dentons.com

DENTONS

Insights and Commentary from Dentons

The combination of Dentons US and McKenna Long & Aldridge offers our clients access to 1,100 lawyers and professionals in 21 US locations. Clients inside the US benefit from unrivaled access to markets around the world, and international clients benefit from increased strength and reach across the US.

This document was authored by representatives of McKenna Long & Aldridge prior to our combination's launch and continues to be offered to provide our clients with the information they need to do business in an increasingly complex, interconnected and competitive marketplace.

The Government Contractor®

THOMSON REUTERS

Information and Analysis on Legal Aspects of Procurement

Vol. 57, No. 12 **March 25, 2015**

Focus

¶ 83

FEATURE COMMENT: The Most Important Government Contracts Disputes Decisions Of 2014

In 2014, the U.S. Court of Appeals for the Federal Circuit, Court of Appeals for the District of Columbia Circuit and Armed Services Board of Contract Appeals issued several important decisions that may have a significant impact on the law of Government contract disputes. In particular, a few key decisions provide valuable guidance on the contours of the Contract Disputes Act statute of limitations, the effect of antecedent material breach, the duty of good faith and fair dealing, certain procedural requirements for Government claims against contractors, and the assertion of attorney-client privilege over internal investigation documents. This Feature Comment analyzes six decisions issued in 2014 by the Federal Circuit, ASBCA and D.C. Circuit, and provides insights on how they impact the law in these areas.

CDA Statute of Limitations Is Not Jurisdictional (*Sikorsky Aircraft Corp. v. U.S.*, 773 F.3d 1315 (Fed. Cir. 2014); 56 GC ¶ 403)—In a case involving a Government claim alleging a Cost Accounting Standards violation, the Federal Circuit held that the CDA's six-year statute of limitations is not jurisdictional, and, on the merits, ruled that the Government had failed to meet its burden of proving a CAS noncompliance.

Sikorsky involved a Government claim alleging that Sikorsky Aircraft Corp.'s allocation of certain costs from 1999–2005 violated CAS 418. The Government claim was asserted in a December 2008 contracting officer decision, which demanded repayment of approximately $65 million plus interest. Sikorsky appealed the final decision to the Court of Federal Claims in December 2009. At the COFC, Sikorsky raised two principal defenses: (1) that the Government's claim was time-barred by the CDA's six-year statute of limitations, codified at 41 USCA § 7103(a)(4)(A); and (2) that its overhead allocation method was CAS compliant.

Parting with precedent in the Federal Circuit, the COFC treated Sikorsky's statute of limitations argument as an affirmative defense rather than as a jurisdictional issue. In doing so, the COFC placed the burden on Sikorsky to prove that the Government's claim was time-barred, instead of requiring the Government to prove that its claim was timely and that the COFC had jurisdiction. The trial court ultimately held that Sikorsky did not meet its burden of proving that the Government had actual or constructive knowledge of its claim more than six years before the CO issued a final decision.

The COFC granted judgment for Sikorsky on the merits; however, it found that the Government had not established that Sikorsky's allocation method was improper under CAS. The Government appealed the COFC's ruling on the CAS issue to the Federal Circuit. Sikorsky filed a cross-appeal of the trial court's CDA statute of limitations rulings, which the Federal Circuit treated as an alternative ground for affirming the COFC's decision.

Before the Federal Circuit, Sikorsky argued that the COFC incorrectly treated its CDA statute of limitations argument as an affirmative defense, instead of as a jurisdictional issue, which would have placed the burden on the Government to establish that its claim was timely presented and properly before the trial court. Sikorsky argued further that, because the CDA statute of limitations is a jurisdictional issue, the Federal Circuit was required to decide it before addressing the merits of the Government's appeal on the CAS ruling. The Federal Circuit disagreed with Sikorsky on both counts.

The Federal Circuit noted that although it had previously characterized the six-year period in the

CDA as jurisdictional, the U.S. Supreme Court had effectively overruled the Federal Circuit precedent in its more recent decision in *Sebelius v. Auburn Reg'l Med. Ctr.*, 133 S. Ct. 817 (2013), in which the Court articulated a stricter test for determining when statutory time limits are jurisdictional. Under *Auburn Regional,* courts should treat a time limit as nonjurisdictional unless Congress clearly has stated it is jurisdictional.

