

# BRIEFING PAPERS®

## SECOND SERIES

PRACTICAL TIGHT-KNIT BRIEFINGS INCLUDING ACTION GUIDELINES ON GOVERNMENT CONTRACT TOPICS

### EXCEPTIONS TO FINAL ACCEPTANCE: LATENT DEFECTS, FRAUD & GROSS MISTAKES AMOUNTING TO FRAUD

By Patricia A. Meagher and Scott M. Rennie

The standard “Inspection” clauses incorporated into fixed-price Government contracts for supplies, construction work, and research and development provide that acceptance by the Government is final and conclusive *except for latent defects, fraud, or gross mistakes amounting to fraud*.<sup>1</sup> If the Government accepts the work you perform under a Government contract but subsequently discovers a latent defect, fraud, or a gross mistake amounting to fraud, it has the right to revoke its acceptance and to demand that you repair or replace the defective work at your own expense. If you refuse to do so, the Government may itself repair or replace the defective work—or contract with a third-party to do so—and then recover from you the reasonable costs of the repair or replacement. The Government also has the right to terminate the contract for default.<sup>2</sup> Alternatively, the Government may decide to accept the work notwithstanding the defect and issue a modification to the contract reducing the contract price by an amount representing the diminished value of the work.<sup>3</sup> Although latent defects, fraud, and gross mistakes amounting to fraud are most commonly used by the Government to revoke acceptance of an article or material delivered under a supply contract, they also may serve as the basis for revoking acceptance of work performed under a construction contract<sup>4</sup> or a research and development contract.

The Government’s right to revoke its final acceptance of your work based on a latent defect, fraud, or a gross mistake amounting to fraud extends indefinitely. The only limit on the Government’s right

to revoke final acceptance is that it must take action within a reasonable time after discovery of the defect.<sup>5</sup> It may be months or even years after acceptance before the defect is discovered. In one case, for example, an alleged latent defect was discovered more than 10 years after installation of a pipeline.<sup>6</sup> In another case, the alleged latent defect arose more than four years after transformers were placed in service.<sup>7</sup>

#### IN BRIEF

##### Latent Defects

- Existence Of A Defect
- Defect Present At Time Of Acceptance
- Defect Was “Latent”
- Defect Caused Work To Fail

##### Fraud

- Reliance On The Misrepresentation
- Misrepresentation Of Material Fact

- Intent To Deceive Or Mislead
- Injury From Reliance On Misrepresentation

##### Gross Mistakes Amounting To Fraud

- Fraud vs. Gross Mistake Amounting To Fraud
- “Gross Mistake Amounting To Fraud” Defined
- Reliance On Gross Mistake
- Failure To Inspect Or Discover Not A Defense

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This BRIEFING PAPER explores the issues presented when the Government attempts to revoke its acceptance of your work on the basis of latent defects, fraud, or gross mistakes amounting to fraud. It focuses on the *elements* the Government must *prove* to establish the existence of latent defects, fraud, or gross mistakes amounting to fraud and discusses situations where the Government met its burden as well as situations where it did not.

In addition to a claim of latent defects, fraud, or gross mistakes amounting to fraud, the Government may invoke its postacceptance rights under the contract's "Warranty" clause. The Federal Acquisition Regulation includes several "Warranty" clauses that may, at the Government's option, be incorporated into your contract.<sup>8</sup> The types of defects covered by a "Warranty" clause depend on the language of the particular clause. The Government's warranty rights are not discussed in this PAPER.<sup>9</sup>

## Latent Defects

The Government has a heavy burden of proving a latent defect claim.<sup>10</sup> The law requires that the Government show that four factors exist. First, it must show that there was a *defect* in your work. Second, it must show that the defect existed *at the time of acceptance* of the work. Third, it must show that the defect was *latent*.<sup>11</sup> Finally, it must show that the defect *caused the failure* of the work to meet contract requirements.<sup>12</sup> If the Government fails to prove the existence of any one of these four factors, it will not be able to revoke acceptance of your work based on a latent defect.

## ■ Existence Of A Defect

To meet the burden of proving that there was a defect in your work, the Government must show that your work *failed to comply with a contract requirement*. The fact that the Government perceives a problem with or deficiency in your work is insufficient. It must point to a failure to comply with a requirement of the contract.

The need for the Government to establish a noncompliance with a contract requirement reflects the distinction between a latent *condition* and a latent *defect*. A latent condition may be undetectable before acceptance and may cause a postacceptance failure, but unless it is the result of a *noncompliance* with a contract requirement, it is not a basis for the Government's revoking acceptance. This is true no matter how harmful the latent condition is to the performance or service life of the item. Only a latent *defect* entitles the Government to revoke acceptance of the contract work.<sup>13</sup>

In establishing whether the work failed to comply with a contract requirement, it is important first to determine what the contract required. To make this determination, a court or board may look to the *inspection and performance standards* set forth in the *contract*. It has been held that defects that are not prohibited by the inspection and performance standards set forth in the contract are not grounds for rejection of performance under the contract.<sup>14</sup> Accordingly, if the deficiency discovered by the Government after acceptance is not prohibited by the inspection and performance standards set forth in the contract, it is not a defect under the "Inspection" clause. In one case, for example, a helicopter crash was found to have been caused by

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rotor spindles that, according to the Government's postcrash data, did not have the requisite fatigue life. This deficiency was not a defect, however, because the spindles had the fatigue life necessary under the inspection method prescribed by the contract. The Government's postcrash data resulted from testing that included "droop stop pounding," a factor the contract did not require the contractor to take into account in calculating fatigue life.<sup>15</sup>

On the other hand, if the work fails to comply with a *contractually specified inspection or test procedure*, it is defective. In many cases, such defects are discovered before acceptance through in-process inspections or testing conducted during the manufacturing process. But in some instances, the defect is not discovered before final acceptance. For example, the Government may randomly test delivered units before acceptance, and one or more of the nontested units subsequently may fail because of a defect. If the Government establishes that these units do not pass the contractually specified test, that failure would provide a basis for a subsequent revocation of acceptance of these units based on latent defects, assuming the other requirements are met, including that the random testing was reasonable and that the defect discovered actually caused the failure.

