Recent Cost & Pricing Developments

At The Court Of Appeals For The Federal Circuit

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I. ALLOCABILITY AND ALLOWABILITY OF LEGAL FEES

***Boeing North American, Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2003)**

FACTS: Four shareholders brought a derivative action, captioned *Citron v. Beall*, which alleged that various named and unnamed directors, officers and employees of Rockwell International Corporation "failed to institute and enforce adequate internal controls, and fostered a 'corporate climate' that encouraged employee misconduct under federal contracts and resulted in criminal and civil penalties and fines." The *Citron* complaint alleged five instances of underlying misconduct: (1) Rockwell paid a $500,000 fine to settle a Government False Claims Act case alleging fraudulent mischarges for work performed on a Space Shuttle contract; (2) Rockwell pled guilty to criminal charges of making false statements in connection with a Government contract and was fined $1 million; (3) Rockwell pled guilty to two counts of a grand jury indictment charging the company and two of its employees with fraud, mail fraud, and willfully making false statements in connection with a global positioning system subcontract, and was fined $5.5 million; (4) A False Claims Act *qui tam* suit was brought against Rockwell for allegedly allowing its employees to use Government assets for personal gain; and (5) Rockwell was the subject of a criminal investigation of alleged hazardous waste dumping and other environmental wrongs. Rockwell settled the *Citron* suit by agreeing to pay a portion of the plaintiffs' legal fees, without any admission of wrongdoing, declaratory relief, or monetary damages. Rockwell included the legal fees and costs associated with the *Citron* suit as G&A costs in its home office overhead. The contracting officer disallowed the legal costs as unreasonable under FAR 31.201-3, and unallowable under FAR 31.204(c) on the basis that they were "similar or related" to costs that are unallowable under FAR 31.205-15 (Fines and penalties) and FAR 31.205-47(b). In upholding the contracting officer's decision, the Armed Services Board of Contract Appeals ("ASBCA"), citing *Caldera v. Northrop Worldwide Aircraft Services, Inc.*, 192 F.3d 962 (Fed. Cir. 1999), held that costs incurred to defend against and settle the shareholders' derivative suit were not allocable because the Board could "discern no benefit

to the Government in a contractor's defense of a third party lawsuit in which the contractor's prior violations of federal laws and regulations were an integral part of the third party allegations." *Boeing North American, Inc.*, ASBCA No. 49994, 2000-2 B.C.A. (CCH) ¶ 30,970. Additionally, the Board held that the costs were unallowable based on Rockwell's antecedent wrongdoing, but for which the derivative suit would not have been brought and the costs would not have been incurred.

HOLDING: The issue in the case involved cost allowability, but before reaching that issue, the court was required to clarify the difference between the concepts of "allocabilty" and "allowability," and the appropriate legal tests for each – issues that had been blurred in the *Northrop* decision. In the *Northrop* case, the court had observed in what essentially was *dicta* that in order for costs to be allocable to a company's Government contracts, the Government had to derive some "benefit" from those costs. The Board in *Boeing* had relied on this portion of the *Northrop* decision as the basis for its holding below.

The court stated that "allowability" is a matter of policy as to whether a cost should be recoverable and is determined by applying the specific allowability regulations, which, the court stated, "embody the government's view, as a matter of 'policy,' as to whether the contractor may permissibly charge the particular costs to the government (if they are otherwise allocable)." The court stated that, on the other hand, allocability is an accounting concept "involving the relationship between incurred costs and the activities or cost objectives (e.g. contracts) to which those costs are charged." Allocability, the court stated, is "addressed to the question of whether a sufficient 'nexus' exists between the cost and a government contract." The court concluded that the term "benefit" was used in the cost allocation regulations only to describe that "nexus" and was not intended to require contracting officers to engage in an "amorphous inquiry" into whether the cost gave the Government sufficient tangible benefit so as to be allowable. The court further observed that while costs may be allocable to a contract, not all of those costs may be allowable.

Turning to the issue of allowability, the panel was bound by the court's decision in *Northrop* and reaffirmed its "holding in *Northrop* that a contractor's legal costs are unallowable when incurred in the unsuccessful defense of a lawsuit that involved a judicial determination that the contractor sought to induce its employees to commit fraud against the government by the contractor." However, the court concluded that the ASBCA "committed legal error in determining the allowability of Rockwell's legal defense costs based on whether the costs conferred a 'benefit [on] the Government' and based on a 'but for' standard that looked solely to the fact that admitted misconduct by Rockwell formed the basis for the complaint." The court, however, also stated "Boeing's conclusion that the costs are allowable rests on a fundamentally flawed assumption – that the only professional service costs that are not allowable under FAR § 31.205-33 are those costs that are specifically disallowed under another FAR provision." The court focused the allowability inquiry on the FAR cost principles. The costs of defending the *Citron* lawsuit are "related" – within the meaning of FAR 31.204(c) – to the costs of defending against government charges of wrongdoing. Where a suit is brought by a private party and settled, FAR 31.205-47(c)(2) provides an appropriate test: "Such costs may be allowable if the contracting officer determines that there was 'very little likelihood that the third party [plaintiffs] would have been successful on the merits.'"

