Maximizing Contractor Recovery of IR&D Costs: Federal Circuit Affirms ATK Thiokol

BY THOMAS A. LEMMER, PHILLIP R. SECKMAN, AND TAYLOR M. MENLOVE

Research and development (R&D) is a vital component of many government contractors' businesses. The government marketplace demands that contractors consistently improve existing technologies and develop new technologies to provide needed products and services to the government.

For the last four decades, however, there has been much debate regarding when contractors can recover R&D costs as indirect costs, or "independent research and development" (IR&D) costs, spread over multiple contracts, as opposed to direct costs of a single contract. This debate centers on the regulatory requirement that R&D costs are recoverable as indirect IR&D costs unless the R&D effort is "required in the performance of a contract." The government repeatedly has argued that this phrase should be interpreted broadly, encompassing not only R&D effort specifically required by contract terms, but also any R&D "implicitly required" or "necessary" for contract performance. Contractors, in response, have argued that the phrase should be interpreted narrowly, only applying to R&D effort specifically required by contract terms. Based on this uncertainty, government auditors have aggressively challenged contractor recovery of IR&D costs, and numerous False Claims Act violations have been alleged.

On March 19, 2010, the United States Court of Appeals for the Federal Circuit (Federal Circuit) provided much needed clarity regarding when R&D costs are properly recoverable under government contracts as IR&D costs. The Federal Circuit's decision, ATK Thiokol, Inc. v. United States, addressing an issue of first impression at the court, held that R&D effort is only "required in the performance of a contract" when the effort is specifically required by a contract's terms. The Federal Circuit's judgment affirmed the decision of the United States Court of Federal Claims (COFC) issued on November 30, 2005.

The Federal Circuit's decision, in combination with...
Karen L. Manos, Chair

It has been an honor and a privilege to serve as chair of the Public Contract Law Section over the past year. This is an eventful time for the government contracting community. Our clients, companies, and agencies are grappling with a procurement system that has been severely strained by sharply increased procurement spending combined with too few government acquisition professionals, a public policy preference for accountability and oversight in lieu of better acquisition management, and a negative public image of both the government and its contractors. These challenges make the work of our Section even more important. Over the past year, we have continued to work for the public good with a common goal of improving the procurement system. During this period, the Section published two monographs: The Guide to the Mandatory Disclosure Rule: Issues, Guidelines and Best Practices and Best Practices in the Acquisition of a Government Contractor. In addition, the Section’s current collection of state law summaries is available for review on the State Law Database Coordination Committee Web page at http://www.abanet.org/dch/committee.cfm?com=PC501800. The Section contributed to the public debate by submitting thoughtful comment letters in response to proposed procurement regulations and pending legislation on such important issues as contractors on the battlefield, contractor business systems, and personal conflicts of interest. And, equally as important, we continued our proud tradition of providing timely, high quality educational programs to our members and the greater government contracting community. I am also proud to note that our Section leadership is now younger and more diverse, and the new leadership has reinvigorated some previously moribund committees.

I have been fortunate to be able to work with extraordinarily talented, conscientious professionals. As I join the august ranks of the past chairs of the Section of Public Contract Law, I will always treasure this year. Thank you for the opportunity to serve as chair of our great Section.

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As you might suspect, this column is being written months before publication. I started this column on my return flight from the March 2010 Federal Procurement Institute. I am now in high gear planning and organizing the year. The enormity of the opportunity and the responsibility of being chair of the Section came into full focus as I sat through the excellent presentations by some of the best minds in the procurement community. Fortunately, none has become the chair overnight. Secretary, vice-chair and chair-elect are progressive years along the way to the chair’s chair, and each chair has effectively had at least three years to study his or her predecessors and plan “the” year. In the vice-chair, and chair-elect years, one is involved in the Long Range Planning Committee and has the opportunity to set goals based around that committee’s ideas and recommendations. Also, the Section is so well developed with such great talent in it, that the chair-elect really just needs to follow the lead of predecessor chairs, and select talented people to staff the committees, and half of the planning for the year is done.

From studying my predecessors, being involved in the long-range planning effort and listening to what is going on in the committees, I believe that 2010-2011 will revolve around five core themes. First, the Section will try to make 2010-2011 the Year of the Government Attorney. Second, 2010-2011 will be a year where we focus our attention on using technology to better deliver our services to our Section members. Third, and perhaps most importantly, the Section will try to build on one of the more creative ideas from the last several years and try to couple our focus as a Section that comments on others’ ideas with continued efforts to propose best practices solutions to the most challenging problems faced by the procurement community.

The fourth theme for the year is one of expanding diversity and youth. Finally, I could not face some of my colleagues who originally mentored me through my early years in the Section if we did not expand the Section’s focus on state and local procurement. I know this is an ambitious list, so let me explain each goal in more detail.

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The Year of the Government Lawyer

As many of you know, I started my career at the Office of General Counsel, Department of the Navy. The three plus years I spent there were some of the most enjoyable of my career. However, my emphasis on the government attorney is rooted in a much more substantive past. The participation of government attorneys is what separates our Section from many other voices in the procurement community. Our positions are balanced by the opinions and efforts of our government attorney members. There is no better example of this than the recent publication of the Guide to the Mandatory Disclosure Rule. This guide was written, in part, by attorneys from the Department of Justice and those in offices of the various inspectors general and government agencies. This is one of the most impressive collaborations between industry and government that I have seen in my 30 years of practice. Without the input of the government attorneys, the guide would only be, at best, half as impressive and effective as it is.

The ABA has fortuitously decided to help make 2010-2011 the year of the government attorney by significantly reducing the cost of membership in the ABA for government attorneys. The Section hopes to use this reduction in cost as a selling point to as many of the general counsels of as many agencies as we can identify. I would like to see a campaign headed up by current Section members who are government attorneys to help sell the benefits of the Section to other government attorneys. I believe the best sales representatives we have on this topic are our current government attorneys. Do not be surprised, therefore, if you find me asking you to help with my efforts. Today approximately 400 Section members, or about 9 percent, identify themselves as government or military lawyers, or members of the judiciary. I hope to report to you in my final column that that number has increased. My secret desire (do not tell anyone) is that at least one member of my old employer, the Office of General Counsel, Department of the Navy, will be among the new members.

The Best Practices Emphasis

I have been so impressed by the Guide to the Mandatory Disclosure Rule and Best Practices in the Acquisition of a Government Contractor that I hope to encourage, if not challenge, each Section committee to go beyond commenting on changes to the FAR. This country is in troubled times. We are currently fighting two wars. During these efforts, there have been deeply troubling activities in the procurement community on both sides of the table. Frankly, our country deserves better. As a result, both Congress and the current administration have understandably expanded oversight of our community. This increased oversight is going to challenge our community in many ways.

It is not enough, in the face of these challenges, to simply criticize the oversight. Nor is it valid to blindly perform the oversight in a vacuum without applying common sense. Both sides of the table eventually report to the American taxpayer. What we need are solutions and strategies to comply with the oversight demands that protect the tax-
payers in an efficient and cost-effective manner.

Our Section is uniquely positioned to help solve these issues. Our committees need to do more than comment on the ideas of other organizations. We need to continue to expand our efforts to be at the forefront in proposing the best solutions not only for acquisition oversight but for virtually all of the challenges our procurement community faces. To do this, we need to think of other types of projects centered on best practices that we can undertake for the procurement community. With this theme in mind, our committees can expand their efforts to define best practices in a manner similar to both the Guide to the Mandatory Disclosure Rule and Best Practices in the Acquisition of a Government Contractor.

Expansion of Diversity and Youth
In my career, I have greatly benefited from my experience with many diverse attorneys. I was a summer associate and watched Togo West serve as general counsel of the U.S. Navy. Pat Szervo was my first supervisor at Navy OGC. I tried (and lost) a case before Ruth Burg. Eileen Fennessy, recently retired from the Civilian Board of Contract Appeals, was a colleague and remains a close friend. I had the privilege of working with Pat Meagher at the Navy and again at Pettit and Martin. Similarly, I have worked with and learned from many Section chairs over the last 20 years who happen to fall into the definition of “diverse.” I am dedicated to continuing the tradition these attorneys have worked so hard to create so that others can experience the same benefits that I have.

At the same time I have noticed the energy and enthusiasm of our Young Lawyers Committee. I am pleased to see so many new, younger, and diverse faces at our meetings. I look forward to working with them during the year.

Expansion of State and Local Efforts
As someone whose practice includes federal, state, and local procurements, I can tell you that the Section’s greatest growth potential lies at the state and local level. This is not a new observation, nor are the obstacles of distance, 50-plus different approaches, and regional resistance to outside input any different today than in the past. Several things are, however, different. First, the Internet and communication capabilities have greatly reduced the obstacle of distance. Second, the Section’s outreach to state and local procurement organizations such as the National Association of State Purchasing Officials (NASPO) and the National Institute of Governmental Purchasing (NIGP) are beginning to pay off. Third, we have a dedicated group of practitioners on both coasts, in private practice, and in government and industry who are breaking down some of the regional resistance.

In May 2011, the Section will hold its Fifth Annual State and Local Procurement Symposium. The year will end at the Annual Federal Procurement Institute in Annapolis, Maryland. This will be the first time the Section has gone to Sacramento, where the state procurement budget alone dwarfs the economies of many countries. I hope to see you there.

Use of Technology
In this area I hope to continue the creative efforts of the Section to bring our services to our members. One idea I really like is to permit people to attend our programs by telephone. I would like to see that expanded to using the Internet to permit remote video access and interactive questions and answers. With travel budgets what they are today, along with the time demands of our members, the use of technology may dramatically enhance the outreach of the Section.

Calendar for the Year
On November 11-13, 2010, we will be in Boston, where the topic of the seminar will be intellectual property in government contracts. On March 3-5, 2011, we will meet again at the Federal Procurement Institute in Annapolis, Maryland. May 12-14, 2011, will find us in Sacramento for the State and Local Symposium. The year will end at the Annual Meeting, August 5-8, 2011, in Toronto, Ontario, Canada.

I am really looking forward to this year. As Section chair I readily recognize that I work for each of you. As such, please feel free to let me know how I am doing, or, better yet, send me some great ideas to implement. At a minimum feel free to contact me with your thoughts. I look forward to a great (and quick) year.
Kiewit and Other Latent Defects Cases

BY ADMINISTRATIVE JUDGE CHERYL L. SCOTT

In Peter Kiewit Sons’ Co.,1 the Interior Board of Contract Appeals (IBCA) denied appellant’s motion for partial summary judgment with regard to the Bureau of Reclamation’s (BOR) assertion of latent defects in siphons many years after acceptance. A lengthy hearing before the IBCA began in 2000 but was suspended when the presiding judge was appointed to the Armed Services Board of Contract Appeals (ASBCA) in 2001. At the parties’ request, the judge then conducted an alternative disputes resolution (ADR) proceeding in 2001 that resolved matters between them, but insurance issues remain. Appellant’s counsel recently noted that, at the time of Kiewit, the contracting community was concerned that BOR’s latent defects claims might portend a spate of such claims. That did not occur.

Inspection Clauses and Definition of Latent Defects

The contracts at issue typically contain Inspection clauses derived from those in the Federal Acquisition Regulation (FAR), or, as in Kiewit, their predecessors. Currently, FAR 52.246-2, Inspection of Supplies—Fixed-Price (Aug. 1996), provides at paragraph (k) that “[a]cceptance shall be conclusive, except for latent defects, fraud, gross mistakes amounting to fraud, or as otherwise provided in the contract.”1 Paragraph (l) provides, in brief, that if acceptance is not conclusive for any of the reasons in (k), then, in addition to any remedies under the law or the contract, the government may require the contractor, at no price increase, to correct or replace the defective supplies or to repay an equitable portion of the contract price. Similarly to FAR 52.246-2(k), paragraph (i) of the Inspection of Construction clause states that “[a]cceptance shall be final and conclusive except for latent defects, fraud, gross mistakes amounting to fraud, or the Government’s rights under any warranty or guarantee.” The FAR defines a latent defect as one that “exists at the time of acceptance but cannot be discovered by a reasonable inspection,” similarly to the Court of Claims’s oft-quoted definition in Kaminer Constr. Corp. v. United States that a latent defect is one “which cannot be discovered by observation or inspection made with ordinary care.”

Latent Defects Cases Preceding Kiewit

In Southwest Welding & Mfg. Co. v. United States, another oft-cited latent defects decision,4 relied upon by the appellant in Kiewit, the Court of Claims reversed decisions by the U.S. Corps of Engineers Board of Contract Appeals (ENGBCA) that had denied the contractor’s claim for an equitable adjustment after the Corps of Engineers had required it to repair alleged defects under its contract to construct penstocks and surge tanks in power plant units of the Garrison Dam Project in North Dakota. The penstocks conveyed water from an artificial lake to a turbine used to generate electricity. The steel plate supplier provided certified mill test reports that the plate conformed to the contract’s specifications. Based on the reports, and visual and physical tests required by the specifications, government inspectors at the mill had approved the plate. After the steel was shipped and after welding, government inspectors radiographically inspected and approved various units. Later, after conflicting expert reports and more tests, including ones the court found did not relate to the contract’s requirements, the contractor was directed to replace or repair some welds and other parts of the units due to alleged defects. After two hearings, the record was very large and included comprehensive fact stipulations. The trial commissioner, whose opinion the court adopted, deemed the dispute to involve issues of law and found the huge record “surprising.”

The court stated that the government had ordered work beyond the contract’s requirements, in effect questioning its own design specifications; the contract was not “zero defects”; alleged defects were not rejectable under the contract; the government’s “mere suspicion” did not warrant the replacement it had directed; and because the government bore the burden of proof, it had to elevate its suspicion to fact.6 The court noted that the items had passed inspection, which was final under the contract’s Inspection clause, except for latent defects and other exceptions that did not apply. It concluded that the defects were not latent
because the parties were aware of them well before installation, or they were readily discoverable by any reasonable inspection prescribed by the contract, or both.7

In 1993, the United States Court of Appeals for the Federal Circuit (Federal Circuit) held that the ASBCA had properly exercised jurisdiction under the Contract Disputes Act of 1978 (CDA) over a contractor’s appeals from contracting officers’ decisions under many contracts that, in pertinent part, had directed the contractor to repair or replace alleged latently defective jet engine parts and had vitiated the U.S. Navy’s prior acceptance.8 Each of the decisions purported to be a final decision and included appeal rights. None of them involved contractor claims or sought monetary relief for the government except for one “ancillary demand” in one decision that the contractor returned funds the Navy had paid it under a separate program to investigate the engine failures, which the ASBCA noted was not implicated in the jurisdictional question at hand.9 The Navy contended that its assertions of its post-acceptance rights were nonmonetary administrative matters that the ASBCA did not have jurisdiction to consider. The majority of ASBCA’s Senior Deciding Group disagreed, concluding that they were government claims under the CDA.10 In its decision on the merits, a three-judge panel held that the Navy had established a latent defect in one appeal, but not otherwise.11

The Kiewit Case

Peter Kiewit Sons appealed on its own behalf and that of its subcontractor, Ameron, Inc., from the contracting officer's September 1995 final decisions demanding payment from Kiewit in the amounts of $32,114,382 and $7,390,544 under contracts it had entered into with BOR in June 1975 and February 1978. The contracts, in the initial amounts of $34,265,637 and $13,498,933, called for the construction of earthwork and structures for 21-foot-diameter reinforced concrete pipe siphons, several miles long, that were part of the Central Arizona Project’s (CAP) Hayden Rhodes Aqueduct, which conveys Colorado River water to the Salt-Gila Pumping Plant about 25 miles east of Phoenix, Arizona. Under each contract (CAP I and CAP II), Kiewit subcontracted with Ameron to fabricate and lay the prestressed concrete pipes (PCPs) for the siphons. During construction, about 24,000 miles of wire were used. BOR accepted the contracts as complete effective in September 1978 and June 1980. The contracting officer's payment demands were based on alleged latent defects in the pipes.

The contracts contained Inspection and Tests by Government clauses stating that, in addition to tests in the specifications, the government reserved the right to inspect and test materials, equipment, and workmanship “during the life of the contract,” in accordance with the Inspection and Acceptance clause in the contracts’ general provisions. The specifications provided that materials furnished by the contractor, specified by reference to federal specifications or standards, or other standard specifications or codes, were to comply with the latest editions or revisions. If materials were not covered by federal or other specifications, they were to be of standard commercial quality.

The contracts’ specifications referred to detailed pipe drawings, which included mortar encasement in the section containing circumferential prestressing wire, which was the PCP’s primary load carrying element. Pipe acceptability was through inspection during and after manufacture to ascertain whether it conformed to the contracts’ specifications, “including design, freedom from defects, and the results of the physical test requirements.”12 Circumferential pipe reinforcement was to be steel wire, hard drawn for PCP in accordance with American Society for Testing and Materials (ASTM) A 648-73 (1973 edition), which contained manufacturing, physical, workmanship, finish, and appearance requirements for the wire. These included chemical requirements, a tension test, and a wrapping test specified in ASTM A 370-74. The wire's surface was to be smooth and free from cross-checking or torn surface, with no “serious die marks, scratches, pits, or seams.”13 The specifications also contained cement mortar coating requirements, to be applied after the steel wire reinforcement had been wound around the pipe.

