

# GOVERNMENT CONTRACT COSTS, PRICING & ACCOUNTING REPORT<sup>®</sup>



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The Editors

**FEATURE ARTICLES**

¶ 1

**Estoppel Against The Government: What Does “Affirmative Misconduct” Have To Do With It?**

*By Karen L. Manos<sup>1</sup>*

**T**wice in the last three years, the Federal Circuit invoked the doctrine of estoppel in the context of a Government contract dispute. Both times, the court stated in dicta, that for estoppel to apply against the Government, the contractor must

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# Government Contract COSTS, PRICING & ACCOUNTING REPORT

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**Karen L. Manos, Editor-in-Chief**

Gibson, Dunn & Crutcher LLP  
Tel: 202.955.8536, Fax: 202.530.9533  
*kmanos@gibsondunn.com*

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show “affirmative misconduct” in addition to the traditional elements of estoppel.<sup>2</sup> Decisions by the Court of Federal Claims and agency boards of contract appeals, including, most recently, the ASBCA in *United Technologies Corp., Pratt & Whitney*, have started applying this dicta as if “affirmative misconduct” were now an established element of estoppel.<sup>3</sup> But is “affirmative misconduct” really a prerequisite for applying estoppel against the Government in the context of a Government contract dispute? And, if so, how does that square with the long line of cases, including binding precedent by the Federal Circuit and its predecessor courts, applying estoppel against the Government without any mention of affirmative misconduct?

Part of the blame may lie with the Government contracts bar for failing to heed the sound admonition of Professors Nash and Cibinic that equitable estoppel “is not a panacea and should be used only where the requisite elements are present.”<sup>4</sup> But a more fundamental problem is the failure—by both litigants and Government contracting tribunals—to recognize that “affirmative misconduct” was adopted as a circumstance justifying an exception to the familiar rule that the Government is not bound by the *unauthorized* acts of its agents; it has no applicability whatsoever to cases involving *authorized* acts.

### The Government Is Bound by the Authorized Acts of Its Agents

The Supreme Court long has held that “[d]ifferent rules prevail in respect to the acts and declarations of public agents from those which ordinarily govern in the case of mere private agents.”<sup>5</sup> In particular, while private parties may in many circumstances be bound by the unauthorized acts and declarations of their agents, the Government is not bound by the unauthorized acts of its agents.<sup>6</sup> An important, but occasionally overlooked, corollary to this maxim is that the Government *is* bound by the acts, omissions and declarations of its agents acting within the scope of their authority.<sup>7</sup> For example, in *Hollerbach v. U.S.*, an early differing site conditions case, the Supreme Court refused to permit the Government to assert a position

contrary to an affirmative representation made in the contract.<sup>8</sup>

These rules apply regardless of whether the Government is acting in its proprietary or sovereign capacity. The difference is that when the Government acts in its proprietary capacity, its agents have authority to waive or modify contractual provisions.<sup>9</sup> For example, the Government has been held to have waived its contractual rights in many circumstances, such as when the contractor relies on the Government’s delay in terminating a contract for default<sup>10</sup> or the CO’s apparent acceptance of the contractor’s non-specification work.<sup>11</sup> Likewise, under the rule of finality, the Government is bound by the contractual acts of its authorized officials even if, in hindsight, the official’s decision was erroneous.<sup>12</sup> These principles are consistent with the Supreme Court’s repeated admonition that “[w]hen the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals.”<sup>13</sup>

Until relatively recently, Government contract estoppel cases fit neatly within these well-settled principles. That is, the Federal Circuit and its predecessor courts consistently applied estoppel against the Government when the course of conduct or representation on which the plaintiff relied was by an officer or agent of the U.S. acting within the scope of his or her authority, and the plaintiff established the four “traditional” elements of estoppel: (1) the Government knew the facts, (2) the Government intended that its conduct be acted upon or acted in such a way that the contractor had a right to believe the Government so intended, (3) the contractor was not aware of the true facts and (4) the contractor detrimentally relied upon the Government’s conduct.<sup>14</sup> In an extension of estoppel principles, both the Court of Claims and agency boards of contract appeals also held that the Government cannot retroactively disallow costs, or retroactively disapprove a contractor’s cost accounting practices when the contractor detrimentally relied on the Government’s acquiescence or approval.<sup>15</sup> As recently as March 2002, the Armed Services Board of Contract Appeals held that a contractor

is entitled to prior authoritative notice before the Government may start disallowing a cost that previously was consistently allowed.<sup>16</sup>

In applying these settled principles prior to the Federal Circuit's dictum in *United Technologies Corp.*, none of the Federal Circuit or Court of Claims cases—which are supposed to be binding precedent<sup>17</sup>—required a showing of, or even mentioned, affirmative misconduct. Federal Circuit Rule 35 provides that only the en banc court may overrule a binding precedent.<sup>18</sup>

### The Government Is Not Bound by the Unauthorized Acts of Its Agents

The Supreme Court cases that have considered—but never applied—estoppel against the Government have typically involved claims for public benefits of one sort or another where the claimant detrimentally relied on a misrepresentation by a Government official. In marked contrast to the typical situation in a Government contracts case, the Government officials on whose declarations the plaintiffs in these cases relied had no delegated authority, and the application of estoppel would have barred the Government from enforcing federal law by requiring the Government to either pay money in violation of a statute, or grant a public benefit contrary to statutory eligibility criteria. In that context, the Supreme Court has consistently and understandably refused to apply estoppel against the Government. As the Court explained in *Heckler v. Community Health Svcs.*, 467 U.S. 51, 60 (1984), “When the government is unable to enforce the law because the conduct of its agents has given rise to an estoppel, the interest of the citizenry as a whole in obedience to the rule of law is undermined. It is for this reason that it is well settled that the government may not be estopped on the same terms as any other litigant.”