***Abraham v. Rockwell International Corp.*, 326 F.3d 1242 (Fed. Cir. 2003)**

FACTS: Rockwell International Corp. operated the Rocky Flats Nuclear Weapons Plant under a cost-reimbursement Management and Operations contract with the Department of Energy. An investigation of alleged criminal environmental wrongs was conducted by the Federal Bureau of Investigation, Environmental Protection Agency, and the U.S. Attorney's Office, but no charges were brought against Rockwell or its employees. After a subsequent investigation, Rockwell agreed to plead guilty to four felony violations of the Resource Conservation and Recovery Act of 1976 and five misdemeanor violations of the Clean Water Act. The settlement agreement stipulated that (1) none of the counts agreed to in the plea

agreement were based on the allegations in the first investigation, (2) there was no admission by Rockwell nor determination by the Department of Justice of "willful misconduct or lack of good faith" by Rockwell's management, and (3) Rockwell could seek recovery under its Management and Operations contract of the legal defense costs incurred prior to January 1, 1990 on behalf of the corporation and in providing legal representation to current and former employees, as well as the costs incurred for a computerized litigation database. The Engineering Board of Contract Appeals held that the Major Frauds Act of 1988 was not a bar to recovery, and that notwithstanding the Contesting Actions Clause,[1] the costs were allowable under the General Allowability Clause,[2] Environmental Costs Clause,[3] Fines and Penalties Clause[4] and Employee Defense Provision[5] of the Management and Operations contract.

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[1] The Contesting Actions Clause provided:

> Legal, accounting, and consulting services and related costs incurred in connection with the preparation and issuance of stock rights, organization or reorganization, prosecution or defense of antitrust suits, prosecution of claims against the United States, contesting actions [or] proposed actions of the United States, and prosecution or defense of patent infringement litigation.

[2] The General Allowability Clause provided:

> The allowable cost or performing the work under the contract shall be the costs and expenses that are actually incurred by the Contractor in the performance of the contract work in accordance with its terms, that are necessary or incident thereto, and are determined to be allowable pursuant to this paragraph (c). The determination of allowability of cost hereunder shall be based on (1) reasonableness, including the exercise of prudent business judgment; (2) consistent application of generally accepted accounting principles and practices that result in equitable charges to the contract work; and (3) recognition of all exclusions and limitation set forth in this clause or elsewhere in this contract as to types or amounts of items of cost.

[3] The Environmental Costs Clause provided:

> All costs incurred by the Contractor with respect to any and all liabilities claims, demands, damage costs, or penalties (such as civil sanctions including fines), arising out of, or related to environmental, safety and health activities, including costs incurred with respect to investigation, removal, remedial action, ground and surface water or other clean-up of hazardous, toxic or contaminated material(s), except for those costs that result from conduct identified in subparagraph (e)(17)(ii) of the clause entitled, "Allowable Costs, Base Fee and Award Fee."

[4] The Fines and Penalties Clause provided:

> Fines and penalties, including assessed interest, resulting from violations of, or failure of, the Contractor to comply with Federal, state, local or foreign laws or regulations, except when incurred as a result of compliance with the scope of work, specific terms and conditions, or other

HOLDING: This case does not require the court to determine the effect of the Major Frauds Act and its implementing regulations, because that aspect of the Engineering Board of Contract Appeals' decision was not appealed. The costs are not allowable under the General Allowability Clause, because it is subject to the express disallowance provisions of the contract, including in particular the Contesting Actions Clause. Although the costs are unallowable under the literal scope of the Contesting Actions Clause, they are allowable under the Environmental Costs Clause. The Engineering Board of Contract Appeal's expansive view of the Fines and Penalties Clause as authorizing reimbursement of all fines and penalties attributable to work within the scope of the contract is questionable, but court need not decide the issue because the costs are allowable under the Environmental Costs Clause. Because the Contracting Officer's denial of reimbursement under the Employee Defense Provision was unreasonable, the employee defense costs are allowable notwithstanding the lack of prior approval.

II. PENSION CASES

***Allegheny Teledyne Inc. et al. and General Motors Corp. v. United States*, 316 F.3d 1366 (Fed. Cir. 2003)**

FACTS: This is a consolidated appeal of two of the three of the pension cases decided by the court of Federal Claims:

> provisions of the contract or written instructions from the Contracting Officer authorizing in advance such payments.

[5] The Employee Defense Provision provided:

> 1. If a claim or legal action is brought against an employee as the result of the employee's conduct when performing duties under this contract and within the employee's scope of employment, the contractor shall be allowed the cost of defending the employee . . .; provided, however, that the prior approval of the Contracting Officer and the consent of the employee to be defended shall be obtained before such defense is undertaken.
>
> 2. The provisions of the contract clause entitled, "Litigation and Claims" shall have the same application to claims and legal actions against employees under this section as it has to those claims and legal actions which are brought directly against the Contractor. Before costs of any retained legal counsel may be allowed, the selection of such counsel must have the concurrence of the Contracting Officer.

- *Teledyne, Inc. v. United States*, 50 Fed. Cl. 155 (2001), involved the 1995 sale of Teledyne Electronic Systems, Inc. and 1996 sale of Teledyne Vehicle Systems. Both segments had pension surpluses at the time of sale. The contractor's appeals in both cases challenged the government's and the *Gould, Inc.*, ASBCA No. 46759, 97-2 B.C.A. (CCH) ¶ 29, 254, *recons. denied*, 98-1 B.C.A. (CCH) ¶ 29, 469, interpretation of original CAS 413. Teledyne was the first case to challenge the validity of "new CAS 413" as amended March 30, 1995.
- *General Motors Corp. v. United States*, No. 00-40C (Fed. Cl.), involved the pre-1996 sale of a segment with a pension deficit. The contractor's appeal adopted the government's former interpretation of original CAS 413.