The contracts contained Material and Workmanship clauses, providing that all material incorporated into the work was to be new and of the most suitable grade for the purpose intended, and in the case of the CAP II contract, that the contractor was responsible for the accurate manufacture and fabrication of equipment in accord with “the best modern practice.”14 Inspection and Acceptance clauses stated that the government’s acceptance of the work was to be final and conclusive except for latent defects, and that its inspection and testing during contract performance did not affect its continuing rights after acceptance with regard to latent defects. The Inspection and Acceptance clause in the CAP II contract added that inspection and testing was for the government’s sole benefit and did not relieve the contractor from providing quality control to ensure that the work strictly complied with contract requirements. The contracts’ Rejections clauses stated that pipe would be subject to rejection due to failure to conform to any specification or because of detrimental defects.

BOR accepted daily certifications, submitted by Kiewit from the wire manufacturers, that the wire satisfied ASTM A 648-73. BOR also visually inspected wire. Although it mostly accepted wire based on the certifications, it sent a few random samples to a private company for testing, which reported that the wire met specifications.

In a 1976 report, citing a 1965 engineering article, Ameron had stated that the “service life of properly designed, produced and installed prestressed pipe has been estimated to be in excess of 100 years.”15 After PCP supplied by Ameron ruptured in 1984 on another of BOR’s CAP projects, BOR investigated, and in 1987 began a corrosion monitoring program. In 1990, an investigative excavation program of selected pipe sections revealed some corroded prestressing wire. During 1991 and 1992, BOR, Ameron, and consultants evaluated the problems, which BOR feared could rupture the siphons, with catastrophic effect. BOR found
that corroded wire from distressed sites contained physical surface defects, but nonetheless passed certain mechanical and chemical tests. The majority of test samples met mechanical requirements even after having been in service for over a decade. The wire also generally passed the tension and wrapping tests and the chemical analysis specified by ASTM A 648-73. However, BOR performed certain tests that revealed that, among other things, at the time of final contract acceptance, the prestressing wire wound on the siphons contained longitudinal cracks or splits, edge cracks, seams, laps, and planes of weakness, and the wire exhibited a propensity to split when subject to torsion testing and was incapable of blunting or halting the continued growth of preexisting sharp-tipped cracks.

In October 1992, the contracting officer asserted to Kiewit that the siphons’ material, workmanship, and construction did not conform to contract requirements; unknown to BOR, defects had been present when they were constructed; and BOR could not have detected the defects by reasonable inspection at time of acceptance. BOR alleged, among other things, that defective steel prestressing wire used on the siphons for circumferential reinforcement did not comply with ASTM A 648-73 and was a principal cause of siphon deterioration. Citing the contracts’ Inspection and Acceptance clauses, BOR revoked its acceptance of the siphons and demanded that Kiewit repair or replace them without charge. Kiewit denied that there were latent defects in the siphons and that it had any responsibility to repair or replace them. It alleged that design flaws, for which BOR was responsible, were the most likely cause of the siphon issues.

BOR completed internal reports in 1992 and 1995, which the contracting officer used as the basis for her final decisions. She concluded that the principal causes of the siphons’ problems were (1) defective prestressing wire, and (2) pH corrosion cell caused by (a) carbonation of the concrete and intermediate mortar surfaces over which the prestressing wire was wrapped and (b) incomplete encasement of the wire with portland cement slurry and mortar coating. Relying in part on alleged trade custom and usage, the contracting officer also determined that the wire with portland cement slurry and mortar coating be applied over and completely encase each layer of wire, the subcontractor’s application was ineffective, such that the failure of the slurry and coating to completely encase the wire, resulting in voids, was a principal cause of the siphons’ distress, which BOR’s inspectors could not have discovered. The contracting officer also charged Kiewit with other alleged latent defects, but did not blame it for several factors contributing to siphon distress, including that it was unknown, under then-state-of-the-art technology, that the contracts’ ASTM tests would not reveal wire manufacturing defects. The contracting officer concluded that there was no clear way to measure each party’s liability and assessed Kiewit with 50 percent of BOR’s costs to replace the siphons.

**Kiewit’s Appeal to the IBCA and Motion for Partial Summary Judgment**

On appeal to the IBCA, the parties requested and were granted an unusually long discovery period due to the appeals’ complexity and problems envisioned because of the many years that had passed since contract completion. Kiewit filed its motion for partial summary judgment after some discovery had occurred, but more was ongoing. It sought dismissal of BOR’s claims regarding the two alleged principal causes of siphon pipe deterioration: defective prestressing wire and incomplete encasement of wire with cement slurry and mortar coating. It also sought dismissal of BOR’s claims concerning alleged contributing factors, said to depend on a finding of defective wire that BOR could not establish. Kiewit contended that BOR could not meet its burden to prove the two alleged principal latent defects because they did not violate the contracts’ requirements; the alleged wire defects were not latent because standard industry tests would have disclosed them; and, although the tests were not in the contracts, and thus not Kiewit’s responsibility, BOR could have conducted them as part of a reasonable inspection. For purposes of its motion, Kiewit did not dispute that, if the siphons contained the alleged latent defects, they required pipe replacement. BOR alleged, among other things, that there were material facts in dispute that precluded summary judgment and it sought additional discovery.

The IBCA noted that BOR bore the burden to prove a latent defect, and liability, causation, and resultant injury, by a preponderance of the evidence.17 BOR had to show that a defect proscribed by the contract existed at the time of contract acceptance, was latent, and caused the damages it claimed.18 It could not apply a more severe inspection procedure or acceptance standard than the contract imposed.19 If work complied with the specifications, it was not defective within the meaning of the Inspection and Acceptance clause.20 Unless the material facts were undisputed and only legal issues of contract interpretation remained,21 the inquiry into whether a latent defect exists was fact-based.22

Indeed, latent defect disputes are “fact laden and difficult to resolve on summary judgment.”23 The Energy Board of Contract Appeals (EBCA) granted summary judgment
to the contractor in a breach of warranty/latent defect case, but described the record as “comparable in size to a full-fledged hearing,” and the circumstances as “rare,” noting that the government did not seek more discovery. The following are some of the disputed matters in Kiewit.

The parties disputed whether there were defects prescribed by the contracts, whether the wire supplier’s testing complied with contract specifications, and which ASTM standards were relevant. The IBCA noted that other tribunals had referred to subsequent ASTM provisions, or to different or revised specifications, in connection with latent defect cases, but it reserved consideration of the weight, if any, that it would give to any ASTM revision or specification that was not part of the contracts.

Kiewit pointed out that, during the siphon investigations, wire known to be defective had passed the ASTM tension and wrapping tests and it cited cases for the proposition that the government could rely on extra-contractual tests only to the extent that they revealed noncompliance with contract standards, and it could not rely on them if they could and should have been incorporated into the contracts. The IBCA distinguished those cases and deemed that the issues of whether certain tests should have been incorporated into the contract, or what their effect would have been, invoked factual inquiries.

The parties disputed whether the wire satisfied physical requirements apart from those associated with tension and wrapping tests. BOR alleged that, even if ASTM tests did not reveal the defects, that did not mean that wire with serious seams, or strain-aged wire, was acceptable under the ASTM standard. It contended that the failure to conform to industry standards and contract requirements was the basis for its latent defect claims and cited an ASBCA case for the proposition that the nature of tests “is irrelevant if it is determined that appellant’s failure to meet the contract requirements caused a latent defect.” The IBCA agreed with BOR that, at the summary judgment stage, whether wire passed ASTM tests was not dispositive and that the contracts required more than compliance with physical tests.

BOR contended that it was entitled to receive pipe suitable for its intended purpose, which was to transport water for decades as part of the critical CAP project. The IBCA noted that the ENGBCA had applied an “intended purpose” analysis in concluding that blockage of an underground closed circuit television conduit, undetectable other than by a dragnet or tests that the contract did not specify, constituted a latent defect. Among other things, BOR also claimed that the wire supplier had not followed standard industry practices. Kiewit disputed that trade practice was relevant to interpreting the contracts, and alleged that the contracts were unambiguous regarding test requirements. BOR replied that the lack of a specified test did not mean that industry standards were to be ignored; and evidence of trade practice in the wire industry was essential to an understanding of the contracting parties’ intent. The IBCA considered the possible materiality of trade practice and its potential use in contract interpretation in latent defect cases. For instance, the ASBCA, after a hearing, had sustained the contractor’s appeal from a government claim that it was entitled to revoke final acceptance of cylinder assemblies and to recover the price paid on the ground that porous areas in metal forming the cylinder walls constituted a latent defect. The ASBCA found that, while the porous areas may have been a latent condition, they were not proved to have been a latent defect that caused cylinders to malfunction. The ASBCA also pointed out that “neither the contract nor an industry standard was referenced as a guide... Thus there is no valid norm against which we can evaluate the degree of porosity found in these cylinders.” The IBCA added that, in denying summary judgment to a contractor on a latent defects claim, the Court of Federal Claims (COFC) had cited tribunals’ common application of trade meaning in interpreting contract language and had noted that “where one party seeks to employ evidence of trade usage, summary judgment is inappropriate because trade usage is a ’factual issue which must be proven.’”

The IBCA identified additional factual issues pertaining to whether the alleged siphon defects existed when BOR accepted the contracts and to whether they were latent. The IBCA noted that certificates of compliance produced by a contractor can negate a claim that defects are patent, but that Kiewit alleged that excessively high tensile strengths, which BOR identified as a problem after acceptance, were reflected on its certificates and readily discoverable.

Citing the EBCA’s summary judgment decision, Kiewit contended that there was no factual issue concerning what constituted a reasonable inspection because, if tests were standard, BOR should have performed them as part of a reasonable inspection. BOR claimed that “reasonable inspection” did not mean that it was required to do shop testing that should have been performed by the wire producer during manufacturing; it did not have readily available testing facilities or capacity at the time; both parties relied upon Amerson’s record as an industry leader and upon its extensive experience with PCP fabrication; and BOR reasonably relied upon it to provide a quality product.

The IBCA noted that, in the EBCA case, the government had called for readily available testing in other similar contracts, but had not required it in the contract at issue. The EBCA had compared the relative expertise of the parties and found it significant that the contractor had no expertise in the design or technical requirements of insulators used on high-voltage transmission lines and had relied entirely upon the specifications’ accuracy and adequacy, the government’s expertise, and the contract’s testing provisions. The IBCA also distinguished an ASBCA case relied upon by the EBCA in which, after a hearing, the ASBCA had denied the government’s latent defect claims. The ASBCA stated that contract-required preproduction tests prepared by the contractor and approved and witnessed by the government were also not conducted during contract performance but should have been. The ASBCA found that most of the alleged defects...
were discoverable by visual inspection or regular test procedures, which the contract had prescribed, or the parties had adopted from the outset, and which had been used during performance, at the discretion of the government’s inspector. The ASBCA also found the circumstances to be unique in that, among other things, the government had a laboratory readily available to conduct the tests at issue and it had conducted them.

The IBCA referred to another ASBCA case and to one decided by the General Services Administration Board of Contract Appeals (GSBCA) in which latent defect claims had been rejected because, although not required by contract, the government could have performed simple tests that would have revealed the defects. The IBCA distinguished Southwest Welding, noting, among other things, that there the parties had stipulated that alleged defects were readily discoverable and known to them at all times. The IBCA also addressed Kaminer, in which the court, after a hearing, held that the contractor was liable for latent defects in derricks. The contract in Kaminer, like the CAP I and CAP II contracts, did not define the extent or nature of inspections or tests the government was to perform. The court stated that, despite potential nonvisual inspection procedures noted or incorporated into the contract, it did not impose upon the government the duty to conduct all-inclusive tests and the government’s visual inspection had been reasonable. The court stressed that the government’s right to inspect did not imply a duty to inspect. Rather, the contractor had the primary duty to ensure that work conformed to contract requirements.

The IBCA noted that the ASBCA had held a defect to be latent when “contractor performance of required contract tests did not detect it and an adequate contractor maintained inspection system was contractually mandated.” The IBCA stated that, although the Inspection clauses in the CAP I and II contracts did not contain the language of those in certain ASBCA cases that required contractors to maintain their own inspection systems, the CAP contracts required the contractor to supply a product that conformed to contract requirements, and they provided that inspection, or the waiver thereof, was not conclusive in that regard.

Lastly, in Kiewit, the parties disputed whether the alleged defects caused BOR’s damages. They disputed whether design inadequacies, rather than defects in siphon construction and material for which the contractor was responsible, were the principal causes of the siphons’ distress. BOR acknowledged that it warranted the sufficiency of its design specifications for their intended purpose, if their requirements were met, but it asserted that its warranty did not extend to the workmanship of the contractor’s materialman. It challenged the sufficiency of the workmanship in the manufacture of the prestressing wire, stating that ASTM A 648-73 did not contain detailed manufacturing steps and listed only the finished product, not the body of wire manufacturing practices that were acceptable at the time. The IBCA concluded that there were genuine issues of material fact in dispute, which precluded summary judgment.

**Latent Defects Cases After Kiewit**

Except for an unpublished Rule 36 affirmance of an ASBCA decision addressed below, the author is unaware of any relevant post-Kiewit latent defects opinions by the Federal Circuit. The most recent post-Kiewit board of contract appeals or COFC latent defects decision was issued by the ASBCA in April 2010. The ASBCA held that it lacked jurisdiction to entertain the contractor’s appeal from a contracting officer’s letter that, citing the Inspection of Supplies clause, revoked acceptance of primers based upon gross mistake amounting to fraud and latent defects. The letter stated that the government reserved the right to submit the dollar amount of its demand at a later date. It was not denominated a “final decision” and it did not include appeal rights. The ASBCA concluded that the revocation of acceptance alone, in conjunction with the reservation of the government’s right to submit a monetary claim, did not constitute a government claim under the CDA. The ASBCA stated that the letter did not demand payment of money in a sum certain or seek an adjustment or interpretation of contract terms or other relief arising under or relating to the contract, and thus did not satisfy the definition of “claim” set forth in the contract’s Disputes clause, FAR 52.233-1 (July 2002).

The ASBCA’s June 2009 decision in American Revolution & Constr. Co., a “gross mistakes” case, in which appellant’s motion for reconsideration is now pending, was issued after a hearing, including expert evidence, on appeals from a contracting officer’s decisions revoking acceptance in two design/build contracts for military housing at a U.S. Air Force base in Montana, and terminating the contracts for default. Although the decision rested largely on the “gross mistakes amounting to fraud” aspect of the Inspection of Construction clause, it cited some cases pertinent to latent defects issues, including for the principles that, when latent defects in manufactured articles cannot be discovered by ordinary diligence, action to revoke acceptance may be taken within a reasonable time after the latent defects become known, and that there is no precise formula for finding “reasonableness,” which is determined on a case-by-case basis.

For example, in 1979 the ASBCA found the government to have acted reasonably when it delayed revocation of acceptance by 10 months in order to determine conclusively that supplies did not comply with contractual specifications, or when it worked with a contractor to solve the problem. In 2000, the COFC found revocation more than six years after the government learned of alleged latent defects to be unreasonable as a matter of law and granted summary judgment to the contractor.

In 2007, after a trial that included expert evidence, the COFC entered judgment for the plaintiffs on their appeal under the CDA from a default termination. Plaintiff Moreland had contracted with the Department of Veterans
Affairs (VA) to construct a building in Las Vegas, Nevada, and lease it to the VA for use as a medical clinic. With regard to the latent defects aspects of the case, the lease contained a FAR Inspection of Construction clause, the FAR 52.246-21 Warranty of Construction clause, and a VA Guaranty clause. Construction was completed in 1997 and the VA took occupancy and began monthly rental payments under a 15-year lease. The VA terminated the lease for default in September 2002, on the grounds that Moreland had failed timely to repair structural deficiencies and the building was unsafe for continued occupancy. However, the VA continued to occupy the building until June 2003, when it ceased its rental payments. The COFC found that the alleged defects were largely cosmetic and could have been easily repaired if the VA had permitted Moreland to do so prior to termination.\(^5\) It stated that the deficiencies most closely fit the FAR's definition of "latent defects." The court found that, upon the parties' reasonable inspections of the building at construction completion, they were unaware of the defects and had begun the lease term without knowledge of them, even though some probably could have been identified by trained inspectors looking specifically for them. The court stated that the VA's remedies for latent defects were in the three clauses listed above, but that only the Inspection clause allowed for default termination, and then, only in the event of pre-acceptance inspections of construction.\(^6\)

In 2004, after an extensive hearing and record, the ASBCA sustained portions of each of a contractor's four appeals after the U.S. Navy had required it to rebuild thousands of defective transducers that an inspector had accepted. The Federal Circuit affirmed the decision in an unpublished Rule 36 judgment.\(^7\) In addition to addressing other latent defects law mentioned above, the ASBCA noted that the contractor's liability for a latent defect survived the two-year time limit in the contract's Warranty clause,\(^8\) and that "the specifications are the touchstone of a latent defect claim," and that "the specifications are the touchstone of a latent defect claim, and a testing procedure or standard for demonstrating compliance more stringent than that set forth in the contract generally may not be used to establish a defect."\(^9\) In affirming its decision on reconsideration, the ASBCA addressed the government's burden of proof with respect to rejection of work under the Inspection and Warranty clauses.\(^10\)

In 2000, the ASCBA denied a contractor's appeal, submitted under Board Rule 11, from the government's partial default termination of a delivery order (DO) to perform custom dive boat modifications, under which the government had accepted the modifications and had approved $68,242 for payment.\(^11\) The basic ordering agreement under which the DO had been issued had incorporated the FAR Inspection of Supplies clause, which the contracting officer cited in revoking acceptance due to an alleged latent defect and in seeking a $31,876 equitable adjustment. The parties were unable to resolve the matter and the partial default termination ensued. The ASBCA found that the government had established a latent defect by a preponderance of the evidence for which it was entitled to seek correction under the Inspection clause and that the default termination was justified.

