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SBA Set-Asides – Do HUBZones Rule?

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Introduction

Federal government contract awards to "small business" contractors as defined under 13 C.F.R. Part 121 are a major preference program with a substantial economic effect on the construction industry. Over the last three decades, Congress has authorized a variety of goals and preferences related to the award of contracts to small businesses. The current government-wide goals for small business participation in federal contract awards, which are expressed as percentages of the total value of all prime contract awards, are:

Category	Goal Not Less Than
Small Business Concerns	23%
HUBZones	3%
SDVOs (Service Disabled Veteran Owned)	3%
WOSBs (Woman Owned Small Businesses)	5%
Section 8(a)/SDBs	5%

The figures for prime contract awards to small business contractors are overall goals based on the total value of contracts awarded by the government. The actual agency goals for construction contracts are often much higher than these percentages as many agencies use construction contract awards to small

SCH NEWSMAKERS

The National Utility Contractors Association has honored **Charles W. Surasky**, a partner with Smith, Currie & Hancock's Atlanta office, by naming him as that organization's associate member of the year. Congratulations, Charles!

On March 19, 2010, the Associated General Contractors of America, at its Annual Convention in Orlando, Florida, presented to Smith, Currie & Hancock's **Thomas J. Kelleher** its prestigious "President's Coin Award" for extraordinary service to the Association and the construction industry and "a job well done". Tom was the sole 2010 recipient of the award and the award is rarely given. Tom was recognized for his unique knowledge and contributions, especially in the area of Federal Government Contracting, and for being a valuable resource to, and extension of, the AGC staff.

The South Florida Chapter of the National Association of Minority Contractors awarded its prestigious Private Sector Award to **Lisa Colon Heron**, an associate with Smith, Currie & Hancock's Fort Lauderdale, Florida office. In addition, primarily due to Lisa's efforts, the Latin Builder's Association recognized Smith Currie as one of its "A List" law firms. Well done, Lisa!

businesses to offset shortfalls in awards of other types of contracts to small business contractors. For example, in FY2007, the Department of Defense awarded almost 40% of all construction work to small business contractors on a dollar value basis. This overweighting of construction awards to small businesses makes the application of the various small business programs of particular importance to the construction industry.

Recently, in a U.S. Court of Federal Claims ("COFC") decision, *Mission Critical Solutions v. United States*, No. 09-864C (Fed. Cl. March 2, 2010), the issue of whether the various small business set-aside programs stand on equal footing was addressed. Specifically, the case discussed whether Historically Underutilized Business Zone ("HUBZone") small business concerns have priority over other small business concerns in set-aside contracts.

Subsequent to the *Mission Critical* decision, the Government Accountability Office ("GAO") considered a bid protest on the same issue and reached the same conclusions as the U.S. Court of Federal Claims. *DGR Associates, Inc.*, Comp. Gen. Dec. B-402494, May 14, 2010. While these decisions reflect an on-going legal controversy involving the GAO, the courts, and the Executive Branch which may be of interest to legal scholars, these decisions have a significant practical effect on small business construction firms, especially for the small business contractor which qualifies as a HUBZone firm.

Smith, Currie's Electronic Newsletter

As previously reported, Smith Currie's "Common Sense Contracting" newsletter is now being distributed exclusively via e-mail.

If you need to update your e-mail address or add others within your organization to our e-mail distribution list, simply send an e-mail to schnewsletter@smithcurrie.com with the following information:

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> **Company Name**

> **E-mail Address**

> **Telephone Number**

Background

In *Mission Critical*, the COFC held that HUBZone businesses have top priority for set-aside contracts over other small business programs when certain conditions are met. In *Mission Critical*, the COFC sustained a protest by Mission Critical Solutions ("MCS"), a SBA Section 8(a) program and a HUBZone qualified small business. MCS was the incumbent contractor providing information technology support services to the Department of the Army under a Small Business Administration ("SBA") 8(a) set aside under a one year sole-source contract.

In December 2008, the Army decided to increase the follow-on contract to an estimated $10.5 million for the same services to include a base year plus two option years. Since the contract value exceeded the $3.5 million threshold for sole-source awards in Federal Acquisition Regulation ("FAR") Section 19.805-1(a)(2), the Army determined that it was not appropriate to award it to MCS on a sole-source basis. Instead, the Army awarded the contract to an Alaska Native Corporation as an 8(a) set aside. Under 13 C.F.R. 124.506(b) tribally-owned and ANC owned concerns are exempt from the $3.5 million threshold and are eligible to receive sole-source 8(a) contracts with no upper limit.)

GAO Decision

In January 2009, MCS filed a protest with the GAO and argued that the Army improperly awarded the contract on a sole-source basis under the 8(a) program, without considering first whether procurement should be set aside for competition among HUBZone businesses such as MCS. In response, the Army argued that the statutory language in the Small Business Act, particularly the 8(a) and HUBZone provisions, did not indicate that the HUBZone program was entitled to priority but instead called for parity among the various SBA programs, including the Service-Disabled Veteran-Owned program ("SDVO"). Rejecting the Army's arguments, the GAO sustained the protest.

Based upon its reading of the HUBZone statute at 15 U.S.C. § 657a(b)(2)(B), the GAO ruled that agencies must set aside federal contracts to qualified HUBZone small businesses, when there is reasonable expectation that two or more such businesses can submit bids at fair market prices. Consequently, under those circumstances, the agencies and the SBA did not have discretion to set aside such contracts for award to small businesses under the 8(a) or SDVO Programs in an effort to achieve parity among the various programs. After the GAO sustained MCS's protest, in July 2009, the Office of Management and Budget directed executive branch agencies to disregard the GAO's rulings in *Mission Critical Solutions,* Comp. Gen. B-401057, 2009 CPD ¶ 93, and *International Program Group, Inc.,* Comp. Gen. B-400278, B-400308, 2008 CPD ¶ 172, pending legal review by the executive branch.