Applying the *Auburn Regional* standard, the Federal Circuit concluded that the CDA's six-year presentment requirement is not jurisdictional. The Federal Circuit reasoned that § 7103 of the CDA "does not have any special characteristic that would warrant making an exception to the general rule that filing deadlines are not jurisdictional." In reaching that conclusion, the Federal Circuit noted that § 7103 of the CDA "does not speak in jurisdictional terms" or provide clear evidence that the provision was meant to carry jurisdictional consequences. Accordingly, the Federal Circuit held that the CDA's statute of limitations is a "claim-processing rule" and not a jurisdictional requirement, and need not be addressed before turning to the merits of a claim.

Key Lessons from Sikorsky: The primary impact of the *Sikorsky* decision is that it shifts the burden of proving the CDA statute of limitations to the moving party. In other words, since the six-year period is not jurisdictional, the proponent of the claim is no longer required to prove that it asserted its claim within six years of accrual. Rather, the party asserting that the claim is time-barred now bears the burden of establishing, in the form of an affirmative defense, that the claim accrued more than six years before the claim was asserted. Further, because a defense based on the CDA statute of limitations is now like any other affirmative defense, it need not be addressed before deciding the merits of the case.

Another important consequence of the *Sikorsky* decision is tolling or waiver of the statute of limitations. Previously, since the statute of limitations was viewed as jurisdictional, it could not be waived or extended by agreement of the parties, and it could be raised at any point in the proceedings, even sua sponte by the court or board. Going forward, parties who fail to promptly assert a statute of limitations defense may find that the defense has been waived.

Moreover, parties are free to negotiate tolling agreements without impacting jurisdiction, and in some instances, it may make sense for the parties to agree to toll the six-year period. For example, given the backlog of Defense Contract Audit Agency audits and the recent trend of Government issuance of placeholder claims to beat the statute of limitations, contractors should expect that the Government will request tolling agreements to allow itself additional time to assess potential cost disallowance claims. Contractors might be amenable to extending the six-year period in the hopes that, after further review, the Government will have whittled down the potential cost disallowances or will have decided not to assert a Government claim at all.

Claims Accrual for Statute of Limitations Requires Objective Inquiry (*Appeal of Laguna Constr. Co., Inc.*, ASBCA 58569, 14-1 BCA ¶ 35,618 (*Laguna I*))—In a case involving a Government claim for $3.8 million in allegedly unreasonable subcontract costs, the ASBCA held that the Government's claim was untimely because the events fixing liability were reasonably knowable to the Government more than six years before it asserted a claim against the contractor.

Laguna Construction Co. Inc. was awarded an indefinite-delivery, indefinite-quantity contract for worldwide environmental remediation and construction services. From 2004–2005, the Government issued 16 cost-reimbursable task orders to Laguna for performance in Iraq. Portions of the remediation and construction work were performed by subcontractors pursuant to fixed-price subcontracts awarded by Laguna. In 2005, Laguna submitted vouchers to the Government for reimbursement of payments made by Laguna to certain of its subcontractors.

The DCAA Iraq Branch Office issued an audit report in December 2005, identifying inadequacies in Laguna's subcontractor management system. The DCAA Salt Lake Valley Branch Office forwarded these findings to the administrative CO in a separate audit report on Feb. 9, 2006. The February report explained that "a significant risk is present relative to the allocability, allowability, and reasonableness of subcontract costs billed to the U.S. Government." More than five years after these audit reports, on March 17, 2011, DCAA issued a "Notice of Contract Costs Suspended and/or Disapproved," which claimed that Laguna's procurement files failed to document the reasonableness of subcontractor prices. Later, on Dec. 17, 2012, the CO issued a final decision on the $3.8 million Government claim.

