NOT A *TECOM* PARTY: THERE'S "VERY LITTLE LIKELIHOOD" *GEREN V. TECOM* WILL PROMOTE SOUND GOVERNMENT CONTRACTING PRACTICES

Edward R. Brown[*]

INTRODUCTION

You own and operate a small project management company that primarily contracts with the federal government. The nature of the work you perform, specifically the difficulty in estimating its scope or price in advance, dictates that the primary vehicle for your services is cost-reimbursement contracts. These contracts provide that the government will reimburse your company for nearly all of the costs it incurs in performance of the work, plus a modest fee.

One Tuesday morning, you are formally served with process and receive a copy of a complaint filed by a former employee. Your company had previously assigned the employee to a cost-reimbursement facilities maintenance contract performed on the local military base. The employee was terminated for excessive absenteeism and other violations of company policy. Before long, what you once viewed as a frivolous employment discrimination allegation has snowballed into a $100,000 legal bill—prior to discovery. Your attorney tells you that the plaintiff is prepared to settle the matter for $50,000. While you strongly deny any wrongdoing, your attorney has also estimated that the cost of prevailing at trial is $200,000. You consider the risks and returns. To complicate matters further, your attorney tells you that the government will only reimburse you for the legal fees and settlement costs, assuming these costs meet all other requirements for reimbursement, if: (1) you prove that the ex-employee plaintiff had "very little likelihood of success on the merits," as determined by your government contracting officer;[1] or (2) you prevail at trial, and your costs are still "reasonable."[2] If you cannot recover your costs from this lawsuit, a substantial amount of your fee on the contract will be eroded. A contract having what you thought was very little business risk has just become your small company's big headache.

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* George Mason University School of Law, Juris Doctor Candidate, May 2012; Member, GEORGE MASON LAW REVIEW, 2010-2011; Virginia Polytechnic Institute and State University, M.B.A., May 2008; Auburn University, B.S. Building Construction, *magna cum laude*, Dec. 2006.

1 A "contracting officer" is a person executing a contract on behalf of the government. W. NOEL KEYES, GOVERNMENT CONTRACTS § 1.21 (3d ed. 2003).

2 Geren v. Tecom, Inc., 566 F.3d 1037, 1046 (Fed. Cir. 2009).

This illustration highlights the problem and impact of the Federal Circuit's recent decision in *Geren v. Tecom, Inc.*[3] Generally, the government reimburses contractors for all reasonable costs incurred through the performance of a cost-reimbursement contract.[4] Prior to *Tecom*, contractors did not face an independent bar to reimbursement for settlement and litigation expenses incurred in defending third-party litigation. However, when a plaintiff alleges that a contractor committed wrongdoing that involved the violation of any term of a government contract, *Tecom* permits the contractor to recover the costs of settling such litigation only if it can meet the heavy burden of proving that the plaintiff's allegation had "very little likelihood of success on the merits."[5] The court claims this outcome is justified because the "policy" of the Federal Acquisition Regulation ("FAR"),[6] which defines the types of costs that a government contractor can recover under a cost-reimbursement contract, "cannot be . . . to permit a contractor who is certain to lose on the merits to defeat disallowance by the simple expedient of settling before the litigation is concluded."[7] Yet, in setting such a high bar for recovery of settlement costs, *Tecom* omitted any evaluation of a holding that operates between these two extremes,[8] despite on-point precedent.[9] As a result, *Tecom* did a disservice to contractors, to the government, and to taxpayers. This judicial failure warrants action by the Federal Acquisition Regulatory Council ("FAR Council")[10] to amend the regulations to restore the pre-*Tecom* standard for allowability, which is based primarily on the fundamental concept of reasonableness. This Note argues that *Tecom* is not only legally incorrect, but it also fails to promote sound government contracting practices.

Part I of this Note discusses the history and background of cost-reimbursement contracts and the allowability of legal defense and settlement costs. Part I also includes a discussion of the Court of Claims' decision in *Dade Bros. v. United States*[11] and of the Federal Circuit's controver-

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3 566 F.3d 1037 (Fed. Cir. 2009).

4 Reimbursement is made pursuant to a uniform set of standards. *See infra* Part I.B.

5 *Tecom*, 566 F.3d at 1046.

6 FAR is a codification of the uniform policies and procedures for acquisition by executive agencies. KEYES, *supra* note 1, § 1.2.

7 *Tecom*, 566 F.3d at 1046.

8 That is, between a contractor who is "certain to lose" and a contractor who can affirmatively prove that a suit against it has "very little likelihood of success on the merits."

9 *See, e.g.*, Hirsch Tyler Co., ASBCA No. 20962, 76-2 BCA ¶ 12,075 (Aug. 23, 1976); Ravenna Arsenal, Inc., ASBCA No. 17802, 74-2 BCA ¶ 10,937 (Oct. 31, 1974).

10 The FAR Council is the body that "oversees development and maintenance of the FAR." *Office of Federal Procurement Policy*, WHITEHOUSE.GOV, http://www.whitehouse.gov/omb/procurement_mission (last visited Sept. 24, 2010). "[Its] members include the DOD Director of Defense Procurement and Acquisition Policy, NASA's Associate Administrator for Procurement, and the GSA Chief Acquisition Officer." *Id.*

11 325 F.2d 239 (Ct. Cl. 1963) (per curiam).

sial decision in *Boeing North American, Inc. v. Roche*.[12] Part II addresses the Federal Circuit's recent decision in *Tecom*. Part III analyzes the legal basis for the *Tecom* decision. Part IV explores the potential implications of its holding.

I. HISTORY AND BACKGROUND

A. *History and Purpose of Cost-Reimbursement Contracts*

Government procurement in America predates its independence.[13] Colonial military forces required food, clothing, and munitions, and they relied heavily on the ingenuity of private industry to provide them.[14] Two centuries later, the modern era of government contracting began as American industry mobilized for World War II.[15] Within three years, these government contractors—viewed by some as "scoundrels without conscience" or "merchants of death"[16] due to perceptions of profiteering—produced more war material than all other combatants combined, supporting an eventual victory in Europe and the Pacific.[17] In the aftermath of World War II and through the onset of the Cold War, the rise of the defense industry continued the rapid advancement of federal government contracting.[18]

Government contracts come in various forms to serve various functions. They are generally classified both by the method of procurement[19] and by the method of contractor reimbursement.[20] Procurement occurs either by sealed bidding[21] or through some type of negotiation,[22] and payment is made under either a fixed-price[23] structure or using a cost-type[24] ap-

12 298 F.3d 1274 (Fed. Cir. 2002).

13 *See* JAMES F. NAGLE, A HISTORY OF GOVERNMENT CONTRACTING 11 (2d ed. 1999).

14 *Id.* at 11-53.

15 *Id.* at 409-42.

16 *Id.* at 352.

17 *Id.* at 431.

18 *Id.* at 446-79.

19 Procurement is "[t]he act of getting or obtaining something or of bringing something about." BLACK'S LAW DICTIONARY 1327 (9th ed. 2009).

20 KEYES, *supra* note 1, § 16.11.

21 This is the traditional method of contracting for public bodies and has been required by statute since the beginning of the Civil War. *Id.* § 14.1. Under this method, competitive bids are publicly solicited, opened, and awarded. *Id.* § 14.11.

22 *See, e.g.*, *id.* § 16.11.

23 Fixed-price contracts provide maximum incentives to contractors to reduce costs for increased profitability. *Id.* § 16.3. They can be further "broken down into firm fixed price contracts and fixed price contracts with escalation." *Id.* § 16.1.

