

## Note from the Field

### Federal Circuit Clarifies the Total Cost Method of Proving Damages

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*“If the total cost method of proving damages were not already dead, the [United States Court of Appeals for the Federal Circuit] CAFC drove a stake through its heart with the Propellex Corporation decision.”<sup>1</sup>*

#### Introduction

In a recent case, the United States Court of Appeals for the Federal Circuit (CAFC) clarified the requirements for recovery of damages in government contract disputes using a total cost method. In *Propellex Corp. v. Brownlee*,<sup>2</sup> the CAFC affirmed an Armed Services Board of Contract Appeals (ASBCA) decision that denied, in part, Propellex Corporation’s (Propellex) modified total cost claim for damages on the basis that Propellex had not established the impracticability of proving its actual losses directly.<sup>3</sup> In its *Propellex* decision, the CAFC interpreted the four requirements for recovery of damages under the total cost method set out in *Servidone Construction Corp. v. United States*.<sup>4</sup> The *Propellex* decision clarified the first of the four *Servidone* proof prerequisites which requires that, in order to recover damages under the total cost method, a contractor must first establish the impracticability of proving its actual losses directly.<sup>5</sup> Here the court held that a contractor cannot establish the impracticability of proving its actual losses

directly by unreasonably failing to keep records of its actual costs.<sup>6</sup>

#### Methods of Establishing Damages

The total cost method is one of several methods a contractor may employ to prove the amount of a claimed equitable adjustment. The accepted methods of proving damages include submitting actual cost data, submitting estimates of actual costs, using a total cost method or a modified total cost method, and using a “jury verdict” method.<sup>7</sup>

Using actual cost data to establish the amount of an equitable adjustment for additional work is the preferred method of proof.<sup>8</sup> Actual cost data “provides the court, or contracting officer, with documented underlying expenses, ensuring that the final amount of the equitable adjustment will be just that—equitable—and not a windfall for either the government or the contractor.”<sup>9</sup> In the absence of actual cost data, contractors may use estimates to establish the amount of an equitable adjustment for additional work.<sup>10</sup>

The total cost method of measuring damages, in contrast to the specificity of proving actual damages, consists of merely subtracting the costs in a contractor’s bid from its actual cost of the contract.<sup>11</sup> This imprecise method of proof does not identify the specific extra costs incurred as a result of the changes, differing site conditions, or delays encountered in contract performance.<sup>12</sup> Instead, this method assigns liability for all costs in excess of a contractor’s bid estimate to the government.

1. Peter A. McDonald, C.P.A., Esq., Remarks at the Annual Meeting of the Boards of Contract Appeals Bar Association (Oct. 22, 2003).

2. 342 F.3d 1335 (Fed. Cir. 2003).

3. *Propellex Corp.*, ASBCA No. 50203, 02-1 BCA ¶ 31,721.

4. 931 F.2d 860, 861 (Fed. Cir. 1991).

5. *Id.*

6. *Id.*

7. Major Thomas C. Modeszto, et al., *Contract and Fiscal Law Developments of 2002—The Year in Review*, ARMY LAW., Jan./Feb. 2003, at 102, n.22 [hereinafter *2002 Year in Review*].

8. *Propellex Corp.*, 342 F.3d at 1338.

9. *Dawco Constr., Inc. v. United States*, 930 F.2d 872, 882 (Fed. Cir. 1991), *overruled on other grounds by* *Reflectone, Inc. v. Dalton*, 60 F.3d 1572 (Fed. Cir. 1995).

10. See JOHN CIBINIC, JR. & RALPH C. NASH, JR., *ADMINISTRATION OF GOVERNMENT CONTRACTS* 706 (3d ed. 1995).

11. *Servidone Constr. Corp.*, 931 F.2d at 861.

12. CIBINIC & NASH, *supra* note 10, at 710.

Accordingly, the use of the total cost method to prove damages is not favored.<sup>13</sup>

The modified total cost method of calculating damages uses the total cost method as a starting point, but makes adjustments to allow for various factors (e.g., a below-cost bid) to arrive at a reduced figure that fairly represents “the increased costs the contractor directly suffered from the particular action of [the] defendant which was the subject of the complaint.”<sup>14</sup> Use of both the total cost method and the modified total cost method of establishing damages is limited to cases that meet four basic requirements described below.<sup>15</sup>

Apart from using actual costs or estimates, the total cost method, or a modified total cost method to calculate damages, courts and boards have also used a jury verdict method to establish the amount of a contractor’s damages when there is clear proof of injury, there is no more reliable method of computing damages, and there is sufficient evidence to make a fair and reasonable approximation of the damages.<sup>16</sup>

### **The Total Cost Method and the *Servidone* Requirements**

The *Servidone* decision sets out four requirements that a contractor must meet in order to use the total cost method to prove its damages.<sup>17</sup> A claimant hoping to employ this method has the burden of proving: “(1) the impracticability of proving actual losses directly; (2) the reasonableness of its bid; (3) the reasonableness of its actual costs; and (4) lack of responsibility for the added costs.”<sup>18</sup> A contractor hoping to employ a modified total cost method still must prove all four of these requirements. The *Propellex* court noted in its decision that, “under its modified total cost method claim, Propellex still had the burden

of proving the four requirements for a total cost recovery set forth above. The modified method simply was a way of easing that burden somewhat.”<sup>19</sup>