Opinion of the Office of Legal Counsel

On August 21, 2009, the Office of Legal Counsel ("OLC") of the United States Department of Justice issued an OLC

Opinion disagreeing with the GAO's position, stating that under the SBA's regulations, federal contracting officers are given substantial discretion to consider and designate contracts for either the HUBZone, 8(a), or the SDVO Program without having to prioritize one program above the others. The OLC further concluded that the SBA's statutory interpretation was permissible and that the regulations established "parity" among the three programs. Finally, the OLC stated that the OLC Opinion, not the GAO decision, was binding on the executive branch. In response to the OLC Opinion, the Army declined to implement the GAO decision, and MCS's complaint to the U.S. Court of Federal Claims followed on December 15, 2009.

U.S. Court of Federal Claims

On March 2, 2010, the COFC sustained MCS's protest and agreed with MCS's and GAO's position that the plain language of the HUBZone statute mandates that federal agencies give HUBZone contractors preference over 8(a) and other small business concerns whenever the contracting officer has a reasonable expectation that two or more qualified HUBZone contractors will submit bids and that the award will be made at a fair market price. The pertinent portion of the HUBZone statute, 15 U.S.C. § 657a(b)(2)(B), states that:

> (B) Notwithstanding any other provision of law –
>
> a contract opportunity ***shall*** be awarded pursuant to this section on the basis of competition restricted to qualified HUBZone small business concerns if the contracting officer has a reasonable expectation that not less than 2 qualified HUBZone small business concerns will submit offers and that the award can be made at a fair market price …."
>
> (emphasis added)

No other statute authorizing other types of small business preference programs contains similar "notwithstanding" or "shall be awarded" language. The COFC concluded that the HUBZone statute plainly and unambiguously dictated that a contract opportunity shall be awarded under the HUBZone statute on the basis of competition when the two or more restriction was satisfied. In contrast, Congress gave the SBA and contracting officers only discretion to place contracts within the 8(a) program, see 15 U.S.C.§ 637(a). The COFC reasoned that this interpretation of the HUBZone statute was more fully expressive of the intent of Congress and rejected the SBA and OLC position as strained interpretations of portions of the Small Business Act.

The COFC then concluded that the Army's procurement actions to award the contract as a sole source set-aside under the 8(a) program was unlawful. The Administration was ordered to determine whether the criteria specified in 15 U.S.C. § 657a(b)(2)(B) are met, such that the contract opportunity at issue must be awarded on the basis of competition among qualified HUBZone concerns. The administration was also enjoined from awarding the contract in a manner that is not in compliance with the COFC's interpretation of the Small Business Act. The Department of Justice has filed an appeal to the U.S. Court of Appeals for the Federal Circuit and stated that the court's injunction applied to only that one procurement.

In its May 14, 2010 decision in *OGR Associates,* the GAO followed its prior rulings on this issue and noted that the COFC had adopted a similar reading of the statutes. More importantly, while it also recognized that the Executive Branch was resolved to follow "its own, contrary interpretation of the HUBZone statute, the GAO clearly signaled that it would sustain similar protests absent a statutory revision or contrary decision by the United States Court of Appeals of the Federal Circuit.

Practical Note

Presently, it appears that HUBZone firms have an advantage over Section 8(a) and SBVO contractor concerns, and other small business concerns. Non-HUBZone small business contractors should evaluate whether they are or can become eligible for HUBZone status. For information on eligibility for the HUBZone program, see 13 C.F.R. Part 126. The government's limitations on subcontracting and joint ventures on HUBZone set-asides should also be carefully reviewed. As more small businesses pursue HUBZone certification to gain access to federal procurement contracts, competition and scrutiny will increase.

The remaining months of the current fiscal year can be expected to have an increased volume of solicitations for construction contracts. Many of these will be set-asides. If the set-aside is not restricted to HUBZone qualified firms, these may be a basis for a valid bid protest to the GAO by a qualified HUBZone contractor. If a firm decides to submit a protest on the grounds set forth in *Mission Control* and *DGR Associates,* it is essential that the HUBZone contractor submit this protest prior to the due date for submission of proposals or the bid opening date.

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False Claim = Major Consequences

651 The submission of an unsubstantiated or inaccurate claim to the federal government can have costly consequences. Federal law contains several statutes which are intended to specifically prevent the submission of unwarranted contractor claims, and to discourage the practice of "horse trading" in the federal contracts arena. In particular, the Contract Disputes Act (41 U.S.C. § 604) ("CDA") and federal False Claims Act (31 U.S.C. § 3729) ("FCA") provide mechanisms whereby the party seeking payment from the government may actually be subject to liability for the entire amount of a claim ultimately found to be inflated or fraudulent. A party in

violation may also be subject to statutory penalties. A recent decision by the United States Court of Appeals for the Federal Circuit in *Daewoo Engineering and Construction Co., Ltd. v. United States*, 557 F. 3d 1332 (2009) illustrates the severity of the penalties for filing a false claim, and also details the various means and methods by which a court may determine the contractor's fraudulent intent when submitting a claim.

Claims Under the CDA and FCA

The CDA specifically requires a contractor to certify any claim in excess of $100,000 in order to encourage honesty in the claims process. The antifraud provision of the CDA provides that a contractor 1) unable to support a portion of its claim and 2) found to have misrepresented a material fact in furtherance of the unsupported claim, shall be liable to the federal government for the full amount of the unsupported claim. A misrepresentation of fact can be either a "false statement of substantive fact or **any conduct** which leads to a belief of a substantive fact material to proper understanding of the matter in hand, made with intent to deceive." (emphasis added).

