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¶ 388

FEATURE COMMENT: The A-12 Saga Continues

On September 28, the U.S. Supreme Court agreed to hear an appeal by the contractors in the case challenging the Navy's 1991 termination for default of the contract for the development and prototype production of the A-12 aircraft. In a 2009 decision the U.S. Court of Appeals for the Federal Circuit began its third separate decision in this matter recognizing that the dispute already was the "American version of *Jarndyce and Jarndyce*," the generations-long lawsuit at the heart of Charles Dickens' *Bleak House*. See *McDonnell Douglas Corp. v. U.S.*, 567 F.3d 1340, 1342 (Fed. Cir. 2009) (*MDC III*); 51 GC ¶ 194. Now the Supreme Court has guaranteed that this saga will continue, at least well into 2011.

Although the case will go on, the questions that the Supreme Court agreed to consider, and those that it declined to revisit, shift the focus of the debate surrounding this matter in important ways. The Court refused to hear the contractors' challenges to the Federal Circuit's formulation of the proper test for a termination for default for failure to make progress, the issue at the center of the dispute through most of this matter's three round trips, over 16 years, between the U.S. Court of Federal Claims and the Federal Circuit. That means that the Federal Circuit's 2009 opinion, nominally endorsing but actually undercutting the seminal decision in *Lisbon Contractors, Inc. v. U.S.*, 828 F.2d 759 (Fed. Cir. 1987); 29 GC ¶ 296, remains, for better or for worse, the latest authoritative word on default terminations for failure to make progress. But the Supreme Court did agree to consider the proper application of the state secrets privilege to this civil dispute. As a result, final resolution of this case may well turn on the complicated and little-explored interplay between the Government's right to protect highly sensitive information and dispute resolution on contracts involving that information. The outcome has the potential to have a major impact on risks, for contractors and for the Government, when entering into contracts that require use of highly classified information.

Background of the Dispute—The long history of the A-12 litigation can be summarized relatively quickly. In 1988, the Navy awarded McDonnell Douglas Corp. and General Dynamics Corp. a fixed-price research and development (R&D) contract to develop a new carrier-based stealth attack aircraft known as the A-12. In early 1991, the Navy terminated the contract for default after then-Secretary of Defense Dick Cheney made clear that he would not support further funding for the program. At the time, the program was over budget and behind schedule. Nonetheless, until Cheney's decision, senior Navy officials had advocated continuation of the contract, contending that the contractors would be able to meet all of the operational requirements for the final plane. The contractors filed a complaint at the COFC challenging the default termination and asking that it be converted to a termination for convenience.

Round 1: In 1996, after a trial on certain of the issues in the dispute, the COFC issued its first merits decision. *McDonnell Douglas Corp. v. U.S.*, 35 Fed. Cl. 358 (1996); 38 GC ¶ 165. It overturned the termination for default, finding that the default was prompted by the Office of the Secretary of Defense's determination that it would withdraw financing and support from the program, not by the contracting officer's exercise of his discretion based on the contractors' performance. Three years later, the Federal Circuit reversed, finding that there was a nexus between the default termination and the contractors' difficulties in performance of the contract. *MDC I,* 182 F.3d 1319 (Fed. Cir. 1999); 41 GC ¶ 297. It remanded to the trial court to determine

whether the contractors truly were in default when the Navy ended the contract.

Round 2: The COFC tried again in 2001. *McDonnell Douglas Corp. v. U.S.*, 50 Fed. Cl. 311 (2001); 43 GC ¶ 344. It found that the CO was reasonably concerned about the ability of the contractors to meet a revised first flight date, which had been unilaterally set by the Navy. As a result, this time it upheld the termination. Another appeal followed, and in 2003 the Federal Circuit again reversed. *MDC II,* 323 F.3d 1006 (Fed. Cir. 2003); 45 GC ¶ 117. It emphatically endorsed the standard for terminations for default for failure to make progress, stated in its decision in *Lisbon Contractors*, requiring that the CO have a reasonable belief that there was no reasonable likelihood that the contractor could perform the entire contract effort within the time remaining. The Federal Circuit instructed the COFC that on remand it needed to determine both the entire effort to perform the contract and the time left to complete the contract in order to be able to judge whether the *Lisbon Contractors* standard had been met.

