

International Aviation, Defense, and Aerospace ALERT

DECEMBER 11, 2002

CONTRACT INDEMNIFICATION IS IT ENFORCEABLE?

Several recent decisions in the federal courts and by the Armed Services Board of Contract Appeals signify that provisions in government contracts cannot always be enforced according to their terms. A couple of these cases address contract indemnification provisions, holding that the provisions could not be enforced against the government, even though they covered the risks at issue and it was reasonable to assume that the risks would be allocated to the government.

I. Unauthorized Contract Provisions

In a series of recent decisions, the federal courts have sent mixed signals on whether contractors can enforce contract provisions that are in conflict with law and regulation. In *Johnson Management Group CFC, Inc. v. Secretary of Housing and Urban Development*, No. 01-1145, October 17, 2002, the U.S. Court of Appeals for the Federal Circuit suggests that contract provisions that are in conflict with requirements of the Federal Acquisition Regulation are void and are not to be given any effect. The Federal Circuit held that the government was not obligated to comply with a provision for the liquidation of advance payments that was agreed to by the government's contracting officer. The Court said that the government was not bound

by the conduct of its agents acting beyond the scope of their authority.

In *Gold Line Refining, Ltd. v. U.S.*, No. 98-543C, October 30, 2002, the U.S. Court of Federal Claims found that an economic price adjustment clause was not authorized by the Federal Acquisition Regulation. Nonetheless, the Court held that the contractor could obtain relief under a theory of *quantum valebant* or reformation of the clause to carry out the intent of the parties. The *Gold Line Refining* court relied on *American Telephone and Telegraph Company and Lucent Technologies, Inc. v. United States*, 177 F.3d 1368, (Fed. Cir. 1999), where the Federal Circuit held that the government's violation of statute and on contract type did not render the contract at issue void *ab initio*. Yet, when the Federal Circuit had another opportunity to address the government's violation, in *American Telephone and Telegraph and Lucent Technologies, Inc. v. U.S.*, No. 01-5044, October 8, 2002, it held that the contractor did not have a valid claim to enforce the government's failure to comply with the statute or to reform the contract.¹ The Court said that even if a valid claim for reformation existed, the contractor waived that claim when it failed to challenge the validity of the contract type at the time of contract negotiation.

¹ In this, the fifth decision in the case, the Federal Circuit (with a dissenting opinion) affirmed the Court of Federal Claims decision on remand from the Federal Circuit's 1999 decision at 177 F.3d 1368. The plaintiffs have asked for rehearing, *en banc*.

WILMER, CUTLER & PICKERING

WASHINGTON ♦ NEW YORK ♦ BALTIMORE ♦ NORTHERN VIRGINIA ♦ LONDON ♦ BRUSSELS ♦ BERLIN

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II. Unenforceable Indemnification Provisions

Recent decisions also show that contract indemnification provisions pose additional concerns for contractors. In the *Appeal of National Gypsum Company*, ASBCA Nos., 53259, 53568, October 25, 2002, the Armed Services Board of Contract Appeals found that an indemnification provision was unenforceable.² The indemnification was made pursuant to the First War Powers Act and its implementing Executive Order.³ The Executive Order, however, limited the exercise of authority under the Act to existing appropriations. Because the Board found that liability under the provision was unlimited in amount, and not otherwise authorized by law, it held that the provision violated the Anti-Deficiency Act.⁴ The Board said that the government was not estopped by its agents acting contrary to an express authority limitation.

In *E.I. Dupont de Nemours and Company, Inc. v. U.S.*, No. 99-101C, November 13, 2002, the U.S. Court of Federal Claims also found that an open-ended indemnification clause violated the Anti-Deficiency Act and was void and unenforceable.⁵ The Court reached this result even though it concluded that (1) the clause was broad enough to cover the liability at issue, and (2) both the contracting officer and contractor believed that the clause placed

the risk of liability on the government. In ruling against the contractor, the Court relied, in part, on a Comptroller General opinion observing that indemnification provisions imposing obligations of an indefinite and unlimited character have consistently been regarded as objectionable in the absence of statutory authority, and that by including such provisions in a contract, a contracting officer may not impose a legal obligation on the government.⁶

In *Union Pacific Railroad Co. v. U.S.*, No. 01-490C, June 28, 2002, the Court of Federal Claims also found an open-ended indemnification provision to be in contravention of the Anti-Deficiency Act and unenforceable.⁷ The Court, however, allowed Union Pacific to amend its complaint in an effort to reform the indemnification provision to make it a definite obligation and remove any argument that it violated the Anti-Deficiency Act.

III. Contract Indemnification Authority

Today, there are a number of statutes that permit federal agencies to indemnify contractors against loss or damage to property and claims by third parties.⁸ The Federal Acquisition Regulation provides for indemnification in two cases: 1) by the “Insurance - Liability to Third Persons” clause in cost-reimbursement contracts,⁹ and 2) for

² The case involved a 1942 War Department contract for procurement of equipment and other services for a plant during World War II. The plant was later reactivated and operated as a munitions plant. National Gypsum sought to recover the costs of defending and settling a suit brought by an individual for negligent operation of the plant.

³ Public Law 77-354 and Executive Order 9001. The First War Powers Act enabled the President to authorize agencies to enter into contracts for the prosecution of the war, without regard to provisions of law relating to the making, performance, and modification of contracts, and is a predecessor to today’s Public Law 85-804 giving the President similar authority.

