Recently Judge Dyk and the Court of Appeals, Federal Circuit, issued **an opinion** that resulted in another contractor loss. This is another Dyk ruling in a long string of questionable rulings against contractor appeals. There is temptation to categorize the Dyk rulings as the result of bias against contractors. But we're not qualified to judge the quality of the rulings, as we are not attorneys, so thus will refrain from casting further stones at the Honorable Judge Dyk.

As we are not attorneys, you should perhaps rely on qualified legal advice to help you navigate the challenges created by the decision, which set a "new and undefined reasonableness standard" that contractors submitting claims and Requests for Equitable Adjustment (REAs) now apparently have to meet.

Short summary of the appeal: contractor Kellogg, Brown & Root (KBR) had a LOGCAP contract, under which it was awarded a CPFF Task Order to provide temporary housing trailers to soldiers and coalition forces at various locations in Iraq. (There was a war at the time. Some would argue there still is.) Under that Task Order, KBR issued a Firm, Fixed-Price subcontract for about 4,000 trailers to First Kuwaiti Company of Kuwait ("First Kuwaiti"). Those trailers were to be manufactured in Kuwait and then transported via convoy to a couple of Iraqi locations. Delays occurred because the US Government breached the contract by failing to provide adequate force protection to the convoys. (See *Sec'y of the Army v. Kellogg Brown & Root Servs., Inc.* , 779 F. App'x 716, 718 (Fed. Cir. 2019). We wrote about the dispute **here** .)

Pursuant to the Changes clause in its subcontract, First Kuwaiti submitted an REA to KBR and the parties eventually negotiated an upward price adjustment of $48.7545 million to its FFP subcontract. KBR then paid First Kuwaiti and billed the FFP value through its prime contract Task Order (which was, remember, CPFF). The contracting officer disallowed all but $3.8 million of the additional costs. KBR appealed to the ASBCA, where the Board found against KBR on various bases, including (1) the government didn't breach the contract, and (2) even if the government did breach the contract, KBR had failed to show that the REA settlement amount it had paid First Kuwaiti was reasonable.

In the words of the Federal Circuit—

The Board stated that KBR had failed to provide the actual costs incurred by Kuwaiti, as is typical in claims for equitable adjustments in other contracts. Instead, KBR's claimed costs were based solely on Kuwaiti's estimates. The Board found that the damages models were 'unrealistic,' 'inconsistent,' 'flaw[ed],' 'unreasonable' and assumed a 'perfect world.' The Board concluded that 'KBR [was] not entitled to any recovery.'

The Federal Circuit affirmed the ASBCA's decision, which upheld the contracting officer's decision and cost KBR about $45 million.

In its opinion, the Federal Circuit did not agree with the ASBCA's finding that KBR was required to have submitted to the contracting officer actual costs incurred by First Kuwaiti. Judge Dyk wrote "As the government conceded at oral argument, the amounts paid by KBR to Kuwaiti were 'costs' under the prime contract, and there is no provision in the prime contract that required KBR to submit the actual costs incurred by its subcontractor. KBR's obligation was to show that the payments to Kuwaiti were 'reasonable.'" So far, so good.

However, the Judge also noted that "the failure to collect and submit Kuwaiti's costs bears on the reasonableness of the payments" that KBR made to First Kuwaiti. That issue became the fatal flaw in KBR's claim.

The methodology used by KBR and First Kuwaiti was based on quantification of the number of delay days times a fixed price per day. The problem with this methodology, according to the Federal Circuit, was that KBR made several unrealistic assumptions, chief of which was the assumption that any delays were caused solely by the lack of force protection. As Judge Dyk wrote:

Third, KBR's spreadsheets calculating idle truck days, 'without substantiating data or records,' were insufficient to establish the reasonableness of its costs. KBR offered no fact or expert witnesses to support the reasonableness of its estimated number of idle truck days. Although Change 5 did not require KBR to provide actual costs to support its claim, the Board properly determined that KBR's failure to provide any supporting data was fatal to its claim. Under KBR's contract with Kuwaiti, Kuwaiti was obligated to 'maintain books and records' reflecting actual costs, and KBR had the right to 'inspect and audit' those records. As the Board found, it was simply not plausible that Kuwaiti did not record 'how long trucks actually waited' at the border … and KBR made no attempt to access or utilize these records. At bare minimum, KBR was required to support its estimates with representative data as to the number of trucks actually

delayed. In fact, KBR supplied no representative data whatsoever. Without further evidence demonstrating the reliability of KBR's estimates, the Board properly found that KBR's claimed costs were not reasonable.

