials" at actual cost and related indirect costs. Under the new rules, "materials" includes direct materials that are used or consumed directly in connection with the furnishing of the service, subcontracts for "incidental services" for which there is not a labor category specified in the contract, other direct costs and applicable indirect costs.[30]

If the contractor furnishes its own materials that meet the definition of a "commercial item" in FAR 2.101, the price to be paid by the Government for such materials shall not exceed the contractor's established catalog or market price, adjusted to reflect (1) quantities being acquired and (2) actual cost of any modifications necessary because of contract requirements.[31] Otherwise, the government will reimburse the contractor for the allowable cost of the materials. Contractors may only include allocable indirect costs and other direct costs in invoices to the extent that they are "clearly excluded" from the hourly rates, allocated in accordance with written or established accounting practices, and are not applied to subcontracts that are paid at the specified hourly rates.

Finally, the new rules make clear that the Government generally will not pay profit or fee to the contractor on materials. There are two exceptions. The first was mentioned above, i.e., when the contractor furnishes its own materials that meet the definition of a commercial item. The second is for materials

(*continued on next page*)

Two Important New Rules Affect Service Contractors (cont'd):

that are sold or transferred between the prime contractor and an affiliate. Those materials may be invoiced to the government at price if (1) it is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any affiliate and (2) the item being transferred qualifies for an exception under FAR 15.403-1(b) from the cost or pricing data submission requirements of the Truth in Negotiations Act and the CO has not determined the price to be unreasonable.[32]

Similar to the new rules on subcontract labor, the new rules concerning materials provide both needed clarity and additional administrative burden. Most of the additional clarity comes in the new provisions concerning the invoicing of commercial items. Most of the new burdens come with the inclusion of the Allowable Cost and Payment clause in these contracts.

Conclusion

The new rules dramatically change and clarify the pricing and payments rules for the increasingly popular T&M contracts. The commercial services rule provide both new business opportunities and new levels of audit scrutiny. The non-commercial service rule adds both needed clarity and additional administrative burden.

---

* - Christopher C. Bouquet is of counsel in the Washington, D.C. office of McKenna Long & Aldridge LLP; Richard B. Oliver is partner in the Los Angeles office of the firm.

Endnotes

1 - 71 *Fed. Reg.* 74667 (December 12, 2006).
2 - Under the definition of a "commercial item" at FAR § 2.101, goods (other than real property) can qualify as commercial items if they are of a type customarily used by the general public or nongovernmental entities for nongovernmental purposes and have been sold, or offered for sale to the general public. Certain goods can also qualify if they have evolved from or are modified versions of such items, even if they have not been offered for sale to the general public. Services can qualify as commercial items if the services are: (1) in support of a good that qualifies as a "commercial item" under the definition in FAR § 2.101; or (2) of a type offered and sold competitively in the substantial quantities in the commercial marketplace under standard commercial terms and conditions based on established catalog or market prices for specific tasks performed or specific outcomes to be achieved.
3 - 71 *Fed. Reg*. 74656 (December 12, 2006).) "Non-commercial services" are services that do not meet the definition of a "commercial item" set forth in FAR §2.101.
4 - The new rules make several other changes to the rules for T&M and labor hour contracts. Individuals involved in pricing and payment should become thoroughly familiar with all aspects of the new rules.
5 - FAR 16.601(b).
6 - FAR 16.602.
7 - 71 Fed. Reg. 74467, 74668 (December 12, 2006).
8 - Section 1432 of the Services Acquisition Reform Act of 2003 (SARA), Pub. L. No. 108-136, limits use of streamlined acquisition procedures for T&M and labor-hour contracts for commercial services to contracts for (1) commercial services procured for support of a commercial item, as described in 41 U.S.C. §403(12)(E), and (2) any other category of commercial services that is designated by OFPP on the basis that—(a) the commercial services in such category are of a type of commercial services that are commonly sold to the general public through use of T&M or labor-hour contracts; and (b) it would be in the best interests of the Federal Government to authorize use of T&M or labor-hour contracts for purchase of the commercial services in such category. OFPP's study was performed in accordance with this statutory mandate to "designate" categories of eligible service contracts. In essence, OFPP found that all categories of services are eligible, provided the Contracting Officer makes the determinations and findings discussed below.
9 - Data supplied by Eagle Eye, Inc., from analysis of Federal Procurement Data System records.
10 - *See* Vernon J. Edwards, *The Time and Materials Contract: the Time Has Come for a Long Hard Look* (Jan. 2004), *at* www.wifconcom/analtandm.htm, at n. 2.
11 - FAR 16.601(c)(1).
12 - Section 1432 of Pub. L. No. 108-136.

(*continued on page 19*)

Bored of Contract Appeals
(a.k.a. The Editor's Column)
by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

In this issue, we have an article by Christopher Bouquet and Richard Oliver that should be of great interest to those who perform service contracts. We also have Steven Feldman's rebuttal to an earlier article on affirmative misconduct done by Karen Manos, and her reply to his rebuttal is included as well. Peter Merrill then cogently discusses how disputes under large construction contracts can be effectively handled. If you have small business clients (and even if you don't), you should be aware of an important change to progress payments procedures, a subject discussed in the insightful and crisply written article *Progress Payment Perils.* (This is REALLY good — don't miss it. I know. I'm a co-author.) (!!) My article involving DCAA's recent guidance on pension costs rounds out the selection.

Although *The Clause* itself is not copyrighted, we will reprint, with permission, previously published and copyrighted articles that deserve further exposure and welcome those and other original articles that will be of interest to government contracts practitioners. But remember everybody: You shouldn't take all this government contract stuff too seriously. And as usual, we received articles that were not suitable for publication, such as: "Pete on D.C. Madam's List! (A '*Preferred Customer*'!)"; "Study: Court Reporters Earn More Than Government Lawyers!!"; and "ASBCA Sanctions *Pro Se*!!!".

BCABA Dues Procedures

⇒ Dues are **$30** for government employees, and **$45** for everyone else.

⇒ An annual dues notification is **emailed** to all members in the **first week of August**.

⇒ Dues are payable **NLT September 30, 2007**.

⇒ There are **no written notices** and **no second notices**.

⇒ Firms that have all their government contract practitioners join are listed as **Gold Medal firms**.

Affirmative Misconduct As An Element of Estoppel Against the Government: A Different Point of View

by
Steven W. Feldman[1]

[Note: This material is reprinted from GOVERNMENT CONTRACT COSTS, PRICING & ACCOUNTING REPORT, VOL. 2, ISSUE NO. 1, JANUARY 2007, and appears here with the permission of the publisher, Thomson/West. Further use without the permission of West is prohibited. For more information or to subscribe, call 1.800.344.5009.]

(CP&A Editor's Note: CP&A REPORT received the following letter in response to my [Karen Manos'] article, Estoppel Against the Government: What Does 'Affirmative Misconduct' Have To Do With It?*, 1 CP&A Rep. ¶ 1.)*

Dear Karen:

Recently, I read your article on estoppel against the Government. It is an interesting piece, and it prompted me to research the issues behind your argument. I respectfully suggest your reasoning and conclusion are not supported, as stated below.

Your basic proposition is that, contrary to the asserted dicta in the two recent Federal Circuit decisions, *United Pacific Ins. Co. v. Roche*[2] and *Rumsfeld v. United Tech. Corp.,*[3] the element of affirmative Government misconduct has "no applicability whatsoever" to equitable estoppel cases involving authorized acts of Government agents. Initially, you reference older Federal Circuit and Court of Claims decisions following the traditional four-part test for equitable estoppel. These decisions lack an affirmative misconduct prerequisite. You state that cases such as *Office of Personnel Mgmt. v. Richmond* (*OPM*)[4] and *Fed. Crop Ins. Corp. v. Merrill* (*Merrill*)[5] "make clear" that they address the application of estoppel only when the agent is not acting within the scope of his authority. Based on precedents from the Ninth, Tenth and Eleventh circuits, you indicate that if a Government agent has acted within his or her authority, then equitable estoppel should "routinely" apply against the agency when (1) the traditional elements of estoppel are met and (2) the Government operated within its proprietary rather than its sovereign capacity.

The Nature of Equitable Estoppel

My first point in rebuttal is that you do not mention key features of equitable estoppel. An affirmative defense, equitable estoppel bars a party from raising a defense or an objection that it otherwise would have or from instituting an action to which it is entitled.[6] Equitable estoppel is a "disfavored" legal doctrine whether enforced against a private entity[7] or a public one, and is "rarely successful."[8]

The reason for this status stems from the nature of equitable estoppel. As the U.S. Supreme Court has long recognized, "estoppels, which preclude the party from showing the truth, are not favored."[9] Because equitable estoppel can suppress the truth and preclude a party's right to present a meritorious claim or defense, this doctrine should receive a strict, rather than lenient, definition. A formulation of equitable estoppel requiring the high bar of affirmative Government misconduct advances the preferred construction of this "disfavored" doctrine.