Even where your work passes all of the inspections and tests required by the contract before and at the time of final acceptance, it does not necessarily mean there is no latent defect in the work. The Government may rely on a failure of a test or inspection *other than* a contractually specified test or inspection to establish the existence of a latent defect. The law requires, however, that any extracontractual test procedure or standard be *no more stringent* than the test procedures or standards specified in the contract.<sup>16</sup> If a defect in your work is discoverable only by the use of more stringent test procedures or standards than those found in the contract, the defect is not a noncompliance with the contract requirements and the Government cannot use it as a basis to revoke its acceptance of your work.<sup>17</sup>

There is one situation where a latent defect may be found notwithstanding your compliance

with the contract specifications. In some instances, a contractor may propose to use its *own specifications* in place of the Government specifications originally set forth in the contract. If the Government accepts this proposal, the contractor's specifications become, in effect, the contract specifications. In this situation, the contractor assumes the risk that its own specifications will work, and their failure to do so may satisfy the requirement for a latent defects claim of non-compliance with contract specifications.<sup>18</sup>

#### ■ Defect Present At Time Of Acceptance

Not only must the Government establish the existence of a defect in your work, the Government must also demonstrate that the defect was present at the time the Government accepted the work.<sup>19</sup> This requirement is often difficult to satisfy, especially where there has been a significant passage of time between final acceptance and discovery of the defect. In one case, for example, the Government could not recover against the contractor for a latent defect because the Government did not eliminate the possibility that the defect could have been the result of damage to the product caused by improper storage after final acceptance.<sup>20</sup> In another case, the Government's claim that eroded and cracked mortar joints were latent defects was rejected because the Government did not prove that the cracks and erosion existed at the time of final acceptance, and it was possible that the cracks and erosion occurred after contract performance as a result of continued exposure to wind and ocean spray.<sup>21</sup>

#### ■ Defect Was "Latent"

Assuming the Government proves that there was a defect in your work and that it existed at the time of final acceptance, it must also establish that the defect was "latent." A "latent" defect is generally defined as a defect that is hidden from the knowledge as well as from the sight of the Government and that could not be discovered before acceptance by ordinary and reasonable care or by reasonable inspection.<sup>22</sup> Stated somewhat differently, a defect that was known to the Government or could have been discovered by reasonable means before acceptance is not a latent defect.<sup>23</sup>

A defect is not “latent” if the Government had *actual knowledge* of the defect at the time of final acceptance.<sup>24</sup> In some cases, the contractor makes a disclosure to the Government regarding a defect before acceptance. Such a disclosure will not necessarily mean that the defect was not “hidden from the knowledge” of the Government and thus was not a “latent” defect. Rather, the contractor’s disclosure must be sufficient to constitute actual knowledge of the defect on the part of the Government. This point was illustrated in a case involving the construction of a metrorail station. The contract required supporting pads made of natural rubber or fiberglass. During performance, the contractor disclosed to the Government that it was substituting pads made from polyester. After final acceptance, the pads failed as a result of hydrolysis, a condition to which polyester is susceptible. The Corps of Engineers Board of Contract Appeals found that the disclosure by the contractor did not constitute actual knowledge of a defect on the part of the Government because the disclosure would not have alerted the ordinary buyer that the substitute material was unsuitable because it was susceptible to collapse under chemical reaction to water.<sup>25</sup>

A latent defect must also be “hidden from the sight” of the Government. If the defect could have been discovered by the Government’s inspector before final acceptance through a *visual inspection*, the defect is not latent. In one case, for example, the ENGBCA found that the defective assembly of a water line was not a latent defect because the Government inspector at the worksite could have easily observed the pipe during its assembly and seen that the nuts were not properly tightened on the bolts that held the pipe flanges together.<sup>26</sup> In another case, the Armed Services Board of Contract Appeals held that a contractor’s failure to use mahogany wood in performing the contract work was not a latent defect because a visual inspection would have disclosed that the wood being used by the contractor varied in color, and the variation should have alerted the Government inspector that the wood might not comply with the specifications.<sup>27</sup> In still another case, the General Services Administration Board of Contract Ap-

peals found that mobile tool cabinets delivered with dents, scratches, misaligned drawers, sharp edges, broken or improper welds, defective locks, and rust could not be rejected on the ground they contained latent defects because the defects were readily discernable upon a visual inspection. The board dismissed the Government’s argument that the defects in the mobile tool cabinets were latent because they were concealed by the shipping crates, commenting “[t]hat dog won’t hunt.”<sup>28</sup>

In addition to being hidden from the knowledge as well as from the sight of the Government, to be “latent,” the defect must not have been discoverable by ordinary and reasonable care or by *reasonable inspection*. Contractors often argue that a defect is not latent because it could have been discovered had the Government conducted certain tests or inspections. But that argument will prevail only if conducting such tests or inspections was reasonable under the circumstances. Not surprisingly, what is a “reasonable” inspection that would have revealed the existence of a defect depends on the facts of the particular case.<sup>29</sup>