This is only a sampling of post-Kiewit decisions, although decisions involving post-acceptance latent defect claims by the government are relatively few. \(^\text{Endnotes}\)

1. IBCA Nos. 3535-95, 3540-95, 99-2 BCA ¶ 30,401.
2. FAR 2.101 (previously FAR 46.101).
4. 413 F.2d 1167 (Cl. Ct. 1969).
5. Id. at 1169.
6. Id. at 1184-85.
7. Id. at 1186.
11. Id. at 119,940.
13. 99-2 BCA ¶ 30,401 at 150,293.
14. Id. at 150,294.
15. Id. at 150,296.
16. Id. at 150,297.
17. Roberts v. United States, 357 F.2d 938, 948-49 (Cl. Ct. 1966).
19. Southwest Welding, 413 F.2d at 1185.
21. E.g., Southwest Welding, 413 F.2d at 1169.
22. United States v. Lembke Constr. Co., 786 F.2d 1386, 1387 (9th Cir. 1986) ("Because the nature of the inquiry required when applying the relevant rule of law to the facts is essentially factual, a determination of latency is treated as factual."); Kaminer, 488 F.2d at 985.
23. M.A. Mortenson Co. v. United States, 29 Fed. Cl. 82, 94 (1993) (Mortenson I) (pipe for hydrant fueling system at Air Force base ruptured after acceptance; court denied summary judgment to contractor despite extensive stipulations, affidavits, and expert opinions, finding genuine issues of material fact, such as whether pipe was defective; identification of industry standards; whether any defect was latent; and whether any latent defect caused pipe failure).
25. H.B. Zachry Co., ASBCA No. 42266, 95-2 BCA ¶ 27,616 (hydrant fueling system pipe ruptured after acceptance; contractor's summary judgment motion denied); Bart, 96-2 BCA ¶ 28,479 at 142,233-34; M.A. Mortenson Co. v. United States, 40 Fed. Cl. 389, 420, 421 (1998) (follow-on to Mortenson I; after trial, court considered changes to specifications in subsequent procurements but accorded them little weight).
26. Southwest Welding.
27. Bart, 96-2 BCA ¶ 28,479.
29. Tricon-Triangle Contractors, ENBCBA No. 5553, 92-1 BCA ¶ 24,667 at 123,084.
30. 99-2 BCA at 150,303 (citing Metric Constructors v. NASA,
169 F.3d 747, 752 (Fed. Cir. 1999)).
31. Jo-Bar, 73-2 BCA ¶ 10,353 at 48,899.
32. Id.
33. Mortenson I, 29 Fed. Cl. at 97 (citation omitted).
34. Citing Harrington & Richardson, ASBCA No. 9839, 72-2 BCA ¶ 9507 at 44,296.
36. Herley Indus., ASBCA No. 13727, 71-1 BCA ¶ 8888.
37. Solid State Elecs. Corp., ASBCA No. 23041, 80-2 BCA ¶ 14,702; Ahern Painting Contractors, Inc., GSBCA No. 7912 et al., 90-1 BCA ¶ 22, 291 (also stating discovery of deficiency after acceptance, which was unknown at time of acceptance, does not automatically equate to latent defect, citing Metalstand Co., GSBCA No. 4682, 77-1 BCA ¶ 12,418).
38. 99-2 BCA ¶ 150,305.
40. Id., 488 F.2d at 986-87.
41. Zachry, 95-2 BCA ¶ 27,616 (citing Wickham Contracting, ASBCA No. 32392, 88-2 BCA ¶ 20,559).
43. The court has issued decisions on appeals from the United States Court of International Trade involving products with latent defects and a decision mentioning latent defects in the context of insurance clauses.
44. Hanley Indus., Inc., ASBCA No. 56976, slip op. (Apr. 22, 2010).
45. ASBCA Nos. 53723, 54038, 09-2 BCA ¶ 34,199 (motion for reconsideration pending).
47. 09-2 BCA ¶ 34,199 at 169,057, citing Perkin-Elmer Corp. v. United States, 47 Fed. Cl. 672, 677 (2000); see also Lee Lewis Constr., Inc. v. United States, 54 Fed. Cl. 88, 92-93 (2002) (summary judgment for plaintiff granted in part, but decision on latent defects issues, including timeliness of government’s notice, deferred for further proceedings).
49. Perkin-Elmer, 47 Fed. Cl. at 672.
51. Id. at 270.
52. Id. at 285-86.
54. 04-2 BCA ¶ 32,804 at 162,250 (citing Keco Indus., ASBCA No. 13271, 71-1 BCA ¶ 8727 at 40,539).
55. Id. (citing United Techs. Corp. v. United States, 27 Fed. Cl. 393, 397 (1992); Stewart & Stevenson Servs., Inc., ASBCA No. 52140, 00-2 BCA ¶ 31,041).
56. Northrop Grumman Corp., ASBCA No. 52178 et al., 05-2 BCA ¶ 32,992 at 163,525-526 (citing Southwest Welding; Ace Precision Indus., ASBCA No. 40307, 93-2 BCA ¶ 127,552; Dale Ingram, Inc., ASBCA No. 12152, 74-1 BCA ¶ 10,436; Ed Dickson Contracting Co., ASBCA No. 27205, 84-1 BCA ¶ 16,950 at 84,311-12 (Warranty clause)).
57. Munson Hammerhead Boats, ASBCA No. 51377, 00-2 BCA ¶ 31,143.

Nominating Committee Announces Slate

The Nominating Committee (Michael W. Mutek, Angela M. Hinton, and Mark E. Langevin), recently announced the following slate of candidates for 2010-2011:

Vice-Chair: Mark D. Colley
Secretary: Sharon L. Larkin
Second Section Delegate: John S. Pachter

Under Article VI, Section 1, of the Bylaws, the chair-elect, Donald G. Featherstun, becomes chair of the Section and the vice-chair, Carol Park-Conroy, becomes chair-elect without any further action by the council or by the Section membership.

Council Members (three-year terms beginning August 7, 2010):

Elizabeth M. Grant
John T. Jones, Jr.
James J. McCullough
Aaron P. Silberman

The slate will be presented at the Section’s Annual Business Meeting on August 7, 2010, in the California East Room at the Westin St. Francis in San Francisco, California.
Third Time’s a Charm? Size Determination Appeal Decisions Provide Necessary Guidance, but Unresolved Issues Remain

By Kathryn E. Swisher

On November 18, 2009, the Small Business Administration (SBA) Office of Hearings and Appeals (OHA) issued its decision in the Size Appeal of Social Impact, Inc.1 This decision culminated a series of three size appeals by Social Impact, Inc. (Social Impact), the first of which was filed on June 26, 2008, more than 18 months earlier.2

In each appeal, Social Impact claimed that the SBA’s Area Office had incorrectly applied 13 C.F.R. § 121.104(a), which allows firms in certain industries to exclude from the calculation of their average annual receipts “amounts collected for another.”

The final decision was significant, not only because OHA granted the size appeal and reversed the Area Office’s size determination, but also because the three Social Impact decisions represent the only recent OHA case law specifically addressing the exception as it applies to conference management service providers.3

While the Social Impact decisions collectively provide much needed guidance from OHA on the application of the exception to “amounts collected for another by conference management service providers,” some issues have yet to be definitively resolved. This article will first discuss the regulation and the Social Impact decisions, and then address how the decisions may be applied by practitioners.

The Regulation

SBA’s size regulations provide an exception from the calculation of average annual receipts for amounts collected for another by conference management service providers, as follows:

Receipts do not include . . . amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker.4

The exception for conference management service providers was added in 1996.2 Discussing the proposed rule, SBA explained that in its view conference management service providers shared certain characteristics with the other industries to which the exception already applied.5 These characteristics had been identified by SBA as follows:

(1) A broker or agent-like relationship between a firm and its third-party provider exists that represents a dominant or crucial activity of firms in these industries.
(2) The pass-through funds associated with the broker or agent-like relationship are a significant proportion of total receipts.
(3) As the normal business practice of firms in the industry, a firm’s income remaining after the pass-through funds are remitted to a third party is typically derived from a standard commission or fee.
(4) Firms do not usually consider billings that are reimbursed to other firms as their own income, preferring instead to count only those receipts that are retained for their own use.
(5) Federal government agencies that engage in the collection of statistics and other industry analysts usually represent receipts of the firms on an adjusted receipts basis.6

SBA explained that conference management service providers shared these characteristics as follows:

Conference management services firms provide a range of services in support of organizing and facilitating conferences, such as travel, lodging, honoraria and other administrative support services. The sponsoring organization is responsible for developing the conference and its contents and for all conference expenses. The conference management service provider principally acts as an agent on behalf of the sponsoring organization by arranging for various support services in connection with the conference and provides few, if any, of the support services itself. The arrangements made through the conference management services provider to a third-party provider are paid for using the sponsoring organization’s funds or by the conference management services provider and later reimbursed by the sponsoring organization. The pass-through monies paid to third-party providers generally account for a majority of the total expenses incurred by the conference management services provider. The conference management services provider’s earnings are based on fees or commissions from these activities.7

SBA sought comments and information regarding the practices of firms in the conference management services industry, in particular, regarding the typical relationship between conference management service providers and their clients.9 The final rule was issued on January 31, 1996, with no change to section 121.104 as proposed.10

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The Social Impact Decisions

In May 2008, following award of a contract to The QED Group, LLC (QED) by the United States Agency for International Development (USAID), Social Impact, a disappointed offeror, filed a protest with the Area Office, asserting QED was other than small for purposes of the procurement.

The Area Office issued its size determination one month later, concluding that QED had properly excluded from its revenue calculations amounts directly attributed to conference management services, and that QED was an eligible small business for the procurement.11

Social Impact filed an appeal with OHA, asserting that the Area Office had allowed QED to exclude all of the costs QED claimed were related to its provision of conference management services, and that the Area Office had failed to determine whether these amounts were collected as an agent for another, as required by the regulation.

OHA agreed, and explained as follows:

The key phrase in the regulation is “amounts collected for another.” The regulation does not permit the exclusion from receipts amounts attributable to whole categories of business.12

OHA remanded the case to the Area Office for a determination of exactly what proportion of QED’s conference management revenues constituted amounts collected as an agent for another.13

The Area Office issued a second size determination five months later, again finding QED to be small. QED sought to exclude conference management expenses in connection with two contracts, one with USAID, and one with the United States Department of Housing and Urban Development (HUD). QED asserted that it had collected the excluded amounts for others, and provided the Area Office with copies of the contracts, task orders, and final invoices.14

The Area Office reviewed the documents, and determined that there were “conference management costs” associated with the two contracts that could properly be excluded from the calculation of QED’s receipts.15

Social Impact filed a second appeal, arguing that the Area Office had exclusively reviewed QED’s contract and task order statements of work to determine which of the identified business activities constituted “conference management services” as defined by NAICS 561920, without regard to whether the costs QED sought to exclude had been collected by QED as an agent for another.16 In other words, the Area Office had, for the second time, incorrectly applied the exclusion to all amounts attributable to conference management services, despite OHA’s direction on remand that such amounts must also have been collected as an agent for another.

OHA found that the Area Office had not distinguished between excludable costs and QED’s own expenses.17 OHA again remanded the case to the Area Office for a determination of exactly what proportion of QED’s conference management revenues were amounts that had been collected as an agent for another.18

The Area Office issued its third size determination on July 20, 2009. The Area Office concluded that QED had acted as an agent on behalf of its government customers.

Social Impact appealed to OHA for the third time. OHA found that the record did not support the Area Office’s conclusion that QED had acted as an agent for its government customers.19 Specifically, while QED had repeatedly provided documentation indicating that it had performed conference management services in connection with the two contracts, QED had not provided evidence of how the revenues from the performance of those contract management services constituted amounts collected as an agent for USAID and HUD.20 OHA granted the size appeal, and reversed the Area Office’s size determination.

Applying the Social Impact Decisions

The Social Impact decisions, as well as OHA precedent and SBA’s regulations, suggest the following analytical framework for determining whether revenues may be excluded by a conference management service provider as amounts collected for another:

1. Are the revenues associated with services provided by the concern in its capacity as a conference management service provider?

2. If so, are the revenues “amounts collected for another”?
   a. Is there an agency relationship with an unaffiliated third party; or
   b. Do the amounts in question constitute the concern’s ordinary business expenses, for which it was reimbursed under a claim of right?

The Social Impact decisions do not, however, resolve some potentially conflicting nuances in the regulations and case law, and thus the application of this two-part test remains problematic.

1. Are the revenues at issue associated with services provided by the concern in its capacity as a conference management service provider?

It is well settled that the exclusion of pass-through receipts is limited to those industries specified in the regulation.21 What has not been clear, however, is whether the application of the exclusion is predicated on the firm itself, i.e., the specific industry to which the concern belongs (as determined by the concern’s primary NAICS code, for example),22 or whether the exclusion applies to the nature of the amounts the concern is seeking to exclude, i.e., whether the allegedly excludable costs were incurred while the concern was acting in the capacity of a firm in one of the enumerated industries.23

Applying the exclusion in the latter manner makes the most practical sense, because most small businesses perform work under multiple NAICS codes. For example, a firm whose primary industry is conference management services (e.g., NAICS code 561920, Convention and Trade Show Organizers) may perform work under an IT services contract. The firm’s pass-through amounts for those IT services
should not be excludable simply because the firm's primary industry is one of those enumerated in section 121.104(a). Conversely, as is clear from the Social Impact decisions, a firm whose primary industry is not listed in the regulation may nevertheless provide conference management services in connection with a contract that has a much broader scope of work. The revenues earned by the firm in its capacity as a conference management services provider should be excludable, provided the amounts were also collected as an agent for another, regardless of whether the firm's entire business is based on providing contract management services.

In the Social Impact decisions, OHA implied that a firm's revenues are excludable under the regulation if those amounts were incurred by the firm while it was performing in the capacity of a firm in one of the identified industries, that is, the firm's "primary industry" is irrelevant. OHA found that the Area Office correctly analyzed whether QED's allegedly excludable revenues were earned in connection with QED's provision of conference management services, but concluded that the Area Office had failed to determine which of those revenues were collected as an agent for another, and thus neglected to perform the second part of the two-part analysis. Thus, although OHA has never specifically elucidated this point, the first step in analyzing whether the exception applies must be to determine whether the amounts the firm seeks to exclude were associated with the firm's provision of conference management services.

2. If so, are the revenues "amounts collected for another"?

In Social Impact, OHA reiterated that the "key phrase" in the regulation is "amounts collected for another." It is not enough to determine that allegedly excludable costs were incurred by a firm in connection with its provision of conference management services. Those amounts must also have been collected as an agent for another. The nature of the agency relationship is, however, unclear—for whom is the firm acting as an agent?

a. Is there an agency relationship with an unaffiliated third party?

SBA's 1995 discussion of the proposed rule indicated that the agency relationship contemplated is between the firm and an unaffiliated third party, rather than between the firm and the firm's customer. Thus, in SBA's estimation, the normal business practices of conference management services providers are akin to those of a travel agency. There is, for example, an agency relationship between a travel agency and its transportation and lodging vendors, because the travel agency receives money from its customers on behalf of those vendors, and is compensated largely by commissions earned from those vendors, rather than by payments for services by customers.

In Social Impact, however, OHA characterized the agency relationship as follows:

I turn again to the preeminent example of the travel agent—the agent buys a plane ticket on behalf of a customer, and the customer pays the agent, who transfers the money directly to the

This characterization is analogous to SBA's statement in the discussion of the proposed rule that a "conference management service provider principally acts as an agent on behalf of the sponsoring organization," an illustration suggesting that this concept has been unclear from its inception. In most cases, including Social Impact, OHA analyzes the alleged agency relationship without regard to whether such relationship is between a firm and its customer, or between a firm and an unaffiliated third party.

For example, in Size Appeal of Cannon & Cannon, Inc., OHA disagreed with the appellant's assertion that money appellant held "as an agent for its customers" constituted pass-through funds. The appellant was primarily engaged in leasing crane equipment, and, as a service to its customers, regularly entered into leases to provide them with other heavy equipment. Appellant asserted that it did so as an agent, acting on behalf of its customers, and that amounts appellant received in this capacity constituted pass-through money it held as an agent for its customers. OHA, however, concluded that "such arrangements are tantamount to subcontracting and, being virtually indistinguishable, cannot be excluded from Cannon's average annual receipt calculations." OHA found that the reimbursed costs were treated as the appellant's ordinary business expenses, and thus were not pass-through amounts.

In Size Appeal of Mid-Columbia Engineering, Inc., claimed to be a "payroll agent," the appellant provided temporary employees to its clients, and billed its clients at an hourly rate for the employees' work. The appellant was compensated based upon a predetermined percentage of the compensation paid to the employees. The appellant sought to exclude from its receipts the amounts the appellant paid to the temporary employees the appellant furnished to its client firms. OHA determined that because the employees looked to the appellant for their pay, and not to the firms for which they performed work, and because the firms paid the appellant, and not the employees, the appellant thus conducted the transactions in its own name, rather than acting as an agent for another.

The nature of the agency relationship at issue in So-
cial Impact was further complicated by the fact that QED claimed that it had an agency relationship with its government customers. The Area Office accepted QED’s contention, concluding that in performing the contracts, QED had acted on behalf of the two federal agencies.