A contractor may also be liable under the FCA for knowingly submitting a false claim to the federal government. The penalty for a violation of that statute is not less than $5,000 with a maximum cap of $10,000, plus damages equal to three times the amount of compensatory damages incurred by the government. "Knowingly" does not require the government to prove that the contractor specifically intended to defraud the government, only that the contractor 1) had actual knowledge of the falsity of the claim, 2) acted with "deliberate ignorance" as to the accuracy of the information provided, or 3) acted in "reckless disregard of the truth or falsity" of the submitted claim. In *Daewoo,* the government was able to effectively utilize both the CDA and FCA upon establishing violations of both statutes by a preponderance of the evidence.

Factual Background of *Daewoo*

In 1999, the Corps of Engineers ("Corps") solicited bids for the construction of a fifty-three mile road in the Republic of Palau. Daewoo submitted a proposal that was originally twenty-seven million dollars less than the next lowest bidder. After the Corps questioned this price, Daewoo increased its price by over fifteen million dollars and received the award. A year and a half after construction began on the road, Daewoo requested an equitable adjustment to its contract claiming defective specifications, the failure of the Corps to disclose superior knowledge pertaining to the project, and the impossibility of performing the contract within the original project schedule. Daewoo specifically requested $13,348,793.07 in additional costs incurred, plus projected future costs of $50,629,855.88. The Corps ultimately rejected Daewoo's claim, and Daewoo responded by filing a complaint with the Court of Federal Claims ("COFC"). The government counterclaimed, seeking forfeiture of Daewoo's claims, and damages for $64 million and $10,000 under the CDA and FCA, respectively. The government specifically alleged that Daewoo knowingly submitted a false claim, and had no factual basis for the amounts demanded.

At trial, Daewoo attempted to support its $64 million claim, but the COFC found the testimony unconvincing, and determined that the evidence clearly showed that the claim submitted by Daewoo for the projected future costs was nothing more than a "means to get the Government's attention. . . ." The COFC found that Daewoo's project manager, who had certified the claim, repeatedly provided inconsistent testimony as to the substantive basis of the claim, and specifically stated on cross examination that he wanted the federal government to understand "the seriousness of the situation" and to "pay attention" to Daewoo's claims for compensation. The court also found that the project manager repeatedly gave false testimony and that Daewoo's other witnesses failed to provide a reasonable explanation as to the calculation of the $50.6 million in future costs/damages. Daewoo's own damages experts seemingly could not understand the computations used by Daewoo in the claim, and continually tried to evade questioning on the validity of the claim.

The COFC ultimately ruled in favor of the government, finding that Daewoo fraudulently submitted its certified claim in violation of the CDA and FCA. The court awarded judgment in favor of the government in the amount of $50.6 million under the CDA and the maximum statutory fine of $10,000 under the FCA. The court determined that the remaining $13 million in actual costs claimed by Daewoo, while not entirely accurate, did not rise to the level of a fraudulent claim under the CDA and FCA.

Federal Circuit Appeal

Daewoo challenged the COFC's decision on appeal, alleging that 1) the request for equitable adjustment for the projected future costs was not a "claim" for purposes of the CDA, 2) the claim submitted to the government was not fraudulent, and 3) that even upon a finding that the claim was fraudulent, the amount awarded should not equal $50.6 million dollars. The government countered that the document submitted was in fact a claim as indicated by its plain language and the subsequent conduct of the parties, and that Daewoo's failure to provide a substantive basis for its claim did in fact amount to fraud under the CDA and FCA.

The Federal Circuit began its analysis by reviewing the four corners of the original document submitted by Daewoo in order to determine whether a claim had in fact been filed. Daewoo argued that the document submitted was merely an estimate of the costs going forward, and therefore did not represent a claim under the CDA. The government in turn relied heavily on the title of the document, which was labeled "Certification of Request for Equitable Adjustment". The court found the face of the document to be inconclusive as to its classification as a certified claim, and concluded that the COFC correctly relied upon the factual record at trial in reaching its conclusions. The Federal Circuit determined that the testimony of Daewoo's

project manager "unquestionably" indicated the clear intent to certify a claim under the CDA and that other extrinsic evidence such as the conduct of the parties after the claim was submitted, supported the government's position that the entire document was intended to be a CDA claim.

The Federal Circuit also found the testimony relevant as to the fraudulent nature of Daewoo's claim, as there was no competent evidence supporting Daewoo's calculations for future damages. The Federal Circuit specifically rejected the argument that a claim can be fraudulent only if it rests on false facts rather than a baseless calculation of estimated damages or future costs.

Practical Points

The *Daewoo* case highlights the necessity of preparing accurate and well-documented claims. The line where the negligent preparation of a claim crosses into the realm of a false claim is not entirely clear, therefore extra precautions must be undertaken at every step during the claim analysis and submission process to defuse possible government counterclaims under the CDA and FCA. First, the claimant must be careful as to the title and scope of the documents submitted. As noted in *Daewoo*, the use of language such as "certification" in the correspondence may give rise to the presumption that the document is a claim subject to the provisions of CDA and FCA.

The law is clear that a claim cannot be submitted in order to gain a tactical advantage in negotiations. Given the severity of the applicable penalties for the filing of a false claim, contractors should implement rigid control systems to ensure the claims reflect genuine costs or reasonable estimates of future costs that can be adequately quantified and explained by the preparer(s). Any claims whether for incurred costs or estimated future costs, warrant a careful review to provide a checks and balances method to identify possible errors and to avoid allegations that the claim calculations are baseless.

Contractors dealing with state governments would also be wise to take note of the *Daewoo* decision, as more and more states are enacting "Little False Claims Acts" and other similar legislation that is often patterned after the federal statutes dealing with the submission of false claims. State courts will likely use the federal decisions such as *Daewoo* to interpret circumstances surrounding the filing of claims in their respective jurisdictions. Finally, contractors should be wary of claims submitted on behalf of subcontractors, so as not to be held liable for the fraudulent conduct of another party. As noted above, adherence to these principles can be the difference between receiving payment, or actually paying the government damages equal to the amount claimed.

