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The Clause

A Quarterly Publication of the Boards of Contract Appeals Bar Association

The President's Column David Nadler

Dear BCABA Members:

With the summer now behind us, it is time to return to the wonderful world of government contracting. We are looking forward to an exciting fall highlighted by two of our most popular programs.

The Executive Policy Forum will be held on **September 22, 2009** at the offices of Arnold & Porter LLP. Thanks to David Metzger of Arnold & Porter for leading this event. Our Annual Program will be held on **October 22, 2009** at the Renaissance M Street Hotel in Washington, D.C. The program titled, "The Ever-Changing Procurement Landscape: Audit, Compliance, Claims and New Administration Initiatives," will feature panels on audit issues, revolving door and conflicts of interest, socio-economic requirements under the Obama Administration, challenges arising from contractors in the battlefield, and a BCA Judges panel. We are excited that our luncheon speaker will be RADM Kathleen Dussault, Director, Supply, Ordinance and Logistics Operations, Office of the Chief of Naval Operations. Thanks to Susan Warshaw Ebner for putting together such a great program.

We have also recently launched our enhanced BCABA website which will be more user-friendly and content rich. Check it out at www.bcaba.org. Thanks to Pete McDonald for (continued on page 3)

Table of Contents

BCABA Board of Governors/Officers	2
Executive Policy Forum	3
Annual Meeting Flyer & Registration Form	4
Contractor Liability for Taxes Under FAR 52.229-3: When Are Equitable Adjustments Permissible? <i>by Steven W. Feldman</i>	7
How to Avoid Giving Away Your Proprietary Technical Data and Computer Software Under Contracts with the Department of Defense <i>by Keith Szeliga</i>	20
Reimbursement of Punitive Damages as a Cost of Litigation: Towards a Practical Solution For Allocation of Extraordinary Damages <i>by Zachary Rose Stern</i>	32
Judging the Common Law: Judge Sotomayor and the Government Contractor Defense <i>by David Nadler</i>	47

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President's Column (cont'd):

his leadership on this initiative. Thanks also to Pete for bringing together another excellent collection of articles for this edition of *The Clause*.

Our next board of governors meeting will be on **September 17, 2009** at the offices of Dickstein Shapiro LLP, 1825 Eye Street, NW, Washington, DC 20006.

Best regards,

Dave Nadler
President

BCABA Executive Policy Forum

The 2009 Executive Policy Forum will be held on **September 22, 2009** at the offices of Arnold & Porter at 555 Twelfth Street, N.W., Washington, DC 20004, in Room 300. The Executive Policy Forum this year will address three significant cases that were decided recently, including the A-12 case, one of the longest running termination cases in the history of government contracts. Mr. Ronald Schechter, Partner, Arnold & Porter will lead the discussion of the A-12 case. The other two cases are from the Armed Services Board of Contract Appeals, *International Oil Trade Center*, ASBCA 55377; CCH 08-2, ¶ 33916; July 16, 2008, and the Civilian Board of Contract Appeals, *Inversa, S.A., v. Department of State*, 08-2 BCA ¶ 33924, CBCA 440, July 29, 2008, WL 3052442 (Civilian B.C.A). These interesting cases from both boards will be discussed by as many of the participants involved in these cases as can attend. We expect these participants will lead a lively discussion of each of the cases.

We hope to have a good attendance by judges from both boards and by members of the government and the private bar to discuss these cases. We hope to see you there.



BCABA Annual Meeting Agenda
Renaissance M Street Hotel, Washington, D.C.
October 22, 2009

8:30-9:00 am Registration*

Welcoming Remarks: David M. Nadler, BCABA President
Susan Warshaw Ebner, Vice-President and Program Chair

9:00 - 10:00 a.m. KNOCK, KNOCK - IT'S TIME FOR YOUR AUDIT

Panelists: Nicole J. Owren Weist, Partner, Wiley Rein; **Darrell J. Oyer, CPA**, Darrell J. Oyer & Associates; **John H. Russell**, Senior Counsel, Northrop Grumman Corporation.
Moderator: Michael Littlejohn, Akerman Senterfitt.

10:00-11:00 a.m. HOW NOT TO GET SPUN UP IN THE REVOLVING DOOR AND OTHER CURRENT CONFLICTS OF INTEREST ISSUES FOR CONTRACT ATTORNEYS -- ETHICS PANEL

Panelists: Stephen Epstein, Government Ethics & Compliance Leader, PricewaterhouseCoopers, LLP and **Wallace "Gene" Shipp, Jr.**, Bar Counsel, DC Office of Bar Counsel.

11:15-12:00 p.m. BUY AMERICAN AND SOCIO ECONOMIC REQUIREMENTS UNDER THE OBAMA ADMINISTRATION

Panelists: Angela Styles, Crowell & Moring, and **Mathew Blum**, Office of Federal Procurement Policy (invited).
Moderator: Christopher R. Yukins, Professor, George Washington University.

12:00 - 1:00 p.m. Luncheon

Speaker: RADM Kathleen Dussault, U.S. Navy, Director, Supply, Ordnance and Logistics Operations, N41, Office of the Chief of Naval Operations.

RADM Dussault started this position in March 2009, but she will speak about her most recent assignment as commander of the Joint Contracting Command Iraq/Afghanistan, headquartered in Baghdad, Iraq, with 18 regional offices throughout both theaters.

1:15 - 2:30 p.m. THE CONTINUING EVOLUTION OF CONTRACTORS ON THE BATTLEFIELD: IRAQ/AFGHANISTAN AND BEYOND?

Panelists: Marcia Bachman, Associate General Counsel (Acquisition) USAF; **Michael K. Love**, Assistant General Counsel, Computer Services Corp.; **Peter Levine**, Counsel, Senate Armed Services Committee (invited); **Doug Brooks**, President, International Peace Operations Association.
Moderator: James McCullough, Fried Frank.

3:00 - 4:00 p.m. BCA JUDGES PANEL

Panelists: Judge Sharon Larkin, Government Accountability Office Board of Contract Appeals; **Judge Jeri Somers**, Vice Chair, Civilian Contract Appeals Board; **Judge Eunice Whitney Thomas**, Vice Chair, Armed Services Board of Contract Appeals; **Judge Jonathan Zischkau**, Chair, District of Columbia Contract Appeals Board.
Moderator: David Black, Holland & Knight.

4:00 - 4:30 p.m. BCABA Business Meeting

* - The BCABA will request 6 hours of VA CLE credit (including 1.0 hour of Ethics) for this program.



Annual Program
 The Ever-Changing Procurement Landscape:
 Audit, Compliance, Claims, and
 New Administration Initiatives

Renaissance M Street Hotel, Washington, D.C.
 October 22, 2009

Name: _____

Title: _____

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To Register for the Program RSVP by *October 10, 2009*. Mail your check payable to BCABA together with this completed form to: BCABA c/o Shelley Butler, Buchanan Ingersoll & Rooney PC, 1700 K Street, NW, Suite 300, Washington, DC 20006.

Questions? Call Shelley Butler at 202-452-7094.

Educational Program Tuition

Non-Members:	\$200
BCABA Members:	\$185
Attendees from Gold Medal Member Firms:*	\$175
Government Employees:	\$150

BONUS!! – For an additional \$10 added to tuition price, attendees will receive BCABA membership for 2009-2010. *(Regular membership for those not attending program is \$45 for private practice attorneys and \$30 for government employees.)*

NOTE: Credit Cards. If you would like to use a credit card *in lieu of paying by check*, please complete the enclosed Credit Card Information Form and forward it along with this Registration Form.

* - A Gold Medal Member Firm is a law firm or organization in which all of its government contracts lawyers are members of the BCABA. Gold Medal Firms as of 2008-2009 or those signing up all government contract attorneys for the 2009-2010 year will be eligible for this discount. We appreciate the support of our Gold Medal Firms!



Annual Program
 The Ever-Changing Procurement Landscape:
 Audit, Compliance, Claims, and
 New Administration Initiatives

Renaissance M Street Hotel, Washington, D.C.
 October 22, 2009

If you wish to pay for the Boards of Contract Appeals Annual Program registration fee(s) and/or membership due(s) by credit card (**VISA or Master Card only**) *in lieu of check*, please provide the following information:

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[Please attach a separate list, if necessary.]

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* Please fill out a separate Membership Registration Form for each individual.

Contractor Liability for Taxes Under FAR 52.229-3: When Are Equitable Adjustments Permissible?

by
Steven W. Feldman*

[Note: “*Contractor Liability for Taxes Under FAR 52.229-3: When Are Equitable Adjustments Permissible?*,” by Steven W. Feldman, 2009, *Procurement Lawyer* 44.4, p. 1-22. © 2009 by the American Bar Association. Reprinted with permission.]

Issues commonly arise where a contractor on a fixed-price agreement seeks an equitable adjustment for taxes omitted from a proposal or taxes imposed after contract award. The primary guidance is standard Federal Acquisition Regulation (FAR) clause 52.229-3, Federal, State and Local Taxes (Apr 1003), which incorporates the basic rule that “the contract price includes all applicable Federal, State and local taxes and duties,” with additional comprehensive coverage for after-imposed and after-relieved taxes. Outside this clause, a fixed-price contract commonly will contain no further terms concerning the contractor’s tax liability.

Notwithstanding the bright-line rules in FAR 52.229-3, both government agencies and contractors often have difficulty interpreting the tax laws and regulations of the diverse jurisdictions. As a result, the contractor might mistakenly decide to omit taxes from its proposal but then seek an adjustment from the contracting officer after award when the contractor learns that taxes did apply. Another potential scenario is when an agency contracting representative incorrectly informs the contractor before award that taxes do not apply, the contractor relies to its detriment on that advice, and the contractor later seeks an adjustment from the government. A third possibility is that before award, the contractor consults with the federal, state, or local taxing authority, relies on the particular authority’s guidance to its detriment, and then seeks an adjustment after award. A fourth circumstance may arise when the federal, state, or local taxing authority either imposes or relieves a tax after award, and the contractor or the government seeks a price modification.

This article will address FAR 52.229-3 and the case law on equitable adjustments for omitted or after-imposed and after-relieved taxes. After analyzing the basic clause and its policy, the article will consider the numerous arguments contractors have made for avoiding the clause’s restrictions where the contractor has discovered it left out required taxes or where taxes have increased. As a general rule, the boards of contract appeals and courts greatly disfavor requests for price increases outside the clause’s limitations. The next topic addressed will be government-requested equitable adjustments to reduce a fixed price for either after-relieved taxes, the amount of the contractor’s unpaid taxes, or the contractor’s failure to obtain a refund. Throughout, the article will suggest improvements to FAR 52.229-3 that will achieve greater fairness to the parties.

FAR 52.229-3: Key Terms

Absent a special adjustment clause or statutory relief, the contractor with a fixed-price
(continued on next page)

Contractor Liability For Taxes (cont'd):

contract assumes the risks of increased costs not attributable to the government as the other contracting party.¹ Regarding possible adjustments for taxes, FAR 52.229-3 governs most competitively awarded fixed-price contracts.² the clause contains the following key terms:

- “The contract price includes all applicable Federal, State and local taxes and duties.”³
- “All applicable Federal, State and local taxes and duties” means “all taxes and duties, in effect on the contract date, that the taxing authority is imposing and collecting on the transactions or property covered by this contract.”⁴
- “The contract price shall be increased by the amount of any after-imposed Federal tax, provided the Contractor warrants in writing that no amount for such newly imposed Federal excise tax or duty or rate increase was included in the contract price, as a contingency reserve or otherwise.”⁵
- “After-imposed Federal tax” means “any new or increased Federal excised tax or duty, or tax that was exempted or excluded on the contract date but whose exemption was later revoked or reduced during the contract period, or the transactions or property covered by this contract that the Contractor is required to pay or bear as a result of legislative, judicial, or administrative action taking effect after the contract date. It does not include Social Security or other employment taxes”⁶
- “After-relieved Federal tax” means “any amount of Federal excise tax or duty, except Social Security or other employment taxes, that would otherwise have been payable on the transactions or property covered by this contract, but which the Contractor is not required to pay or bear, or for which the Contractor obtains a refund or drawback, as a result of legislative, judicial, or administrative action taking effect after the contract date.”⁷
- “The Government shall, without liability, furnish evidence appropriate to establish any exemption from any Federal, State, or local tax when the Contractor requests such evidence and a reasonable basis exists to sustain the exemption.”⁸

Numerous decisions of the courts, boards of contract appeals, and the Government Accountability Office (GAO) address the ground rules of FAR 52.229-3 or its essentially identical predecessor clauses. The cases adhere to the rule that FAR 52.229-3 does not require the inclusion of inapplicable taxes.⁹ The clause is unambiguous;¹⁰ it plainly places upon firms doing business with the government the risk of ascertaining the applicability of federal, state, and local taxes, as well the risk of including sufficient amounts in their bids and proposals to cover such taxes.¹¹ Contractors have no immunity from a tax the incidence of which falls on a firm doing business with the government.¹² Custom, trade practice or other extrinsic evidence cannot vary the clear tax terms of a contract.¹³ Offerors have the duty to ascertain whether any taxes apply and the possibility of receiving tax exemptions.¹⁴ An offeror taking exception to a solicitation requirement that the price must on a tax-included basis could render its bid or proposal unacceptable for award.¹⁵ Even where the offeror submits a proposal on a tax-exempt basis, it bears the ultimate responsibility for any tax liability that may arise from the contract.¹⁶

In a principle of special importance, the decisions hold that without a special adjustment clause or statutory relief, contractors subject to FAR 52.229-3 bear the risk of increased state
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Contractor Liability For Taxes (cont'd):

and local taxes imposed after award, regardless of the amount or timing of the increase, and notwithstanding that the clause grants a remedy for after-imposed federal taxes.¹⁷ Several board judges have criticized this disparity in the treatment of after-imposed federal versus state and local taxes, especially where the contractor could not have reasonably anticipated the new or increased state or local tax. As stated by the former Interior Board of Contract Appeals (IBCA):

It is not clear why the Government should routinely reap the benefit of the fact that these taxes are often imposed on its contractors unexpectedly and without notice, and therefore cannot be included in formal bids (except as an undesirable contingency item), or why the contractor should be held to have accepted the risk of such an unexpected tax imposition despite the fact that the project on which the tax was imposed was entirely for the benefit of the Government and was a legitimate project cost.¹⁸

Unfortunately, the Defense Acquisition Regulations Council and Civilian Agency Acquisitions Council (the bodies responsible for promulgating the FAR) have yet to heed these valid criticisms of FAR 52.229-3.

