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Fed. Cir. Applies Restrictive Standard For Allowability Of Title VII Settlement Costs

Geren v. Tecom, Inc., 2009 WL 1378149 (Fed. Cir. May 19, 2009)

An adverse judgment in an action alleging sex-based discrimination in violation of Title VII of the Civil Rights Act of 1964 would breach the clause at Federal Acquisition Regulation 52.222-26, "Equal Opportunity," and render the contractor's defense costs unallowable. Therefore, the costs of defending and settling a Title VII action are not allowable unless the contractor can prove that the plaintiff had "very little likelihood of success," the U.S. Court of Appeals for the Federal Circuit has held, reversing a judgment of the Armed Services Board of Contract Appeals.

Tecom Inc. was awarded a cost-reimbursement contract for military housing maintenance. The contract incorporated the clause at FAR 52.222-26, which states in part, "The Contractor shall not discriminate against any employee or applicant for employment because of race, color, religion, sex or national origin." Sex-based discrimination in violation of Title VII is a clear breach of this contract clause.

During contract performance, a former employee sued Tecom under Title VII, alleging sexual harassment and that the employee was fired in retaliation for filing a sexual-harassment claim. The allegations arose from the employee's work on the contract.

Tecom incurred $93,163 in legal fees to defend the case and, without admitting wrongdoing, settled it by paying the employee $50,000, which did not include back pay. Tecom requested reimbursement of the settlement payment as a direct cost and reimbursement of the defense costs as indirect costs. Tecom contended that the former employee's allegations were false and that it settled the matter to avoid $300,000 in costs to try the case.

At the ASBCA, the Government argued that attorney fees and damages associated with a judgment of liability on a Title VII claim were not allowable costs, and that under *Boeing N. Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002), the cost of settling such claims would also be unallowable unless the contractor proved that the suit had very little likelihood of success on the merits. The ASBCA granted the contractor's motion for summary judgment, holding that the *Boeing* standard for allowability did not apply if there were no charges that the contractor had engaged in criminal conduct, fraud or violations of the Major Fraud Act of 1988. See 49 GC ¶ 419.

Under FAR 31.201-2, a cost incurred by the contractor is "allowable only when the cost complies with all of the following requirements: (1) Reasonableness. (2) Allocability. (3) [The Cost Accounting Standards]. (4) Terms of the contract. (5) Any limitations set forth in this subpart." The fifth requirement refers to the cost allowability rules in FAR subpt. 31.2. Only the fourth and fifth requirements were at issue in *Tecom*.

Although FAR subpt. 31.2 specifically provides that some costs are allowable and others are unallowable, it does not address every element of cost. The absence of a FAR provision addressing a specific type of cost does not mean that it is either allowable or unallowable. If neither the contract nor the FAR dictates the treatment of specific costs, the Federal Circuit determines the appropriate treatment by looking to the "principles and standards" in FAR subpt. 31.2 and the treatment of similar or related items. FAR 31.204(c).

The costs of professional services and settling litigation are allowable in some cases. If the claimed costs relate to a settlement agreement, the Federal Circuit conducts a two-step inquiry to determine allowability. First, the Court asks if the damages, costs, and attorney fees would be allowable if an adverse judgment were reached. If not, the Court asks whether the costs of settlement would be allowable.

Addressing the first step in the analysis, the Federal Circuit concluded that the damages, costs and attorney fees associated with a violation of Title VII would not be allowable. The Court noted that, like *Tecom*, its cost-allowability decision in *Boeing* involved a claim for the cost of settling a private lawsuit. In *Boeing,* the action was a shareholder suit against 14 company directors. The shareholder suit alleged that the directors failed to establish sufficient controls to prevent the fraud that led to the company's criminal conviction for fraud against the Government.