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Setting Aside Final Acceptance

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Background

Under the standard federal government Inspection of Construction clause (FAR § 52.246-12) the government's acceptance of the work is final and conclusive except for latent defects, fraud, gross mistakes amounting to fraud, or any applicable warranty rights. The decision by the Armed Services Board of Contract Appeals ("Board" or "ASBCA") in *American Renovation and Construction Co.,* ASBCA No. 53723, 09-2 BCA ¶ 34,199, provides a good insight on what constitutes gross mistakes amounting to fraud, but also provides guidance as to what constitutes a reasonable time for the government to revoke final acceptance.

This case arose out of a contracting officer's final decision to revoke acceptance and default terminate two design/build contracts for military housing at Malmstrom Air Force Base, Montana ("MAFB"). The two contracts are referred to as "M2" and "M3." M2 was a design/build contract for the construction of 122 duplex and single family housing units contained in 69 buildings. M3 was a design/build contract for the construction of 72 new family housing units, as well as the demolition of 64 existing units and 15 garages. The government awarded M2 to American Renovation and Construction Company ("ARC") in September 1997 and awarded M3 to ARC six months later.

Constructing on Fat Clay

A major potential problem with the entire site was the existence of fat clay. Fat clay has a strong affinity for moisture. The greater the access to moisture, the more the fat clay will swell. Fat clay can exert considerable upward pressure. Residential facilities are normally designed for a live load of 40 pounds per square foot. Swelling fat clay can exert upward pressures of 4,000 to 5,000 pounds per square foot! Slab-on-grade ("SOG") is a concrete slab that is cast directly on the soil and is supported by the soil. If a SOG is placed on fat clay there will be problems because the fat clay will swell, causing the SOG to heave.

The government's geotechnical engineers recommended that a "floating slab" be used in order to minimize slab movement. A floating slab is a SOG that is structurally isolated or separated from bearing walls and columns with expansion joint material. A floating slab allows unrestricted vertical movement. However, a floating slab is much more costly than a SOG. The entire Great Falls area, as well as the existing 1,406 houses on MAFB, utilize SOG with basements. It is simply too cost prohibitive to do anything else in residential construction.

The government decided to use SOG with basements for both the M2 and M3 contracts. The primary concern was the presence of fat clay at foundation grade. The government therefore required that where saturated fat clay was found in the building footing, saturated fat clays needed to be excavated and backfilled with compacted stabilized material or lean mix concrete. The government received two proposals, both of which were too high.

The government worked with prospective offerors to try to bring the cost of the contract down. The offerors suggested, and the government approved a number of changes. The two most germane to this case were that fat clay was redefined as satisfactory material except next to foundation walls, and compaction requirements for backfill against the sides of footings and the base of the walls were reduced.

The changes to the contract specifications were all designed to provide the government with a cost-effective project allowing for an acceptable risk of slab movements. However, there were numerous problems with the construction of the projects, which ultimately resulted in the Board finding that ARC's performance constituted gross mistakes amounting to fraud.

Construction Problems

There were problems from the beginning. Evidently, ARC did not segregate soils by soil type during excavation. As an example, witnesses testified seeing 2' to 3' clay balls being mixed with sand material being used for backfill. If the clay balls are too dry to compact, they will create voids in the soil. The result is that the surface grades sink. The ASBCA also found that ARC placed fat clay adjacent to the foundations about 50% of the time. This was a violation of the specifications, which called for no fat clay next to foundation walls.

The Board also found that ARC materially deviated from the specifications regarding lifts of fill material. The specifications called for backfill to be placed in 8" lifts and that compaction would be tested after every third lift. The Board found that ARC regularly placed backfill in lifts of two or three feet, and in one area, ARC placed fill in six or eight feet lifts. In addition, the Board found that ARC timed its backfill operations so the inspector could not observe placement of the lifts.

ARC had major problems with compaction tests. The M2 contract required 1,464 compaction tests. ARC made only 158 tests. To make matters worse, ARC concealed the test reports from the government, turning them over to the government just as the warranty period was expiring. None of the samples tested for compaction four years after construction passed.

The specifications required that excavations be dewatered and prohibited standing water in the excavations. ARC routinely backfilled areas of water and compacted it in order that it would go unnoticed.

Acceptance and Termination of the Contracts

The government accepted the units under the M2 contract by October 1999, and the units under the M3 contract in November 2000. There were problems almost immediately. The problems all appeared to be related to settlement. The government and ARC attempted to work together to fix the problems. In February 2001, the government received a report opining that the settlement and related damage were a direct result of insufficient compaction. In July 2001, the government indefinitely suspended ARC's work due to its failure to provide acceptable solutions to the soil subsidence issues. In December 2001, the government revoked acceptance and terminated the M2 contract for default, alleging breach of contract and latent defects. Nine months later, in September 2002, the government revoked acceptance and terminated the M3 contract for default on grounds substantially similar to the M2 contract.

ARC challenged the government's revocation and acceptance of the M2 and M3 contracts. ARC's primary arguments were that the revocations and terminations were improper because the actual cause of the problems was the government specification of SOG construction in an area of fat clay. ARC also argued that it was not responsible because the government knew of ARC's noncompliant construction methods.

Under federal law, the government can revoke acceptance and terminate the contract within a reasonable period of time if ARC's performance was tainted by gross mistakes amounting to fraud. The Board concluded that ARC's concealment of compaction test reports and its own egregious workmanship defects were gross mistakes amounting to fraud.

The ASBCA used February 2001 (the date the government received the report regarding the settlement issues related to the M2 contract) as the start date to measure reasonableness of the time taken to revoke acceptance and terminate the M2 contract. The Board found that the 10 ½ months the government took to revoke acceptance and terminate the M2 contract was reasonable. Regarding the M3 contract, the Board found that the 22 months the government took to revoke acceptance and terminate the M3 contract was ***not*** reasonable.