FAR 52.229-3: Policy

The purpose of requiring offers on a tax-included basis is to ensure that the government will not be obligated to reimburse the contractor for any taxes the contractor might have to pay in the event they were omitted from the proposed price.¹⁹ Offerors and contractors have the burden of determining the amount of payable taxes under FAR 52.229-3 because they are generally more familiar with the application of state and local taxes than the contracting agency. The challenge here is that nearly all states and many localities impose taxes or duties, and the rules vary greatly from one jurisdiction to another.²⁰ As the GAO has observed, it would be inappropriate for agencies to shoulder the undue administrative burdens of examining the tax situation and analyzing the various state and local tax laws for each offeror that might submit a proposal.²¹ The GAO has further commented that contracting agencies ordinarily lack sufficient familiarity with the offeror's operations to make these taxability determinations.²²

Along with the above-mentioned policies, proof problems militate against the contractor's broad entitlement to a post-award adjustment for omitted taxes. In *Centric Jones Construction*, the former IBCA commented:

Moreover, as a practical matter, there is no way the Government can ever be sure that a successful bidder did not somehow include the possibility of potentially applicable taxes in its bid It would be in derogation of the bidding process for a successful bidder easily to be able to come back later and say, "Oh, by the way, I misunderstood or neglected to include X, Y, or Z in my bid, so I need another hundred thousand dollars or so to complete the contract."²³

Another policy underlies FAR 52.229-3 concerning the contractor's mandatory (not *continued on next page*)

Contractor Liability For Taxes (cont'd):

discretionary)²⁴ entitlement under paragraph (c) of the clause, discussed above, to a price adjustment for after-imposed *federal* taxes. Courts and boards typically state on this policy issue, “[b]idders and contractors are encouraged to depend on a price adjustment if they subsequently find themselves forced to pay higher taxes, rather than to seek to protect themselves in advance by raising their prices to cover the mere possibility of a tax increase.”²⁵ The tribunals apply this standard liberally in favor of the contractors so they will be encouraged not to pad their offers.²⁶ Again, however, as mentioned above, an inconsistency exists in that contractors have no similar entitlement to an equitable adjustment for after-imposed state and local taxes.

Contractor Theories for Recovering Omitted Taxes

The courts and boards have rejected on a case-by-case basis numerous theories for avoiding the bar of FAR 52.229-3 where the contractor has omitted an amount for taxes from its fixed-price agreement.²⁷

Unilateral Mistake

Contractors have argued that they made a unilateral mistake in calculating taxes during offer preparation. Under this unilateral mistake doctrine, a contractor may obtain a remedy for a mistaken offer only if the contracting officer knew or should have known of the contractor’s error when the offer was accepted. To succeed, the contractor must meet a two-part test. In addition to establishing knowledge on the part of the contracting officer, the contractor must also demonstrate that the error was a clear-cut clerical or arithmetical mistake or a misreading of the specification as opposed to a judgment error.²⁸

Contractor invocation of the unilateral mistake doctrine has been uniformly unsuccessful. The consistent rule is that no legal basis exists for adjusting a fixed-price contract merely because the contractor made a mistake in business judgment or misunderstood the application of the tax laws to the contract.²⁹ Omitting taxes is not a compensable mistake when the contractor decides it can purchase needed items without incurring applicable tax and does not include that tax as part of the price.³⁰ Additionally, it will be difficult for the contractor to prove the contracting officer knew or should have known of the mistake, especially where the dollar amount of the claim is relatively small compared to the offered price.³¹

Mutual Mistake

Contractors have asserted that the government and the contractor were mutually mistaken in believing that a project was exempt from taxes, and that the contract should be reformed to reflect a higher price.³² The elements for a compensable mutual mistake are: (1) the parties to the contract were mistaken in their belief regarding a fact; (2) that mistaken belief constituted a basic assumption underlying the contract; (3) the mistake had a material effect on the bargain; and (4) the contract did not put the risk of the mistake on the party seeking reformation.³³

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Contractor Liability For Taxes (cont'd):

Mutual mistake as to a contractor's obligation to pay a tax under FAR 52.229-3 generally is not compensable. Absent unusual circumstances, such mistakes of law cannot form the basis for reformation.³⁴ The theory also has a low chance for success because one of the essential elements of reformation for mutual mistake is that the contract must not place the risk of the mistake on the party seeking reformation.³⁵ In this respect, FAR 52.229-3 unambiguously places the risk of a mistake on tax applicability on the contractor, not the government.³⁶ Where the laws change, and the contractor seeks recovery based on mutual mistake, the failure of the parties to anticipate such changes is not a compensable "mutual mistake."³⁷

Superior Knowledge

Contractors have asserted claims based on the government's alleged failure to communicate its "superior knowledge" of the contractor's potential tax obligation. The elements of a superior knowledge claim are: (1) the contractor undertook to perform without vital knowledge of a fact that affects performance costs or direction; (2) the government was aware the contractor had no knowledge of, and no reason to obtain, such information; (3) any contract specification supplied misled the contractor, or did not put it on notice to inquire; and (4) the government failed to provide the relevant information.³⁸

Based on the facts, the boards have rejected this theory in the omitted taxes scenario. In one case, the contractor failed to prove the government knew or should have known of the impending tax requirements in dispute.³⁹ In a second decision, the particular information allegedly withheld pertaining to the applicability of sales tax — that the government was not agreeable to directly purchasing materials — was readily available to the contractor upon reasonable inquiry.⁴⁰ In a third decision, the contractor failed to show that the government misled the contractor into pursuing a course of action regarding tax liability that the agency knew to be defective.⁴¹

Equitable Estoppel

Contractors have argued that they detrimentally relied on the incorrect pre-award advice of federal government employees that taxes were not applicable. This contention expressly or impliedly invokes the doctrine of "equitable estoppel." the elements of equitable estoppel are: (1) misleading conduct, which may include not only statements and actions, but silence and inaction, leading another to reasonably infer that rights will not be asserted against it; (2) reliance upon this conduct; and (3) because of such reliance, material prejudice if the delayed assertion of such rights is permitted.⁴² Additionally, the claimant must show "affirmative government misconduct," i.e., affirmative misrepresentation or concealment of a material fact as opposed to mere negligence, delay, inaction, or failure to follow agency guidelines, because the government may not be estopped on the same terms as any other litigant.⁴³

In this regard, equitable estoppel against a federal agency is generally not available to
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Contractor Liability For Taxes (cont'd):

Individuals who rely on incorrect legal advice from government employees.⁴⁴ Where the government official giving this advice lacks the actual authority to do so, the courts and boards generally give this argument especially short shrift. As the Court of Federal Claims observed: “Any contractor who enters into an arrangement with an agent of the government bears the risk that the agent is acting outside the bounds of his authority, even when the agent himself was unaware of the limitations on his authority.”⁴⁵

Consistent with these principles, the Armed Services Board of Contract Appeals (ASBCA) in *Trieu-Tiet* denied a claim for omitted taxes, reasoning that the contracting officer had no authority to give the contractor advice on the legal implications of the tax requirements. Further, the board said the contracting officer’s advice was legally incorrect, and that a government employee’s erroneous conclusion of law is not binding on the party who makes it or upon a court or board.⁴⁶ Other decisions also observe it makes no difference whether the government has incorrectly provided the contractor with evidence to establish a tax exempt certificate because FAR 52.229-3(h) insulates the government from any liability in the process.⁴⁷

In a variation on this “incorrect advice” scenario, contractors sometimes assert that state or local government officials have misled them about the applicability of taxes. Absent a statute or a contract clause, the United States Government has no liability to its contractors for the excess costs stemming from the independent, incorrect advice of state or local government officials.⁴⁸ Notably, in *Kearny Post Office Associates*,⁴⁹ the former Corps of Engineers Board of Contract Appeals (ENG BCA) arrived at this result when an official of the local government — the mayor of the township — gave the contractor incorrect advice about the applicability of taxes. According to the board, the contractor’s only remedy is under state or local law against officials who provide invalid advice. The board reached its conclusion based on the rationale that the federal government cannot be an insurer for contractors against the errors of state or local officials on tax questions.⁵⁰

Most states properly follow the same actual authority rule cited above for the alleged invalid advice of state or local officials. This, in *Service Mgmt. Inc. v. State Health and Human Services Finance Commission*,⁵¹ the South Carolina Court of Appeals commented: “[T]he public cannot be estopped . . . By the unauthorized or erroneous conduct or statements of its officers or agents which have been relied on by a third party to his detriment.” Similarly, the Ohio Court of Appeals said in *Gaston v. Board of Review*⁵² that: “Persons seeking information must assume that the risk that the agent of the government might be wrong.” Therefore, little likelihood exists that the contractor receiving misleading advice from state or local officials on taxes will have a remedy even under state law.

Misrepresentation

Contractors have sought an equitable adjustment where the government allegedly has misrepresented to the contractor the extent of its tax liability. To prevail on this theory, the
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Contractor Liability For Taxes (cont'd):

Contractor must prove an erroneous representation of material fact by the government and the contractor's reasonable reliance thereon.⁵³

This theory has the greatest chance for success by contractors. There have been a few cases in which the contractor was granted relief based upon government misrepresentation about the status of taxes, even with a clause such as FAR 52.229-3 in the contract. The former IBCA⁵⁴ and the ASBCA⁵⁵ have so held in favor of the claimant. Intermixing issues of mutual mistake of law with its analysis on this point, the GAO has allowed a remedy for government misrepresentations,⁵⁶ and a number of board decisions accept the theory in principle while rejecting it under the specific circumstances presented.⁵⁷

The cases granting or approving relief for misrepresentation are incorrect. By comparison, cases considering the closely related mutual mistake theory have ruled in the government's favor on similar facts. These decisions properly deny relief because the contractor under FAR 52.229-3 bears the risk of including all applicable taxes in its offer. Thus, the United States Court of Federal Claims in *Foley Co. v. United States*, while noting that the particular government employee had no authority to provide binding information on taxes, also persuasively emphasized that the cases granting relief for contractors have failed to consider the full preclusive effect of FAR 52.229-3 and its allocation of risk of taxes to the contractor.⁵⁸ Indeed, the general rule is that all persons are presumed to know the law, and so there ordinarily cannot be a misrepresentation by one party regarding something (here, tax liability) that the other party is presumed to know was incorrect.⁵⁹ To the same effect, the ASBCA has ruled that an actionable misrepresentation will be lacking where a contractor unreasonably relied on unauthorized advice that conflicted with the contract.⁶⁰

In further support of the position that the misrepresentation cases are often wrongly analyzed or decided, another criticism exists in this area. The factual circumstances here are no different in their essentials from when the contractor seeks relief on an equitable estoppel theory, especially with the usual scenario based on the agency employee's negligent misrepresentation about the contractor's tax liability.⁶¹ In both situations, the contractor seeks relief based on misleading government statements that lead to detrimental reliance, and yet the cases have established a bright line standard strongly disfavoring relief based on equitable estoppel but not for misrepresentation. Because the same policy concerns exist in either scenario, the equitable estoppel cases are more persuasive.

Government Equitable Adjustments

FAR 52.229-3(d)-(f) allow the government a price reduction for the amount of any after-relieved federal taxes as well as for any federal excise tax or duty (except Social Security or other employment taxes) that the contractor is required to pay or bear, or does not obtain a refund of, through the contractor's fault, negligence, or failure to follow instructions of the contracting officer. The government has no equivalent right to obtain an equitable adjustment for state or local taxes in these categories.⁶² Therefore, it can be seen that this circumstance
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Contractor Liability For Taxes (cont'd):

results in an undeserved windfall to the contractor because the government's right to an adjustment should not turn simply on the identity of the taxing authority.⁶³

Conclusion

Courts and boards have rejected almost all attempts by contractors to avoid FAR 52.229-3 where the contractor, after award, seeks an adjustment for omitted taxes. Based on the particular circumstances, the decisions generally hold for the government on unilateral and bilateral mistake, government superior knowledge, incorrect advice of state and federal officials, and contracting agency misrepresentation. A few decisions grant relief with proof of government misrepresentation, but the better rule is that such an adjustment is incorrect because knowledge of the tax laws and regulations is imputed to the contractor and FAR 52.229-3 unambiguously places the risk of a mistake on the contractor.

While fair in most respects, the tax clause can be unjust to both contractors and the government, and the regulators should remedy these issues. The clause is unfair to contractors in disallowing an equitable adjustment for after-imposed state and local taxes. The clause is unfair to the government because it inappropriately deprives the government of a price reduction for after-relieved state or local taxes the contractor was required to pay or bear through fault, negligence, or failure to follow the instructions of the contracting officer. The Defense Acquisition Regulations Council and Civilian Agency Acquisitions Council should address these issues promptly.

Although the contract clauses and case law strongly favor disallowance of equitable adjustments beyond the existing standards, another policy objective is at stake in the taxes scenario. Government officials and contractors under the FAR's vision for the procurement system "should work together as a team"⁶⁴ with "fairness" and "open communication."⁶⁵ This policy has express recognition in FAR 52.229-3(h), which requires the government to cooperate with the contractor by furnishing it with appropriate evidence to establish an exemption from any federal, state or local tax albeit with no governmental liability in the process. Accordingly, government officials should cooperate as much as possible with contractors and prospective contractors that desire assistance on tax applicability.⁶⁶ Contractors also should remember that government officials generally act without liability in rendering advice. Where the parties meet these objectives, contractors will receive fair treatment and agencies will be better able to purchase goods and services at reasonable prices.

* - Steven W. Feldman is an attorney-advisor with the U.S. Army Engineering and Support Center, Huntsville, Alabama. He is the author of the *Government Contract Guidebook* (Thomson West, 4th ed., 2008), and a co-author, with Prof. Ralph C. Nash, of *Government Contract Changes* (Thomson West, 3rd ed., 2007). The views expressed in this article are those of the author and not those of any government agency.