The Federal Circuit did, however, uphold the trial court on another issue. It concluded that the COFC had properly applied the state secrets privilege to preclude the contractors from pursuing their defense that the Government had superior knowledge concerning stealth technology that it had failed to disclose to them. The Federal Circuit agreed that the risk of disclosure of highly classified information prevented the contractors from attempting to develop this defense. And it rejected the contractors' argument that the unavailability of that defense meant that the Government could terminate only for convenience, not for default.

Round 3: Following the Federal Circuit's 2003 decision, it was more than four years before the COFC issued its most recent (and last?) decision. The court again upheld the termination for default, but in a way that on its face seemed to ignore the direction of the Federal Circuit to determine the time remaining to complete the contract work. *McDonnell Douglas Corp. v. U.S.*, 76 Fed. Cl. 385 (2007); 49 GC ¶ 199. Rather, it found that this R&D contract did not have a fixed completion date against which progress could be measured. Nonetheless, it concluded that the *Lisbon Contractors* standard could be applied using as a yardstick for progress the milestones for eight prototype aircraft, a piece of the contract work.

This time the Federal Circuit upheld the decision below and, in what amounted to an unusual confession of error, conceded that its instructions on remand in round 2, if read literally, would be "difficult to apply." In *MDC III*, the Federal Circuit reaffirmed *Lisbon Contractors* but explained that it did not apply to situations like the one before it in which the contract did not specify a fixed delivery date. Instead, the court found that, if the absence of a concrete end date made it impossible for a CO to apply the *Lisbon Contractors* test of determining whether there was any reasonable possibility that the contractor could complete within the contract time remaining, other factors should be examined to determine whether a contractor failed to prosecute the work so as to endanger performance. Here the court found that both the contractors' repeated failures to meet milestones and the difficulties in their financial situation given the huge losses on the contract meant that "the contracting officer was reasonably justified in feeling insecure about the contractors' rate of progress." *MDC III*, 567 F.3d at 1353. That alone justified the termination for default.

At the Supreme Court: This past April, both Boeing, as the successor to McDonnell Douglas, and General Dynamics filed petitions requesting that the Supreme Court hear the case. The contractors identified similar problems in the decisions below. They both complained that the Federal Circuit's 2003 decision permitted the Government to use the state secrets privilege to bar a defense to the termination while still allowing the Government to claim that the contractors were in default. They also both objected that the lower court's most recent decision abandoned well-settled law on terminations for default in Government contracts, although for somewhat different reasons. Boeing emphasized that the court permitted a termination for failure to make progress without a valid contract completion date against which to measure such progress. General Dynamics focused on its view that the decision undercut the required exercise of discretion by the CO by permitting the termination to be upheld on grounds on which he never relied.

On September 28, the Supreme Court granted the petition of each contractor but agreed to hear only the issues related to Federal Circuit's application of the state secrets privilege in its 2003 *MDC II* decision. See 52 GC ¶ 329(b). The question accepted by the Court, as stated by General Dynamics, was, "Whether the government can maintain its claim against a

party when it invokes the state-secrets privilege to completely deny that party a defense to the claim."

Since *MDC II* in 2003, the A-12 litigation focused exclusively on the rules for terminations for default. Certainly, the Supreme Court's decision not to hear the termination-based challenges by the contractors affects the law in that area. It means that the Government and contractors alike are left to puzzle out the effect of the Federal Circuit's 2009 *MDC III* decision on the reach and meaning of the *Lisbon Contractors* standard in measuring the validity of future terminations for default for failure to make progress. Still, the Supreme Court's decision to use this case as a vehicle to review the application of the state secrets privilege to civil contract cases has a potentially broader effect. The Court's decision may well affect the risk analysis for contractors, and for the Government, of participating in contracts involving highly classified technology or information.