FAR 31.205-47 specifically makes unallowable costs incurred in connection with a criminal proceeding resulting in a conviction or with a civil proceeding resulting in a finding of liability for fraud against the Government. But the FAR does not address shareholder suits alleging a failure to prevent criminal wrongdoing. As required by FAR 31.204(c), to determine the allowability of the settlement costs, the *Boeing* court assessed whether the costs of the shareholder suit were "similar or related" to the costs of the underlying convictions. The *Boeing* court concluded that although the costs of the shareholder suit and the criminal convictions were not similar, the costs were related. Judgment for the plaintiff in the shareholder suit would depend on a finding that the directors did not maintain adequate controls to prevent the fraud against the Government. Because there was a sufficiently direct relationship to the disallowed costs of the criminal convictions, the costs of defending the shareholder suit were also unallowable, the *Boeing* court held. See also *Sw. Marine, Inc. v. U.S.*, 535 F.3d 1012 (9th Cir. 2008) (civil penalties under Clean Water Act similar to unallowable costs of False Claims Act proceedings).

After summarizing *Boeing*, the Federal Circuit concluded that it did not need to address the FAR 31.205-47 allowability of the costs incurred in connection with an adverse judgment in the Title VII action or whether those costs were similar or related to disallowed monetary penalties under FAR 31.205-15. Instead, the Court held that the costs of such an adverse judgment would be unallowable because a contractor violation of Title VII would breach the contract, and costs related to that breach would be unallowable.

FAR 31.201-2 states that a cost is allowable only if the "cost complies with [the] [t]erms of the contract." The contract also specifically barred any form of discrimination based on sex, including sexual harassment and retaliation. If those allegations were established at trial, the costs of the defense and the judgment "would certainly result from a breach of the contract," the Court said.

The unallowability of costs attributable to a breach of contract has long been the rule in Government contracts. In *Dade Bros., Inc. v. U.S.*, 325 F.2d 239 (Ct. Cl. 1963), the contract generally allowed reimbursement of the cost of defending third-party suits. Union members successfully sued the contractor and certain union officials for depriving the workers of seniority rights under the union contract. The contractor attempted to treat the costs of defending the action and the adverse judgment as allowable costs on its Government contract. The U.S. Court of Claims rejected the claim because the costs were associated with a breach of the contract, which required the contractor to comply with its union contract.

The unallowability of costs attributable to a breach of contract has been part of the procurement regulations since 1958, the Federal Circuit noted. FAR 31.201-2 contains that prohibition today. Moreover, the prohibition on reimbursing costs attributable to violations of Title VII is consistent with public policy. See *NAACP v. Fed. Power Comm'n*, 425 U.S. 662 (1976) (Government-approved utility-rate calculation properly excluded costs of discriminatory employment practices).

Tecom argued that if costs related to private lawsuits that establish a violation of the contract are unallowable, virtually any lawsuit will result in unallowable costs because the Permits and Responsibilities clause, FAR 52.236-7, makes it a breach of the contract to violate any law. The Federal Circuit rejected Tecom's argument because it construed the Permits and Responsibilities clause too broadly. That clause assigns the contractor the responsibility for obtaining necessary licenses and permits and for complying with federal, state and local laws applicable to performing the work, so that failure to perform is not excused by the contractor's failure to meet legal obligations, the Court said.

Having determined that the costs attributable to an adverse judgment would not be allowable, the Court moved to the second part of the allowability analysis—the allowability of costs attributable to the settlement of the action. The Court held that FAR policy is to disallow the cost of settling suits that were likely meritorious if those costs would be disallowed in the case of an adverse judgment. For actions by private plaintiffs, no assumption of the merit of the settled action is proper. To determine the allowability of the settlement costs in *Boeing*, the Federal Circuit looked to the FAR provisions on settlement of "private suits" brought under the FCA. Under FAR 31.205-47(c)(2), those costs are not allowable unless the contractor can show that the action had very little likelihood of success on the merits.

The Court held that the allowability of the *Tecom* settlement costs was "squarely addressed" in *Boeing*, which applies to defense costs and settlement payments, although only defense costs were at issue in *Boeing*. Thus, if the damages or penalties paid in the case of an adverse judgment are unallowable, the settlement costs are also unallowable unless the contractor can establish that the private Title VII plaintiff had very little likelihood of success on the merits, the Federal Circuit held.

The Court rejected the dissent's argument that the *Boeing* standard should be limited to fraud settlements. "*Boeing* clearly adopted a broader rule applicable to private settlements generally where the defense and judgment costs would be disallowed in the case of a final adjudication," the Court held. Allowing a contractor that is certain to lose on the merits to recover otherwise unallowable defense costs by "the simple expedient of settling" contravenes FAR policy, the Court held.