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Contractor Liability For Taxes (cont'd):

Endnotes

1. Federal Acquisition Regulation (FAR) 16.201; *Hazard, Inc.*, ASBCA No. 35752, 88-3 BCA ¶20,873, at 105,548. *See also Tri-State Maintenance, Inc.*, ASBCA No. 22852, 78-2 BCA ¶13,430 (taxes imposed after formation of a fixed-price contract generally recoverable only with a contract clause authorizing reimbursement).
2. *See* FAR 29.401-3(a). The main exception to the use of FAR 52.229-3 is FAR 229-4, Federal, State, and Local Taxes (State and Local Adjustments)(APR 2003), which applies to noncompetitive contracts that meet all the conditions in FAR 29.401-3(a) and where the price otherwise would include an inappropriate contingency for potential post-award changes in state or local taxes. *See* FAR 29.401-3(b); *see also* B&M Cillesen Construction Co. v. Department of Health and Human Services, CBCA No. 1110, 2009 WL 367,160 (rejecting argument agency improperly used FAR 52.229-3 instead of FAR 52.229-4). The clause used for commercial item procurements under FAR Part 12, FAR 52.212-4(k), simply states that “[t]he contract price includes all applicable Federal, State, and local taxes and duties,” with no possibility of equitable adjustments for either after-imposed or after-relieved taxes.
For the treatment of taxes in cost reimbursement and time-and-materials contracts, *see* FAR 31.205-41, Taxes. *See also* Karen L. Manos, 1 Government Contract Costs & pricing, Ch. 48 (2004 & Supp. 2008)(excellent analysis of cost principle).
3. FAR 52.229-3(b).
4. FAR 52.229-3(a).
5. FAR 52.229-3(c). The contractor must promptly notify the contracting officer of all matters relating to any federal excise tax or duty that may reasonably be expected to result in either an increase or decrease in the contract price, and thereafter take appropriate action under the contracting officer’s directions. FAR 52.229-3(g).
6. FAR 52.229-3(a).
7. *Id.*
8. FAR 52.229-3(h).
9. *BMV, Division of Harsco Corp.*, ASBCA No. 36805, 98-2 BCA ¶25,684, at 122,782.
10. *Hunt Constr. Group, Inc. v. United States*, 48 Fed. Cl. 456, 459 (2001), *aff’d*, 281 F.3d 1369, 1372 (Fed. Cir. 2002), 44 GC ¶105; *C.W. Over & Sons, Inc. v. United States*, 44 Fed. Cl. 18, 30 n. 12 (1999).
11. *Walker Equipment v. Int’l Boundar and Water Comm’n*, GSBCA No. 11527-IBWC, 93-3 BCA ¶25,954, at 129074-75; *Tumpane Services Corp.*, Comp Gen. B-220465, Jan. 28, 1986, 86-1 CPD ¶95. *See also* *Holmes & Narver Constructors, Inc.*, ASBCA No. 52429, 02-1 BCA ¶31,849, at 157,395 (“A bidder must include the amount of tax in its bid or assume the risk of paying it without reimbursement since the duty of determining tax applicability is on the bidder”); *Intelcom Support Services, Inc.* ASBCA No. 36815, 90-2 BCA ¶22,818, at 114,582 (policy applies irrespective of the amount of omitted taxes).
12. *Heritage Healthcare Services, Inc.*, VABCA No. 5603, 5604, 99-1 BCA ¶30,209.
13. *All Star/SAB Pacific, J.V.*, ASBCA No. 50856, 98-2 BCA ¶29,958, at 148,235; *Bannes-Shaughnessy, Inc.*, VABCA No. 2373, 87-2 BCA ¶19,884, at 100,591.
14. *C.W. Over*, 44 Fed. Cl. At 30-31; *Allied Painting and Decorating Co.*, ASBCA No. 43287, (*continued on next page*)

Contractor Liability For Taxes (cont'd):

Endnotes (cont'd)

93-3 BCA ¶26,218, at 130,483, 35 GC ¶617 (contractor cannot shift the responsibility to the government for ascertaining waiver of state or local taxes). “To fulfill this responsibility, prospective contractors are responsible for conducting sufficient investigation to ascertain the existence or non-existence of taxes.” *B&M Cillesen*, 2009 WL 367,160 at 5, citing *GarCom, Inc.*, ASBCA No. 55034, 86-1 BCA ¶44,146.

15. See *Westinghouse Elec. Corp.*, Comp. Gen. B-227091, Aug. 10, 1987, 87-2 CPD ¶145 at 4; *Turner Constr. Co. v. GSA*, GSBCA No. 11361, 92-3 BCA ¶25,115, at 125,212, at n. 1; *Kiewit Network Technology, Inc.*, GSBCA No. 10876-P, 91-1 BCA ¶23,599, *aff'd*, 954 F.2d 735 (Fed. Cir. 1992)(table).

16. *Zeiders Enterprises, Inc.*, Comp. Gen. B-251628, Apr. 2, 1993, 93-1 CPD ¶291, at 3.

17. See *Robertson & penn, Inc.*, ASBCA No. 55622, 08-2 BCA ¶33,921, at 167,861; *Intelcom; MIDCON of New Mexico, Inc.*, ASBCA No. 37249, 90-1 BCA ¶22,621, at 113,469; *R.B. Hazard, Inc.*, ASBCA No. 35752, 88-3 BCA ¶20,873. The same rules apply to tribal taxes under the clause. See *B&M Cillesen*, CBCA No. 1110, 2009 WL 367,160.

18. *Cannon Structures, Inc.*, IBCA No. 3968-98, 99-1 BCA ¶30,236, 41 GC ¶155 citing *R.B. Hazard*, 88-3 BCA ¶20,873 at 105,548-51 (Andrews, J., dissenting).

19. *Zeiders Enterprises*, 93-1 CPD 291 at 2-3; *Tumpane Services Corp.*, 86-1 CPD 95.

20. *Id.* See also *Harry Claterbos Co. (JV) ENG* BCA No. 5300-87-3 BCA ¶20,146 (denying claim where contractor argued the applicable state tax was difficult for laypersons to find, let alone understand).

21. *Tumpane Services*.

22. *Id.*

23. IBCA No. 3899-98, 98-2 BCA ¶29,966, at 148,261. *But see infra* not 27 (noting other issues).

24. *BMY, Division of Harsco Corp.*

25. *Id.* at 127,781-82, 35 GC ¶270 (quoting *Morrison-Knudsen Co., Inc. v. United States*, 427 F.2d 1181, 1183-84 Ct. Cl. 1970))(also stating the clause protects contractors from being held liable by later interpretations of the federal tax requirements through “refined linguistic parsing”). Compare *AM General Corp.*, GSBCA No. 3910, 74-2 BCA ¶10,910, at 51,908-909 (stating five elements of proof for contractors seeking a price adjustment for after-imposed federal taxes).

26. *BMY, Division of Harsco Corp.*, 93-2 BCA ¶25,684, at 127,781-82.

27. These issues are separate from the other requisites for an equitable adjustment, such as the contractor’s proof that it did not include the taxes in either the original proposal or the contract price. Compare *Consolidated Constr. Inc.*, ASBCA No. 46498, 99-1 BCA ¶30,148, at 149,158; *BMY, Division of Harsco Corp.*, 93-2 BCA ¶25,684, at 127,783 (proof established contractor’s price did not include omitted taxes) with *Huff & Huff Service Corp.*, ASBCA No. 36039, 91-1 BCA ¶23,584, at 118,255 (contractor failed to prove the offer excluded taxes). One commentary indicates the contractor’s adjustment should include the applicable tax amount as well as the overhead and profit attributable to the management of its tax liability. 40 GC ¶500 (citing Comp. Gen. Dec. B-159066, Feb 12, 1969, 11 GC ¶161).

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Contractor Liability For Taxes (cont'd):

Endnotes (cont'd)

28. *C.W. Over & Sons, Inc. v. United States*, 54 Fed. Cl. 514, 523 (2002). *Compare* Ellis Environmental Group, LC, ASBCA No. 54066, 07-1 BCA ¶33,551, at 166,162 (stating five-part test for unilateral mistake).
29. *United International Investigative Services, Inc. v. United States*, 56 Fed. Cl. 619, 628-29 (2003)(contractor failed to show excusable misreading of specifications); *Costello Industries, Inc.*, ASBCA No. 49125, 00-2 BCA ¶31,098, at 153,585 (judgmental mistakes in offers on tax applicability “not compensable”); *B&M Cillesen*, 2009 WL 367,160 (relief not available for errors in judgment). *Compare Ellis Environmental Group* (rejecting unilateral mistake claim under FAR 52.229-4, Federal, State, and Local Taxes).
30. *C.W. Over*, 54 Fed. Cl. At 524-5.
31. *E.g.*, *Fields Roof Service, Inc.*, VABCA No. 3147, 90-3 BCA ¶23,232 (\$10,594.23 mistake on a \$479,899.95 bid). *Compare* *Klinger Constructors, Inc.*, ASBCA No. 41006, 91-3 BCA ¶24,218 (government’s bid verification was adequate) *with* *Dunbar & Sullivan Dredging Corp.*, Comp. Gen. B-188584, Dec. 23, 1977, 77-2 CPD ¶497 (government improperly failed to verify unduly low bid). *See also* *Ralph C. Nash, Mistakes in Proposals and Quotations: Is Verification Required?*, 20 *Nash & Cibinic Rep.* ¶38 (Aug. 2006)(noting uncertainty in the law regarding offer verification in negotiated procurements).
32. *E.g.*, *C.W. Over*, 54 Fed. Cl. at 525; *Foley Co. v. United States*, 36 Fed. Cl. 788, 790 (1996).
33. *C.W. Over*, 54 Fed. Cl. at 525.
34. *See* *General Dynamics Corp.*, ASBCA No. 49339, 97-2 BCA ¶29,167, at 145,030-31, 39 GC ¶393 (government claim under the clause). *But see* *Veterans Administration — Washington State Tax*, Comp. Gen. B-215543, 85-2 CPD ¶361 at 5, 64 Comp. Gen. 718 (1985) (allowing reformation based on mutual mistake of law regarding taxes).
35. *Foley*, 36 Fed. Cl. at 790 (distinguishing ASBCA and GAO decisions not following this requirement).
36. *Id.* at 790-92.
37. *Hugh S. Ferguson Co.*, PSBCA No. 2178, 89-1 BCA 21,294, at 107,385.
38. *AT&T Communications, Inc. v. Perry*, 296 F.3d 1307, 1312 (Fed. Cir. 2002). *See also* *Intelcom*, 90-2 BCA ¶22,818, at 114,582 (contractor must show the government possesses knowledge vital to the successful completion of the contract and that it is unreasonable for the contractor to obtain that vital knowledge from any other accessible source).
39. *Intelcom*.
40. *Bannes-Shaunessy*, 87-2 BCA ¶19,884, at 100,591.
41. *Humphrey Construction, Inc.*, IBCA No. 2266, 87-2 BCA ¶19,923, at 100,820.
42. *Lincoln Logs, Ltd. V. Lincoln Pre-Cut Log Homes, Inc.*, 971 F.2d 732, 734 (Fed. Cir. 1992).
43. *Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000); *In Re DePaolo*, 45 F.3d 373, 376-77 (10th Cir. 1995).
44. *Walker Equipment*, 93-3 BCA ¶25,954, at 129,075. *See also* *Air Transport, Inc.*, AGBCA No. 89-198-1, 92-1 BCA ¶24,509, at 122,326 (contractor failed to prove the government had
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Contractor Liability For Taxes (cont'd):

Endnotes (cont'd)

given incorrect advice); Institutional and Environmental Management, Inc., ASBCA No. 32924, 90-3 BCA ¶23,118 (contractor failed to prove detrimental reliance). *But see* Boyd Int'l Ltd. V. United States, 10 Cl. Ct. 204, 206 (1986)(prior course of dealing between the same parties can estop the government from enforcing an otherwise explicit contractual requirement).

45. *Foley*, 36 Fed. Cl. at 791. *See also* Challenge Equipment Corp., PSBCA No. 183, 76-2 BCA ¶12,143 (contracting officers have no authority to exclude or modify contract clauses required by regulation); Conner Bros. Constr. Co. v. United States, 65 Fed. Cl. 657, 693 (2005) (estoppel not available against the government on the basis of an unauthorized representation). *See also* Gardner Zemke Co. v. Dep't of the Interior, CBCA No. 1308, 2009 WL 577179 (granting the government summary judgment where contractor relied on the representations of Bureau of Reclamation employees (who were not contracting officers) that the contractor would receive a tax increase under a contract modification).

46. ASBCA No. 16170, 73-1 BCA ¶9803, at 45,797. *See also* Turner Constr. Co., 92-3 BCA ¶25,115, at 125,213 (“A person who relies on a legal representation made by a government officer does so at his own risk”).

47. *See supra* note 8 and accompanying text (describing government’s obligation to furnish contractor documentation to support a tax exemption). *See also* Heritage Healthcare Services, Inc., 99-1 BCA ¶30,209 (criticizing the government for furnishing the contractor an inapplicable nontaxable transaction certificate but giving no relief on this basis); *Bannes-Shaunessy* (government’s obligation to cooperate with the contractor on obtaining a tax exemption certificate is only a ministerial act); *Litsinger Motor Co.*, PSBCA No. 583, 79-1 BCA ¶13,755 (agency has no liability for furnishing the contractor assistance on tax exemption certificates, particularly when the contractor executes the certificate after award). *See also* *Robertson & Penn* (no reasonable basis existed for government to support the exemption; rejecting argument contractor was an agent of the federal government); *Edward L. Nezelek, Inc.*, PSBCA No. 298, 77-1 BCA ¶12,296, at 59,173 (government’s duty limited to “necessary certification,” which becomes void with no reasonable basis for an exemption).

48. *Cf. R.B. Hazard*, 88-3 BCA ¶20,873, at 105,548 (government liable only for increased costs attributable to the government as the contracting party or where a particular statute or clause exists granting such relief).

49. ENG BCA No. 3602, 77-2 BCA ¶12,710.

50. *See* *Ubique, Ltd.*, DOTCAB No. 71-28, 72-1 ¶9340, at 43,316 (absent agency fault, the government “is not an insurer of those who contract with it”).

51. 379 S.E.2d 442, 444 (S.C. App. 1989).

52. *Gaston v. Board of Review*, 477 N.E. 2d 460, 462 (Ohio App.1983).

53. *Robertson & Penn*. A related possible theory could be the warranty of specifications. *See Gardner Zemke; Centric-Jones Constr.*, IBCA No. 3899-98, 98-2 BCA ¶29,966, at 148,259-60. The changes clause is not available as a basis for relief where a taxing authority increases the taxes, because the government is not the cause of the increase. *See Gardner Zemke*.

54. *Jim Sena Constr. Co.*, IBCA 3761, 98-2 BCA ¶29,891, at 147,964, 40 GC ¶500.

55. *Capitol Temptrol Corp.*, ASBCA No. 27859, 84-2 BCA ¶17,332.