Under United States v. Johnson Controls, Inc., 713 F.2d 1541 (Fed. Cir. 1983), an agency relationship between the government and a government contractor is established as follows:

To establish an agency relationship between the government and a government contractor, the record must show that the contractor was: (1) acting as a purchasing agent for the government; (2) the agency relationship was established by clear contractual consent; and (3) the contract between the contractor and the government specifically stated that the government would be directly liable to subcontractors for goods or services provided to the prime contractor.36

In Social Impact, nothing in the record evidenced a clear contractual agency relationship between QED and either USAID or HUD, nor was there a specific statement indicating that either agency would be directly liable to subcontractors.

OHA has “relied upon the law of agency” when determining whether certain amounts may be excluded, considering the following criteria:

Is the challenged firm merely acting as an agent for another in the transactions it seeks to exclude? Does the firm enter into the transactions in its own name? If so, is the challenged firm liable for the transactions it enters into which produce the revenues in question? Do these transactions not constitute an integral part of the challenged firm’s business?37

OHA precedent, however, does not appear to distinguish between government and nongovernment customers. For example, in Courtesy Associates, the appellant identified reimbursable costs it had incurred under both government and commercial contracts. In Size Appeal of D.K. Shifflet & Associates, Ltd., the protested concern argued that it was acting as a “purchasing agent” or “distributing agent” for the National Institutes of Health.38

OHA’s conclusion in Social Impact did not address which analysis to apply when determining whether an agency relationship exists between a firm and its government customer.39 Rather, OHA emphasized the lack of evidence in the record to support the Area Office’s conclusion. OHA explained as follows:

Under either . . . agency test . . . QED failed to meet its burden of proving it acted as an agent for USAID or HUD. To prove an agency relationship, QED needed to explain precisely its role in each transaction as well as the government’s role in each transaction. This required clarification as to how the transactions proceeded logically—i.e., How did the money flow between the entities? Did USAID and HUD reimburse QED for these expenses? Did USAID and HUD advance money for these expenses to QED? What entity contracted for these expenses? Did QED enter into the transactions in its own name? Could the recipients of the funds for each transaction hold QED responsible for payment? Could the recipients of the funds hold the government responsible for payment? Were these expenses included in QED’s revenue as reported on its IRS Form 1040? Instead of offering this sort of precise information, QED has merely generally and conclusorily asserted throughout these proceedings that it acted as an agent in providing conference management services. This is insufficient.40

Arguably, OHA should not have analyzed this issue at all, and should have instead simply concluded that the Area Office’s determination that QED had an agency relationship with its customers was irrelevant because such an agency relationship is not contemplated by the regulation.

b. Do the amounts in question constitute the concern’s ordinary business expenses, for which it was reimbursed under a claim of right?

If there is no agency relationship between the concern and its third-party vendors, then the amounts are simply the concern’s ordinary business expenses, for which it was reimbursed by its customer under a claim of right, and, as such, may not be excluded.41

Conclusion

The Social Impact decisions provide necessary guidance on the exclusion of amounts collected for another by conference management service providers. OHA clearly explained that the exclusion does not apply to whole categories of business; rather, “[i]t is a simple legal question of what role the conference management service provider played in the transaction,”42 i.e., were the amounts in question collected as an agent for another?

What is not clear is whether the exclusion may only be applied to a firm whose primary industry is one of those enumerated in the regulation, or whether a firm acting in the capacity of a concern in an identified industry may exclude amounts it collects as an agent for another. OHA’s decision in Social Impact suggests that the latter application is acceptable.

In addition, the nature of the required agency relationship is debatable. SBAs’ discussion of the rule, as proposed, suggests that the agency relationship contemplated is between a firm and its unaffiliated third-party vendors. Such an interpretation is consistent with the business practices of firms in the industries to which the exclusion applies, e.g., travel agents or real estate agents.

OHA precedent does not, however, appear to distinguish between an agency relationship with an unaffiliated third party, and an agency relationship between a firm and its government or commercial customer.43 Ultimately, it would be most helpful for OHA to analyze the nature of the agency relationship contemplated by the regulation. Such an analysis, however, will have to wait for another appeal. PL

(continued on page 34)
Saturday, August 7

7:00 a.m. to 8:15 a.m.
Council Breakfast
California East, 2nd Floor
For 2009-2010 and nominees for 2010-2011 Section Officers and Council Members only

8:30 a.m. to 12:00 noon
Council Meeting
California West, 2nd Floor
Open to all Section members

12:00 noon to 2:00 p.m.
Section Luncheon and Annual Alan E. Peterson Lecture
California East, 2nd Floor
Luncheon Speaker: Daniel I. Gordon, Administrator, Office of Federal Procurement Policy, Washington, DC

This year’s Luncheon is made possible by the following Sponsors who have contributed to help defray its expenses:

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2:00 p.m. to 2:15 p.m.
Annual Section Business Meeting
California East, 2nd Floor
Includes election of 2010-2011 Officers and Council Members and other Section business
Presiding: Karen L. Manos, 2009-2010 Section Chair
Gibson, Dunn & Crutcher LLP, Washington, DC

2:15 p.m. to 3:45 p.m.
2010-2011 Section Leadership Brainstorming Session
California East, 2nd Floor

4:00 p.m. to 5:30 p.m.
Committee and Division Meetings
◆ Battle Space and Contingency Procurements
   Olympic Room, 2nd Floor
◆ Cybersecurity, Privacy and Data Protection
   Victorian Room, 2nd Floor
◆ International Procurement
   Kent Room, 2nd Floor
◆ State and Local Procurement Division
   Yorkshire Room, 2nd Floor

6:30 p.m. to 8:30 p.m.
Section Reception
The City Club of San Francisco
155 Sansome Street
This gracious social gathering, for Section members and their guests, and honoring the incoming Section Chair, is made possible through the generosity of the following Sponsors who have contributed to defray its expenses:

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Section of Public Contract Law

Annual Meeting Program Co-Chairs:
Robert L. Schaefer and Gail D. Zirkelbach

Annual and Quarterly Programs Co-Chairs:
Patricia A. Meagher and Holly Emrick Svetz

Unless otherwise noted, all sessions will be held at
Westin St. Francis
Union Square, 335 Powell Street
San Francisco, CA 94102
415-397-7000
The lawyers for MEGA and ACME are evaluating the acquisition of the ACME Widget Company, a company that does much of its business as a government contractor. The lawyers—from the Government, companies and the private bar—who wrote this best-selling book published by the Section of Antitrust Law are skilled at solving the kind of acquisition issues that arise in government contracting. Combined with the book, this session will give both acquirers and sellers a realistic idea of what to expect.

Applying Best Practices in the Acquisition of a Government Contractor

Whether you are representing the acquiring company, the company being acquired, or representing the government, this program will demystify the acquisition process and help you understand the reasonableness of each party's practical expectations.

In December 2009, the Section of Public Contract Law published Best Practices in the Acquisition of a Government Contractor. The lawyers—from the Government, companies and the private bar—who wrote this best-selling book brought their many years of experience in the intricate areas of law that must be addressed in the process of acquiring a government contractor. The book contains over 90 “Best Practice Tips” not found anywhere else.

Now, the authors of this book will take you inside the process to discuss how these best practices are applied, by dealing with a true-to-life hypothetical. The Worldwide MEGA Corporation is evaluating the acquisition of the ACME Widget Company, a company that does much of its business as a government contractor. The lawyers for MEGA and ACME are given a few weeks to address an ever-increasing list of issues, each of which might take months to consider under more leisurely circumstances. But, there is no time to wring hands over how hard these issues are—they must be solved quickly.

The session will begin with jump starting the due diligence process. The parties and their lawyers have to:

◆ negotiate a non-disclosure agreement, establish the due diligence team and organize the data room;
◆ decide what documents MEGA as the buyer should request and what ACME as the seller should provide; and
◆ prepare for and participate in briefings.

Given the volume of ACME’s government business, the initial focus will be on the government contract issues raised by this potential transaction. These bread and butter issues for government contracts lawyers (but perhaps not as well known to the transactional lawyers) include:

◆ the type of contracts that ACME performs;
◆ the cost issues that are unique to government contracts;
◆ ACME’s claims, disputes and bid protests;
◆ ACME’s compliance program, and how it will mesh with MEGA’s ethics program;
◆ possible conflicts of interest that will be created by the proposed combined company; and
◆ intercompany transfers following the transaction.

But wait, there’s more. New issues arise that require very specialized knowledge:

◆ MEGA already owns other widget companies, raising possible antitrust concerns. How and when should those issues be decided and who decides them?
◆ much of ACME’s work is classified, and MEGA has foreign ownership. How does that get resolved and by whom?

While the diligence progresses, there are transactional issues to address, including:

◆ deciding on the scope of the representations about government contracts that go into the acquisition documents;
◆ dealing with the fact that MEGA’s tax and corporate lawyers want to restructure ACME into a different form of entity;
◆ discussing with the Government the requirement for, and scope of, novation and guarantee agreements;
◆ determining the impact of the restructuring on cost allowability.

It’s a lot to cover in one session. But, it is emblematic of the intensity in a real acquisition. The speakers on this panel have been through it all before and know where the traps are. Combined with the book, this session will give both government contracts and transactional lawyers a realistic idea of what to expect.

Allan Joseph, Moderator, Rogers Joseph O’Donnell
San Francisco, CA

Antitrust
Raymond Jacobsen, McDermott, Will & Emery
Washington, DC

Classified Contracts/CFIUS/Exon-Florio
Chris Griner, Kaye Scholer LLP
Washington, DC

Jay Fraude, Defense Security Service
Alexandria, VA

Corporate Structure and Practice
Marian Block, Lockheed Martin Corporation
Bethesda, MD

Sunday, August 8

7:00 a.m. to 9:00 a.m.
Long Range Planning Committee Breakfast Meeting
Elizabethan Room A, 2nd Floor

9:00 a.m. to 12:00 noon
CLE Program: Inside the Due Diligence Process—Applying Best Practices in the Acquisition of a Government Contractor
California West, 2nd Floor
Co-sponsored by the Section of Antitrust Law

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Alexandria, VA

Corporate Structure and Practice
Marian Block, Lockheed Martin Corporation
Bethesda, MD
In resolving criminal and civil fraud matters, DOJ has
◆ The “zero tolerance” prosecution perspective on alleged
◆ How the Government is managing the flow of mandatory
disclosures from contractors; of productivity claims, including the following:
◆ Effects of the 2009 and 2010 amendments to the False
Claims Act on potential liability;
◆ Practical issues in Mandatory Disclosure Rule compliance:
Identifying “significant” overpayments, finding the
threshold for “credible evidence” and other common
issues in interpreting the rules;
◆ How the Government is managing the flow of mandatory
disclosures from contractors;
◆ United States v. Rhule: Lessons learned from the Broadcom
investigation and prosecution; how to avoid problems
with attorney-client communications, representation
issues and prosecutorial misconduct issues;
◆ The “zero tolerance” prosecution perspective on alleged
fraud under Stimulus Package Programs;
◆ In resolving criminal and civil fraud matters, DOJ has
long maintained a “hands-off” policy concerning
related suspension and debarment actions; is a different
approach in the works?

Among the subjects the three-hour panel will address are
the following:
◆ Effects of the 2009 and 2010 amendments to the False
Claims Act on potential liability;
◆ Practical issues in Mandatory Disclosure Rule compliance:
Identifying “significant” overpayments, finding the
threshold for “credible evidence” and other common
issues in interpreting the rules;
◆ How the Government is managing the flow of mandatory
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related suspension and debarment actions; is a different
approach in the works?

E. L. “Pete” Hoffman, Co-Moderator
Jackson Kelly PLLC, Martinsburg, WV
Susan A. Mitchell, Co-Moderator
McKenna Long & Aldridge LLP, Los Angeles, CA
Bryan D. Daly, Sheppard Mullin Richter & Hampton LLP
Los Angeles, CA
Eric R. Feldman, Senior Advisor to the Director
for Procurement Integrity, Nat’l Reconnaissance Office
Los Angeles, CA

Steve A. Linick, Director, Nat’l Procurement Task Force
and Deputy Chief, Fraud Unit, U.S. Department of Justice
Washington, DC
James S. Kennell, Vice President and Assistant General
Counsel, SAIC, McLean, VA
Kevin McCall, Assistant General Counsel
Northrop Grumman Corporation, Los Angeles, CA
Frances Lynn McCormick, Special Agent, Program
Manager, Contractor Disclosure Program, Department of
Defense Inspector General, Washington, DC
Michael G. Scheininger, McKenna Long & Aldridge LLP,
Washington, DC

Monday, August 9

7:00 a.m. to 7:30 a.m.
Construction Program Continental Breakfast
California East, 2nd Floor
This continental breakfast is included in the ABA All-Access
CLE Badge or CLE Program Ticket used for the program that
follows.

7:30 a.m. to 9:00 a.m.
CLE Program: Recent Developments—Proving
Acceleration and Inefficiency Claims in Construction
Contracts
California East, 2nd Floor
This 90-minute CLE program and 7:00–7:30 a.m. continental
breakfast are made possible by our Gold Sponsors—The
Kenrich Group LLC and Smith Pachter McWhorter PLC—and
our Silver Sponsor—Smith, Currie & Hancock LLP—whose
contributions have helped to defray its expenses.

Loss of productivity claims are among the most challeng-
ing disputes for construction professionals to litigate. While
the parties can often identify discrete project events that
resulted in changes, delays, or disruptions, they usually
disagree as to both liability for and quantification of lost
productivity damages.

The contentious nature of these disputes is also reflected in
the body of case law. Courts and boards have utilized several
different methodologies to justify large damages awards for
lost productivity. Many of these same methodologies, however,
have also been subject to criticism and questioned in both
their theory and practical application. The panel will consider
several questions pertaining to the proving and pricing of loss
of productivity claims, including the following:
◆ The phenomenon that symptoms of lost productivity are
typically identifiable, although the resulting damages are
often difficult to quantify;
◆ Potential impact of common contract clauses on the
recovery of lost productivity claims;
◆ Methods often utilized to quantify lost productivity
damages and their acceptance and criticism by courts
and boards;
◆ Impact of recent judicial decisions on parties that are
litigating lost productivity claims.

Mark A. Sgarlata, Moderator
Watt, Tieder, Hoffar & Fitzgerald, L.L.P., McLean, VA
Ken Smith, Group Counsel
Granite Construction, Inc., Waterville, CA
Among the questions they will address are:

◆ What can contracting officers do when they disagree with the DCAA’s audit findings?
◆ After the GAO and IG criticisms, will contractors more often object to DCAA audit findings?
◆ Will the DoD have to rely less on the DCAA and more on outside audit firms when litigating cost issues?
◆ Will DCAA’s audit requirements be increased with fewer, but more rigorous, audits completed?

Andrea B. Tecce, Moderator, Navigant Consulting
Washington, DC

Cheryl A. LeeVan, TM Financial Forensics LLC
Chicago, IL

David A. Hall, Alvarez & Marsal Dispute Analysis & Forensic Services, LLC, Denver, CO

Greg S. Bingham, The Kenrich Group LLC
Washington, DC

12:00 noon to 2:00 p.m.
8th Annual Ruth C. Burg Luncheon for Women in Public Contract Law
Empress of China, 838 Grant Avenue

This year’s Luncheon is made possible through the generosity of the following Sponsors who have contributed to defray its expenses:

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Smith Pachter McWhorter, PLC
Steptoe & Johnson LLP
Teledyne Technologies Incorporated
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Wiley Rein LLP
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Practical Advice for Those Who Deal With the More Active DCAA

This panel of accounting experts who regularly advise clients on thorny accounting issues will explain the events of the last two years in a historical context—from the DIVAD litigation to the more recent GAO and IG Reports. They will explain in practical terms how shifting audit and oversight roles, and changes in audit guidance and regulations, are affecting contractors, government agencies and shareholders.
The FEC Military Commissions Act: A Na(t)ive Analysis

By Ael Thiveole Minneck, FEC assistant attorney general, and Thael Voleen Minneck, general counsel, FEC War Department

Translated by Michael K. Love

Translator’s note: In the twenty-first century, the armed forces of the United States have so integrated contractor support into their operations that such support in the field is now vital to the success of U.S. military missions. The functions performed by contractor employees range broadly to include providing meals, base support, vehicle maintenance, truck drivers, on-site support for deployed weapons, security for other contractors, and myriad other services. While there are plausible arguments for limiting some of the functions currently provided by contractors, the current U.S. force structure requires contractor support of deployed forces as a practical matter, and such support is vital to mission success. Indeed, even if the United States decided today to transition away from contractor support completely, such support would still remain a key element in military deployments for years to come. As a result, our adversaries will be confronted with how to treat U.S. contractor employees, from many nations, whom they may encounter in the battle space.

Given the increasing tensions between the United States and FEC, I thought it appropriate to translate and offer for publication a somewhat abridged version of a recent article by two of FEC’s most prominent attorneys, who are especially expert in military affairs. This article analyzes FEC’s recently enacted FEC Military Commissions Act (FMCA). FEC closely modeled its FMCA on the U.S. Military Commissions Act of 2006 (MCA). Pub. L. No. 109-366, codified in Title 10 of the United States Code in a new Chapter 47a, which is fortunate indeed, because as of the publication deadline, no English translation had yet been made of the FMCA. Thus, the citations are to the MCA, but those U.S. provisions are substantively identical to the FMCA except for changing the country name and those of some of the involved officials.