Conclusion

There are not many cases providing insight into the test of what constitutes gross mistakes amounting to fraud that would entitle the government to revoke acceptance of a project. This case provides examples of what not to do on a project. The ASBCA appeared to be particularly bothered by ARC concealing test results from the government. The Board also appeared bothered by how ARC cavalierly performed its work in breach of the express specifications.

Regarding the reasonableness of revocation of acceptance after a mistake is discovered, the boards (and courts) look at the issue on a case-by-case basis. This case (and previous cases) indicate that the government's argument that its actions were reasonable are harder to make once it waits more than about a year. The longer after one year the government waits to revoke acceptance, the harder it is for the government to prevail.

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Which Payment Bond Applies?

653 Virtually all public construction projects, as well as many private construction projects, require the general contractor to post a payment bond, guarantying payment on valid claims asserted by recognized lower-tier subcontractors, materialmen, and suppliers. Prudent general contractors often require their main subcontractors to post similar payment bonds. When multiple payment bonds exist, it becomes important to understand which bond is securing any given claim. In an era when it is common for one surety to write payment bonds for both subconrtractors and the general contractor on the same project, a failure to make the correct analysis can be costly. A contractor that does not recognize which bond is securing a claim might end up paying more than anticipated to its surety through indemnification. On the other hand, a surety that fails to understand this issue may end up incurring unnecessary costs and seeking indemnification from the wrong bond principal. The recent case of *First National Insurance Co. v. Cam Painting, Inc.,* 93 Cal. Rptr. 3d 808 (Cal. Dist. Ct. App. 2009), highlights the importance of recognizing which payment bond covers a claim.

Two Bonds, One Surety

In *First National*, Cam Painting ("Cam") served as the general contractor on a construction project for the Los Angeles Unified School District (the "School District"). Cam was required by California law, and its contract with the School District, to post a payment bond, naming the School District as obligee (the "Cam Bond"). First National was the surety on this bond. Cam subcontracted with Sabco Electrique, Inc. ("Sabco") to perform some of the work for the School District. Cam similarly required Sabco to post a payment bond (the "Sabco Bond"). The Sabco Bond named Cam as the obligee. Coincidentally, First National was also the surety on the Sabco Bond.

Allsale Electric supplied materials to Sabco for installation on the project. Sabco failed to pay Allsale $47,000.00 for the materials it supplied and Allsale sued Sabco, the School District, Cam, and First National for the unpaid balance. In this suit, Allsale filed one count against First National on the Cam Bond, and a second count against First National on the Sabco Bond.

The Surety Strikes Back

Ultimately, First National determined that Allsale had a valid payment bond claim and paid Allsale in exchange for dismissal of its claims against the surety. First National paid Allsale with two checks, each for $23,500.00. In what it called "fairness", First National attributed half of the payment to the Cam Bond, and the other half to the Sabco Bond. First National then sued both Cam and Sabco to recover the amounts paid, as well as attorneys' fees and costs in defending the Allsale suit.

In these claims, First National asserted that each party had breached its respective indemnity agreement with the surety, and that both Cam and Sabco were required by California statute to reimburse the surety for any disbursement that satisfies the principal's obligation, in whole or in part. Specifically, First National sought to recover the $47,000 it paid to Allsale, the attorneys' fees it incurred in connection with the claims made against both bonds, and additional fees it might incur in the future. First National sought equal amounts from Cam Painting and Sabco. The trial court found in favor of First National against Cam and Sabco. Since First National paid half of the claim on each bond, the court ordered each party to reimburse First National for the amount disbursed plus costs and expenses, including $30,370 in attorneys fees First National incurred in defending the Allsale action.

Surety's Duty To Investigate

Cam appealed the trial court's ruling, arguing that, because this was a claim by Sabco's material supplier, First National's primary obligation as surety, rested with Sabco's payment bond. The California Court of Appeal agreed. In reaching this decision the court applied general principles of contract interpretation and surety law. The court reasoned that the "surety relationship is a tripartite one, in which the obligee, rather than the principal, is protected by the surety's promise to pay if the principal does not, in exchange for which promise the principal pays the premium for the bond." The court also recognized the general rule that surety bonds are construed most strongly against the surety and in favor of all persons intended to benefit from the bond.

Based on these principles, the court reasoned that, as to Allsale's claim for payment, First National was required to perform on the Sabco Bond in accordance with its terms. That bond required First National to protect Cam from losses caused by Sabco's debt. Through its contract with Sabco, Cam required that Sabco obtain a payment bond for protection in the event that Sabco failed to pay a supplier. In such event Cam relied on Sabco's surety's promise to pay the claim.

Although Allsale had a valid bond claim directly against Cam's surety, Cam's surety could have tendered the defense to Sabco's surety. This defense tender did not occur because Cam and Sabco both utilized the same surety — First National. But, this coincidence did not afford First National the luxury of determining which bond it could use to satisfy the claim. Instead, First National had a duty to investigate Allsale's claim and determine whether Cam or Sabco were liable to Allsale.

First National could not merely claim that it could not determine which principal was liable, especially when facts existed to the contrary. Allsale's complaint clearly stated that it was Sabco that owed it the money. Sabco and Allsale also had a written contract, in which Sabco guaranteed payment to Allsale. For these reasons, the court found that First National could not attribute any of the Allsale settlement payment or the defense costs to Cam's bond. As such, First National could not seek indemnification and reimbursement of attorneys fees and litigation expenses from Cam.

Comment

Contractors posting payment bonds are well advised to investigate any claims asserted. This would be particularly important in a situation where multiple payment bonds might cover the same claim. Where a claim is made against a single surety that posted multiple bonds, it is in the contractor's best interest to have the surety tender the defense and pay a claim on account of the bond other than its own. If a contractor allows its surety to pay a claim or even defend against a claim, that contractor might ultimately be liable through indemnification. Of course, if the contractor does not perform the necessary investigation, a surety will seek indemnification from whoever it can.