### **The Dispute**

In 1988 and 1990, the U.S. Army Armament, Munitions and Chemical Command awarded Propellex two firm fixed-price contracts to deliver Mark 45 electric gun primers to the U.S. Navy for a combined total price of approximately \$2.6 million.<sup>20</sup>

The contracts required Propellex to submit production lot samples to the government for testing at the Naval Surface Warfare Center (NSWC) facility in Indian Head, Maryland.<sup>21</sup> This lot acceptance testing included a moisture analysis of the black powder contained in the primers.<sup>22</sup> As a result of this testing, in September 1990, the Army determined that lot six under the first contract did not meet contract requirements, because black powder samples exceeded the maximum allowable moisture content limit.<sup>23</sup> In 1991, the NSWC conducted lot acceptance testing of production lots under the second contract, and the government found lots one through three also exceeded the maximum allowable black powder moisture content limit.<sup>24</sup>

The contracting officer notified Propellex on 18 October 1990 that lot six of the first contract had failed inspection requirements due to excessive black powder moisture content.<sup>25</sup> As a result, Propellex conducted an investigation into the cause of the alleged excessive moisture in the primers and diverted some of its employees to investigate the moisture problem.<sup>26</sup> While it kept records of tests it performed, Propellex’s records

13. See *Servidone Constr. Corp.*, 931 F.2d at 861 (“A trial court must use the total cost method with caution and as a last resort.”).

14. *Propellex Corp. v. Brownlee*, 342 F.3d 1335, 1339 (Fed. Cir. 2003).

15. *Id.*

16. *WRB Corp. v. United States*, 183 Ct. Cl. 409, 425 (1968).

17. *Servidone Constr. Corp.*, 931 F.2d at 861.

18. *Id.*

19. See *Propellex Corp.*, 342 F.3d at 1339.

20. *Propellex Corp.*, ASBCA No. 50203, 02-1 BCA ¶ 31,721.

21. *Id.* at 156,720.

22. *Id.*

23. *Id.* at 156,722.

24. *Id.*

25. *Id.*

26. *Id.*

did not include the number of employees, labor hours, or materials used during testing.<sup>27</sup>

When Propellex completed this investigation, it informed the Army that it found no evidence to indicate that the moisture content of its black powder was excessive.<sup>28</sup> The government and Propellex then jointly observed testing procedures at the NSWC and found defects in the Navy's procedures.<sup>29</sup> The Army ultimately accepted all of the primers that Propellex produced.<sup>30</sup>

Propellex subsequently requested an equitable adjustment of the contract price, asserting that faulty government testing caused it to incur additional costs. On 16 September 1994, Propellex filed a claim with the contracting officer in the amount of \$1,790,065 for both contracts.<sup>31</sup> The contracting officer issued a 5 September 1996 final decision admitting "some culpability" and allowing recovery of \$77,325, but denying the remainder of Propellex's claim.<sup>32</sup>

### The ASBCA Decision

Propellex appealed the contracting officer's final decision to the ASBCA under the Contract Disputes Act of 1978 (CDA).<sup>33</sup> Regarding entitlement, the board determined that the government had failed to conduct the disputed lot acceptance tests under the contract testing requirements.<sup>34</sup> Propellex presented

27. *Id.* at 156,727.

28. *Id.* at 156,723.

29. *Id.* at 156,725.

30. *Id.* at 156,722. Through bilateral contract modifications, the contracting officer waived the "high moisture content" of the rejected lots and accepted these lots in exchange for price reductions. *Id.*

31. *Id.* at 156,726. By the time of the ASBCA hearing, Propellex claimed \$1,356,580 on a modified total cost basis. *Id.* at 156,727.

32. *Id.* at 156,726.

33. 41 U.S.C. § 607 (2000).

34. *Propellex Corp.*, 02-1 BCA ¶ 31,721 at 156,729.

35. Propellex both adjusted its bid for possible understatement [Servidone requirement #2] and excluded from its claim some of the actual incurred costs for which it admitted responsibility [Servidone requirement #4]. *Propellex Corp. v. Brownlee*, 342 F.3d 1335, 1339 (Fed. Cir. 2003); *see Servidone Construction Corp. v. United States*, 931 F.2d 860 (Fed. Cir. 1991).