The authors conditioned their permission to publish this abridged translation on disclosure of the following, which Feceans, as they call themselves in the rest of FEC, already know from their childhood teachings. The assistant attorney general comes from the tribe of Ughabannians. The War Department’s general counsel is a Chonna. Thus, although there is a certain similarity between their last names, their bloodlines are pure and unrelated. The military officer corps is almost all Lackcannes, who would sit on the military commissions established under the FMCA. Both the authors assured me, however, that since the cease fire of 1997, Lackcannes generally follow FEC civil authority—even when it is presented by a (sic) Ughabannian or Chonna.

In my view, the FMCA could put at risk every contractor employee supporting U.S. forces in a combat operation against FEC. If contractors and their employers did not accept this risk and perform in spite of it, the FMCA would imperil the ability of the contractors to provide vital support to U.S. missions and would thus imperil the success of those missions themselves.

The FEC Analysis

The FEC Military Commissions Act provides an enlightened approach to resolving issues of who is a combatant or unlawful combatant when engaging or supporting the engagement of the forces of our glorious land, FEC. Before passing this law, the Committee on All Things Military studied the laws of the leader of the free world, the United States, with particular focus on the Military Commissions Act of 2006. After much deliberation and open public debate covering a full 10 calendar days, six legislative days, the FEC legislature passed the FMCA. When the premier signed the bill, seven days later on December 31, 2006, the FMCA became the law of FEC.

Key to understanding the FMCA’s potential impacts on contractor employees supporting any operation in or against FEC are several definitions:

(1) UNLAWFUL ENEMY COMBATANT—(A) The term “unlawful enemy combatant” means—

(i) a person who has engaged in hostilities or who has purposefully and materially supported hostilities against the [FEC] or its co-belligerents who is not a lawful enemy combatant (including a person who is part of the Taliban, al Qaeda, or associated forces); or

(ii) a person who, before, on, or after the date of the enactment of the [FEC] Military Commissions Act of 2006, has been determined to be an unlawful enemy combatant by a Combatant Status Review Tribunal or another competent tribunal established under the authority of the [Premier of FEC] or the [FEC] Secretary of [War].
(2) LAWFUL ENEMY COMBATANT—The term “lawful enemy combatant” means a person who is—
(A) a member of the regular forces of a State party engaged in hostilities against [FEC];
(B) a member of a militia, volunteer corps, or organized resistance movement belonging to a State party engaged in such hostilities, which are under responsible command, wear a fixed distinctive sign recognizable at a distance, carry their arms openly, and abide by the law of war; or
(C) a member of a regular armed force who professes allegiance to a government engaged in such hostilities, but not recognized by [FEC].
(3) ALIEN—The term “alien” means a person who is not a citizen of [FEC].
(5) GENEVA CONVENTIONS—The term “Geneva Conventions” means the international conventions signed at Geneva on August 12, 1949.

Before the foreign invader gets a hearing before the FEC Military Commission, his or her status as an unlawful enemy combatant is conclusively determined by “a finding, . . . by a FEC Combatant Status Review Tribunal or another competent tribunal established under the authority of the [premier] of FEC or the FEC Secretary of War.” FMCA § 948d(c). FEC military commissions are then empowered to determine whether captured foreign invaders violated the law of war or committed other violations. FMCA § 948b(b). A FEC military commission “is a regularly constituted court, affording all the necessary ‘judicial guarantees which are recognized as indispensable by civilized peoples’ for purposes of common Article 3 of the Geneva Conventions.” FMCA § 948b(f).

FEC also eliminates a foreign invader’s right, if FEC determines that person to be an unlawful enemy combatant, to look to the Geneva Conventions for protection. The FMCA states: “No alien unlawful enemy combatant subject to trial by [FEC] military commission under this chapter may invoke the Geneva Conventions as a source of rights.” FMCA § 948b(g).

The FMCA system is guided by a War Department order that establishes the FEC Combatant Status Review Tribunals. This glorious order does not direct the tribunals to determine whether detained foreign invaders are unlawful enemy combatants, but only whether they are enemy combatants. Wisely the FMCA gives conclusive weight to the tribunal’s determination that these invaders are unlawful enemy combatants. Each foreign invader has been generously provided adequate rights to contest his or her designation as an unlawful enemy combatant. A FEC military commission’s jurisdiction might be challenged by a foreign invader who had not been explicitly found to be an unlawful enemy combatant by a FEC Combatant Status Review Tribunal. The FEC courts’ willingness and ability to rule impartially and with binding effect on the FEC military is unquestioned.

The authors have discussed this issue within their tribes and the Lackcannes and assure the world that when we capture these foreign invaders, they will be impartially provided the treatment they deserve.

The FMCA follows generally the FEC Code of Military Justice. Some express exceptions are made, however. Captured foreign invaders are not entitled to a speedy trial and the results of the pretrial investigations need not be shared with them. FMCA § 948b(d). As discussed below, protections against self-incrimination are less than protections afforded to FEC soldiers or lawful enemy combatants being court-martialed under the FEC Code of Military Justice. Moreover, while the FMCA follows the FEC Code of Military Justice, FEC military commissions may not apply any provision of the FEC Military Code of Justice unless its application is specifically provided for in the FMCA. Judicial interpretations of the FEC Code of Military Justice are not binding on FEC military commissions. FMCA § 948b(c). The FMCA, as is confirmed by the FMCA itself, meets all FEC-recognized international requirements: “A military commission established under this chapter is a regularly constituted court, affording all the necessary judicial guarantees which are recognized as indispensable by civilized peoples’ for purposes of common Article 3 of the Geneva Conventions.” FMCA § 948b(f).

FEC military commissions can sentence captured foreign invaders whom the commission determines deserve any punishment up to and including death. FMCA § 948d(d).

Each member of a commission trying a foreign invader must be active officers in the FEC armed forces but cannot be the accuser or a witness for the prosecution or have acted as an investigator or counsel in the same case.” FMCA § 948i(b). A FEC military judge is appointed to consult with the commission but cannot vote or consult privately with commission members. FMCA § 948j. The captured foreign invader is entitled to appointed defense counsel from among FEC military lawyers. FMCA § 949k. Proceedings are to be transcribed and may be interpreted. FMCA § 948l.

The FMCA eliminates inconsequential rights of a foreign invader compared to FEC criminal proceedings or a FEC court-martial. The FMCA states that the “Miranda-type” warnings to be given under the FEC codes of military justice (and the U.S. Uniform Code of Military Justice) do not apply and that evidence obtained in violation of such rules may be used against the foreign invader. FMCA § 948b(d)(B). While the FMCA prohibits use of statements secured through torture and provides that a captured foreign invader may not be compelled to testify against himself or herself before a FEC military commission, the military commission may admit coerced statements if:

(1) the totality of the circumstances renders the statement reliable and possessing sufficient probative value;
(2) the interests of justice would best be served by admission of the statement into evidence; and
(3) the interrogation methods used to obtain the statement do not amount to cruel, inhuman, or degrading treatment.
rules for FEC court-martials so far as the FEC “Secretary of War] considers [those rules] practicable or consistent with military or intelligence activities.” FMCA § 949a(a). The FMCA also guarantees a captured foreign invader the following rights:


2. The FMCA contains no geographic limitation. Accordingly, if unlawful enemy combatants or noncombatants support hostilities against FEC anywhere in the world, the FMCA covers them. FEC will deal with them accordingly.


4. FMCA § 948c. The FMCA, as the U.S. Congress did, expressly prohibits FEC military commissions from exercising jurisdiction over lawful enemy combatants. FMCA § 948d(b). Lawful enemy combatants must be court-martialed in the FEC military court just as a FEC soldier is. FEC thus treats honorable foreign invaders as well as it treats its own soldiers. Only 96 FEC soldiers were executed in the entire period from January 27, 2003, to July 23, 2003, the only period for which any figures are available. [The translator was unable to verify this number. He notes, however, the infamous “July Officer Purges” that began in late July 2005.]

5. Just as the willingness of U.S. courts to question and bind the U.S. military in time of war is clear.

6. FMCA § 948r(d). FEC has enacted a law parallel to the Detainee Treatment Act of 2005, Title X of Pub. L. No. 109-148, Defense Appropriations Act for 2006. Section 1003(d) of the Act contains the following definition:

(d) Cruel, Inhuman, or Degrading Treatment or Punishment Defined—In this section, the term “cruel, inhuman, or degrading treatment or punishment” means the cruel, unusual, and inhumane treatment or punishment prohibited by the Fifth, Eighth, and Fourteenth Amendments to the Constitution of the United States, as defined in the United States Reservations, Declarations and Understandings to the United Nations Convention Against Torture and Other Forms of Cruel, Inhuman or Degrading Treatment or Punishment done at New York, December 10, 1984.

7. FMCA § 949a(b)(1).

8. FMCA § 949a(d)(2).

(A) The accused shall be permitted to present evidence in his [or her] defense, to cross-examine the witnesses who testify against him [or her], and to examine and respond to evidence admitted against him [or her] on the issue of guilt or innocence and for sentencing, as provided for by this chapter.

(B) The accused shall be present at all sessions of the military commission (other than those for deliberations or voting), except when excluded under section 949d (for disruptive or dangerous behavior or to protect FEC classified information) of this title.

(C) The accused shall receive the assistance of counsel as provided for by section 948k (appointed FEC military counsel and, if the accused pays for it, civilian counsel that is licensed in FEC and that agrees to protect FEC classified information in accordance with FEC rules).

(D) The accused shall be permitted to represent himself or herself, if he or she conforms his or her deportment and the conduct of the defense to the rules of evidence, procedure, and decorum applicable to trials by military commission.

The FMCA allows the military commissions latitude to expedite justice by accepting evidence that evidentiary rules of FEC criminal courts would normally preclude such as hearsay. FMCA § 949a(a)(2).

The FEC military commission proceedings are open to the public unless the military judge determines closure is necessary to:

(A) protect information the disclosure of which could reasonably be expected to cause damage to [FEC] national security, including intelligence or law enforcement sources, methods, or activities; or

(B) ensure the physical safety of individuals.

A captured foreign invader shall have a reasonable opportunity to obtain evidence and compel witnesses to testify and produce evidence if the witnesses are within FEC jurisdiction. FEC trial counsel prosecuting the case may protect sources and methods of gathering evidence but must disclose evidence that “reasonably tends to exculpate” the captured foreign invader, or if the evidence is classified, provide an adequate substitute for it. FMCA § 949).

Conclusion

Our government has devised a wise, transparent, and fair system, overseen by our tribal brothers in arms, to ensure that foreign invaders receive their just reward after a full, fair, and expeditious hearing that equitably balances FEC needs to protect itself in a time of peril caused by these invaders with adequate procedural protections endorsed by the United States through it own Military Commissions Act.

Editor’s Note: After correcting numerous grammatical errors, noun-verb disagreements, and egregious misspellings (which, by the way, plagued the entire article when submitted), we have left the substance of the translator’s obviously flawed conclusion in the note preceding the article intact, because he insisted on it. U.S. citizens acting as contractor employees have a clear chain of command, always wear distinctive signs, and never violate the laws of war by directly engaging in hostile acts. Thus, in the fair and impartial proceedings prescribed by the FMCA, every U.S. citizen/employee captured by FEC in the struggle that is about to begin will be treated fairly and found to be a noncombatant. They are at no risk when they purposefully and materially support the U.S. mission against FEC. FEC would never dare to put U.S. lives at risk. We thought these translated analyses by these two FEC lawyers would be of interest. We suggest the translator be ignored. 

Endnotes


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7. FMCA § 949a(b)(1).

8. FMCA § 949a(d)(2).
Canada-United States Agreement on Government Procurement: A Canadian Perspective

By Gerry Stobo

In November 2009, for the second time in six months, Cambridge Brass Inc., a Canadian brass fittings manufacturer, was informed that parts it had provided to customers in the United States were being rejected because they were not of U.S. origin. The City of Sacramento, California, informed the company that the parts it had provided, and which were already in the ground, would have to be ripped up at the company’s expense. Cambridge Brass stood to lose as much as CDN$1.5 million, a crippling blow for a company that had already laid off almost half of its employees.1

This story is a tangible, if extreme, example of how “Buy American” provisions hurt Canadian businesses. Moreover, it was these types of stories that created much anxiety in Canada about lost opportunities due to protectionist restrictions that prevented businesses north of the 49th parallel from taking advantage of opportunities presented by the US$787 billion in economic stimulus spending announced by President Barak Obama in February 2009.

Resentment against barriers imposed by the Buy American requirements fueled growing anger in the Canadian marketplace. Stories of lost jobs and lost sales due to those requirements could not be ignored by Canadian politicians. Action was needed, or at the very least, governments needed to be seen to be taking steps toward open access to state and local procurements to Canadian suppliers. As a consequence of Canadian-led pressure, the U.S. administration agreed to enter into talks about ways those restrictions could be lessened or eliminated. On February 5, 2010, the Canadian and U.S. governments announced that an agreement had been reached to ensure greater access to subfederal procurement spending on both sides of the border.

This article examines the agreement between the government of Canada and the government of the United States on government procurement (Canada-U.S. Procurement Agreement or CUSPA) from the Canadian perspective. To that end, it will examine the background that led to the negotiations and will consider some of the key provisions contained in the final text of the agreement.

In the final analysis, as its creators acknowledge, CUSPA is an interim step. While addressing an urgent and immediate problem, it does not purport to resolve all of the outstanding public procurement irritants that continue to exist between Canada and the United States. It is a first step, and an important one, along the path to greater access for suppliers in both Canada and the United States.

Dark Clouds over the Border

In 1988, Canada had what many have described as a “free trade” election, where the Conservative government of Prime Minister Brian Mulroney staked its reelection prospects on the Free Trade Agreement it had negotiated with the U.S. government under President Ronald Reagan. Twenty years later, in 2008, free trade was again an election issue as the economic downturn forced candidates for the U.S. presidency to stake out clear positions on cross-border trade. The resulting debate was closely monitored on both sides of the border as the specter of protectionism regained a measure of prominence.

In view of the seamless integration of many Canadian and U.S. industries, as well as our deeply interconnected supply chains, Canadian businesses bristled at the Buy American sentiment and the subsequent obstacles they faced when attempting to sell into the U.S. market. Business leaders were perplexed by the “thickening” of our border given that each day more than CDN$2 billion worth of trade is exchanged between our two countries.

Not only was the voice of Canadian business loud and clear, media outlets in Canada took up the cause and highlighted stories like that experienced by Cambridge Brass on a weekly, if not daily, basis. Those stories frequently included quotes from leading Canadian business stakeholders including Jayson Myers, president of the Canadian Manufacturers and Exporters, who called growing American protectionism his organization’s “hottest issue.”2

The Canadian government—led by Prime Minister Stephen Harper—was being inundated with calls to do something to open U.S. procurement opportunities before the economic stimulus spending was depleted. Officials at the provincial and municipal level joined their federal counterparts and began flexing their collective spending muscle by threatening that unless U.S. markets were to open up to Canadian suppliers, Canadian subfederal entities would impose similar restriction on U.S.-made goods.3

By the summer of 2009, and in an effort to stem the rising tide of rhetoric, Canadian and American negotiators began to discuss ways that U.S. business opportunities at the state and local level could be opened up to Canadian suppliers and, at the same time, how Canadian subfederal procurement by provinces and territories could reciprocally be opened to U.S. suppliers.

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While spending at the federal level by both the Canadian and U.S. governments is relatively open to suppliers from our respective countries as a result of provisions contained in both the North American Free Trade Agreement (NAFTA) and the World Trade Organization-Agreement on Government Procurement (WTO-AGP), neither country had opened up spending at the subfederal level to each other’s suppliers. Access to subfederal spending is of critical importance to businesses on both sides of the border given that most government spending takes place at the state/provincial and local levels. In Canada, for example, it is estimated that all levels of governments combined spend almost CDN$100 billion annually, of which about 70 percent is estimated to be spent by municipalities, hospitals, and academic entities. In 1995, Canada’s representative explained to the WTO negotiating group the reasons why Canada refused to include coverage at the subfederal level:

Canada was prepared to table an offer at the sub-central level if, and only if, members were prepared (1) to include sectors of priority interest to Canadian suppliers, for example, in the steel and transportation area; and (2) to agree to circumscribe the use of small business and other set-asides in a manner that, while not precluding their use, would provide an acceptable security of access to suppliers from all members of the Interim Committee. It was Canada’s position that, in providing increased and secure market access to its trading partners, it was not unreasonable to expect the same degree of reciprocal market access in return. In the context of the present offers, this circumstance simply did not exist.

Yet, while Canada resisted including subfederal coverage, the same could not be said of all other signatories. In fact, U.S. commitments to the WTO-AGP included coverage for the procurement activities of 37 states, albeit subject to a variety of exemptions and exclusions.

For almost 15 years since the NAFTA and WTO-AGP were signed, the lack of access to subfederal procurement in the United States and Canada sat as a thorn in the side of business and political leaders on both sides of the border. Over the course of 2009, Prime Minister Harper spoke on a number of occasions with U.S. President Obama about the importance of reducing the barriers facing Canadian suppliers that wanted to participate in procurement opportunities presented by spending under the American Recovery and Reinvestment Act of 2009 (Recovery Act). In fact, President Obama stated that “Prime Minister Harper . . . has brought this up with me every single time we’ve met, so he’s been on the job on this issue.”

