

GOOD CASE LAW VERSUS BAD CASE LAW:

*Some interesting natural consequences
and the world of Government Property!*

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Dedicated to my friend John B. Wyatt III, Esquire.

The views expressed herein are those of the author and do not necessarily reflect the views of the
Defense Acquisition University or the Department of Defense.

Law, lawyers, judges, courts, legal decisions, judicial decisions – we are a society of laws, driven by law, regulated by laws, in many ways controlled by laws, but most importantly freed by the laws created to protect life, liberty and the pursuit of happiness. O.k., so much for the philosophical rhetoric! Where am I going with this? Well, within the world of Government contracting we often base our decisions upon precedent – the ruling of the courts in areas challenged by numerous parties in an attempt to clarify and resolve conflict, differing interpretation – or just to seek justice in a situation.

Within the world of Government property, as a subset of contract management, as a subset of acquisition, we have a wonderful body of laws that support what we do in our day-to-day Government property actions. It is certainly nowhere near as rich and robust as the legal decisions surrounding other areas of contract management, but we do have our seminal cases! Moreover, as property professionals we need to have a working knowledge of these cases for proper application.

We have a body of legal knowledge as it relates to the application of the Government Property clauses:

[G.L. Christian and Associates v. U.S.](#), 312 F2d 418,
160 Ct.Cl.1*419

[Chamberlain Manufacturing](#), ASBCA No. 18103
[Harts Food](#), ASBCA No. 30756.

We have a body of legal knowledge as it relates to the application of liability for the loss, damage or destruction of Government Property:

[Dynalectron Corporation](#), ASBCA No. 29831
[Fairchild Hiller](#), ASBCA No. 14387

and even

[Litton](#), ASBCA No. 29672.

We have a body of legal knowledge as it relates to the application of disposal of Government Property when this property is a hazardous waste:

[Dickerson Inc. v. Holloway](#) 685 F.Supp.1555, 27 ERC 219

In addition, there are numerous other court cases that we analyze and discuss in the Defense Acquisition University course IND 202, the Executive Contract Property Seminar. These court cases have stood the test of time and legal challenge. Yet, every once in a while a court case is adjudicated that really, really, *really* causes one to sit up and take notice. Well folks, I got one for ya' here! It is a wonderful case that addresses the issue of *title* to government property. Who has title, when do they have title, how do they have title – a myriad of questions that we think we understand the answers for and to, but which this one court has presented in an *entirely different* light.

So, ladies and gentlemen, I offer to you the case of *Hughes Aircraft Co. v. County of Orange* (2002), Cal.App.4th [No. E029745. Fourth Dist., Div. Two. Feb. 26, 2002.]. (Note: you can find this case at a wonderful resource at the following Web address www.findlaw.com.)

The case opens with its hypothesis. It states,

"This case concerns the assessment of ad valorem taxes by the County of Orange (County) against the personal property, including manufacturing supplies, expensed equipment and office space partitions, used by Hughes Aircraft Company (Hughes), a defense contractor in the performance of government contracts. We are asked to determine whether title to such property passes to the United States Government (Government) in accordance with the Federal Acquisition Regulation (FAR), 48 Code of Federal Regulations part 52.232-16 (1998), with respect to fixed-price Government contracts with progress payments, and 48 Code of Federal Regulations part 52.245-5 (1998), with respect to cost-reimbursement Government contracts, such that, when in the possession of Hughes, the property is not subject to local taxation."

With this as our foundation I would like to walk you through the case and its findings and then provide you with my analysis – as well as the potential for some natural consequences. I have taken the liberty of numbering the items of discussion just so we can keep straight the issues at hand. Are you ready? Well, sit down with your copy of the Federal Acquisition Regulations (FAR) and let's have at it! (Note: All of the below numbered italicized items are direct quotes from the reported court case.)

Item # 1 – Those Government contracts were subject to the FAR and the United States Cost Accounting Standards (CAS). The contracts at issue in this case were either "cost reimbursement" (/52.245-5(c)) or "fixed price" (/52.232-16(d)) contracts.