Likewise, sureties who decide to write bonds for different principals on the same project, must thoroughly investigate claims to determine which bond applies. Although the surety can seek indemnification and reimbursement from the bond principal on a valid claim paid by the surety, the *Cam Painting* case should serve as a reminder that surety's are typically not at liberty to decide unilaterally which bond applies. If the surety chooses to do so, it may risk being unable to recover fully from the proper indemnifying party.

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Implied Authority In Government Contracting

654 Authority to bind a party can be a significant issue in construction contract administration, particularly federal government contracting. A contractor should always know who has the authority to bind the federal government to actions such as changes taken under a contract, and the extent of that authority. For example, a representative might have the authority to bind the government up to a limit of $500,000 on one contract and a person with the same title may have authority to bind the government only up to $50,000 on a different contract. Prudent construction industry professionals should determine the actual authority of government representatives at the beginning of a project, and should remain aware of such authority during the entire project, since personnel changes often occur during contract performance.

What about the flip side? What factors will courts or boards look to in determining whether to hold a contractor responsible for the actions of its representative? In a recent Armed Services Board of Contract Appeals ("Board" or "ASBCA") decision, *Al-Dhiyaa Bureau for General Contracting; Al-Ghadeer Bureau for General Contracting; Al-Sa'Doon Bureau for General Contracting*, ASBCA No. 55788, 10-1 BCA ¶ 34,391 ("*Al-Dhiyaa Bureau*"), the Board invoked the concept of apparent authority and ruled against a contractor claiming it had not been paid for work performed for the government. Though the facts of the case are quite unusual, it illustrates that the ASBCA applies a different authority standard to hold a contractor responsible for the actions of its representatives than the standard the Board applies to bind the government. Under the Board's analysis, if a contractor's employee appears to have the authority to bind the contractor, then the contractor will have to live with that employee's actions. The Board's decision did not specify any particular signs that it will look for; instead, it applied a "seems to" test. That is, if the employee ***seems to*** have authority to act on behalf of the government contractor, then the actions of that employee can bind the contractor.

The *Al-Dhiyaa Bureau* Decision

In 2004, the Army awarded three contracts to refurbish three forward operating bases (FOBs) around Basra, Iraq. The Army awarded these three contracts to three different companies. Specific project and contract details were unclear, but the three firms appeared to be affiliated in some regard. One of the contact persons listed for one contract apparently was the majority owner of all three firms. Ultimately, the three contractors completed their respective work scopes, and the Army accepted all work performed under these contracts. After the work was completed, representatives of each contractor submitted standard forms seeking payment. However, due to the state of the Iraqi banking system, or apparent lack thereof at that time, each contract was written so that payment would be made to the contractor by check and delivered personally by a courier. After the checks were cut in the United States, all three were sent to Baghdad. At that time, travel from Baghdad to Basra was dangerous and, consequently, the Army's representative was delayed in bringing the checks to Basra.

The government courier finally brought the checks to Basra and contacted each firm using contact information listed in the contract documents. The Army instructed each contractor to send a representative to Basra with a copy of the contract to use as identification. On the date set for delivery of the checks, a representative of each firm showed up, presented a copy of the respective contract as identification, and signed for and received the checks. Each check was then cashed on the spot by Army finance representatives. The signatures acknowledging receipt of payment, as well as the signatures endorsing the three checks were illegible.

About a year later, an individual named Khudair, the contact person listed for one of the firms, informed the Army that his firm had yet to be paid for work performed. In a follow-up email, Khudair asserted that there was a problem with payment on all three contracts. Army representatives responded that the payment due to Khudair's firm had been made, and that the other two firms had also been paid. After continuing to communicate via e-mail, the Army told Khudair that in 2005 it had given the checks to representatives bearing copies of each contract.

Eventually, a claim was filed with the contracting officer on behalf of all three firms and each claim was denied.

In its decision, the ASBCA assessed whether the individuals who received and cashed the checks for the three contractors were authorized representatives of their respective firms. Since the three individuals were contacted through phone numbers and e-mail addresses listed in the contract files and the individuals had copies of the contracts, the Board found that those three individuals, whoever they were, each had implied authority to receive payment for the work performed under the respective contract.

Different Authority Standards for Contractors and the Government

Certainly the facts of *Al-Dhiyaa Bureau* are quite unusual. Because of the unique facts, and because the vast majority of contracts now require that payment be made by electronic funds transfer, it might be easy for other contractors to overlook this case on the assumption that "this would never happen to us." However, the underlying issue of who speaks for or binds the parties to a contract is a recurring problem. The standards for contractors and the government are not the same. Contractors would be well served to compare the *Al-Dhiyaa Bureau* decision to a recent Federal Circuit case, *Winter v. Cath-DR/Balti JV*, 497 F.3d 1339 (Fed. Cir. 2007). Such a comparison shows that, when it comes to the issue of implied or apparent authority in federal government contracting, contractors are not held to the same standard as their contracting counterparts – the federal government.

In *Cath-DR/Balti*, the contractor performed work that deviated from the contract specifications, as directed by the project's Resident Officer in Charge of Construction (ROICC). The government denied the contractor's subsequent claim for a contract modification. On appeal the Federal Circuit held that, to bind the government, a government representative must have express, actual authority. Additionally, the Federal Circuit ruled that the ROICC did not have implied authority to modify the contract because making modifications to a contract was not "an integral part of the duties" of the ROICC. As reflected by the *Cath-DR/Balti* decision, the federal government will typically be bound only if it can be shown that the government representative had express authority to bind the government under the contract.