Laguna appealed the decision to the ASBCA in February 2013, arguing that the Government's claim was barred by the CDA because it was filed more than six years after the claim accrued. The ASBCA agreed with Laguna. The Board first examined the legal basis of the Government's claim to determine when the alleged liability was fixed for purposes of claim accrual. The Board concluded that the claim's legal basis was Laguna's alleged failure to document the price reasonableness of the subcontract awards. Next, the Board recognized that a claim accrues when the proponent knew or should have known the basis of its claim, unless the facts were concealed or "inherently unknowable at that time." See *Raytheon Missile Sys.*, ASBCA 58011, 13-1 BCA ¶ 35,241; 55 GC ¶ 73.

The Board ultimately determined that the Government was aware of Laguna's failure to document the reasonableness of subcontract awards as early as late 2005, and that its findings to that effect were documented in its December 2005 and February 2006 audit reports. Additionally, the Board found that the Government was aware of its "injury"—i.e., the subcontractor prices awarded by Laguna and paid by the Government—as early as 2005.

Relying on this analysis, the Board held that "all events fixing the alleged liability of the claim *were reasonably knowable and should have been known by the government* no later than 9 February 2006, when the DCAA report was submitted to the [CO]." The Board did not address whether the claim accrued even earlier, i.e., from the date of the first DCAA audit report. Finding that the Government claim was untimely, the Board dismissed the case for lack of jurisdiction. (Note that *Laguna* was decided before the Federal Circuit's *Sikorsky* decision discussed above, which held that the CDA statute of limitations is not jurisdictional.)

Key Lessons from Laguna I: The ASBCA's decision in *Laguna I* adds to the growing number of statute of limitations cases involving Government claims. It is noteworthy because, among other reasons, it demonstrates that a Government claim accrues at the moment when DCAA, in the performance of an audit, obtains sufficient information regarding the events forming the basis of liability. Thus, a claim can accrue before completion of an audit and before DCAA issues a recommendation to the CO. Second, the *Laguna I* decision confirms that the "should have been known" test has a reasonableness component and turns, *objectively*, upon what facts were reasonably knowable by the claimant.

Fraud as Antecedent Material Breach (*Laguna Constr. Co.*, ASBCA 58324, 14-1 BCA ¶ 35,748; 56 GC ¶ 334 (*Laguna II*))—In a related matter involving the same contract at issue in *Laguna I*, the ASBCA ruled that a contractor's criminal acts constituted a prior material breach, which excused the Government from paying the contractor's invoices.

As discussed above, Laguna was awarded an IDIQ contract for remediation and construction services, and received multiple task orders for work in Iraq. Some of that work was performed by subcontractors. In 2008, the Government initiated an investigation into allegations that Laguna employees were receiving kickbacks from subcontractors on its Iraq projects.

Criminal charges were later filed, and the project manager and certain company officers eventually pled guilty, admitting they had received kickbacks and that kickback-inflated subcontractor billings were passed on to the Government. During the pendency of the investigation, Laguna filed a claim with the CO for approximately $2.9 million. Laguna's claim was for unpaid task order invoices that were rejected based on DCAA findings after an incurred cost audit. The ACO did not issue a decision on the claim, and Laguna appealed to the ASBCA based on a deemed denial.

At the ASBCA, Laguna's complaint alleged that the Government had breached the contract by failing to pay the invoices. After the appeal commenced, Laguna's vice president for operations pled guilty to soliciting and accepting kickbacks. The Government thereafter amended its answer to assert an affirmative defense of fraud. On cross-motions for summary judgment, the ASBCA ruled that even if Laguna could show that the Government breached the contract by failing to pay the invoices, Laguna could not recover because of its prior, material breach.

As the ASBCA noted, when a party to a contract is sued for breach, it may defend on the ground that there existed, at the time of the breach, a legal excuse for nonperformance. The ASBCA found that Laguna had committed a prior breach of contract by breaching its duty to perform in good faith and fair dealing. The Board explained that "an essential element of this covenant is the duty of each party to perform with integrity. A breach of such a duty is not only a breach of contract but a betrayal of trust, and vitiates the reasonable and justifiable expectation of the parties in the performance of the contract." *Laguna*, 14-1 BCA at 174,950.