Teledyne appealed part of the Court of Federal Claims' decision regarding the 1995 sale of Teledyne Electronic Systems, Inc., and General Motors appealed the COFC's decision regarding the 1993 sale of Allison Gas Turbine division. The United States cross-appealed portions of both decisions. Because neither Teledyne nor the United States appealed the COFC's decision regarding the 1996 sale of Teledyne Vehicle Systems, "new CAS 413" as amended in March 1995 was not at issue, including in particular the COFC's holding that application of "new CAS 413" to previously allocated pension costs was a change in cost accounting practice entitling the contractor to an equitable adjustment.

The third case, *General Electric Co. v. United States*, No. 99-172C (Fed. Cl.), involved the pre-1996 sale of a segment with a pension surplus. The contractor's suit challenged the government's interpretation of original CAS 413. General Electric was not the subject of the Federal Circuit appeal, although the court addressed the issue of proper treatment of employee contributions in its decision.

HOLDING: Affirmed the COFC on each of the issues appealed. The sale of a segment is a segment closing within the meaning of original CAS 413-50(c)(12). The Federal Circuit specifically referred to the Allowable Cost and Payment clause, FAR 52.216-7(h)(2) and the credits provision, FAR 31.201-5 as providing the mechanism for a government recovery. The

segment closing adjustment extends to pension costs under all CAS-covered contracts, but the recoverability of the adjustment depends on the terms of the contracts to which the pension costs were originally allocated. Accordingly, no adjustment is recoverable for pension costs allocated to fixed-price contracts. Nor can the government recover that portion of pension surplus arising from contributions allocated to pre-CAS 413 contracts or made by employees. The adjustment is made in the year of the segment closing, meaning that it may be recovered under any flexibly-priced contract that remains open during that year. The segment closing adjustment required by original CAS 413 is not a change in cost accounting practice entitling the contractor to an equitable adjustment.

***Eastman Kodak Co. v. Rumsfeld*, 317 F.3d 1377 (Fed. Cir. 2003)**

FACTS: Until 1982, Kodak used the frozen initial liability actuarial cost method for funding, financial reporting, tax and government contract accounting purposes. In 1982, Kodak changed to the projected unit cost method but failed to inform the government. That same year, Kodak made a tax deductible contribution to its pension plan that exceeded the amount required under the projected unit cost method. Kodak treated the excess contribution as a prepayment credit. In 1984, the pension plan went into full-funding, but the government continued to reimburse Kodak for an allocable share of the amortized prepayment credit. The ASBCA determined the government was entitled to a refund of the reimbursed pension costs for the period 1984 through 1986.

HOLDING: Affirms the ASBCA decision. Once the pension plan went into full-funding, the amortized prepayment credits were no longer allowable, because Kodak had neither a valid liability to make any contribution nor actual liquidation of a liability.

III. ASSET REVALUATION

***Kearfott Guidance & Navigation Corp. v. Rumsfeld*, 320 F.3d 1369 (Fed. Cir. 2003)**

FACTS: In August 1988, Astronautics Corporation of America purchased all of the capital stock of Kearfott Guidance & Navigation Corporation from Kearfott's parent, the Singer Company. Kearfott was subsequently merged and became a wholly-owned subsidiary of Astronautics Corporation of America. As required by generally accepted accounting principles and CAS 404, the business combination was accounted for using the purchase method of accounting for third party reporting, with the resultant "step-up" in asset bases to their fair market value. For income tax purposes, the parties treated the transaction as a purchase and constructive liquidation of assets. Approximately 17 months later, the government made a requirement FAR 31.205-52, with a stated effective date of July 23, 1990. As originally presented, FAR 31.205-52 provided that: "When the purchase method of accounting for a business combination is used, allowable amortization, cost of money and depreciation shall be limited to the total of the amounts that would have been allowed had the combination not taken place." In 1992, Kearfott was awarded a Navy contract, to which Kearfott allocated depreciation costs based on the "stepped-up" asset values in accordance with CAS 404 and 409.

HOLDING: FAR 31.205-52 applies to contracts awarded on or after July 23, 1990, regardless of when the business combination occurred. FAR 31.205-52 does not conflict with CAS 404 and 409: "Nothing in FAR 31.205-52 precludes contractors from measuring and allocating their costs pursuant to the protocol set forth in the pertinent CAS provisions. The FAR provision therefore has no impact on the measurement and assignment of costs under CAS to a contractor's commercial contracts. Rather, the FAR provision merely operates as an after-the-fact ceiling on the extent to which certain costs will be allowed once they have been allocated among the acquired asset values under the CAS provisions."

IV. COST INPUT BASE

***Rumsfeld v. United Technologies Corp., Pratt & Whitney*, 315 F.3d 1361 (Fed. Cir. 2003)**

FACTS: Pratt & Whitney entered into collaboration agreements with its foreign suppliers under which the suppliers paid a "program entry fee" and supplied engine parts in exchange for a percentage share of the engine program revenues. Title to the parts remained with the collaborator until just before delivery of the engine to the customer, when title instantaneously passed to Pratt. Pratt did not include the revenue share payments in its material cost base for allocation of general and administrative expenses under CAS 410 and indirect costs under CAS 418 and 420. The government argued the transactions were purchases and the prices paid to the suppliers should have been included in the allocation base. Pratt & Whitney argued that, because the CAS does not define the term "cost," one must refer to generally accepted accounting principles ("GAAP"); under GAAP, the economic substance rather than the legal form of the transaction controls; and the transactions were in substance joint ventures or consignments rather than sales.