However, even in that context—when applying estoppel would result in the Government being bound by the unauthorized acts of its agents—the Supreme Court has refused to establish a per se rule that estoppel never applies against the Gov-

ernment. The Court came closest to establishing a per se rule in *Office of Personnel Management v. Richmond*,<sup>19</sup> involving a disabled former Government employee who relied on inaccurate advice from a Navy employee relations official about how much income he could receive and still continue to draw disability payments. Relying on the erroneous advice, Richmond accepted additional part-time work, earning enough to become disqualified for disability payments. He appealed OPM's denial of benefits, arguing that OPM was estopped from denying benefits by the erroneous advice of the employee relations official. The Supreme Court rejected Richmond's argument, but declined to establish a blanket rule that estoppel never applies against the Government. Rather, the Court expressly limited its holding to claims for money from the Public Treasury, stating that, for those claims, the Appropriations Clause of the Constitution provides an “explicit rule of decision.”<sup>20</sup> In so holding, the Court specifically declined to address whether there were any “extreme circumstances that might support estoppel in a case not involving the payment from the Treasury.”<sup>21</sup> Importantly, however, the *Richmond* decision makes clear that it addresses the application of estoppel when the agent was *not* acting within the scope of his authority. The Court stated:

From our earliest cases, we have recognized that equitable estoppel will not lie against the Government as it lies against private litigants. In *Lee v. Munroe & Thornton*, 7 Cranch 366, 3 L.Ed. 373 (1813), we held that the Government could not be bound by the mistaken representations of an agent *unless it were clear that the representations were within the scope of the agent's authority.*

\* \* \* \*

The principles of these and many other cases were reiterated in *Federal Crop Ins. Corporation v. Merrill*, 332 U.S. 380 (1947), the leading case in our modern line of estoppel decisions.<sup>22</sup>

### Genesis of “Affirmative Misconduct” Language

The “affirmative misconduct” language stems from a series of decisions involving applications

for U.S. citizenship, in which the Supreme Court expressly left open the question of whether affirmative misconduct could estop the Government from enforcing immigration laws.<sup>23</sup> As the Court in *Richmond* observed:

The proposition about which we did not “stop to inquire” in [the first of these immigration cases] has since taken on a life of its own. Our own opinions have continued to mention the possibility, in the course of rejecting estoppel arguments, that some type of “affirmative misconduct” might give rise to estoppel against the Government.<sup>24</sup>

While only mentioned as a possibility in the Supreme Court’s opinions, all of the federal circuit courts of appeals have concluded that affirmative misconduct *can* give rise to estoppel against the Government for the unauthorized acts of its agents. However, apart from the Federal Circuit’s recent dicta, no federal appellate court has suggested, much less held, that affirmative misconduct is necessary to establish estoppel when the Government officials acted within the scope of their authority. Moreover, at least three federal circuits have expressly recognized that estoppel routinely applies against the Government when (1) the traditional elements of estoppel are met, (2) the Government is acting in its proprietary rather than sovereign capacity and (3) the Government agents acted within the scope of their authority.<sup>25</sup>

### Where Did the Federal Circuit Go Wrong?

The Federal Circuit has considered estoppel in the context of a Government contracts dispute in four cases since *Richmond*. In *JANA, Inc. v. U.S.*, a decision issued shortly after *Richmond*, the Federal Circuit questioned whether “the defense of estoppel is still available against the government” and whether the Federal Circuit’s “contract precedent prior to *Richmond* is still valid.”<sup>26</sup> The *JANA* court ultimately did not decide this question because the court found that the plaintiff failed to satisfy even the pre-*Richmond* “contract precedent.”<sup>27</sup> Two years later in *Burnside-Ott Aviation Training Ctr, Inc. v. U.S.*, the Federal Circuit seemed to recognize the continued vitality of estoppel

in Government contract cases by distinguishing between claims for payment of money contrary to a statutory appropriation—or entitlement contrary to statutory eligibility criteria—and claims or defenses based solely on contract.<sup>28</sup> In reversing the lower court’s decision that estoppel can never apply against the Government for monetary claims, the Federal Circuit held that, because the contractor’s claim was based on its Government contract rather than on a statutory entitlement, “neither the holding nor analysis in *Richmond* is applicable to this case, and *Burnside-Ott*’s equitable estoppel claim is not barred as a matter of law because of *Richmond*.”<sup>29</sup>

In *Rumsfeld v. United Technologies Corp.*, the Federal Circuit stretched to address an estoppel issue not yet considered by the ASBCA and gratuitously advised the board that on remand:

Adjudication of the estoppel issue must proceed under the “well settled [rule] that the Government may not be estopped on the same terms as any other litigant.” *Heckler v. Cmty. Health Servs. of Crawford County, Inc.*, 467 U.S. 51, 60 (1984). Beyond a mere showing of acts giving rise to an estoppel, [the contractor] must show “affirmative misconduct [as] a prerequisite for invoking equitable estoppel against the government.” *Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000) (emphasis added).<sup>30</sup>

The Federal Circuit repeated this assertion, once again in dicta, in *United Pacific Ins. Co. v. Roche*, stating, “Our own precedent dictates ‘that if equitable estoppel is available at all against the government some form of affirmative misconduct must be shown in addition to the traditional requirements of estoppel.’ *Zacharin v. U.S.*, 213 F.3d 1366, 1371 (Fed. Cir. 2000).”<sup>31</sup>