The Board ruled that even though the Government had not proven that kickbacks were paid under every task order, the breaches were material, since any degree of fraud is material as a matter of law. Accordingly, the ASBCA ruled that Laguna's prior material breach excused the Government from subsequently paying Laguna's invoices.

Key Lessons from Laguna II: The *Laguna II* decision demonstrates that the implied obligation of good faith and fair dealing applies to both contractors and the Government. Under the Board's rationale in *Laguna II*, contractors can be barred from recovering on legitimate breach claims for nonpayment if the Government asserts (and proves) that the contractor violated its duty of good faith by committing fraud during the performance of the contract, thereby committing "first breach." Going forward, contractors should anticipate that the Government may assert antecedent breach as the basis for denial of breach claims, and that such breach can be based on conduct that violates the implied duty of good faith and fair dealing.

Breach of the Duty of Good Faith Does Not Require Proof of "Specific Targeting" (*Metcalf Constr. Co. v. U.S.*, 742 F.3d 984 (Fed. Cir. 2014); 56 GC ¶ 82)—In a decision involving an alleged breach of the implied duty of good faith and fair dealing, the Federal Circuit held that a contractor need not prove it was the victim of "specific targeting" by the Government.

In 2002, the Navy awarded Metcalf Construction Co. a contract to build housing units at a Navy facility in Hawaii. Prebid documents from the Government included a report that described the soil conditions at the site. After it was awarded the contract, Metcalf hired a lab to investigate the condition of the soil, which was revealed to be different from the conditions described in the request for proposals. Metcalf notified the Navy of the results of the investigation and insisted that it be permitted to use certain alternative construction methods.

After waiting for a year for the Navy to approve its proposed approach, Metcalf moved forward with its alternative construction plan even though it was not approved in a formal contract modification. Metcalf completed the project at a cost much higher than the original contract price due to the differing soil conditions it encountered. When Metcalf sought to recover its increased costs of performance, the Government denied liability for the additional costs and paid Metcalf approximately $26 million less than the total cost of construction.

In March 2007, Metcalf filed a claim for damages with the Navy CO arguing that the Navy had breached its implied duty of good faith and fair dealing under the contract by, among other things, failing to timely investigate the soil conditions, causing delays and hindering performance through an uncooperative inspector. The CO denied the claim, and Metcalf appealed to the COFC.

Relying heavily on the Federal Circuit's decision in *Precision Pine & Timber, Inc. v. U.S.*, 596 F.3d 817 (Fed. Cir. 2010); 52 GC ¶ 97, the COFC rejected Metcalf's claim that the Government breached its duty of good faith and fair dealing. The COFC reasoned that, under *Precision Pine,* a contractor could establish a breach of the duty of good faith and fair dealing only if it proved that the Government's actions were "specifically designed to reappropriate the benefits the [contractor] expected to obtain from the transaction, thereby abrogating the government's obligations under the contract." *Metcalf Constr. Co., Inc. v. U.S.*, 102 Fed. Cl. 334, 346 (2011). The COFC further explained that "incompetence and/or failure to cooperate or accommodate a contractor's request do not trigger the duty of good faith and fair dealing, unless the Government 'specifically targeted' action to obtain the 'benefit of the contract' or where Government actions were 'undertaken for the purpose of delaying or hampering performance of the contract.' " Id. at 363–64. Relying on this reading of *Precision Pine*, the COFC ruled against Metcalf. Metcalf appealed to the Federal Circuit.

On appeal, Metcalf argued that the trial court applied the wrong legal standard in analyzing its claim for breach of the duty of good faith and fair dealing. The Federal Circuit agreed with Metcalf, finding that the COFC's decision rested on an unduly narrow view of the duty. Specifically, the Federal Circuit found that the COFC misinterpreted *Precision Pine.*

The Federal Circuit explained that although "specific targeting" *could* give rise to a claim for breach of the implied duty, *Precision Pine* did not hold that proof of specific targeting was required to establish breach. 742 F.3d at 993. The Federal Circuit added that *Precision Pine* "does not impose a specific-targeting requirement applicable across the board or in this case." Id. Rather, the "specifically targeted" requirement has limited applicability to situations like those present in *Precision Pine*, where the challenged Government conduct occurred in implementing a separate Government authority and duty independent of the contract (in *Precision Pine*, enforcement of and compliance with an injunction).