A defect is “patent”—not latent—if it was or could have been discovered by the inspection or testing procedures *specified in the contract*.<sup>30</sup> Similarly, a defect is patent if the defect is readily discoverable by an *ordinary examination* or *test*, and the Government’s failure to conduct such an examination or test does not make it latent.<sup>31</sup> In one case, for example, the Government argued that the contract required that integrated circuit logic gates be furnished with three circuits and claimed that the integrated circuit logic gates furnished by the contractor with only one circuit had latent defects. The ASBCA rejected the Government’s claim because it found that the fact that the devices had only one circuit rather than three circuits could have been determined easily by an energizing test or use of an ohmmeter.<sup>32</sup> But where a contract does not provide for Government inspection or testing of the work in progress but does contain the standard “Inspection” clause requiring the *contractor* to maintain an *adequate inspection system* and to perform such tests as necessary to ensure contract compliance, it has been held

that the Government fulfills its obligations to exercise ordinary care in accepting the work by conducting a visual examination of the completed work.<sup>33</sup>

Where the contract specifically requires the contractor to conduct a particular test and to *certify* the results, the Government may have the right to rely on the contractor's testing. In one case, for example, the contract contained a "Contractor Quality Control" clause that placed an explicit, affirmative obligation upon the contractor to conduct certain tests and inspections during performance of concrete repair work to ensure that the work conformed to the contract requirements. The clause also required the contractor to certify that the work was performed in compliance with the contract plans and specifications. The ASBCA held that the Government had no obligation to perform these tests again but instead could rely on the contractor's certifications that it was abiding by the specifications.<sup>34</sup> Other cases also have held that where a contractor submits a certification of compliance to the Government under the contract, it is reasonable for the Government to rely on the certification and to conduct a more limited inspection of the goods.<sup>35</sup> A different result may be found, however, where the Government inspector fails to obtain from the contractor the certification required by the contract or fails to ensure that the contractor in fact performed the required testing.<sup>36</sup> Likewise, if a reasonable review of the contractor's certifications would have revealed the alleged defect the Government now complains of, the defect is not latent.<sup>37</sup>

Note, however, that some cases deal with contractor-certified work later found not to comply with the specifications as a gross mistake amounting to fraud rather than as a latent defect.<sup>38</sup> What the Government must prove to revoke acceptance based on a gross mistake amounting to fraud is discussed later in this PAPER.

Some defects may be discoverable only by tests conducted in a *laboratory*. In one case, for example, the ASBCA held that a defect was latent because the defect could have been discovered only by laboratory testing that could not have

been performed at final inspection.<sup>39</sup> By contrast, in another case, the board held that the contractor's use of a substitute metal material, confirmed by laboratory testing several months after completion of a contract, was "readily discoverable" and thus not a latent defect because the tests were "ordinary processes" and the use of the laboratory for such testing was available to the Government during contract performance.<sup>40</sup>

#### ■ Defect Caused Work To Fail

The fourth factor that must be established by the Government to prove its latent defect claim is that the defect caused the work to fail. This is the legal element of "causation."

In a latent defect claim, the Government must prove a *definite nexus* between the latent defect and the product failure. This burden is more difficult than the burden imposed on the Government in a breach of warranty claim where the Government is not required to establish precisely what contractor acts or omissions caused the defect.<sup>41</sup> The law is clear that the mere fact of a postacceptance failure does not establish the existence of a latent defect. It has been held that "[p]roof of the defect that caused the failure must be direct and not left to inference."<sup>42</sup>

Perhaps it is most difficult for the Government to establish contractor liability based on a latent defect where there is *more than one cause* of the failure. It is not uncommon for a failure to be a result of several defects, only some of which may be latent. In those cases, the Government's recovery is limited to that portion of the damages that it establishes with reasonable accuracy *resulted from latent defects*.<sup>43</sup>

If the Government fails to establish the damages that resulted from the latent defects in your contract work, you will be excused from any liability.<sup>44</sup> In one case, for example, there were defects in a roadway, some of which were latent, some of which were patent, and some of which were the result of the Government's faulty design. The Government's evidence included the overall cost of repairing the roadway but did not provide any basis for making a reasonably accurate determination of the amount of the damages that was a result of latent defects as

opposed to patent defects or the Government's faulty design. Accordingly, the Government recovered nothing from the contractor, despite the latent defects in the roadway work.<sup>45</sup> In another case, the Government did not prevail in its latent defects claim arising out of the construction of a federal office building plaza even though there were defects in the precast concrete paving panels furnished by the contractor. The board found that other factors contributed to the deterioration of the pavement, and the Government did not prove the amount of the replacement costs that were due to the latent defects.<sup>46</sup>

## Fraud

Fraud is the deliberate making of an untrue statement or the taking of dishonest action with intent to deceive another to his detriment.<sup>47</sup> As with a latent defects claim, the Government has the burden of proving its fraud claim against you. To revoke final acceptance of your work based on fraud, the Government must prove—by a preponderance of the evidence<sup>48</sup>—that (1) its acceptance of your work was induced by *reliance on a misrepresentation* by you, (2) the misrepresentation pertained to a *material fact*, (3) the misrepresentation was made with the *intent to deceive* or *mislead* the Government into relying on the misrepresentation, and (4) as result of relying on your misrepresentation, the Government suffered *injury*.<sup>49</sup> Proof need not be established by direct evidence but may be based solely on circumstantial evidence.<sup>50</sup>

### ■ Reliance On The Misrepresentation

The Government must prove that it relied on the alleged misrepresentation in accepting contract work and that its reliance was *reasonable* under the circumstances. If the Government cannot prove that your alleged misrepresentation caused it to accept your work, or that it was justified in accepting the work under the circumstances, then its fraud claim against you will fail.