*Zacharin*, the precedent on which both *United Technologies* and *United Pacific Ins.* rely, is not a Government contracts case and did not purport to overrule the Federal Circuit’s “contract precedent.” *Zacharin* was an appeal of a Court of Federal Claims decision dismissing a federal employee’s patent infringement suit on the basis that the patented invention was on sale more than one year prior to the filing of the patent application. The employee argued unsuccessfully

that the Government should be estopped from raising the on-sale bar because the Army attorneys who filed his patent application were aware of the sales, but filed the application anyway. The lower court rejected the employee's argument for two reasons: (1) the plaintiff failed to establish the traditional elements of estoppel; and (2) in any event, a claim for money contrary to a statute is barred by *Richmond*. The Federal Circuit agreed with the lower court's holding that the Government may not be estopped from invoking the on-sale bar as a defense, but for the different reason that there was no evidence of affirmative misconduct. The court stated:

While the Supreme Court has not squarely held that affirmative misconduct is a prerequisite for invoking equitable estoppel against the Government, this court has done so, *see Henry v. United States*, 870 F.2d 634, 637 (Fed. Cir. 1989); *Hanson v. Office of Personnel Management*, 833 F.2d 1568, 1569 (Fed. Cir. 1987), as has every other court of appeals, *see Tefel v. Reno*, 180 F.3d 1286, 1303 (11th Cir. 1999) (citing cases).<sup>32</sup>

Army attorneys filing a patent application for a civil servant plainly have no authority to modify or waive the statutory patent requirements. The two Federal Circuit decisions relied on by the *Zacharin* court similarly involved agents with no delegated authority. In *Henry v. U.S.*, the Federal Circuit held that the Internal Revenue Service was not estopped from raising a statute of limitations defense against a taxpayer's refund suit because the IRS agent's erroneous advice did not constitute the type of affirmative misconduct required as an element of estoppel against the Government.<sup>33</sup> In *Hanson v. OPM*, the court held that the Government was not estopped from denying the plaintiff a civil service retirement annuity because the federal official's good faith, but erroneous, interpretation of the statutes on which the plaintiff relied was not affirmative misconduct.<sup>34</sup> *Tefel v. Reno* collects "affirmative misconduct" cases from all of the federal circuits, none of which involved a Government agent acting within the scope of his or her employee. Because neither *Zacharin* nor any of the cases it cited involved agents acting within the scope of their authority, the *Zacharin* court may not have

perceived any need to distinguish the facts of that case from cases in which the plaintiff sought to hold the Government liable for acts or declarations of its agents acting within the scope their authority.

It is far less clear why the *United Technologies* and *United Pacific Ins.* courts failed to recognize this distinction, particularly given the *JANA* court's awareness of the Federal Circuit's "contract precedent." Unfortunately for practitioners, judicial mistakes become worse with repetition because the more removed a talismanic holding is from both the cases on which it relies and the cases it sub silentio overrules, the less able a new court will be to correct (or even recognize) the mistake. Moreover, lower tribunals, in struggling to support the superior court's holding, will only exacerbate the initial mistake, as happened with the ASBCA's decision on remand in *United Technologies*.<sup>35</sup>

### **The ASBCA's Decision in *United Technologies Corp.***

At issue in *United Technologies* was whether revenue share payments that UTC paid pursuant to its collaboration agreements with foreign parts suppliers constituted a "cost" that must be included in the contractor's indirect cost allocation bases. The ASBCA initially concluded that the payments were not a cost for parts and need not be included in the indirect cost allocation bases.<sup>36</sup> The Federal Circuit disagreed, holding that the parts were sold to the suppliers and the revenue share payments represented the cost of obtaining the parts. The Federal Circuit vacated the board's decision on entitlement and remanded to the board to address the estoppel issue raised by UTC. On remand, the ASBCA found that UTC had not met the traditional elements of estoppel. In particular, the board was not convinced that the Government knew the facts or that UTC detrimentally relied on the Government's conduct.<sup>37</sup> Had the board's opinion ended there, the case would be unexceptional. Regrettably, the board proceeded to address the "affirmative misconduct element."

Although finding that the Federal Circuit's dictum about affirmative misconduct was not the law of the case, the ASBCA nevertheless tried valiantly to find a legal basis to support the Federal Circuit's guidance. UTC argued that "the affirmative misconduct standard conflicts with the tenet that the government must be treated the same as a private litigant when acting in its proprietary capacity as a contracting party." In response, the ASBCA noted that *Zacharin* was factually similar to a proprietary case, while *United Technologies* was factually distinct from a private contract case. With regard to the first point, the ASBCA stated:

While *Zacharin* was not a contract case, it did involve actions by the Government that were of a proprietary or business nature inasmuch as the underlying issue involved whether the Government was required to reimburse appellant for its use of a patented invention.<sup>38</sup>

On the other hand, the ASBCA found that the "government's performance of contractual duties in conjunction with CAS rules and regulations" implicate "governmental regulatory rights and obligations [that] are not applicable to contracts between private litigants, and certainly not in the context of equitable estoppel."<sup>39</sup> Accordingly, the ASBCA found no conflict between the Federal Circuit's guidance and the Supreme Court's application of general contract law principles when the Government is acting in its proprietary capacity.

With due deference to the ASBCA, the critical distinguishing fact in *Zacharin* was not whether the Government was acting in a sovereign or proprietary capacity, but whether the Army attorneys who filed the plaintiff's patent application had authority to waive the Government's rights. *Zacharin* stands for the unremarkable proposition that absent affirmative misconduct, the Government is not bound by the unauthorized acts of its agents. In contrast to the Army attorneys in *Zacharin*, who had no delegated authority, it is within the authority of an administrative contracting officer to determine whether a contractor's cost accounting practices comply with the Cost Accounting Standards.

