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Federal Circuit Casts Cloud on Future Recovery of Settlement Costs in Non-Fraud-Related Cases

On May 19, 2009, the Federal Circuit in *Secretary of the Army v. Tecom* upheld the contracting officer's disallowance of a contractor's legal costs and settlement expenses in a sexual harassment and retaliation action brought under Title VII. The opinion is sweeping, and appears to extend the holding in *Boeing North American, Inc. v. Roche*, 298 F.3d 1272 (Fed. Cir. 2002) to almost every instance in which the contractor elects to settle in lieu of litigating cases to a conclusion.

The Facts in *Tecom* and Background

During the performance of a government contract, the plaintiff sued Tecom for sexual harassment and retaliation under Title VII. In pursuit of its defense, Tecom incurred legal costs and determined that it would be less costly to settle the matter – even though Tecom denied the allegations – than to try it. Tecom submitted its claim for legal defense costs and settlement payments, and when the contracting officer did not issue a decision on the claim, Tecom appealed to the Armed Services Board of Contract Appeals. The Board agreed with Tecom that the costs were allowable and remanded to the contracting officer to determine whether the costs were reasonable.

The Federal Circuit reversed, holding that the Board did not apply the Federal Circuit's decision in *Boeing North American.* In that case, the Federal Circuit determined that legal costs incurred by a contractor to defend against a shareholder derivative suit were disallowed where the alleged antecedent fraudulent conduct on which the derivative action was based had resulted in criminal and civil penalties and fines. The court held that *Boeing North American* required the Board to determine (1) whether Tecom could recover the claimed costs in the event of an adverse judgment and (2) if not, whether Tecom's settlement costs would be allowable. As in *Boeing North American*, the contractor could not prevail without showing that the plaintiff's case had "very little likelihood of success on the merits."

The Federal Circuit held that because Federal Acquisition Regulation ("FAR") 52.222-26 (Equal Opportunity) required Tecom not to discriminate "because of race, color, religion, sex, or national origin," the allegations if true would have breached the contract. Because FAR 31.201-2(a)(4) allows only those costs that comply with the contract, an adverse judgment against

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Tecom would have meant it could not recover its costs of defending against the allegations. The court bolstered this conclusion with an appeal to public policy that seeks to prohibit sexual discrimination. The court then concluded that *Boeing North American* extended to settlement payments of matters in the non-fraud context, and noted that Tecom had made no demonstration that "very little likelihood of success" existed.

***Tecom*'s Impact**

Tecom will affect contractors in at least three key respects:

(1) *Tecom* expressly extends *Boeing North American* to settlement payments. While this extension is hardly a great leap on the part of the court, its holding eliminates whatever residual doubt contractors may have had in this regard.

(2) Fraudulent misconduct or similar wrongdoing is no longer a *sine qua non* in the disallowance of legal and/or settlement costs. Costs incurred defending or settling a matter involving any type of wrongdoing that can be characterized as a violation of the contract terms are now squarely, and precedentially, in the sights of the Defense Contract Audit Agency ("DCAA").

(3) Although the *Tecom* decision hastily dismissed this possibility, the decision can be expected to be relied upon by DCAA to recommend the disallowance of any costs that relate to any alleged violation of law or regulation whenever there is broad requirement in the contract to comply with all applicable laws.

Contractors can no longer avoid having to prove that the plaintiff's case has "very little likelihood of success on the merits." As difficult as this element is to satisfy, it will now become essential to the settlement calculus. This may place a heavy premium on the careful contemporaneous preparation of a case assessment memorandum and a well-crafted settlement agreement that has an eye on this requirement, although there will always be the potential "Catch 22" rejoinder that settlement of a case that had so little chance of success was unreasonable. Some contractors might rightly reason that, under some circumstances, it is easier actually to *succeed* on the merits rather than to *disprove the plaintiff's likelihood of success* in the absence of a litigated result.

The "likelihood of success" standard is plainly amorphous and highly subjective. Unlike Potter Stewart's famous definition of obscenity – essentially, "I know it when I see it" – "likelihood of success" is not a concept for which there is a common, culturally accepted baseline. As the dissent in *Tecom* observed, no one party in a settlement can reliably count on success and – to restate the obvious – the Government has no great interest weighing the merits of un-litigated lawsuits between private parties involving anything other than contract-related fraud (where Uncle Sam has a dominant stake in the financial recovery).

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The Federal Circuit off-handedly stated in *dicta* that the costs of settlement should be unallowable when the contractor settles only because it knows that it is "certain to lose." No one is likely seriously to dispute that proposition. Nonetheless, the hash marks that separate a "certain to lose" defendant from a "very little likelihood of success" plaintiff are set widely apart. It is between these hash marks that DCAA now has been given free rein to play. Truly, in the wake of *Tecom*, for the purposes of allowability under Part 31 of the FAR, contractors accused of wrongdoing by a private litigant are guilty until proven innocent.

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