Under Item # 1 the court discusses the topic of a Cost Reimbursement contract and the use of FAR 52.245-5, the Cost reimbursement Government Property Clause. The court also discusses the topic of a Fixed Price contract and the use of the Progress Payments Clause, FAR 52.232-16.¹

Item # 2 – In the performance of its Government contracts, Hughes acquired certain supplies, expensed equipment and office partitions. This property was purchased under indirect accounts, i.e., it was not charged to a particular Hughes contract, and consistent with the prescribed and applicable CAS and the FAR, was allocated among all of Hughes Government contracts. Property purchased on such indirect accounts is often referred to as "overhead" property.

It is important to note that the focus here is on property charged to the contractor's **overhead** or **indirect accounts** and that it was not charged as a **direct item of cost**.

In the Discussion portion of the case it continues.

Item # 3 – Because this case involves the assessment of ad valorem taxes, resolution of the issues raised by the parties depends on the answer to the question: Do the title provisions in parts 52.245-5 and 52.232-16 vest title to Hughes's overhead property in the Government?

Ladies and Gentlemen, this is a **critical** question that the court poses, because of the natural consequences that it may foreshadow.

*Item # 4 – According to the parties' stipulation, the overhead property in this case was consumed or used in the performance of qualifying Government contracts. The overhead property was described as consisting of supplies, expensed equipment and partitions. "Supplies" includes materials consumed in the production process, such as welding supplies, plating compounds, abrasives, brushes, anodes, acids, sandpaper and emery cloth, as well as artist and drafting supplies, and **general office supplies**. "Expensed equipment" includes durable, low cost items of equipment purchased for general use with a life expectancy of less than 18 months, such as **low cost laboratory and test equipment, small tools, jigs, dies, molds, patterns, taps, gauges, and similar manufacturing aids, as well as drafting equipment, lamps, calculators and blackboards**. "**Partitions**" consists of movable office space dividers used at Hughes's various business locations to establish work areas for performance of Hughes's contracts. All of the overhead property was accounted for by Hughes as indirect cost items allocated among all of Hughes's then-pending con-*

tracts, rather than directly to particular contracts. To the extent that Hughes used the overhead property in the performance of the Government contracts, it was reimbursed by the Government. After completion of contract work, any remaining expensed equipment or partitions were sold by Hughes at bid sale, and the proceeds credited back to the Government. (Any Boldface is done by the author for emphasis.)

This item provides us some discussion as to the physical characteristics of the property, i.e., the types of property we are dealing with.

Item # 5 – The contracts at issue were either "cost reimbursement" (/52.245-5(c)) or "fixed price" (/52.232-16(d)) contracts. They specifically and expressly incorporated by reference either the cost-reimbursement contract title clauses or the progress payment title clauses, dependent upon the type of Government contract involved.

I do have a question. Why is the court addressing the **cost reimbursement** government property clause and then comparing it to a financing clause, since the two cannot be used together, i.e., the Progress Payments clause is used **only** with **fixed price** contracts and cannot be used with Cost Reimbursement contracts?

Item # 6 – According to Hughes, its contracts that included part 52.245-5 transferred title to the overhead property used in performance of those contracts to the Government.

Please note that this is a very interesting statement on the part of Hughes and one that we will need to analyze in much closer detail.

The following items were discussed in the court case under the portion entitled **Cost Reimbursement Contracts** (/52.245-5(c)).

Item # 7 – To summarize the above, [Note – I omitted paragraph (c) of FAR 52.245-5 that the court quoted – but included its "Interpretation" of its meaning.] the Government has title to three types of property pursuant to part 52.245-5(c), namely,

(1) *Government-furnished property; [Yup, we all recognize Government Furnished Property (GFP) as a property type as described in FAR 45.101.]*

(2) *property the contractor purchases for which he is entitled to be reimbursed as a direct item of cost; and [Yup, we can even recognize this class of property as Contractor Acquired Property (CAP) as defined in FAR 45.101.]*

(3) *all other property, the cost of which is reimbursable to the contractor, such as indirect cost items. [Hmmm, I do not know where this "class" of property would fit in the property typology set forth anywhere within the FAR. I believe that the court created a type of property.]*

Logically, a contractor will not recover any costs for Government-furnished property for the obvious reason that the contractor did not incur any costs in obtaining the property. Equally obvious is the fact that the contractor will be reimbursed for its direct costs, i.e., that property which can be traced to having been purchased directly for

use in fulfilling the Government contract. Thus, the third category of property must refer to indirect cost property (overhead property) for which the contractor is also entitled to be reimbursed. By their nature, indirect costs are incapable of being specifically identified with a particular contract.

