

ALERT

# Federal Circuit Gives Judges Greater Discretion to Second-Guess Cost Reasonableness; Denies Government's Ambitious Fraud Counterclaims

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Last Thursday, the U.S. Court of Appeals for the Federal Circuit issued a precedential decision in *Kellogg Brown & Root Servs., Inc. v. United States (KBR)*, Nos. 2012-5106, -5115 (Fed. Cir. Sept. 5, 2013), that addresses three issues of importance to Government contractors, particularly those performing cost reimbursable contracts in contingency environments. *First*, the *KBR* appeal provides the Federal Circuit's most substantive application of the legal standard for determining the "reasonableness" of incurred costs under cost-reimbursable contracts. *Second*, the Federal Circuit in *KBR* rejected the U.S. Department of Justice's (DOJ) attempt to dramatically expand the scope of conduct triggering liability under the False Claims Act and theories of common law fraud. *Third*, the Federal Circuit reversed the U.S. Court of Federal Claims' (COFC) conclusion that the actions of two KBR employees who received kickbacks from Tamimi's Vice President could not be imputed to KBR for purposes of the double-penalty provision of the Anti-Kickback Act.

*KBR* is a partial win for the contracting industry. On the one hand, Wiley Rein had previously filed an *amicus* brief on behalf of Professional Services Counsel (PSC) and the National Defense Industrial Association (NDIA) urging the Court to apply a deferential standard of reasonableness that would appropriately consider the context in which a cost is incurred, such as a rapidly changing wartime environment. Although the Court acknowledged several of the points made by PSC/NDIA in its brief, and portions of the opinion adhere more closely to the standard in the Federal Acquisition

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Regulation (FAR) 31.201-3 than others, the KBR opinion ultimately makes a number of broad and troubling statements that are likely to embolden the Government to question future costs. On the other hand, the Federal Circuit affirmed the COFC's rejection of the Government's fraud counterclaims as overly-broad interpretations of the law, as PSC/NDIA urged the Federal Circuit to do.

### **Determining Cost Reasonableness under a Cost-Reimbursement Contract**

The cost reasonableness issue involved \$41.1 million that KBR paid to a subcontractor, Tamimi, to operate dining facilities in Iraq shortly after the 2003 invasion. The Federal Circuit affirmed the COFC's decision that all but \$11.5 million of these costs were unreasonable. In doing so, the *KBR* opinion brushed aside as "non-binding" precedent decades of Board of Contract Appeals decisions emphasizing that "[t]he contractor is entitled to exercise its discretion and sound judgment in incurring costs without the substitution of judgment by the contracting officer disallowing the costs." *Boeing Aerospace Operations, Inc.*, ASBCA Nos. 46274, 46275, 94-2 BCA ¶ 26,802, at 133,283, *aff'd on recons.*, 94-3 BCA ¶ 27,281. Instead, the Federal Circuit's opinion emphasizes that FAR 31.201-3 "affords the reviewing officer or court considerable flexibility in assessing the reasonableness of costs." Later, the Court's opinion states: "The standard for assessing reasonableness is flexible, allowing the Court of Federal Claims to consider many fact-intensive and context-specific factors." By focusing on the discretion afforded to the Government and the reviewing court or board, rather than contractors, the Federal Circuit's opinion stands FAR 31.201-3 on its head.

Other portions of the Federal Circuit's opinion, however, adhere more closely to the text of the FAR. The opinion acknowledges that "FAR § 31.201-3(a) requires the court to examine the reasonableness of a contractor's actions to ensure that those actions result in costs that do not exceed 'that which would be incurred by a prudent person in the conduct of competitive business.'" The Court also accepted the point repeatedly made by both KBR and PSC/NDIA that reasonableness must be determined in light of the circumstances facing the contractor at the time the costs were incurred. The Federal Circuit ultimately concluded that the COFC had considered these circumstances. The Court noted that the COFC "adopted KBR's urging at trial that reasonableness must be determined in context, not based on standards for 'conference room' contracting," and properly understood that "costs need to be reasonable, not in a vacuum, but in the context of the events in which they arose."

In the end, however, the Federal Circuit's opinion rests on the principle, contrary to the plain language of FAR 31.201-3 and decades of precedent, that the reviewing court or board has flexibility to assess the reasonableness of costs incurred by the contractor. Lacking from the opinion was any discussion of the fundamental notion that the contractor itself is entitled to discretion in incurring costs "without the substitution of judgment by the contracting officer disallowing the costs." *Boeing Aerospace Operations, Inc.*, ASBCA Nos. 46274, 46275, *supra*.