Terminations for Default for Failure to Make Progress—The contractors' petitions to the Supreme Court painted the effect of the Federal Circuit's decision in *MDC III* in stark terms. Boeing argued that the Federal Circuit's decision, if left standing, would "destabilize an important area of the law." Not to be outdone, General Dynamics described *MDC III* as "putting at risk existing and future government contracts, including those for critical military projects." The Supreme Court did not find these dire predictions sufficient reason to accept the purely default termination issues that the contractors presented. A perhaps more measured assessment of the effect of the decision is that, although it does undercut *Lisbon Contractors* in important ways, it leaves standing the core test for termination for failure to make progress, at least for now, for most cases.

In one respect, the Federal Circuit's decision does mark a repudiation of *Lisbon Contractors*. That earlier decision seemed to establish a fixed rule for the steps that the CO must take before issuing a termination for default for failure to make progress. Specifically, *Lisbon Contractors* emphasized the need for an independent analysis by the CO, before the termination for default took place, that resulted in a reasonable belief "that there was no reasonable likelihood that the contractor could perform the entire contract effort within the time remaining for contract performance." 828 F.2d at 765.

Here, the trial court had found as a factual matter early in the litigation that the CO had conducted no such analysis before making the determination to terminate for default. But the Federal Circuit's decision focused on what the CO *could* reasonably have found, given the facts at the time of termination, not what he actually found. General Dynamics in particular emphasized that, contrary to earlier law, this meant that a court was not assessing the CO's informed discretion by reviewing the basis for the default termination articulated by the Government at the time of the termination.

General Dynamics is correct that the Federal Circuit's *MDC III* decision appears inconsistent with its emphasis in *Lisbon Contractors* on the CO's exercise of independent discretion before the termination takes place. That is not, however, something new for the Federal Circuit. In its 2004 decision in *Empire Energy Mgmt. Sys., Inc. v. Roche,* 362 F.3d 1343 (Fed. Cir. 2004), the court had endorsed an Armed Services Board of Contract Appeals decision that had upheld a termination for failure to make progress based on reasons that were never considered by the CO. *Empire Energy* reflected a clash between two strains of termination for default law. The first was the long-standing rule that a termination for default can be upheld for any reason that existed at the time the termination took place, even if it was not known to the CO at the time. See, e.g., *Kelso v. Kirk Bros. Mech. Contractors, Inc.*, 16 F.3d 1173, 1175 (Fed. Cir. 1994); 36 GC ¶ 283. The second was the emphasis in *Lisbon Contractors* on the exercise of independent discretion by the CO before deciding to terminate for default. In the eyes of many, *MDC III* simply confirmed that *Empire Energy* had resolved the conflict in favor of the former rule.

In another respect, the Federal Circuit's decision is more clearly inconsistent with the consensus in the prior cases. The court cited *Universal Fiberglass Corp. v. U.S.*, 537 F.2d 393 (Ct. Cl. 1976), as showing that its conclusion that a failure to make progress could occur even if there is no existing delivery date was consistent with previous law. But *Universal Fiberglass* involved a relatively small contract for postal service vehicles where the contractor was "making no progress at all" and had refused to give a schedule as to when it might even perform work. Id. at 397. Those circumstances were certainly very different from those presented by the A-12 contract, under which the contractors continued spending millions of dollars a month until termination. Since the time *Universal Fiberglass* was decided, it has been widely regarded as a case about abandonment rather than

failure to make progress. Given the particular facts in *Universal Fiberglass* and the nearly 35 years since it was decided, the Federal Circuit's reliance on that case as support for its move away from *Lisbon Contractors*' emphasis on measuring progress against a fixed delivery date is not entirely convincing.

