THE NASH & CIBINIC REPORT
government contract analysis and advice monthly from professors ralph c. nash and john cibinic

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JANUARY 2022 | VOLUME 36 | ISSUE 1

¶ 5 Appeals To Watch: Federal Circuit Addresses The Presumption Of Prejudice And Novel Theories To Recover False Claims Act Defense Fees In *System Studies* And *Tolliver* Appeals

A special column by Nathaniel E. Castellano, a senior associate in the Government contracts and national security practice group at Arnold & Porter; the ideas presented herein, particularly those that may prove to be in error, are his own.

The U.S. Court of Appeals for the Federal Circuit heard argument in two significant Government contracts appeals in November 2021. The first, *System Studies & Simulation v. U.S.*, No. 21-1469, may finally lay rest to the notion of "presumed prejudice" in bid protest cases. The second, *The Tolliver Group, Inc. v. U.S.*, No. 20-2341, involves a novel contractual theory for recovering the costs of defending against False Claims Act allegations, as well as the Department of Justice's practices for seeking dismissal of *qui tam* cases. For audio recordings of the oral arguments in these appeals, see https://cafc.uscourts.gov/home/oral-argument/listen-to-oral-arguments/.

Both appeals were argued by Huntsville, Alabama attorney Brad English (along with Emily Chancey, Jon Levin, and Michael Rich). Brad also argued the *Harmonia Holdings* appeal that I featured in my most recent contribution to the REPORT, *Harmonia Delayed: Anticipating the Federal Circuit's Next Decision on Bid Protest Timeliness*, 35 NCRNL ¶ 61. Just a few weeks ago, the Federal Circuit issued a clear and unanimous decision in the *Harmonia Holdings* appeal, deftly avoiding for now any serious disruptions to the current bid protest timeliness rules. *Harmonia Holdings Group, LLC v. United States*, ___ F.4th ___, 2021 WL 5816288 (Fed. Cir. Dec. 7, 2021). See in this issue *Postscript: Harmonia Better Late Than Never*, 36 NCRNL ¶ 6. As a Huntsville native myself, I always enjoy seeing Rocket City procurement lawyers and professionals impacting the field. Roll Tide.

Presumption Of Prejudice

The first appeal, *System Studies*, will hopefully resolve an issue that frequently complicates bid protest litigation: presumed prejudice. The decision may also provide further clarity as to the U.S. Court of Federal Claims' discretion to decide when an evaluation error is prejudicial to an agency's

award decision, rather than remanding the procurement to the agency to decide in the first instance whether the award decision will change.

To succeed, a protester must establish not only an error in the procurement, but also that any error is prejudicial. While the prejudice requirement has been described in many different ways over the decades, it is most clearly rooted in the Administrative Procedure Act requirement that, when a court reviews agency action, "due account shall be taken of the rule of prejudicial error." 5 USCA § 706; *American Relocation Connections, L.L.C. v. U.S.*, 789 F. App'x 221 (Fed. Cir. 2019). The fundamental rule that a court should not disturb an agency's actions based on an error that would not make any difference to the outcome seems simple enough, but it can be messy in application and does not always produce a satisfying result. See *Protests: The "No Prejudice" Rule*, 11 N&CR ¶ 20; *Prejudice in Award Controversies: What Comes First?*, 17 N&CR ¶ 29.

When the Federal Circuit was first articulating what a plaintiff needs to demonstrate to succeed in a bid protest under 28 USCA § 1491(b), the court described two paths to victory—one where "the procurement official's decision lacked a rational basis" and another where the "procurement procedure involved a violation of regulation or procedure." *Impresa Construzioni Geom. Domenico Garufi v. U.S.*, 238 F.3d 1324, 1332–33 (Fed. Cir. 2001), 43 GC ¶ 29. Curiously, the court then stated that: "When a challenge is brought *on the second ground*, the disappointed bidder must show 'a clear and prejudicial violation of applicable statutes and violations.' " (Emphasis added.).