24 Under a cost-type approach, a contractor's payment is provided for based on the contractor's allowable costs incurred in the performance of the particular contract. *Id.* § 16.11.

proach.[25] The purpose and nature of the underlying contract performance dictates which government contract type is utilized.[26]

During both world wars, the government widely used cost-reimbursement contracts[27] to obtain urgently needed supplies and equipment.[28] Under a cost-reimbursement contract, the contractor receives payment for all allowable costs incurred in the performance of the contract, and it is usually rewarded with a profit or "fee."[29] These contracts have long been perceived as wasteful or inefficient.[30] Consequently, their use is limited to specific circumstances in which no other form of contracting will do.[31] Modern regulations require the use of fixed-price[32] contracting unless the circumstances satisfy certain and specific criteria.[33]

However, fixed-price contracts may be impractical in certain situations.[34] For example, if a contract is highly complex or if it is impossible at the time of procurement to determine how to perform the contract, a contractor who is paid under a fixed-price contract will face a high degree of risk.[35] Under such circumstances, it may benefit the government, as well as the contractor, to award a cost-type contract.[36] A cost-type contract will benefit contractors and decrease their risk because the government will reimburse them for costs that arise from performance of the contract that neither party may have been able to predict at procurement. The contract will also benefit the government because contractors will bid for it at a lower price, reflecting the contract's decreased risk by lowering expected profits or removing fee contingencies.[37] The resulting lower prices, obtained through the competitive marketplace, are then passed on to the government.[38]

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25 *Id.*

26 *See* KEYES, *supra* note 1, § 16.11.

27 Although various types of cost-reimbursement structures exist, such distinctions are immaterial for the purpose of this Note. For a discussion of cost-reimbursement contract types, see *id.* §§ 16.11-16.19. Examples of arrangements include: (1) the cost-plus-fixed-fee contract; (2) the cost-plus-incentive-fee contract; (3) the cost-plus-award-fee contract; (4) the cost-reimbursement-variable-quantity contract; and (5) the cost-sharing contract. JOHN CIBINIC, JR. & RALPH C. NASH, JR., COST-REIMBURSEMENT CONTRACTING 39 (3d ed. 2004).

28 CIBINIC & NASH, *supra* note 27, at 3.

29 MELVIN RISHE, GOVERNMENT CONTRACT COSTS 3-20 (1984).

30 Robert Braucher & Covington Hardee, *Cost-Reimbursement Contracts with the United States*, 5 STAN. L. REV. 4, 4 (1952).

31 *Id.* at 5; *see also* CIBINIC & NASH, *supra* note 27, at 3 (noting that there is little evidence that the government used cost-reimbursement contracts between World War I and World War II).

32 *See supra* note 23 and accompanying text.

33 CIBINIC & NASH, *supra* note 27, at 10-16.

34 STEVEN W. FELDMAN, GOVERNMENT CONTRACT GUIDEBOOK § 4:17 (4th ed. 2008).

35 KEYES, *supra* note 1, § 16.1.

36 *Id.*

37 *Id.*

38 *Id.*

Accordingly, the government today uses cost-reimbursement contracts when it is unable to adequately estimate the costs of a contract's performance.[39] In cost-reimbursement contracting, the government must pay for all "allowable" costs incurred during performance of the contract.[40] The "allowability" of such costs—whether the contractor will be paid for amounts incurred through performance of the contract—is based on congressionally enacted statutory provisions[41] and implementing regulations.[42] "Allocability" of cost, an accounting concept, is similarly prescribed by the cost accounting standards ("CAS")[43] promulgated by a legislatively enacted governmental board, the Cost Accounting Standards Board ("CASB").[44]

The modern concept of allowability of costs originated during World War I. Made necessary by the rapid increase in cost-reimbursement contracting to support the war effort, the government distributed pamphlets defining which "costs" were reimbursable.[45] The government incorporated these pamphlets by reference into various military contracts.[46] In 1942, it issued the first set of combined War and Navy Department cost principles for government contracting to protect against excessive contractor spending.[47] In 1947, Congress passed the Armed Services Procurement Act which consolidated the military departments under a newly created Department of Defense, leading to the promulgation in 1949 of the Armed Services Procurement Regulation ("ASPR"), which contained a set of principles controlling allowability of cost.[48] Around that same time, the General Services Administration ("GSA") issued the Federal Procurement Regulations ("FPR") as a basic set of regulations governing procurement by civilian agencies.[49] In 1984, the FAR became effective, combining and simplifying all previous procurement regulations.[50]

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39 CIBINIC & NASH, *supra* note 27, at 14-16.

40 RISHE, *supra* note 29.

41 As contained in part 31 of FAR. *See* CIBINIC & NASH, *supra* note 27, at 639.

42 *See* FAR pt. 31 (2009).

43 CIBINIC & NASH, *supra* note 27, at 743.

44 *Id.* at 652.

45 NAGLE, *supra* note 13, at 419.

46 *Id.*

47 *Id.* at 431.

48 JAMES P. BEDINGFIELD & LOUIS I. ROSEN, GOVERNMENT CONTRACT ACCOUNTING § 6-7 (2d ed. 1985). The ASPR was later restyled as the Defense Acquisition Regulation. *Id.*

49 *Id.* § 6-9.

50 *Id.*

B. *Allowable Costs in a Cost-Reimbursement Contract*

Under a cost-reimbursement contract, a contractor receives payment for all allowable costs incurred in the performance of the contract.[51] Both direct costs—those identified with a particular contract[52]—and indirect costs—those identified with two or more contracts[53]—are recoverable.[54] FAR section 31.201-2[55] sets forth the five elements for allowable costs.[56]

First, the cost must be reasonable. Reasonableness is a subjective determination that is highly dependent on the facts and circumstances surrounding a particular cost.[57] A cost is reasonable if, in both nature and amount, "it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."[58]

Second, the cost must be allocable. Allocability is an accounting concept.[59] A cost is allocable to a particular contract if a sufficient nexus exists between the specific cost and the government contract.[60] All direct costs are typically fully allocable to a particular government contract, while indirect costs are only partially allocable.[61] Significantly, the concept of cost allocation is broad and can lead to differing results,[62] which has necessitated the development of uniform cost and accounting standards that are applicable to all major cost contractors.[63]

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51 RISHE, *supra* note 29.

52 United States v. Newport News Shipbuilding & Dry Dock Co., 862 F.2d 464, 465 (4th Cir. 1988).

53 *Id.*

54 RISHE, *supra* note 29, at 3-24.

55 FAR 31.201-2 (2009).

56 These are: (1) "Reasonableness;" (2) "Allocability;" (3) "Standards promulgated by [the CASB], if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances;" (4) "Terms of the contract;" and (5) "Any limitations set forth in [subpart 201-2]." *Id.*

57 DARRELL J. OYER, PRICING AND COST ACCOUNTING: A HANDBOOK FOR GOVERNMENT CONTRACTORS 59 (2005).

58 FAR 31.201-3(a).

59 Boeing N. Am., Inc. v. Roche, 298 F.3d 1274, 1280 (Fed. Cir. 2002).

60 Lockheed Aircraft Corp. v. United States, 375 F.2d 786, 794 (Ct. Cl. 1967); *see also* CIBINIC & NASH, *supra* note 27, at 743.

61 David V. Anthony et al., *Cost Recovery and Payment*, *in* 1 FEDERAL CONTRACT MANAGEMENT § 7.01, at 7-1, § 7.03(1)(b)(iv), at 7-31 (Norman A. Steiger et al. eds., 2010).

62 CIBINIC & NASH, *supra* note 27, at 743. For example, a bluegrass band at a company picnic could reasonably be considered an allowable "employee morale" cost under FAR 31.205-13 or an unallowable "entertainment" cost under FAR 31.205-14. More appropriately, if possible, the cost could be apportioned between the two. *See* Steven L. Briggerman, *Allowability of Legal Costs: Settlement of Third-Party Litigation*, 23 NASH & CIBINIC REP. 9 (2009). The issue could be further complicated if, for example, company employees assigned to other contracts were invited.