Nonetheless, unless *MDC III* is the precursor of an even more drastic disavowal of *Lisbon Contractors*, it is hard to see this latest Federal Circuit decision in quite the dire terms that the contractors presented to the Supreme Court. The Federal Circuit's decision went out of its way to emphasize that the exception that it was establishing to the *Lisbon Contractors* rule that a failure to make progress was measured against the contract completion date applied only "where such a comparison is inapplicable." *MDC III*, 567 F.3d at 1351. Presumably that means that so long as a contract has an enforceable delivery date, the Government will continue to have the burden of proving that the CO had (or could have had) a reasonable belief that there was no reasonable possibility that the contractor would complete the contract work within the contract time remaining.

There are, however, still uncertainties. The test stated in *MDC III* for the situation in which there is not an enforceable delivery date does seem more forgiving to the Government than the *Lisbon Contractors* standard when there is an enforceable date. Without a delivery date, all that apparently is required is that the CO be "reasonably justified in feeling insecure about the contractor's rate of progress." Id. at 1353. That seems far easier than establishing a reasonable belief that there is no reasonable likelihood that the contract can be completed in the time remaining, as *Lisbon Contractors* requires. It is even conceivable that the disparity might tempt the Government to waive the delivery date to take advantage of an easier standard. How would a court or board react in that situation?

The broader questions are whether this is really the end of the chipping away at the *Lisbon Contractors* standard, or whether we are moving again to a more broadly applied standard that permits termination after the equivalent of a Uniform Commercial Code 2-609 demand for further assurances. The latter had seemed to be the direction that Federal Circuit was tending in its decision in *Danzig v. AEC Corp*., 224 F.3d 1333 (Fed. Cir. 2000); 42 GC ¶ 418. But in subsequent decisions, including its 2005 decision in *MDC II*, the court seemed to back away and reemphasize the primacy of the *Lisbon Contractors* standard. Given the Supreme Court's refusal to consider the issues related to the standard for a termination for default, those questions will be answered only by future litigation, not in this case.

The State Secrets Privilege—The Federal Circuit's state secrets decision in *MDC II* acknowledged that in some situations the Government's failure to share its superior knowledge with contractors can constitute a breach of the contract, and provide a valid defense to a default termination. In the A-12 case, however, the court affirmed that the defense could not be litigated safely because the alleged superior knowledge was classified stealth technology from the B-2 and F-117 aircraft that, if disclosed, would harm national security.

Relying principally on *U.S. v. Reynolds*, 345 U.S. 1 (1953), the Supreme Court's modern pronouncement of the state secrets privilege in the civil case context, the Federal Circuit observed that, when properly invoked, the rule allows the Government to block discovery, and requires dismissal of a claim that cannot be made without the privileged information. *Reynolds* was a wrongful death suit brought by the widows of three civilian observers who died in the crash of a military aircraft on which they were testing secret equipment. The widows sought production of the Air Force's accident investigation report. The Air Force refused, and on that basis the trial court (affirmed by the circuit court) ordered that the widows' allegations of negligence be deemed established.

The Supreme Court reversed, holding that the Government's invocation of its evidentiary privilege against divulging military secrets did not by itself merit the sanction of imposing liability. It rejected the widows' analogy to criminal trials, in which the Government can withhold material from the defense only at the expense of the prosecution. In the court's view, "[s]uch rationale has no application in a civil forum where the Government is not the moving party, but is a defendant only on terms to which it has consented." 345 U.S. at 12. Instead, the court ruled that on remand the plaintiffs would have to establish the cause of the accident using the means available to them, including the testimony of the surviving crew members.

In *MDC II*, the Federal Circuit agreed that the Government had met *Reynolds*' two requirements for invoking the privilege. First, it satisfied the requirement of "a formal claim of privilege, lodged by the head of the department which has control over the

matter, after personal consideration by that officer," by submitting a declaration from the secretary of the Air Force that set forth the reasons for asserting the privilege. *MDC II*, 323 F.3d at 1022. Second, the Government established to the court's satisfaction that the circumstances surrounding the assertion of the privilege indicated that it was appropriately invoked. In a cautionary note regarding the latter requirement, the Federal Circuit repeatedly alluded to "security breaches and discovery abuses" that had occurred in the litigation as evidence of the "risk that the military and state secret once divulged is unlikely to remain protected in this case." Id.