36. *Propellex Corp.*, 02-1 BCA ¶ 31,721 at 156,730.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at 156,731.

its case for damages before the board using a modified total cost method.<sup>35</sup> In furtherance of its modified total cost claim, Propellex contended that it was impracticable to prove its claimed losses directly because Propellex "did not segregate and record, and could not estimate, the labor hours and costs of the black powder moisture investigation."<sup>36</sup> The labor hours and costs due to Propellex's moisture investigation were commingled with all labor hours and costs of contract performance.<sup>37</sup> Propellex, however, was able to estimate certain costs not attributable to the moisture investigation, and Propellex had documented its moisture investigation efforts.<sup>38</sup>

The ASBCA determined that the contractor had failed to establish the impracticability of proving its claimed losses directly.<sup>39</sup> Additionally, regarding the fourth prerequisite to using the total cost method, the board found that Propellex had not excluded from its claim other additional costs that were not attributable to the moisture investigation.<sup>40</sup> The board held that Propellex could not use the modified total cost method to prove its damages, because Propellex failed to meet two of the *Servidone* requirements.<sup>41</sup> The board awarded the appellant \$33,110 plus applicable profit, fees, and interest.<sup>42</sup>

### The CAFC Decision

On appeal, Propellex argued that the ASBCA erred in determining that Propellex had failed to prove the impracticability of

proving its claimed losses directly and had erroneously determined that it failed to satisfy the fourth *Servidone* requirement. The CAFC affirmed the board's decision. It held that substantial evidence supported the ASBCA's conclusion that Propellex had not established the impracticability of proving its actual losses directly.<sup>43</sup> Consequently, the CAFC did not decide whether Propellex met the fourth *Servidone* requirement.<sup>44</sup>

The CAFC found that Propellex had the ability to track the costs of the moisture investigation, but it failed to do so.<sup>45</sup> The CAFC noted that Propellex's controller testified that he could have set up an account in Propellex's cost accounting system to segregate the actual costs of the moisture investigation, but he did not do so.<sup>46</sup> The court also noted that Propellex's facilities manager testified that its labor records should have reflected which employees were engaged in the moisture testing and the amount of time they spent on it.<sup>47</sup> The court rejected Propellex's argument that it did not segregate the costs of its moisture investigation because it believed Propellex—not the government—was responsible for the moisture problem. The CAFC stated that if Propellex believed it was responsible for the problem, "it was all the more important for it to segregate costs relating to that problem from costs incurred under the contracts for which it was entitled to be paid by the Army."<sup>48</sup>

In holding that substantial evidence supported the board's conclusion that Propellex failed to establish the impracticability of proving its actual losses directly, the court clearly articulated the rule it applied:

Where it is impractical for a contractor to prove its actual costs because it failed to keep accurate records, when such records could have been kept, and where the contractor does not provide a legitimate reason for its failure to keep the records, the total cost method of recovery is not available to the contractor.<sup>49</sup>

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43. *Propellex Corp. v. Brownlee*, 342 F.3d 1335, 1342 (Fed. Cir. 2003).

44. *Id.* at 1340.

45. *Id.* at 1341-42.

46. *Id.* at 1341.

47. *Id.* This part of the court's analysis is unclear, because as these were fixed price contracts, there was no reason to segregate the costs for which the contractor believed itself responsible.

48. *Id.* at 1342.

49. *Id.* (citing *WRB Corp. v. United States*, 183 Ct. Cl. 409, 426 (1968)); *Youngdale & Sons Constr. Co. v. United States*, 27 Fed. Cl. 516 (1993); *S.W. Elecs. & Mfg. Corp.*, ASBCA Nos. 20698 & 20860, 77-2 BCA ¶ 12,631 (June 23, 1977), *aff'd*, 655 F.2d 1078 (Ct. Cl. 1981).

## What the *Propellex* Decision Means to Practitioners

Government attorneys and contracting officers should carefully scrutinize the evidence of claimed costs that contractors submit in support of their requests for equitable adjustment. Contracting officers should insist on submission of sufficient actual cost data to support the claimed amount of damages before issuing a final decision on a contractor's claim, even if it appears the government may bear responsibility for additional costs incurred by the contractor due to a constructive change, differing site condition, or government-caused delay.

Similarly, contractors must track their actual costs carefully if there is any possibility that additional work is required because of government changes. Contractors are now on increased notice to account for additional costs due to constructive changes as the costs are incurred if they hope to be reimbursed by the government for such costs later. Propellex prevailed on entitlement before the ASBCA, only to lose its quantum case due to its insistence on asserting a total cost claim without the requisite evidence. If Propellex had simply submitted evidence of its actual costs, or had even estimated its actual costs, as it could have done, the appellant would likely have recovered those costs.

In addition, while Propellex used a modified total cost claim, neither the ASBCA decision nor the CAFC decision focused on the modified elements of Propellex's claim; rather, both holdings concerned the basic prerequisites for using any total cost method to prove damages. Accordingly, while the CAFC decision disposed of a modified total cost claim, its holding is broadly applicable to all claims employing a total cost method of proving damages.

## Conclusion

While the total cost method may still apply to limited circumstances in which it is truly impossible to segregate additional costs, the CAFC has made it more difficult for claimants to use the total cost method of proving damages, or even a modified total cost method, in its *Propellex* decision. The CAFC will hold would-be total cost method claimants to a very high standard of proving damages. If a contractor can set up its

accounting system to track additional costs resulting from a constructive contract change, but fails to keep such accounting

records without a legitimate explanation, the contractor cannot obtain a total cost method recovery.