Some contractors may believe that they can avoid a revocation of acceptance based on fraud

on the ground that the Government's failure to discover the noncompliance was due, at least in part, to the Government's own lack of diligence in inspecting the contract deliverables. However, faith in such a defense is misplaced. A contractor that *knowingly* misleads or deceives the Government cannot avoid the consequences of its intentional misdeeds by asserting that the Government should have discovered the fraud.<sup>51</sup> Accordingly, the Government's failure to inspect your contract deliverables, even when such inspection is required by regulation or the contract, does not render unreasonable the Government's reliance on your representation that the deliverables conform to the contract nor does it insulate you from liability for fraud.<sup>52</sup>

If the Government actually knew at the time it accepted your work of the falsity of the misrepresentation, however, then its reliance on that misrepresentation will be deemed unreasonable and cannot be used to prove a fraud claim against you.<sup>53</sup> This point is illustrated by a case in which the Government claimed, among other things, that a masonry contractor had misled it by surreptitiously buttering over old brick joints instead of removing the bricks. However, the contractor proved that the Government had knowledge of the nonconformity by establishing that a Government inspector was present on the jobsite and observed the performance of the obviously nonconforming masonry repair work. The Department of Transportation Contract Appeals Board held that the Government was precluded from relying on the misleading action since its onsite inspector observed the masonry work and knew or should have known that the work was nonconforming. Accordingly, the Government could not revoke its acceptance on the basis of fraud (or a gross mistake amounting to fraud).<sup>54</sup>

### ■ Misrepresentation Of Material Fact

The contractor's misrepresentation must pertain to a fact, as opposed to a matter of law or opinion, and the fact must be material.<sup>55</sup> At least one board has found that a contractor misrepresented a material fact where the contractor misstated that an item complied with contract requirements and was suitable for its intended use by the Government.<sup>56</sup>

The *failure to disclose* information can be as much a misrepresentation as an *affirmative misstatement*. For example, in one case, a contractor knew that certain items listed on a DD250 Acceptance Form were nonconforming but failed to disclose the nonconformity to the Government during acceptance. The Government argued that the nondisclosure was a misrepresentation because the DD250 form required the contractor to identify all nonconformances to contract specifications and the contractor had failed to do so. The Court of Federal Claims agreed, holding that the contractor had misrepresented that the items were conforming.<sup>57</sup>

If you fully inform the Government of a nonconformity before acceptance, however, it will be difficult for the Government later to claim fraud. In one case, a contractor laying marine cables alerted the Government to its discovery of unexpected harbor bottom conditions that prevented the burying of cable to the depth specified in the contract. The contractor kept the Government informed of deviations from the contract specifications that were required as a result of the unexpected conditions. Four years later, Government divers attempted to verify the site conditions identified by the contractor and to inspect the contractor's work. The Government claimed that the divers found conditions that differed from those reported by the contractor and alleged that the contractor had misled it. The evidence established that the bottom conditions had changed dramatically in the intervening four years and that the conditions encountered by the Government divers were not indicative of the conditions at the time the contractor performed the work. The DOTCAB found that the contractor had truthfully, correctly, and fully informed the Government of what it found and what it was doing. Accordingly, it held that the contractor had not misled the Government, and therefore the Government could not revoke its acceptance of the contractor's work based on fraud.<sup>58</sup>

#### ■ Intent To Deceive Or Mislead

The Government also must prove a contractor's intent to deceive or mislead, and frequently such proof must be made without the assistance of

direct evidence. The Government, however, has successfully proven intent to deceive by *circumstantial evidence*. In one case, the Government established that the contractor knew its vendor was supplying parts that did not conform to contract requirements, and that the contractor continued to incorporate the nonconforming parts in its work without requesting a waiver from the Government or taking steps to correct the nonconformance. The Court of Federal Claims found that the contractor had no reasonable basis to believe that it was complying with the contract requirements. It also found that the contractor failed to notify the Government of the noncompliance or to correct it. The court held that these findings, coupled with the contractor's continued delivery of the nonconforming items to the Government, demonstrated its intent to deceive.<sup>59</sup>

The *failure to notify* the Government of a nonconformity, however, does not automatically prove that you intended to deceive the Government. In one case, the contractor's preproduction vehicle body was two inches longer than specified and, because of that extra length, would not mount properly on the chassis without the addition of an extra cross-member. The contractor agreed to eliminate the extra body length in the production models, but in doing so, the contractor also removed the additional cross-member. Although it was shown that the contractor did not notify the Government of the removal of the additional cross-member, no evidence was presented that the contractor had reason to believe that removal of the additional cross-member would adversely affect the vehicle bodies. In addition, Government inspectors were present in the contractor's plant and could compare production models to a preproduction model retained by the contractor. The ASBCA found that the contractor did not act covertly when it removed the cross-member and, accordingly, did not intend to mislead the Government.<sup>60</sup>

#### ■ Injury From Reliance On Misrepresentation

The Government must prove not only that it relied on a contractor's misrepresentation but that it was injured by its reliance on the misrepresentation.<sup>61</sup> The Government can prove

that it was injured by a misrepresentation by establishing that it *would not have accepted* your nonconforming contract work had it known of the nonconformity.<sup>62</sup> The Government met its burden in one case where it claimed that it relied on the contractor's misrepresentation that it had fully performed certain metallurgical testing to determine the structural soundness of the trunnion mounting brackets on howitzers. The Government introduced evidence that a failure of the mounting bracket could cause the howitzers to explode. It also proved that upon discovering the contractor's misrepresentation, it had removed the howitzers from use due to the safety concern. The Court of Federal Claims held that the Government would not have accepted the howitzers had it known of the contractor's failure to properly inspect the howitzers. It also held that the Government was injured by the contractor's fraudulent misrepresentation.<sup>63</sup>

The Government can also prove that it was injured by a misrepresentation by establishing that the finished work is *degraded by the noncompliance*. In one case, the contractor misrepresented to the Government that it was proceeding with the installation of roof trusses "as per plan," which in context meant in accordance with the Government drawings.<sup>64</sup> The Government drawings required that the trusses be of a certain dimension and that wood blocking be used between the truss and the wall. The trusses installed by the contractor did not meet the dimensions and did not incorporate the required blocking. The ASBCA held that the misrepresentation injured the Government because it caused the Government to accept noncompliant trusses and blocking that would potentially cause differential settlement of the exterior and interior walls and unacceptable overloading of some trusses.<sup>65</sup>

## Gross Mistakes Amounting To Fraud

### ■ Fraud vs. Gross Mistake Amounting To Fraud

Claims of fraud and gross mistakes amounting to fraud both require that the Government

prove a misrepresentation by the contractor of a material fact and reliance on the misrepresentation by the Government to its detriment. To establish a gross mistake amounting to fraud, however, the Government need *not* prove an intent to deceive.<sup>66</sup> In addition, whereas fraud connotes a *deliberate* untrue statement or a dishonest action, mistake connotes an *unintentional* misstatement or action that produces an unintended and undesirable result.<sup>67</sup> You should note that not all mistakes rise to the level of gross mistakes amounting to fraud, however, since there must be proof of recklessness or conduct inconsistent with good faith, as discussed below.