⁴ At the time that the contract was entered, the Anti-Deficiency Act stated that no government agency could create a contract obligation for future payment of money in excess of appropriations made for a particular fiscal year, unless authorized by law. Today, a similar Anti-Deficiency Act precludes government officials from authorizing an expenditure or obligation in excess of appropriations. See 31 § U.S.C. 1341.

⁵ The case involved a 1940 contract to construct and operate a chemical production facility. Dupont sought to recover costs that it had incurred pursuant to the Comprehensive Environmental Response Compensation and Liability Act in connection with the facility that it built and operated during World War II.

⁶ 35 Comp. Gen. 85 (August 12, 1955).

⁷ This case involved a more recent contract by which the General Services Administration granted an easement over railroad tracks for switching purposes. GSA agreed to keep the tracks clear and to indemnify Union Pacific to the extent permitted by the Federal Tort Claims Act (28 U.S.C. § 1346 (b)(1)). Union Pacific sought to recover the cost of defending and settling a claim by an injured employee.

⁸ See, for example, the indemnification authority of the Nuclear Regulatory Commission under the Price-Anderson Act (42 U.S.C. § 2210), the indemnification authority of the Veterans Health Administration for hazardous research projects (38 U.S.C. § 7317), and the indemnification authority contained in the Comprehensive Environmental Response Compensation and Liability Act (42 U.S.C. § 9619(c)).

⁹ 48 C.F.R. §§ 28.311-1 and 52.228-7.

unusually hazardous risks, when authorized pursuant to Public 85-804.¹⁰ Department of Defense acquisition regulations also provide for indemnification under contracts involving research and development work, pursuant to the statutory authority at 10 U.S.C. 2354.¹¹

Indemnification under the “Insurance - Liability to Third Persons” clause is limited, as the name of the clause implies, to liability to third parties and is “subject to the availability of funds at the time a contingency occurs.”¹² Indemnification under 10 U.S.C. 2354 covers both contractor property and claims by third parties for death or injury or for loss or damage to property, from defined unusually hazardous risks. Indemnification under Public Law 85-804 covers loss or damage to government property, as well as contractor property and claims by third parties, also from defined unusually hazardous risks. Unlike the executive order in the *National Gypsum* case, however, Executive Order 10,789 implementing Public Law 85-804 provides that indemnification provisions are not subject to appropriations limitations.

IV. Some Observations

As liability insurance becomes less affordable and more difficult to obtain for high-risk ventures, contractors may wish to seek contract indemnification provisions to protect them from liability for loss or damage to contractor or government property and from third party claims for injury or death or loss or destruction of property. Many agencies are authorized to provide contract indemnification for unusually hazardous risks pursuant to Public Law 85-804 and its implementing Executive Order 10,789. Since indemnification under this authority is not limited to

available appropriations, the Anti-Deficiency Act will be less of a concern. Yet, other limitations and approvals do apply.

The new Homeland Security Act of 2002 limits the liability of companies when employing qualified anti-terrorism technologies in defense of, response to, or recovery from terrorist acts.¹³ The Act, however, does not contain additional authority for the government to indemnify contractors for the research, development, or production of such technologies, and it remains to be seen how the protections of the law will be implemented and how extensive they will ultimately be.

Contractors obtaining indemnification must be careful to examine whether any indemnification protection contained in their contracts will be enforceable. Where an indemnification provision might fail because of the Anti-Deficiency Act, reformation of the contract provision may still be available. Yet for reasons stated by the Federal Circuit Court of Appeals in the fifth *American Telephone* case, a contractor may be found to have waived any right to seek reformation.

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For more information regarding contractor indemnification, contact:

John Janecek* John.Janecek@Wilmer.com
+1 (202) 663-6750

* Admitted in CA only

¹⁰ *Id.* at. §§ 50.403 and 52.250-1.

¹¹ *Id.* at. §§ 235.070-2, 252.235-7000 and 252.235-7001.

¹² *Id.* at § 52.228-7(d).

¹³ Public Law 107-100, November 25, 2002, Sec. 863.

WCP International Aviation, Defense and Aerospace

Gregorio B. Cater
J. Edward Cox
Stephen P. Doyle
Christian Duvernoy
Leon B. Greenfield
Michael R. Holter
John P. Janecek
Neil J. King
F. David Lake, Jr.

Dieter G. Lange
James W. Lowe
Natalie Luebben
Jeffrey A. Manley
Ronald I. Meltzer
Thomas Mueller
Cathleen P. Peterson
Stephen W. Preston
Ulrich Quack

Bruce H. Rabinovitz
John Ratliff
Leonard M. Shambon
Charles S. Stark
Ali M. Stoepelwerth
Sven B. Vöelcker
Paul A. von Hehn
Matthias Wissmann

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|------------------------------|------------------------------|------------------------------|------------------------------|-------------------------------|-----------------------------|-------------------------------|
| 2445 M Street, N.W. | 399 Park Avenue | 100 Light Street | 1600 Tysons Boulevard | 4 Carlton Gardens | Rue de la Loi 15 Wetstraat | Friedrichstrasse 95 |
| Washington, D.C. 20037-1420 | New York, NY 10022 | Baltimore, MD 21202 | Tysons Corner, VA 22102-4826 | London SW1Y5AA | B-1040 Brussels | D-10117 Berlin |
| Telephone: +1 (202) 663-6000 | Telephone: +1 (212) 230-8800 | Telephone: +1 (410) 986-2800 | Telephone: +1 (703) 251-9700 | Telephone: +44 (20) 7872-1000 | Telephone: +32 (2) 285-4900 | Telephone: +49 (30) 2022-6400 |