## Conclusion

Affirmative misconduct is not and never has been a condition prerequisite for applying estoppel against the Government so long as the Government agents were acting within the scope of their authority. The Federal Circuit's recent dicta to the contrary directly conflicts with the binding "contract precedent" of the Federal Circuit and its predecessor courts. While other federal circuits have recognized affirmative misconduct as an exception to the rule that the Government is not bound by the unauthorized acts of its agents, the Federal Circuit's dicta has instead created a Government contracts exception to the rule that the Government is bound by the acts of its agents acting within the scope of their authority.

## ❖ Endnotes

- 1 Karen L. Manos is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP. Ms. Manos is the author of *GOVERNMENT CONTRACT COSTS & PRICING*, © 2004 Thomson/West.
- 2 See *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362, 1366 (Fed. Cir. 2005); *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361, 1377 (Fed. Cir. 2004).
- 3 See *Die Casters Int'l Inc. v. U.S.*, 67 Fed. Cl. 362, 383 (2005); *General Electric Co. v. U.S.*, 60 Fed. Cl. 782, 797 & n.11 (2004); *DeMarco Durzo Dev. Co. v. U.S.*, 60 Fed. Cl. 632, 637-38 (2004); *Ervin & Assocs., Inc. v. U.S.*, 59 Fed. Cl. 267, 297 (2004), aff'd, 120 Fed. Appx. 353 (Fed. Cir. 2005); *Capital Properties, Inc. v. U.S.*, 56 Fed. Cl. 427, 436 (2003); *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. at 44-47 (ASBCA May 12, 2006); *RGW Communications, Inc., d/b/a Watson Cable Co.*, ASBCA Nos. 54495 et al., 05-2 BCA ¶ 32,972; *Kearfott Guidance & Navigation Corp.*, ASBCA Nos. 49271 et al., 04-2 BCA ¶ 32,757, recons. denied, 05-1 BCA ¶ 32,845.
- 4 "Equitable Estoppel: Still Hanging in There," 6 N&CR ¶ 31.
- 5 *Whiteside v. U.S.*, 93 U.S. 247, 256 (1876).
- 6 See, e.g., *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380 (1947).
- 7 See, e.g., *Cooke v. U.S.*, 91 U.S. 389, 398 (1875); see also *P.I.O. GmbH Bau Und Ingenieurplanung v. International Broadcasting Bureau*, GSBCA No. 15934-IBB, 04-1 BCA ¶ 35,592; *URS Consultants*, IBCA No. 4285-2000, 02-1 BCA ¶ 31,812; *Folk Constr., Inc.*, ENGBCA Nos. 5839 et al., 93-3 BCA ¶ 26,094; *Mick DeWall Constr.*, PSBCA No. 2580, 91-3 BCA ¶ 24,180; *Bell Helicopter Co.*, ASBCA No. 17776, 74-1 BCA ¶ 10,411.
- 8 *Hollerbach v. U.S.*, 233 U.S. 165, 177 (1914).
- 9 *Branch Banking & Trust Co. v. U.S.*, 96 F. Supp. 757, 766 (Ct. Cl. 1951); accord *Broad Avenue Laundry & Tailoring v. U.S.*, 681 F.2d 746, 747-48 (Ct. Cl. 1982); *Manloading & Mgt. Assoc., Inc. v. U.S.*, 461 F.2d 1299, 1303 (Ct. Cl. 1972).
- 10 See, e.g., *Precision Dynamics, Inc.*, ASBCA Nos. 41360 et al., 97-1 BCA ¶ 28,722.
- 11 See *Miller Elevator Co. v. U.S.*, 30 Fed. Cl. 662, 688-89 (1994).
- 12 See, e.g., *Decker & Co. v. West*, 76 F.3d 1573, 1583 (Fed. Cir. 1996); accord *MPR Assocs., Inc.*, ASBCA No. 54689, 2005 WL 2840533 (Oct.