63 CIBINIC & NASH, *supra* note 27, at 743.

Third, the cost claimed must be consistent with accounting standards. When costs are inconsistent with the CAS or the generally accepted accounting principles ("GAAP"), they are not allocable and therefore not allowable.[64] Ordinarily, contractors must adhere to the CAS, but when these are not applicable, contractors must adhere to GAAP.[65] The aim of the cost principles under both the CAS and the GAAP is to allocate costs in an accurate, fair, and consistent manner.[66]

Fourth, the cost claimed must be consistent with the terms of the contract. A contract may often contain special limitations on the allowability of certain costs unique to that particular contract.[67] For example, a contract may specifically cap allowable overhead rates or may expressly disallow certain types of expenses on a particular contract. These specific contractual terms may modify general government contract cost principles by imposing clauses unique to a particular contract.[68]

Finally, the cost must be allowable under the FAR cost principles. FAR section 31.205 lists a number of specific costs as either allowable or unallowable.[69] For example, bond costs are expressly allowable,[70] while lobbying and political activity costs are expressly unallowable.[71] If the text does not specifically address the allowability of a cost, the FAR provides that the "determination of allowability shall be based on the principles and standards . . . and the treatment of similar or related selected items."[72]

C. *Costs Resulting from the Breach of a Government Contract*

While cost principles for professional and consultant services, such as those provided by accountants or lawyers, are theoretically uniform, costs concerning legal fees have garnered a greater amount of litigation than other such services.[73] Nonetheless, prior to the promulgation of FAR section 31.205-47, legal fees incurred in connection with government contracts had historically been allowable as an ordinary business expense under most circumstances, absent a specific showing of contractor bad faith.[74] A contractor can even recover attorneys' fees for litigation resulting in an adverse

64 *See* CIBINIC & NASH, *supra* note 27.

65 KEYES, *supra* note 1, § 30.2; FAR 31.201-2 (2009).

66 CIBINIC & NASH, *supra* note 27, at 743.

67 *See, e.g.*, Dynalectron Corp., ASBCA No. 20240, 77-2 BCA ¶ 12,835 (Oct. 26, 1977).

68 *See* Richard C. Johnson et al., Geren v. Tecom, Inc.*: The Federal Circuit Creates a New FAR Cost Principle*, 4 GOV'T CONT. COSTS, PRICING & ACCT. REP. ¶ 27 (2009).

69 FAR 31.205-1 to -52.

70 *Id.* § 31.205-4.

71 *Id.* § 31.205-22.

72 *Id.* § 31.204(d).

73 RISHE, *supra* note 29, at 20-9.

74 *Id.*

judgment against it,[75] including when the conduct complained of breached the terms of a government contract.[76] For example, in *Hirsch Tyler Co.*,[77] the Armed Services Board of Contract Appeals held that the government must reimburse a contractor for the legal costs of the contractor's unsuccessful defense of a civil rights action brought by one of its former employees, despite a contract term prohibiting employment discrimination in violation of federal law.[78] After noting that the costs of both litigation and an adverse adjudication were reasonable and not expressly unallowable, the Board held that "the contracting officer exceeded his authority by erecting a standard not provided in the contract" to deny reimbursement.[79]

Yet, prior to the promulgation of FAR section 31.205-47, not all costs of litigation or settlement were per se allowable. Cost principles prescribed the elements of allowability.[80] Moreover, some contracts included specific terms setting forth the circumstances under which a contractor would receive reimbursement for litigation. In *Dade Bros. v. United States*, for example, one such clause limited the contractor's recovery for certain expenses incurred through various legal proceedings.[81]

In *Dade*, a contractor sought reimbursement for legal fees incurred in defending a suit brought by former employees.[82] The workers charged that the contractor had conspired with a union and union officials to deprive the employees of certain rights.[83] The contract at issue had a specific provision allowing reimbursement for costs incurred in "litigation in connection with claims of third parties arising out of the performance of the contract." [84] The contractor submitted for reimbursement the costs of the adverse judgment and the costs incurred in litigation.[85] However, the Contracting Officer disallowed the reimbursement because the contractor's acts of conspiracy with union officials did not relate to performance of the government contract within the meaning of the specific litigation-reimbursement clause.[86] There-

75 *Id.*

76 *See, e.g.*, Hirsch Tyler Co., ASBCA No. 20962, 76-2 BCA ¶ 12,075 (Aug. 23, 1976); Hayes Int'l Corp., ASBCA No. 18447, 75-1 BCA ¶ 11,076 (Jan. 28, 1975); Ravenna Arsenal, Inc., ASBCA No. 17802, 74-2 BCA ¶ 10,937 (Oct. 31, 1974).

77 ASBCA No. 20962, 76-2 BCA ¶ 12,075 (Aug. 23, 1976).

78 *Id.*

79 *Id.* The contracting officer is the person executing a contract on behalf of the government. KEYES, *supra* note 1, §1.21.

80 *See* FAR 31.201-2 (2009).

81 Dade Bros., Inc. v. United States, 325 F.2d 239, 239 (Ct. Cl. 1963).

82 *Id.*

83 *Id.*

84 *Id.* (internal quotation marks omitted).

85 *Id.* at 240.

86 *Id.* ("The Contracting Officer disallowed any reimbursement because the contractor had . . . engag[ed] in the conspiracy found by the state courts [and] therefore, he held, the . . . litigation did not arise out of the proper performance by the contractor of its contract with the Government (within the meaning of the litigation-reimbursement clause).").

fore, because the contractor's willful and malicious actions did not arise out of the contract, they did not qualify for reimbursement.[87]

The specific contractual provision in *Dade* was essential to the court's holding.[88] The provision vested broad discretion in the contracting officer to determine allowability.[89] The *Dade* court, limiting its analysis to the Board's review of the Contracting Officer's determination of allowability under the clause, held that "the [Board of Contract Appeals] was free to reach these conclusions [that the contractor failed to prove, among other things, that its actions were committed in performance of the contract] and was not required, on the record before it, to decide in the contractor's favor."[90] Specifically, the Board opinion stated:

> [A] contractor who commits a malicious and willful tort in derogation of the contract provisions cannot be said to be in the commission of such tort acting within the framework of the contract within the meaning of [the litigation reimbursement clause]. In other words, the conspiracy cannot be considered as arising out of the performance of the contract; it was an act beyond the intendment and beyond the scope of the contract . . . . It would be unreasonable to hold that the contract requires the Government to reimburse a contractor for the litigation costs arising out of willful and malicious action not only violative of the rights of third parties but in contradiction to the very terms of the contract itself.[91]

The Contracting Officer approved payment for litigation and adjudication costs for several of the employee counts, such as the contractor's failure to pay overtime wages pursuant to its union agreement, despite the fact that the government contract specifically required the contractor to "abide by all the terms and conditions of the Union Agreement."[92] It was only the costs stemming from the tortious misconduct that the Contracting Officer exercised his discretion in disallowing.[93]

D. *Fraud Exception Origins*

Prior to the codification of the modern FAR section 31.205-47,[94] even legal expenses in connection with fraud against the government were not easily disallowed. For example, the Armed Services Board of Contract Appeals has held that legal costs incurred in connection with a grand jury in-

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87 *Dade Bros.*, 325 F.2d at 241.

88 *Id.* at 240.

89 *Id.* at 239 ("[I]f the Contracting Officer determined that the contractor should defend 'litigation in connection with claims of third parties arising out of the performance of the contract,' the contractor would be entitled to reimbursement . . . .").

90 *Id.* at 240.

91 Dade Bros., Inc., No. 980, 1957 WL 514 (ENGBCA Apr. 4, 1957).

92 *Id.*

93 *Dade Bros.*, 325 F.2d at 241.