Item # 8 – According to the parties' stipulations, Hughes calculated the percentage of its indirect costs allocable to each of its Government contracts. Hughes was then reimbursed by the Government for those indirect costs.

Hang onto this one folks as there is a lot riding on this issue of “percentage.”

Item # 9 – Clearly, the above paragraph [Author's note – they are referring to FAR 52.216-7] evidences the Government's obligation to pay for a contractor's allocable and allowable indirect costs when submitted in accordance with the clause's procedures, i.e., the FAR and the CAS. More importantly, it shows that the Government has purchased the indirect property used by the contractor by reimbursing it for its properly allowable and allocable indirect costs. By purchasing the indirect cost property, the Government receives **absolute title** [emphasis added] through the language of part 52.245-5(c)(3) which states that “[t]itle to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government”

Remember this phrase “**absolute title.**” It will play an important role later on in this analysis.

Item # 10 – Again, according to the parties' stipulation of facts, Hughes did in fact credit to the Government the proceeds obtained from the bid sale of any remaining expensed equipment or partitions.

Ah, see, there – they said it again. We also have to discuss what they mean by credit to the Government.

Item # 11 – By reading part 52.245-5(c)(3) together with part 52.216-7(b)(1)(E) and (h)(2), it is clear that title to Hughes's overhead property passed to the Government by virtue of the Government's payment to Hughes to reimburse it for the monies spent on such property. Having paid Hughes for the overhead property, the Government bought the property and thus acquired title.

Yes, if you read 52.245-5 and 52.216-7 together one might lead to that erroneous discovery. Better to have read 52.245-5 (Cost Reimbursement GP Clause) and compared it to 52.245-2 (Fixed Price GP Clause), i.e., comparing apples with apples!

Please note that the following items were discussed in the court case under the portion entitled **fixed-price** contracts (/52.232-16(d)). Please also note that they did not use the Fixed Price **Government Property** clause but shifted gears to the financing clause for **progress payments**. A reasonably prudent person would have thought about using the **Government Property** clause **applicable** to that type of Contract, i.e., a **fixed price** contract versus a financing clause.

Item # 12 – Likewise, Hughes contends that title to its overhead

property used in fulfilling the Government fixed-price contracts (which included § 52.232-16) was also transferred to the Government.

Item # 13 – Part 52.232.16(d) provides that title to property described in that paragraph vests in the Government upon the date of the contract or when it is allocable or properly charged to the contract. It provides as follows:

“(d) Title.

(1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

(2) 'Property,' as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.

(i) Parts, materials, inventories, and work in process;

(ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;

(iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and

(iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

(3) Although title to property is in the Government under this clause, other applicable clauses of this contract, e.g., the termination or special tooling clauses, shall determine the handling and disposition of the property.

(4) The Contractor may sell any scrap resulting from production under this contract without requesting the Contracting Officer's approval, but the proceeds shall be credited against the costs of performance.”

The court then proceeds through a lengthy discussion regarding earlier legal cases. Many of them are familiar to us involved with Government Property, and for this case more importantly with the issues surrounding Progress Payments. These include:

TRW, *supra*, 50 Cal.App. 4th 1703

Motorola, Inc. v. Arizona Dept. of Revenue (Ariz.App.Div. 1 1999)

993 P.2d 1101, 1106-1107 (Motorola.)

Aerospace, *supra*, 218 Cal.App.3d 1300

Marine Midland Bank v. United States (Cl.Ct. 1982) 687 F.2d 395

So, the last item that the Court provides is the conclusion.