By comparing *Cath-DR/Balti* and *Al-Dhiyaa Bureau*, it is clear that the standards applied to bind the government and those applied to bind a contractor are quite different. Typically, the government will be bound only when a representative has express authority, as provided in a warrant or in the contract documents. In some circumstances, the government may be bound under an implied authority theory, but this concept should be treated as highly unusual and rarely applied. A contractor, on the other hand, will be bound under a much lower standard as the contractors in *Al-Dhiyaa Bureau* discovered. If a board or court finds that circumstances make it appear that a contractor's employee or representative has the authority to make a decision or bind the contractor, then the contractor will likely be responsible for the decisions or conduct of the person (or persons) who ***seems to*** have such authority.

In practice, contractor personnel should know what their role on a project is, whether they are a decision maker, and who has responsibility to commit the contractor. In most cases, preventative measures such as this will help a contractor avoid situations where it becomes responsible under an implied authority theory for the actions of an employee whom the contractor may not have intended to possess such authority.

Promptly Assert Potential Claims

Finally, contractors can take way and hopefully apply another lesson from *Al-Dhiyaa Bureau* in their business with the federal government. Do not wait too long to request payment or bring a claim. The Board in *Al-Dhiyaa Bureau* repeatedly expressed concern about the length of time it took for the owner or owners of the three firms to inquire about the payments. These claims were not time barred, but the delay in presenting the claims struck the Board as odd.

Construction professionals, if faced with an obvious problem in contract administration, especially payment, would be best served to act on that problem as promptly as possible. The Board, in its decision in *Al-Dhiyaa Bureau*, appears to have thought that if there really was a problem with payment, the owners would not have waited a year to complain. Otherwise, if a contractor appears to have dragged its feet in bringing a claim, a judge may look at such claim with increased skepticism. This could lead to a decision less favorable to the contractor on the merits of the claim.

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"Or Equal" Rejection Upheld

655 Frequently, contract documents specify materials or components to be used in the construction project. These specifications vary widely from the generic to being quite specific. Specifications often require that a particular manufacturer's materials or components be used, but may also permit the contractor to substitute an equivalent "or equal" product. Construction professionals bidding work on a firm fixed price or lump sum basis need to understand that certain risks arise when attempting to substitute a seemingly equivalent material or product for a specific product required by the specifications.

Consider *John T. Jones Construction Co. v. Hoot General Construction*, 543 F.Supp.2d. 982 (D. Iowa 2008) ("*Jones Construction*"). In *Jones Construction*, the

owner's request for bids on a wastewater storage project included a specification for a wastewater lining system that specified one manufacturer's brand name product, or an equivalent lining system. When the owner's engineer denied the contractor's "or equal" product submittal, the contractor sued its subcontractor, the engineer, and the project owner. A key issue before the court related to the significance of the "or equal" specification and who would be responsible for the increased cost of meeting the specification as written.

Because the bid documents and the contract between the owner and the contractor stated that no "or equal" substitutions would be considered until after the contract was awarded, the contractor bore the risk that the "or equal" substitution would not be permitted. The court found that the words "or equal" did not represent a guarantee by the owner that an "equal" product was available, only that the engineer would consider "or equal" submittals in good faith.

The "Or Equal" Specification

In *Jones Construction,* the Des Moines, Iowa Wastewater Reclamation Authority, a special purpose public entity, engaged an engineering firm, Black & Veatch ("B&V"), to design and bid the specified work. The design scope for which B&V was responsible included preparing a wastewater lining system specification. B&V researched the products on the market and recommended a specific wastewater lining system produced by one of the two major manufacturers of such systems. B&V's first draft of the specification was a "sole source specification", expressly stating that "no substitutions or alternatives will be permitted." B&V used technical information from the recommended manufacturer to develop the specification and the result was a draft specification that used the manufacturer's proprietary, trademarked language and brand name.

To avoid using a sole source specification, the owner, a public entity, asked B&V to add the words "or equal" to the wastewater lining system specification. In fact, the attempt to avoid sole source specifications was carried throughout the bid documents and contract. Ultimately, the court noted that the "or equal" language would have applied to the wastewater lining system specification regardless because the contract incorporated by reference the Urban Standards for Public Improvements Manual, which states: "when a 'manufacturer's brand or model is mentioned, it is to be understood that the words equivalent or equal are assumed to follow… whether or not they do in fact." Further, the specific project requirements section of the contract stated that where a brand name was specified, "the specified item shall be understood as establishing the type, function and quality desired."

The owner also engaged B&V to provide pre-award services, and project administration and control. These responsibilities included reviewing contractor submittals. The contract stated that determination of whether a material qualified as "equal" was in the sole discretion of the engineer and the engineer's decision was final. Again, however, B&V was not required to evaluate "or equal" submittals from the contractor until after the contract was awarded.

Contractor's "Or Equal" Submittal Rejected

Jones Construction was the low bidder, and intended to subcontract the wastewater lining system portion of the project. In preparing its bid, Jones Construction received multiple quotes from potential subcontractors and those using the wastewater lining system brand specified in the contract were significantly higher than the quote using an "or equal" system. Jones Construction ultimately based its bid on a proposed "or equal" quote and entered a subcontract with a subcontractor who submitted an "or equal" quote for the wastewater lining system. The subcontractor who was awarded this portion of the work testified that it told contractor that the specification looked like a sole source specification and it would only bid on the project on an "or equal" basis. The subcontract, however, obligated the subcontractor to meet the general contract specifications.

Immediately after the contract award, Jones Construction sent B&V the subcontractor's submittal calling for use of the other manufacturer's lining system. B&V rejected this submittal on grounds that it did "not meet the specification requirements." Jones Construction sought a written explanation from B&V as to why it denied the proposed alternative lining system. B&V responded, enumerating several reasons why the systems were not equivalent. Jones Construction then submitted a change order request for the difference in price; however, B&V denied this request based on the plain language of the specification in the contract–it was not a change. Finally, Jones Construction approached the owner directly about its "or equal" request. The owner investigated and ultimately agreed with B&V's rejection of the proposed alternative lining system. When Jones Construction told its original subcontractor to use the specified product, the subcontractor claimed the contractor breached the subcontract by failing to secure approval for the "or equal" system. Jones Construction engaged a new subcontractor to furnish the specified system.