Public Policy Considerations

Second, you give insufficient weight to the strong public policies favoring a strict definition of

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel (cont'd):

equitable estoppel. In *Phelps v. Fed. Emergency Mgmt. Agency*, the First Circuit observed,

> The Supreme Court … from its early decision in *Lee v. Munroe & Thornton*, 11 U.S. (7 Cranch) 366, 3 L.Ed. 373 (1813), to its most recent decision in *Heckler v. Community Health Services of Crawford County Inc.*, [467 U.S. 51 (1984)], has consistently refused to apply the equitable estoppel doctrine against the government, no matter how compelling the circumstances. Justification for this refusal rests primarily upon considerations of sovereign immunity and constitutional grounds—the potential for interference with the separation of governmental powers between the legislative and executive. Thompson, *Equitable Estoppel of the Government*, 79 COLUM. L. REV. 551, 565 (1979). There is also a vital concern for public policy. *Heckler v. Community Health Services*, *supra*, 467 U.S. at 63, 104 S. Ct. at 2225. In a complex government with thousands of agencies and departments, and innumerable employees, there is a very real need to protect the Government against binding commitments by improper conduct of its agents, which might promote fraud or collusion. "Fear of uncontrollable liability and crippling losses to the public treasury have also played a role in sustaining the rule." *Thompson*, supra at 557.[10]

Requiring governmental affirmative misconduct ensures that the injustice to an individual or entity caused by the Government's conduct is sufficiently severe to outweigh the countervailing public interest not to be unduly damaged by the imposition of equitable estoppel.[11] These policies have the same force irrespective of whether the agent has acted within his or her authority. Simply put, equitable estoppel may be imposed against the Government only with the "utmost caution and restraint."

Dicta or Something Else?

Third, you term as "dicta" the Federal Circuit's statements in *United Pacific Ins. Co.*[13] and *Rumsfeld*[14] imposing affirmative misconduct as an element of equitable estoppel. "Dicta" is a discussion unnecessary to the decision in the case or something stated in passing in an opinion.[15] A review of the decisions, however, does not support your characterization.

In *United Pacific*, the pertinent part of the court's opinion reads,

> Our own precedent dictates 'that if equitable estoppel is available at all against the government some form of affirmative misconduct must be shown in addition to the traditional requirements of estoppel.'*Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000). The evidence is undisputed that the incorrect recital in the 'Whereas' clause was the result of unintentional mathematical errors, not affirmative misconduct.

Again, in *Rumsfeld*, the court observed,

> Beyond a mere showing of acts giving rise to an estoppel, Pratt must show 'affirmative misconduct [as] a prerequisite for invoking equitable estoppel against the government.' *Zacharin v. United States*, 213 F.3d 1366, 1371, 55 USPQ2d 1047, 1051 (Fed. Cir. 2000).

In both cases, the Federal Circuit stated the affirmative misconduct element is central to the doctrine. The court specifically ruled that the plaintiff had to establish this element as part of its equitable estoppel defense. In no sense was the discussion of affirmative misconduct unnecessary to the Federal Circuit's decisions or mere passing commentary. Indeed, Professor Ralph Nash in his analysis of these same decisions strongly indicates that this language reflects a legal requirement and not dicta. Professor Nash opined, "It can be seen that this 'affirmative misconduct' language has become standard language that the court is using to indicate its understanding of the Supreme Court cases dealing with equitable estoppel against the Government."[16]

Proprietary v. Sovereign Functions

Fourth, citing the above-mentioned courts of appeals decisions, you indicated that, assuming the traditional elements of estoppel are present and the Government agent acted within his or her authority,

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel (cont'd):

equitable estoppel should "routinely" apply against the Government when it acts in its proprietary rather than its sovereign capacity.

An agency operates in its proprietary capacity when it engages in a business-like venture such as entering into a contract or being an employer. It functions in its sovereign capacity when it serves the public at large. These concepts overlap and, as a result, this distinction has been criticized as contributing "only ambiguity and confusion" to the field of Government contracts.[17] Indeed, as the First Circuit stated in *Phelps*, "the Supreme Court ... found no merit in this distinction in *Federal Crop Insurance v. Merrill* (where the Government was in the business of selling insurance) ...."[18] More recently, in the Supreme Court's *OPM* decision, the Court determined that the Government was acting in its proprietary capacity as an employer when the Government agent gave a retired employee misleading advice about disability benefits. Yet in mentioning the possibility that affirmative misconduct could establish equitable estoppel, the Court never referenced the proprietary/sovereign capacity distinction as a factor.[19] Therefore, based on *Merrill* and *OPM,* the rules for applying equitable estoppel are the same in either the proprietary or sovereign capacity setting, to the extent these labels have any value.

Acting Within or Without the Scope of the Agent's Authority: Does It Matter?

Fifth, just as the U.S. Supreme Court has given no weight to the proprietary/sovereign function distinction for equitable estoppel, there is no indication that the Court will carve out an exception to the affirmative misconduct prerequisite simply because the agent acted within his or her authority. Although you posit that no federal appellate court has held that affirmative misconduct is necessary to establish estoppel when a Government official has acted within his authority, several state and federal decisions have done so.

In *Tosco Corp. v. Hodel*,[20] after a thorough canvassing of Supreme Court and lower court decisions, the court observed in the context of a mining claim, "We conclude that for the estoppel doctrine to be applied against the government, the conduct must be within the scope of the agent's authority and must be an affirmative act which, on a balance of all the equities, amounts to 'unconscientious or inequitable' behavior." Courts in other jurisdictions have expressly approved this formulation.[21] Then again, in *Burstein v. Retirement Account Plan for Employees of Allegheny Health Education and Research Foundation*,[22] the district court observed in considering an Employee Retirement Income Security Act of 1974 claim, "Taken together, the caselaw demonstrates that estoppel can only lie against [the Pension Benefit Guaranty Corp.] if one of its agents, acting within the scope of his or her authority, engaged in affirmative misconduct that was relied upon by plaintiffs." The Third Circuit expressly approved the district court's resolution of the equitable estoppel issue.[23] Thus, at least one federal appellate court other than the Federal Circuit has recognized that affirmative misconduct is necessary for an equitable estoppel claim against the U.S. if the agent acted within his or her authority, even though you claim otherwise.

Contrary to your analysis, it does not follow that because (a) various cases accept affirmative misconduct as an exception to the rule that the Government is not bound by the unauthorized acts of its agents, then (b) affirmative misconduct is not an element if a party asserts equitable estoppel regarding an agent acting within his or her authority. Given the strong public policy considerations behind a strict application of equitable estoppel against the Government in all circumstances, the test should be the same irrespective of the agent's authority.

Conflict with Earlier Precedents—A Reconciliation

Sixth, you emphasize that until recently, precedent within the Federal Circuit followed the traditional four-part test for equitable estoppel without mention of affirmative misconduct. Citing Federal Circuit

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel (cont'd):

Rule 35, you contend that the Federal Circuit's recent dicta to the contrary violates the requirement that only an *en banc* court may overrule a binding precedent.

You accurately cite the earlier decisions, as well as Federal Circuit Rule 35, but you omit a well-settled case law exception to the en banc limitation. In *European Cmty. v. RJR Nabisco, Inc*.,[24] the Second Circuit observed, "We recognize an exception to this general rule when there has been an intervening Supreme Court decision that casts doubt on our controlling precedent." Federal Circuit case law is to the same effect, and *OPM* is that intervening Supreme Court decision. In *JANA, Inc. v. U.S.*,[25] the court questioned whether its pre-*OPM* precedent is still valid. After *JANA*, no Federal Circuit decision has approved the traditional four-part test. In this respect, your main Federal Circuit decision, *Burnside-Ott Aviation Training Ctr., Inc. v. U.S.*,[26] does not address the pre-*OPM* test for equitable estoppel or analyze whether the current standard includes affirmative misconduct.

Case law has analyzed the issue you raise. The contractor in *Gen. Elec. Co. v. U.S.*[27] relied upon the pre-*OPM* precedent from the Federal Circuit and argued that affirmative misconduct is not required. The *General Electric* court dismissed the argument in a footnote, commenting that the current test is otherwise in the Federal Circuit.[28] The Armed Services Board of Contract Appeals in *United Tech. Corp., Pratt & Whitney*[29] cited *General Electric* with approval, along with other Court of Federal Claims cases requiring affirmative misconduct. Accordingly, the Federal Circuit has not violated its own Rule 35 in stating the elements for equitable estoppel.

Comparison to Private Contract Litigation

Lastly, you correctly cite the Supreme Court's admonition in *Mobil Oil Exploration and Producing Southeast, Inc. v. U.S.* that "[W]hen the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals."[30] In this regard, affirmative misconduct is a familiar principle for equitable estoppel in private contract litigation. The U.S. Court of Appeals for the Eighth Circuit said, "Under the doctrine of equitable estoppel, the party requesting the estoppel must show that the defendants have engaged in affirmative conduct ... that was designed to mislead or was unmistakably likely to mislead a plaintiff."[31] The *Redman* case illustrates that an affirmative misconduct element for equitable estoppel in public contract cases is consistent with the doctrine for private-sector contracts litigation.