The contractors did not dispute that the privilege applied. Instead, they questioned the consequence that flowed from the Government's invocation of the privilege in the context of a contract dispute. The contractors argued that it would violate due process to allow the Government to invoke the state secrets privilege to shield discovery into their superior knowledge defense while leaving intact the termination for default and its attendant recoupment of progress payments, which the Government had the burden to prove was warranted. The contractors reasoned that if the Government chose to use the privilege to defeat a defense, it should be at the expense of the Government's default termination claim.

The Federal Circuit denied the contractors' contention as the "very argument" the Supreme Court rejected in *Reynolds.* Id. at 1023. In the Federal Circuit's view, unlike a criminal defendant, the contractors were not unwilling Government targets. Rather, they were civil litigants "suing the sovereign on the limited terms to which it has consented," and as such, due process did not demand that "they be able to present all defenses, including a defense that would threaten national security." Id.

Both contractors challenge these conclusions in several ways in their petitions to the Supreme Court. First, the contractors contend that they are plaintiffs in name only, and that, because the Government must prove its default termination claim, the Government is, under *Reynolds*, the "moving party" in the first instance. They stress that it is the Government that is seeking the recovery of billions of dollars. As a result, the contractors argue that the Government should not be allowed to assert the state secrets privilege to defeat a valid defense to the termination on the fiction that the contractors are, like the widows in *Reynolds*, bringing a claim.

The Government responds that the contractors' default caused it to seek return of progress payments the contractors ultimately did not earn, and that the result in the case should not turn on the random fact of whether payments for the work had already been made. In the Government's view, it invoked the state secrets privilege not to meet its burden of justifying the termination, but rather only in response to the contractors' affirmative claim that its default was excused by the Government's failure to disclose its superior knowledge.

Not surprisingly, on this issue all parties seek support in *Molerio v. FBI*, 749 F.2d 815 (D.C. Cir. 1984), an opinion written by Justice Scalia when he sat on the D.C. Circuit. In that case, the plaintiff contended that the Federal Bureau of Investigation improperly refused to hire him as a special agent because his father may have participated in socialist organizations in the U.S. By affidavit, the FBI asserted that its background investigation of Molerio indicated that he would not qualify for the required top secret security clearance, but the Bureau invoked the state secrets privilege to withhold from evidence the specific basis for that assertion. Then-Judge Scalia noted that Molerio had made a "circumstantial case permitting the inference that his father's political activities were a 'substantial factor' … in the failure to hire." Id. at 825. Ultimately, however, the court concluded that the FBI's successful invocation of the state secrets privilege "prevent[ed] the issue from proceeding." Id.

Here, the contractors read *Molerio* to mean that, because the state secrets privilege required them to lay down their shield of the superior knowledge defense, due process required the Government to lay down its sword of default termination. In response, the Government views *Molerio* as support for permitting dismissal of a civil action to protect state secrets even if the plaintiff has made an initial showing that it may have a case. It does not appear, however, that either side takes full account of the particular circumstances in that earlier case.

In *Molerio*, privileged information apparently provided a nondiscriminatory basis for the FBI's refusal to hire the plaintiff. At least, the court's review of an in camera affidavit made it unwilling to accept any other inference that could have been drawn from Molerio's "circumstantial case." As a result then-Judge Scalia concluded that to do anything other than dismiss the case "would be a mockery of justice." Id.

But here, where the court did not do an in camera review to determine the strength of the contractors' superior knowledge claim, it is not clear that *Molerio* provides much support for either side.