The negotiations towards a bilateral procurement agreement were long and hard fought. There was both opposition and support for a new procurement government agreement on both sides of the border. Many U.S. suppliers, for example, were equally keen to have full access to the almost CDN$30 billion injected into the Canadian economy through various forms of stimulus spending—much of which was going to be spent at the provincial/territorial and municipal level. Among those in favor of reduced barriers to the North American supply chain was Jeffrey Immelt, chairman and CEO of General Electric, who was quoted as saying the Buy American provisions were terrible: “Protectionism is not a philosophy. It’s a cry for help. It’s a sign of weakness.”

Some of the most vocal opposition came from unions that were, understandably, anxious to protect the jobs of their members. Their voices were joined by some business leaders whose opposition was motivated by a desire to protect market share. Their message was plain: Stimulus spending is intended to create domestic jobs and improve domestic economies, not the prosperity of foreign workers and businesses.

Notwithstanding the opposition, however, on February 5, 2010, both governments announced that a final agreement had been reached, which, if ratified, would come into force on February 16, 2010. To some, CUSPA is nothing more than a political valve designed to release the pressure that had been mounting for several months. To others, CUSPA is a landmark development in Canadian/U.S. trade relations. The truth, as always, lay somewhere in between.

The Canada-U.S. Procurement Agreement

Under the terms of CUSPA, Canada has committed those entities listed in Annex 2 of Appendix I of the 1994 WTO-AGP to the obligations contained in the Revised Text of the Agreement on Government Procurement (Articles I–XXI) as at 13 November 2007 (“2007 Revised WTO-AGP”). Annex 2 of Canada’s commitment to the 2007 Revised WTO-AGP covers all provinces and two of Canada’s three territories, the Northwest Territories, and the Yukon.

This commitment to the 2007 Revised WTO-AGP is only available to U.S. suppliers at this time. That said, however, Canada has indicated a willingness to offer to other signatories of the WTO-AGP access to subfederal spending, but only if reciprocal commitments and access are offered by those other parties.

Given Canada’s constitutional separation of powers, the federal commitment cannot commit provinces to the terms of an international treaty or agreement on matters that are within the province’s or territory’s exclusive jurisdiction. Therefore, because CUSPA covers commercial activity within the sole jurisdiction of provinces and territories, it was necessary to obtain the consent of those governments to be bound by its terms. Some provinces were more eager to commit to opening of their province’s procurements than others, but in the end, all provinces and two of the three territories agreed to be bound.

In Canada, constitutional authority with respect to municipalities, schools, universities, and hospitals is vested in the provinces and territories. Those subprovincial/territorial entities are given their jurisdiction through a variety of legislative and regulatory instruments. Consequently, it was the provinces and territories that had the authority to open
up municipal spending to U.S. suppliers—something they did subject to certain exemptions that will be discussed later.

By committing the provinces/territories and municipalities to the disciplines of the 2007 Revised WTO-AGP, U.S. suppliers will have access to procurements that exceed the monetary thresholds: (i) for goods and services, $355,000 special drawing rights (SDRs) (approximately CDN$550,000), and (ii) for construction services, 5,000,000 SDRs (approximately CDN$8 million).12

While it may be perceived that open access to Canada's subfederal spending will present significant new opportunities for U.S. suppliers, even before CUSPA was signed, public procurements in Canada rarely discriminated against U.S. suppliers—or, indeed, against suppliers from any other country. Public authorities in Canada have long recognized the need to have the greatest pool of suppliers and the greatest variety of innovative solutions in order to obtain best value and best fit for Canadian taxpayers. Were foreign suppliers to be excluded from public spending, given the size of the Canadian market relative to the U.S. marketplace, the cost of purchasing would rise—in some cases by a significant margin. As a result, procurements that were restricted to Canadian suppliers or gave Canadian suppliers a significant preference over non-Canadian suppliers, were not a common feature of government spending at the subfederal levels.

That said, there have been some notable exceptions, including the Government of Ontario's commitment to purchase subway cars from provincial manufacturers and the requirement of some provinces that any energy producers use domestic goods and services in order to qualify for provincial subsidies. This exemption has been preserved in Annex 2, which provides that the CUSPA does not, in the case of Ontario, apply to the procurement of "urban rail and urban transportation equipment, systems, components and materials incorporated therein, as well as all project-related materials of iron and steel."

In addition to Canada's commitment to bind subfederal entities to the 2007 Revised WTO-AGP, Canada has also agreed to allow U.S. suppliers access to some construction spending arising from Canada's CDN$30 billion stimulus package that was not previously open (as of right) to U.S. suppliers.13 As in the United States, part of Canada's stimulus spending is devoted to identified projects, but much of it is also earmarked for benefits such as income tax relief and skill development.

Opening up procurements for construction projects alone is estimated to present an opportunity for U.S. suppliers in the range of CDN$20-25 billion.14 This door will remain open for U.S. suppliers until September 2011, to coincide with the anticipated end date for U.S. stimulus spending, and the opportunities allowed Canadian suppliers under the CUSPA.

In Part B, the Temporary Agreement on Enhanced Coverage, Canada has committed to open subfederal procurement of construction services to the United States including for iron, steel, and manufactured goods of U.S. origin. Not only does Part B, Annex 2 cover all provinces and two of the three territories, Appendix C, Part B, Market Access, opens up coverage to U.S. suppliers for construction projects undertaken by most municipalities and provincial/territorial Crown corporations.15

While the benefits to U.S. suppliers as a result of the CUSPA are undeniable, there are long lists of exemptions that will continue, at least on paper, to give preference or exclusive access to Canadian suppliers. In addition to the example cited above in respect of urban rail transportation in Ontario, other exclusions have been carved out including exemptions for highway projects, procurements designed to promote development of distressed areas, and measures with respect to aboriginal peoples.16

One of the more interesting features of CUSPA relates to the inclusion of "Core Principles" in Appendix C, Part A. Many of these core principles reflect the national treatment and nondiscrimination disciplines found in the NAFTA and WTO-AGP (as well as the 2007 Revised WTO-AGP). So, for example, covered entities must commit to conducting open competitive procurement processes subject to certain exemptions that permit the direct award of sole-source contracts.17 Consequently, sole-source contracts can be awarded when there is:

i) a requirement for compatibility with existing products;
ii) an absence of competition for technical reasons and the construction services can be supplied only by a particular supplier where no substitute or alternative exists; or
iii) an unforeseen situation of urgency and the construction services cannot be obtained in time through an open competitive process.

Furthermore, covered entities must set out the technical specifications in terms of performance or functional requirements, rather than design or descriptive characteristics.18 This provision ensures that contract authorities do not bias specifications in favor of one supplier, thereby defeating the chances of other suppliers that can provide goods and services that are functional and performance equivalents.

Articles 16-22 of Appendix C of CUSPA create the obligation for provinces and territories to provide a domestic review, or bid challenge, process for U.S. suppliers before an administrative or judicial authority. Those suppliers are permitted access to that bid challenge mechanism if the covered entity has failed to conduct a procurement in accordance with the terms of the appendix.

A U.S. supplier that feels that a covered entity has biased the specifications in favor of one supplier over others, or that a contract was improperly sole-sourced to a competitor, has the right to complain that the obligations of the appendix have been breached. Paradoxically, this same right is not provided to Canadian bidders, or bidders from any other country. Therefore, U.S. suppliers will have greater rights in challenging the procurement activities of covered entities than those available to a Canadian sup-
plier involved in the same procurement. For instance, if a province/territory conducted a procurement in which it allegedly failed to respect the core principles indicated in Appendix C, a U.S. supplier could challenge the procurement behavior of that contract authority, whereas a Canadian supplier bidding on the same procurement could not.

According to the current state of Canadian jurisprudence, the provisions of a trade agreement do not create freestanding and/or enforceable rights unless those treaty obligations are enacted by statute into law. Consequently, once the domestic review provisions of CUSPA are enacted by the provinces and territories, U.S. suppliers will be able to enforce those obligations. Because those provisions have not been enacted into law for Canadian (or any other country’s) suppliers, however, non-U.S. suppliers could not obtain similar relief from a Canadian bid challenge authority.

That being said, to date, no provinces or territories have implemented this impartial bid challenge mechanism. It is uncertain, therefore, just how meaningful this bid challenge provision will be. Courts in Canada have stated on several occasions that treaty obligations are not enforceable unless they are implemented into domestic law. If governments do nothing to implement this domestic review process, it is unlikely that U.S. suppliers will be better off than suppliers from any other country, including Canada.

As a result, unless and until provinces and territories pass the necessary legislative instruments, the bid challenge mechanism will likely remain theoretical rather than real. Unfortunately, this is not unusual in Canada. Notwithstanding strong language contained in the Agreement on Internal Trade, an agreement containing a procurement chapter, negotiated between the provincial and the federal government, the absence of a bid challenge mechanism has made it difficult to successfully bring a challenge against a noncompliant provincial authority.

A Good Deal for Canada?

What do Canadian suppliers get from the CUSPA? As noted above, they will receive access to the procurements conducted by the 37 states included in the U.S. commitments in the WTO-AGP. Secondly, Canada will receive an exemption (or “waiver”) from the Buy American provisions of the U.S. stimulus package. This begs the question: Do these concessions by the U.S. administration present the business windfall Canadian companies wanted? Some say yes, while others say no.

Those who claim that the WTO-AGP commitments of the United States at the subfederal level are a hollow concession base this view, in part, on the numerous state-level exemptions and carve-outs that either exclude foreign suppliers or give preference to domestic suppliers. They also note that local procurement is not at all covered.

The European Union, a signatory to the WTO-AGP, framed its scepticism over U.S. subfederal commitments this way:

Even in the (WTO-AGP) bound states, various exemptions (i.e. for purchases of cars, coal, printing and steel and for set-asides) seriously limit the procurement opportunities open to foreigners. Besides, all procurements by States and localities that benefit from particular types of federal funding (e.g. in mass transit and highway projects) are subject to the Buy America Act.)

Moreover, procurements such as mass transit, highway construction, and public utilities services, including telecommunications, are excluded from the WTO-AGP commitments of the United States.

The focus of so much Canadian attention has been the U.S. stimulus package, which will inject US$787 billion into the American economy. In view of the focus of that spending—on infrastructure and major public projects—many Canadian businesses felt fully qualified to offer effective and best-value solutions. They were, in other words, ready, willing, and able to compete for those spending dollars.

Given the requirements and limitations in the Recovery Act, however, much of the stimulus money was being allocated as contracts, grants, and loans that carried Buy American preferences. Wisely though, U.S. lawmakers required that the provisions of the Recovery Act be implemented in accordance with its international obligations. As a result, as U.S. federal spending is concerned, the provisions of NAFTA and the WTO-AGP would ensure that Canadian suppliers were not discriminated against.

The real chest of riches in U.S. government spending was, however, opened at the subfederal level. The measure of subfederal treasure in the United States can be seen in the numbers: Estimated state and local expenditures in the United States amounted to nearly US$1.79 trillion in 2009, whereas Canada’s entire GDP in 2009 was estimated to be only US$1.28 trillion.

As attractive as that spending opportunity appears to be, the more immediate benefit to Canadian suppliers from the CUSPA arose with respect to seven projects funded by the stimulus package. In these projects, the U.S. administration has waived the Buy American restrictions on the use of U.S.-made iron, steel, and manufactured goods. In Article 7, Part B, Temporary Agreement on Enhanced Coverage, the United States commits to listing “seven programs under List C [of Annex 3 of Appendix I of the WTO-AGP] and providing that, with respect to those programs, the domestic purchasing requirement of section 1605(a) of the American Reinvestment and Recovery Act of 2009 will not be applied as a condition of financing those programs with respect to Canadian iron, steel and manufactured goods” that exceed the monetary thresholds.

These seven programs include the U.S. Department of Agriculture’s water and waste disposal programs and community facilities program; the Department of Energy’s state energy program; the Department of Housing and Urban Development’s community development block grants recovery and public housing capital fund; and the Environmental Protection Agency’s clean water and drinking water state revolving funds (where those funds are reallocated under the Recovery Act after February 17, 2010).
Canadian suppliers will have access to procurements undertaken with funds allocated for these programs until September 2011.

**Hope, Hype, and Reality**

In announcing the completion of negotiations, U.S. Ambassador to Canada David Jacobson stated: “We all won. That’s the nature of the trade deal. As we open up our markets, it makes sense for people on both sides of the border.”22 Canadian politicians issued similarly laudatory statements about the benefits of the CUSPA.

But just how good a deal is this for Canadian and U.S. suppliers? Stripping away the hype and hysteria, little has changed. Canadian suppliers, including Cambridge Brass, might have benefited from the Buy American waiver had it been in place in 2009. However, because so many exemptions still exist in state and local procurements, and because so much of the stimulus spending was allocated or spent before the deal came into force, the extraordinary victory claimed by Canadian politicians is clearly overblown.

While Canadian suppliers may have looked at the US$787 billion stimulus package as the pot of gold at the end of the procurement rainbow, only US$275 billion was allocated to “contracts, grants and loans” that could be used for procurement projects at the federal, state, and local level. The remaining amount, the bulk of the stimulus funding, was directed at tax benefits and entitlements, including benefits under Medicaid, unemployment, and nutritional assistance programs. None of these two latter funding components of the Recovery Act have a procurement dimension that would benefit Canadian suppliers.

One commentator has framed the negligible benefits to Canadian suppliers this way:

> Government ministers and Canadian trade officials have avoided saying just how much the tentative deal on Buy American preferences is worth to Canadian suppliers. As the details of the agreement begin to emerge, the reasons for this reticence are becoming clear.

The agreement gives Canada fleeting access to a sliver of the U.S. stimulus package. Canadian businesses will get to compete for US$4-5 billion worth of projects. This amounts to less than 2% of the US$275 billion of procurement funded under the Recovery Act. The rest falls outside of the agreement.26

That view may be unduly pessimistic, but it reflects the doubts some have about the value of this procurement agreement. That said, it is unlikely, at least from a Canadian perspective, that CUSPA will provide suppliers with the opportunities touted by our government and senior trade officials. While it does present some valuable opportunities for those in Canada’s steel and iron sector, even those gains are, and will be, modest with so much of the stimulus spending having already been allocated and so many exceptions and carve-outs still in place.

The real winner from this deal is Canada’s federal government. It can rightly boast that when the Buy American concerns were communicated, it acted.

U.S. politicians can also claim they opened up the holy grail of government spending in Canada by negotiating access to this country’s subfederal spending. That much is true, but because so few procurements at the provincial/territorial and municipal levels have historically been off-limits, gains for U.S. suppliers from the signing of the CUSPA are similarly expected to be modest.

Perhaps the greatest hope from the CUSPA comes from the commitment by both parties to work towards a comprehensive continental procurement agreement in 2010. If both Canadian and American officials approach those negotiations with courage, taking into account the degree of integration of our economies, those negotiations could reduce the dizzying array of barriers that continue to prevent the North American supply chain from working as seamlessly as it should.

Protectionism in government procurement is both shortsighted and cancerous. It leads to higher costs to taxpayers on both sides of the border. It prevents true competition, the foundation upon which both our economies rest. It also prevents the best thinkers and producers in our countries from being able to freely sell their products and ideas. We all lose when governments erect barriers that are fuelled by narrow and short-sighted political considerations.

The CUSPA negotiations forced both governments to confront this buying prejudice, and the collective hope is that the hard work that led to this agreement will be the beginning of the end to barriers that serve neither country well. 

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**Endnotes**


5. World Trade Organization, GPA/IC/M/5, December 6, 1995, “Interim Committee on Government Procurement, Minutes of the meeting held on 25 October 1995.”


8. The Government of Canada chose to tie its new commitments to the 2007 Revised WTO-AGP, rather than the original WTO-AGP, even though the Revised WTO-AGP is not officially in force. The changes between the two versions are primarily organizational in nature, although the revised version does include new provisions dealing with, for example, electronic tendering.

9. Canada’s newest territory—Nunavut—is not included.


11. Jurisdictional authority over territorial matters is vested pursuant to statutes, such as the Yukon Act, 2002, Ch. 7, rather than through Canada’s constitutional separation of powers referred to earlier.


13. Canada had excluded from its WTO-AGP commitments a number of construction projects, generally infrastructure in nature.
RECOVERING IR&D COSTS

(continued from page 1)

the COFC’s decision, should end much of the uncertainty regarding the proper interpretation of the regulatory phrase “required in the performance of a contract.” Further, the Federal Circuit’s decision confirms that “parallel” IR&D and the use of “branch technology” are appropriate, so long as contracts are properly negotiated and drafted.

The Federal Circuit’s decision also provides added confidence to contractors that their adherence to the terms of their Cost Accounting Standard (CAS) Disclosure Statements will guide whether R&D costs are properly classified as indirect costs under CAS 420 and are allowable under Federal Acquisition Regulation (FAR) 31.205-18. Indeed, the Federal Circuit affirmed that contractors, within the broad parameters established by the CAS, are free to adopt cost accounting practices that make sense for their businesses and that, once established and not otherwise noncompliant, bind the contractor and the government.

Finally, the Federal Circuit’s decision provides guidance on proper contractor accounting for bid and proposal (B&P) costs, costs that are similar to IR&D costs and governed by the same regulatory framework. The decision also ensures consistency between cost accounting and data rights regulations.

