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Government Contracts Update – Third Party Beneficiaries

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Subcontractor Suit Barred Where Officials Lacked Authority to Bind Government

Summary: The recent decision of the U.S. Court of Appeals for the Federal Circuit ("CAFC") in *Flexfab, LLC v. United States*, No. 05-5018 (Fed. Cir., Sept. 27, 2005) serves as a reminder that subcontractors can face severe obstacles in any attempt to sue the Government under implied-in-fact contract or third-party beneficiary theories.

Facts: Flexfab, which performed as a subcontractor to an SBA 8(a) set-aside contractor, Capital City, attempted to arrange for direct payment from the government under a DLA prime contract for supply of air-duct hose. Flexfab indicated to certain government officials prior to award that it would not enter into the subcontract with Capital City unless the government agreed to pay Flexfab directly through an escrow account.

- Capital City, the DLA's small business specialist responsible for identifying and placing the contract into the 8(a) program, and an employee at the Defense Finance and Accounting Services ("DFAS") were all aware of the subcontractor's requirement to receive direct payments. Moreover, Capital City requested and received a contract modification to change the remittance address to an address associated with an escrow account controlled by Flexfab and to indicate that the place of performance and inspection would be at Flexfab's facilities.

- However, the prime contract's provision for payment by direct electronic funds transfer to Capital City remained unchanged and DLA proceeded to pay by electronic funds transfer to Capital City rather than by submitting payment to Flexfab at the remittance address.

- Flexfab was never paid by Capital City, and subsequently filed suit against the government under third-party beneficiary and implied-in-fact contract theories in the Court of Federal Claims (*Flexfab, LLC v. United States*, No. 02-1096C (Fed. Cl., 2004). Although it expressed sympathy for Flexfab's plight, the Court of Federal Claims granted summary judgment to the government finding Flexfab was unable to establish that any government official with actual authority had either intended to benefit Flexfab or had agreed to bind the government to the escrow payment arrangement.

Decision: On appeal, the Federal Circuit affirmed the Court of Federal Claims, noting the long-standing principle that "[a]nyone entering into an arrangement with the Government takes the risk of having accurately ascertained that he who purports to act for the government stays within the bounds of his authority," citing *Fed. Crops Ins. Corp. v. Merrill,* 332 U.S. 380, 384 (1947). The Federal Circuit expressed little sympathy for Flexfab, however, noting that in an earlier suit involving similar issues (*Flexfab, Inc. v. United States,* No. 94-974 (Fed. Cl. Feb. 8, 1996), Flexfab had been able to demonstrate that an authorized government official, a contracting specialist with authority to negotiate on the government's behalf, i.e., on behalf of a "contracting officer," had accepted a direct payment arrangement with the "intent" of the contracting officer "to benefit Flexfab directly."

Moreover, while noting that that issue was not before it, the Federal Circuit questioned whether the arrangement between Flexfab and Capital City violated the SBA regulations governing the 8(a) program on the basis that Flexfab, which was apparently not a small business, was delivering all of the air-hose supplied under the contract, creating the appearance that Capital City was merely a "front" for Flexfab.

Practitioner Tips:

- The *Flexfab* decision serves as only the latest reminder that any business dealing with the government must take great care to confirm that the government officials with whom they are dealing have the authority to bind the government – it is never inappropriate to request that a government representative produce her or his credentials as a Contracting Officer or as an authorized representative of the CO.
- In negotiating and drafting contract changes such as the payment terms at issue in *Flexfab,* ensure that all related contract clauses and terms are modified. The payment problem in *Flexfab* might have been avoided if, in addition to adding the payment remittance address to the contract, the clause relating to payment by electronic funds transfer had been similarly modified.
- Subcontractors and their representatives must take care to address their burden of proving that an official with actual authority to bind the government either intended a contract to benefit the subcontractor or intended to contract with the subcontractor if they consider pursuing a claim directly against the government under a third-party beneficiary theory.
- Parties pursuing a claim based on an implied-in-fact contract will also have the burden of proving that there was a mutual intent on the part of the party and the government to enter into a contract and the relevant government agents possessed the authority to enter into the contract.

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