Item 14 – Moreover, the parties stipulated that the overhead property in this case was consumed or used in the performance of qualifying Government contracts. All of the subject supplies, expensed equipment and partitions were accounted for by Hughes as overhead, i.e., as indirect cost items allocated among all of Hughes's then-pending contracts, rather than directly to particular contracts. Pursuant to its contracts with the Government, Hughes was reimbursed by the Government for that **portion**

(emphasis added) of the supplies, expensed equipment and partitions used in the performance of the Government contracts. After completion of contract work, any remaining expensed equipment or partitions were sold by Hughes at bid sale, and the proceeds credited back to the Government.

Given the parties' stipulation of facts, we were called upon to only determine whether the title provisions in parts 52.245-5 and 52.232-16 vest title to Hughes's overhead property in the Government. After consideration of Aerospace and Motorola, we conclude that they do.

So, the bottom line of this case as ruled by this court is that the **Government** has **absolute title** to all property **charged** by a **contractor** through **overhead**, under the Cost reimbursement Government Property clause and the Progress Payments clause in its Government contracts.

In simple language – **WOW!**

ANALYSIS

The issue of title has been fought long and hard in many courts and dealing with many different circumstances. Yet, this is the quintessential case when it comes to lack of clarity and, as I said earlier, comparing apples with oranges.

I would like to cover the issues of title to “pure” Government Property, an analysis of the Government Property clauses, the Progress Payments Clause and a few of the errors made in this court case – well, at least in my opinion. So, ladies and gentlemen, here goes.

The first thing we have to look at are the two **Government Property clauses**, the Cost Reimbursement Government Property found at FAR 52.245-5 and the Fixed Price Government Property Clause, found at 52.245-2. This is the first area of concern in the court's analysis. The court provided its analysis of the Cost Reimbursement Government Property Clause, FAR 52.245-5, and then moved promptly to the Progress Payments clause, FAR 52.232-16.

“Wait a minute, what happened to the **fixed price** Government Property clause, FAR 52.245-2?”

Surely, the court should analyze this clause, a Government Property clause, before moving to a financing clause, i.e., the Progress Payments clause. Well, it did not. The court totally ignored the Fixed Price Government Property clause. If it had reviewed this clause, it should have reached a totally different conclusion.

O.k., so, let's stick with the Cost Reimbursement Government Property clause for the time being and analyze its title provisions. Paragraph (c) reads:

(c) Title.

(1) The Government shall retain title to all Government-furnished property.

Pretty straightforward here, the Government claims title to Government furnished property. It is a “pure” title, not just a financial encumbrance. The Government clearly

owns this property.

(2) Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract shall pass to and vest in the Government upon the vendor's delivery of such property.

Even this subparagraph of the Government Property clause is pretty clear. It uses the word title – so we are sure that the Government means to take ownership of the property. Well, what property? Property acquired by the contractor. In other words, property that the contractor has gone out and **acquired** to perform this contract. But the sentence doesn't end there. It continues “*for which the contractor is entitled to be reimbursed...*” Here, we have a **condition** placed upon the property that was acquired. It must be something for or to which the contractor is **entitled** to be reimbursed. Well, what does that mean? It means that it must meet a number of tests set forth in FAR Part 31 – it must **reasonable, allocable** and **allowable** (31.201). Now this is not as critical as the next phrase in the sentence.

“*As a direct item of cost.*”

Whoa! In other words – only those items charged **direct** are considered Government Property. Right? So far, isn't that what the clause says? It limits paragraph (c)(2) **only** to those items that are charged **direct**. Now, if anyone can read that sentence differently – just that one sentence – then I would really, really, really like to speak with them – cause I am really confused.

Ahhh, but the title paragraph does not end there. It continues in another vein, and this is the area where the court got confused.

(3) Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon --

- (i) Issuance of the property for use in contract performance;
- (ii) Commencement of processing of the property for use in contract performance; or
- (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.

It addresses the issue of “Title to all other property.” The court interpreted this to mean **indirect cost property** (Item # 7 in the opening pages of this paper). Let's see if we can get to another conclusion by taking a different tack.

In (3) it addresses “all other property, the cost of which is reimbursable.” O.k., we know it is something that the Government will pay for – and we assume that it will pay for in its entirety. The clause sets forth three instances as to the **exact instant** when the Government **takes title**.