HOLDING: The ASBCA should not have considered expert testimony on the interpretation of CAS:

> The views of self-proclaimed CAS experts, including professors of economics and accounting, a former employee of the CAS Board, and a government contracts accounting consultant, as to the proper interpretation of those regulations is simply irrelevant to our interpretive task; such evidence should not be received, much less considered, by the Board on the interpretive issue. That interpretive issue is to be approached like other legal issues – based on briefing and argument by the affected parties.

However, "[t]estimony as to the requirements of GAAP is another matter; the Board could properly consider expert testimony on such an issue." Because CAS does not define the terms "cost" or "material," it would have been appropriate to consult standard dictionary definitions and other pertinent regulations, including the Federal Acquisition Regulation and Uniform Commercial Code. Because title passed to Pratt, there was a "sale" by the parts suppliers to Pratt

for which Pratt became obligated to pay a price. Pratt's "economic substance" argument is fatally flawed for the following reasons: (1) GAAP applies only when CAS itself does not provide the answer, and CAS does provide the answer when the terms "cost" and "material costs" are given their ordinary, commercial meaning; (2) it is not clear that GAAP requires the use of substance over form; and (3) even if GAAP does require the use of substance over form, it fails to provide any meaningful guidance as to what constitutes the "substance" of a transaction or the circumstances under which "substance" treatment is appropriate. Therefore, Pratt was required by CAS 410, 418 and 420 to include a cost for the collaboration parts in its allocation bases.

V. STATE TAX REFUND

***Hercules Inc. v. United States*, 292 F.3d 1378 (Fed. Cir. 2002)**

FACTS: Hercules Inc. in 1987 incurred a significant state tax liability for which it was reimbursed under its government contracts then in effect. In 1995, Hercules received a refund of the state taxes earlier paid in 1987. In accordance with its consistently-applied practice, Hercules assigned the refund to the cost accounting period in which the refund was received.

HOLDING: FAR 31.205-41, Taxes; FAR 52.216-7, Allowable Cost and Payment; and FAR 31.201-5, Credits, require that any refund of a tax that has been allowed as a contract cost must be credited or paid to the government using the same factors by which the costs were originally charged (*i.e.*, using the contract "mix" in effect in 1987 rather than the "mix" in 1995). There is no conflict with CAS:

> [A]lthough CAS 406 requires a contractor to be consistent in its assignment of adjustments to expense to particular years, it does not grant the contractor immunity from specific FAR provisions governing the treatment of particular cost-related items, such as tax refunds. In this regard, the general requirement of consistent treatment of adjustments to expense is quite different from the specific CAS requirement regarding the allocation and assignment of pension costs that was held to prevail over an inconsistent DAR provision in *United States v. Boeing Co.*, 802 F.2d 1390 (Fed. Cir. 1986).

VI. DAMAGES; CONTRACTUALLY GUARANTEED MINIMUM AND QUANTITY ESTIMATES ERRONEOUSLY LOW

***White v. Delta Constr. Int'l, Inc,*, 285 F.3d 1040 (Fed. Cir. 2002)**

FACTS: Delta Construction International ("Delta") entered into a Indefinite Delivery/Indefinite Quantity contract with the government related to construction work at an Army base. The government provided estimates of the dollar value of its anticipated total orders for three periods as well as estimates for particular items of the work. The contract stated that the government's estimated quantities could change drastically with a guaranteed minimum of $200,000. Delta was only tasked to perform services equal to some $86,323 and sought to recover the difference between the work performed and the guaranteed minimum of $200,000.

HOLDING: The ASBCA awarded the contractor the difference between the dollar amount of work the government actually ordered and the total minimum dollar amount of the contract obligated by the government (*i.e.*, the difference between $200,000 and the $86,323 in orders performed, or $113,677).

The Federal Circuit overruled this decision by concluding that this difference was an impermissible basis for calculating damages, because it put the contractor in a more favorable position than the contractor would have been if the government had performed rather than breached its contractual commitment. In other words, "the non-breaching party 'should on no account get more than would have been accrued if the contract had been performed.'" (quoting *DPJ Co. v. FDIC*, 30 F.3d 247,250 (1st Cir. 1994)). As summarized by the Federal Circuit below, the proper basis for damages was the loss the contractor suffered as a result of the government's breach (*i.e.*, costs incurred standing ready to perform the work and a reasonable profit), not the total amount it would have received without the breach (*i.e.*, the total price of the unperformed work). The Federal Circuit stated that:

> The Board's decision here violates these established principles by awarding Delta the full amount it would have received if the government had not breached the contract. If the government had provided Delta with the $200,000 of work it had contractually guaranteed to provide, Delta would have been required to perform

> that work. To so perform, Delta would have incurred the additional costs of doing the additional work. The Board's award, however, gives Delta the entire amount of the additional work the government would have provided -- $113,676.93 -- without any reduction to reflect the additional costs Delta would have incurred in doing the work. The Board thus gave Delta more to compensate it for the breach "than would have accrued if the contract had been performed."

Accordingly, the Federal Circuit remanded to the ASBCA to award Delta the loss it suffered as a result of the government's breach of the contract.

***Rumsfeld v. Applied Co. Inc.*, 318 F.3d 1317 (Fed. Cir. 2002), reh'g denied (Apr. 2, 2003)**

FACTS: The Defense Logistics Agency issued a Request For Proposals on a requirements contract for two types of storage cylinders with an estimated volume of 120,000 units. The Request For Proposals stated that the variation in quantities actually purchased could be expected to vary ± 0.03 percent. Based upon this information, Applied Companies, Inc. ("Applied") submitted the lowest responsive offer. Prior to award, the Defense Logistics Agency determined that the estimates contained in the Request For Proposals were considerably higher than its actual needs, or approximately 3 percent of the total cylinders originally estimated. The Defense Logistics Agency did not inform Applied of this change in quantities and, in fact, reaffirmed its original estimates when it awarded the contract.

