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## Developments

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### **Contractors May Recover Legal Defense Costs “Apportioned” To Successfully Defended Fraud Claims, ASBCA Says**

*General Dynamics Corp., ASBCA 49372, 2002 WL 1307491 (June 10, 2002)*

The Armed Services Board of Contract Appeals has held that a contractor may recover as “allowable costs” its attorney’s fees and expenses incurred successfully defending against Government fraud claims even if the contractor did not prevail on all claims in the “proceeding.” There must, however, be a reasonable basis to apportion the costs between the successful and unsuccessful claims and the successfully defended claims must not stem from the same wrongdoing as the unsuccessful claims, the Board ruled. The ASBCA rejected the Government’s argument that the contractor was not entitled to any recovery because it settled the unsuccessfully defended claims, which, according to the Government, triggered the FAR prohibition against the recovery of legal defense costs when contractors have settled fraud claims. The Board also reversed the statutory penalties imposed by the CO, finding that the Government failed to prove that it was “unreasonable under all circumstances” for the contractor to have sought recovery of its legal defense costs.

**Background**—General Dynamics was awarded a contract by the Government to manufacture two liquid natural gas tankers. One of its subcontractors, Frigitemp, bribed two General Dynamics’ employees to get the subcontract. The bribes were paid through kickbacks from federal subsidies used to fund the prime contract.

When the Government discovered the fraud, it sued General Dynamics, the subcontractor and the employees in the U.S. District Court for the Southern District of New York. The complaint alleged that the bribes violated the Anti-kickback Act, 41 USC § 51, and the False Claims Act, 31 USC § 3729 (the “Frigitemp kickback” claim). In addition, the Government alleged that General Dynamics violated the FCA by submitting inflated payment estimates (the “false estimates” claim).

The District Court dismissed both claims, finding that General Dynamics’ payment estimates were fair and reasonable. In addition, the District Court ruled that the FCA preempted the “Frigitemp kickback” claims. See *U.S. v. Davis*, 803 F. Supp. 830 (S.D.N.Y. 1992). The U.S. Court of Appeals for the Second Circuit affirmed the District Court’s decision concerning the “false estimates” claim but reversed and remanded the “Frigitemp kickback” claim. See *U.S. v. General Dynamics Corp.*, 19 F.3d 770 (2d Cir. 1994). The Government and General Dynamics then executed a settlement, agreeing to dismiss the lawsuit “with prejudice and without costs or attorney’s fees to either party.”

General Dynamics then sought to recover approximately \$3.1 million in attorney’s fees and expenses defending against the “false estimates” claim as an “allowable” cost under FAR 31.205-47. That provision implements the Major Fraud Act of 1988 by allowing up to 80% of a contractor’s “reasonable” legal costs incurred to successfully defend against Government fraud claims. See 10 USC § 2324. The Contracting Officer, however, also citing FAR 31.205-47, determined that the costs were unallowable because (1) the proceeding was resolved by consent or compromise, and (2) the settlement agreement did not state that the defense costs were allowable. See FAR 31.205-47(b), (c). In addition, the CO stated that the settlement agreement

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waived General Dynamics' right to recover attorney's fees.

**ASBCA Appeal**—On appeal, General Dynamics argued that the lawsuit involved two separate and distinct “fraud” claims. And because it successfully defended against the inflated payment estimates claim, which was dismissed before the settlement, it was entitled to recover the portion of its legal defense costs attributable to that successful defense. The Government argued that the case involved a single fraud “proceeding” centered on a single contract and, once settled, FAR 31.205-47 precluded recovery. In addition, the Government asserted that the settlement agreement waived General Dynamics' right to recover attorney's fees.

**Apportionment Required**—The Board acknowledged that the fraud claims were raised in a single proceeding, but rejected the Government's argument that the settlement rendered General Dynamics' legal defense costs unallowable. Rather, the Board pointed out that the “Frigitemp kickback” and “false estimate” claims were based on different facts and, therefore, did not stem from the same alleged wrongdoing.

In addition, the Board noted that Congress' intent in enacting the Major Fraud Act was to permit recovery of legal defense costs when a contractor was successful. In addition, the Act also ensures that contractors are not rewarded for wrongdoing, by among other things, allowing recovery when contractors settle valid fraud claims. To accomplish those “dual goals,” the Board reasoned, apportionment is required under the FAR between successfully and unsuccessfully defended claims.

Accordingly, the ASBCA held that a contractor's legal defense costs in a single proceeding may be apportioned between “allowable” successful defense costs and “unallowable” unsuccessful defense costs even if the case has been settled provided (a) the claims do not stem from the same wrongdoing, (b) there is a reasonable basis to apportion the costs, and (c) the settlement agreement does not otherwise preclude recovery of the successful defense costs.