Key Lessons from Metcalf: Following the Federal Circuit's 2010 decision in *Precision Pine*, some courts viewed the decision as creating a new, broadly applicable "specifically targeted" standard for establishing breach of the implied duty of good faith and fair dealing. The Federal Circuit's decision in *Metcalf* provides some much-needed clarity regarding the applicable scope and standard for asserting a breach of the implied duty of good faith and fair dealing. On balance, the Federal Circuit's ruling should help contractors overcome arguments by the Government for the automatic application of the more stringent "specific targeting" standard.

***Maropakis* Applies to Government Claims (*Raytheon Co. v. U.S.*, 747 F.3d 1341 (Fed. Cir. 2014); 56 GC ¶ 124)**—In a case involving segment closing adjustments, the Federal Circuit held that a final decision from the CO is a jurisdictional prerequisite for a Government claim, even when the Government is seeking to offset amounts due on a contractor claim.

In the late 1990s and early 2000s, Raytheon underwent a major restructuring, which included the closing of several Raytheon segments. Under the CAS, when a segment closes, the contractor must calculate whether the pension allocated to that segment is underfunded or overfunded. If the segment is overfunded, the contractor pays the Government a portion of the surplus. If it is underfunded, the Government pays an amount to cover its share of the deficit.

Raytheon paid its share of the surplus for overfunded segments, but the Government refused to pay its share of the deficit for the underfunded segments. In late 2004 and early 2005, Raytheon submitted certified CDA claims to recover the unpaid deficit, and after the CO denied the claims, it filed suit in the COFC. The Government asserted two defenses: (1) Raytheon's segment closing adjustments did not comply with the Federal Acquisition Regulation's "timely funding" requirements, and (2) the Government was entitled to a downward equitable adjustment on any recovery by Raytheon to account for pension contributions made prior to the amendment of CAS 413 in 1995.

The COFC rejected the Government's arguments and awarded Raytheon approximately $59 million for the deficit adjustments. Specifically, as to the Government's claim for offset, the COFC ruled that it lacked jurisdiction to consider the Government's request for a downward adjustment of Raytheon's recovery because that claim had not been submitted to the CO for a final decision.

Both parties appealed to the Federal Circuit, and one issue was whether a CO's final decision is required to establish jurisdiction over a Government defense to a contractor claim. The underlying basis for the Government's offset claim was an equitable adjustment under the standard FAR CAS clause 52.230-2, which was outside the scope of Raytheon's segment closing adjustment claim. Accordingly, the Government's offset claim was a separate claim requiring a separate final decision in order to establish jurisdiction.

The Federal Circuit agreed that the trial court lacked jurisdiction to decide the merits of the Government's offset claim, and in doing so, extended its decision in *M. Maropakis Carpentry, Inc. v. U.S.*, 609 F.3d 1323, 1331 (Fed. Cir. 2010); 52 GC ¶ 225, to Government claims asserted as defenses to contractor claims. In *Maropakis*, the Federal Circuit held that "a *contractor* seeking an adjustment of contract terms must meet the jurisdictional requirements and procedural prerequisites of the CDA, whether asserting the claim against the government as an affirmative claim or as a defense to a government action." 609 F.3d at 1331. Accordingly, because there was no evidence that the Government issued a final decision to support its claim for an equitable adjustment, the Federal Circuit held that the trial court lacked jurisdiction to hear the issue.

Key Lessons from Raytheon: *Raytheon* makes clear that *Maropakis* applies equally to both contractors and the Government, and before the Government can assert a claim of offset or entitlement to an equitable adjustment in litigation, those claims must be the subject of a CO's final decision.