Conclusion

From its earliest decisions, the Supreme Court has recognized that equitable estoppel will not lie against the Government as it does against private litigants. Enforcement of an affirmative misconduct element for equitable estoppel maintains that distinction and advances the important public policy considerations favoring a strict view of this disfavored doctrine. The Federal Circuit in *United Pacific* and *Rumsfeld* properly invoked the affirmative misconduct aspect of the equitable estoppel rule without concern for whether the agent has acted within his or her authority. Other courts have done the same. So, in answer to your question, "Estoppel Against the Government: What Does 'Affirmative Misconduct' Have to Do With It?," I say—Everything!

Endnotes

1 - Steven W. Feldman is an attorney for the U.S. Army Corps of Engineers. The opinions expressed in this article are those of the author and do not represent those of the Corps of Engineers.
2 - *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362 (Fed. Cir. 2005).
3 - *Rumsfeld v. United Tech. Corp.*, 315 F.3d 1361 (Fed. Cir. 2003).

(*Endnotes continued on page XX*)

Affirmative Misconduct As An Element of Estoppel (cont'd):

Endnotes (cont'd)

4 - *Office of Personnel Mgmt. v. Richmond*, 496 U.S. 414 (1990).
5 - *Fed. Crop Ins. Corp. v. Merrill*, 332 U.S. 380 (1947).
6 - *Conner Bros. Constr. Co., Inc. v. U.S.*, 65 Fed. Cl. 657, 692–93 (2005).
7 - *Elvis Presley Enter., Inc. v. Elvisly Yours, Inc.*, 936 F.2d 889, 895 (6th Cir. 1991).
8 - *Gibson v. West*, 201 F.3d 990, 994 (7th Cir. 2000).
9 - *Richardson v. City of Boston*, 60 U.S. 263, 267 (1856); accord *Bogoslowsky v. Huse*, 142 F.2d 75, 77 (Cust. & Pat. App. 1944).
10 - *Phelps v. Fed. Emergency Mgmt. Agency*, 785 F.2d 13, 16–17 (1st Cir. 1986).
11 - See *McCurty v. U.S.*, 30 Fed. Cl. 108, 112 (1993); *Beacom v. Equal Employment Opportunity Comm'n*, 500 F. Supp. 428, 435–36 (D. Ariz. 1980).
12 - See *Estate of Akin v. U.S.*, 31 Fed. Cl. 89, 96 (1994).
13 - *United Pacific Ins. Co.*, 401 F.3d at 1366.
14 - *Rumsfeld*, 315 F.3d at 1377.
15 - BLACK'S LAW DICTIONARY 454 (6th ed. 1990).
16 - *Equitable Estoppel as a Viable Claim: Must Affirmative Misconduct be Proved?*, 19 NASH & CIBINIC REP. ¶ 43 (September 2005).
17 - See *Washington County Bd. of Educ. v. MarketAmerica, Inc.*, 693 S.W.2d 344, 349 (Tenn. 1985); see also *Massman Constr. Co. v. Tennessee Valley Auth.*, 769 F.2d 1114, 1125–26 (6th Cir. 1985) (questioning the significance of any distinction between the Government's proprietary and sovereign activities).
18 - *Phelps*, 785 F.2d at 17.
19 - See *McCurty v. U.S.*, 30 Fed. Cl. 108, 112 (1993) (analyzing *OPM*).
20 - *Tosco Corp. v. Hodel*, 611 F. Supp. 1130, 1199, 1205-06 (D. Colo. 1985), vacated as moot, 826 F.2d 948 (10th Cir. 1987).
21 - See *In re Kreidle*, 146 B.R. 464, 473-74 (Bankr. D. Colo. 1991); *Tetlin Native Corp. v. State*, 759 P.2d 528, 536 (Alaska 1988).
22 - *Burstein v. Retirement Account Plan for Employees of Allegheny Health Educ. and Research Found.*, 263 F. Supp. 2d 949, 965 (E.D. Pa. 2002), rev'd on other grounds, 334 F.3d 365 (3d Cir. 2003).
23 - See *Burstein*, 334 F.3d at 383.
24 - *European Cmty. v. RJR Nabisco, Inc.*, 424 F.3d 175, 179 (2d Cir. 2005).
25 - *JANA, Inc. v. U.S.*, 936 F.2d 1265, 1270 (Fed. Cir. 1991).
26 - *Burnside-Ott Aviation Training Ctr., Inc. v. U.S.*, 985 F.2d 1574 (Fed. Cir. 1993).
27 - *Gen. Elec. Co. v. U.S.*, 60 Fed. Cl. 782 (2004).
28 - Id. at 797 n.11.
29 - *United Tech. Corp., Pratt & Whitney*, ASBCA 47416, et al., 06-1 BCA ¶ 33,289.
30 - *Mobil Oil Exploration and Producing Southeast, Inc. v. U.S.*, 530 U.S. 604, 607 (2000).
31 - *Redman v. U.S. West Business Res., Inc.*, 153 F.3d 691, 695 (8th Cir. 1998) (claim under a collective bargaining agreement).

Editor's Reply

[by Karen Manos]

I appreciate Steve Feldman's thoughtful response to my article, and hope that CP&A REPORT will become a forum for precisely this type of discussion. It probably is not surprising that I do not agree with Steve's analysis or conclusion. I will address each of Steve's points in the order in which he raised them.

First, I do not disagree with Steve's point about the nature of equitable estoppel. However, as Steve's article acknowledges, estoppel is as much a "disfavored" legal doctrine for private litigants as it is for public litigants. Consequently, nothing in the nature of estoppel supports requiring an extra element to establish estoppel in litigation against public litigants that is not required in litigation against private litigants.

Second, I agree that there are strong public policy reasons for why the Government should not be bound by the unauthorized acts of its agents. It is for that reason that the Supreme Court repeatedly has held (*continued on next page*)

Affirmative Misconduct As An Element of Estoppel—Editor's Reply (cont'd):

that estoppel will not lie against the Government as it does against other litigants. Steve cites no authority, and I am not aware of any, for his contention that "[t]hese policies have the same force irrespective of whether the agent has acted within his or her authority." Contrary to Steve's assertion, the cases themselves have emphasized that public policy is to protect the Government from the *unauthorized* acts of its agents. For example, in *OPM*, the Court provided the following summary of its estoppel decisions leading up to the seminal case of *Fed. Crop Ins. Corp. v. Merrill*:

> From our earliest cases, we have recognized that equitable estoppel will not lie against the Government as it lies against private litigants. In *Lee v. Munroe & Thornton*, 7 Cranch 366, 3 L.Ed. 373 (1813), we held that the Government could not be bound by the mistaken representations of an agent *unless it were clear that the representations were within the scope of the agent's authority*. In *The Floyd Acceptances*, 7 Wall. 666, 19 L.Ed. 169 (1869), we held that the Government could not be compelled to honor bills of exchange issued by the Secretary of War *where there was no statutory authority for the issuance of the bills.* In *Utah Power & Light Co. v. United States*, 243 U.S. 389, 408-409, 37 S.Ct. 387, 391, 61 L.Ed. 791 (1917), we dismissed the argument that *unauthorized representations by agents* of the Government estopped the United States to prevent erection of power houses and transmission lines across a public forest in violation of a statute: "Of this it is enough to say that the United States is neither bound nor estopped by acts of its officers or agents in entering into an arrangement or agreement to do or cause to be done what the law does not sanction or permit."[1]

In describing the holding of each case, the Court was careful to note that the case involved the unauthorized acts of Government agents. Similarly, *Merrill*, the Court took care to note that the Government agent on whose erroneous advice Farmer Merrill relied was acting outside his authority. Indeed, that was the basis for the Court's holding in *Merrill*. The Court stated:

> Whatever the form in which the Government functions, anyone entering into an arrangement with the Government takes the risk of having accurately ascertained that he who purports to act for the Government stays within the bounds of his authority. The scope of this authority may be explicitly defined by Congress or be limited by delegated legislation, properly exercised through the rule-making power. And this is so even though, as here, the agent himself may have been unaware of the limitations upon his authority.