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Contractor Liability For Taxes (cont'd):

Endnotes (cont'd)

56. *E.g.*, Rust Engineering Co., Comp. Gen. Dec. B-180071, 74-1 CPD ¶101, 16 GC ¶122; Comp. Gen. B-169959, Aug. 3, 1970 (government liable for innocent for inadvertent misrepresentation); Comp. Gen. B-159066, May 6, 1966, and Feb. 13, 1969 (agency liable for statement that Michigan use taxes inapplicable). For additional discussion of these GAO decisions, *see* Steven W. Feldman, *Agency Oral Explanations of Solicitations: The Divergent Approaches and Proposed Solutions*, 39 Procurement Law. 1 (Fall 2003).
57. *E.g.*, *Robertson & Penn, Inc.*, 08-2 BCA ¶33,921 (“If the Government makes a representation regarding taxes, it is held responsible for the accuracy of that representation”; government did not make a representation about taxes); *Holmes & Narver*, 02-1 BCA ¶31,849, at 157,395; *Heritage Healthcare; C.H. Reforesters; Gardner Zemke* (no misrepresentation where contractor simply make a judgmental error in its bid).
58. *Foley*, 36 Fed. Cl. At 792.
59. *See Hoseman v. Weinschneider*, 322 F.3d 468, 476 n. 2 (7th Cir. 2003)(“As a general rule, one is not entitled to rely upon a representation of law since both parties are presumed to be equally capable of knowing and interpreting the law”); *Miller v. Yokohama Tire Corp.*, 358 F.3d 616, 621 (9th Cir. 2004)(well settled as a general rule that fraud cannot be predicated upon misrepresentation of law or as to matters of law); *Franklin W. Peters*, IBCA No. 762-1-69, 71-1 BCA ¶8615, at 40,032 (also discussing the exceptions to the rule that are based on the parties not being on equal terms).
60. *See Visicon, Inc.*, ASBCA No. 51706, 02-2 BCA ¶31,887.
61. Although equitable estoppel is a matter of defense and misrepresentation is an affirmative theory of recovery, the primary difference is that an explicit representation is not required for equitable estoppel. *See Conner Bros.*, 65 Fed. Cl. at 693.
62. *Allied Building & Airport Services*, 93-2 BCA ¶25,737; *Northwest Piping, Inc.*, IBCA No. 2611-A, 89-2 BCA ¶21,794.
63. *See FAR 52.229-4(d), (e)*, cited in note 2, *supra*, allowing a credit for “any” after-relieved taxes as well as “any” federal, state, or local tax, other than an excepted tax, that was included in the contract price and that the contractor should have paid.
64. FAR 1.102(a).
65. FAR 1.102-2(c)(1).
66. *But see Hunt Constr. Group*, 281 F.3d at 1376 (government rejected one offeror’s initial proposal because it excluded state and local taxes; agency was not required to communicate that rejection to all other proposers to ensure they did not make the same mistake where the solicitation was unambiguous).



How to Avoid Giving Away Your Proprietary Technical Data and Computer Software Under Contracts with the Department of Defense

by
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It can be more difficult than you might think to avoid granting the government broad license rights in your proprietary technical data and computer software (collectively “data”) under a defense contract. The Defense Federal Acquisition Regulation Supplement (“DFARS”) provisions governing data rights are both complex and unforgiving. An act as seemingly innocuous as accepting a contract to develop a minor modification to an existing product, or failing to use an appropriate restrictive legend, can have the unintended consequence of allowing the government to use your proprietary technical data for competitive procurement purposes or to reverse engineer or decompile your proprietary computer software.

This article explains the DFARS data rights framework in a manner that will help you avoid such unfortunate results. It offers both a straightforward explanation of the applicable regulations and a discussion of best practices for protecting your proprietary rights.

Defining Technical Data and Computer Software

The DFARS identifies two broad categories of information in which the government may obtain license rights – technical data and computer software.

Technical Data

Technical data are any recorded information of a scientific or technical nature.¹ They may be recorded on any medium (*e.g.*, paper, CD, DVD, hard drive, thumb drive, tape backup) and in any form (*e.g.* drawings, graphs, pictures, raw data, tables, text). Among the most important types of technical data are detailed manufacturing or process data that describe the steps, sequences, and conditions for making your items and components or performing your processes.² Other examples of technical data include computer software documentation, computer databases, manuals, specifications, standards, technical reports, and form fit and function data, which describe the characteristics of your items, components, or processes to the extent necessary to identify physically and functionally interchangeable items.³ The term technical data does not include computer software or data incidental to contract administration, such as financial or management information.⁴

Computer Software

Computer software includes source code and object code.⁵ It also includes non-code aspects of software, such as design details, algorithms, processes, flow charts, formulae, and related materials that would enable the software to be reproduced, recreated, or recompiled.⁶ Computer databases and computer software documentation are not computer software under the DFARS.⁷ (*continued on next page*)

Avoid Giving Away Your Proprietary Data (cont'd):

Types of Government License Rights

When the government buys your supplies or services, you generally retain ownership, and the government generally acquires license rights, in your technical data and computer software. Although you remain free to use such data, the scope of the government's license rights can impact significantly the government's ability to reprocur your supplies or services from another contractor.

Limited Rights (Technical Data)

Limited rights allow the government to use your technical data internally.⁸ The government may not use limited rights data for manufacturing or reprocurement purposes, and may not disclose such data to third parties except under very narrow circumstances (*e.g.*, emergency repair and overhaul), subject to a prohibition on further use and disclosure.⁹ The government obtains limited rights in:

- Technical data pertaining to items, components, or processes developed exclusively at private expense; and
- Technical data developed exclusively at private expense and delivered under contracts that do not require the development, manufacture, construction, or production of items, components, or processes.¹⁰

Restricted Rights (Computer Software)

Restricted rights allow the government to use a computer program on a single computer, to transfer a computer program to another government agency, to copy a computer program for archival or backup purposes, and to modify a computer program and obtain restricted rights in the modification.¹¹ In addition, the government may disclose restricted rights computer software to third parties under very limited circumstances (*e.g.*, to diagnose and correct deficiencies in a computer program, to combine or merge a computer program with other programs, to respond to "urgent tactical situations," and to enable emergency repair and overhaul services), subject to a prohibition on further use and disclosure.¹² The government may not use restricted rights software for any other purpose, and thus cannot freely duplicate, reverse engineer, decompile, or disclose such computer software. The government obtains restricted rights in noncommercial computer software developed exclusively at private expense and required to be delivered or otherwise provided to the government under a contract.¹³

Government Purpose Rights

Government purpose rights allow the government and its contractors to use your data in any activity in which the government is a party.¹⁴ Thus, the government may disclose such data to your competitors for reprocurement, and may duplicate, reverse engineer, or decompile such computer software, but may not authorize your competitors to exploit those data commercially.¹⁵

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Avoid Giving Away Your Proprietary Data (cont'd):

The government obtains government purpose rights in:

- Technical data pertaining to items, components, or processes developed with mixed government and private funding (“mixed funds”);
- Technical data created with mixed funds under a contract that does not require the development, manufacture, construction, or production of items, components, or processes; and
- Computer software developed with mixed funds.¹⁶

Government purpose rights generally last for a specified period of time, often five years, after contract award, at which point the government automatically obtains unlimited rights.¹⁷

Unlimited Rights

Unlimited rights allow the government to use, modify, reproduce, release, perform, display, or disclosure your data “in any manner and for any purpose,” and to authorize others to do the same.¹⁸ Most importantly, the government may provide unlimited rights data to your competitors for any purpose, including competitive procurement and commercial use. Unlimited rights also allow the government to duplicate, reverse engineer, or decompile your computer software, to modify your source code, and to disclose your source code and all other aspects of your computer software to third parties without restriction.

The most important categories of unlimited rights data are defined by the source of funds used for your development efforts. These include:

- Technical data pertaining to items, components, or processes developed exclusively with government funds;
- Technical data created exclusively with government funds under a contract that does not require the development, manufacture, construction, or production of items, components, or processes; and
- Computer software developed exclusively with government funds.¹⁹

The government also obtains unlimited rights in certain other categories of data, regardless of the source of funding. Examples include:

- Studies, analyses, and test data produced for a contract and specified as an element of performance;
- Form, fit, and function data;

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Avoid Giving Away Your Proprietary Data (cont'd):

- Technical data necessary for installation, operation, maintenance, or training purposes (including computer software documentation);
- Corrections or changes to government furnished technical data and computer software; and
- Data that are otherwise publicly available or have been released or disclosed without restrictions on further use, release, or disclosure.²⁰

These categories of unlimited rights data typically are less critical, however, because they are unlikely to enable a competitor to become an alternate source for your supplies or services.

Commercial License Rights

The DFARS contains a specific clause for the acquisition of rights in technical data pertaining to commercial items (including commercial components and processes).²¹ The clause provides the government with unlimited rights in form, fit, and function data, corrections to technical data furnished by the government, and operation, maintenance, and training manuals.²² All other types of technical data pertaining to commercial items may be used only within the government, except for emergency repair and overhaul services.²³ The clause also prohibits the government from using technical data pertaining to commercial items for manufacturing purposes.²⁴

The DFARS does not contain a standard clause for commercial computer software.²⁶ Instead, it allows you to deliver commercial computer software with your standard commercial license.²⁵

Specifically Negotiated License Rights

Specifically negotiated license rights are those license rights mutually agreed to by the parties.²⁶ With regard to technical data, a defense agency cannot agree to a license that provides the government lesser rights than those obtained by the government pursuant to a limited rights license.²⁷

* * *

Two critical points emerge from the foregoing discussion:

- If you do not want your competitors to obtain particular data, then you generally must furnish that data to the government with limited, restricted, or commercial license rights.
- In order to deliver data with limited, restricted, or commercial license rights, you must

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Avoid Giving Away Your Proprietary Data (cont'd):

- develop the underlying item, component, or process, or the relevant computer software, exclusively at private expense.

The latter point illustrates the “follow-the-funds” test, which is described in further detail below.

Follow-the Funds Test

The basis for allocating data rights under the DFARS is commonly referred to as the “follow-the-funds” test. As reflected above, this characterization is somewhat of an oversimplification because it does not account for the categories of data that must be delivered with unlimited rights regardless of the source of funding (*e.g.*, form, fit, and function data). Nevertheless, it provides a useful tool for understanding the allocation of rights in the most important types of data.

Under the “follow-the-funds” test, the government receives:

- Unlimited rights in technical data pertaining to items, components, or processes, and in computer software, developed exclusively at government expense;
- Government purpose rights in technical data pertaining to items components, or processes, and in computer software, developed with mixed funding; and
- Limited rights in technical data pertaining to items, components, or processes, and restricted rights in computer software, developed exclusively at private expense.

Understanding the “follow-the-funds” test – including the sources of funding that qualify as “private expense,” the point at which hardware and software are deemed to be “developed,” and the level of granularity at which the test applies (“segregability”) – is critical to protecting your proprietary rights.

Private Expense

Data pertaining to commercial items is presumed to be developed at private expense, although this presumption is rebuttable.²⁸ A non-commercial item is considered to developed at private expense if its development has been funded exclusively with:

- Costs properly charged to indirect cost pools (*e.g.*, independent research and development and bid and proposal costs);
- Costs properly not allocated to a government contract (*e.g.*, profit, equity, and costs charged to commercial contracts); or
- Any combination of the foregoing costs.²⁹

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Avoid Giving Away Your Proprietary Data (cont'd):

Development

You can deliver data with unlimited or restricted rights only if the underlying hardware or software has been “developed” exclusively at private expense prior to the acceptance of any government funding.³⁰ If you accept government funding before your hardware or software has attained the status of being developed, then it will be deemed to have been developed with mixed funding and the government will obtain government purpose rights.

Hardware

An item, component, or process has been developed for data rights purposes if:

- It exists; and
- It is workable.³¹

Under the first prong of this test, an item or component exists when it has been constructed (*e.g.*, when a prototype has been fabricated) and a process exists when it has been performed.³² Thus, it is likely that computer modeling alone cannot establish development at private expense.

Under the second prong, an item, component, or process is workable if there has been sufficient analysis and testing to demonstrate a high probability that it will function as intended.³³ The extent of analysis and testing required depends on the technology and the state of the art.³⁴ Hardware incorporating cutting edge technologies requires more analysis and testing than hardware incorporating technologies that are more established.

Software

A software program or module is considered developed if it has been:

- Operated successfully in a computer; and
- Tested to the extent necessary to demonstrate that it can be expected to perform its intended purpose.³⁵

This standard requires coding, compilation, and sufficient testing to demonstrate workability (*e.g.*, a “beta” version). Thorough debugging is unnecessary.

The non-code aspects of computer software, such as algorithms and flowcharts, are considered developed if they have undergone sufficient testing or analysis to demonstrate that the software program, when coded, can be expected to perform its intended purpose.³⁶ Computer software documentation, such as user manuals and training aids, is considered developed when it has been written in sufficient detail to comply with the applicable contract requirements.³⁷ This requires a case by case analysis, based on the requirements of each contract.

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Avoid Giving Away Your Proprietary Data (cont'd):

Segregability

If you develop a product exclusively at private expense, and then accept government funds to develop a new component, there are two ways to allocate the resulting data rights. At the macro level, the modified product as a whole would be developed with mixed funding, since the government paid for development of the new component. This approach would result in the government obtaining government purpose rights in data pertaining to the entire modified product, thus enabling it to use your data to reprocur that product from your competitors.

The regulations, however, do not require this harsh result. Pursuant to the doctrine of segregability, you can apply the “follow-the-funds” test at the component or process level. Thus, instead of obtaining government purpose rights in data relating to the entire modified product, the government would obtain limited rights (hardware) or restricted rights (software) in data pertaining to components developed at private expense, and unlimited rights in data pertaining to components developed with mixed funding.³⁸ If the components for which the government receives limited or restricted rights would be difficult to duplicate, then the government’s unlimited rights in data pertaining to the other components would not, as a practical matter, allow your competitors to duplicate your technologies.

In order to take full advantage of the doctrine of segregability, it is important to understand which components are deemed sufficiently “segregable” for purposes of allocating data rights.

Hardware

The little guidance that exists in the DFARS suggests that the doctrine of segregability should be applied at the lowest component level.³⁹ Thus, any segregable replacement part or assembly, any part that can be physically removed from an assembly, and any separately performed element of a process should be considered segregable. It is less likely that minor parts, such as nuts and bolts, can be segregated, although the regulations do not expressly preclude such a result.