So KBR is out roughly $45 million, unless it decides to proceed further. But we're not done yet. There was a dissent filed by Judge Newman that's worth a bit of discussion.

Judge Newman concurred with the basic reasoning of the majority, but believed that the appeal should have been remanded back to ASBCA in order to determine whether or not the negotiated REA was reasonable. She wrote "My colleagues hold that the correct standard is 'reasonableness,' and while complaining about the absence of evidence and witnesses and argument on this standard, my colleagues make extensive findings on information that has not been presented, and decide the issue of reasonableness without participation of the parties." She further wrote—

I also agree that the correct standard is 'reasonableness.' However, my colleagues do not remand for application by the ASBCA of this standard; they do not discuss whether the methodology used by KBR was reasonable, although this aspect was the subject of testimony at the ASBCA; and they do not consider whether any of the costs of delay were reasonable in the circumstances that existed. Instead, my colleagues extract isolated costs from un-briefed documents, and rule, with no briefing and no argument, that reasonableness was not shown. Although KBR requested remand to the ASBCA if this court agrees that the ASBCA's decision should be reversed, remand is not provided. KBR has no opportunity to meet this court's new standard. Instead, my colleagues scavenge among assorted materials that were provided in other contexts, and complain about the absence of evidence and expert testimony related to the court's new standard.

Okay. So what have we learned here?

We have learned that it's not simply enough to negotiate a subcontractor REA or claim and then submit the payment to the government for reimbursement. Instead, prime contractors (or, potentially, higher-tier subcontractors) need to *thoroughly review the basis for the subcontractor's REA or claim* , including requesting and reviewing actual costs incurred. In this case, according to the Courts, even though Kuwaiti's subcontract was FFP, it included language requiring Kuwaiti to maintain books and records reflecting actual costs incurred—and thus KBR should have looked at those books

and records before choosing a quantification strategy that ignored them.

Now this is not the first time we've written about subcontractor cost reasonableness. Far from it. For example, in 2012 we devoted a three-part article to subcontractor cost reasonableness. That article (link to **first post**) discussed yet *another* KBR legal decision that cost the company roughly $30 million in subcontractor payments.

Are you getting the picture that subcontractor cost reasonableness is a big deal? Because if so, then we're doing our job here.

It's important to show a contracting officer that you, as a prime contractor (or higher-tier subcontractor) approached evaluating and negotiating your subcontractors' REAs and claims in a *reasonable* manner. The FAR defines "reasonableness" at 31.201-3. It's not a "bright line" definition, because "what is reasonable depends upon a variety of considerations and circumstances …." However, the concept of reasonableness generally is summed up as "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." Thus, you have to show that your actions and course of dealing are those of a prudent businessperson. In this case, both the ASBCA and the Federal Circuit found that KBR's actions and course of dealings did not meet that standard.

This concept is also important for contractors evaluating supplier and other subcontractor claims for COVID-19 related costs, such as CARES Act Section 3610 stand-by labor costs. In fact, there may be a good analogy between your subcontractor's REA (or claim) for Section 3610 stand-by labor costs and the REA submitted by First Kuwaiti to KBR for the truck driver labor associated with delayed convoys. In the case of First Kuwaiti, the Courts expected KBR to thoroughly review First Kuwaiti's books and records to evaluate whether the additional costs it was claiming were actually reflective of the costs it had incurred. If the analogy holds true, then we would expect prime contractors receiving Section 3610 REAs to make the subcontractors support those REAs with actual cost reports.

There are going to be subcontractors who either cannot or will not support their REAs. They may have inadequate accounting systems. Or they may assert that they will not provide cost information to a potential competitor. There are going to be challenges in reviewing subcontractor Section 3610 REAs under the standard established by the Federal Circuit in this recent KBR opinion. Prime contractors simply are going to have to overcome them.

As we've written before, we expect a number of Section 3610 REAs to become claims, which will ultimately be appealed. This Federal Circuit decision established the standard for how prime contractors' handling of their subcontractors' REAs will be judged.

You ignore it at your own peril.