Approximately two months after contract award, the Defense Logistics Agency informed Applied that its estimates had been erroneous and sought to modify the contract. Applied proposed a higher price per cylinder for the substantially reduced volume (*i.e.*, about 10% of the previous projection) and requested $615,945 in "under absorbed direct costs." The Defense Logistics Agency and Applied were not able to come to terms and the Defense Logistics Agency terminated the contract for convenience.

Applied submitted a termination settlement proposal alleging that, as a result of the government's negligent estimates, it was entitled to approximately $1.79 million to recover unabsorbed overhead and to compensate for the differences in the cylinder estimates. After the Termination Contracting Officer rejected Applied's settlement proposal, Applied submitted a

breach of contract claim to the Contracting Officer. This breach of contract claim contended that Applied had relied upon the Request For Proposals estimates and that, prior to award, the Defense Logistics Agency had negligently failed to provide corrected estimates. The Contracting Officer denied Applied's breach claim and instead deemed the Government's actions to be a constructive change to the contract that entitled Applied to an equitable adjustment under the Changes Clause. Applied appealed both of the Contracting Officers' final decisions to the ASBCA.

Noting that the Government did not dispute that the Defense Logistics Agency had determined, before awarding the contract, that the Defense Logistics Agency had significantly overestimated the cylinder quantities, the ASBCA ruled that the Defense Logistics Agency had breached the contract and that Applied was therefore entitled to compensatory damages. The Government then appealed the ASBCA's ruling to the Federal Circuit, asserting that the ASBCA erred as a matter of law.

HOLDING: The Federal Circuit concluded that DLA's estimates contained an "implied obligation upon the Government 'to act in good faith and use reasonable care in computing its estimated needs.'" Since DLA conceded that it knew of the overestimation prior to contract award, the court concluded that the ASBCA properly held that DLA had negligently breached its contract obligations.

Although the ASBCA's decision was limited to the issue of entitlement, the court went further and examined statements by the ASBCA regarding quantum. Applied asserted that the company was entitled to anticipatory profits as compensation for the lower cylinder sales, while the Government countered that Applied should only receive reliance damages and a price adjustment. The court rejected Applied's claim noting (1) that a "nonbreaching party is entitled to an award of damages that will place it 'in as good a position as [it] would have been in had the breaching party fully performed,'" and (2) "'the nonbreaching party 'should on no account get more than would have accrued if the contract had been performed.'"

The court held that Applied was not entitled to compensation for those cylinders that exceeded the Defense Logistics Agency's actual requirements (i.e., no anticipatory profits). Applying the quantum principles developed in *Everett Plywood v. United States*, which calculated damages resulting from an inaccurate Request For Proposals estimate based upon the loss incurred as a result of the faulty estimate, the court stated that:

> In short, during the quantum proceedings which are to follow, Applied should have the opportunity to establish that it is entitled to an equitable adjustment in the price of the cylinders it delivered because it relied on DLA's negligent estimates and, as a result, suffered damages. We note that, in denying Applied's breach claim, DLA's contracting officer set forth such an approach. The contracting officer noted that "an equitable adjustment compensates for changes by paying a contractor its increased costs resulting from the change, plus an allowance for profit on that cost."

The court therefore remanded the case to the ASBCA to determine the amount that Applied was entitled to recover due to the Defense Logistics Agency's breach. The dissenting opinion asserted that, since there is no controlling precedent for this situation, the court should rely on the general law of contracts under which Applied would be allowed to recover lost profits.

VII. DAMAGES; LOST PROFITS

***Energy Capital Corp. v. United States*, 307 F.3d 1314 (Fed. Cir. 2002)**

FACTS: The United States Department of Housing and Urban Development ("HUD") planned to permit owners of government-subsidized multifamily housing properties to obtain energy efficiency loans. Accordingly, HUD negotiated an agreement with Energy Capital Corporation ("Energy") to eliminate the regulatory barriers to financing energy improvements in HUD properties. The agreement became known as the Affordable Housing Energy Loan Program agreement. Under this agreement, any first mortgage on these properties would be subordinated to the energy loan. HUD terminated the agreement before any loans had been made even though the contract did not contain a Termination for Convenience clause. Energy

brought suit in the Court of Federal Claims for breach of contract. The government conceded liability, and a trial was held on damages. The trial court entered an award of $10,082,000 in lost profits for Energy, and the government appealed.

HOLDING: The court addressed three primary issues, stating:

> According to the government, the Court of Federal Claims made three errors of law: (i) awarding damages in the form of lost profits in the case of a new venture that never was performed; (ii) engaging in speculation in concluding that the AHELP agreement would have yielded profits for Energy Capital; and (iii) applying a risk-free discount rate and discounting future profits to the date of judgment rather than to the date of the government's breach of contract.

With regard to awarding damages in the form of lost profits, the court let the COFC's decision stand, saying:

> In this case, the Court of Federal Claims properly recognized that while the evidentiary hurdles to recovering lost profits for a new venture are high, such profits may be recovered if the hurdles are overcome. Because the court found as a matter of fact that Energy Capital had established causation, foreseeability, and reasonable certainty, and because the government does not challenge the court's findings of fact, we will not disturb the court's holding that Energy Capital is entitled to recover lost profits.