The doctrine of segregability has numerous applications in the hardware context. For example:

- If you were to develop an item at private expense and then accept a government contract to develop physically segregable components, the government would receive limited rights in technical data pertaining to the privately developed item and unlimited rights in technical data pertaining to the newly developed components and their integration.
- If you were to accept a government contract to develop a new system from components previously developed at private expense, the government would obtain limited rights in technical data pertaining to the privately developed components and unlimited rights in technical data pertaining to their integration.

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Avoid Giving Away Your Proprietary Data (cont'd):

- If you were to develop a component at private expense and then integrate that component into a system developed under a government contract, the government would receive limited rights in technical data pertaining to the privately developed component and unlimited rights in technical data pertaining to the rest of the system and its integration.

In each case, the government would be unable to provide your competitors with limited rights data pertaining to the privately developed items, components, or processes, thus making it more difficult for competitors to duplicate your technologies.

Software

The doctrine of segregability applies to computer software at the “lowest practicable” level.⁴⁰ Thus, portions of a computer software program that are physically and functionally divisible, such as modules and sub-routines,⁴¹ should be considered segregable. For example:

- If you were to develop a software program at private expense and then accept a government contract to add functionality through new modules, the government would obtain restricted rights in the privately developed portion of the program and unlimited rights in newly developed modules.
- If you were to compile a software module from source code developed at private expense and subsequently integrate that module into a computer program developed with government funds, the government would receive restricted rights in the privately developed module and unlimited rights in the remainder of the program.

Once again, if your competitors cannot independently duplicate the modules delivered with restricted rights, the government may be unable to find an alternative source for your software.

The doctrine of segregability also should apply to the non-code elements of software. Although the DFARS provides little guidance on this point, the fact that it defines what it means for such elements to be developed suggests that they may be segregable,⁴² and in practice, that is the case.

Four Common Traps

Failure to Analyze Data Rights Before Proposal Submission

Accepting a contract that requires broad development efforts or includes unusual data rights clauses can destroy your proprietary rights. Accordingly, you should have in place a procedure for analyzing the data rights implications of each potential government contract. Relevant considerations that should be analyzed in connection with each solicitation include:

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Avoid Giving Away Your Proprietary Data (cont'd):

- Whether the statement of work requires further development or testing of products developed at private expense;
- Whether any necessary development or testing efforts can be limited to segregable components, elements, or modules;
- Whether performance of the contract requires the production of new technical data for pre-existing, privately developed products or software;
- Whether the solicitation includes any unusual data rights clauses (e.g., the “Rights in Special Works” clause) that would allow the government to acquire title in data produced under the contract;⁴³
- Whether it is necessary to include any proposal language that clarifies the parties’ proprietary rights; and
- Whether it is necessary to include any proposal language that clarifies the company’s obligations under the statement of work.

Addressing these considerations will allow you to analyze carefully whether performing the work could risk compromising valuable proprietary rights and whether your proposed technical solution could be structured to mitigate such risks.

Failure to List Proprietary Data in Pre-Award Notice

Proposals submitted to military agencies are required to include a standard form attachment that identifies all technical data and computer software to be delivered with less than unlimited rights.⁴⁴ Data that you fail to list on this form must be delivered with unlimited rights, unless you can establish that your failure to identify the data, prior to award, was based on lack of information regarding your need to use the data or an inadvertent omission.⁴⁵ In the case of inadvertent omission, however, you may not be permitted to assert proprietary rights if receipt of unlimited rights in the omitted data was a significant factor in selecting your company for award.⁴⁶ Accordingly, it is critical to implement policies and procedures adequate to ensure that every item of proprietary data that may need to be delivered under the contract is listed in the relevant attachment to your proposal.

Failure to Use an Appropriate Restrictive Legend

Data delivered with less than unlimited rights must be marked with an appropriate restrictive legend.⁴⁷ The regulations require a different restrictive legend for each type of license right, and you must comply strictly with the prescribed language.⁴⁸

The government obtains unlimited rights in data furnished without an appropriate restrictive legend, even if that data otherwise would qualify for delivery with limited or restricted rights.⁴⁹ You can add a legend to unmarked data within six months after delivery, but the government will not be liable for use or disclosure of any data that had not been marked.⁵⁰ Accordingly, it is important to implement policies and procedures to ensure that each and every piece of proprietary data delivered under a contract includes the prescribed legend.

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Avoid Giving Away Your Proprietary Data (cont'd):

With regard to placement, the appropriate restrictive legend must appear on the transmitted document or storage container and, for printed material, on each page that contains data furnished with less than unlimited rights.⁵¹ When only a portion of a page is subject to the asserted restriction, you are required to identify that portion by circling, underscoring, a note, or some other method.⁵² For computer software, it is advisable that you include the legend in as many locations as practicable, including boot screens, windows of programs, help menus, related documentation, packaging, and the physical media on which the data reside. The legend, of course, must not unreasonably obstruct the operation of the software or its intended use.⁵³

Although the regulations do not require restrictive legends for technical data pertaining to commercial items or commercial computer software, it is advisable to include such a legend so that the user will know that the data have been furnished with commercial, rather than unlimited, license rights.

Failure to Document Development at Private Expense

If the government challenges your assertion of proprietary rights in data, you will have the burden to justify that you were entitled to deliver those data with less than unlimited rights.⁵⁴ Thus, you must create and maintain evidence sufficient to establish development at private expense. Although the DFARS does not specify what records are required for this purpose, it is advisable to create and maintain the following documents:

- A memorandum that documents the baseline technology, describes the nature of the planned development, and creates a separate account number for the development effort;
- Records of all costs charged to the separate development account;
- Periodic status reports on the progress of the development effort;
- Records of all significant tests performed and the design status at the time of testing;
- Engineering, laboratory, and project management logs and journals; and
- Copies of all contracts under which products incorporating the relevant technology are delivered, modified, tested, or enhanced.

Following these simple guidelines will make it much easier for your to validate your proprietary rights in the event they are challenged by the government.

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Avoid Giving Away Your Proprietary Data (cont'd):

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Endnotes

1. DFARS 252.227-7013(a)(14).
2. DFARS 252.227-7013(a)(5).
3. DFARS 252.227-7013(a)(10).
4. DFARS 252.227-7013(a)(14).
5. DFARS 252.227-7013(a)(2),(3), -7014(a)(3),(4).
6. DFARS 252.227-7013(a)(3), -7014(a)(4).
7. *Id.*
8. DFARS 252.227-7013(a)(13).
9. *Id.*
10. DFARS 252.227-7013(b)(3).
11. DFARS 252.227-7014(a)(14).
12. DFARS 252.227-7014(a)(14)(v),(vi).
13. DFARS 252.227-7014(b)(1)(b)(3).
14. DFARS 252.227-7013(a)(11), -7014(a)(10).
15. *Id.*
16. DFARS 252.227-7013(b)(2), -7014(b)(2).
17. DFARS 252.227-7013(b)(2)(ii), -7014(b)(2)(ii).
18. DFARS 252.227-7013(a)(15), -7014(a)(15).
19. DFARS 252.227-7013(b)(1), -7014(b)(1).
20. *Id.*
21. DFARS 227.7102-3(a); DFARS 252.227-7016.
22. DFARS 252.227-7015(b)(1).
23. DFARS 252.227-7015(b)(2)(ii).
24. DFARS 252.227-7015(b)(2)(1).
25. DFARS 227.7202-3(a).
26. DFARS 227.7103-5(d), 227.7203-5(d).
27. DFARS 227.7103-5(d)(i).
28. DFARS 227.7102
29. DFARS 252.227-7013(a)(7); DFARS 252.227-7014(a)(7).
30. DFARS 252.227-7013(b)(3)(i), -7014(b)(3)(i).
31. DFARS 252.227-7013(a)(6); *Bell Helicopter Textron*, ASBCA No. 21192, 85-2 BCA ¶ 18,415.
32. DFARS 252.227-7013(b)(6)
33. *Id.*; *see also Bell Helicopter, supra.*
34. *Id.*
35. DFARS 252.227-7014(a)(6)(i).
36. DFARS 252.227-7014(a)(6)(ii).
37. DFARS 252.227-7014(a)(iii).
38. DFARS 227.7103-4(b), 227.7203-4(b), 252.227-7013(a)(7)(i), -7014(a)(7)(i).

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Avoid Giving Away Your Proprietary Data (cont'd):**Endnotes (cont'd)**

39. DFARS 227.7103-4(b), 252.227-7103(a)(7).
40. DFARS 227.7203-4(b), -7014(a)(7)(i).
41. *Id.*
42. DFARS 252.227-7014(a)(6)(ii).
43. DFARS 252.227-7020.
44. DFARS 252.227-7017.
45. DFARS 252.227-7013(e); -7014(e).
46. DFARS 252.227-7013(e)(3); -7014(e)(3).
47. DFARS 252.227-7013(f); DFARS 252.227-7014(f).
48. DFARS 252.227-7013(f)(3) (limited rights); DFARS 252.227-7014(f)(3) (restricted rights).
49. DFARS 227.7103-10(c); DFARS 227.7203-10(c).
50. DFARS 227.7103-10(c)(2); DFARS 227.7203-10(c)(2).
51. DFARS 252.227-7013(f)(1), -7014(f)(1).
52. DFARS 252.227-7013(f)(1).
53. *Id.*
54. DFARS 252.227-7019, -7037.



**Reimbursement of Punitive Damages
As Costs of Litigation: Towards a Practical
Solution for Allocation of Extraordinary Damages**

by
Zachary Rose Stern*

I. The Problem

There is currently neither case law nor any FAR clause or section that addresses the reimbursement of punitive damages, assessed against a government contractor for their torts,¹ as costs of litigation under a cost reimbursement contract. Because punitive damages may arise from any number of circumstances, there is a genuine need for guidance on their reimbursement. Although punitive damages may not arise often there is a need to address their Reimbursement because the sums involved can be substantial. Such regulation will protect the public fisc from incurring improper costs, will ensure that the costs of remedying the wrongdoing are allocated to the proper party, and will help deter wrongdoing. Consider the following hypothetical situation:

The Government has just contracted out the design, construction, and operation of a major new research and development center on a cost reimbursement basis. A cost reimbursement contract was chosen because it the Government cannot properly assess what will be required to complete the facility in order for it to be able to perform its stated goals. The Government has only been able to specify the goals of the facility and has made some minor requirements in building materials. During construction the contractor informed the Government that some of the specified materials might not be suitable given the construction methods chosen by the contractor. The Government instructed the contractor to continue regardless of these concerns. During building inspection the building collapses causing severe and permanent injuries to the building inspector. An investigation cannot determine whether the collapse was caused by faulty construction methods, the use of inappropriate building materials, or some combination of the two. The building inspector files suit against the contractor. The contractor raises the government contractor defense, however this proves to be unsuccessful.² A jury awards the building inspector punitive damages, on the theory that the contractor acted with “recklessness, malice or deceit,” for continuing construction despite concerns that the building methods might not be appropriate or that inappropriate materials were used.³ The contractor has contacted the Contracting Officer seeking reimbursement of the actual and punitive damages as reimbursement for costs of litigation arising from performance of the contract. What should the Contracting Officer do and to what extent is she constrained by statute and regulation?

Before addressing these issues it is important to limit the discussion in two ways. First, the discussion will only deal with cost reimbursement contracts.⁴ Second, this note only

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Reimbursement of Punitive Damages (cont'd):

addresses punitive damages. It is by now generally accepted that the Government will Reimburse compensatory damages in a cost reimbursement context.⁵ In any event a discussion of the merits of reimbursing compensatory damages is outside the scope of what this note can address.

Ultimately this note will seek provide a model clause for inclusion in the FAR Specifying when and under what conditions the Government should reimburse punitive damages. Part II provides background for the analysis by reviewing the relevant FAR sections and clauses and other considerations and discussing cost reimbursement and indemnification. Part III addresses alternative analyses of the issue of punitive damages in government contracts. In Part IV this note presents a solution by considering economic factors, procurement objectives, applicability of solution and a model clause. Part IV analyzes the application of the model clause to a number of case studies.

II. Background

A. FAR Sections and Clauses

FAR 31.205-47 is the general regulation governing reimbursement of litigations costs. Most of the subsections relate to suits brought by governments or by a third party on behalf of the Government.⁶ As a simple reading shows there is no indication from this section that punitive damages awarded to a third party would be unallowable. However such a scheme seems contrary to the purposes of punitive damages. Punitive damages are imposed to “punish him [the wrongdoer] for his outrageous conduct and to deter him and others like him from similar conduct in the future.”⁷ If the contractor is able to pass along the burden of paying punitive damages to the Government through Cost Reimbursement Principles, punitive damages neither punish the contractor’s wrongdoing nor serve to deter others in a similar situation from acting the same way.

There is therefore a genuine need for a FAR clause, applicable throughout government procurement, that would address the issue of reimbursement of punitive damages. Such a clause should generally prohibit reimbursement of punitive damages except those specifically allowed for in the contract, indemnified through Public Law 85-804, or specifically allowed by the Contracting Officer in a particular instance for good cause arising from unusual circumstances. While this type of clause falls short of providing a bright-line rule prohibiting reimbursement of all punitive damages, it allows for more flexibility in individual cases and puts contractors on notice that punitive damages are unlikely to be reimbursed in most cases as a matter of policy.⁸

The Department of Energy’s supplement to the FAR contains the only two clauses that directly address the reimbursement of punitive damages. Both clauses state that “[p]unitive damages are not allowable unless the act or failure to act which gave rise to the liability resulted

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Reimbursement of Punitive Damages (cont'd):

from the compliance with specific terms and conditions of the contract or written instructions from the contracting officer.”⁹ Although this language does make clear that the Government will not reimburse punitive damages, in some ways it is overbroad. By stating a bright-line rule that punitive damages will not be reimbursed except for liability arising out of “compliance with specific terms. . . or written instructions,”¹⁰ these clauses do not allow for any flexibility arising from ambiguous terms or instructions, or from unusual and extraordinary circumstances in unique situations.

This bright-line rule also deprives the Contracting Officer of her usual level of discretion in making determinations relating to the contract, by ordering the disallowance of punitive damages unless liability arises from prior instructions. There is no way for the Contracting Officer to make an *ex post* determination in individual cases that certain punitive damages should be reimbursed, especially given the fact that juries are fallible in their determinations. Such a bright-line rule also creates a perverse incentive for the contractor to settle all suits before letting them reach a jury on the merits. By avoiding litigation of the issue punitive damages can never be assessed against the contractor. Furthermore the cost of the settlement will likely be reimbursable as a cost of litigation.¹¹ This perverse incentive could also lead third parties to bring strike suits or other spurious litigation, knowing *a priori* that the contractor is going to settle the suit to avoid incurring costs. Overall a scheme similar to that the Department of Energy has instituted is against the governmental and public interest because it is likely to increase total costs across procurement. Such a scheme will lead to an increased number of strike suits that will need to be settled. The end result is higher government expenditures and consequently higher taxes.