94 FAR 31.205-47 (2009).

vestigation into alleged fraud in the contractor's government contracts are allowable absent a showing of bad faith.[95] The Board held that it was improper to disallow legal costs simply because the contractor incurred them during an investigation into potential fraud, noting that such costs might still be allowable even if some act of fraud were established.[96]

In 1983, the FAR was amended with respect to the allowability of legal fees incurred in both litigation and settlement of fraud-related actions.[97] Specifically, FAR section 31.205-47(b) disallows legal fees incurred (1) in connection with the defense of a fraud suit, (2) brought by or on behalf of the government, and (3) if the suit resulted in a judicial determination that the contractor defrauded the government.[98] Additionally, FAR section 31.205-47(c)(2) specifically disallows the costs of such suits if settled under certain criteria.[99] As amended, this provision provides:

> In the event of a settlement of any proceeding brought by a third party under the False Claims Act in which the United States did not intervene, reasonable costs incurred by the contractor in connection with such a proceeding, that are not otherwise unallowable by regulation or by separate agreement with the United States, may be allowed if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.[100]

This section does not apply to cases brought by third parties that are not on behalf of the government.[101] Nevertheless, FAR section 31.204(d)[102] provides that costs not expressly covered by section 31.205 are neither impliedly disallowed nor allowed and that allowability should be based on the FAR cost principles through items which are "similar or related."[103] In 2002, the Federal Circuit was confronted with an opportunity to extend the statutory disallowance of legal defense and settlement costs to cases brought by third parties where the underlying conduct primarily consisted of fraud against the government in *Boeing North American, Inc. v. Roche*.[104]

In 1996, a large defense and aerospace contractor, Rockwell, merged with a Boeing subsidiary and subsequently changed its name to Boeing North American, Inc.[105] Rockwell had both firm fixed-price and cost-

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95 John Doe Co., ASBCA No. 24576, 80-2 BCA ¶ 14,620 (July 28, 1980); *cf. Dade Bros.*, 325 F.2d at 239 (sustaining a contracting officer's decision to disallow certain costs when the contractor acted "willfully and maliciously").

96 *John Doe Co.*, 80-2 BCA ¶ 14,620.

97 *See* FAR 31.205-47(b).

98 *See id.*

99 *Id.* § 31.205-47(c)(2).

100 *Id.*

101 *See id.*

102 *Id.* § 31.204.

103 FAR 31.204.

104 Boeing N. Am., Inc. v. Roche, 298 F.3d 1274, 1274 (Fed. Cir. 2002).

105 *Id.* at 1276.

reimbursable arrangements with the federal government.[106] On a number of prior occasions, the government and parties on behalf of the government had successfully sued Rockwell, alleging fraud and other misconduct against the government.[107]

In June of 1989, four Rockwell shareholders filed a derivative suit against fourteen directors and 200 unidentified "officers, directors and other members of management and employees, who were involved in the wrongdoing complained of."[108] The underlying misconduct arose from government-initiated suits, qui tam suits on behalf of the government,[109] and government investigations of Rockwell.[110] These actions all related to Rockwell's alleged false statements and other fraud against the government.[111]

Rockwell eventually settled the derivative suit but denied all allegations of wrongdoing contained in the complaint.[112] Rockwell included its settlement costs as general administrative ("G&A") expenses[113] and claimed reimbursement for the portions allocated to cost-reimbursable government work.[114] After the costs were denied, Rockwell unsuccessfully appealed to the Armed Services Board of Contract Appeals, and the case eventually found its way to the Federal Circuit.[115]

The Federal Circuit grappled with a difficult decision in *Boeing*. The underlying misconduct central to the shareholder derivative suit arose out of the same fraud-related conduct as that of the government-initiated suits, the qui tam suits on behalf of the government, and the government investigations of the company.[116] The court held that the costs of defense and settlement in a breach of fiduciary duty suit, where the vast majority of underlying conduct involved fraud and false statements against the government, were "related" to the costs of a qui tam suit under the False Claims Act.[117] Thus, the court applied FAR section 31.204(d) to find that the costs were not similar but "related" to those expressly disallowed by FAR section

106 *Id.*

107 *Id.* at 1277.

108 *Id.* at 1276-77 (internal quotation marks omitted).

109 A "qui tam action" is "[a]n action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will receive." BLACK'S LAW DICTIONARY 1368 (9th ed. 2009).

110 *Boeing*, 298 F.3d at 1277.

111 *Id.*

112 *Id.* at 1278.

113 A "general administrative expense" is "[a]n expense incurred in running a business, as distinguished from an expense incurred in manufacturing or selling; overhead. Examples include executive and clerical salaries, rent, utilities, and legal and accounting services." BLACK'S LAW DICTIONARY 659 (9th ed. 2009).

114 *Boeing*, 298 F.3d at 1278.

115 *Id.* at 1279-80.

116 *Id.* at 1277.

117 *Id.* at 1288-89 & n.17.

31.205-47.[118] Moreover, the court heightened the statutory burden for allowability beyond the five elements for allowable costs: a contractor could not recover unless it proved that the underlying suit had "very little likelihood of success on the merits."[119] In doing so, the court extended the reach of the disallowance provision of FAR section 31.205-47(c)(2) from actions alleging fraud or other similar wrongdoing *against the government* to actions arising out of similar conduct.

Boeing did not go uncriticized.[120] Notably, two commentators expressed concern that contracting officers would "improperly misinterpret [*Boeing*] to apply the [very little likelihood of success standard] to any third-party civil cases filed against government contractors."[121] Others agreed that such an interpretation would be erroneous but did not share the same fear of misapplication because the standard set forth by the *Boeing* court applied only to suits in the context of fraud against the government.[122] Thus, it is clear that practitioners agreed that contractors incurring costs from the litigation and settlement of third-party suits *unrelated to fraud against the government* would only have to prove that such costs were reasonable and otherwise allowable to be able to receive reimbursement for these costs.[123]

II. *GEREN V. TECOM, INC.*

Prior to *Geren v. Tecom, Inc.*, a breach of contract did not serve as an independent bar to reimbursement. Moreover, the "very little likelihood of success" standard for disallowing certain costs did not apply to suits outside the context of fraud against the government. In a dramatic shift from precedent, the *Tecom* majority created a new exclusionary cost principle. First, the court held that costs are per se unallowable if they arise out of conduct that breaches the terms of a government contract.[124] Next, the court held that a contracting officer could only approve the costs for litigation and settlement of a suit alleging such conduct if the contractor made an affirmative showing that the underlying allegations had "very little likelihood of success on the merits."[125]

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118 *Id.* at 1287-89.

119 *Id.* at 1289 (internal quotation marks omitted).

120 *See* Ralph C. Nash, Jr. & John Cibinic, Jr., *Allocability and Allowability of Costs: Vive la Différence*, 16 NASH & CIBINIC REP. ¶ 29 (2002).

121 Ralph C. Nash, Jr. & John Cibinic, Jr., *Postscript: Allocability and Allowability of Costs*, 16 NASH & CIBINIC REP. ¶ 45 (2002).