**Settlement Agreement Did Not Bar “Allowable” Legal Defense Costs**—The ASBCA also rejected the Government's argument that General Dynamics' “allowable” legal defense costs were barred by the settlement agreement. The Board noted that there is a difference between attorney's

fees as an “item of ancillary relief or damages” versus the allowability of attorney's fees as a contract cost under the FAR. Here, the Board concluded that the settlement agreement only covered attorney's fees as damages because, among other things, the parties' stipulated that attorney's fees as costs were not discussed during settlement negotiations. In addition, the Board noted that the settlement agreement did not expressly preclude General Dynamics from recovering attorney's fees as costs. Accordingly, the Board ruled that General Dynamics was entitled to recover its legal defense costs associated with the successful defense of the false estimates claim subject to the FAR's 80% limitation.

**Penalties Vacated**—In addition to rejecting General Dynamics' legal defense costs, the CO imposed a \$1.7 million penalty under 10 USC § 2324, contending that the costs were “expressly unallowable” under the FAR cost principles. The Board rejected that assessment, however, noting that a penalty should not be assessed where, as here, there were “reasonable differences of opinion about the allowability of costs.” To impose a penalty for seeking unallowable costs, the Government must show that it was “unreasonable under all circumstances for a person in the contractor's position to conclude that the costs were allowable,” the Board ruled. Since General Dynamics' position on the allowability of its costs to defend against the false estimates claim was “sound,” the Board concluded that the statutory penalties were invalid.

◆ **Practitioner's Comment**—The Board's decision in *General Dynamics Corp.* reached the right result for all the right reasons. Unlike *Boeing North American, Inc. v. Roche*, 283 F.3d 1320 (Fed. Cir. 2002), 44 GC ¶ 112, and *Caldera v. Northrop Worldwide Aircraft Services, Inc.*, 192 F.3d 962 (Fed. Cir. 1999), 18 FPD ¶ 136, 42 GC ¶ 430, *General Dynamics* involved legal defense costs incurred in a proceeding brought by the U.S., not a third party. Hence, the case did not involve an attempt to expand the “legal and other proceedings” cost principle beyond its statutory foundation. See Manos, FEATURE COMMENT,

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“The Federal Circuit’s Decision in *Boeing North American: Better, But Still Wrong*,” 44 GC ¶ 203. Rather, the legal costs at issue in *General Dynamics* fell squarely within the scope of 10 U.S.C. § 2324. Appropriately, the Board looked to the statutory basis of the cost principle and reached a result entirely consistent with both the literal language of the statute and congressional intent.

*General Dynamics* should be helpful for practitioners in at least two respects. First, neither the statute nor cost principle expressly contemplates a situation in which there are two distinct fraud claims in a single proceeding, and the contractor is completely vindicated on the major claim before settling the minor claim. Although the CO’s position in *General Dynamics*—that settling the minor claim after the appellate court had affirmed the lower court’s dismissal of the major claim and remanded the minor claim because of a legal error rendered all of the defense costs expressly unallowable—seems so absurdly unreasonable that the issue may not arise with any frequency, the Board helpfully defined what is meant by the phrase “disposition of the matter by consent or compromise.” While agreeing with the Government that there had been only one “proceeding,” the Board held that the “disposition” of the proceeding was the more important issue. The term “proceeding” focuses on the process; whereas, the term “disposition” focuses on the outcome, and therefore requires an examination of the substance of what was in controversy. Accordingly, the Board held, it is appropriate to distinguish between those claims on which the contractor has prevailed and those factually distinct claims that were compromised.

Second, the Board’s decision clarifies what constitutes an “expressly unallowable” cost for the purpose of imposing penalties. Once again appropriately looking to the underlying statute, the Board held that “since Congress adopted the ‘expressly unallowable’ standard to make it clear that a penalty should not be assessed where there were reasonable differences of opinion about the allowability of costs,” the burden is on the Government to “show that it was unreasonable under all the circumstances for a person in the contractor’s position to conclude that the costs were allowable.” Whether the contractor’s position is reasonable depends on “the clarity and com-

plexity of the particular cost principle” and all the facts and circumstances. By way of example, the Board noted that while there may be little room to debate the allowability of the costs of alcoholic beverages, the allowability of legal defense costs is not necessarily obvious. Because the costs at issue in *General Dynamics* were the subject of an ongoing “serious and reasonable” dispute and the contractor openly included them in its indirect cost proposal, the Board concluded that the Government had not met its burden of proving that the imposition of a penalty was appropriate.



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