A gross mistake amounting to fraud has the same effect as fraud—the Government has been induced by contractor action to accept work that does not conform to contract requirements. Thus, even though the gross mistake was made without intent to deceive, the result is the same: the Government is permitted to revoke acceptance of your work, assuming it proves injury.<sup>68</sup>

### ■ "Gross Mistake Amounting To Fraud" Defined

Not every mistake is a "gross mistake," and not every gross mistake amounts to fraud.<sup>69</sup> A "gross mistake" has been described as a mistake that "a reasonable contractor acting honestly would not reasonably be supposed to make."<sup>70</sup> A gross mistake can take the form of words, actions, or failure to disclose material facts.<sup>71</sup> In addition, your gross mistake must be such that it *cannot be reconciled with good faith*.<sup>72</sup> But it has been held that the Government does *not* have to prove that you acted in *bad faith* to establish a gross mistake amounting to fraud, and your proving that you acted in good faith is not a defense.<sup>73</sup>

Whether your mistake rises to the level of a gross mistake amounting to fraud will depend on the circumstances. For example, in the case discussed above where the contractor's preproduction vehicle body was two inches too long and required an extra cross-member to mount on the chassis, the ASBCA held that

the contractor's failure to notify the CO of the removal of the additional cross-member was not irreconcilable with good faith, and thus, was not a gross mistake amounting to fraud.<sup>74</sup>

In another case, the ASBCA found that the contractor had no reasonable basis to believe that material it substituted without the Government's knowledge was suitable for use in the device in which it was incorporated, and that the contractor knew that the device would be used in the pneumatic systems of high performance military aircraft.<sup>75</sup> Accordingly, the board held that the substitution of material was a gross mistake "out of all measure, beyond allowance, and not to be excused."<sup>76</sup>

#### ■ Reliance On Gross Mistake

As with fraud, to revoke acceptance on the basis of a gross mistake amounting to fraud, the Government must prove that it relied on your gross mistake in accepting your work or supplies.<sup>77</sup> Thus, the Government is not entitled to revoke acceptance of nonconforming contract work when a Government inspector had full knowledge of the nonconformance at the time of acceptance.<sup>78</sup> In one case, the contract required that a part be a single piece of forged metal. The contractor, however, manufactured the part from three pieces using a screw machine and furnace brazing to attach the pieces. The Government inspector accepted the first lot of parts and authorized future shipments with full knowledge of the contractor's manufacturing method and its nonconformance with contract drawings. The ASBCA held that because the Government inspector knew of the deviation and accepted the parts, the Government could not revoke acceptance on the basis of a gross mistake amounting to fraud.<sup>79</sup>

#### ■ Failure To Inspect Or Discover Not A Defense

You cannot use the Government's failure to inspect your work before acceptance<sup>80</sup> or its failure to discover readily apparent defects in your work<sup>81</sup> as a defense to the Government's claim

of a gross mistake amounting to fraud. Boards have found that a contractor's failure to disclose noncompliance with a material requirement of the contract—whether or not the noncompliance was readily apparent at the time of acceptance—is a gross mistake amounting to fraud.<sup>82</sup>

In one case, the contract required that aircraft bolts be heat treated to obtain a high level of strength and that the contractor certify that its bolts met the contract requirements. The contractor presented untreated bolts to the Government inspector and misrepresented to the inspector that it had been advised by telephone that no heat treatment was required. The ASBCA held that the contractor's misrepresentation, combined with its failure to heat treat the bolts, was a gross mistake amounting to fraud that allowed the Government to revoke its acceptance, despite the Government's failure to perform an inspection that would have revealed that the bolts did not have the required strength.<sup>83</sup>

In another case, the contractor's certification misrepresented that items presented for acceptance testing were identical to previously tested and approved conforming items, inducing the Government inspector to forgo complete acceptance testing. The ASBCA held that this misrepresentation was a gross mistake amounting to fraud.<sup>84</sup> In a third case, a contractor, while providing the Government inspector with revised drawings incorporating polystyrene end pieces, failed to inform the Government inspector that an earlier drawing of the item to be inspected incorporated polyvinyl chloride end pieces. The ASBCA held that the contractor's failure to disclose the earlier drawing induced the Government to accept and pay for items with polystyrene end pieces, and therefore was a gross mistake amounting to fraud, despite the fact that an inspector could have obtained the correct drawing from the CO.<sup>85</sup> Where, however, a Government inspector is present and observing the performance of the work and the defect in the performance is obvious, the Government cannot claim to have reasonably relied in accepting the work on the mistake of the contractor.<sup>86</sup>

## ★ GUIDELINES ★

These *Guidelines* are designed to assist you in understanding the scope of the Government's right to revoke final acceptance of your contract work on the basis of latent defects, fraud, or gross mistakes amounting to fraud. They are not, however, a substitute for professional representation in any specific situation.

1. Remember that as a Government contractor, *acceptance* by the Government of your work affords you certain protections. Acceptance is deemed *final* and *conclusive except for* any continuing *warranty* obligation. The only basis on which the Government can revoke acceptance is if it can prove a *latent defect, fraud, or a gross mistake amounting to fraud*. The *Government* bears a heavy *burden of proof* in establishing these claims.