122 *Id.*

123 *Id.*

124 The implications of this holding are discussed *infra* Part IV.

125 Geren v. Tecom, Inc., 566 F.3d 1037, 1046 (Fed. Cir. 2009).

A. *Facts*

Tecom, Inc. ("Tecom") was awarded a cost-reimbursement contract for the maintenance of military housing at Fort Hood, Texas.[126] As is typical for such contracts,[127] the government contract incorporated by reference clauses mandated by statutes designed to prevent employment discrimination.[128] During contract performance, a former employee sued Tecom alleging Title VII violations after the company terminated her employment.[129] The conduct complained of in the lawsuit occurred while the employee worked on the government contract.[130]

Tecom spent $96,163.16 defending the litigation before eventually settling with the former employee for $50,000.[131] The settlement agreement contained a stipulation whereby Tecom admitted no wrongdoing.[132] Tecom sought to include its legal fees in its G&A expense pool as an indirect cost and sought to bill its cost of settlement as a direct cost to the contract.[133] In requesting reimbursement, the company claimed that it violated no law, that the allegations were false, and that the defense and settlement costs were reasonable, prudent, and allowable under the FAR.[134]

After the Contracting Officer denied the expenses, Tecom submitted a formal claim.[135] After the claim was deemed to have been denied by the Contracting Officer because he did not respond within the statutory period, Tecom filed a timely notice of appeal to the Armed Services Board of Contract Appeals.[136] Arguing that *Boeing* applied, the government contended that the costs should be unallowable unless Tecom proved that the suit had "very little likelihood of success on the merits."[137] Tecom argued that costs of settling a Title VII suit are always allowable, except when such costs include an explicit backpay award, which is explicitly disallowed by the FAR.[138] Similarly, Tecom argued that *Boeing* was inapplicable because *Boeing* applied to costs that were "related" to fraud against the government,

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126 *Id.* at 1039.

127 A contracting officer must include an "Equal Opportunity" provision in solicitations for various contracts. *See* FAR 22.810(e) (2009). The clause requires non-discrimination, including compliance with all applicable laws and regulations. *Id.* § 52.222-26.

128 *Tecom*, 566 F.3d at 1039.

129 *Id.*

130 *Id.*

131 *Id.*

132 *Id.*

133 *Id.*

134 *Tecom*, 566 F.3d at 1039-40.

135 *Id.* at 1040.

136 *Id.*

137 *Id.*

138 *Id.* at 1040 & n.1; *see also* FAR 31.205-6(h) (2009).

whereas no such allegation of misconduct was made against it.[139] On cross-motions for summary judgment, the Board granted Tecom's motion.[140] The government promptly filed an appeal with the Federal Circuit.[141]

B. *Majority Opinion*

To determine whether the settlement and litigation costs were allowable, the Federal Circuit turned to the five major requirements of allowability under the FAR.[142] The majority did not take issue with the determination that the litigation and settlement costs were (1) reasonable, (2) allocable, and (3) consistent with the relevant accounting principles.[143] Nevertheless, it sought to determine whether the costs could be disallowed by either (4) the terms of the contract or (5) any other disallowance provision set forth in the FAR.[144]

After acknowledging that "costs of professional services and costs of settling litigation are generally allowable," the majority expounded that *Boeing* required "a two-step inquiry in addressing the allowability of such costs: (1) we ask whether, if an adverse judgment were reached, the damages, costs, and attorney's fees would be allowable; (2) if not, we ask whether the costs of settlement would be allowable."[145]

Assessing the first prong, the majority held that an adverse judgment in a Title VII suit would not be allowable.[146] The court relied on *Dade*, asserting that *Dade* stood for the proposition that "costs resulting from a breach of a contractual obligation are not allowable costs."[147] The majority then proceeded to explore the regulatory history before concluding that "[t]he modern FAR . . . explicitly articulates this principle, stating that a cost is allowable only if the 'cost complies with . . . [t]he terms of this contract.'"[148]

Because the majority—relying on *Dade*—determined that costs of an adverse judgment would not be allowable, it stated that any settlement agreement "need only be discussed briefly, as the issue is squarely ad-

139 *Tecom*, 566 F.3d at 1040.
140 *Id.*
141 *Id.*
142 These requirements are: (1) "Reasonableness;" (2) "Allocability;" (3) "Standards promulgated by [the CASB], if applicable, otherwise, [GAAP] and practices appropriate to the circumstances;" (4) "Terms of the contract;" and (5) "Any limitations set forth in [subpart 201-2]." FAR 31.201-2; *see also supra* Part I.B.
143 *Tecom*, 566 F.3d at 1041.
144 *Id.*
145 *Id.* (citing Boeing N. Am., Inc. v. Roche, 298 F.3d 1274, 1285-89 (Fed. Cir. 2002)).
146 *Id.*
147 *Id.* at 1043.
148 *Id.* at 1044 (third and fourth alterations in original) (quoting FAR 31.201-2 (2008)).

dressed by [its] decision in *Boeing*."[149] The majority then held that costs for attorneys' fees and settlement were only allowable if the contractor could prove the settled suit had "very little likelihood of success on the merits."[150] It reasoned that the policy of the FAR could not be "to permit a contractor who is certain to lose on the merits to defeat disallowance by the simple expedient of settling before the litigation is concluded."[151]

C. *Judge Lourie's Dissenting Opinion*

Dissenting, Judge Alan Lourie argued against extending *Boeing* to cases not involving contractor fraud.[152] Although the settlement agreement at issue in *Boeing* related to a shareholder derivative suit and was based on a breach of fiduciary duty, four out of the five instances of underlying misconduct in the derivative suit involved fraud or false statements concerning government contracts.[153] Additionally, Judge Lourie noted that the "very little likelihood of success on the merits" standard was premised on FAR section 31.205-47(c)(2), a provision that applies to settlements of suits brought under the False Claims Act.[154] Thus, the *Boeing* court's extension of this FAR principle rested on the analogy between a qui tam suit and a shareholder derivative suit if both suits were based on the same underlying fraud-related conduct.[155] Judge Lourie found the *Tecom* extension improper because of the different factual natures of the cases, specifically the lack of any nexus between the allegations of the former employee and any such fraud against the government.[156] Finally, Judge Lourie warned that—aside from being difficult to determine—the "little likelihood of success" standard would lead to a decrease in the settlement of disputes and, consequently, to an increase in litigation.[157]

III. THE MAJORITY MISSES THE MARK

The majority's decision reverses decades of government contracts precedent. This Part analyzes the *Tecom* decision by focusing on two points. Section III.A questions the *Tecom* court's analysis of *Dade*, including the conclusion that costs resulting from a contract breach are not allow-

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149 *Tecom*, 566 F.3d at 1045.
150 *Id.* at 1046.
151 *Id.*
152 *Id.* at 1048 (Lourie, J., dissenting).
153 *Id.* at 1047.
154 *Id.* at 1048.
155 *Tecom*, 566 F.3d at 1048.
156 *Id.*
157 *See id.*

able. Section III.B analyzes the inappropriate expansion of the "very little likelihood of success on the merits" standard to third-party litigation in non-fraud contexts.

A. *The Mischaracterization of* Dade[158]

By misconstruing *Dade*, the *Tecom* majority overturned decades of settled government contract law regarding the allowability of costs and effectively created a new cost principle.[159] The *Tecom* majority asserted that *Dade* stands for the proposition that "costs resulting from a breach of a contractual obligation are not allowable costs under [a standard government] contract."[160] The court's discussion of *Dade*, however, fails to describe accurately the contract terms, the events triggering the litigation, or the actual holding in that case.[161] In doing so, the *Tecom* court misconstrued the law and reached an unprecedented decision.

The specific contract provision in *Dade*, which vested broad discretion in the contracting officer to determine allowability, was essential to the court's holding.[162] The *Tecom* court posited that the term *generally* made costs allowable.[163] This, however, was not an accurate description of this contract-*specific* clause.[164] Instead of focusing on this contractual provision, the *Tecom* court claimed that the holding of *Dade* was that costs of satisfying an adverse judgment that would alone constitute a breach of contract would, as a matter of law, be unallowable.[165] Notably, however, the *Dade* court limited itself to hold that "the [Board of Contract Appeals] was free to reach these conclusions[—that the contractor failed to prove, among other things, that its actions were committed in performance of the contract—] and was not required, on the record before it, to decide in the contractor's favor."[166] Specifically, the court emphasized the unique factors of the case and its standard of review and noted that there was a judicial determination of willful and malicious wrongdoing by the contractor.[167]

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158 This Note does not explore the flawed regulatory history, as described in the *Tecom* opinion. *See* Johnson et al., *supra* note 68 (discussing the regulatory history behind the *Tecom* decision).