The Third Circuit case quoted at length in Steve's article similarly involved unauthorized representations by a Government employee.[2] On the other hand, the Supreme Court has long held that the Government *is* bound by the authorized acts and representations of its agents, even if those acts are negligent or erroneous. For example, the Court held in *Cooke v. U.S.,* "Generally, in respect to all commercial business of the government, if an officer specially charged with the performance of any duty, is authorized to represent the government in that behalf, neglects that duty, and loss ensues, the government must bear the consequences of his neglect."[3]

Steve's third point misconstrues the meaning of dicta. That the Federal Circuit in *Rumsfeld v. United Tech. Corp.* and *United Pacific Ins. Co. v. Roche* "stated the affirmative misconduct element as a central part of the doctrine" does not mean that the court's statements were not dicta. What matters in determining whether something is dicta is whether it was necessary to the decision in the case. The Federal Circuit's statements that affirmative misconduct is a necessary element of estoppel were completely unnecessary to the court's decision in either *United Tech.* or *United Pacific*. In *United Tech.*, the Federal Circuit disagreed with the Armed Services Board of Contract Appeals' determination that UTC's revenue sharing payments were

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel—Editor's Reply (cont'd):

not costs and, on that basis, reversed and remanded to the board. The ASBCA did not even address UTC's estoppel argument. The Federal Circuit's statements about estoppel were, therefore, both gratuitous and wholly unnecessary to the court's decision. In fact, it was for that reason that the ASBCA concluded that the Federal Circuit's statements were not the "law of the case" and were not binding on the board. In this regard, the ASBCA stated:

> We agree with Pratt that the CAFC's comments about the elements required to establish equitable estoppel, and in particular the application of the affirmative misconduct standard, were not necessary to its decision regarding CAS compliance and could be characterized as dictum. Further, the comments had nothing to do with the merits of the estoppel defense and are not the law of the case, a doctrine limited 'to issues that were actually decided, either explicitly or by necessary implication, in the earlier litigation.'[4]

United Pacific arose out of claims asserted by a surety that took over performance of a construction contract. The surety claimed, in pertinent part, that it was entitled to recover the contract balance stipulated in the takeover agreement's "Whereas" clauses, which the surety conceded was inaccurate. Before the ASBCA, the surety argued, among other things, that "the government expressly agreed to pay it the amount specifically set forth in the Takeover Agreement."[5] Applying black letter contract law, the ASBCA found that the "Whereas" clauses "cannot create any right beyond those arising from the operative terms of the document," and "[t]he operative terms of the Takeover Agreement do not include a specific amount, but refer, for example, to 'sums now due and payable and to become due and payable upon the CONTRACT, including all unearned Contract balances.' "[6] Consequently, the ASBCA's discussion of estoppel was not necessary to its decision on the surety's contract balance claim. On appeal, the Federal Circuit agreed with the board that the "Whereas" clause was a recital of fact and only part of the takeover agreement that set out a specific dollar amount for the balance, and that the operative terms of the takeover agreement entitled the surety to "all sums now due and payable and to become due and payable" under the contract.[7] Because the "Whereas" clauses do not create substantive rights beyond those arising from the operative terms of the takeover agreement, the Federal Circuit's findings were sufficient to deny the surety any relief, even without addressing the estoppel issue.

Fourth, I agree that, whether the Government is acting in its proprietary as opposed to its sovereign capacity is not the relevant distinguishing factor, and said as much in my article. However, as a practical matter, when the Government is acting in its proprietary capacity, individual Government employees—such as a Government contracting officer—are more likely to have authority to bind the Government than when the Government is acting in its sovereign capacity.

For his fifth point, Steve relies primarily on a 1988 decision by a district court in the Tenth Circuit, which was subsequently cited in decisions by a bankruptcy court and an Alaska state court. However, not only was the district court decision vacated on appeal, but its discussion of the elements of estoppel is contrary to the 1990 Tenth Circuit decision cited in my article. In *Penny v. Guiffrida*, the Tenth Circuit provided the following explanation of the law of estoppel:

> Historically, equitable estoppel has been used to prevent a party from taking a legal position inconsistent with an earlier statement or action that places his adversary at a disadvantage. The purpose of the doctrine of equitable estoppel is to ensure that no one will be permitted to "take advantage of his own wrong." In private suits, the traditional elements of equitable estoppel are: (1) the party to be estopped must know the facts; (2) the party to be estopped

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel—Editor's Reply (cont'd):

> must intend that his conduct will be acted upon or must so act that the party asserting the estoppel has the right to believe that it was so intended; (3) the party asserting the estoppel must be ignorant of the true facts; and (4) the party asserting the estoppel must rely on the other party's conduct to his injury.
>
> The law of estoppel against the government is considerably less clear. Of course, the government is ordinarily bound by the authorized acts of its agents under traditional concepts of agency or contract law. The difficulty comes when one seeks to hold the government responsible for the unauthorized acts of its agents under estoppel concepts. Traditionally, the Supreme Court has held that unauthorized acts of the government agents cannot be the basis for estoppel. However, recent Supreme Court decisions have at least suggested the possibility that unauthorized official conduct may give rise to an estoppel against the government where the litigant makes out the requisites of private estoppel and additionally shows the existence of "affirmative misconduct." Nevertheless, no Supreme Court case has ever actually applied estoppel against the government for the unauthorized acts of its agents, and a 1984 Supreme Court case has made it clear that the Court still has not resolved whether estoppel may ever be applied against the government.[8]

In any event, the district court's decision in *Tosco Corp. v. Hodel* provides little support for Steve's position. Indeed, in *Tosco* and in the two cases citing it, the courts applied estoppel against the Government. The *Tosco* court reasoned that estoppel against the Government can apply *only* when the Government agent is acting within the scope of his or her authority.[9] When one starts from that erroneous premise, it necessarily follows that if affirmative misconduct is an element of estoppel at all, it must be an element when estoppel is applied to the authorized acts of a Government agent since, according to the *Tosco* court, that is the only time estoppel can ever apply. Nevertheless, the *Tosco* court interpreted "affirmative misconduct" so broadly that estoppel would apply whenever it would be inequitable to not apply it. The *Tosco* court reasoned:

> [W]e do not believe that the Supreme Court, in suggesting "affirmative misconduct" as an element of estoppel, intended that a government agent must engage in an intentional misrepresentation or concealment before his conduct could estop the government. Such a requirement would be irreconcilable with the Court's long-standing rule that the government cannot be estopped by the unauthorized conduct of its agents. See *Federal Crop Insurance Corp. v. Merrill*, supra. It is hard to imagine a situation where the conduct of an agent can be both intentionally tortious and authorized by the government. Therefore, we conclude that for the estoppel doctrine to be applied against the government, the conduct must be within the scope of the agent's authority and must be an affirmative act which, on a balance of equities, amounts to "unconscientious or inequitable" behavior.[10]

Applying that test, the *Tosco* court held that the Department of the Interior was estopped from invalidating mining claims for the nonperformance of annual assessment work if the claimants had relied to their detriment on the department's long-standing policy of not contesting claims on such grounds. Citing *Tosco*, the bankruptcy court in *Kreidle v. Dep't of the Treasury* held that the Internal Revenue Service was estopped from asserting or collecting any tax deficiency resulting from the debtor's failure to make a tax election because the IRS knew about the bankruptcy proceeding and that the tax liability would seriously affect the rights and payments to be made to the other creditors, but nevertheless remained silent for three years while the bankruptcy matter was proceeding.[11] Thus, without deciding whether affirmative misconduct is a requirement, the bankruptcy court held that "the behavior of the IRS in the instant case would (*continued on next page*)

Affirmative Misconduct As An Element of Estoppel—Editor's Reply (cont'd):

meet the standard of affirmative misconduct, if affirmative misconduct were a requirement for estoppel against the IRS pursuant to bankruptcy case law."[12] Similarly, the Alaska court in *Tetlin Native Corp. v. State* found that "the actions of the Department of the Interior in both denying and granting easements constitute the authorized affirmative conduct," and therefore applied estoppel because it would be inequitable to permit an agency to redetermine the validity of a grant.[13]

It is not the case, as Steve suggests, that the Third Circuit in *Burstein v. Retirement Account Plan for Employees of Allegheny Health Educ. & Research Found.* expressly approved the district court's resolution of the estoppel issue as against the Government agents. *Burstein* was an action on behalf of a group of employees who were denied benefits under a partially terminated ERISA "cash balance" pension plan. The employees brought claims against the plan trustees and the Pension Benefit Guaranty Corp. as a guarantor of the pension benefits. The language Steve quotes is dicta by the district court after the court had determined that the plaintiffs were not entitled to benefits under the plan, and that any claim for benefits based upon PBGC's guarantee necessarily also must fail."[14] The district court found that plaintiffs did not establish the requisite elements of estoppel against either the plan trustees or the PBGC. The district court's holding regarding the PBGC was not appealed. The Third Circuit expressly stated that: "*Burstein* did not argue on appeal that equitable estoppel applied to the PBGC."[15] Thus, the Third Circuit's decision does not embrace the language quoted in Steve's article.

Steve's sixth point erroneously contends that the Supreme Court's decision in *OPM v. Richmond* is an intervening contrary decision that justifies an exception to the requirement of Federal Circuit Rule 35 that only an *en banc* court may overrule binding precedent. *OPM* is not an intervening contrary decision because it involves reliance on an *unauthorized representation* by a Government agent. The decision falls squarely within the rationale and holding of *Fed. Crop Ins. Corp. v. Merrill*, and is wholly inapposite to cases—including the Federal Circuit's pre-*OPM* Government contracts cases—involving acts and representations that are within the scope of the agent's authority.