Alternatively a system that would allow for occasional reimbursement of punitive damages creates an incentive to litigate fully those cases that lack any basis in law and fact, and would therefore limit the total costs of settlements and create disincentives for third parties to bring strike suits. This scheme would therefore reduce overall litigation costs arising from damages. This would lead to lower government expenditures and consequently lower taxes in comparison to the scheme in which the Government denies punitive damage *a priori*.¹²

It is for the above reasons that this note advocates a more nuanced rule that falls short of a bright line while at the same time indicating that the general government policy will be to disallow the reimbursement of punitive damages.

B. Other Considerations

Besides serving the general purposes of punitive damages, there are several other indicia that the Government should have a general policy of not reimbursing punitive damages as costs of litigation. In suits brought against the Government punitive damages may not be awarded. The Federal Tort Claims Act serves as a limited waiver of sovereign immunity “to the same extent as a private individual under like circumstances, but shall not be liable for. . . punitive damages.”¹³ If it has been the long-standing policy of the Government that it should not be

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Reimbursement of Punitive Damages (cont'd):

liable for punitive damages, *a fortiori*, it should be the general policy of the Government not to reimburse others for punitive damages.

Additionally the contractor has recourse to the government contractor defense, which, if successful, completely bars any recovery by the third party plaintiff, saying nothing of punitive damages.¹⁴ However if the factors for applying the defense as stated in *Boyle* and its progeny are not met, namely complying with reasonably specific terms set by the Government, and warning about any foreseeable dangers in advance, suits against the contractor can proceed in full, without any regard to punitive damages that may be involved.¹⁵ Given the factors for applying the defense it can easily be imagined that there will be instances when reasonable people will disagree about whether or not the defense should apply. In such situations if the suit is allowed to proceed, punitive damages may very well be assessed against the defendant contractor.

The government contractor defense is a by-product of sovereign immunity;¹⁶ in this case the contractor gets the benefit of immunity when acting under the supervision of and at the direction of the Government. However the government contractor defense and the invocation of pure sovereign immunity are clearly not the same. When the government contractor defense is applied all suits are barred from proceeding, protecting government contractors from liability to a greater extent than that to which the government is subjected under the Federal Tort Claims Act.¹⁷ However when the contractor cannot claim the privileges of the defense, the contractor receives no benefit of immunity.

Without getting into the merits of the government contractor defense, it is enough to note that some have criticized contractor's sharing of immunities, particular from damages, for reasons of accountability to the Government and to the public for their actions.¹⁸ However this confuses the issues of immunity and reimbursement. This confusion leads to a situation where if punitive damages are assessed against the contractor because they do not share in the Government's immunity, they can still pass the costs on to the Government. This situation is the worst combination: not only is there no accountability for contractor actions because the mechanism for punishment is passed through, but punitive damages, which the Government would ordinarily not pay itself, are paid on behalf of a contractor and leads to a lack of transparency regarding government-contractor relations.¹⁹

C. Cost Reimbursement

A cost reimbursement contract does not mean that all costs incurred by the contractor are to be reimbursed.

A cost is allowable only when the cost complies with all of the following requirements:

- (1) Reasonableness.
- (2) Allocability.

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Reimbursement of Punitive Damages (cont'd):

- (3) Standards promulgated by the CAS board, if applicable, otherwise generally accepted accounting principles and practices appropriate to the circumstances.
- (4) Terms of the Contract.
- (5) Any limitations set forth in this subpart.²⁰

Ordinarily it would therefore seem that punitive damages should never be allowable: punitive damages are arguably not reasonable costs nor are they normally sufficiently related to the contract to be allocable to it. Wrongdoing sufficient to lead to the assessment of punitive damages arguably should not be part of any government contract. Additionally the Government should reasonably expect contractors to conduct their operations properly. It is therefore unreasonable to expect that there would be wrongdoing that would subject the contractor to punitive damages that the Government should reimburse.

D. Indemnification

In certain circumstances, the Government may choose to indemnify the contractors. Such indemnification is extremely rare. FAR 50.104-3 covers the procedures for requesting indemnification under Public Law 85-804. Such indemnification is limited to “unusually hazardous or nuclear risks.”²¹ Such requests must include, *inter alia*: a statement identifying the risk and how the contractor would be exposed to it, a disclosure of all insurance coverage applicable to the risk and a statement discussing the factors for determining the amount of financial coverage.²² After receiving the contractor’s request the Contracting Officer with assistance from counsel and the program office review the request for a determination.²³ If the Contracting Officer recommends approval, the request is forwarded through appropriate channels to the secretary or administrator of the relevant agency.²⁴ If the request is approved, clause 52.250-1 is incorporated into the contract.²⁵ In relevant part, this clause states:

- (b) Under Pub. L. 85-804 (50 U.S.C 1431-1435) and Executive Order 10789, as amended, and regardless of any other provisions of this contract, the Government shall, subject to the limitations contained in the other paragraphs of this clause, indemnify the Contractor against –
 - (1) Claims (including reasonable expenses of litigation or settlement) by third persons (including employees of the Contractor) for death; personal injury; or loss of, damage to, or loss of use of property;
 - (2) Loss of, damage to, or loss of use of Contractor property, excluding loss of profit; and
 - (3) Loss of, damage to, or loss of use of Government property, excluding loss of profit.
- (c) This indemnification applies only to the extent that the claim, loss, or damage
 - (1) arises out of or results from a risk defined in this contract as unusually hazardous or nuclear and
 - (2) is not compensated for by insurance or otherwise.
 Any such claim, loss, or damage, to the extent that it is within the deductible amounts of the Contractor's insurance, is not covered under this clause. If

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Reimbursement of Punitive Damages (cont'd):

insurance coverage or other financial protection in effect on the date the approving official authorizes use of this clause is reduced, the Government's liability under this clause shall not increase as a result.

(d) When the claim, loss, or damage is caused by willful misconduct or lack of good faith on the part of any of the Contractor's principal officials, the Contractor shall not be indemnified for --

- (1) Government claims against the Contractor (other than those arising through subrogation); or
- (2) Loss or damage affecting the Contractor's property.

If a claim arises from conduct that is indemnified under this scheme, punitive damages should be allowable. First the clauses recognize that claims may arise from "willful misconduct or lack of good faith," but limit indemnification only for claims by the contractor or by the Government, not by third parties.²⁶ Additionally because the process of securing indemnification under this scheme is limited to "unusually hazardous or nuclear risks," requires approval not only of the Contracting Officer but also of political officials with the concurrence of legal counsel and by its own language, it appears that this indemnification scheme is intended to be all inclusive within the narrow scope of its applicability.

There is another type of indemnification, to which scholars outside of government contracts have given greater attention. The Price-Anderson Act, first passed in 1957, extended government indemnification to the country's nascent civilian nuclear energy above the limits of what insurance could cover for accidents.²⁷ The Act is now codified at 42 U.S.C. §2210 (2000). This Act indemnifies only nuclear activities, and limits liability depending on the specific type of activity involved.²⁸ Because this indemnification is statutory it does not appear that any contract modification is necessary to incorporate this type of indemnification, although indemnification agreements are envisioned by the Act.²⁹ Additionally it is noteworthy that this indemnification is not limited to government contractors and extends to other types of businesses, namely Nuclear Regulatory Commission licensees.³⁰ Most important for the current discussion is the language of subsection (s), which states: "no court may award punitive damages in any action with respect to a nuclear incident or precautionary evacuation against a person on behalf of whom the United States is obligated to make payments under an agreement of indemnification covering such incident or evacuation." This section provides some evidence that the Government will not pay punitive damages for government contractors, at least when the punitive damages are envisioned as arising while the Government is engaged as a quasi-insurer of contractor activities.³¹

III. Solution

A. When the Government Should Pay Punitive Damages on Behalf of Contractors

While recognizing that generally the contractor should pay punitive damages, there are a few circumstances in which the Government should reimburse the contractor. As mentioned

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Reimbursement of Punitive Damages (cont'd):

above indemnification under Public Law 85-804 is one of these circumstances. Public Law 85-804 indemnification is specifically contracted for, and requires a long process for approval subject to a showing of demonstrated need for the indemnification. The indemnification only applies to specific liabilities defined in the contract, and can only apply to unusually hazardous or nuclear risks. Neither the text of the Public Law, nor the relevant FAR regulations discuss its applicability to punitive damages. When contrasted with the Price-Anderson Act or with the Federal Tort Claims Act, the lack of a reference to punitive damages argues in favor of allowing indemnification for punitive damages under 85-804, since Congress could have limited liability if it so chose, and clearly knows the type of language to use to effect such a limitation. Congress can add language that would bar punitive damages in such circumstances at any time it chooses.

Another possible alternative would allow for contract modifications to permit specific instances of reimbursement. Such a scheme would provide for the Contracting Officer to exercise the maximum amount of discretion on behalf of the agency to take account of the totality of circumstances, including the reasonableness of the jury verdict. Other factors that should be considered include the foreseeability of the underlying issue in the litigation and the total amount of damages, the proper allocation of risk under the contract, the scope of the contract and the working relationship with the contractor. Regarding foreseeability if the risk of punitive damages is high, some type of coverage should be negotiated beforehand, whether through the purchase of insurance, a modification of the contract to allow for reimbursement of punitive damages under the contract, or through an express understanding that the contractor assumes the risk of liability for punitive damages for that underlying issue. Where foreseeability is low, the Contracting Officer should take into account the totality of circumstances giving rise to the litigation before making a determination on allowability.

Allocation of risk under the contract and scope of the contract are intimately related. Typically under a cost reimbursement contract the Government is perceived to have assumed the majority of the risk associated with the contract. The broader and more general the contract is, the greater the risks that the Government has accepted. However a narrow contract calling for extremely hazardous or unknown risks should also be construed as allocating risks against the Government. When a relatively small amount of punitive damages is awarded against the contractor, the Contracting Officer might want to exercise discretion and allow the damages to avoid the costs of further appeals and losses, or may even encourage an early settlement to avoid costs of litigation altogether. Additionally the Contracting Officer may come to some sort of agreement with the contractor whereby the Government will pay the reasonable and allowable portion of punitive damages while the contractor pays the rest.

Taking a wider view of the procurement system the Contracting Officer should also account of the relationship with the contractor, at least to some degree. If punitive damages arise early on in a multi-year contract where both the Government and the contractor view the punitive damages as an improper jury verdict, but are nonetheless unallowable as a matter of law, such a determination will hinder the working relationship between the contractor and the Government for the duration of the contract.

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Reimbursement of Punitive Damages (cont'd):

In many cases such factors cannot be considered before the action underlying litigation has occurred, and therefore there needs to be a mechanism for an *ex post* determination by the Contracting Officer to allow certain punitive damages in specific instances.

B. Economic Factors

There are a number of economic consequences to take into account in allowing punitive damages under cost reimbursement contracts. First, by allowing punitive damages, there would be some measure of uncertainty in the federal budget. Appropriations would depend on how many lawsuits were brought and the size of the punitive damages awarded. However there is already a similar measure of uncertainty in the federal budgets, as the agencies themselves are sued, and there is a standing appropriation for the judgment fund.³² Some similar mechanism will be required. A consequence of the bigger budgets, assuming that all projects are kept at their current size, will be an increased tax load or increased deficit.

While most punitive damages will seem like a mere drop in the bucket of overall federal spending, taken in their aggregate, especially for activities involving the likes of nuclear risks, such liabilities may amount to billions of dollars, a significant amount, which will eventually have to be paid through taxes. If on the other hand a policy of never allowing punitive damages is adopted, all of the burden will be put on private entities. This burden will affect profit margins, since punitive damages would have to be paid out of the expected profits of the companies. This burden could then be shifted to the stockholders, either by withholding dividend payouts, or by a marked sell off of stocks. However if the stockholders maintain their interest into the company, they will begin to take a vested interest in how the corporations conducts their activity, which might lead to better corporate governance and an overall reduction in the number of actions which could give rise to punitive damages. Additionally, shifting the burden to the private entities may encourage the contractors to increase the dollar value of their bids in an effort to cover the risk, thereby increasing procurement system costs.

Naming either the contractor or the Government as the cheapest cost avoider to complete this economic analysis is difficult. In theory both sides should have access to the same amount of information, and even if this is not the objective reality, the contractor and the Government have knowledge of different information regarding the judicial system and the likelihood of liabilities. The Government's deep pockets make it more able to cover the costs of paying out or insuring for punitive damages. The contractor has more immediate control over intentional actions that could lead to punitive damage liability, but both the Government and the contractor share the same degree of control about latent problems that could give rise to liability for negligence. More often than not the Government is likely to be the cheapest cost avoider because of its access to knowledge and its ability to financially cover or insure against punitive damage liability. However in situations where the contractor exercises significantly more control over the conduct which gives rise to the liability, the contractor will be the cheapest cost avoider.

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Reimbursement of Punitive Damages (cont'd):

C. Applicability

The policy of limited reimbursement of punitive damages will only have limited applicability. Punitive damages in a cost reimbursement context are most likely to arise from personal or environmental injury resulting from a research and development, management and operations, or services contracts. These types of contracts are particularly susceptible to punitive damages because they involve some measure of unknown risk in what is being researched and can extend over long periods of time and over many different activities with varying degrees of risks in management and operations and services contracts. To a lesser extent these policies will apply to products created under a design or research and development contracts, and still more rarely under design and construction contracts, as in the scenario proposed at the beginning of this note. Once a product has been fully designed, developed and tested the level of risk declines to great extent, however some measure of risk is always present. With construction projects, there is always some measure of risk of structural failure, however with sound construction methods the risk is slight. In certain circumstances it will also arise in employment and labor law contexts for personnel issues when state law provides for punitive damages for violations of employment law.³³

D. Proposed Language

This note proposes the following language be inserted into the FAR to govern the allowability of punitive damages in cost reimbursement contracts:

Punitive damages are not allowable as costs of litigation unless:

- (1) the punitive damages have been awarded as a result of liability arising from activity for which the contractor is indemnified under Public Law 85-804 and that indemnification has been invoked;
- (2) unless the act or failure to act which gave rise to the liability resulted from the compliance with specific terms and conditions of the contract or written instructions from the Contracting Officer;³⁴ or
- (3) if the Contracting Officer with the advice of counsel determines that all or part of the punitive damages awarded against the contractor should be deemed allowable. Factors to consider when making a determination under this subsection include: the amount of damages assessed as punitive damages, whether the liability giving rise to the punitive damages is of a nature for which punitive damages are normally assessed, the level of direction and supervision of a government employee over the activity giving rise to liability, the extent of government advice and participation in the litigation from which the punitive damages were awarded, and the foreseeability that punitive damages would have been awarded in this case.