In any case, there is some reason to question whether the Supreme Court would want to establish the rule that makes the effect of invocation of the state secrets privilege in a civil case turn on who is classified as the "moving party" in a particular situation. In many instances, as here, who should be designated the moving party is simply not clear. Are the contractors the "moving party" in the A-12 case because they have brought the action to challenge the default termination and have asserted the affirmative defense of superior knowledge? Or is the Government the moving party because the Navy has the burden of making a prima facie case that the termination is proper? The answer does not seem obvious.

Second, the contractors argue that the Federal Circuit again elevated form over substance by not considering the Government's claim of a right to recoupment to be a form of penalty akin to a criminal punishment. This contention has some appeal given the enormous sums at stake—with interest, the recoupment would be nearly $3 billion, and the contractors claim billions more in pretermination costs. But there are also some fundamental distinctions between the Government's invocation of the state secrets privilege as a civil litigant and as, say, prosecutor of a Guantanamo Bay detainee. In a criminal case, due process rightfully may—under the Blackstone formulation that it is "better that ten guilty persons escape than one innocent suffer"—require the Government to choose between the state secret and a prosecution. Given modern, adversarial Government contract litigation, however, would the Supreme Court impose on Government attorneys the prosecutorial obligation "to see that justice is done," *Reynolds*, 345 U.S. at 12, rather than the obligations all counsel must meet as officers of the court? While it indeed would be "unconscionable" for the Government to undertake a criminal prosecution and then "deprive the accused of anything which might be material to his defense," id., the Supreme Court may be reluctant to draw the same conclusion (automatically converting the termination for default into a termination for convenience) if civil claims are disputed and money, not freedom, is at stake.

Last, the contractors argue that the COFC found that they could make a prima facie showing of their superior knowledge defense without resorting to withheld information, and that this finding was never overturned. In evaluating this argument it may be helpful to imagine the result if the evidence were unavailable to either party, an approach taken by the D.C. Circuit in cases such as *In re Sealed Case*, 494 F.3d 139, 144–45 (D.C. Cir. 2007), and *Ellsberg v. Mitchell*, 709 F.2d 51, 64 and n.56 (D.C. Cir. 1983). As *Ellsberg* stated, "the result [of a properly invoked state secrets privilege] is simply that the evidence is unavailable, as though a witness has died, and the case will proceed accordingly, with no consequences save those resulting from the loss of evidence." Id.

Such an approach would seem to give the contractors their most powerful argument. In support of the trial court's finding that the contractors had made a prima facie showing of superior knowledge from A-12 data, it is common sense to presume that stealth technology developed at enormous expense for the land-based B-2 and F-117 aircraft would have aided the development of the carrier-based stealth A-12. If the contractor can make a prima facie case that it has a valid superior knowledge defense and the Government cannot overcome it without relying on the very classified information that it has sought to exclude from the litigation, then perhaps the contractor should prevail. At the same time, a rule in contract cases involving classified information that the Government must choose between the privilege and the default termination only after the contractor makes a prima facie showing of the Government's superior knowledge would guard against contractors' specious, preemptive resorts to a superior knowledge defense without requiring the trial court to review the alleged secret information.

What the climax to the state secrets portion of the long-running A-12 case will be, much less what it will mean to the Government and its contractors, is anyone's guess at this point. The contractors warn that the Federal Circuit's decision will tempt Government officials to invoke the privilege if their default termination decisions are challenged on programs that involve classified technology. The contractors may overstate the danger if for no other reason than because the vast majority of Government contracts do not involve classified technology or secret programs. Nonetheless, the Supreme Court's answers to the state secrets issues raised by the A-12 dispute will undoubtedly affect the calculation of risk for both the Government and contractors on those contracts that

do involve classified information. Depending on the Supreme Court's resolution, contractors undertaking such contracts may have to accept that superior knowledge defenses involving the classified data are essentially unavailable to them if they are terminated for default. Alternatively, the Government may have to accept that, if it invokes the state secrets privilege in a challenge to a termination for default, it must convert the termination to one for convenience, rather than for default. Given the current schedule, which calls for oral argument in January, we should know the answer by the end of the Supreme Court's term in June.

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