- 27, 2005); *Honeywell Federal Sys., Inc.*, ASBCA No. 39974, 92-2 BCA ¶ 24,966.
- 13 *Mobil Oil Exploration and Producing Southeast, Inc. v. U.S.*, 530 U.S. 604, 607 (2000).
- 14 See *USA Petroleum Corp. v. U.S.*, 821 F.2d 622, 627 (Fed. Cir. 1987); *American Electronic Lab., Inc. v. U.S.*, 774 F.2d 1110, 1113 (Fed. Cir. 1985); *Broad Avenue Laundry & Tailoring v. U.S.*, 681 F.2d 746, 749 (Ct. Cl. 1982); *Emeco Indus., Inc. v. U.S.*, 485 F.2d 652, 657 (Ct. Cl. 1973); *Manloading & Mgt. Assoc., Inc. v. U.S.*, 461 F.2d 1299, 1303 (Ct. Cl. 1972).
- 15 See *Litton Systems, Inc. v. U.S.*, 449 F.2d 392, 401 (Ct. Cl. 1971); *Falcon Research & Dev. Co.*, ASBCA No. 19784, 77-1 BCA ¶ 12,312; *Symetrics Eng'g Corp.*, NASBCA No. 1270-20, 74-1 BCA ¶ 10,553; *Sanders Assocs., Inc.*, ASBCA No. 15518, 73-2 BCA ¶ 10,055; *AC Electronics Div., General Motors Corp.*, ASBCA No. 14388, 72-2 BCA ¶ 9736; *Penninsular Chem Research, Inc.*, ASBCA No. 14384, 71-2 BCA ¶ 9066; *Wolf Research & Dev. Corp.*, ASBCA No. 10913, 69-2 BCA ¶ 8017.
- 16 *Lockheed Martin Western Dev. Labs.*, ASBCA No. 51452, 02-1 BCA ¶ 31,803.
- 17 Decisions from the former Court of Claims are binding precedent until and unless overturned by the Federal Circuit sitting en banc. See *South Corp. v. U.S.*, 690 F.2d 1368, 1369 (Fed. Cir. 1982). Likewise, a panel is bound by the holding of another panel unless overturned by the en banc court. See *Vas-Cath Inc. v. Mahurkar*, 935 F.2d 1555, 1563 (Fed. Cir. 1991).
- 18 See Fed. Cir. R. 35(a)(1) (2006).
- 19 *OPM v. Richmond*, 496 U.S. 414, 419 (1990).
- 20 496 U.S. at 424.
- 21 496 U.S. at 434.
- 22 496 U.S. at 419-20 (emphasis added).
- 23 See *INS v. Miranda*, 459 U.S. 14, 19 (1982) (per curiam); *INS v. Hibi*, 414 U.S. 5, 8 (1973) (per curiam); *Montana v. Kennedy*, 366 U.S. 308, 315 (1961).
- 24 *Richmond*, 496 U.S. at 421.
- 25 See *Penny v. Giuffrida*, 897 F.2d 1543, 1546-47 (10th Cir. 1990); *U.S. v. Killough*, 848 F.2d 1523, 1526 (11th Cir. 1988); *U.S. v. Georgia-Pacific Co.*, 421 F.2d 92, 100-101 (9th Cir. 1970).
- 26 *JANA, Inc. v. U.S.*, 936 F.2d 1265, 1270 (Fed. Cir. 1991).
- 27 *Id.*
- 28 *Burnside-Ott Aviation Training Ctr, Inc. v. U.S.*, 985 F.2d 1574 (Fed. Cir. 1993).
- 29 985 F.2d at 1581.
- 30 *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361, 1377 (Fed. Cir. 2003).
- 31 *United Pacific Ins. Co. v. Roche*, 401 F.3d 1362, 1366 (Fed. Cir. 2005).
- 32 *Zacharin v. U.S.*, 213 F.3d 1366, 1371 (Fed. Cir. 2000).
- 33 *Henry v. U.S.*, 870 F.2d 634, 637 (Fed. Cir. 1989).
- 34 *Hanson v. OPM*, 833 F.2d 1568, 1569 (Fed. Cir. 1987).
- 35 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. (May 12, 2006).
- 36 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., 01-2 BCA ¶ 31,592, rev'd sub nom., *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361 (Fed. Cir. 2003), cert. denied, 540 U.S. 1012 (2003).
- 37 *United Technologies Corp., Pratt & Whitney*, ASBCA Nos. 47416 et al., slip op. at 35-40.
- 38 *Id.* at 44.
- 39 *Id.* at 45.

## ¶ 2

## Quantum

By Peter A. McDonald<sup>1</sup>

## Background

Most Government contract appeals are bifurcated, with quantum taking a back seat to entitlement issues. Indeed, there are comparatively few quantum appeals because board decisions on entitlement are remanded to the contracting officer, and damages issues are generally settled. This article addresses significant developments affecting quantum determinations.

*Propellex and Grumman*

There are established methodologies for calculating contract damages. In order of preference, they are actual costs, modified total costs and total costs. The total cost method is not only the least preferred and requires the contractor to prove that (1) it is impossible or impractical to determine the actual losses, (2) the contractor's bid (or estimate) was realistic, (3) the contractor's actual costs were reasonable and (4) the contractor was not responsible for the added expenses. Because of the long-standing reluctance of the courts and boards to accept claims computed with the total cost method, it has been used infrequently in recent years. Moreover, as a result of the decision by the U.S. Court of Appeals for the Federal Circuit in *Propellex*, it will be difficult for contractors to justify the use of either the total cost method or modified total cost method.<sup>41</sup>

In *Propellex*, the contracting officer ultimately conceded entitlement because the facts showed that the Government had wrongly rejected conforming goods. *Propellex* then used the modified total cost method to compute its claim. Because *Propellex* could have accumulated its actual additional costs of performance, but failed to do so,

its modified total cost claim was denied by the CO. The Armed Services Board of Contract Appeals affirmed the CO's decision when Propellex appealed. Propellex then appealed to the Court of Appeals for the Federal Circuit, which affirmed the ASBCA. Essentially, *Propellex* stands for the proposition that contractors will be required to prove their claims by the actual cost method, or be able to prove why they could not.

The holding in *Propellex* was recently reinforced by the decision of the ASBCA in *Grumman Aerospace Corp.*<sup>42</sup> In *Grumman*, the contractor's original claim was approximately \$66 million. After the contractor won entitlement on some of the issues, the parties could not settle on the amount due. To support its position on appeal to the ASBCA, the contractor submitted a report by a major accounting firm. Using the modified total cost method, their report concluded that Grumman's damages amounted to \$50.4 million. In its decision, the ASBCA determined that Grumman had not met three of the four requirements for the modified total cost method, and rejected the accounting firm's report. Using the available evidence in the record (some of which had been introduced by the Air Force), the ASBCA determined Grumman's damages to be about \$387,000.

The significance of the *Grumman* decision lies beyond the matters disputed between the parties. In short, the decision was another painful reminder to contractors that they will be expected to prove their quantum through the actual cost methodology, or be able to prove why they could not. After *Propellex* and *Grumman*, it will be a rare case indeed when a contractor meets the following criteria for applying the modified total cost methodology:

- (1) Impracticality of proving the contractor's actual losses;
- (2) The contractor's bid price was reasonable;
- (3) The contractor's actual costs were reasonable; and
- (4) The Government was responsible for the increased costs.

Even if actual cost data are not available, accountants can use various techniques to establish reasonably reliable data that may be used in lieu of actual cost documentation. Many of these techniques were developed by disaster recovery experts, who reconstruct unavailable data based on known information. The tools developed in disaster recovery situations are now applied by accountants in many other areas, including Government contract claims.