✦ **Note**—The dissent would limit the *Boeing* allowability test to settlement of actions asserting fraud. The "very little likelihood of success standard," found only in FAR 31.205-47(c)(2), was a "far more 'appropriate standard' for the facts of that case than for the present situation," the dissent said. That cost principle applies to "settlement of any proceeding brought by a third party under the False Claims Act" if the U.S. did not intervene. It does not apply to "any and all settlements of lawsuits." The allegations of fraud related to the shareholder suit support the *Boeing* court's decision to apply the very-little-likelihood-of-success standard in that case, the dissent said.

Tecom, however, did not involve questions of fraud, and extending *Boeing* to the *Tecom* facts "is unwarranted given the specific applicability of FAR 31.205-47(c)(2) to private suits brought under the False Claims Act in which the government does not intervene." Finally, the dissent "recoiled from … extending that difficult-to-apply likelihood of success rule beyond its current borders" and warned that determining "the likelihood of success in a law suit is not so easily done."

✦ **Practitioner's Comment**—The Federal Circuit's decision in *Tecom* is stunning for a number of reasons. First, the Court overturned nearly 35 years of case law determining that the cost of defending and settling employment lawsuits, even the cost of defending a suit that is unsuccessful, are allowable costs. See, e.g., *Hayes Int'l Corp.*, ASBCA 18447, 75-1 BCA ¶ 11076. The long-held rationale for such decisions is that an ordinarily prudent business person would incur costs to defend and sometimes settle such cases, regardless of the merits of the allegation. See 49 GC ¶ 419 (practitioner's comment).

Second, as the dissent points out, the Court seems to have extended the reach of the underlying *Boeing* decision far beyond the holding of that case. In *Boeing*, the court concluded that the costs of defending and settling a shareholder derivative suit involving breach of fiduciary duty on underlying actions based on alleged fraud and criminal acts was related to the provisions of FAR 31.205-47(b). Whereas extension of the *Boeing* decision to *Sw. Marine*, cited in *Tecom*, could be justified by the similarity of the qui tam-type provisions alleging violation of the Clean Water Act to a qui tam action under the FCA, to which FAR 31.204-47(b) specifically applies, it would not seem to apply to general, civil, third-party lawsuits. See 47 GC ¶ 130. Yet, the Court held, "We think that *Boeing* clearly adopted a broader rule applicable to private settlements generally where the defense and judgment costs would be disallowed in the case of a final adjudication." In extending the holding of *Boeing* to the broader universe of third-party suits, it seems, at least, that the Court found that some parameters apply to the rule, but those parameters remain unclear.

Moreover, the Court need not be compelled to force every type of litigation through the "similar or related" standard of FAR 31.204(d). If a cost principle in FAR part 31.205 does not apply, the cost is subject to the allowability standard of FAR 31.201-2 on reasonableness, allocability and the application of accounting standards.

Third, the decision assumes away the possibility that the contractor might have succeeded in its defense. Settling a case, regardless of the outcome, is often the most prudent and cost effective approach. If left to prove the incomprehensible and ill-defined "likelihood of success on the merits" standard—which the Court never defined in *Boeing*, see 49 GC ¶ 419, contractors will be left with no choice but to pursue all litigation to resolution in order to recover the costs in those cases where the contractor is successful. In the end, this serves no one (contractors, Government or the judiciary) well.

Truthfully, contractors will likely continue to consider settlement as a means to resolve litigation because it will remain a better business practice. Nevertheless, in high stakes litigation, the *Tecom* decision may motivate contractors to litigate to the death, rather than settle, in light of the risk that the costs would not be allowable under Government contracts.

Finally, it is very fair to wager that this decision will not be the end of the issue. The Court vacated and revised its original decision in *Boeing* en banc. That remains an option in the *Tecom* case. Even so, another case is bound to come along to test the bounds of the "breach of contract" element of *Tecom* or finally get some judicial holding on the amorphous "likelihood of success on the merits" standard. Stay tuned.

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