Lastly, Steve erroneously contends that affirmative misconduct is required to establish estoppel in litigation between private parties. If affirmative misconduct were required in private litigation, there would be no issue. However, Steve has confused the requirement for "affirmative conduct," which is required by the Eighth Circuit decision mentioned in Steve's article, and "affirmative misconduct." As the Tenth Circuit stated in *Penny v. Guiffrida*,

> In private suits, the traditional elements of equitable estoppel are: (1) the party to be estopped must know the facts; (2) the party to be estopped must intend that his conduct will be acted upon or must so act that the party asserting the estoppel has the right to believe that it was so intended; (3) the party asserting the estoppel must be ignorant of the true facts; and (4) the party asserting the estoppel must rely on the other party's conduct to his injury.[16]

In summary, despite Steve's enthusiastic support, the Federal Circuit's recent dicta has muddied the law and effectively created a Government contracts exception to the rule that the Government is bound by the authorized acts of its agents.

Endnotes

1 - *Office of Personnel Mgmt. v. Richmond*, 496 U.S. 414, 419-20 (1990) (emphasis added).

(*continued on next page*)

Affirmative Misconduct As An Element of Estoppel—Editor's Reply (cont'd):

Endnotes (cont'd)

2 - *Phelps v. Fed. Emergency Mgmt. Agency*, 785 F.2d 13, 18 (1st Cir. 1986) ("The salient facts in Merrill, with one exception, paralleled the facts in this case. Both involved insurance coverage obtained from a government agency. In each case, a government agent made erroneous representations to the insured. In both cases, the insured relied on those representations to the insured's detriment. The only distinction is that in Merrill the respondents were not entitled to coverage whereas the plaintiffs here were.").
3 - See *Cooke v. U.S.*, 91 U.S. 389, 393 (1875), cited with approval in *U.S. v. Winstar Corp*., 518 U.S. 839, 895 n.39 (1996).
4 - *United Tech. Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., 06-1 BCA ¶ 33,289.
5 - *United Pacific Ins. Co.*, ASBCA No. 54270, 04-1 BCA ¶ 32,494.
6 - Id. (citations and internal quotation marks omitted).
7 - *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362, 1365 (Fed. Cir. 2005).
8 - *Penny v. Giuffrida*, 897 F.2d 1543, 1545-46 (10th Cir. 1990) (citations and footnotes omitted).
9 - *Tosco Corp. v. Hodel*, 611 F. Supp. 1130 (D. Colo. 1985), vacated as moot, 826 F.2d 948 (10th Cir. 1987).
10 - 611 F. Supp. at 1205.
11 - *Kreidle v. Dep't of the Treasury*, 146 B.R. 464, 473 (D. Colo. 1991).
12 - Id.
13 - *Tetlin Native Corp. v. State*, 759 P.2d 528, 536 (Alaska 1988).
14 - *Burstein v. Retirement Account Plan for Employees of Allegheny Health Educ. & Research Found.*, 263 F. Supp. 2d 949, 963 (E.D. Pa. 2002).
15 - *Burstein v. Retirement Account Plan for Employees of Allegheny Health Educ. & Research Found.*, 334 F.3d 365, 383 (3d Cir. 2003).
16 - *Penny v. Giuffrida*, 897 F.2d 1543, 1545-46 (10th Cir. 1990).

Two Important New Rules Affect Service Contractors (cont'd from page 8):

Endnotes (cont'd)

13 - 71 Fed. Reg. 74667.
14 - *Id*.
15 - *Id*.
16 - *Id*.
17 - *Id*.
18 - *Id*.
19 - Another change that is worth mentioning is a new provision that requires the government to pay Prompt Payment Act interest on overdue bills for T&M and labor-hour contracts. 71 *Fed. Reg*. 74656 (Dec. 12, 2006).
20 - Standards for adequate price competition are set forth in FAR §15.403-1(c)(1).
21 - 71 Fed. Reg. 74656, 74665 (Dec. 12, 2006).
22 - *Id*. At 74469.
23 - *Id*.
24 - The rule also provides that on acquisitions of commercial items, offerors must simply identify for each proposed labor-hour rate whether the rate applies to prime contractor employees, subcontractor employees and/or employees from divisions, subdivisions or affiliates of the offeror.
25 - 71 Fed. Reg. 74469 (Dec. 12, 2006).
26 - *Id*.
27 - *Id*.
28 - Vernon Edwards, *Clarifying the Time and Materials Payment Clause: A Lost Clause?* 19 Nash & Cibinc Report 172, ¶54.
29 - Memorandum for Regional Directors, Audit Guidance on Review of Orders Under GSA Schedule Contracts (April 9, 2004).
30 - 71 Fed. Reg. 74469 (Dec. 12, 2006).
31 - *Id*. Under the prior rules, contractors could only bill their own materials at catalog or market prices in limited circumstances. *See* FAR 16.601(b)(3)(2006).
32 - *Id*.; FAR 31.205-26(e).

Plain Talk About Large Construction Project Disputes

by
Peter G. Merrill

[© Copyright 2007, Peter G. Merrill. All rights reserved. For reprint permission of this article, please contact Peter G. Merrill at 888-930-0011 or petermerrill@cdrsllc.com.]

It is virtually impossible to complete a large construction project without any disputes developing between any of the parties. Those who plan ahead will most likely be less adversely affected by the disputes that might develop. Although Dispute Review Boards (DRB) have been around for many years, they traditionally only offer advisory opinions upon which the parties should be able to resolve their dispute through discussions based on those advisory opinions. If the parties can not resolve their dispute after considering the advisory opinion of the DRB, they would need to proceed on to an outside arbitration or to litigation, whichever is specified in the construction contract, or Dispute Review Board Agreement, to reach a final and binding resolution to the dispute.

According to the Rand Corporation, the average construction litigation case takes approximately 2 ½ years to complete including appeals. During that time, the parties often continue working on the project but may perform differently because of the pending dispute. If the dispute is between two major parties in the construction project, a project may have to shut down until the dispute is settled. The comfort level of the parties working together will diminish and the project will begin to see a different level of cooperation between the disputing parties. Regardless of the nature of the dispute, the project most likely will be adversely affected and will most likely run behind schedule and might run over budget due to the effects of the dispute.

When a major sports event is scheduled to be run, a medical emergency crew, trained to handle medical emergencies, usually stands by just in case someone is injured. Response time can mean life or death in some instances. A construction project can utilize the same planning ideas. If you have construction-knowledgeable specialists available in the event that there is a construction dispute, the same emergency treatment can be rendered by those construction experts to minimize the injuries to the construction project. Better yet would be to have a team of construction experts meeting on a regular basis to not only handle any disputes, but to help in the prevention of any disputes. That team of construction experts is known as a Dispute Review Board (DRB).

DRBs have been utilized by the construction industry across the world for many years. A DRB usually meets on a regular basis; every month, two months, quarterly or as specified in the DRB Agreement. The DRB will review the progress of the project and will try to anticipate any possible future disputes or will handle any disputes that have developed since their last meeting. All DRBs issue an "Advisory Opinion" specifying how the DRB feels the issue should be handled by the parties to prevent or settle the dispute. Each party to the dispute has an opportunity to present their case to the DRB for their consideration. As the DRB has the success of the project in mind and acts as neutrals without representing any of the parties, it renders its advisory opinion as to how the dispute should be handled for the betterment of the project to keep the project on time and within budget.

As mentioned earlier, if the parties can come to an agreement through discussions based around the

(*continued on next page*)

Plain Talk About Large Construction Project Disputes (cont'd):

advisory opinion, the dispute will come to an end. If the parties do not come to an agreement, the dispute will need to be referred to an outside arbitration or to litigation. Arbitration and especially litigation can take several months to reach a final and binding decision from the arbitrator, judge and/or jury. It can easily take years for a dispute to come to a final settlement. Many parties, especially small subcontractors and similar small companies go out of business waiting for a dispute to settle.

It would certainly be in the interest of the success of the project to have the dispute handled as quickly as possible. It would be even better if all disputes could be handled quickly and inexpensively by construction-knowledgeable neutrals. A traditional DRB that only offers advisory opinions can accomplish this only if the parties agree on how to handle the dispute as a result of an advisory opinion.

Instead of using a traditional DRB, an Extended Dispute Review Board (EDRB) can provide full Alternative Dispute Resolution (ADR) including mediation and binding arbitration, which would insure that all disputes can be handled and settled entirely "In-House". In addition, an EDRB can provide its services to all parties involved in the construction project including not only the Project Owner and the General Contractor, but all subcontractors, sub-subcontractors, material suppliers, service providers, etc. Traditional DRBs usually are very effective in helping to prevent or settle disputes between the Project Owner and the General Contractor; however, any disputes between any other two parties would be outside of the DRB responsibilities and would require those disputes to go on to outside arbitration or litigation. All parties to the construction project under an EDRB are required to agree to utilize the three-step dispute resolution process including advisory opinions, mediation and if necessary, binding arbitration to settle all disputes. Depending on the complexity of the dispute and the preparation time that a party might need to make a proper presentation to the EDRB, a typical dispute can be completely settled in 30 – 60 – 90 days. If a dispute is of a critical nature, the parties may mutually choose to skip the advisory opinion and/or mediation processes and proceed directly to binding arbitration to reach an expeditious final settlement to the dispute. A major benefit of an EDRB is its flexibility which allows to parties to select the best process to settle their dispute.