With respect to the finding that Energy would have earned profits, the court found that the COFC's decision was not speculative, saying:

> [W]e do not find the trial court's finding that 66 percent of first mortgagees would have consented to AHELP loans to be clearly erroneous. Nor do we find the court's overall determination that Energy Capital was entitled to lost profits to be speculative as a matter of law.

After a lengthy discussion of the appropriate method of measuring lost profits, the court affirmed the COFC's decision to award lost profits reduced to present value as of the date of the judgment. (The government had argued that that the lost profits should be discounted back to the date of the breach.) The COFC's use of a risk-free discount rate was reversed, and the case was remanded for recalculation of damages using a risk-adjusted discount rate.

VIII. DAMAGES; EQUITABLE ADJUSTMENT; TERMINATION

***Raytheon Co. v. White*, 305 F.3d 1354 (Fed. Cir. 2002)**

FACTS: The Raytheon Company ("Raytheon") entered into a supply contract with the Army to produce, on a "build-to-print" basis, a newly designed guidance section for its Chaparral ground-to-air missiles. Raytheon was successor-in-interest to Hughes Missile Systems Company. The Army terminated the contract for convenience and Raytheon submitted an equitable adjustment claim to the Contracting Officer, along with a termination settlement proposal. Between award and termination of the contract, the Army incorporated into the contract 379 engineering change proposals to correct deficiencies in the technical data package. While the technical data package had numerous deficiencies, some of the worst problems involved the refrigerated detection units ("RDU"), the detection portion of the seeker. Raytheon's request for equitable adjustment sought to increase the contract price for costs it had incurred and would have incurred had it not been terminated (i.e., estimate-to-complete costs). Raytheon's claims were based upon several theories "including a 'discrete events' approach and a 'modified total cost' approach." The Contracting Officer concluded that Raytheon was entitled to an additional $13,577,360 for incurred costs, but denied the balance of its claim. As of the termination Raytheon anticipated a total cost overrun of over $22,000,000. Raytheon appealed the Contracting Officer's decision to the ASBCA. The ASBCA held that the Government was liable for its "misrepresentation and failure to disclose superior knowledge . . . when it expressly represented in the executive summary of the RFP for the production contract that the AN/DAW-2 guidance section was 'a build-to-print item.'" The ASBCA limited the contract price increase to $7,421,271 and Raytheon appealed to the Federal Circuit, challenging the adverse portion of the ASBCA's rulings.

HOLDING: The Federal Circuit first determined that the ASBCA failed to provide explicit findings justifying its rejecting of Raytheon's claim for direct material costs for 200 new and 411 reworked refrigerated detection units. Specifically, it found that the ASBCA had not

expressly addressed whether Raytheon needed to purchase 200 new RDUs to avoid a break in production, whether the price adjustment should have included projected costs for future failures of RDUs during production, or whether the equitable adjustment for re-worked RDUs should be based on historical cost or the latest price quoted by the RDU vendor where the vendor had closed its production line. Accordingly, the court remanded this issue to the ASBCA to make specific findings on contractor's discrete arguments in support of its claim.

The court next concluded that the ASBCA had correctly rejected the claim for engineering and administrative costs, because Raytheon had failed to present sufficient evidence linking the additional costs to deficiencies in the government furnished technical data package. The court also found that the ASBCA correctly deducted the amount that Raytheon had bid for compliance with the contract's Preproduction and Production Evaluation Requirements ("PPE") clause. This clause required Raytheon to initiate corrections to the technical data package at no charge to the Government and without delay in the schedule. Raytheon argued on appeal that it had not included costs for compliance with this clause in its claims, so deduction of this amount was improper.

Raytheon's "time extension impact" claim sought a price adjustment for the increase in "touch labor" rates that occurred as a result of extended program performance due to delay. Although Raytheon maintained that the company was claiming higher labor costs on unchanged work, the court observed that "[a]lthough the Government may indeed be liable for the additional costs of any unchanged amount of labor when the cost of that labor has risen as a result of Government delay, Raytheon failed to prove that the amount of the labor was unchanged." The court further agreed with the ASBCA that the time extension impact claim relied on a total cost calculation that neglected to account for Raytheon's $7.6 million bid price reduction.

The court next addressed Raytheon's contention that, pursuant to Section 611 of the Contract Disputes Act, the company should have been awarded interest on prospective costs allowed by the ASBCA and not just incurred costs. Raytheon argued that the court's decisions in *Servidone Construction Corp. v. United States* and *Caldera v. J.S. Alberici Construction Co.*

required that payment of interest should not be limited just to costs actually incurred. The court agreed that section 611 "sets a single, red-letter date for interest on all amounts found due by a court without regard to when the contractor incurred the costs." The court further explained that "[w]e have never held that section 611 permits interest to accrue on costs that, because of the termination of the contract, were never actually incurred by the contractor." The court found that the ASBCA had correctly ruled that only the amount of money due to Raytheon pursuant to the contract's Termination for Convenience Clause would be subject to the interest provision of section 611 of the Contract Disputes Act. Ultimate recovery under the Termination for Convenience clause often depends in part on the application of the loss ratio provisions of FAR 49.203, of which the adjusted contract value is a key variable.

Finally, the court addressed Raytheon's claim that the contract was commercially impracticable due to its excessive cost overrun. The ASBCA had noted that Raytheon had delivered 576 of the 1,171 contracted for units despite the difficulties caused by deficiencies in the technical data package. The court agreed with the ASBCA that a cost overrun of 57 percent did not by itself establish that the contract was commercially impractical, and further, that delays and low production yields were not so unusual that performance would be deemed impracticable.