2. Bear in mind that the only time limit on the Government's right to revoke acceptance of your work on the basis of a latent defect, fraud, or a gross mistake amounting to fraud is that it must take action *within a reasonable time after discovery of a defect in the work*. A defect, however, may not be discovered until years after acceptance of your work. Thus, you should consider *retaining your records* for a period of some years after final acceptance to provide you with the information you need to prove that your performance conformed to the contract requirements.

3. Be aware that in attempting to prove that a defect existed at the time of acceptance, the Government may point to alleged deficiencies in the manufacturing process that could have created the defect. Your *quality control manuals* and your *quality assurance testing records* will be important evidence in responding to such claims.

4. During performance, keep the Government fully informed *in writing of any deviation* from the contract requirements and retain a copy of the writing. Any *oral discussions* about the deviation should be *memorialized* in a journal noting the details of the conversation, including the *name* of the Government representative to whom you spoke and the *date* and *place* of the conversation. Documentation showing that you were forthcoming and truthful regarding your contract performance will be important evidence to refute the Government's claim that you *failed to disclose*

*material information* regarding nonconforming work in the event the Government attempts to revoke its acceptance based on *fraud* or *gross mistake amounting to fraud*.

5. Recognize that in many *latent defect* cases, the Government is more interested in having you *repair* or *replace* the defective work than it is in rejecting the work or terminating your contract for default. Indeed, you are *entitled* to repair or replace the defect. The Government cannot use a latent defect as an *excuse* to return a delivered and accepted item it no longer wants or needs.

6. If you cannot resolve a claim of latent defect, fraud, or gross mistake amounting to fraud through discussion or negotiation with the Government, consider *mediation*. Although the law is clear that the Government has the heavy burden of proving the existence of latent defects, fraud, or gross mistakes amounting to fraud, the consequences of bearing this burden may not be fully understood by Government officials more familiar with defending claims than prosecuting them.

7. If the claim must be litigated, be prepared to retain outside *consultants* familiar with the type of work you did under the contract. An expert consultant may be able to explain to the Government (or to testify at trial if necessary) (a) why the alleged deficiencies, even if they do exist, *could not have resulted in the failure* of the contract deliverables or (b) that the defects the Government now complains of *would have been discovered* had the Government conducted a *reasonable inspection* before acceptance.

8. Understand the paperwork you must submit with your work. Some standard Government forms—such as the DD250—require that you *identify all nonconformities* in your contract work. If you submit such a form without disclosing nonconformities *known to you*, the Government may have a basis to revoke acceptance of your work on the grounds of fraud or gross mistake amounting to fraud. On the other hand, if you identify all nonconformities and the Government accepts the work, it would have no basis to revoke acceptance of your work based on any disclosed nonconformity even if the item later fails.

