

## **6<sup>th</sup> Circuit Court of Appeals Rejects High Value Items Clause as a Contractor Defense Barring Damages Under the False Claims Act**

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On September 12, 2002, in a 2-1 ruling, the United States Court of Appeals for the Sixth Circuit issued a decision in *United States of America ex rel. Brett Roby v. Boeing Co.* affirming a District Court ruling that allows the United States Army (“Army”) to recover damages under the False Claims Act (FCA) for loss of a Chinook (CH-47) helicopter resulting from the failure of a defective flight safety critical item. The incident giving rise to the litigation involved an Army CH-47D helicopter crash that occurred in Saudi Arabia in January 1991. It was found to be a result of defective transmission gears and occurred after the aircraft had only fifty-six flight hours in operation. The genesis of this decision arose from a *qui tam* action filed by Mr. Brett Roby in May 1995 on behalf of himself and the Government alleging that The Boeing Co. (Boeing) and its subcontractor, Speco Corp. (Speco), had violated the FCA by making false statements about the manufacture, sale and installation of defective flight safety critical transmission gears delivered to the Army by Boeing under the CH-47D remanufacture contract. That contract represented an upgrade of the Chinook fleet to its present configuration (D-model). In conjunction with an approximately \$40M settlement agreement between the Army and Boeing signed in August 2000, the District Court had certified for interlocutory appeal the question of law as to whether the High-Value Items clause (HVIC)(Federal Acquisition Regulation (FAR) 52.246-24), that had been incorporated into Boeing’s contract, operates as a defense to damages under the FCA.

The HVIC represents the Government’s assumption of the risk for high dollar value items, like aircraft, that may be lost or critically damaged after acceptance due to defects in the equipment. It exists to minimize the cost of liability insurance borne by the contractor that is ultimately passed on to the Government in the negotiated price for high-dollar value weapon systems. The salient portion of FAR 52.246-24 reads as follows: “(a)...the Contractor shall not be liable for loss of or damage to property of the Government (including the supplies delivered under this contract) that- (1) Occurs after Government acceptance of the supplies delivered under this contract; and (2) Results from any defects or deficiencies in the supplies. (b) The limitation of liability under paragraph (a) of this clause shall not apply when the defect or deficiency in, or the Government’s acceptance of, the supplies results from willful misconduct or lack of good faith on the part of any of the Contractor’s managerial personnel.” The Sixth Circuit, however, rejected Boeing’s argument that the HVIC “prohibits the recovery of damages under any and all causes action, when those damages result from fraud of non-managerial personnel,...” *2002 FED App. 0315P (6<sup>th</sup> Cir.) at page 4*. (Note: the parties stipulated to

the fact that the fraud had not committed by Boeing's managerial personnel). The Court held that although the loss of the aircraft occurred after Government acceptance, and was the result of a defective Speco gear, the loss was specifically caused by Boeing's misrepresentation at delivery that the aircraft met and conformed to all contractual requirements set forth in the underlying contract. The Court went on reject Boeing's position the HVIC should be interpreted as a standard insurance policy with ambiguous provisions and exclusionary clauses being construed against the insurer. In its decision, the Court stated: "The HVIC insures contractors only indirectly; it is, by its own terms a self-insurance policy, which means the Government is both insurer and insured. Because nothing in the HVIC suggests that its limitation of contractor liability covers statutory violations, we hold that the district court did not error in concluding the HVIC does not provide a defense to damages sought under the FCA." *2002 FED App. 0315P (6<sup>th</sup> Cir.) at page 5.*

In arriving at the decision the Court had to distinguish two cases that seemed to support Boeing's position. First, the facts in *Roby* are very similar to a 1952 case decided by the Eighth Circuit, *United States v. Untied States Cartridge Co.*, 198 F.2d 456 (1952). In that case, the defendant constructed and operated the Government-owned St. Louis Ordnance Plant during World War II mass-producing small arms ammunition for the armed forces under a cost-plus-fixed-fee contract. The Government alleged that the defendant defrauded the Government by presenting claims for payment that were false because they knowingly maintained an inadequate system of inspection that allowed for a variety of fraudulent practices. The fraudulent conduct included resubmitting rejected ammunition for acceptance without being reworked and surreptitiously intermingling and packing rejected ammunition with accepted ammunition. The result was much of the ammunition produced by the plant was substandard and failed when used by the armed forces. The contract contained a limitation of liability clause similar to the present day HVIC exempting the contractor from liability for the failure of ammunition or delays in delivery of ammunition except for the personal failure of the corporate officers or certain supervisory personnel to exercise good faith or due diligence in the performance of their duties. The Eighth Circuit upheld a District Court decision dismissing the Government's suit stating the Government had failed to meet its burden of proof to present substantial evidence that there was personal failure on the part of the defendant's corporate officers or key supervisory personnel to exercise good faith or due diligence in the performance of the contract and, therefore, the Government could not show they had committed fraud in the presentment of claims to the Government. The Court refused to impute to the defendant knowledge of, or to hold responsible for, the misconduct of the defendant's subordinate personnel that the Government had relied upon to establish its case against the defendant. See *198 F.2d at 461.*