Any decisions taken under this subsection (3) may only be appealed internally to the Agency, under an abuse of discretion standard to prevent collateral attacks of prior judgments.³⁵

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Reimbursement of Punitive Damages (cont'd):

IV. Case Studies

Applying this model rule to the scenario presented at the beginning of this note indicates that punitive damages should be reimbursed. The government contractor defense arguably should have applied under those circumstances. The Contracting Officer had ordered the contractor to continue despite the contractor's concerns. Additionally, the jury did not make any clear findings of fact as to which elements caused the injury, and therefore the Contracting Officer may question the reasonableness of the jury's verdict. This is contrary to a different hypothetical scenario where the Government orders construction of a building and tells the contractor to dispose of construction debris, and the contractor chooses to do this by throwing the debris into the adjacent street causing physical and property damage. While these hypothetical scenarios are somewhat helpful, actual cases where punitive damages were requested against government contractors are much more informative.³⁶

In *Dalkilic v. Titan Corporation*,³⁷ interpreters for a government contractor sued the contractor for fraudulent inducement to sign a contract, failure to obtain permission from the Turkish government to take the interpreters to Iraq and failure to properly train, pay and protect the interpreters while working for the contractors in Iraq. In this case, the government contractors specifically argued that punitive damages are not available to the claimants under law; the court rejected that claim finding that the claimants alleged sufficient disregard on the part of the contractor to merit an award of punitive damages. In this case, the contractor will most likely seek to pass along the costs of the allowed punitive damages to the Government. Due to the facts alleged in this case, the Government will most likely not choose to exercise discretion under the proposed rule. There is no indication that applicability of the government contractor defense was in any doubt in this case, and the type of wrongdoing alleged, if true, such as fraud and failure to protect from bodily harm is of the nature for which the Government should reimburse punitive damages.

In *Vietnam Association for Victims of Agent Orange v. Dow Chemical Company*,³⁸ the claimants brought suit against various chemical companies for personal injury and property damage resulting from exposure to Agent Orange. This case was barred by the government contractor defense, with the court finding that there was sufficient governmental oversight of the contractor activities. However, there it is possible to foresee courts that would have allowed this claim to proceed with a judgment resulting in punitive damages against the contractors because the determination on whether to apply the government contractor defense is highly fact-specific, and a shift in perspective is all that may be required to alter the result. This is precisely the type of situation in which the Government would seek to exercise its discretion under the proposed rule to reimburse the contractor for punitive damages.

In *Glynn v. EDO Corporation*,³⁹ a former employee brought suit and sought punitive damages alleging that their termination of employment was in retaliation for voicing concerns over the company's product and later informed the Government of his concerns. The court allowed the suit to proceed under wrongful discharge tort claims under New Hampshire law.

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Reimbursement of Punitive Damages (cont'd):

When the jury returns a verdict in this case, they might very well grant the former employee's request for punitive damages, which the contractor will then seek to have reimbursed by the Government. Given the facts of the case, this is not the type of case where the Government should exercise its discretion under the proposed rule to allow punitive damages because the misconduct alleged has nothing to do with performance of the underlying contract. Furthermore, there is no possibility that the government contractor defense would prove successful in this case. However, if the Government approved of the termination, that could alter the outcome of the decision. Even if the Government only approved of the termination and did not order it, the Government might be seen as having exercised sufficient oversight over the contractor's conduct to warrant exercising its discretion to allow punitive damages in this case.

In *Abdi Jama v. Esmor Correctional Services*,⁴⁰ aliens brought an action against a government contractor for violating the Religious Freedom Restoration Act and for violations of state law. The jury found for the aliens, but did not award them punitive damages. Again, this is the type of case where the jury could easily have decided differently and awarded punitive damages. This case revisits some of the issues found in *Richardson v. McKnight*,⁴¹ wherein the Supreme Court decided that the government contractor defense did not apply to service contracts. While leaving the *Richardson* principle intact, we can find that if punitive damages arose in that context, under the proposed rule they would be reimbursed depending on the Government's degree of control in setting the operational policies and procedures. Furthermore, detention is inherently a state police power, and in situations such as *Abdi Jama* and *Richardson*, if the Government wanted to avoid the payment of punitive damages it could staff the prison with federal employees instead of private contractors.⁴²

Finally, in *3D Global Solutions, Incorporated. v. MVM, Incorporated*,⁴³ a provider of security guards brought suit against a government contractor for breach of contract, promissory estoppel, intentional misrepresentation, constructive fraud, concealment, interference with business advantage, enrichment and conversion and sought punitive damages. The court allowed the case to proceed. If punitive damages are awarded at the conclusion of trial, the Government should not reimburse punitive damages in this case. The claims do not appear to have anything to do with government responsibility or oversight for the contractor misconduct because they allege fraud and misrepresentation, which ordinarily fall outside the scope of work of government contracts and therefore reflects independent action by the contractor. The type of claims alleged, namely fraud and business misconduct, are not of the type from which the Government should insulate the contractor.

Looking at this set of cases as a whole, it is clear that in those cases in which the government contractor defense is most likely to prevail, the Government is more likely to exercise its discretion to reimburse punitive damages. Conversely, in the cases in which the government contractor defense would not apply, the Government would not reimburse punitive damages.

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Reimbursement of Punitive Damages (cont'd):

V. Conclusion

It is unquestioned that punitive damages are meant as a punishment for wrongdoing. If the contractor objectively acted with gross misconduct, the contractor merits punishment through punitive damages and should not be allowed to pass through that punishment to the Government and from the Government to the taxpayers. Further, as Mr. Sabatino argues, the contractors should not share in the Government's sovereign immunity.⁴⁴ If the Government wanted the contractors to share its immunities, the Government could establish government corporations, stop outsourcing work to contractors or enact legislation granting limited immunity to government contractors. The Government itself is not totally immune from suit, through the enactment of the Federal Tort Claims Act. As the procurement regulations stand the contractor is already likely to be reimbursed the ordinary costs of litigation including attorneys' fees, court costs, and any compensatory damages. Government contractors should not be able to get away with gross misconduct without paying anything out of pocket themselves.⁴⁵

As has been demonstrated, in advocating a government procurement-wide rule on punitive damages, as a general rule punitive damages will not be reimbursed. However there are specific instances that might warrant reimbursement. Cases where the risk is indemnified under Public Law 85-804 will allow for indemnification of punitive damages.⁴⁶ Public Law 85-804 indemnification will apply to contracts involving nuclear work and those types of projects where the risks are unknown or of such a scale that the risk is considered to be unusually hazardous. The Government would also reimburse punitive damages in those cases where the contractor asserted the government contractor defense and the defense failed to the disbelief of the agency. Furthermore, unforeseen circumstances might warrant a contract modification for a specific instance, such as to maintain a key working relationship between the agency and the contractor, or from unforeseen litigation that would not ordinarily give rise to punitive damages but under the vagaries of local law awards the claimant punitive damages.

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Endnotes

1. These are not limited to personal injury suits, but may include wrongful termination suits where punitive damages may be assessed against the tortfeasor as a matter of state law or in other instances. See, *infra*, Part IIIC (Applicability) for a more complete discussion.
2. Under *Boyle v. United Technologies Corp.*, 487 U.S. 500 (1988), to successfully raise a government contractor defense, the party must show that: the Government approved relatively precise specifications; the product conforms to the specifications; and that warning is given where appropriate. In this case, the very reason for which a cost reimbursement contract was chosen, namely inability to fully define the specifications other than the goal of the facility, means that the first prong of the three part government contractor defense test is not met. Generally
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Reimbursement of Punitive Damages (cont'd):

Endnotes (cont'd)

speaking when a third party brings suit against a government contractor, the contractor may defend against liability essentially by extension of the Federal Tort Claims Act's discretionary function exception. See Lawrence S. Sher, *The Government Contractor Defense: A Potential Shield Against Tort Liability for Service Contractors*, 22 No. 5 Andrews Gov't Cont. Litig. Rep. 1 (2008); 28 U.S.C. §2680(a) (2006). The defense applies to products as well as services supplied to the Government and has been extended by some Circuit Courts of Appeals to cases involving civilian products and services. Sher, *supra*, at 1, 3. If raised successfully the government contractor defense "shields contractors from tort liability. . . ." *Id.* at 1.

3. BLACKS LAW DICTIONARY, 175 (3d pocket ed. 2006).

4. The difference between cost reimbursement and fixed price contracts can be viewed as a difference of risk allocation. In a fixed price contract, the contractor assumes the majority of the risk related to the contract, including risks associated with litigation relating to performance of the contract. In a cost reimbursement contract, the allocation of risk is reversed, with the Government assuming the risks, and compensating the contractor for the costs that are allocable, reasonable and allowable to the contract. FAR Subpart 31.201. "Cost-reimbursement contracts are suitable for use only when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract." FAR 16.301-2. Fixed price contracts are either Firm-Fixed-Price or allow for economic conditions. FAR 16.201. Contracting Officers must use Fixed-Price contracts for acquisition of commercial items. *Id.*

According to the 14th Annual Government Contractor Survey government agencies have been increasing their use of cost reimbursement contracts. Elise Castelli, "Cost-reimbursement Contracts Gain Bigger Foothold in Procurement," *Federal Times*, January 27, 2009, available at <http://www.federaltimes.com/index.php?S=3918835>. However, section 1554 of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009), requires agencies to use Fixed-Price contracts to the greatest extent possible. Additionally, section 4201 of the Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, H.R. 5658, 110th Cong. (2008), is aimed at minimizing "the inappropriate use of cost-reimbursement contracts."

It has been suggested that a contractor under a fixed price contract might seek to have its punitive damages offset through an equitable adjustment under change orders. E-mail from Steven Schooner to Zachary Stern (Mar. 31, 2009, 12:54 EDT) (on file with author); FAR 52.243-1. This does not seem likely since equitable relief under change orders must stem from changes to "drawings, designs, or specifications," "method of shipment or packaging," or "place of delivery." FAR 52.243-1(a). Since the conduct giving rise to punitive damages is unlikely to be the result of a specifically mandated change, this not has limited applicability to fixed price contracts. When punitive damages are a result of a contractor complying with a change order the analysis provided in this note is applicable. See, *infra*, Part IIIA (When the Government Should Pay Punitive Damages on Behalf of Contractors) for an analysis of the factors to be considered.

5. Although the actual reimbursement of the costs is litigated, the cases themselves prove that in principle compensatory damages assessed against the contractor that are not otherwise disallowed will be reimbursed. See, e.g., *Southwest Marine, Inc.*, ASBCA No. 54234, 05-1 BCA ¶32,892.

6. FAR 31.205-47(f) regarding other costs of litigation states:

Costs not covered elsewhere in this subsection are unallowable if incurred in connection with:

(1) Defense against Federal Government claims or appeals or the prosecution of claims or appeals against the Federal Government (see 2.101).

(2) Organization, reorganization, (including mergers and acquisitions) or resisting mergers and acquisitions (see also 31.205-27).

(3) Defense of antitrust suits.

(4) Defense of suits brought by employees or ex-employees of the contractor under section 2 of the Major Fraud Act of 1988 where the contractor was found liable or settled.

(5) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from either—

(i) An agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest; or

(ii) Dual sourcing, coproduction, or similar programs, are unallowable, except when—

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Reimbursement of Punitive Damages (cont'd):

Endnotes (cont'd)

- (A) Incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer, or
- (B) When agreed to in writing by the contracting officer.
- (6) Patent infringement litigation, unless otherwise provided for in the contract.
- (7) Representation of, or assistance to, individuals, groups, or legal entities which the contractor is not legally bound to provide, arising from an action where the participant was convicted of violation of a law or regulation or was found liable in a civil or administrative proceeding.
- (8) Protests of Federal Government solicitations or contract awards, or the defense against protests of such solicitations or contract awards, unless the costs of defending against a protest are incurred pursuant to a written request from the cognizant contracting officer.
7. RESTATEMENT (SECOND) OF TORTS, §908 (1979).
8. Other alternatives to this scheme are foreseeable: the Government could bar the award of punitive damages against government contractors as a corollary to the government contractor defense, which is itself an extension of the Federal Tort Claims Act to government contractors. *See, supra*, note 2. The Act does not allow for punitive damages to be assessed the Government under any circumstances, and it therefore seems logical that if the contractor were to be held liable they should not be in a position to pay more in damages than the Government would if the Government were sued under the Act. *See* 28 U.S.C. §2674 (2006). However such a scheme seems patently unfair, in that it deprives the third party of a complete remedy and ignores the objective reality that, while the government contractor is acting under government supervision, it is not itself part of the sovereign. Adopting such a scheme would be a major policy decision regarding sovereign immunities and their applicability to government contractors and falls outside the scope of this paper.
9. DEAR 952.231-71(j)(2), 970.5228-1(j)(2).
10. *Id.*
11. *See* FAR 31.205-47.
12. This analysis is based on the working assumption that the aggregate expenditures to reimburse settlements of strike suits will exceed the rare expenditure to reimburse punitive damages actually awarded by a jury.
13. 28 U.S.C. §2674 (2006). This language was first passed in Pub. L. 80-773 §2674 in 1948.
14. *Sher, supra* note 2, at 1.
15. *See* footnote 2, *supra*, for a more complete discussion of the government contractor defense.
16. *Sher, supra* note 2, at 1.
17. *See* 28 U.S.C. §2674 (2006).
18. *See* Jack M. Sabatino, *Privatization and Punitives: Should Government Contractors Share the Sovereign's Immunities from Exemplary Damages?*, 58 Ohio St. L.J. 175, 178 (1997) (specifically stating that punitive damages serve as a form of accountability for actions both to the Government and to the public and that therefore contractors should not share immunity from punitive damages).
19. *See* Part III, *infra*, discussing the objectives of procurement. Transparency is important to “ensure that government business is conducted in an impartial and open manner” and also furthers the integrity of the procurement system. Steven L. Schooner, *Desiderata: Objectives for a System of Government Contract Law*, 11 Pub. Proc. L. Rev. 103, 105-06 (2002).
20. FAR 31.201-2(a).
21. FAR 50.104-3(a).
22. *Id.*
23. FAR 50.104-3(b).
24. *Id.*; FAR 50.102-1(d). If the request is for coverage of more than \$55,000, secretarial approval is required. FAR 50.102-1(b).
25. FAR 50.104-4.
26. FAR 52.250-1(d).
27. United States Nuclear Regulatory Commission, *A Short History of Nuclear Regulation, 1946-1999*, Chapter 1: The Formative Years of Nuclear Power Regulation, 1946-62, <http://www.nrc.gov/about-nrc/short-history.html>.