A recent development designed to assist a DRB or an EDRB and to lessen the costs of a DRB or EDRB is a Construction Settlement Panel (CSP). On major construction projects it is not unusual to see several DRBs each with its own specialization. On the "Big Dig" artery project in Boston, there were 49 different DRBs utilized through out the construction project. These DRBs each met on a regular basis to review the progress of the project and to render advisory opinions as necessary to prevent or handle a dispute. The use of the 49 DRBs was quite costly and several of the DRBs sometimes met as scheduled without really having any important issues to handle. In an effort to provide the same expertise supplied by the many DRBs, without the high costs related to those multiple DRBs, the CSP was developed. The CSP is comprised of several construction-knowledgeable individuals, each with their own special expertise that was supplied by the multiple DRBs, however, the CSP is available only on request and they do not meet on a regular basis as did the DRBs. As an example, there may have been an "HVAC – DRB" that met on a regular basis whether or not there were HVAC issues to handle. If those same individuals were on the CSP rather than the DRB, they could be called upon by a General DRB who might need their expertise if an HVAC related dispute was submitted to the General DRB to be handled. The expense of those HVAC CSP Members would only be incurred when there was a dispute to be handled related to HVAC matters rather than as incurred through the regular DRB meetings. CSP Members would serve as a panel of construction specialists at the request of a General DRB. It would not be unusual to see both construction-knowledgeable specialists and construction ADR specialists on a CSP.

(*continued on next page*)

Plain Talk About Large Construction Project Disputes (cont'd):

The members of a CSP would all have been individually selected by the Project Owner and the General Contractor and all required paperwork including the "CSP Member Agreement" would have been executed that would specify the expertise of the CSP Member and his/her required fees for his/her professional services. Keep in mind that all parties participating on the construction project would also have executed the EDRB Agreements including an Agreement to Mediate and an Agreement to Arbitrate and related agreements, addendums and other required documents.

The flexibility of the EDRB program supported by a CSP allows any number of possible combinations of EDRBs. The most popular scenario is to set up one, two or three General EDRBs depending on the size and complexity of the construction project. If those EDRBs found that they were constantly calling on the same CSP Members, it might be advisable for a new EDRB to be established including those CSP Members who were being called upon on a regular basis. CSP members must rearrange their schedules to accommodate the requests of the EDRB. If they were scheduled to meet on a regular basis, scheduling would not be a problem as they could plan far in advance for their meetings rather than trying to juggle their schedule to accommodate the requests of the EDRB.

On more complex construction projects, it might be necessary to set up several specialized EDRBs whose members were not experienced in ADR but who could call on CSP Members with ADR experience to mediate or arbitrate a dispute if the advisory opinion rendered by the DRB was not accepted by the parties to the dispute. In another scenario, there could be several specialized DRBs and one or two ADR DRBs established to handle the mediation or arbitration requirements of the project.

A common misconception is that all DRBs or EDRBs are comprised of construction-technical individuals. It would not be unusual to see a "Financial Oversight EDRB" comprised of a forensic accountant and two other individuals with construction estimating or construction accounting background whose responsibilities would be to analyze all invoices, change orders, addendums, etc. The likelihood of overcharges, kick-backs, payments under the table, graft, corruption, etc. would be minimal if there was a DRB with the responsibility of reviewing the financial matters of the project. As mentioned earlier in this article, the EDRB possibilities are limited only to the imaginations of the major parties, especially the Project Owner who formulates the initial DRB or EDRB program.

As most Project Owners are not experienced with the formulation of a DRB or EDRB program, it is recommended that the Project Owner work with a National and/or International DRB provider firm such as Construction Dispute Resolution Services, LLC (CDRS). That provider should be able to analyze the complexity and requirements of the construction project and should be able to recommend several possibilities for combinations of DRBs, EDRBs and a CSP to properly address the potential disputes of the construction project.

A DRB provider can also coordinate all administrative aspects of the DRB or EDRB program. A typical DRB is formed by an Owner, such as a municipality, putting out a Request for Proposal (RFP) for the public to respond if they would like to get RFPs from individuals who would like to serve on their DRB program. The Owner would have to review those RFPs, select the Members along with the General Contractor and would individually contract with each DRB Member for their services. Those DRB members would then have to make all of their own travel arrangements and would submit their expenses as individuals to the proper party for payment. A DRB provider, such as CDRS, can provide a National and/or International Panel of DRB Members who have all been properly trained in the DRB and EDRB process. In addition, the provider could handle the execution of all required documents including the DRB Member Agreements, Party Participation Agreements, Agreements to Mediate, Agreements to Arbitrate, all CSP

(*continued on next page*)

Plain Talk About Large Construction Project Disputes (cont'd):

member agreements and other required documents and forms. At the end of each month, the provider would bill the appropriate party for all three of the DRB, EDRB Members and for all fees and expenses of CSP Members rather than looking to each DRB, EDRB or CSP Member to submit their expenses as individuals. There is always a good amount of additional administrative functions required for each of the meetings of the EDRB that could be handled by the DRB provider.

On large construction projects, bidders usually build in a "Litigation Contingency" into their bids to cover the costs of any future disputes. It is purely a guess as to the future costs of litigations that might be required for dispute resolution. If the EDRB is established prior to the project going out to bid, which is the normal process, the cost of the EDRB would be available through the EDRB provider similar to the bid estimates for the other aspects of the construction project. If the established EDRBs did not need any special meetings, the costs related to EDRB program would be available at the time of the bid and contractors would not need to allow for a litigation contingency. The costs for any special EDRB meetings, if required, are usually shared equally by the parties involved in the dispute.

This article is titled "Plain Talk about Large Construction Project Disputes". Let's talk about some other plain facts about construction disputes. If you were injured or became sick, you would go to a doctor or a hospital for the best treatment. You would not go to a judge or a jury to decide how to administer to your injury or illness. A doctor knows how you are built and how to remedy your medical problem. Likewise, a construction-specialist knows how the project should be built and the best ways to correct a problem or a dispute. If you bring a construction dispute before an arbitrator, judge or jury who are not familiar with construction, the parties, usually with the assistance of their attorneys make a presentation to convince the arbitrator, judge or jury as to which party is correct in their position. The best and most convincing presentation usually is the winner, not necessarily which presentation was right or wrong. As a result, CDRS highly recommends that all parties to a construction project utilize construction-knowledgeable individuals to decide how to prevent or settle a construction dispute. CDRS also recommends the use of attorneys on DRBs. An attorney, with construction litigation or construction ADR experience can be a very effective DRB chair and will be able to conduct the affairs of the DRB in a professional and organized manner.

Although there are fixed and variable costs related to the implementation of the DRB or EDRB program, the direct costs of just one outside arbitration or litigation can be many thousands of dollars and the indirect costs of a project delay or similar occurrence, while waiting for a dispute to be settled, would be impossible to estimate. If there were several major disputes that went on to outside settlement through arbitration or litigation, the project would most likely experience unnecessary delays and additional non-budgeted expenses. The existence of an EDRB program can also give the parties a "peace of mind" as to success of the project relating to the proper handling of construction disputes. The EDRB program offers a type of insurance that virtually guarantees the parties that they will never be involved in lengthy and costly litigations that can fester for many months or even years before they are settled.

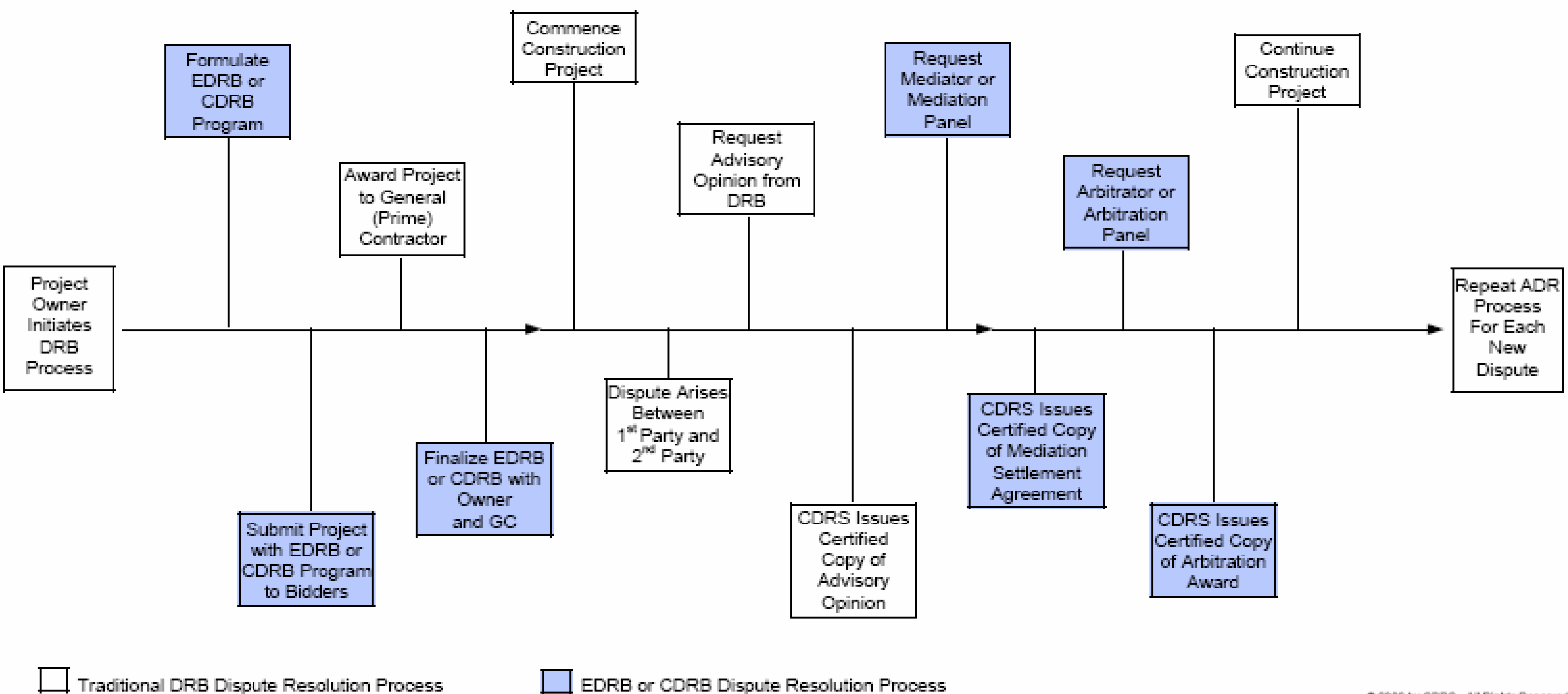
Additional information, including many of the required agreements, forms and documents concerning the DRB, EDRB and CSP programs is available on the CDRS website: www.constructiondisputes-cdrs.com or you can call CDRS toll-free at 888-930-0011.