The Sixth Circuit in *Roby* distinguishes *United States Cartridge Co.* citing the fact that the ammunition contract was made during a time of a national emergency (World War II) and noted the unique contractual arrangement that existed where the Government owned

the facility and exercised substantial supervision and control over the contractor, its employees and the facility itself. Roby cites the Eighth Circuit opinion for support that the unique situation at the St. Louis Ordnance Plant created relief for the contractor from penalties under the FCA: “If this contract were to be regarded as one creating the conventional relationship between the Government and a commercial corporate contractor not subject to Government supervision and control, for supplying goods and services, and if the provisions limiting liability were to be viewed merely as an attempt to relieve the contractor from liability of its own fraud, the Government’s argument [that the limitation of liability was void] might be unanswerable. 2002 FED App. 0315b (6<sup>th</sup> Cir.) at page 6 citing United States Cartridge Co., 198 F2d at 464-465. The Roby Court clearly did not want to rule that Boeing could contractually limit their liability for false claims under the FCA: “[W]e believe that the Government’s public policy argument in this case is stronger than it was in United States Cartridge Co.,...The contract in this case was a conventional one for the remanufacture of helicopters almost entirely during peacetime, and Boeing was not subject to Government supervision or control. These differences suggest that the limitation of liability in United States Cartridge Co. allocated risks in a way much more favorable to the defendant than does the HVIC. In short, we do not read the HVIC as an agreement by the Government to assume the risk of damages to high-value items that it sustains because of FCA violations.” 2002 FED App. 0315b (6<sup>th</sup> Cir.) at page 6.

Boeing also cited a more recent decision in support of its position that the Government was contractually bound not to pursue damages for an FCA violation by virtue of the inclusion of the HVIC in their contract. In United States v. Bankers Insurance Co., 245 F.3d 315 (4<sup>th</sup> Cir. 2001), the question on appeal was whether the existence of an FCA claim negated an arbitration clause in the contract and allowed the Government to immediately pursue litigation. The case involved the Government suing a private insurance company for alleged fraud and breach of contract in connection with the selling and administrating of flood insurance policies under the National Flood Insurance Program. The Fourth Circuit reversed a lower District Court opinion and found that an FCA claim did not negate the arbitration provision in the contract and required the Government to submit to non-binding arbitration before it could pursue its FCA claim against the contractor. Boeing used the rationale in Banker’s Insurance to argue that the Government was foreclosed from pursuing an FCA violation for damages because inclusion of the HVIC created a contractual obligation on behalf of the Government to refrain from seeking damages under the FCA unless managerial personnel committed the fraud. The Roby Court, however, compellingly distinguishes the Banker’s Insurance decision, noting that the contract in that case merely deferred litigation of the FCA claim until after the non-binding arbitration had been completed as opposed to the facts in Roby where Boeing’s interpretation of the HVIC would limit the Government from recouping anything more than a \$10,000 civil penalty for damages. The Court went on to state: “Given Congress’s explicit recognition while amending the FCA ‘that a large number of fraud cases and many of the larger-dollar cases arise out of Department of Defense contracts,’ it strikes us as incongruous that the HVIC would relieve contractors for high-

value items from the FCA's damage provision. After all, the motivating purpose of the FCA is to combat and to deter fraud, which would not be served in the context of defense contracts by civil penalty alone." *2002 FED App. 0315b (6<sup>th</sup> Cir.) at page 7.*

Judge Boggs issued the dissenting opinion in *Roby*. He argues that both the wording and purpose of the HVIC support Boeing's position that the Government has contracted away its right to seek property damages from suppliers of high-value items. The FAR language at 52.246-24 specifically cites an exception to the contractor's protection from damages under the clause when there is "willful misconduct or lack of good faith" on the part of managerial personnel. Judge Boggs equates willful misconduct and lack of good faith with "fraud" and goes on to state "[t]herefore, the HVIC expressly exempts from protection losses to fraud on the part of managerial personnel. The negative pregnant, therefore, would be that the HVIC does protect contractors from losses due to non-managerial fraud." *2002 FED App. 0315b (6<sup>th</sup> Cir.) at page 10.* Judge Boggs also cites the legislative history on the HVIC to support the argument that the clause was intended to act as a self-insurance policy for DOD precluding liability for loss of certain Government equipment- even when the loss was a result of non-managerial fraud by contractors. He points to the overriding purpose of the HVIC as relieving contractors from the necessity to purchase liability insurance when producing high dollar value items, the cost of which would be prohibitive and passed on to the Government. He concludes: "The plain language of the HVIC at issue in the present case conforms to that purpose. However, the court's decision today does not; under it, contractors will have to insure against potential FCA liability for treble damages for the loss of high-value items resulting from actions that might be held to be fraudulent on the part of any personnel. Presumably, this cost will be passed on to the Government." *2002 FED App. 0315b (6<sup>th</sup> Cir.) at page 11.*

The *Roby* decision is important for all Government agencies (and specifically DOD) in attempting to recover damages for losses to high-dollar value equipment resulting from fraudulent conduct by contractors. Had the Sixth Circuit adopted Boeing's position, damages for the lost CH-47D helicopter would have been limited to a \$10,000 civil penalty. The parties had previously negotiated a \$15 million dollar settlement (out of the total settlement amount of approximately \$40M) for the damages resulting from the crash in Saudi Arabia that was contingent upon the favorable outcome of this issue for the Government. Boeing has appealed the decision and has requested an en banc hearing before the Sixth Circuit. If the decision stands, agencies will know that claims pursued under the FCA will not have restrictive damage limitations simply by virtue of the inclusion of the HVIC in their contracts. Whether it will also translate into Judge Boggs' fear of higher costs to the Government for these items due to the liability concerns of contractors will have to be determined. So stay tuned.