

**Statement of John S. Pachter**  
**Before the**  
**Section 1423 Acquisition Advisory Panel**  
**July 7, 2006**

Good morning ladies and gentlemen. I appear on behalf of the Section of Public Contract Law, American Bar Association. I am a former Chair of the Section and currently serve as one of the Section's two delegates to the ABA House of Delegates, the organization's ruling body. Today I speak in support of the Section's Comments on interest reform measures, attached to the letter dated June 30, 2006 signed by our Section Chair Rob Schaefer. With me is our Chair Rob Schaefer, along with Ruth Burg, also a former chair of the Section, and a retired Administrative Judge of the Armed Services Board of Contract Appeals who is active as an arbitrator and mediator. Also here are Alan Peterson, Tom Patrick and Alan Washburn, who presented a paper on today's subject to the Panel in June 2005.

Our subject is recovery of interest by government contractors on claims and disputes. Why should your Panel be concerned with this subject? Your recommendations to Congress will undoubtedly include measures to improve the competitive process, taking into consideration commercial practices. In his presentation to you, Professor William Kovacic outlined requirements for effective competition. A cornerstone was "credible commitments" to prospective government contractors. One major commitment was "resolving disputes fairly." Any reasonable system for resolution of disputes should assure contractors of fair compensation in the event of a government breach of contract. Fair compensation cannot occur unless the contractor has a right to expect recovery of reasonable interest along with other costs and damages. Without adequate interest, the contractor cannot be made whole.

It is a simple matter. Interest is universally recognized as a real cost, the same as any other cost – labor, material or overhead. This is true whether interest is in the form of borrowings or the use of the contractor's own money. The recovery of interest serves to compensate for the time value of money in either case.

Let's say you entered into a contract 15 years ago in 1991 and the other party committed a breach of contract requiring the payment of damages. Assume that you obtain a judgment in 2006 but the court says you are only entitled to your money in depreciated 1991 dollars with no interest. The other party will have had the free use of your money for 15 years, in effect enjoying a huge discount. That is exactly what has happened to many government contractors. It is the same as though the government could compel you to give it an interest-free loan.

What does this do? It creates a negative incentive for the government, inviting unfair treatment of contractors. This is the opposite of what we generally find in the commercial world. It is not what would happen, for example, under the law of Maryland, Virginia and the District of Columbia, and the two leading commercial states, New York

and California. Pre-judgment interest statutes from those five jurisdictions are attached to the Section's Comments before your panel.

When government officials are aware of potential liability for reasonable interest recovery, they are more sensitive to the need for efficiency in resolution of claims and disputes. This means fewer stale claims, and greater satisfaction with the system for all concerned. Unlike the situation I described a moment ago, it gives government officials incentive to treat contractors fairly, and lessens the likelihood of abuses. Fair treatment, in turn, attracts more qualified suppliers to the government marketplace. It fosters and strengthens public respect for the acquisition system. It benefits the government as well as the contracting community.

Our legal system recognizes the doctrine of sovereign immunity. This means the government cannot be sued without its consent. Before 1861, Congress had not waived sovereign immunity for breach of contract claims. Contractors had to petition Congress for a private relief bill. In 1861, President Abraham Lincoln signed the Tucker Act into law, creating the United States Court of Claims. His words at that time are engraved in marble above the entrance to the building that houses the United States Court of Federal Claims and the United States Court of Appeals for the Federal Circuit. Here are the words of President Lincoln:

It is as much the duty of the government to render *prompt justice* against itself, in favor of citizens, as it is to administer *the same* between private individuals.

(emphasis added.)

Two essential concepts are embodied in Lincoln's timeless phrase. First, the duty of the government to render *prompt justice* against itself in favor of citizens. Second, that justice must be *the same* as administered between private individuals, in what we call the commercial world.

After 145 years, we have still not reached the goal set for us by President Lincoln. The Section's proposal would not close the gap. But it would move us closer and in significant ways.

There is a respectable body of opinion that when the government waived sovereign immunity for breach of contract claims, it also waived immunity for interest claims asserted as part of breach damages. Nevertheless, the courts have held that contractors may not recover interest in the absence of a statute or contract clause that allows interest recovery. Congress took a partial step in that direction in enacting the Contract Disputes Act of 1978. That statute provides that contractors asserting claims under certain procurement contracts are entitled to interest at stipulated rates from the date of submission of a certified claim until the date of payment. In fact, the contractor may have suffered damages for some time before it is able to submit a certified claim. The CDA does not provide for interest during that time. In contrast, I should point out

that the government has a virtually unlimited right to collect interest on its claims against contractors, and in fact has a duty to collect that interest.

Let me now turn to the Section's recommendations. First, the Section recommends that interest be allowed as part of damages under all government contracts, not just certain contracts for the procurement of supplies or services or construction. Our Comments provide a number of examples of contracts for which the contractor today has no right whatsoever to recover interest. We include a quotation from an opinion by then Chief Judge Loren Smith of the Court of Federal Claims, in which he stated that the inability to recover interest meant the claimant could not be made whole, and he called for legislative action to provide a remedy.

Second, the Section recommends that contractors be entitled to recover interest on a stand-alone basis, that is, a claim for breach of contract that is not based on an underlying claim for a principal amount. These are claims in which the only element of damages is interest. The courts have denied such interest claims, leaving contractors empty handed even though the government breached the contract. In short, contractors should be entitled to recover interest for breach of contract where the claim is otherwise proved, regardless of whether interest is *a* component or the *only* component of damages.

Third, the Section recommends a more equitable rate of interest. The CDA interest rate, the old Renegotiation Board rate, is woefully inadequate. As our Comments illustrate, the CDA rate dramatically understates private sector financing costs. It is also less than the rates applicable to government claims against contractors. In short, even when contractors are able to recover interest, it is at rates that are significantly below their financing rates. The reverse is true for the government. The government obtains long-term financing currently at about 5%. This is the "risk free" rate available only to the government. Yet, the government is able to impose interest rates on contractors in excess of that borrowing rate. There is therefore a huge disparity between government and private sector financing costs. The government over-recovers its financing costs in its claims. But contractors, when they are able to recover any interest, dramatically fall short of their own financing costs.

The difference is even greater when you consider that compounding of interest is common in the commercial world and in some instances in the government world. Although the Section does not recommend compound interest, we need to take it into consideration in arriving at an accurate picture of economic reality.

The result is a substantial discounting of contractor claims even when contractors are fortunate enough to obtain any interest recovery at all.

To partially redress this imbalance, the Section recommends, in place of the old Renegotiation Board rate, the Internal Revenue Service rate for large corporate underpayments. The IRS terminology does not apply to large corporations as such. It applies to any corporation, large or small, that owes more than \$100,000 in tax. IRS

determines the rate quarterly. The rate is still lower than the actual cost of capital for most private sector companies.

Alternatively, the Section would recommend an increase in the CDA rate to at least the rate used for individual tax underpayments and for Truth in Negotiation and Cost Accounting Standards violations.

In closing, we urge the Panel to focus on fairness between the government and its contractors. Fairness is missing when

- contracts do not qualify for any interest recovery in the event of a breach, or
- actual damages that are measured only by interest cost are nonrecoverable, or
- interest rates are significantly below actual financing costs.

The CDA was designed to encourage more timely resolution of disputes and to provide fairness. The measures we recommend would promote the spirit and intention of the CDA. They would encourage more timely resolution of disputes. A redress of these shortcomings would also make the government marketplace more attractive to qualified competitors by bringing government contracting more in line with commercial practices.