### Actual Costs

Disaster recovery accounting is a specialized practice area far afield from Government contracts, but many of the recent developments in that area apply directly to Government contract claims. First consider what disaster recovery involves.

Disasters, such as floods, tornadoes and fires, not only destroy lives and property, they also destroy electronic and paper records. Previously, when records were destroyed, the data they contained were no longer available. This, however, is no longer true. Thanks to creative techniques, accountants now can reconstruct data, with confidence that the reconstructed data are the same as the destroyed data, or have only immaterial differences.

Suppose a plant burned down two days before payday, destroying all the payroll records. By referring to the employer's most recent state and federal tax filing, accountants could reverse engineer the payroll records. While this is a simplistic example of how records are recreated, the point is that accountants can use collateral sources of information to determine historical costs, with a narrow margin of error.

Consider a Government contractor that prevails on its entitlement appeal after years of litigation, and now must pay attention to a previously neglected facet of its appeal: quantum. Assume that, under the contractor's records retirement policies, the needed actual cost data are either in its archives or not readily available. (To digress, companies spend the absolute minimum amount necessary on archived records. For that reason,

archived records are generally found in the most undesirable warehouses available.)

There are instances in which technical assistance is needed by accountants: determining the scope of effort needed, output capacity for equipment, or other matters. However, getting such qualified assistance is normally available in the contractor's organization.

## Accounting Records

The topic of accounting records necessarily entails a discussion about accounting systems, all of which are automated. The market offers virtually hundreds of accounting software programs, ranging in features commensurate with their price. Not surprisingly, inexpensive programs have limited capacity and few "bells and whistles," while more costly programs have considerably greater capabilities. For example, some accounting software programs permit data to be exported to word processing programs, but some do not. Some have foreign exchange conversion features, but some do not. However, no one program offers everything, largely because there is no market for such a product. Rather, different software programs have different attributes.

All widely used accounting programs have three critical accounting functions: audit trails, internal controls and reports. However, accounting systems perform these functions differently.

The amount of data available for a contractor's claim, and the accounting records that substantiate that claim, depend on the capabilities of the contractor's accounting system. Whether the claim is resolved through settlement negotiations, alternative dispute resolution or litigation, at some point, the contractor's documentary support for the amount of actual costs demanded in its claim will be scrutinized.

If specific claimed items are challenged, the contractor bears a heavier burden of proof, whether in settlement negotiations or litigation. In establishing quantum, an important part of the accounting system is the chart of accounts. While the chart of accounts merely lists the

account numbers and account titles, its role is significant because it is axiomatic that the costs follow the work. Accordingly, contractors claiming actual costs for additional work will extract those costs from the affected accounts. For example, labor costs will appear in payroll accounts, while supplier or subcontractor costs will show up in other direct costs. Similarly, overhead costs will be found in the cost elements of the overhead pool. In brief, the chart of accounts can be used to track back to crucial source documents. As discussed in the prior section, even if source documents are unavailable, accountants still can ascertain the actual costs with reasonable precision.

## Conclusion

The requirement for contractors to quantify their claims using the actual cost method is not as onerous and burdensome as some attorneys may believe. As shown above, even when the original records are unavailable accountants can determine the actual costs, or a figure very close, with a high level of confidence. By submitting a claim using the actual cost method, contractors may avoid the kind of results that occurred in the *Propellex* and *Grumman* cases.

## ❖ Endnotes

- 1 Peter A. McDonald, an attorney-C.P.A., is a director in the Government contracts practice at the national accounting firm of RSM McGladrey, Inc.
- 2 *Propellex Corp. v. Brownlee*, 342 F3d 1335 (Fed. Cir. 2003).
- 3 *Grumman Aerospace Corp.*, ASBCA No. 48006, 06-1 BCA ¶ 33216.

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## CASES OF SPECIAL NOTE

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## ¶ 3

### Enforceability Of Open-Ended Indemnification Clauses

*Boeing Co.*, ASBCA No. 54853, 2006 WL 1064132 (April 12, 2006), arose out of a series of 1960s and

1970s era contracts for development and production of the short range attack missile. Boeing's prime contracts included open-ended indemnification clauses under P.L. 85-804 and 10 USCA § 2354. With the Air Force's permission, Boeing included the same clauses in its subcontracts with Lockheed. Lockheed's performance of the subcontracts required the use of trichloroethylene and ammonium perchlorate, which were subsequently found in local groundwater. Boeing asserted a sponsored claim, pursuant to the indemnification clauses of its prime contracts, for Lockheed's past and future costs of environmental response and remediation and defending against multiple class-action toxic tort suits. Boeing's appeal was styled as a breach of contract action based on the Air Force's refusal to honor its indemnification obligations. The Air Force moved to dismiss, arguing that the ASBCA lacks jurisdiction because (1) relief under both statutes is committed to the unreviewable discretion of the secretary, and (2) the open-ended indemnification clauses violate the Antideficiency Act. The ASBCA denied the Government's motion, finding that both arguments constitute affirmative defenses rather than jurisdictional impediments. While recognizing that the Contract Disputes Act does not grant jurisdiction over the broadly discretionary settlement authority conferred by statutes such as P.L. 85-804, the ASBCA held that neither P.L. 85-804 nor 10 USCA § 2354 precludes the board's CDA jurisdiction for breach of contract claims.