Regulatory Framework for Recovery of IR&D and Other Indirect Costs

Understanding the Federal Circuit’s ATK decision begins with understanding the regulatory framework under which contractors seek recovery of IR&D costs and other indirect costs. Two regulations address when R&D costs are indirect IR&D costs and when these costs are direct costs of a contract. Both regulations require that R&D costs be treated as IR&D costs unless the R&D effort is “required in the performance of a contract.”

CAS 420, which governs the allocation of IR&D and B&P costs, states that IR&D does not include the costs of effort sponsored by a grant or required in the performance of a contract (emphasis added). CAS 420, therefore, requires that R&D costs that have a broad benefit be classified as “independent” indirect costs allocated to multiple contracts. By contrast, when R&D costs are “required in the performance of a contract,” they must be treated as direct costs because only one contract is benefited.

Where CAS 420 governs the allocation of IR&D and B&P costs, FAR 31.205-18 governs the allowability of these costs. Like CAS 420, FAR 31.205-18 defines IR&D costs as costs resulting from R&D effort that is not “required in the performance of a contract.” This FAR section further provides that R&D costs accounted for under CAS 420 as IR&D costs are allowable R&D costs.

Important to the Federal Circuit’s decision in ATK is that both CAS 420 and FAR 31.205-18 address the accounting for and allowability of B&P costs, for relevant purposes, in an identical manner to IR&D costs. As with IR&D costs, both the CAS and the FAR provisions use the same limiting phrase, “required in the performance of a contract,” to define costs that do not qualify as B&P costs. Indeed, as discussed below, the Federal Circuit’s decision turned in large part on the fact that IR&D and B&P costs are defined by the same regulatory language.

Notably, the phrase “required in the performance of a contract” has remained unchanged in relevant government contract procurement regulations since 1971. Since its inception, however, it has been the subject of significant debate between the government and contractors. Beginning in the 1990s, and prior to ATK, there had been a number of federal court decisions, including Newport News, that reinforced the government’s view that “required in the performance of a contract” should be interpreted broadly to mean any development necessary to or implicitly required by a contract.

Based on these cases, government auditors had become increasingly aggressive in attempting to prevent the government from paying for what the government viewed as “commercial development” by asserting that such development was “required in the performance” of contractors’ commercial contracts and, therefore, not IR&D. This resulted in increased questioning of contractors’ IR&D costs and created increased uncertainty and risk of fraud allegations for contractors. As discussed below, the Federal Circuit’s decision in ATK, combined with the COFC’s decision, provides contractors with the basis to defeat such government arguments.

In addition to CAS 420 and FAR 31.205-18, CAS 402 also governs contractor recovery of IR&D costs. Further, CAS 402 Interpretation No. 1 addresses when the costs of B&P efforts may be treated as indirect B&P costs. Although Interpretation No. 1 does not address IR&D costs, it is relevant given the near identical accounting for IR&D and B&P.
CAS 402 requires consistency in contractor classification of costs as direct or indirect. Specifically, CAS 402 requires that “[a]ll costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives.”" The rule defines a “direct cost” as “any cost which is identified specifically with a particular final cost objective.” Further, CAS 402 defines an “indirect cost” as “any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives . . . .”

CAS 402 Interpretation No. 1, which the CAS Board issued in 1976, before issuing CAS 420, stated that costs of B&P efforts must be treated as indirect costs when there is no “specific requirement” for the effort in a contract. Importantly, when issuing Interpretation No. 1, the CAS Board chose the “specific requirement” standard over broader language “such as ‘related to,’ ‘arising from,’ ‘identified with’ or ‘directly associated with.’” Indeed, the terms the CAS Board rejected are nearly identical to the “necessary” or “implicitly required” standard adopted in Newport News and argued by the government in ATK.

After issuing CAS 402 Interpretation No. 1, the CAS Board issued CAS 420, effective in 1980, which defined both IR&D and B&P costs as costs not “required in the performance of a contract.” When it issued CAS 420, the CAS Board did not withdraw Interpretation No. 1, or provide, or even imply, that CAS 402 Interpretation No. 1 and CAS 420 were inconsistent. The CAS Board’s retention of CAS 402 Interpretation No. 1, despite defining B&P and IR&D costs in CAS 420, manifests the board’s intent that “required in the performance of a contract” means that no “specific requirement” for the R&D or B&P effort existed in a contract.

Moreover, courts consistently have applied the “specific requirement” standard from CAS 402 Interpretation No. 1 to determine when B&P costs properly are charged direct to a contract. For example, in Boeing Co. v. United States, the Federal Circuit applied Interpretation No. 1 to determine proper accounting for B&P costs. The issue before the court was whether a differing circumstance existed that warranted charging certain related B&P costs direct and some indirect. To determine the proper accounting, the court relied on CAS 402 Interpretation No. 1 and its guidance that a “specific requirement in an existing contract” is the differing circumstance that triggers charging B&P costs direct to a contract.

The ATK Thiokol Dispute
The dispute in ATK resulted from efforts in the 1990s by ATK’s predecessor, Thiokol Corporation (hereinafter, ATK), to upgrade a variant of its Castor IV rocket motor to help increase sales to both commercial and government customers. ATK management had decided to develop the upgraded motor after the marketplace had shown genuine interest in the upgraded motor. ATK marketed the upgraded Castor IV motor to various potential customers, including McDonnell Douglas, Lockheed Martin, and the United States Air Force.

In February 1996, Mitsubishi Heavy Industries expressed serious interest in purchasing the upgraded motor. Mitsubishi refused from the beginning, however, to pay for the development effort required to upgrade the motor, although it agreed to pay for development necessary to modify the upgraded motor for attachment to the Japanese launch vehicle. Accordingly, the contract between ATK and Mitsubishi for an upgraded Castor IV motor stated, as a precondition, that ATK would provide a ready-to-launch upgraded motor. The Mitsubishi contract also did not include a price or statement of work (SOW) for the effort needed to upgrade the motor. Further, ATK had documentation that the price it negotiated with Mitsubishi excluded any effort to upgrade the motor.

In July 1997, when ATK began the upgrade development effort, the company’s management determined that it was reasonably possible that the upgraded Castor IV motor would be sold under multiple government and commercial contracts, not just under the Mitsubishi contract. Based on this determination, management approved spending company R&D funds to perform the effort needed to upgrade the motor. Management also determined that the upgrade costs would be accounted for as IR&D costs. This decision was consistent with ATK’s disclosed cost accounting practices for R&D, as well as its past practice in accounting for R&D costs relating to certain government programs. Under disclosed and consistently followed cost accounting practices, ATK treated R&D costs as IR&D costs unless:

(1) the particular contract in question specifically required that ATK incur the cost; (2) the contract paid for the cost; or (3) the cost had no reasonably foreseeable benefit to more than one cost objective.

Shortly after making this accounting decision, ATK proposed an advance agreement to its divisional administrative contracting officer (DACO) to establish the costs as properly allocable and allowable IR&D costs. Despite the fact that ATK had classified the costs in a manner consistent with its disclosed and approved accounting practices, the DACO disallowed the costs on the basis that they were “required in the performance of” the Mitsubishi contract and, therefore, had to be charged direct to that contract.

COFC Decision: The Castor IV Motor Upgrade Was Properly Classified as IR&D
On appeal from a contracting officer’s final decision denying ATK recovery of the Castor IV upgrade costs as IR&D, the COFC found that ATK properly had allocated the upgrade costs because the upgrade effort was not “required in the performance of” the Mitsubishi contract. Specifically, the court found, following a detailed discussion of the relevant regulatory history applicable to IR&D costs, that determining whether R&D effort is “required in the performance of a contract” is a function of the contractor’s cost accounting practices and CAS 420, CAS 402, and CAS 402 Interpretation No. 1, all of which the court said focused on what the
contract required. Thus, the proper cost classification of ATK's R&D costs was a matter of contract interpretation.

The COFC then determined that the Castor IV upgrade effort was not "required in the performance of" the Mitsubishi contract. The court found that ATK and Mitsubishi did not intend the upgrade effort to be "required in the performance of" the contract. Further, the contract's terms neither required the effort nor included a price for the effort. Rather, the contract's terms reflected the parties' belief that a market existed for the upgraded Castor IV motor and, accordingly, that there would be multiple purchasers of the upgraded motor.

**Government's Appeal: The COFC Misinterpreted "required in the performance of a contract"**

On appeal, the government argued that the COFC's legal analysis was incorrect. Specifically, the government contended that the lower court misinterpreted relevant regulations because "required in the performance of a contract," based on its plain language, precludes all R&D costs, whether specifically or implicitly required by a contract, from being classified as IR&D.

The government thus argued, based on Newport News, that the Castor IV upgrade effort was "required in the performance of" the Mitsubishi contract because ATK could not meet the contract requirement to provide Mitsubishi an upgraded motor without first performing the upgrade effort. According to the government, because the upgrade effort was necessary to ATK's ability to perform the Mitsubishi contract, the effort was "required in the performance of" the contract. The government also argued that the COFC's decision should be reversed on policy grounds because the decision enabled contractors to "game the system" by improperly shifting commercial contract costs to the government.

In opposition, ATK argued that the COFC's decision achieved harmony between the regulatory definitions of IR&D and B&P costs and that because both IR&D and B&P costs are defined using the same limiting phrase, "required in the performance of a contract," the definitions of these costs should be interpreted consistently. According to ATK, therefore, the COFC properly extended the definition of B&P costs contained in CAS 402 Interpretation No. 1—the "specific requirement" standard—to IR&D costs.

ATK also argued that the COFC's decision was consistent with the Federal Circuit's holding in Boeing, where the court relied on CAS 402 Interpretation No. 1's "specific requirement" standard to determine whether B&P costs should be charged direct or indirect. Thus, based on the fact that IR&D and B&P costs are defined using the same limiting phrase, ATK argued that Boeing and CAS 402 Interpretation No. 1 should control the interpretation of IR&D costs as well.

ATK further argued that the government's reliance on Newport News was wrong and that the court in Newport News ignored the fact that IR&D and B&P costs are subject to the same regulatory framework as well as the Federal Circuit's precedent in Boeing. ATK contended, therefore, that the COFC had properly rejected the Newport News standard.

Next, responding to the government's policy arguments, ATK contended that CAS 402 and the requirement that contractors comply with established cost accounting practices precluded contractors from "gaming the system." ATK pointed out specifically that the requirement that contractors follow established accounting practices disclosed to, and approved by, the government in CAS Disclosure Statements would prevent any such manipulation.

Finally, ATK argued that the government's interpretation created a countervailing and adverse impact on IR&D, known as the "first in line" problem: If the government's interpretation of "required in the performance of a contract" as including any effort "implicitly" required were to be adopted, the first purchaser of any product, whether a government or commercial customer, would have to pay all R&D costs associated with that product or the contractor would have to recognize its R&D costs as a loss for any unsuccessful R&D effort.

Accordingly, ATK argued, the government's interpretation would actually harm the government's interest whenever the government itself was the first purchaser of a product that benefited from significant contractor R&D effort. In this circumstance, the government's broad interpretation of the IR&D exclusion would result in significant R&D costs being considered a direct cost of a government program. Accordingly, the government no longer would benefit from contractors' ability to spread R&D costs for government products that had potential commercial application across both government and commercial work, as the government had done previously under agreement with ATK.

**Federal Circuit Affirms COFC: The Castor IV Motor Upgrade Was Properly Classified as IR&D**

The Federal Circuit affirmed the COFC's decision and in doing so also provided much needed guidance by establishing that R&D effort is "required in the performance of a contract," and therefore not properly accounted for as IR&D, only when the effort is "specifically required by the terms of an existing contract." To reach this conclusion, the Federal Circuit applied settled principles of regulatory construction.

First, the Federal Circuit considered whether the phrase "required in the performance of a contract" has a clear meaning based on the plain language of CAS 420 and FAR 31.205-18. The court concluded that the regulation is "ambiguous," without a clear meaning. In so doing, the court rejected the government's plain language argument based on Newport News that "required in the performance of a contract" means effort both specifically and implicitly required by a contract. By rejecting the government's argument, the court rejected the legal analysis that forms the basis for the Newport News decision.

Second, the Federal Circuit considered the relevant regulatory history to determine whether it aided in interpreting the phrase "required in the performance of a contract." While the
court credited the COFC’s “thorough and well-documented review of the regulatory history,” it concluded that “[t]he plain text . . . the regulatory history is inconclusive.”

Unable to rely on the plain language or the regulatory history, the Federal Circuit then turned to other relevant regulations, specifically CAS 402 Interpretation No. 1 and the settled interpretation of B&P costs. The court held that while Interpretation No. 1 does not address IR&D costs, IR&D costs cannot be interpreted differently from B&P costs because such an outcome would “result in a construction in which identical regulatory language . . . would be interpreted differently for IR&D than for B&P.” Thus, the Federal Circuit concluded that CAS 402 Interpretation No. 1 and the court’s own decision in Boeing governed the proper interpretation of the IR&D costs definition.

Relevant to the Federal Circuit’s decision, CAS 402 Interpretation No. 1 provides:

[C]osts incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirements. The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.

Based on this language, the Federal Circuit explained that the “effect of Interpretation No. 1 is to equate the B&P [and IR&D] definitional exclusion of proposal costs that are ‘required in the performance of a contract’ with the category of costs that are ‘specifically required by the provisions of a contract.’” The court concluded, then, that the phrase “required in the performance of a contract” means that costs resulting from efforts specifically required by a contract do not qualify as B&P or IR&D costs.

The Federal Circuit also rejected the government’s policy argument. The court found that there was no risk that government contractors, as suggested in the government’s brief, would “game the system” to charge the government for costs that do not properly qualify as IR&D. In addition to rejecting the government’s argument, the court identified as a chief concern the potential detrimental impact to the government from the “first in line” problem:

[The government’s approach] would either disproportionately burden the contract that happened to be first in line or ensure that the first contract would be a losing one. For research that, by hypothesis, benefits multiple potential contracts, both commercial and government, allocating general research and development costs in that manner is not sensible as a policy matter.

Moreover, the court recognized that IR&D benefits both the government and contractors:

Spreading IR&D costs across multiple contracts encourages general research that enables the contractor to innovate, to maintain a high level of technological sophistication, and ultimately to improve the products it offers the government.

Accordingly, the Federal Circuit concluded that public policy supports categorizing R&D effort that benefits multiple contracts as IR&D, the costs of which are recoverable under government contracts.

Impact of the Federal Circuit’s Decision

ATK provides much needed guidance regarding IR&D costs. Most importantly, the decision clarifies when R&D effort is not independent, requiring that resulting costs be classified as direct contract costs. The decision also establishes consistent treatment of B&P and IR&D costs, and provides “best practices” for government contract cost accounting. Finally, the decision ensures proper consistency between cost accounting and technical data rights regulations.

The court’s decision clarifies that R&D effort is “required in the performance of a contract,” thus precluding resulting costs from being IR&D costs, only when the effort is “specifically required by the terms of an existing contract.” Thus, absent a specific contract requirement, contractors confidently can classify R&D costs as IR&D and charge such costs indirect.

Further, based on the Federal Circuit’s decision in ATK, contractors now can confidently define IR&D in their CAS Disclosure Statement as R&D effort that is not “specifically required by a contract.” Indeed, the facts of ATK provide added clarity in implementing this concept in a Disclosure Statement. Based on ATK’s accounting practices, it would be appropriate for other contractors to define “specifically required by a contract” to mean that: (1) the effort is not specifically required by the contract’s SOW or other term or specifically included in the contract’s price or cost build-up in support of the price; and (2) there is a reasonable expectation at the time the R&D effort begins that the effort will benefit more than one contract. This last point regarding benefit to more than one contract means exactly that, and not benefit to more than one “program” or more than one “buyer.”

Consistent with this clarification from the Federal Circuit, contractors should consider whether their disclosed cost accounting practices are compliant with the requirements of CAS 420 and CAS 402. Specifically, contractors should consider whether R&D costs incurred in like circumstances for the same purpose are consistently classified as either direct or indirect costs. Further, in determining whether R&D costs qualify as IR&D costs, contractors should consider the circumstances and purpose of the R&D effort and how those circumstances are addressed in their CAS Disclosure Statements.

Contractors should also take heed that the facts and circumstances relating to a contract will continue to be relevant, and carefully consider the facts relating to any contract that might arguably specifically require R&D effort to ensure that the determination made regarding clas-
classification of the related costs as IR&D costs is appropriate and consistent with disclosed cost accounting practices. Facts relevant to this inquiry may include: (1) the parties’ intent, as shown by proposals, negotiation documentation, and internal documentation regarding contract negotiation; (2) the wording of the contract; (3) the contract’s cost estimates and actual costs; and (4) work delineations (i.e., drawings, outlines, and portrayals). Finally, facts supporting the existence of a reasonable expectation of multiple contracts for the product (multiple sales) remain important, and there should be documents created contemporaneous to the decision to perform the R&D effort that support the basis for a multiple benefit.

In addition to the above, the Federal Circuit’s decision confirms that “parallel” or “generic” IR&D remains appropriate. That is, the decision permits contractors to engage in R&D effort to support ongoing contract work and to classify the resulting costs as IR&D costs so long as the support just described exists. The Federal Circuit’s decision also means that contractors may use ongoing IR&D effort to support a contract that is to be performed in the future. For example, contractors can perform R&D to generate “branch technologies” that will be used to perform a contract being negotiated or that are likely to support other future contracts. Thus, these types of R&D efforts result in IR&D costs so long as contractors appropriately negotiate and draft contracts and the costs are properly considered IR&D costs under disclosed cost accounting practices that are followed consistently.