## ★ REFERENCES ★

- 1/ FAR 52.246-2, para. (k) ("Inspection of Supplies—Fixed-Price" clause), 52.246-7, para. (f) ("Inspection of Research and Development—Fixed-Price" clause), 52.246-12, para. (i) ("Inspection of Construction" clause).
- 2/ Sentell Bros., Inc., DOTBCA 1824, 89-3 BCA ¶ 21,904; Cross Aero Corp., ASBCA 14801, 71-2 BCA ¶ 9075, 14 GC ¶ 74; see FAR 52.246-2, 52.246-7, 52.246-12.
- 3/ Munson Hammerhead Boats, ASBCA 51377, 00-2 BCA ¶ 31,143; see FAR 52.246-2, 52.246-7, 52.246-12.
- 4/ Roberts v. United States, 357 F.2d 938 (Ct. Cl. 1966), 8 GC ¶ 154.
- 5/ Munson Hammerhead Boats, 00-2 BCA ¶ 31,143 (citing Bar Ray Prods., Inc. v. United States, 162 Ct. Cl. 836 (1963), 5 GC ¶ 329); Cross Aero Corp., 71-2 BCA ¶ 9075.
- 6/ Peter Kiewit Sons' Co., IBCA 3535-95 et al., 99-2 BCA ¶ 30,401.
- 7/ General Elec. Co., IBCA 442-6-64, 65-2 BCA ¶ 4974.
- 8/ See, e.g., FAR 52.246-17 ("Warranty of Supplies of a Noncomplex Nature" clause), 52.246-18 ("Warranty of Supplies of a Complex Nature" clause), 52.46-19 ("Warranty of Systems and Equipment Under Performance Specifications or Design Criteria" clause), 52.246-20 ("Warranty of Services" clause), 52.246-21 ("Warranty of Construction" clause); see FAR subpt. 46.6.
- 9/ See generally Ralph C. Nash, Jr. & John Cibinic, Jr., Administration of Government Contracts 884-99 (3d ed. 1995).
- 10/ Geranco Mfg. Corp., ASBCA 12376, 68-1 BCA ¶ 6898, 10 GC ¶ 239.
- 11/ United Techs. v. United States, 27 Fed. Cl. 393 (1992); Herley Indus., Inc., ASBCA 13727, 71-1 BCA ¶ 8888, 13 GC ¶ 353; Kaminer Constr. Corp. v. United States, 488 F.2d 980 (Ct. Cl. 1973), 16 GC ¶ 46.
- 12/ M.A. Mortenson Co. v. United States, 29 Fed. Cl. 82 (1993), 35 GC ¶ 398.
- 13/ Jo-Bar Mfg. Corp., ASBCA 18292, 73-2 BCA ¶ 10, 353; Santa Barbara Research Ctr., ASBCA 27831, 88-3 BCA ¶ 21,098, 31 GC ¶ 118.
- 14/ M.A. Mortenson Co., 29 Fed. Cl. 82.
- 15/ United Techs., 27 Fed. Cl. 393.
- 16/ M.A. Mortenson Co., 29 Fed. Cl. 82 (citing United Techs., 27 Fed. Cl. 393, and Southwest Welding & Mfg. Co. v. United States, 413 F.2d 1167 (Ct. Cl. 1969), 11 GC ¶ 358).
- 17/ Southwest Welding & Mfg. Co., 413 F.2d 1167; M.A. Mortenson Co., 29 Fed. Cl. 82; United Techs., 27 Fed. Cl. 393.
- 18/ Norair Eng'g Corp., ENGBCA 5244, 92-2 BCA ¶ 25,009.
- 19/ Santa Barbara Research Ctr., ASBCA 27831, 88-3 BCA ¶ 21,098, 31 GC ¶ 118.
- 20/ Ordnance Parts & Eng'g Co., ASBCA 40277, 90-3 BCA ¶ 23,142.
- 21/ Bromley Contracting Co., DOTCAB 78-1, 81-2 BCA ¶ 15,191.
- 22/ Bart Assocs., EBCA C-9211144 et al., 96-2 BCA ¶ 28,479 at 142,235-2; Norair Eng'g, Corp., 92-2 BCA at 124,648; Geranco Mfg. Corp., ASBCA 12376, 68-1 BCA ¶ 6898 at 31,861, 10 GC ¶ 239; see FAR 46.101. See also Cross Aero Corp., ASBCA 14801, 71-2 BCA ¶ 9075 at 42,085 (citing Herley Indus., Inc., ASBCA 13727, 71-1 BCA ¶ 8888, 13 GC ¶ 353, and cases cited therein), 14 GC ¶ 74; Teller Envtl. Sys., Inc., ASBCA 25550, 85-2 BCA ¶ 18,025 at 90,427; Kaminer Constr. Corp. v. United States, 488 F.2d 980 (Ct. Cl. 1973), 16 GC ¶ 46; Royson Eng'g Co., ASBCA 15438 et al., 73-2 BCA ¶ 10,229.
- 23/ M.A. Mortenson Co. v. United States, 29 Fed. Cl. 82 (1993), 35 GC ¶ 398; Southwest Welding & Mfg. Co. v. United States, 413 F.2d 1167 (Ct. Cl. 1969), 11 GC ¶ 358; Solid State Elecs. Corp., ASBCA 23041, 80-2 BCA ¶ 14,702 at 72,503, 23 GC ¶ 219.
- 24/ United Techs. v. United States, 27 Fed. Cl. 393 (1992); Southwest Welding & Mfg. Co., 413 F.2d 1167.
- 25/ Norair Eng'g, Corp., 92-2 BCA ¶ 25,009.
- 26/ Tricon-Triangle Contractors, ENGBCA 5553, 92-1 BCA ¶ 24,667.
- 27/ Dale Ingram, Inc., ASBCA 12152, 74-1 BCA ¶ 10,436.
- 28/ California Power Sys., Inc., GSBCA 7462, 86-1 BCA ¶ 18,598 at 93,367.
- 29/ See, e.g., Bart Assocs., EBCA C-9211144 et al., 96-2 BCA ¶ 28,479; Tricon-Triangle Contractors, 92-1 BCA ¶ 24,667; Jung Ah Indus. Co., ASBCA 22632, 79-1 BCA ¶ 13,643, 21 GC ¶ 91; Royson Eng'g Co., ASBCA 15438 et al., 73-2 BCA ¶ 10,229; Herley Indus., Inc., ASBCA 13727, 71-1 BCA ¶ 8888, 13 GC ¶ 353; Solid State Elecs. Corp., ASBCA 23041, 80-2 BCA ¶ 14,702, 23 GC ¶ 219.
- 30/ ABM/Ansley Bus. Materials, GSBCA 9367, 93-1 BCA ¶ 25,246, 34 GC ¶ 595; California Power Sys., Inc., 86-1 BCA ¶ 18,598; Stewart Avionics, Inc., ASBCA 15512 et al., 75-1 BCA ¶ 11,253; Gordon H. Ball, ASBCA 8316, 1963 BCA ¶ 3925.
- 31/ Dale Ingram, Inc., 74-1 BCA at 49,331 (citing Herley Indus., Inc., 71-1 BCA ¶ 8888); Solid State Elecs. Corp., 80-2 BCA at 72,503.
- 32/ Solid State Elecs. Corp., 80-2 BCA ¶ 14,702.
- 33/ Munson Hammerhead Boats, ASBCA 51377, 00-2 BCA ¶ 31,143; Wickham Contracting, Co., ASBCA 32392 et al., 88-2 BCA ¶ 20,559; see FAR 52.246-2, para. (b), 52.246-7, para. (a), 52.247-12, para. (b).
- 34/ Teller Envtl. Sys., Inc., ASBCA 25550, 85-2 BCA ¶ 18,025.
- 35/ ABM/Ansley Bus. Materials, 93-1 BCA at 125,749 (citing Harrington & Richardson, Inc., ASBCA 9839, 72-2 BCA ¶ 9507); see Nash & Cibinic, *supra* note 9, at 879.