"Or Equal" Meant Only "Good Faith" Consideration

In the ensuing lawsuit, Jones Construction and its original lining system subcontractor argued that the owner and engineer had a "secret scheme or plan to sole-source" the wastewater lining system, which was "disguised" according to competitive bidding principles by adding the "or equal" language to the specification. In evaluating this claim, the court considered what "or equal" meant and did not mean, and what it required and did not require of the owner and engineer.

According to the court, the phrase "or equal" was an implied representation that the engineer would in good faith consider an "or equal" submittal. It did not mean that an equivalent product was actually available and did not mean that B&V or the owner would approve an "or equal" material substitution. On the other hand, the court found that it would not be permissible for the owner and engineer to reject an "or equal" material submittal simply because the material was not the specified brand.

Good faith required B&V to conduct a "reasonable and objective" determination of (1) whether the "or equal" material would perform adequately under the specified conditions of service in the contract and (2) whether the "or equal" material was equivalent to the specified material in type, function, and quality. In this case, the court found that the contractor and subcontractor made a threshold showing that the proposed wastewater lining system was equivalent to the specified system. But, this did not end the inquiry. Instead, the court went on to find that rejecting the "or equal" submittal was not bad faith because a reasonable engineer could prefer one system over the other, and reasonable engineers could disagree on whether the systems were equivalent. Thus, the court rejected the argument that the owner and B&V conspired secretly to sole source the wastewater lining system. In this regard, the court found no ill-intent by B&V or the owner.

Managing the Risk of an "Or Equal" Denial

In *Jones Construction*, the contractor bore the risk that the engineer and/or the owner would deny its "or equal" material submittal. To better assess that risk, the contractor could have taken several steps that it did not take in this case. First, it could have attended the pre-bid conference and inquired about the lining system specification. Second, the contractor could have requested of the engineer or owner an interpretation of the lining specification before submitting its bid. The contractor also could have adjusted its bid to mitigate the risk of denial of an equivalent product.

Instead, Jones Construction chose to pass the risk of denial to its original subcontractor, who had bid the job on an "or equal" basis, because the subcontract bound the subcontractor to perform the specification as written. Just as the owner did not guarantee that the "or equal" submittal would be approved, the contractor did not guarantee that the engineer and owner would approve the substitution. The subcontractor, who attempted to terminate the subcontract after the contractor failed to secure approval for the "or equal" system, was found liable for the contractor's cost of engaging the replacement subcontractor. To minimize that risk, the subcontractor could have expressly limited the scope of the subcontract to its "or equal" based bid so it would not be contractually responsible for meeting the specification in the general contract.

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UPCOMING SEMINARS

Geotechnical & Environmental Consultants, Inc., NPDES Permit Requirements: Plain and Simple, June 24, 2010, Hamilton, Georgia. *Scott Walters will be speaking on EPA's New ELG Rule.*

Government Contracting Series III – Teaming & Joint Ventures for Small Businesses and Other Set-Asides, July 6, 2010, ABC of Virginia, Dulles, VA. *Reginald M. Jones.*

Masters Institute in Construction Contracting, July 13-15, 2010, Federal Publications, Hilton Head, SC. *James F. Butler, III, will present The Owner's Perspective on July 14.*

Government Contracting Series III – Benefits and Limitations of the SBA and other Agency Mentor-Protégé Programs, July 20, 2010, ABC of Virginia, Dulles, VA. *Reginald M. Jones.*

What's Different About Federal Government Contracts? July 24, 2010, Carolinas AGC, Charleston, SC. *Thomas J. Kelleher, Jr.*

Common Sense Construction Law for Florida Licensed Contractors – Florida Continuing Education Course, July 29-30, 2010, AGC of East Tennessee, Inc., Chattanooga, TN. *Thomas J. Kelleher, Jr., Joseph C. Staak and John M. Mastin, Jr.*

Common Sense Construction Law for Florida Licensed Contractors – Florida Continuing Education Course, August 5-6, 2010, Georgia AGC, Atlanta, GA. *Thomas J. Kelleher, Jr., Joseph C. Staak and John M. Mastin, Jr.*

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UPCOMING SEMINARS

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Common Sense Construction Law for Florida Licensed Contractors – Florida Continuing Education Course, August 12-13, 2010, Rosen Centre Hotel, Orlando, FL. *Thomas J. Kelleher, Jr., Joseph C. Staak and John M. Mastin, Jr.*

Government Contracting Series III – Buy American Act: Understanding the Requirements, August 17, 2010, ABC of Virginia, Dulles, VA. *Reginald M. Jones.*

What's Different About Federal Contracts? August 18, 2010, Carolinas AGC, Pinehurst, NC. *Philip L. Fortune and Gene F. Rash.*

Common Sense Construction Law for Florida Licensed Contractors – Florida Continuing Education Course, August 19-20, 2010, ABC of Alabama, Birmingham, AL. *Thomas J. Kelleher, Jr., Joseph C. Staak and John M. Mastin, Jr.*

Government Contracting Series III – ARRA Reporting Requirements: How to Comply, August 31, 2010, ABC of Virginia, Dulles, VA. *Reginald M. Jones.*

Government Contracting Series III – Developing Compliant Federal Subcontracting Plans, September 14, 2010, ABC of Virginia, Dulles, VA. *Reginald M. Jones.*

Georgia Lien Law Update, October 6, 2010, Georgia AGC, Atlanta, GA. *S. Gregory Joy.*

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