159 *Id.*

160 *Tecom*, 566 F.3d at 1043.

161 Johnson et al., *supra* note 68.

162 Dade Bros., Inc. v. United States, 325 F.2d 239, 239-40 (Ct. Cl. 1963).

163 *Tecom*, 566 F.3d at 1043.

164 *Dade Bros.*, 325 F.2d at 239-40. The contract provided that "if the Contracting Officer determined that the contractor should defend 'litigation in connection with claims of third parties arising out of the performance of the contract,' the contractor would be entitled to reimbursement." *Id.* at 239.

165 *Tecom*, 566 F.3d at 1044.

166 *Dade Bros.*, 325 F.2d at 240.

167 *Id.* at 239; *see also supra* Part I.C.

Further undermining the *Tecom* majority's analysis, the Contracting Officer in *Dade* actually approved payment for litigation and adjudication costs for a majority of the counts, such as the failure to pay overtime wages as specified in the contractor's union agreement, despite the fact that the contract specifically required the contractor to "abide by all the terms and conditions of the Union Agreement."[168] Thus, contrary to the *Tecom* majority's description of the case, the *Dade* court actually took no issue with the reimbursement of costs for litigation and adverse adjudication arising out of conduct that breached the particular contract.

Another curious feature of the *Tecom* opinion was the complete omission of post-*Dade* decisions applying *Dade* to similar suits. *Ravenna Arsenal, Inc.*,[169] *Hayes International Corp.*,[170] and *Hirsch Tyler Co.*[171] all stand for the proposition that costs are not unallowable merely because they are incurred as a result of third-party litigation, even when the litigation arises out of conduct that, if proven, would violate the terms of the contract.

In *Ravenna Arsenal*, the Armed Services Board of Contract Appeals ruled that attorneys' fees and settlement costs resulting from the settlement of an employee suit alleging Title VII violations were allowable costs.[172] The Equal Employment Opportunity Commission found "reasonable cause" to determine that the contractor had engaged in practices prohibited by Title VII, in direct contravention of specific contract terms requiring non-discrimination in employment.[173] Denying wrongdoing, the company settled the employee suits.[174] It subsequently sought reimbursement for attorneys' fees and settlement costs.[175] Noting that there was no showing of contractor wrongdoing, nor a demonstration of unreasonableness with regard to the costs, the Board held that the costs were allowable.[176]

In *Hayes*, the Armed Services Board of Contract Appeals held that attorneys' fees were allowable even though they resulted from alleged Civil Rights Act violations.[177] The allegations, which reached finality when the parties entered into a consent decree, included conduct that would have violated the terms of the government contract.[178] The government cited *Dade* as supporting the proposition that legal fees in defense of such suits, by their very nature, were unreasonable and, thus, unallowable.[179] Yet the

168 Dade Bros., Inc., No. 980, 1957 WL 514 (ENGBCA Apr. 4, 1957).
169 ASBCA No. 17802, 74-2 BCA ¶ 10,937 (Oct. 31, 1974).
170 ASBCA No. 18447, 75-1 BCA ¶ 11,076 (Jan. 28, 1975).
171 ASBCA No. 20962, 76-2 BCA ¶ 12,075 (Aug. 23, 1976).
172 *Ravenna Arsenal*, 74-2 BCA ¶ 10,937.
173 *Id.*
174 *Id.*
175 *Id.*
176 *Id.*
177 Hayes Int'l Corp., ASBCA No. 18447, 75-1 BCA ¶ 11,076 (Jan. 28, 1975).
178 *See id.*
179 *Id.*

Board refused to apply *Dade*, distinguishing it on two grounds.[180] First, the Board noted that *Dade* involved a judicial determination of wrongdoing as opposed to a consent decree.[181] Notably, the Board expressly refused to base its decision on the "appearance or implication" of wrongdoing.[182] Secondly, the Board noted that *Dade* involved willful and malicious conduct.[183] It further indicated that the intent of the actors was relevant in determining whether costs are allowable, noting that "disagreements among honorable men occur and that the resolution of these disagreements often includes resort to litigation."[184] In short, the Board held that the costs were allowable because they were reasonable, allocable, and not made unallowable by any specific contract term or the default cost principles in the ASPR.[185]

The facts of *Hirsch Tyler* are perhaps most damning to the *Tecom* court's account of settled law under *Dade*. The Hirsch Tyler Company had a cost-reimbursement contract with the government.[186] The contract contained an equal opportunity clause that prohibited the contractor from "discriminat[ing] against any employee or applicant for employment because of race, color, religion, sex, or national origin."[187] The contract further provided that costs would be allowable if they satisfied the regulations and were not "expressly excluded from payment by the terms of the contract itself."[188] The contractor was ultimately found liable for the very discriminatory practices expressly prohibited under the terms of the government contract.[189] Notably, however, the Board held that both attorneys' fees and the expenses of satisfying the civil judgment were allowable.[190] The Board reasoned that the "determination of allowability must be made on a case-by-case basis" and that it should be "controlled by considerations of the reasonableness of the costs in nature and amount and whether their reimbursement is otherwise prohibited by some exclusionary cost principle."[191]

It is apparent that the *Tecom* majority failed to accurately capture *Dade*'s holding. It glossed over the unique factors of the case: a judicial determination of wrongdoing by willful and malicious conduct coupled with broad discretion vested in the contracting officer with regard to allowability under a specific contractual provision. Further, the *Tecom* majority failed to mention that the contracting officer in *Dade* had no problem what-

180 *Id.*
181 *Id.*
182 *Id.*
183 *Hayes*, 75-1 BCA ¶ 11,076.
184 *Id.*
185 *Id.* The ASPR is one of the predecessors to the modern FAR. *See supra* Part I.A.
186 Hirsch Tyler Co., ASBCA No. 20962, 76-2 BCA ¶ 12,075 (Aug. 23, 1976).
187 *Id.*
188 *Id.*
189 *Id.*
190 *Id.*
191 *Id.*

soever with reimbursing the contractor for the costs of litigation for much of the employee suits, which would in fact independently breach the contract. Commentators have noted that the *Tecom* majority relied on a faulty regulatory history for the "principle" it derived from *Dade* (now FAR section 31.201-2), perhaps explaining how the Federal Circuit could reach such a misguided decision.[192]

Cost principles for government procurement are set forth in FAR Part 31.[193] However, the *Tecom* majority, using misplaced reliance on *Dade* and omitting any reference to other relevant precedent,[194] determined that such principles were insufficient to deal with what Congress or others may construe as a "prudent business decision"[195] to settle employment disputes rather than expend time and resources on costly litigation. In effect, it created a new cost principle that countered the otherwise settled law that had survived in federal courts for the past half-century.

B. *The Unprecedented Extension of* Boeing

The *Tecom* court's extension of *Boeing* to private litigation—having no nexus to underlying fraud against the government—is unsettling. First, the standard set by the Federal Circuit in *Boeing*,[196] extending the "very little likelihood of success" standard beyond the regulatory text, was deemed appropriate only in its unique factual context, and there is no indication that the Federal Circuit intended to extend it beyond that context.[197] Specifically, in *Boeing*, the Federal Circuit did not allow the reimbursement of legal defense and settlement costs when the contractor was sued for conduct arising out of its alleged fraud and false statements perpetrated against the government.[198] In contrast, the *Tecom* court disallowed the reimbursement of legal defense and settlement costs when the plaintiff merely alleged that Tecom had committed discriminatory employment practices, and the company settled the litigation when it was clear that the costs of settlement would be far less than the best-case scenario in successfully litigating the merits. Secondly, *Tecom*'s extension of the *Boeing* standard is directly con-

192 For a detailed analysis on this point, see Johnson et al., *supra* note 68.

193 FAR pt. 31 (2009).

194 *Hirsch Tyler*, 76-2 BCA ¶ 12,075; *see also* Ravenna Arsenal, Inc., ASBCA No. 17802, 74-2 BCA ¶ 10,937 (Oct. 31, 1974).