Next, the Federal Circuit’s decision emphasizes consistent treatment of IR&D and B&P costs. For accounting purposes, B&P costs are subject to the same rules as IR&D costs. Indeed, the Federal Circuit’s decision is based on its recognition that CAS 402 Interpretation No. 1 and other interpretations of B&P costs govern both IR&D and B&P costs. The court’s decision regarding how to determine when R&D effort is “required in the performance of a contract,” therefore, applies equally to determining when the costs of B&P efforts may be properly treated as indirect B&P costs. Contractors should therefore consider whether their cost accounting practices apply the same standard to determine both IR&D and B&P costs, as different standards might result in disapproved costs and accounting practices.

The Federal Circuit’s decision in ATK also establishes certain “best practices” for cost accounting. The court held that contractors have “considerable freedom” in selecting their disclosed accounting practices, and further recognized that contractors’ primary means for establishing these practices is through their CAS Disclosure Statements.

This aspect of the decision is very important. The court’s reaffirmation that contractors have broad discretion to select proper cost accounting practices provides contractors a strong basis to dispute government contentions that a contractor’s accounting practice is “not acceptable” or not the best practice and needs to be changed even when the practice is CAS compliant. Lately the Defense Contract Audit Agency (DCAA) is increasingly raising such contentions regarding contractor accounting practices. As a counterbalance to this trend, the Federal Circuit’s decision in ATK establishes that disclosed and approved accounting practices are acceptable and binding on contractors and the government alike, absent noncompliance with an enumerated CAS requirement.

Thus, contractors should demand government compensation for any change in practice, absent an established CAS noncompliance. Further, when the government coerces a change by, for example, disapproving of a contractor’s accounting system because an accounting practice creates a deficiency, contractors should acquiesce only after reserving their rights to be compensated for a contract change or breach of contract.

Although the Federal Circuit in ATK did not directly address technical data rights, an important impact of the court’s decision is that it ensures continued consistency between cost accounting and data rights regulations. This consistency provides additional legal support for the court’s determination that R&D is not “required in the performance of a contract” under CAS 420 and FAR § 31.205-18 merely because the effort is “necessary” or “implicitly required” for contract performance.

Specifically, technical data rights regulations permit contractors to classify R&D effort necessary to or impliedly required by a contract as IR&D so long as no contract specifically requires the effort. In fact, in 1995, Department of Defense (DoD) regulators addressing the data rights regulations specifically rejected government arguments that “necessary” effort (an effort performed during contract performance that “relates” to a contract) is “required” effort that results in direct costs and government data rights.

For background, prior to 1985, the DoD’s technical data rights provisions stated that a contractor owned the rights to technical data if the data were “developed exclusively at private expense.” Private expense meant, and still includes, indirect costs including IR&D. For example, in Bell Helicopter Textron, the Armed Services Board of Contract Appeals (ASBCA) held that technical data generated from R&D efforts not specified as an element of contract performance specifically requires the effort. In fact, in 1995, Department of Defense (DoD) regulators addressing the data rights regulations specifically rejected government arguments that “necessary” effort (an effort performed during contract performance that “relates” to a contract) is “required” effort that results in direct costs and government data rights.

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The COFC in its ATK decision similarly recognized the discretion that the government and contractors have to include R&D effort as a specific contract requirement.
The Bell Helicopter decision (and several congressional mandates requiring that the DoD clarify its regulatory coverage regarding technical data rights) resulted in DoD's issuing the 1988 Technical Data Regulations, which provided:

Developed exclusively at private expense means, in connection with an item, component or process, that no part of the cost of development was paid for by the Government and that the development was not required for the performance of a Government contract or subcontract. Independent research and development and bid and proposal costs, as defined in FAR § 31.205-18 (whether or not included in a formal [IR&D] program) are considered to be at private expense. All other indirect costs of development are considered Government funded when development was required for the performance of a Government contract or subcontract. Indirect costs are considered funded at private expense when development was not required for the performance of a government contract or subcontract.\(^24\)

Further, in these regulations, the term “required for the performance of a Government contract or subcontract” was defined to mean that

the development was specified in a Government contract or subcontract or that the development was accomplished during and was necessary for the performance of a government contract or subcontract.\(^25\)

A groundswell of dissatisfaction with the 1988 Technical Data Regulations prompted a congressional directive to review data rights issues using a “Joint Committee” of government and contractor representatives. The Joint Committee focused on, among other things, whether the 1988 Technical Data Regulations were being used to acquire rights in technical data for the government because data were developed “during and was [sic] necessary for performance” even though the data, in fact, had been developed at private expense (as defined in the regulations to include IR&D).

The Joint Committee ultimately concluded that the government did not need to use the “during and was necessary for” concept. Rather, compliance with the CAS and FAR definitions of direct and indirect costs assured that the government and contractors received appropriate rights in technical data. The Joint Committee’s recommendation to the DoD regulators explained:

Developers’ representatives identified the “required for performance” criterion as one of the more onerous aspects of the existing regulations. They suggested that the criterion was inconsistent with statutory requirements by permitting the government to claim unlimited rights in data pertaining to an item or process developed at private expense when development was accomplished concurrent with performance of a government contract and not expressly called for by the contract.\(^26\)

Thus, the Joint Committee was satisfied that the appropriate mechanisms for distinguishing “direct” government-funded contract R&D effort from “indirect” IR&D are CAS and FAR provisions, contractors’ disclosed cost accounting practices, and contractors’ obligations to consistently apply these practices.

Responding to the Joint Committee’s recommendation, the DoD in its final rule issued June 28, 1995, eliminated the 1988 Technical Data Regulations’ “during” and “necessary” criteria and the definition in those regulations of “required for the performance of a Government contract or subcontract.”\(^27\) The DoD explained this change, stating:

DOD believes [the “required for performance”] criterion should be eliminated to protect private expense development, encourage developers of new technologies or products, many of whom are small businesses, to offer their products to the Government, encourage dual use development, and balance the interests of data users and data developers.\(^28\)

When adopting the final rule, therefore, the DoD clarified that, under technical data regulations, a government contract does not specifically require R&D effort when that effort is only “necessary” to contract performance. This conclusion bears a striking resemblance to the Federal Circuit’s statement regarding the fundamental policy underlying IR&D effort. In short, the Federal Circuit’s holding in ATK is fortunate. If the court had adopted the “necessary” or “implicitly required” standard followed in Newport News and similar cases, the current data rights regime would have been turned upside down.

**Implementing Guidance**

The Federal Circuit’s ATK decision provides much needed guidance to contractors seeking recovery of IR&D costs. To implement this guidance, contractors should consider:

- Examining their cost accounting practices, CAS Disclosure Statements, and related policies and procedures to ensure that IR&D cost allowability is maximized;
- Ensuring that their contract pricing and negotiation policies and procedures, as well as standard terms and conditions and SOWs, for both government and commercial contracts, establish a clear statement of intent in the contract language regarding what R&D effort is specifically required by a particular contract;
- Drafting IR&D project descriptions to demonstrate that the project will benefit multiple contracts; and
- Preparing IR&D project delineations to show no specific contract requirement.

The Federal Circuit’s ATK decision will help contractors maximize recovery of IR&D costs. The decision provides contractors a basis to defeat DCAA challenges, based on Newport News and similar cases, to contractor recovery of these costs. The decision should also resolve the long existing debate regarding the proper meaning of “required in the performance of a contract” under CAS 420 and FAR 31.205-18. Finally, the decision provides practical guidance to contractors seeking recovery of IR&D costs.
Endnotes
1. 598 F.3d 1329 (Fed. Cir. 2010).
5. 48 C.F.R. § 9904.402-30(a)(3).
6. 48 C.F.R. § 9904.402-30(a)(5).
8. 862 F.2d 290 (Fed. Cir. 1988).
9. Before both the COFC and the Federal Circuit, the government argued that the negotiations between ATK and Mitsubishi were improperly designed to shift the upgrade costs to the government. Both courts found nothing objectionable in the parties’ agreement to exclude the Castor IV upgrade costs from the Mitsubishi contract or ATK’s decision to charge the costs as IR&D costs.
10. ATK, 598 F.3d at 1331.
11. The government also cited Mayman, 894 F. Supp. at 221-23, to support its argument that the Castor IV upgrade effort was “required in the performance of” the Mitsubishi contract because ATK could not meet the contract’s requirement to provide Mitsubishi an upgraded motor without first performing the upgrade effort.
12. ATK, 598 F.3d at 1333.
13. Id. at 1333-34.
14. Id. at 1334-35 (explaining that “we agree with the trial court and ATK that the meaning of the limiting phrase in the definition of IR&D must be the same as the meaning of that phrase in the definition of [B&P] costs.”).
15. 48 C.F.R. § 9904.402-61(c) (emphasis added).
16. ATK, 598 F.3d at 1335.
17. Id.
18. Id. at 1335-36.
19. Id. at 1335.
20. Id. at 1332.
23. Id.
26. Tab 33, at 00616-17 (Memorandum for the Secretary of Defense, re: Recommended Technical Data Regulations (March 24, 1994)).
27. DFARS 252.227-7013(a)(7).

SIZE DETERMINATION APPEALS
(continued from page 15)

Endnotes
2. The author represented Social Impact in all three appeals before OHA.
3. There is one other OHA decision addressing “conference and management services,” which was issued before “conference management service providers” were added to the regulation in 1996. See Size Appeal of Courtesy Associates, Inc., SBA No. SIZ-2941, 1988 WL 219851 (Aug. 23, 1988). See also discussion infra and note 34.
4. 13 C.F.R. § 121.104(a).
9. Id.
12. First Size Appeal at 3 (emphasis in original).
15. Id.
21. See Second Size Appeal at 6. See also, e.g., Reiner, Reiner & Bennett, 2003 WL 22815888, at *3; Size Appeal of Recycling Res., LLC, SBA No. SIZ-4324, 1998 WL 644767, at *4 (Sept. 4, 1998); Size Appeal of Aliron Int’l, Inc., SBA No. SIZ-4317, 1998 WL 531866, at *3 (Aug. 3, 1998). See also 13 C.F.R. § 121.104(a) (“For size determination purposes, the only exclusions from receipts are those specifically provided for in this paragraph. All other items, such as subcontractor costs, reimbursements for purchases a contractor makes at a customer’s request, and employee-based costs such as payroll taxes, may not be excluded from receipts.”).
22. See, e.g., Size Appeal of Communicar, Inc., SBA No. SIZ-4551, 2003 WL 23205062, at *4 (“Pass-through receipts may not be excluded from a concern’s size unless its primary industry is one for which the SBA’s size regulations authorize such exclusion.”); Recycling Res., 1998 WL 644767, at *4 (“The . . . regulation does not include Appellant’s industry or its [NAICS] code.”). Interestingly, if OHA had applied the exclusion in this way, QED would arguably not have met this first criterion. According to QED’s profile on SBA’s Dynamic Small Business Search database, QED’s primary NAICS code is 541611, Administrative Management and General Management Consulting Services, not 561920, Convention and Trade Show Organizers. See generally http://dsbs.sba.gov, and QED profile on file with author.
23. See, e.g., Aliron Int’l, 1998 WL 531866, at *3 (“Neither the items Appellant claims for exclusion nor the specific industry to which Appellant belongs, falls within the exclusion.”).
24. See, e.g., Third Size Appeal at 4 (“Although in its second size determination the Area Office properly asked QED to define the business activities included in the revenues it seeks to exclude, QED’s explanations for the exclusions were overly broad. Therefore . . . I again remanded the case to the Area Office for a determination of exactly what amount of QED’s total conference management revenues are amounts collected as an agent for another.”). See also Third Size Appeal at 9 (“[The excerpted [SOW] pages indicate that QED did provide conference management services under the . . . contracts. However, these documents do not indicate how QED acted as an agent . . . in performing or paying for those services.”).
Eldon H. “Took” Crowell, the founding partner of the law firm of Crowell & Moring and a leader in Washington, D.C., public interest activities, died at home in Washington on May 23, 2010, at the age of 86. He was born in Middletown, Connecticut. After service in the Army Air Corps in World War II, he graduated from Princeton University and received his law degree from the University of Virginia.

Took was a visiting lecturer at the law schools of the University of Virginia and George Washington University. He was an active member of the Section of Public Contract Law of the ABA from 1966 to 1993, and served on the Section’s Council from 1973 to 1976. His other ABA activities included an active membership in the Section of Administrative Law, and a fellowship on the American Bar Foundation. He was also a public member of the Administrative Conference of the United States, as well as a fellow of the National Contract Management Association, from which he received its 1992 Roback Award for outstanding service. Although he actively litigated against the government, Took was a staunch proponent of alternative dispute resolution—ADR—and as a member of the Administrative Conference, he advocated the passage of legislation authorizing and promoting the use of such informal processes by the government.

Took Crowell was a leading practitioner of public contract law. His legal career started in 1951 at Cummings & Stanley in Washington. He was a partner in the successor firms of Cummings & Sellers and Sellers, Conner & Cuneo, where he specialized in international and government contract law. In 1970, he joined Reavis Pogue Neal & Rose, a Washington affiliate of Cleveland’s Jones Day, and started a government contracts practice there. Within a few years, the group became one of the foremost public contracts practices in the country, representing many of the major government contractors of the era.

In 1979, Took, with more than 50 lawyers from Jones Day’s Washington office, founded Crowell & Moring, where he served as the firm’s chairman in its formative years. The Washington Post famously reported on the breaking up of Jones Day and the formation of Crowell & Moring as “The Split.” He served on numerous boards: the City Lights School, 1994-2000, including three years as its president; Equal Justice Works, 1994-2001, president from 1995 to 2000; the Conservation Research Foundation, 1999-2002; the Judiciary Leadership Council, 1989-1993; and the Constitutional Accountability Center since 2005. He also served on the boards of the Madeira School, the Williston-Northampton School, the Greenenergy Investments Foundation, the Foreign Student Service Council, and the Experiment in International Living.

In 1997, Took established a small, private charitable foundation, The Took Trust, that assists troubled, hurt, and at-risk youth. He was awarded the “Servant of Justice Award” from the Legal Aid Society in 1999, and the “Scales of Justice Award” from Equal Justice Works in 2000. In 2008, Legal Times named him as one of 30 “visionaries” in its list of “Greatest Washington Lawyers of the Last 30 Years.”

Took Crowell was a resident of the Washington, D.C., area from 1951 to 2009, when he moved to Ft. Lauderdale, Florida. He maintained residences in Washington and Flint Hill, Virginia. His former wife, Mimi Crowell, died in September 2006. He is survived by his niece, Carolyn (Lynne) Fouch, and nephew, Richard Pauli, both of Washington State. He will be greatly missed by his family and friends, and his associates throughout the public contract law community and within the Section.

— Contributed by Stan Johnson and John Burkholder
25. Further, the more specific the firm can be when making this assertion the better. See, e.g., Second Size Appeal at 5 (noting Social Impact’s argument that QED failed to identify for the Area Office which portions of its invoiced costs related to conference management services).


27. See, e.g., 60 Fed. Reg. at 57,985 (noting characteristics under which it might be appropriate to exclude from a concern’s revenues certain funds received from a client firm to be transmitted to an unaffiliated third party, including a “broker or agent-like relationship between a firm and its third party provider”). See also 13 C.F.R. § 121.201 n.10 (noting that “funds received in trust for an unaffiliated third party, such as bookings or sales subject to commissions” are excludable).

28. See 60 Fed. Reg. at 57,985 (“As the normal business practice of firms in the industry, a firm’s income remaining after the pass-through funds are remitted to a third party is typically derived from a standard commission or fee.”).

29. Third Size Appeal at 9-10 (emphasis added). There are additional examples of OHA’s interpretation. For example, in the second size appeal, OHA stated that “The crux of the matter is whether an agency relationship exists with respect to the costs in question, i.e., they are not ordinary business expenses of the challenged business, but are costs incurred on behalf of the client.” Second Size Appeal at 7 (emphasis added). Similarly, the Area Office, in its third size determination, concluded that QED had sought to exclude “only pass-through amounts paid by QED as an agent for another,” which suggests that QED was acting as an agent by making payments on behalf of its customer, rather than holding funds in trust for an unaffiliated third party. Third Size Appeal at 5 (emphasis added).

30. 60 Fed. Reg. at 57,986 (emphasis added).


33. Courtesy Associates, 1988 WL 219851, at *8. Courtesy Associates appears to be the only decision prior to Social Impact that deals with the exclusion of amounts collected for another by a “conference and management services” provider. This case has not been specifically overruled by the 1996 addition of conference management service providers to the regulation, and, indeed, the analysis is arguably the same, i.e., whether the allegedly excludable amounts were collected by a business concern acting as an agent for another.


35. Mid-Columbia Eng’g, 1996 WL 33703, at *5.

36. Third Size Appeal at 5.


39. Indeed, these analyses are not incompatible. The critical question is whether the customer will be directly liable to third-party vendors with which the firm contracts. The government, however, will not enter into an agency relationship without giving clear contractual consent to such liability.

40. Third Size Appeal at 9-10.

41. See, e.g., Courtesy Associates, 1988 WL 219851, at *8. See also Mid-Columbia Eng’g, 1996 WL 33703, at *5.

42. Third Size Appeal at 11.

43. Indeed, Social Impact may have generated some of this confusion in its appeal, by arguing that the agency relationship contemplated by the regulation is the firm’s relationship with unaffiliated third parties, while at the same time attempting to refute QED’s claim that it had an agency relationship with its government customers.