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Reimbursement of Punitive Damages (cont'd):

Endnotes (cont'd)

28. 42 U.S.C. §2210 (c-d) (2000). Differences are seen between activities of licensees of the Nuclear Regulatory Commission and contractors of the Department of Energy. Indemnification of activities of Department of Energy contractors may be supplemented through Public Law 85-804 as discussed above.
29. 42 U.S.C. §2210 (d) (2000).
30. 42 U.S.C. §2210 (c) (2000).
31. This thought runs against the near total indemnification provided by Public Law 85-804 discussed above.
32. *See* 31 U.S.C. §1304 (2006).
33. *See, e.g.,* Joseph A. Seiner, *The Failure of Punitive Damages in Employment Discrimination Cases: A Call for Change*, 50 Wm. & Mary L. Rev. 735 (2008) (discussing the role of punitive damages in employment discrimination).
34. This language is taken from DEAR 952.231-71(j)(2) and 970.5228-1(j)(2).
35. At first glance the language in subsection (3) seems to abrogate the preclusive effect of the jury award of punitive damages, however this is not the case. The punitive damages award against the contractor stands, and will be paid in full, though it will be paid at least in part by the Government. Furthermore, the fact that the Government in once case decided to reimburse the punitive damages should not be taken as an indication that it will always do so, as the facts must be reevaluated in each individual case, and in fact may serve as notice to contractors that one specific case was unique and that they should not expect to have their punitive damages reimbursed in a similar situation. Finally, the clause itself prohibits review by another judicial body, thus eliminating the appearance of a collateral attack. Although this lack of “appealability” might seem unfair, it is the necessary compromise to allow for the possibility of reimbursement of punitive damages.
36. Except where specified the cases that follow were all at the trial level between the claimant and the government contractor. How the Government handled reimbursement of punitive damages is unknown to the author and may not yet have been resolved.
37. *Dalkilic v. Titan Corp.*, 516 F. Supp. 2d 1177 (S.D. Cal. 2007).
38. *Vietnam Ass'n for Victims of Agent Orange v. Dow Chem. Co.*, 517 F.3d 104 (2d Cir. N.Y. 2008).
39. *Glynn v. EDO Corp.*, 536 F. Supp. 2d 595 (D. Md. 2008).
40. *Abdi Jama v. Esmor Corr. Servs.*, 549 F. Supp. 2d 602 (D.N.J. 2008).
41. *Richardson v. McKnight*, 521 U.S. 399 (1997).
42. This option also leaves open the possibility of the injured party bringing a *Bivens* action against government officials involved. A full discussion of the ramifications of the *Bivens* action is outside the scope of this paper.
43. *3D Global Solutions, Inc. v. MVM, Inc.*, 552 F. Supp. 2d 1 (D.D.C. 2008).
44. Sabatino, *supra*, note 18.
45. The contractor is, however, likely to suffer from negative performance evaluations, potential termination or disbarment, and future premiums on liability insurance. E-mail from Steven Schooner to Zachary Stern, author (Mar. 31, 2009 12:54 EDT) (on file with author). These costs are not however direct out of pocket expenses that go towards remedying the underlying wrongdoing.
46. As should be clear by now, indemnification is distinct from cost reimbursement.



**Judging the Common Law:
Judge Sotomayor and the Government Contractor Defense**
by
David M. Nadler and Joseph R. Berger*

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The Government contractor defense affords federal legal immunity against state law claims to contractors who follow instructions from the Federal Government, as set forth by the 1988 U.S. Supreme Court decision *Boyle v. United Techs. Corp.*, 487 U.S. 500 (1988), which ruled on design defects in equipment manufactured for procurement by the military. Since that time, the Government contractor defense has been tested frequently, and its boundaries have been refined by the district and circuit courts. Dozens of decisions on the application of the defense have been issued in the last several years, including cases originating in the war zones of Iraq and Afghanistan.

On the U.S. Court of Appeals for the Second Circuit, Judge Sonia Sotomayor followed the reasoning of the Supreme Court majority in *Boyle*. Judge Sotomayor has ruled on the contractor defense more recently than the current Supreme Court justices. In a 2008 decision involving the recovery efforts at the World Trade Center site after 9/11, Sotomayor was part of a three-judge panel of the Second Circuit that expanded the potential application of the Government contractor defense, while affirming a district court that ruled against the defendants in that case, including contractors asserting the defense.

Judge Sotomayor first indicated that, in her view, the Government contractor defense might apply outside the military manufacturing context in her decision in *Malesko v. Correctional Servs. Corp.*, 229 F.3d 374 (2d Cir. 2000), rev'd on other grounds, 534 U.S. 61 (2001) (holding, 5–4, that a “*Bivens*” action for civil rights violations could not be brought against a Government contractor). In this case involving a privately run federal prison, Sotomayor had ruled that because there was no allegation that the Government played a role in the contractor’s decisions at issue, the contractor would not be protected by the Government contractor defense. Judge Sotomayor wrote,

Although the government contractor defense has primarily developed in the context of military contractors, the defense has been applied more broadly by some courts to protect contractors in non-military contexts. This Circuit has never expressly addressed the issue. However, this case does not present the appropriate forum in which to do so since, even assuming the potential applicability of the defense outside the military context, the requirements necessary for its application are not satisfied here.

229 F.3d at 382 (citations and footnote omitted).

The Second Circuit addressed the issue again in the 2008 decision *In re World Trade*

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Judging the Common Law (cont'd):

Center Disaster Site Litig., 521 F.3d 169 (2d Cir. 2008), written by Judge Richard Wesley, who was joined by Sotomayor and Judge Jon Newman. The plaintiffs included construction and rescue workers, firefighters, police and others who assisted in the recovery efforts at the World Trade Center site after 9/11. The defendants included New York City, the Port Authority of New York and New Jersey, and private companies that were hired by the city to work at the site.

The plaintiffs alleged that they “ ‘were exposed to toxic fumes and gases and other hazardous conditions, and that they suffered respiratory injuries due to the failure of the City and the Port Authority to monitor those conditions and to provide them with adequate safety equipment, and/or to warn them of the hazards.’ ” 521 F.3d at 173 (citation omitted). The plaintiffs alleged that the city “ ‘took control of the site, engaged contractors, and supervised the clean-up operations, but failed to provide adequately for the safety of workers engaged in the clean-up operations.’ ” *Id.* at 174 (citation omitted). The litigation began in state court and was removed to federal court in the Southern District of New York. The defendants moved for summary judgment on various defenses, including federal immunity defenses.

The defendants argued, under federal common law, that they were entitled to immunity for actions taken, to the extent that federal agencies—the Army Corps of Engineers, the Occupational Safety and Health Administration, and the Environmental Protection Agency—controlled and directed those actions. *Id.* at 176. The district court ruled against them, but stated that if the defendants could show they relied on federal health and safety standards, their conduct could be “ ‘tantamount to actions by the federal authority.’ ” *Id.* (citation omitted). The district court held that no similar derivative immunity existed under the 1974 Robert T. Stafford Disaster Relief and Emergency Assistance Act. *Id.* The Stafford Act governs the coordinated response by the Federal Government to assist disaster-stricken state and local governments.

On appeal, the defendants relied on the federal common law principles in *Boyle* and *Yearsley v. W.A. Ross Constr. Co.*, 309 U.S. 18 (1940). In *Yearsley*, a takings case, the Supreme Court recognized an immunity for private contractors, and stated that “it is clear that if this authority to carry out the project was validly conferred, that is, if what was done was within the constitutional power of Congress, there is no liability on the part of the contractor for executing its will.” 309 U.S. at 20–21. The defendants before Judge Sotomayor argued that this reasoning applied to the Stafford Act. 521 F.3d at 193–94. The Second Circuit turned to *Boyle*, in which the Supreme Court set forth the Government contractor defense.

According to the Second Circuit, the “rationale for this defense is not to protect the contractor as a contractor, but ‘solely as a means of protecting the government’s discretionary authority over areas of significant federal interest.’ ” *Id.* at 194 (citation omitted).

The issue as to Stafford Act derivative immunity for non-federal entities is whether the purpose of the Stafford Act to assure a prompt and comprehensive federal response to a

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Judging the Common Law (cont'd):

national disaster would be frustrated by imposition of liability upon these entities when their actions are taken under the specific direction and close supervision of federal agencies, comparable, with some adaptation, to the restrictions imposed on the defense contractor in *Boyle*.

Id. As stated by the Second Circuit, in *Boyle*, “the Court refined the requirements for a type of derivative immunity for government military contractors.” Id. at 196.

The *Boyle* decision held that

“[I]liability for design defects in military equipment cannot be imposed, pursuant to state law, when (1) the United States approved reasonably precise specifications; (2) the equipment conformed to those specifications; and (3) the supplier warned the United States about the dangers in the use of the equipment that were known to the supplier but not to the United States.”

487 U.S. at 512.

The Second Circuit stated that it had yet to decide whether the defense extended to contractors in non-military contexts, but noted that other circuits had held that the defense “can apply outside the military context.” 521 F.3d at 196.

Without deciding its applicability in other contexts, we think that the rationale for the government contractor defense would extend to the disaster relief context due to the unique federal interest in coordinating federal disaster assistance and streamlining the management of large-scale disaster recovery projects, as evidenced by the Stafford Act. If a federal agency orders a private contractor or City agency to implement decisions made by the federal agency, in its discretion, we think that “the interests of the United States will be directly affected” if the contractor or City agency does not follow those orders for fear of liability.

Id. at 197 (citation omitted). With that statement, the Second Circuit panel, including Judge Sotomayor, expanded the potential application of the Government contractor defense beyond the military manufacturing setting of the Supreme Court decision in *Boyle*:

Derivative immunity under the *Boyle* framework could apply in the Stafford Act context where: (1) the agency, in its discretion, approved reasonably precise specifications regarding the management of a recovery site; (2) the agency supervised and controlled an entity charged with implementing those specifications; and (3) the entity warned the agency about any dangers known to it but not to the agency. However, if the government merely accepted, without substantive review or enforcement authority, decisions made by an entity, that entity would not be entitled to derivative discretionary function immunity.

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Judging the Common Law (cont'd):

Only three justices who participated in the *Boyle* decision remain on the Court today. The majority 5–4 opinion in *Boyle* was written by Justice Antonin Scalia, who was joined by Justice Anthony Kennedy. Justice John Paul Stevens filed a vigorous dissent, arguing that the defense involved “ ‘questions of policy on which Congress has not spoken.’ ” 487 U.S. at 531 (Stevens, J., dissenting).

Congress ultimately embraced the common law of the Government contractor defense in 2002 when it adopted the Support Anti-Terrorism by Fostering Effective Technologies Act (SAFETY Act), codified at 6 USCA §§ 441–444. The SAFETY Act provides a “rebuttable presumption” that, in the event of an act of terrorism, the Government contractor defense applies to antiterrorism technologies that are certified by the Department of Homeland Security as approved products. 6 USCA §442(d)(1).

The SAFETY Act was intended to promote the development and use of antiterrorism technologies, and DHS has certified products designed for use in a variety of domestic security settings beyond the military context of *Boyle*. The Act may be more expansive than common law because after DHS certifies a product, the defense applies by statute whether the product is procured by the Federal Government, a state or local government, or a private entity. 6 USCA §442(d)(1). DHS stated in the preamble to its final regulation that “Congress incorporated government contractor defense protections outlined in the Supreme Court’s *Boyle* line of cases as it existed on the date of enactment of the SAFETY Act, rather than incorporating future developments of the government contractor defense in the courts.” 71 Fed. Reg. 33150 (June 8, 2006).

It is likely that the Supreme Court will rule again on the Government contractor defense. When it does, Sotomayor likely will play a pivotal role as justice. In the 2008 decision of the Second Circuit, the panel reversed the district court’s decision that derivative Stafford Act immunity did not exist as a matter of law, with reasoning based on the Government contractor defense, but affirmed the lower court’s decision to deny summary judgment for the defendants based on the factual record. The Second Circuit panel, quoting the district court, concluded:

[W]e must strike a “delicate balance” between the needs of Defendants, who insist that immunity is necessary to encourage companies to volunteer their efforts, and Plaintiffs, who were “the very individuals who, without thought of self, rushed to the aid of the City and their fallen comrades.” The standard we enunciate today attempts to strike that balance.

521 F.3d at 201 (citation omitted).

The Second Circuit’s interpretation of the law was thoughtfully reasoned and provides some insight as to how Sotomayor might approach this issue on the Supreme Court should it revisit *Boyle*, and how other courts may rule in the future. After more than 20 years, *Boyle* will continue to be applied as accepted precedent by the lower courts. As Government contract

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Judging the Common Law (cont'd):

oversight increases, so will application of the defense. It will continue to arise in new factual contexts, including procurement outside the military setting and provision of services supervised by federal entities. The federal common law will continue to evolve in the district and circuit courts, as they apply the holding of *Boyle* to the facts that arise today from government contract specifications and requirements that are vastly more complex than existed twenty years ago.

This FEATURE COMMENT was written for THE GOVERNMENT CONTRACTOR by David M. Nadler, partner and Joseph R. Berger, associate, in the Government Contracts practice of the law firm Dickstein Shapiro LLP in Washington, D.C .



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

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

Please note the October 22nd Annual Meeting flyer and Registration Form on page 3.

Leading this issue is Steve Feldman's interesting article on equitable adjustments related to taxes. Keith Szeliga then provides some sage advice about how not to give away your technical data. Zach Stern discusses reimbursement for punitive damages, and makes thoughtful recommendations for improvements in this area. Finally, Dave Nadler, our outgoing president (get it?), closes out the issue with an analysis of Justice Sotomayor's track record in cases involving the government contractor defense.

The Clause will reprint, with permission, previously published articles. We are always receptive to original articles that may be of interest to government contracts practitioners. But listen, everybody: Don't take all this government contract stuff too seriously. We again received some articles that were just not suitable for publication, such as: "Klaatu Barada Nikto!"; "Pro Se Sends R4 on Twitter!!"; and "BCABA Annual Meeting Hosts Air Guitar Competition — *Members Only!!!*"