First, if it is issued.

Well, issued from **where**?

The Contractor's stockroom.

Well, then it had to be delivered by a vendor and as such, the Government already has title under paragraph (c)(2) – right?

Not necessarily. This “stuff” in the stock room was **contractor property** that they acquired with their own capital, their own money. It was not until the contractor issued it for use or performance of the Government contract that the title provision kicks in.

Commencement of processing takes a similar tack. There might be material, my word “stuff” on the contractor's factory or production floor – **contractor property** – that the contractor decides to use for the Government contract – remember that this is a cost reimbursement type contract. As such, the moment the contractor starts processing that stuff, with its subsequent charging to the Government, it becomes Government property – title vests in the Government.

The last issue is one of reimbursement – and the conditional – whichever comes first.

So, the contractor is expecting to be reimbursed for this “stuff.” All of this “stuff.”

Now, and here is the really interesting deviation from the court's interpretation.

THE CRUX OF THE MATTER

All of this applies only to those items charged direct! “Wait a minute,” you say, “how did you reach that conclusion?”

It is so simple, but you have to see it first. The first paragraph (2) clearly relates title to the issue of a **direct** cost. Paragraph (3) is silent regarding **direct** cost. Why? Because paragraph (3) is really a **subset** of paragraph (2) in one **primary reason**. It refers to **vendor's** delivery as the driving force. Paragraph (3) talks about “all other property.” It, paragraph (3), is addressing “stuff” that the contractor **already has in its possession** as its **own property** but then either issues or commences processing for that Government contract – and for which it wants to be reimbursed.

The issue of direct charge filters down over this other stuff. It could have been made much clearer if the sentence structure had been revised to read,

(3) Title to all other property, not delivered by a vendor, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon –

We will see a better wording of this concept when we analyze the Fixed Price Government Property clause in FAR 52.245-2, a little later in this article.

Let me offer one other defense to this understanding that paragraph (c)(3) deals with direct charged property.

Now I know I am quoting out of context here – but the court did it – and if it's good enough for the court, well, it's good enough for me! So, here's the extract that gives further credence to the belief that the items covered under paragraph (c)(3) deals with **direct charged** property. FAR 45.502 (c) states:

- “(1) The contractor shall be responsible for the control of Government property under this Subpart 45.5 upon...
- (i) Delivery of Government-furnished property into its custody or control;
 - (ii) Delivery, when property is purchased by the contractor and the contract calls for reimbursement by the Government (this requirement does not alter or modify contractual requirements relating to passage of title);
 - (iii) Approval of its claim for reimbursement by the Government or upon issuance for use in contract performance, whichever is earlier, of **property withdrawn from contractor-owned stores and charged directly to the contract**; (emphasis added)...”

FAR 45.502(c) relates **directly** back to the constructs established under FAR 52.245-5(c). With the alignment of these two paragraphs expressing the same concept one would be hard pressed to deny that there is a relationship – and that there needs to be a joint reading of the two.

There can be no doubt to the uninitiated in Government Property that an erroneous interpretation of the paragraph was made by the court. It is unfortunate because this court ruling potentially might have far reaching implications – those implications will be discussed later.

Now, this is where I want to deviate from the court's analysis. As I have stated earlier I believe that the courts overlooked a **very** important issue when it did not analyze or enter into evidence the Fixed Price Government Property clause. Instead, the court looked at the financing provisions of the Progress Payments clause, FAR 52.232-16. So, let's go down the correct path first and look at the Fixed Price Government Property Clause, FAR 52.245-2 and its title provisions.

TITLE UNDER THE FIXED PRICE GOVERNMENT PROPERTY CLAUSE – FAR 52.245-2

This clause, FAR 52.245-2, reiterates a number of the same points as we covered under the cost reimbursement Government Property clause, FAR 52.245-5.

It states:

(c) Title in Government property. (1) The Government shall retain title to all Government-furnished property.

Pretty straightforward here – again, Government has title to all GFP.