- 36/ Tricon-Triangle Contractors, ENGBCA 5553, 92-1 BCA ¶ 24,667.
- 37/ Royson Eng'g Co., ASBCA 15438, 73-2 BCA ¶ 10,229.
- 38/ Boston Pneumatics, Inc., GSBCA 3122, 72-2 BCA ¶ 9682; Nasatka & Sons, Inc., IBCA 1157-6-77, 79-2 BCA ¶ 14,064, 22 GC ¶ 177; Catalytic Eng'g & Mfg. Corp., ASBCA 15257, 72-1 BCA ¶ 9342, 14 GC ¶ 202.
- 39/ Cross Aero Corp., ASBCA 14801, 71-2 BCA ¶ 9075, 14 GC ¶ 74.
- 40/ Herley Indus., Inc., ASBCA 13727, 71-1 BCA ¶ 8888, 13 GC ¶ 353.
- 41/ Bart Assocs., EBCA C-9211144 et al., 96-2 BCA ¶ 28,479 at 142,235.
- 42/ Id.; see Datamark, Inc., ASBCA 12767, 69-1 BCA ¶ 7464.
- 43/ M.A. Mortenson Co. v. United States, 29 Fed. Cl. 82, 105 (1993), 35 GC ¶ 398.
- 44/ Bromley Contracting Co., DOTCAB 78-1, 81-2 BCA ¶ 15,191 at 75,197 (citing Roberts v. United States, 357 F.2d 938 (Ct. Cl. 1966), 8 GC ¶ 154, and Commerce Int'l Co. v. United States, 167 Ct. Cl. 529 (1964), 6 GC ¶ 442).
- 45/ Roberts, 357 F.2d 938.
- 46/ Utley-James, Inc., GSBCA 6831, 88-1 BCA ¶ 20,518.
- 47/ Catalytic Eng'g & Mfg. Corp., ASBCA 15257, 72-1 BCA ¶ 9342 at 43,364, 14 GC ¶ 202.
- 48/ BMY—Combat Sys. Div. of Harsco Corp. v. United States, 38 Fed. Cl. 109 (1997).
- 49/ Chilstead Bldg. Co., ASBCA 49548, 00-2 BCA ¶ 31,097 at 153,575; Stewart Avionics, Inc., ASBCA 15512 et al., 75-1 BCA ¶ 11,253 at 53,630.
- 50/ BMY—Combat Sys. Div. of Harsco Corp, 38 Fed. Cl. 109.
- 51/ United States v. Aerodex, Inc., 469 F.2d 1003 (5th Cir. 1972), 15 GC ¶ 29.
- 52/ Id.; see United States v. Kiefer, 228 F.2d 448 (D.C. Cir. 1955).
- 53/ See Kiefer, 228 F.2d 448.
- 54/ Bromley Contracting Co., DOTCAB 78-1, 81-2 BCA ¶ 15,191.
- 55/ Hydro Fitting Mfg. Corp., ASBCA 16394, 73-2 BCA ¶ 10,081, 15 GC ¶ 264; Catalytic Eng'g & Mfg. Corp., ASBCA 15257, 72-1 BCA ¶ 9342, 14 GC ¶ 202.
- 56/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA ¶ 9342.
- 57/ BMY—Combat Sys. Div. of Harsco Corp. v. United States, 38 Fed. Cl. 109 (1997).
- 58/ Warren Beaves, DOTCAB 1160, 84-1 BCA ¶ 17,198, 26 GC ¶ 336.
- 59/ BMY—Combat Sys. Div. of Harsco Corp., 38 Fed. Cl. 109.
- 60/ Stewart Avionics, Inc., ASBCA 15512 et al., 75-1 BCA ¶ 11,253.
- 61/ BMY—Combat Sys. Div. of Harsco Corp., 38 Fed. Cl. 109.
- 62/ Id.
- 63/ Id.
- 64/ Chilstead Bldg. Co., ASBCA 49548, 00-2 BCA ¶ 31,097 at 153,574–75.
- 65/ Id.
- 66/ Bar Ray Prods., Inc. v. United States, 340 F.2d 351 n.14 (Ct. Cl. 1964), 6 GC ¶ 441; Catalytic Eng'g & Mfg. Corp., ASBCA 15257, 72-1 BCA ¶ 9342 at 43,365, 14 GC ¶ 202.
- 67/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA at 43,365.
- 68/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA ¶ 9342.
- 69/ Id.
- 70/ Id. at 43,369.
- 71/ Hydro Fitting Mfg. Corp., ASBCA 16394, 73-2 BCA ¶ 10,081, 15 GC ¶ 264.
- 72/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA at 43,369; Bromley Contracting Co., DOTCAB 78-1, 81-2 BCA ¶ 15,191 at 75,198.
- 73/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA ¶ 9342.
- 74/ Stewart Avionics, Inc., ASBCA 15512 et al., 75-1 BCA ¶ 11,253.
- 75/ Catalytic Eng'g & Mfg. Corp., 72-1 BCA ¶ 9342.
- 76/ Id. at 43,369.
- 77/ Stewart Avionics, Inc., 75-1 BCA ¶ 11,253; Hydro Fitting Mfg. Corp., 73-2 BCA ¶ 10,081.
- 78/ Peters Mach. Co., ASBCA 21857, 79-1 BCA ¶ 13649, 21 GC ¶ 160.
- 79/ Id.
- 80/ Chilstead Bldg. Co., ASBCA 49548, 00-2 BCA ¶ 31,097 at 153,576; see Bar Ray Prods., Inc. v. United States, 162 Ct. Cl. 836 (1963), 5 GC ¶ 329; Z.A.N. Co., ASBCA 25488, 86-1 BCA ¶ 18,612, 28 GC ¶ 168.
- 81/ Chilstead Bldg. Co., 00-2 BCA at 153,576; see Mason's Inc., ASBCA 27326, 86-3 BCA ¶ 19,250.
- 82/ E.g., Mason's, Inc., 86-3 BCA ¶ 19,250.
- 83/ Jo-Bar Mfg. Corp., ASBCA 17774, 73-2 BCA ¶ 10,311, 16 GC ¶ 55.
- 84/ Boston Pneumatics, Inc., GSBCA 3122, 72-2 BCA ¶ 9682, 14 GC ¶ 468.
- 85/ Catalytic Eng'g & Mfg. Corp., ASBCA 15257, 72-1 BCA ¶ 9342, 14 GC ¶ 202.
- 86/ Bromley Contracting Co., DOTCAB 78-1, 81-2 BCA ¶ 15,191.