The ASBCA's holding on the Government's ADA argument may be of even greater interest to practitioners. The ADA prohibits Government employees from obligating the Government in advance or in excess of funds appropriated by Congress. The U.S. Comptroller General has ruled that, absent specific statutory authority, indemnification provisions that subject the Government to indefinite or potentially unlimited liability violate the ADA and are unenforceable. In *Ford Motor Co. v. U.S.*, 378 F.3d 1314 (Fed. Cir. 2004), and *E.I. DuPont de Nemours and Co. v. U.S.*, 365 F.3d 1367 (Fed. Cir. 2004), the Federal Circuit found sufficient statutory authority in the Contract Settlement Act to uphold two World War II-era indemnification clauses. Since July 1971,

the executive order implementing P.L. 85-804 has expressly authorized open-ended indemnification claims under that statute. What is most notable about the ASBCA's decision in *Boeing* is its holding with regard to the pre-1971 contracts. The ASBCA observed that the Government's argument "ignores the interplay between the Anti-Deficiency Act and the judgment fund." Then, quoting from its decision in *South Carolina Public Service Authority*, ASBCA No. 53701, 04-2 BCA ¶ 32,651, the board stated:

[T]he Anti-Deficiency Act "does not impinge on ... contingent liabilities under the contract any more than the [Act] would preclude consideration, for example, of [Contract Disputes Act] claims for constructive changes under the standard Changes provision. To the extent that the government is liable for [Contract Disputes Act] claims, the judgment fund is generally available."

This suggests that, wholly apart from P.L. 85-804, the judgment fund itself provides sufficient statutory authority to support a claim for breach of an open-ended indemnification provision.

## ¶ 4

### Segment Closing Adjustments Under CAS 413

*Viacom, Inc. v. U.S.*, No. 01-79C, 2006 WL 1388415 (Fed. Cl. May 8, 2006), is the latest interlocutory decision in one of many pension cost cases currently pending before Judge Nancy B. Firestone of the Court of Federal Claims. By way of background, in *Teledyne, Inc. v. U.S.*, 50 Fed. Cl. 155 (2001), aff'd, 316 F.3d 1366 (Fed. Cir. 2003), the court held that the sale of a segment is a segment closing under both original CAS 413 and "new" CAS 413 in effect after the March 30, 1995 amendments, and with regard to original CAS 413, the Government is not entitled to recover the part of the pension surplus attributable to fixed-price contracts, contracts awarded prior to the effective date of CAS 413, or employee contributions. The Court held that

applying new CAS 413 to contracts awarded prior to the effective date of the 1995 amendments represents a Government-mandated accounting change, entitling the contractor to an offsetting equitable adjustment in the amount by which the Government's claim under new CAS 413 exceeds the amount of the claim under original CAS 413. The Defense Contract Audit Agency and Defense Contract Management Agency issued joint guidance, dated July 23, 2004, that purportedly implements the *Teledyne* decision, but would effectively preclude any contractor claim for a pension deficit. In *General Motors Corp. v. U.S.*, 66 Fed. Cl. 153 (2005), the court held that neither (1) GM's failure to fund the segment closing adjustment amount in the year of the segment closing, nor (2) its release of claims under closed cost type contracts, nor (3) the Limitation of Cost and Limitation of Funds clauses barred GM from recovering any segment-closing adjustment that it might be owed pursuant to a segment-closing under original CAS 413.

Viacom's claims arose out of the sales of two segments with pension deficits. One sale occurred before the March 30, 1995 revisions took effect; the other sale occurred after the revisions took effect. As with all pension deficit claims under both original and new CAS 413, the Government denied Viacom's claims. Raytheon, which has four new CAS 413 pension deficit claims pending before the same judge, is participating in the case as amicus curiae. The court's May 8 opinion addresses four defenses the Government has raised to deny liability for any pension deficit claim. Following its decision in *General Motors*, the court held that none of the following precludes a contractor's pension deficit claim under either original or "new" CAS 413: (1) the contractor's failure to fund the pension deficit in the year of the segment closing; (2) the contractor's failure to comply with notice provisions of the Limitation of Cost and Limitation of Funds clauses; and (3) any general release of claims the contractor may have signed upon receipt of final payment under its closed cost type contracts. Following its decision in *Teledyne*, the court held that a segment closing that applies "new" CAS 413 is a mandatory change in cost accounting practices for pension costs attributable

to contracts entered into under original CAS 413, entitling the Government to an offsetting equitable adjustment. See 48 GC ¶ 219.

## ¶ 5

### Determining Increased Costs Paid In The Aggregate

*Lockheed Martin Corp. v. U.S.*, No. 00-129C, 2006 WL 979260 (Fed. Cl. Mar. 29, 2006), involved the allocation of CRAY computer costs among three operating companies. The Court of Federal Claims held that the contractor's "resource commitment" method of allocating the computer costs based on forecasts that were never revised to reflect actual usage violated CAS 418-40(c)(2), regardless of whether the practice resulted in any increased costs paid by the U.S. Brushing aside the contractor's argument that the Court need not resolve the CAS compliance issue because there were no increased costs, the Court stated that "the root issue whether plaintiff complied with CAS 418 was properly raised by defendant in its cross-motion, leaving plaintiff with no choice but to respond, if it had a response—it could neither rest on its earlier pleadings, nor leap past this liability issue to what is, in effect, a question of damages."