By limiting its articulation of the prejudice requirement to "the second ground," the Federal Circuit gave way to a line of Court of Federal Claims decisions holding that prejudice may be presumed if a protester succeeds on the first ground, i.e., establishes that an agency's actions lack a rational basis. However, the Federal Circuit has never endorsed any presumption of prejudice, and there is significant U.S. Supreme Court and Federal Circuit precedent indicating that prejudice must be demonstrated in every case under APA review, without exception. *Shinseki v. Sanders*, 556 U.S. 396 (2009); *DynCorp International, LLC v. U.S.*, 10 F.4th 1300 (2021), 63 GC ¶ 268.

Understandably, the presumption of prejudice surfaces frequently in bid protest practice, and in the *System Studies* protest, Judge Sweeney provided a detailed discussion of the presumption and its origins. *System Studies & Simulation, Inc. v. U.S.*, 152 Fed. Cl. 20 (2020). Judge Sweeney attempted to reconcile the presumption with Supreme Court and Federal Circuit precedent, concluding that "in a situation where a procuring agency has acted irrationally, a presumption of prejudice would apply only when that irrational action actually affected the protestor's ability to be awarded the contract." The court went on to find that, even though the agency had acted irrationally in assigning a strength to the awardee's proposal, that "error identified by the court neither undercut the integrity of the Agency's procurement process nor harmed plaintiffs' chances of being awarded the contract."

Systems Studies appealed, seeking clarification of the presumption of prejudice and challenging the court's ultimate finding that the procurement error was not prejudicial. One of the panel judges, Judge Prost, had just months earlier authored a decision stating that "[t]he APA does not provide an exception to the prejudicial-error rule for arbitrary and capricious action." *DynCorp*, 10 F.4th at 1308 n.6. During argument, Judge Prost pressed Systems Studies' counsel as to how a presumption of prejudice could be reconciled with binding Federal Circuit precedent, to which Brad responded:

> I don't think the presumption itself, if it exists, is necessarily contrary to the rule of prejudicial error…the rule of prejudicial error would just say that the Court of Federal Claims has to consider whether

> an error is harmless before it sets aside an agency action. Whereas a presumption is an evidentiary convention that would essentially set who speaks first on that point. If there is an irrational action, then presumably the presumption would be rebuttable, and the Court would take account of the rule of prejudicial error as part of a rebuttal analysis.... If the error was a violation of law, then it would be the protester's burden in the first instance....

During argument, the DOJ joined in System Studies' request that the Federal Circuit clarify whether any presumption exists. While that clarification would certainly be welcome, it is not clear that the presumption would make a difference in this case, because the court actually did find that the error was harmless.

To that, System Studies argues that the prejudice inquiry cannot allow the Court of Federal Claims to assume the role of source selection authority and divine whether the error would impact the award decision. As I have discussed elsewhere, this is a tricky area of bid protest practice and administrative law, where the rule of harmless error risks violating the "*Chenery* doctrine" (*SEC v. Chenery Corp.*, 318 U.S. 80 (1943), which holds that a court may not make a decision in the first instance that the agency is vested with discretion to make on its own. See Castellano, *Year in Review: The Federal Circuit's 2019 Government Contracts Decisions*, 69 AM. U. L. REV. 1265, 1290–93 (Apr. 2020). But see *Oracle America, Inc. v. U.S.,* 975 F.3d 1279, 1290 (Fed. Cir. 2020), 62 GC ¶ 257, *cert. denied,* 142 S. Ct. 68 (2021), 63 GC ¶ 305.

Recovering FCA Attorney Fees Through Breach Of Implied Warranty

While the Federal Circuit is no stranger to bid protest prejudice, the second significant appeal argued in November, *Tolliver*, introduced an issue that is always top of mind for Government contractors and their counsel but rarely surfaces before the Federal Circuit—the civil False Claims Act (FCA). During argument, the panel judges raised several questions about a particularly controversial aspect of FCA practice: the DOJ policy towards seeking dismissal of meritless *qui tam* cases. Steve Schooner addressed some of the FCA dismissal issues recently in *False Claims Act: Greater DOJ Scrutiny of Frivolous Qui Tam Actions*, 32 NCRNL ¶ 20.