195 *Hirsch Tyler*, 76-2 BCA ¶ 12,075.

196 Interestingly, the *Boeing* decision was authored by Judge Dyk (who wrote for the majority in *Tecom*) and was joined by Judge Lourie (who wrote the dissent in *Tecom*). *See* Boeing N. Am., Inc. v. Roche, 298 F.3d 1274, 1276 (Fed. Cir. 2002).

197 *Id.* at 1288.

198 *Id.*

trary to the government's policy that contract cost principles should be clear and explicit.[199]

Following its determination that the costs of an adverse judgment, if found, would not be allowable, the *Tecom* court stated that the costs of any settlement agreement "need[ed] only be discussed briefly, as the issue is squarely addressed by [its] decision in *Boeing*."[200] In other words, the *Tecom* court claimed that the *Boeing* standard—extending the "very little likelihood of success" test—controlled in this case. However, the *Boeing* court had limited its holding to "suits in [its] context," so an assertion by the *Tecom* court that the issue was "squarely" addressed is peculiar.[201] First, the "very little likelihood of success on the merits" language is derived from FAR section 31.205-47(c)(2),[202] a provision addressing costs resulting from, and in connection with, fraud against the government. This provision was applicable to the facts of *Boeing* because the court held that those costs were "related" to a fraud charge.[203] In contrast to the facts of *Tecom*, there is no such regulation addressing the disallowance of costs for either employment discrimination judgments or employment discrimination settlements.

The court's reasoning may have been guided by its overarching policy concerns: "It cannot be the policy of the FAR to permit a contractor who is certain to lose on the merits to defeat disallowance by the simple expedient of settling before the litigation is concluded."[204] Its remedy, then, was to extend the rule from *Boeing* to "prevent[] such an outcome."[205] The majority provides a false choice rather than conceding that there may be some middle ground between a situation where the contractor is "certain to lose" and where the contractor must sustain the burden of proof in showing that some underlying litigation had "very little likelihood of success on the merits." The majority created a new rule, displacing the traditional risk allocation construct of cost-reimbursement contracts.[206]

The *Tecom* majority lacked any legal precedent for its decision. It patently erred in assessing regulatory history.[207] It misconstrued the vital holding of *Dade*.[208] It omitted other relevant decisions.[209] It ignored Congress's

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199 *See* 10 U.S.C. § 2324(f)(1) (2006) (stating that FAR "shall contain provisions on the allowability of contractor costs . . . [and that s]uch provisions shall define in detail and in specific terms those costs which are unallowable, in whole or in part, under covered contracts").

200 Geren v. Tecom, Inc., 566 F.3d 1037, 1045 (Fed. Cir. 2009).

201 *Boeing*, 298 F.3d at 1288.

202 FAR 31.205-47(c)(2) (2009).

203 *Boeing*, 298 F.3d at 1287-89.

204 *Tecom*, 566 F.3d at 1046.

205 *Id.*

206 *See supra* Part I.A.

207 Johnson et al., *supra* note 68.

208 *See supra* Part III.A.

209 *See supra* Part III.A.

stated intent for contract cost principles.[210] In effect, *Tecom* created major problems for contractors.

IV. THE *TECOM* FALLOUT

In addition to *Tecom*'s unsound legal reasoning, the Federal Circuit's application of a per se rule of unallowability for contract breaches will lead to many negative practical effects. The potential implications of *Tecom* are vast and far-reaching. First, this Part explores the "very little likelihood of success" standard—an amorphous inquiry that rests on very little precedent and provides very little guidance for contracting actors—and highlights the increased risk faced by contractors for projects as a result of *Tecom*. Second, this Part identifies the potential that *Tecom* will disallow all costs of litigation and settlement, as it creates the potential for a perverse "Catch-22" for contractors. Lastly, this Part explores the possibility of a specific mitigation strategy for settlement, ultimately concluding that such a process is unlikely to occur and that the contractors will likely be unable to avoid litigation while receiving reimbursement.

A. *The "Very Little Likelihood of Success on the Merits" Litigation Conundrum*

Following *Tecom*, a contractor seeking reimbursement for attorneys' fees or settlement costs stemming from a common third-party legal action faces an uphill battle. In addition to meeting the typical requirements for allowability, the contractor bears the burden of proving that the underlying suit had "very little likelihood of success on the merits."[211]

To determine whether the cost of a settlement is allowable, a contracting officer must apply FAR standards.[212] Yet the application of even a clear standard can be vexing for both contractors and the government. Most contracting officers are not trained in specialty areas of the law that pertain to the settlement, such as employment discrimination.[213] Further, contracting officers often lack any expertise to determine whether a particular suit is meritorious.[214] Lastly, a factual investigation into the likelihood that a settled lawsuit was meritorious may be difficult or infeasible under certain

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210 *See supra* note 199 and accompanying text.

211 *See supra* Part III.B.

212 *See* FAR pt. 31 (2009).

213 Gregory R. Bockin, *Who's on First—Do Contracting Officers Decide the Merits of Employment Discrimination Cases Filed Against Government Contractors After* Boeing v. Roche*?*, ARMY LAW., Oct. 2003, at 1, 12.

214 *Id.*

circumstances, as was the case in *Tecom*.[215] These same difficulties would trouble contractors, as well as all other parties involved in the lawsuit or settlement, because the highly factual nature of each underlying claim presents a ripe opportunity for reasonable minds to differ.[216]

The application of a well-defined rule may be difficult or infeasible, but the hazy "very little likelihood of success on the merits" standard further exacerbates such problems. In short, it is unclear what the standard actually means. Fruitless searches through statutes, regulations, and case law show the absence of any guidance on how to apply the words "very little likelihood of success on the merits" in any meaningful way.[217] The lack of a bright-line rule is understandable, but the complete absence of any coherent framework makes this rule unpredictable and unworkable. This contravenes Congress's intent to have clear and express contract cost principles.[218] Further, no baseline case exists where a contractor actually made this showing, indicating a presumption of disallowance.

As the "very little likelihood of success on the merits" standard is a speculative, imprecise, and unclear inquiry, its practical effect is to force contractors to perform a risk-return calculation for the costs of litigation and settlement without a clear indication of whether reimbursement will follow. The *Tecom* court justified the outcome on the statement that the "policy" of the FAR "cannot be . . . to permit a contractor who is certain to lose on the merits to defeat disallowance by the simple expedient of settling before the litigation is concluded."[219] Yet this "certain to lose" standard lies at one extreme end of the spectrum, whereas the "very little likelihood of success" standard lies on the other. The *Tecom* majority thus did what Congress and the FAR Council did not: place the burden on the contractor to affirmatively disprove allegations in non-fraud contexts.

This lack of clarity is troubling. Specifically with regard to unsettled or confusing cost principles, including legal or other professional costs, Congress intended the FAR "to define the specific categories of costs that are unallowable."[220] Congress unambiguously articulated the policy that government contract cost principles should be clear and explicit.[221] Unfor-

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215 *See id.*

216 *See id.* at 11-12.

217 For example, a case surviving a motion to dismiss but losing on summary judgment might be construed as having "little likelihood of success" by virtue of its pre-trial adjudication, yet deemed to have more than "*very* little likelihood" because it survived a motion to dismiss. However, there is no authoritative guidance for this type of scenario.