IX. DAMAGES; UNABSORBED OVERHEAD

***P.J. Dick Inc. v. Secretary of Veterans Affairs,* 324 F.3d 134, 1370 (Fed. Cir. 2003)**

FACTS: P.J. Dick Inc. entered into a fixed-cost contract with the Department of Veterans Affairs for the construction of a Department of Veterans Affairs Medical Center. The Department of Veterans Affairs issued over 400 change orders, causing P.J. Dick to complete its contract 260 days after the original contract completion date. As a result of the delays, P. J. Dick filed a claim citing that the company was on standby and therefore was entitled to compensation for unabsorbed overhead charges.

HOLDING: The court decision rejected P. J. Dick's claim against the Department of Veterans Affairs, citing that P. J. Dick did not adequately prove that it was on standby as a result

of the government delay. In reaching this decision, the court provided a lengthy discussion of the requirements for recovery of unabsorbed home office overhead ("*Eichleay*") damages, especially the standby requirement. The court found it useful to clarify the Federal Circuit case law delineating the standby requirement. In determining if the standby requirement has been met, the court should first determine whether the Contracting Officer has issued a written order that suspends all the work on the contract for an uncertain duration and requires the contractor to remain ready to resume work immediately or on short notice. Under these circumstances, the contractor need not offer further proof of standby. In instances where the Contracting Officer does not issue such a written order, the contractor must then prove standby by indirect evidence. To do so, the court said the contractor must show three things.

> First, the contractor must show that the government-caused delay was not only substantial but was of an indefinite duration. . . .
>
> Second, the contractor must show that during that delay it was required to be ready to resume work on the contract, at full speed as well as immediately. . . .
>
> Third, the contractor must show effective suspension of much, if not all, of the work on the contract. *Cf. Melka*, 187 F.3d at 1375. Our early decisions do contain some statements that arguably support the notion that suspension of the work and idleness are not prerequisites to a determination that the contractor is on standby. *E.g., Altmayer v. Johnson*, 79 F.3d 1129, 1134 (Fed. Cir. 1996) ("There is no requirement that a contract be suspended before a contractor is entitled to recover under *Eichleay*."); *Interstate*, 12 F.3d at 1057 n.4 ("Although idleness of workers is evidence that a contractor is on standby, i.e., performance has been suspended, it is neither conclusive nor required."). At no time, however, has this court held that a contractor has been placed on standby merely because a government-caused delay of uncertain duration occurred, at the end of which the contractor must be ready to resume work….[6]

The Federal Circuit went on to provide a six-part test for use in determining if a contractor is entitled to *Eichleay* damages:

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[6] The Court's discussion of standby does not include the Eichleay decision itself. *Eichleay Corp*., ASBCA No. 5183, 60-2 B.C.A. (CCH) ¶ 26888, *aff'd on recon.*, 61-1 B.C.A. (CCH) ¶ 2894. In *Eichleay* the Board determined that the contractor was entitled to unabsorbed home office overhead damages in a situation where "[t]he suspension applied to only about 50 percent of the work, and direct costs were continuously incurred on unaffected work." By contrast, the court stated in *P.J. Dick Inc. v. Secretary of Veterans Affairs,* that "[a]t worst, PJD's direct billings during one of the periods of suspension were 47% of what they were in prior months."

> In short, a court evaluating a contractor's claim for *Eichleay* damages should ask the following questions: (1) was there a government-caused delay that was not concurrent with another delay caused by some other source; (2) did the contractor demonstrate that it incurred additional overhead (i.e., was the original time frame for completion extended or did the contractor satisfy the Interstate three-part test); (3) did the government CO issue a suspension or other order expressly putting the contractor on standby; (4) if not, can the contractor prove there was a delay of indefinite duration during which it could not bill substantial amounts of work on the contract and at the end of which it was required to be able to return to work on the contract at full speed and immediately; (5) can the government satisfy its burden of production showing that it was not impractical for the contractor to take on replacement work (i.e., a new contract) and thereby mitigate its damages; and (6) if the government meets its burden of production, can the contractor satisfy its burden of persuasion that it was impractical for it to obtain sufficient replacement work. Only where the above exacting requirements can be satisfied will a contractor be entitled to *Eichleay* damages.

Even though the court found that P.J. Dick was not entitled to *Eichleay* damages, the court found for P.J. Dick with respect to damages under the Suspension of Work ("SOW") clause, stating:

> We conclude that the stipulation did obviate the need for PJD to separately prove facts demonstrating entitlement to Eichleay damages beyond showing its right to recover for delays compensable under the SOW clause. The language of the stipulation establishes a single condition precedent to PJD's receipt of the enumerated damages: entitlement to damages under the SOW clause. *Entitlement to recovery under the SOW clause requires proof entirely different, and less demanding, than that required to show entitlement to Eichleay damages.* Compare *P.J. Dick, Inc., 2001 VA BCA LEXIS 12,* at *120 ("PJD must provide proof meeting a four-part test to establish its entitlement to recover an equitable adjustment under the suspension of work clause. First, there must be a delay of unreasonable length extending the Contract completion time. Second, the delay must have been proximately caused by the VA's action or inaction. Third, the delay resulted in some injury and fourth, there is no delay concurrent with the suspension that is the fault of PJD."), with *All State Boiler, 146 F.3d at 1373"* [Emphasis added]

On remand, the ASBCA was directed to investigate various delay issues necessary for the determination of quantum and, in accordance with the parties' stipulation, calculate the amount of home office overhead P.J. Dick was entitled to for government-caused delays compensable under the SOW clause and award that amount to P.J. Dick.