---

* - Peter G. Merrill is the President and CEO of Construction Dispute Resolution Services, LLC a national provider of construction ADR services with construction ADR Specialists located in all 50 states and selected foreign countries. He was the "Builder of the Year" in 1996 in the state of New Mexico. He represented the construction industry on a Federal Reserve Board Advisory Council from 2002-2005. He is an associate member of the American Bar Association Dispute Resolution Section and is a well-known speaker and author on Construction ADR procedures.

Construction Dispute Resolution Services, LLC
Specializing in Mediation & Arbitration & Dispute Review Boards
3600 Rodeo Lane, Suite B7
Santa Fe, NM 87507
New Mexico: 505-474-9050
Fax Phone: 505-474-9061
Toll Free: 888-930-0011
Email: cdrs@cdrsllc.com
Website: www.constructiondisputes-cdrs.com

EXPANDED AND COMPREHENSIVE DISPUTE REVIEW BOARD PROCESS FLOW CHART



© 2006 by CDRS - All Rights Reserved

CONSTRUCTION DISPUTE RESOLUTION SERVICES, LLC

SPECIALIZING IN MEDIATION & ARBITRATION & DISPUTE REVIEW BOARDS

3600 Rodeo Lane, Suite B7
Santa Fe, NM 87507

New Mexico: 505-474-9050
Fax Phone: 505-474-9061

Toll Free: 888-930-0011
Email: cdrs@cdrsllc.com

Website: www.constructiondisputes-cdrs.com

EXPANDED OR COMPREHENSIVE DISPUTE REVIEW BOARD
OPTIONS FLOW CHART

Project Owner (PO) | Subcontractor | Sub-Subcontractor | Service Provider | Material Supplier | General Contractor (GC)

↓

DISPUTE REVIEW BOARD

PO Rep *Optional* | PO Neutral | Neutral Chair | GC Neutral | GC Rep *Optional*

↓

Advisory Opinion

- Advisory Opinion Unacceptable
  - Co-Mediation Panel: PO Neutral and GC Neutral
  - Mediator: PO Neutral or GC Neutral
  - ↓ Mediation Settlement Result
    - Unresolved Issues
      - Arbitration Panel: PO Neutral | Neutral Chair | GC Neutral
      - Arbitrator: Neutral Chair
      - ↓ Arbitration Award Result
    - Agreement On All Issues
- Advisory Opinion Acceptable

COLOR CODES

- White: Traditional Dispute Review Board (DRB)
- Green: Add PO & GC Representatives to the DRB
- Red: Add All Parties to Participate in the DRB ADR Processes
- Yellow: Add Final & Binding ADR Processes to DRB Responsibilities

© 2006 by CDRS - All Rights Reserved

Progress Payment Perils

by
Christyne K. Brennan
and
Peter A. McDonald*

[Note: This material is reprinted from GOVERNMENT CONTRACT COSTS, PRICING & ACCOUNTING REPORT, VOL. 2, ISSUE NO. 3, MAY 2007, and appears here with the permission of the publisher, Thomson/West. Further use without the permission of West is prohibited. For more information or to subscribe, call 1.800.344.5009.]

The Progress Payments clause (FAR 52.232-16) is well-known to both government contractors and government contract practitioners. This clause, which enables contractors to receive partial payments during performance, has long been the most widely used form of contract financing. Recently, however, there has been a little known development that addresses the Government's security interest arising under this clause and which may impose further administrative burdens on government contractors.

Subparagraph (d) *Title* of FAR 52.232-16 states:

> (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.
>
> (2) "Property," as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.
>
> (i) Parts, materials, inventories, and work in process;
> (ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;
> (iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and
> (iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

Under this subparagraph, the case law holds that the Government gains a title interest in the contractor's property that is allocable or properly chargeable to the contract. As a result, the Government has successfully sought to enforce its interest in such property in bankruptcy proceedings of government contractors. *See In re American Pouch Foods, Inc.*, 769 F.2d 1190 (7th Cir. 1985); *In re Verco Industries,* 27 Bankr. 615 (Bankr. 9th Cir. 1982); *In re Coated Sales, Inc.*, 112 B.R. 560 (Bankr. S.D.N.Y. 1988). *But see Marine Midland Bank v. United States,* 687 F.2d 395 (Ct.Cl. 1982).

It would appear, then, unnecessary for the Government to require any further enhancement of its rights to a contractor's property under the Progress Payments clause. Nonetheless, the Defense Contract Management Agency (DCMA) has prepared a standard Subordination Agreement (DCMA Form 1619),
(*continued on next page*)

Progress Payment Perils (cont'd):

which is applicable to Department of Defense and NASA contracts. The Subordination Agreement is a relatively new DCMA form created in February 2004, but not often utilized by the Government until recently. The Subordination Agreement states, in pertinent part:

> The contract or contracts include provisions for interim financing. Pursuant thereto, the Debtor has requested interim financing, which the Government is willing to grant in accordance with the terms of the contract clauses and upon condition that [Insert Creditor's Name] [Insert Creditor's Description, Address, etc.] hereinafter referred to as the Creditor, agrees to subordinate all of its rights with respect to payments due or to become due from the Debtor to the undersigned Creditor to the rights of the Government under or arising out of existing and future contracts. The rights of the Creditor on any and all, present and future, recorded or perfected liens under the Uniform Commercial Code are fully subordinated to the Government with respect to any property to which the Government has title under, or arising out of, the aforementioned contracts and future contracts. The property to which the Government has title pursuant to the contract clauses includes, but is not limited to, parts, material, inventory, and work in process.

In addition, DCMA's guidance concerning its use of the Subordination Agreement provides as follows:

> [W]hen a secured loan is found, the DCMA Analyst should assure that before the Government makes [a] progress payment to a secured contractor where the bank has inventory as part of the security, the bank sign a release (Uniform Commercial Code Form UCC-3) for the progress payment inventory and/or a Subordination Agreement which will subordinate the bank's right to inventory on which the Government has made progress payments….The use of Subordination Agreements is appropriate to protect the Government's interest when working capital has been provided by way of loans during contract performance. <u>Specifically, the use of Subordination Agreements support the rights of the Government by certain clauses that may be in the contract that give title</u>. There is a basic form for accomplishing this; it is DCMA Form 1619. [Emphasis added.]

In view of the rights accorded the Government under the Progress Payments clause, it would appear that such a Subordination Agreement would be unnecessary. Indeed, DCMA's own guidance recognizes that the contract may already include such title-vesting clauses.

Furthermore, in addition to being seemingly unnecessary, such a form imposes a heavier administrative burden on contractors who will need to identify specific property as being associated with a government versus commercial contract. Specifically, the bank's security interest under the U.C.C. may extend to inventory and other property unrelated to the contract, while the Government's security interest would only be in property connected with the performance of the government contract. Ideally, this should be two distinct groups of property. However, the burden of identifying the property will fall most heavily on small businesses, who generally lack such administrative controls or the staff to operate them. Even where knowledgeable staff is available, small businesses typically get by with inexpensive accounting systems, while accounting software with integrated asset management capability costs more than most can

(*continued on next page*)

Progress Payment Perils (cont'd):

Or are willing to pay. As a result, the paradox is that the use of DCMA Form 1619 may actually be an obstacle for those that Progress Payment financing is most intended to assist.