Attorney-Client Privilege over Contractor's Internal Investigation Materials (*In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014); 56 GC ¶ 224)—The D.C. Circuit granted Kellogg Brown & Root Inc.'s petition for a writ of mandamus and vacated the district court's order compelling KBR to produce documents relating to an internal investigation.

A qui tam relator filed a False Claims Act suit against his former employer, KBR, alleging that the company overcharged the Government for certain services and accepted kickbacks while performing work for the military in Iraq. During discovery, the relator sought privileged documents that were generated during an internal investigation by the company. KBR asserted attorney-client privilege over the documents. In response, the relator claimed that the documents were not subject to the privilege.

In addressing the issue, the district court determined that the attorney-client privilege did not apply. It ruled that the privilege applies only if KBR could establish that the communications in any particular document "would not have been made 'but for' the fact that legal advice was sought." *U.S. ex rel. Barko v. Halliburton Co.*, 37 F. Supp. 3d 1, 5 (D.D.C. 2014); 56 GC ¶ 98. Applying this test, the district court concluded that the privilege did not apply because the internal investigation was "undertaken pursuant to regulatory law and corporate policy rather than for the purpose of obtaining legal advice." Id.

Following this ruling, KBR requested that the district court certify the privilege question to the D.C. Circuit for interlocutory appeal and stay its order pending a petition for mandamus. The district court denied the requests and ordered KBR to produce the disputed documents. KBR then filed a petition for mandamus in the D.C. Circuit. The D.C. Circuit stayed the lower court's order requiring production, and reversed the district court's ruling on the privilege issue.

Specifically, the D.C. Circuit held that the district court erred when it applied a "but-for" test in determining whether the documents were made for the purpose of obtaining legal advice. The D.C. Circuit noted that "the District Court's novel approach would eradicate the attorney-client privilege for internal investigations conducted by businesses that are required by law to maintain compliance programs, which is now the case in a significant swath of American industry." *In re Kellogg Brown & Root*, 756 F.3d at 759. Further, the D.C. Circuit found that the "but-for" test applied by the lower court was inconsistent with the Supreme Court's decision in *Upjohn v. U.S.*, 449 U.S. 383 (1981), and contrary to long-standing principles of attorney-client privilege law.

In *Upjohn*, the Supreme Court held that the attorney-client privilege protects confidential employee communications made during a business' internal investigation conducted by in-house counsel. 449 U.S. 383, 383–84 (1981). The D.C. Circuit explained that in *Upjohn*, the Supreme Court recognized the paramount importance of preserving the privilege for companies' internal investigations, given "the vast and complicated array of regulatory legislation confronting the modern corporation," which requires corporations to "constantly go to lawyers to find out how to obey the law ... particularly since compliance with the law in this area is hardly an instinctive matter." *Upjohn*, 756 F.3d at 757.

After rejecting the but-for test applied by the district court, the D.C. Circuit held that KBR's assertion of the privilege was materially indistinguishable from the privilege that was asserted and upheld by the Supreme Court in *Upjohn*. Specifically, the D.C. Circuit found that under *Upjohn*, "so long as obtaining or providing legal advice was *one of the significant purposes* of the internal investigation, the attorney client privilege applies, even if there were other purposes for the investigation and even if the investigation was mandated by regulation." *In re Kellogg Brown & Root*, 756 F.3d at 758–59 (emphasis added).

Key Lessons from In re Kellogg Brown & Root: The D.C. Circuit's decision on mandamus confirms that the attorney-client privilege applies if one of the significant purposes of a company's internal investigation is to obtain or provide legal advice. This is the case even if the investigation is conducted pursuant to the company's compliance program or code of ethics, or required by statute or regulation.

Conclusion—The decisions described in this Feature Comment are among the most important Government contract claims decisions in 2014. These cases provide much-needed clarity in several fast-moving areas of Government contracts disputes law, and contractors and their counsel should carefully analyze their potential impact on pending and future litigation.

✦

This Feature Comment was written for The Government Contractor by* Elizabeth A. Ferrell, *partner,* Alejandro L. Sarria, *associate, and* Jeremiah J. McIntyre III, *associate, of McKenna Long & Aldridge LLP.