The Federal Circuit has already issued its decision in the *Tolliver* case, vacating the decision on appeal on the basis that Tolliver never submitted a claim that encompassed the theory of liability that the Court of Federal Claims ruled on. ___ F.4th ___, 2021 WL 5872256 (Fed. Cir. Dec. 13, 2021). Notwithstanding that dispositive procedural issue in this case, the principal issue presented in the *Tolliver* appeal was whether a contractor can leverage a breach of contract theory to recover attorney fees incurred defending against FCA allegations. While the Federal Circuit has made it notoriously difficult for contractors to recover the costs associated with third- party litigation claims, *Geren v. Tecom, Inc.*, 566 F.3d 1037, 1039 (Fed. Cir. 2009), 51 GC ¶ 190, neither the oral argument exchanges nor the court's opinion expressed any inherent objection to recovery of FCA-related attorney fees where, as here, the FCA claims arise due to the Government's performance shortfalls.

To make a long story short—the Army and Tolliver became parties to a contract under which the Army would provide Tolliver with a technical data package, and Tolliver would use that data to provide the Army with technical manuals for military vehicle field users. The Army, however, was not able to obtain the technical data package and ultimately modified the contract to permit Tolliver to prepare and deliver the manuals without reliance on the data packages. A Tolliver employee filed a *qui tam* suit under the civil FCA asserting that Tolliver falsely certified compliance with the technical data package despite not having it.

The Army knew the *qui tam* relator was wrong, and Army contracting personnel assisted Tolliver in defending against the case through affidavits, but the Government did not seek dismissal of the case. Tolliver successfully defended itself: "The district court dismissed the complaint, concluding that it lacked merit because the Army intended to provide Tolliver with the technical data package for use in developing the manuals, it did not do so, it knew that it did not do so, and still instructed Tolliver to proceed with performance. Thereafter, the U.S. Court of Appeals for the Fourth Circuit affirmed the district court's dismissal of the suit." *Tolliver Group, Inc. v. U.S.*, 148 Fed. Cl. 351, 353 (2020) (citation, quotation, and alteration omitted).

Tolliver sought equitable adjustment for the approximately $200,000 in attorney fees incurred in defending against the *qui tam* suit. The Army Contracting Officer denied the claim, and Tolliver proceeded to the Court of Federal Claims. Judge Lettow found the Government liable for Tolliver's FCA defense fees, invoking the "S*pearin* doctrine," which holds that "when the government provides a contractor with defective, erroneous, or promised but missing specifications, the government is deemed to have breached the implied warranty that satisfactory contract performance will result from adherence to the specifications, and the contractor is entitled to recover costs proximately flowing from the breach." *Tolliver Group, Inc. v. U.S.*, 146 Fed. Cl. 475, 482 (2020) (quotation omitted) *U.S. v. Spearin*, 248 U.S. 132 (1918).

Judge Lettow found that the Government's failure to perform as required directly resulted in Tolliver incurring legal costs to defend against the *qui tam* case:

> Because the absence of the technical data package triggered and served as the basis for the *qui tam* suit, the litigation and the legal fees Tolliver incurred to defend itself are attributable to the government's failure to provide the data. If the missing data had been provided, the *qui tam* suit could not have been brought. Therefore, the government's action is both the actual and proximate cause of the legal costs at issue here, and Tolliver has successfully shown the elements necessary to prevail in obtaining an equitable adjustment to account for its legal fees.

Tolliver, 146 Fed. Cl. at 483–84. Judge Lettow recognized that *Spearin* claims, which are based on a theory of implied warranty, cannot be used to recover costs of defending against third-party claims, a limitation rooted in Supreme Court precedent that limits the Government's ability to agree to open ended indemnifications for third-party claims. *Hercules, Inc. v. U.S.*, 516 U.S. 417 (1996), 38 GC ¶ 11. But, Judge Lettow concluded that the limitation does not apply in the FCA context because *qui tam* cases are brought on behalf of the United States. *Tolliver*, 146 Fed. Cl. at 485–86.

The United States appealed to the Federal Circuit, raising a host of procedural challenges, including that Tolliver's claim to the CO did not adequately set out any breach of implied warranty claim, that the United States did not have adequate opportunity to fully develop its defense to that claim during the trial court proceedings, and that the *Spearin* doctrine does not allow for recovery of litigation costs associate with third-party claims.