In an issue of first impression, the court emphatically rejected the Government's argument that 48 CFR § 9903.306(e) precludes a contractor from offsetting cost decreases on fixed-price contracts against cost increases on cost-reimbursement contracts. The court stated that under 41 USCA § 422(h)(3), "where there are multiple 'relevant contracts,' the 'increased cost' to the United States is determined by considering the costs among those contracts in the aggregate." Citing DCAA's Jan. 9, 2002 audit guidance on calculating cost impacts, the Court observed that while § 9903.306 does not define decreased costs on fixed-price contracts, "the CAS statute presumes that there can be decreased costs paid by the government since it provides for adjustment to remove only increased costs paid in the aggregate." Decreased costs paid by the U.S. occur

when more costs are accumulated on fixed-price contracts after an accounting change or when the price negotiated using the noncompliant practice is less than the price that would have been negotiated using compliant practices. Thus, the court concluded, § 9903.306, and even DCAA's Jan. 9, 2002 guidance, when properly interpreted, are consistent with the statutory prohibition against recovery of increased costs in the aggregate. The Court stated:

Based upon this guidance, not to mention the plain wording of the statute and FAR provision at issue, defendant is incorrect in suggesting that decreased costs associated with other fixed-price contracts it had with Lockheed cannot have the effect of diminishing or even eliminating the cost increases associated with the noncompliance of the CAS in question. Were defendant correct, a contractor that used a computer only to service Government contracts might still end up owing the government increased costs for a CAS violation, even if, rather than using that computer in a flexibly-priced contract as forecasted, the contractor instead used the computer entirely for other fixed-price Government contracts. This result, of course, would be anomalous and provide the government with a windfall. More importantly, it is precisely the result that Congress sought to avoid in admonishing that—"[i]n no case shall the Government recover costs greater than the increased cost ... to the Government, in the aggregate, on the relevant contracts subject to the price adjustment."

The *Lockheed Martin* decision is the first to interpret the phrase "increased costs paid in the aggregate."

## ¶ 6

### Contract Disputes Act Jurisdiction

In *Dual, Inc.*, ASBCA Nos. 53827 & 53889 (March 29, 2006), the ASBCA dismissed the appeal for lack of subject matter jurisdiction because the contractor's corporate charter had been forfeited for failure to pay Maryland state

taxes. While the charter was forfeited, the Government terminated the contract for convenience, the defunct corporation's president submitted a termination settlement proposal, the contracting officer issued a final decision denying the contractor's termination settlement proposal and asserting a Government claim for a refund of alleged overpayments under the contract, and the contractor's president filed a notice of appeal. The corporate charter was not reinstated until after the expiration of the one-year period for submitting a termination settlement proposal and the 90-day period for appealing a CO's final decision. The board held that it lacked jurisdiction because, under Maryland law, corporate officers do not have authority to act for defunct corporations except to wind up the corporation's affairs. Because the contractor was continuing to function and actively seeking reinstatement of its charter, the board found that the president was not winding up the corporation's affairs. Although under Maryland law the revival of a corporate charter validates retrospectively the capacity of the corporation, the ASBCA held that this could not cure the failure to submit a valid termination settlement proposal within one year after the termination or a valid notice of appeal within 90 days after the CO's unilateral determination of the amount owed. The board rejected the contractor's argument, based on Fed. R. Civ. P. 9(a), that the Government waived the contractor's lack of capacity by waiting more than two years to file a motion to dismiss. The board held that the failure to timely file a termination settlement proposal and notice of appeal is an unwaivable jurisdictional impediment, and not merely a question of capacity.

Twice in the past few months, the Court of Federal Claims denied Government motions to dismiss under the election doctrine, holding that such motions are not ripe until the board of contract appeals determines whether it has jurisdiction. See *Edward Grinnell v. U.S.*, No. 06-231C (April 27, 2006); *States Roofing Corp. v. U.S.*, No. 05-960 (April 12, 2006). Under the Election Doctrine, once a contractor makes a binding election to appeal a CO's final decision in one forum, the contractor loses its right to pursue the appeal in

the other forum. See *Bonneville Assocs. v. U.S.*, 43 F.3d 649, 653 (Fed. Cir. 1994). However, the contractor's election does not become binding until the selected forum determines that it has jurisdiction. See *National Neighbors, Inc. v. U.S.*, 839 F.2d 1539, 1543 (Fed. Cir. 1988) ("an untimely appeal to the board is not a binding election under the Election Doctrine").

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## DEVELOPMENTS

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## ¶ 7

### In Brief

- (a) **Office of Management and Budget Notice, Determination of Executive Compensation Benchmark Amount, 71 Fed. Reg. 26114 (May 3, 2006).** The "benchmark" compensation amount for contractors' Fiscal Year 2006 is \$546,689.
- (b) **Cost Accounting Standards Board, Accounting For the Cost of Employee Stock Ownership Plans.** OMB's most recent Unified Agenda reports that the CAS Board expects to issue its final rule on accounting for the cost of ESOPs in September 2006. See 71 Fed. Reg. 23444 (April 24, 2006). The ESOP notice of proposed rulemaking was published on July 22, 2005, 70 Fed. Reg. 42293, and the comment period ended on Sept. 20, 2005.
- (c) **CAS Board Working Group on CAS 412 & 413 and Pending Pension Funding Reform.** On April 27, the CAS Board Staff Director for Pensions, Eric Shipley, sent an e-mail notice to interested actuaries, soliciting their views about the pension reform legislation and any issues or conflicts that should be identified. Shipley's e-mail explained that the CAS Board has asked Elliott Friedman (Lockheed Martin),

Patrick Ring (Department of Energy) and Shipley to monitor progress of the pension reform legislation and advise the Board regarding how the ERISA changes might conflict with CAS 412 and 413. The working group intends to develop a white paper on potential issues that should be addressed and anticipates that the paper could form the basis for a staff discussion paper.

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## FOR YOUR INFORMATION

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## ¶ 8

### Miscellany

- (a) **Where Have All the CAS Board Members Gone?** Despite the flurry of activity by the CAS Board staff and the president's April 2006 nomination of Paul Denett as administrator of the Office of Federal Procurement Policy, do not expect the CAS Board to begin functioning any time soon. Even if the Senate quickly confirms the new OFPP administrator and chair of the CAS Board, the terms have expired without replacements being named for the accounting, Department of Defense and industry member positions of the CAS Board.

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