X. URANIUM ENRICHMENT SERVICES PROVIDED BY THE GOVERNMENT TO UTILITIES; COSTS IMPROPERLY INCLUDED IN GOVERNMENT PRICE DETERMINATIONS

***Florida Power & Light Co. v. United States*, 307 F.3d 1364 (Fed. Cir. 2002)**

FACTS: The Department of Energy traditionally has performed uranium enrichment services for domestic and foreign utilities, among others. Each customer utility held a contract with the Government that specified the manner in which the enriched uranium would be provided, the associated costs upon which prices would be based and maximum or "ceiling" prices. The Atomic Energy Act provided that prices for such services should be on a basis of recovery of the Government's costs over a reasonable period of time. The Energy Policy Act of 1992 amended the Atomic Energy Act, created the U.S. Enrichment Corporation and provided that the U.S. Enrichment Corporation take over the enrichment services from the Department of Energy. The amendment also established a fund to pay for decontamination and decommissioning costs, which the Government financed through a separate special assessment on the utilities beginning in Fiscal Year 1993. The special assessment was not considered in determining the prices charged to the utilities for uranium enrichment services.

The plaintiffs filed suit at the Court of Federal Claims asserting that the Department of Energy had overcharged them for uranium enrichment services during Fiscal Year 1993. More specifically the plaintiffs asserted that the Department of Energy's 1993 price formulation improperly included $1 billion in "remedial action costs," $480 million in costs of disposing of depleted uranium tails over 12 years, $773 million in imputed interest on the Gas Centrifuge Enrichment Project, and $394 million in costs that related only to the production of high-assay uranium for governmental (mostly military) applications. The plaintiffs also asserted their entitlement to interest on the claim amount in accordance with the Contract Disputes Act. The Federal Circuit summarized the COFC's findings as follows:

> the Court of Federal Claims held that the government had improperly included the remedial action and depleted uranium costs in the price of enrichment services, and it awarded damages to the utilities in the amount that those costs added to the

> price of enrichment services during the transition period. The court refused to grant recovery on the imputed interest and high-assay uranium claims, however, on the ground that the utilities had delayed unreasonably in presenting those claims and that the government had been prejudiced by the delay. Finally, the trial court held that the Contract Disputes Act did not apply to the contract, and that the utilities therefore were not entitled to recover interest from the date their claims were submitted.

The Government appealed from the judgment awarding damages for breach of contract. The utilities cross-appealed the court's rulings that the contracts were not covered by the Contract Disputes Act and that the utilities were barred from recovering on two theories because those theories were raised too late.

HOLDING: On appeal, the Government did not dispute the COFC's finding that the COFC improperly included the remedial action and depleted uranium costs in the price for enrichment services, but disputed the award of damages. The Government argued that damages were not appropriate because (1) the Government was not limited to a cost-recovery basis for pricing its enrichment services during the transition period and (2) the price for the Government's enrichment services would have been the same even if the costs disallowed by the COFC had been omitted in calculating the price of enrichment. The Federal Circuit rejected the Government's first argument, finding that, even though the statute mandating that the Government determine enrichment prices in accordance with Department of Energy policy had been repealed in 1992, such pricing policy remained in effect during the transition period.

The Federal Circuit, however, did not reject the Government's second argument. The Federal Circuit held that the COFC had not fully considered the government's argument; namely that, because the ceiling price was below the total amount of the Department of Energy's appropriate costs, eliminating the costs that the court ruled inappropriate would not have reduced DOE's appropriate costs below the ceiling price. The court remanded to the COFC to consider the Government's argument. The court also directed the COFC, on remand, to determine the "reasonable period of time" over which recovery of the cumulative loss should be projected.[7]

[7] The Department of Energy set its uranium enrichment price for 1993 by considering the Cumulative Loss To Be Recovered, the anticipated operations of the Uranium Enrichment Activity of the Department of Energy, and the

The plaintiffs had argued that it would be inconsistent with the Department of Energy's established pricing policy to set the 1993 price to recover over just nine months all the losses that had accumulated over decades. Previous projections used by the Department of Energy, including those used in prior years' pricing as well as the projections used as part of the price-setting mechanism for 1993, had incorporated 10 to 12 year projection periods.

The Federal Circuit further held that the COFC acted appropriately in finding that the utilities' claims related to imputed interest and high-assay uranium costs were untimely raised. The Federal Circuit noted that, on remand, the COFC might have to address those particular claims to the extent the government raised those issues in addressing the justification for its enrichment costs, thereby impacting the judgment for the utilities.

Finally, the Federal Circuit rejected the utilities' claim that the Contract Disputes Act should apply to the enrichment contracts, which would have permitted the companies to recover interest running from the date their claims were submitted. The utilities argued that the Department of Energy actually contracted for the procurement and disposal of personal property. The Federal Circuit found that the enrichment contracts could not be neatly described as either providing a service or disposing of personal property. Based on the nature of the contractual pricing scheme, the court concluded that the Department of Energy had contracted to provide services rather than sales of enriched uranium.

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contractual ceiling price. The Cumulative Loss To Be Recovered reflected the recoverable portion of all past annual losses (or profits) of the Uranium Enrichment Activity and was by statute to be recovered over "a reasonable period of time." Section 161(v) of the Atomic Energy Act specified that "any prices established under this subsection shall be on a basis of recovery of the Government's costs over a reasonable period of time." 42 U.S.C. § 2201(v) (1988). The Department of Energy's charges for enrichment services were established "on a basis that recovers appropriate Government costs over a reasonable period of time" [underline added] (see 10 C.F.R. § 762.5 (1988).