Judge Dyk presided over the merits panel—the same judge that authored the Federal Circuit's *Tecom* decision, which severely restricts contractors' ability to recover legal costs associated with third-party litigation claims, and a more recent decision reaffirming the *Tecom* rationale, *Bechtel National, Inc. v. U.S.*, 929 F.3d 1375 (Fed. Cir. 2019), 61 GC ¶ 223. To the extent the Government was hoping for a sympathetic audience, however, it did not receive one.

The panel did not seem to have any real objection to the premise that because the *qui tam* action is brought in the Government's name, the costs of defending against the *qui tam* action are ef-

fectively imposed by the Government against the contractor. The panel also did not express any apparent concern over the end result that Tolliver would recover its legal fees from the Government under a breach of contract theory. Indeed, Judge Taranto found a "certain appeal" to Tolliver's position:

> The picture on the other side has a certain appeal. You all promised in the original contract to provide some information that would make completion of the job easier. Undisputedly, you didn't provide that information. The job got a lot more expensive. You directed them: continue on the job. You then negotiated an additional dollar figure, much larger dollar figure. But meanwhile, the United States, represented by [the relator], imposes $200,000 of litigation costs. I attribute that, in their theory, to the government. So, the government sues Tolliver, imposes $200,000 of costs, for doing what the government said. Now there seems something that cries out for: the government should pay for that extra $200,000. How should that have happened?

Suggesting an alternative to liability under the *Spearin* doctrine, Judge Taranto asked whether the *qui tam* suit might have resulted in a breach of the Government's implied contract of good faith and fair dealing:

> Could there have been a cause of action for the breach of the duty of good faith and fair dealing, at whose core is the obligation of the other side of the contract not to take affirmative action to interfere with the other side's receipt of the contemplated benefits? That seems like a fairly apt description here of the government suing and imposing costs that could not have been contemplated.

The Government's response was to note that such an action would be an improper challenge to the Government's discretionary determination regarding whether to intervene in or seek dismissal of a particular case.

Judge Dyk was particularly interested in the DOJ policies to intervene in and seek dismissal of *qui tam* cases. Judge Dyk recognized that the Government is generally not liable to reimburse contractors for costs incurred based on litigation brought by third parties, but recognized a distinction in *qui tam* cases where the Government is named as the plaintiff and does not seek dismissal:

> Help us understand what happens in these *qui tam* suits… How many of these *qui tam* suits are there? What is the government policy about intervening and dismissing, or not intervening?
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> * * *
>
> I am just puzzled about why the government approaches it this way. They had the contracting officer supply an affidavit. It must have been authorized to do that, and to help defeat the action. But the easier way to do that would have been just to intervene and dismiss. I just don't understand what the government policy is in this area.

Government counsel could not (or at least would not) answer these and similar questions about policies of the DOJ Fraud Section. When Government counsel argued that the decision to intervene or seek dismissal is irrelevant, Judge Dyk disagreed:

> It looks as though the government, by allowing this to proceed, is imposing costs on the contractor that the contractor couldn't possibly have anticipated.…The theory in a sense is that these costs are being imposed by the government on the contractor.

Despite the substantive exchanges at oral argument, the Federal Circuit's opinion dodges the ultimate issue of liability. The court agreed with the Government that Tolliver never submitted a claim that encompassed a breach of implied warranty theory, and therefore the Court of Federal Claims never had jurisdiction to impose liability on that basis. *Cf.* Castellano, *After Arbaugh: Neither Claim Submission, Certification, Nor Timely Appeal Are Jurisdictional Prerequisites to*

Contract Disputes Act Litigation, 47 PUB. CONT. L.J. 35 (2017). In a footnote, the opinion states that "the United States has raised significant questions about whether the *Spearin* doctrine applies here." The decision does not otherwise address the potential to recover FCA defense costs under the *Spearin* doctrine, and does not grapple with Judge Taranto's suggested breach of the implied duty of good faith and fair dealing: "We also do not address whether other theories of recovery might be applicable here and might yet be presented to the contracting officer."

While the United States may have won this appeal, the *Tolliver* decision leaves the possibility that, with the right claim and the right facts, a contractor may well be able to recover legal fees that are incurred defending against an FCA action, whether under a theory of breach of implied warranty, breach of implied duty of good faith and fair dealing, or otherwise. And, based on the oral argument exchange, there is at least some indication that the Federal Circuit may be amenable to that ultimate outcome. *Nathaniel E. Castellano*