### **The Government's Fraud Counterclaims**

The Government's fraud counterclaims asserted that \$38,000 in kickbacks that KBR's subcontractor, Tamimi, paid to two KBR employees (1) constitutes fraud sufficient under the Forfeiture Statute, 28 U.S.C. § 2514, to forfeit KBR's claim for reimbursement; (2) rendered all of KBR's invoices for Tamimi costs false claims actionable under the False Claims Act; and (3) rendered the subcontract *void ab initio* and thereby entitled the Government to disgorgement of all payments for costs incurred by the subcontractor under a theory of common law fraud, regardless of whether, and to what extent, the kickbacks actually affected the award of the subcontract. The Federal Circuit affirmed the COFC's dismissal of these counterclaims and rejected the Government's claim that "the subcontract at issue was fraudulent from its inception."

The Court rejected the Government's Special Plea in Fraud that any invoice submitted upon a fraud-tainted contract violates the Forfeiture Statute as "an impermissibly broad reading" of that law. The Court noted that, "[o]n its face, the statute is limited to those circumstances where the Government proves fraud 'in the proof, statement, establishment, or allowance' of a claim at the Court of Federal Claims, not in the execution of a contract."

The Court also rejected the Government's claim under the False Claims Act that "the invoices for the Camp Anaconda dining services subcontract were false or fraudulent because the subcontract itself was tainted by kickbacks." As stated by the Court, "the Government does not argue here and did not argue below that the invoices themselves were false or fraudulent, a showing that is required for a [False Claims Act] claim to be successful."

Finally, the Court rejected the Government's common-law fraud counterclaim, concluding that the Government failed to prove a causal link between the kickbacks and the contract provisions. "This court's precedent confirms that common-law fraud is not established simply by showing that kickbacks were paid to personnel involved in contract decision making. . . . Rather, the record must show some causal link between the illegality and the contract provisions." The Court affirmed the COFC's finding that Tamimi would have received the subcontract regardless of the kickbacks.

### **The Government's Anti-Kickback Act Claim**

The Court, however, reversed the COFC's finding that the actions of Mr. Hall and Mr. Holmes in accepting the kickbacks could not be imputed to KBR. The COFC refused to apply the Anti-Kickback Act's double penalty provision and awarded the Government only \$38,000—the actual amount taken by the KBR employees. In reversing the COFC's decision, the Federal Circuit recited the Anti-Kickback Act's provision imposing a double penalty on "any person who *knowingly* engages" in prohibited conduct, and noted that the corporation could be subject to this double penalty for the actions of its employees under the theory of vicarious liability, regardless of whether or not the corporation was aware of the employee's actions. "Corporations act through their employees; the general rule is that an agent's knowledge is imputed to the principal when employees are acting with the scope of their authority or employment, absent special circumstances." The Court concluded that one of those special circumstances—the adverse-interest exception—did not apply in this case because KBR did, in fact, receive a benefit from Tamimi's kickbacks.

Judge Newman dissented on this point, arguing that the majority's decision "erases the distinction between the two statutory levels of liability in the [Anti-Kickback Act]." Moreover, Judge Newman argued that "[t]here was no evidence that the bribes paid to Hall and Holmes were known to KBR or were of benefit to KBR. Hall and Holmes kept the entire payments for themselves, as 'party money' and for sham business ventures."

### **Conclusion**

Overall, the *KBR* opinion represents a unique and rare addition to the case law governing cost reasonableness and is the Federal Circuit's most substantive application of the reasonableness standard. Although portions of the decision appear to adhere closely to the language of FAR 31.201-3, the Court's decision ultimately ignores decades of precedent on this issue and instead makes a number of broad and troubling statements that are likely to embolden Government auditors to question future costs as "unreasonable." At the same time, the Federal Circuit's rejection of the DOJ's ambitious fraud counterclaims is a win for contractors, which have been increasingly subjected to fraud-related suits by the Government. PSC and NDIA were represented by Wiley Rein attorneys Daniel P. Graham, Nicole J. Owren-Wiest, Brian Walsh, Tara L. Ward, and Collin D. Swan.