At the very least, contractors affected by the use of DCMA Form 1619 are advised to obtain guidance from knowledgeable counsel.

---

* - Christyne K. Brennan is a partner with the Washington, D.C. office of Gibson, Dunn & Crutcher LLP specializing in government contracts . Peter A. McDonald, an attorney-C.P.A., is a director in the RSM McGladrey Government Contracts practice.

Viewpoint:
DCAA Audit Guidance Conflicts with the Pension Protection Act

by
Peter A. McDonald*

[Note: This article originally appeared in BNA *Federal Contracts Report*, Vol. 87, No. 21, pp.637-638 (May 29, 2007). Copyright 2007 by The Bureau of National Affairs, Inc. (800-372-1033), http://www.bna.com.]

On 1 May 2007, the Defense Contract Audit Agency (DCAA) issued a memorandum for regional directors entitled "Audit Guidance on the Impact of the Pension Protection Act of 2006." For reasons set forth below, I believe this guidance may conflict with the Pension Protection Act and may be wanting in authoritative support.

This DCAA guidance stated in pertinent part (*see* "DCAA Pension Act Guidance Continues Call for Compliance with CAS 412, 413," by Martha A. Mathews, BNA *Federal Contracts Report*, Vol. 87, No. 20, May 22, 2007):

> However, contractors are required to continue to comply with CAS [Cost Accounting Standard] 412 and 413 for Government contract costing purposes. Auditors should question any proposed pension costs in excess of the amounts calculated in compliance with CAS 412 and 413.

The guidance also stated:

> The Director, Defense Procurement and Acquisition Policy (DPAP), issued DoD policy addressing the impact of the PPA on forward pricing (see Enclosure). The key provisions of the DoD policy are that pension costs priced into contracts shall continue to comply with CAS 412 and 413 and that contracting officers shall not negotiate any increase in contract price or include a re-opener clause that would allow for a later adjustment for pension costs in anticipation of a revision to CAS 412.

Finally, the guidance stated that pension plan contributions in excess of the Cost Accounting Standards (CAS) are to be treated as "prepayment credits, as provided in CAS 412.50(a)(4)." Clearly, this guidance concluded that *only* pension funding determinations done in accordance with CAS were allowable. I disagree.

In August 2006, the Pension Protection Act (PPA) made numerous changes to the legal requirements applicable to defined benefit plans. The PPA increased minimum funding levels, made actuarial changes (such as interest rate and mortality assumptions), imposed stricter accounting, and significantly enhanced the recordkeeping and reporting requirements applicable to plan sponsors (*see* "The Pension Protection Act of 2006: A Primer for Government Contractors and Grantees," by Peter A. McDonald, BNA *Federal Contracts Report*, Vol. 86, No. 10, September 19, 2006). Only the largest DOD contractors (as defined in the PPA) were permitted delayed implementation.

One result of the Pension Protection Act created a particular dilemma for some government contractors. Specifically, depending on the type of pension plan involved, the demographic profile of the work force, and other factors, the minimum pension funding amount determined in accordance with the Employee Retirement Income Security Act (ERISA) as amended by the PPA, could materially differ from the minimum pension funding amount determined in accordance with the CAS. Section 106(d) of the Pension Protection

(*continued on next page*)

Viewpoint: DCAA Audit Guidance Conflicts with the Pension Protection Act (cont'd):

Act recognized this problem, and rather than supplying a solution the Act provided as follows:

> Cost Accounting Standard Pension Harmonization Rule - The Cost Accounting Standards Board shall review and revise sections 412 and 413 of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413) to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 of eligible government contractor plans and government reimbursable pension plan costs not later than 1 January 2010. Any final rule adopted by the Cost Accounting Standards Board shall be deemed the Cost Accounting Standard Pension Harmonization Rule.

Clearly, the Pension Protection Act does not state that the cost allowability of pension funding differences are to be resolved by the Director, Defense Procurement and Acquisition Policy (DPAP), or even by DCAA guidance. To the contrary, the Act specifically requires PPA funding differences to be resolved by the Pension Harmonization Rule. Unambiguously, that rule is to be determined by the Cost Accounting Standards Board, not the DPAP and not DCAA (indeed, DCAA lacks rule making authority). In short, the reference in the DCAA guidance to a "requirement" that only CAS pension funding determinations are allowable appears to contravene the Pension Protection Act by effectively creating a rule DCAA has no authority to make.

Legislative Intent. There is another reason why the DCAA audit guidance conflicts with the PPA. Consider what the Pension Harmonization Rule was intended to accomplish. As quoted above, the Pension Harmonization Rule stated that CASB "shall review *and revise sections 412 and 413 . . . to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974. . .*" [Emphasis added.] This language can be construed as the legislative intent for CASB's Pension Harmonization Rule to *raise* the CAS thresholds to the new ERISA levels. As a federal statute, the PPA is a higher form of law than a regulation, such as CAS 412 and 413. I believe that Congress would not have directed the Pension Harmonization Rule "to harmonize [with] the minimum required contribution under ERISA" unless the ERISA-determined amounts were to be allowable.

Accordingly, the DCAA guidance, which states that "contractors are required to continue to comply with CAS 412 and 413 for Government contract costing purposes," relies on regulations that were at least implicitly superseded by this provision of the PPA. Keep in mind that the legislative intent was for all plan sponsors to be liable for increased ERISA amounts. As shown by the italicized language above, the PPA's Pension Harmonization Rule is to revise the CAS minimum contribution amounts to be consistent with the new ERISA minimum requirements. Therefore, the Pension Harmonization Rule appears to contradict the DCAA guidance that "contractors are required to continue to comply with CAS 412 and 413."

I also disagree with the statement in the May 1 audit guidance that the "key provisions of the DoD policy are that pension cost[s] priced into contracts shall continue to comply with CAS 412 and CAS 413" (note the compulsory word "shall"). There is no such language anywhere in the DPAP policy letter of December 22, 2006. Even if there were, it would make no difference as the DPAP lacks authority to create policy that violates federal law, such as the PPA. On the question of whether the DPAP policy requires that contractors "shall continue to comply with CAS 412 and CAS 413," the DPAP letter actually states:

> 1. Proposed Increased Pension Costs Using Current CAS Rules
>
> …
>
> When contractors propose increased pension costs based on the current Cost Accounting Standards (CAS) and the PPA, contracting officers *shall contact* their cognizant Administrative Contracting Officer (ACO) and/or Defense Contract Audit Agency (DCAA)

(*continued on next page*)

Viewpoint: DCAA Audit Guidance Conflicts with the Pension Protection Act (cont'd):

> auditor for assistance in reviewing these costs before negotiating the contract price. [Emphasis supplied.]

In my view, the requirement that contracting officers "shall contact" their ACO and/or DCAA auditor is decidedly *not* a requirement that pension costs priced into contracts "shall continue to comply with CAS 412 and CAS 413," as stated in the DCAA guidance. To reinforce the point that COs were only to internally coordinate, the DPAP policy letter repeated it:

> In summary, if the contractor proposes increased pension costs as a result of the PPA, contracting officers *shall consult with* the cognizant ACO and auditor before determining whether to include any proposed costs relating to the contract price or FPRs. [Emphasis added.]

In sum, the assertion in the DCAA audit guidance, that "contractors are required to continue to comply with CAS 412 and 413 for Government contract costing purposes," is not supported by the wording of the DPAP policy letter of December 22, 2006.

It now appears that the Pension Harmonization Rule will not be soon forthcoming. Accordingly, affected contractors will have to make their pension funding determinations in the absence of rules clarifying the ERISA/CAS minimum funding differences. To ascertain the minimum funding requirements of the Pension Protection Act, a contractor must determine its minimum funding in accordance with ERISA (as amended by the PPA). In my opinion, those ERISA-determined pension costs are fully allowable even where such costs exceed the amount of CAS-determined pension costs because the Pension Protection Act requires *both* determinations for government contractors, and the Pension Harmonization Rule (when made) will require the CAS-determined amounts to agree with the ERISA-determined amounts. Recall also that the DPAP policy letter does not state that ERISA-determined pension costs are unallowable. As shown above, where a contractor's minimum pension costs exceed the CAS-determined amount, DPAP policy only requires contracting officers to contact their ACO and auditor.

Finally, I was disappointed that the DPAP policy letter, as well as the May 1 DCAA audit guidance, ignored the fact that for some pension plans the PPA applies retroactively. Also ignored was the issuance by the Financial Accounting Standards Board (FASB) of Statement of Financial Accounting Standard No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. Each of these developments make accounting for pension costs more difficult, and are among the many complexities in this area that any new guidance will need to address.

From my review of the relevant sources, I conclude that the May 1 DCAA audit guidance appears to conflict with the Pension Protection Act, and is not supported by the DPAP policy letter of December 22, 2006.

---

* - Peter A. McDonald, attorney-C.P.A., is a director in the Government Contracts practice of RSM McGladrey in Bethesda, Maryland, and is a member of the BNA *Federal Contracts Report* editorial advisory staff.