218 *See* 10 U.S.C. § 2324(f)(1) (2006) (mandating that FAR include "provisions on the allowability of contractor costs" and that "such provisions shall define in detail and in specific terms those costs which are unallowable, in whole or in part, under covered contracts").

219 Geren v. Tecom, Inc., 566 F.3d 1037, 1046 (Fed. Cir. 2009).

220 Bill Strong Enters. v. Shannon, 49 F.3d 1541, 1548 (Fed. Cir. 1995), *overruled on other grounds by* Reflectone, Inc. v. Dalton, 60 F.3d 1572 (Fed. Cir. 1995).

221 *See* 10 U.S.C. § 2324(f)(1).

tunately, the *Tecom* court created a fuzzy standard in direct contravention of these aims. Further, a simpler, less opaque, and clearly defined standard already exists: reasonableness under FAR section 31.201-3.[222]

B. *The Reasonableness "Catch-22"*

One of the five elements for allowability under a government contract is reasonableness.[223] FAR section 31.201-3(a) states that "[a] cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."[224]

The fact pattern in *Tecom* provides a useful application of a possible "Catch 22" of settlement costs and their allowability. In *Tecom*, the costs of a successful suit were estimated at $300,000, while the cost of attorneys' fees and settlement were $146,163.[225] Presumably, a "prudent person in the conduct of competitive business" would likely abandon litigation in favor of a less costly, less risky, and less time-consuming settlement alternative. Therefore, a contractor acting in a "reasonable" manner pursuant to the FAR would settle the litigation *regardless of the merits of the underlying suit*. In a competitive marketplace with razor thin profit margins,[226] reasonable conduct is essential for those companies wishing to survive.

However, this reasonable expenditure could only be reimbursed if the contracting officer determined that the underlying suit satisfied the "very little likelihood of success" standard. Putting aside issues relating to the dubious inquiry and possible misapplication by contracting officers, contractors are sure to face circumstances in which litigating the merits would be unreasonable, per the text of the FAR, while those same cases fall short of the stringent "very little likelihood of success" standard. When it would be unreasonable for a contractor to litigate a claim instead of settle, yet the contractor lacks sufficient proof (or is prevented from disclosing the proof)[227] to satisfy the "very little likelihood of success" standard, the contractor finds its fee eroded by settlement and/or litigation costs. Still, even if the contractor litigates to finality and achieves a favorable adjudication, the costs may be unallowable as unreasonable because the contractor should

222 *See* Nash & Cibinic, *supra* note 120.

223 FAR 31.201-2 (2009). A contractor must prove that a particular cost meets the following five elements for reimbursement as an allowable cost: (1) "Reasonableness;" (2) "Allocability;" (3) "Standards promulgated by [the CASB], if applicable, otherwise, [GAAP] and practices appropriate to the circumstances;" (4) "Terms of the contract;" and (5) "Any limitations set forth in [FAR]." *Id.*

224 *Id.* § 31.201-3(a).

225 Geren v. Tecom, Inc., 566 F.3d 1037, 1039-40 (Fed. Cir. 2009).

226 The appropriate level of profit for a contractor depends on a myriad of factors, including the project risk. *See* FAR 315.404-4(d)(3)(i). Because cost-reimbursement contracts generally have less cost risk than fixed-price contracts, the allowable profit is significantly less. *Id.*

227 For example, a non-disclosure agreement may be part of a settlement agreement.

have settled. Thus, *Tecom* has shifted the burden of nearly all third-party litigation to contractors.

A second possible scenario obtains the same undesirable results for contractors, yet does so in a seemingly opposite way. A contracting officer may determine[228] that it is per se unreasonable to settle any litigation that has "very little likelihood of success on the merits;" that is, a contractor that could affirmatively disprove any allegations of wrongdoing under such a stringent standard would not be acting reasonably if it settled baseless claims. Under that interpretation of the new *Tecom* standard, costs arising out of a settled lawsuit alleging contractor violations of a government contract would, in effect, never be allowable.

The extent of the *Tecom* fallout is not yet fully known. However, *Tecom* strongly suggests that contractors can now easily be precluded from recovering costs arising out of third-party litigation under a wide range of circumstances. This is significant because if a contractor knows that it will be reimbursed for its costs incurred through the performance of a contract, its cost risk is low, and, consequently, it can price the contract with a low fee contingency.[229] However, if contractors are unlikely to be reimbursed, then they will be forced to pay for third-party litigation out of pocket, which will in turn harm the government because fewer contractors will be willing to bid for government contracts.

C. *Settlement Agreements*

Arguably, a contractor could minimize the difficulty of meeting the *Tecom* burden by having each plaintiff sign an affidavit tending to disprove the allegations, such as one stating that the allegations had "very little likelihood of success on the merits" or that the settlement was in no way merit-driven. However, it is unclear whether this strategy would be successful.

First, as previously discussed, the "very little likelihood of success" standard is unclear: if neither contracting officers nor contractors know what the standard means or how it will be applied, a plaintiff's counsel is also unlikely to be able to identify the relevant standards and then apply them.[230] Further, since the standard is based on what the *contractor* would have the burden of proving,[231] the plaintiff and counsel would likely lack a credible basis for making such an affirmation.

Second, the plaintiff's counsel would face its own Catch-22: if it admits that there was no underlying basis for the lawsuit at issue, the counsel

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228 Alternatively, a court may rule that it is per se unreasonable.

229 CIBINIC & NASH, *supra* note 27, at 2.

230 *See supra* Part IV.A.

231 *See supra* Part III.B.

may subject itself to sanctions.[232] Moreover, a plaintiff might be reluctant to file suit and then subsequently claim that there was no factual basis for its allegations. A plaintiff and his counsel would, in effect, have to admit that the initial claim was factually baseless or otherwise frivolous if, as part of any settlement agreement, they provided language that could help the contractor in obtaining reimbursement.[233]

Lastly, it is unclear how contracting officers would interpret such statements. Would such a signed statement conclusively show that the underlying allegations had "very little likelihood of success"? What if the contracting officer had reason to doubt the validity or the truthfulness of the statements, perhaps taking it to the "little likelihood of success" threshold, but failing to reach the overwhelming "very little likelihood" standard that was imposed by the *Tecom* court? A court or contracting officer could, arguably, construe such statements as prima facie evidence that the underlying allegations had "very little likelihood of success on the merits." However, that too would simply be another judicial reconstruction of an otherwise clear and unambiguous regulation.[234] Further, contracting officers could even construe the very *existence* of a contractor settlement as prima facie evidence that the underlying suit had some potential merit.[235] The questions with regard to application of this new cost principle, and its consistency, remain open and unanswered. The difficulties with interpreting and applying the standard, the dilemmas likely facing plaintiffs and counsel at settlement, and the contracting officer's challenge in determining what effect such statements would have on the "very little likelihood of success" standard make the effect of settlement agreements in such situations far from certain.

CONCLUSION

The *Tecom* court mischaracterized a crucial holding, thereby creating a new principle for allowability. Accordingly, *Tecom* has created confusion and uncertainty as to whether costs are reimbursable and, in doing so, has created a rule in direct contravention of Congress's stated aims. There exists no cost principle standing for the proposition that costs arising out of conduct that would constitute a breach of contract are automatically unallowable. In contrast, established government contracts precedent shows that the critical factor for allowability should be based on reasonableness. Further, the court applied a wholly inapplicable standard by imposing the "very little likelihood of success on the merits" test—intended for and written into

232 FED. R. CIV. P. 11.
233 *See supra* Part IV.A.
234 *See supra* Part III.B.
235 *See supra* Part IV.B.

a statute dealing solely with costs arising out of fraud against the government—to any third-party litigation. In so doing, *Tecom* harmed contractors by precluding them from obtaining reimbursement for settlement and litigation costs that would otherwise be, and previously were, allowable. This failure warrants action by Congress or the FAR Council through a regulatory amendment.