I am going to skip paragraph (2) as it describes a control requirement. Instead, I am going to go to paragraph (4) to continue this analysis. Paragraph (4) states:

- (4) If this contract contains a provision directing the Contractor to purchase material for which the Government will reimburse the Contractor as a direct item of cost under this contract--
 - (i) Title to material purchased from a vendor shall pass to and vest in the Government upon the vendor's delivery of such material; and
 - (ii) Title to all other material shall pass to and vest in the Government upon-
 - (A) Issuance of the material for use in contract performance;
 - (B) Commencement or processing of the material or its use in contract performance; or
 - (C) Reimbursement of the cost of the material by the Government, whichever occurs first.

Whoa! Wait a minute! Here we have a **direct contradiction** of the court's argument. Here we see that the concept of the **"direct charge"** serves as an umbrella over **all** of the actions that drive the taking of title. We see the **same exact** situations as we saw under the cost reimbursement clause – but by changing a tiny element within the phrase we now see a clearer intent that this title issue applies **only** to items charged direct.

Let me show you a side by side comparison of the two clauses – breaking them down into manageable chunks. See the table below.

Please take notice that if you line up the two clauses and their title vesting provisions that language reads almost identical. It is the slight alteration of the cost reimbursement language that has caused some **major** confusion on the part of the court. Clearly, it was the Government's intent in **both** of these clauses to take title to **only** that property charged **direct**. To read otherwise opens a Pando-

ra's Box. And yup, one more time – I plan to discuss that Pandora's box a little later.

Now, on to the Progress Payments Clause.

THE PROGRESS PAYMENTS CLAUSE, FAR 52.232-16

The Progress Payments clause emanates out of Part 32 of the FAR, which deals with the **financing** of Government Contracts. The court's analysis combined a number of factors that were unrelated to come to its conclusions – some of these followed established precedent, while others broke new, if somewhat erroneous ground. The topic of title under the Progress Payments clause has been fought over and over and over – and just for effect, over again!

I have chosen not to muddy the waters by discussing the Progress Payments clause and whether or not Progress Payments Inventory **is** or **is not** Government Property. The courts in various cases have ruled both ways – some saying it is pure or absolute title in the Government, others saying it is only a lien or a security interest.

The Progress Payments Clause 52.232-16, discusses title under Paragraph (d). It states:

(d) Title.

- (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.
- (2) "Property," as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.

FIXED PRICE GOVERNMENT PROPERTY CLAUSE, FAR 52.245-2(c)	COST REIMBURSEMENT GOVERNMENT PROPERTY CLAUSE, FAR 52.245-5(c)
<i>"directing the Contractor to purchase material for which the Government will reimburse the Contractor as a direct item of cost under this contract--</i>	<i>(2) Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract</i>
<i>(i) Title to material purchased from a vendor shall pass to and vest in the Government upon the vendor's delivery of such material; and</i>	<i>shall pass to and vest in the Government upon the vendor's delivery of such property.</i>
<i>(ii) Title to all other material shall pass to and vest in the Government upon- (A) Issuance of the material for use in contract performance; (B) Commencement or processing of the material or its use in contract performance; or (C) Reimbursement of the cost of the material by the Government, whichever occurs first"</i>	<i>(3) Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon -- (i) Issuance of the property for use in contract performance; (ii) Commencement of processing of the property for use in contract performance; or (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.</i>

- (i) Parts, materials, inventories, and work in process;
- (ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;
- (iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and
- (iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

The clause clearly discusses title to property – but it is **silent** as to whether this property is direct charged or “overhead/indirect” charged property. My opinion, I would agree whole-heartedly with the Court that the State of California should not be taxing Progress Payments Inventory.

I disagree with the court categorizing property charged to overhead as Government property – with the Government having absolute title. Remember, this was the finding of the court in Item # 14 at the start of this article. Let me provide some analysis as to why I make this statement.

INDIRECT or OVERHEAD PROPERTY

The court uses the term indirect or overhead property interchangeably. See Items # 2, # 4, #7, #8, and #9 at the beginning of this article. The court makes the argument that Hughes Aircraft acquired this property (With a very detailed description of the types or examples of this property being given in Item # 4) and charged it to its Government contracts, both fixed price and cost reimbursement where it expected to be reimbursed. In Item # 4 the court reports “All of the overhead property was accounted for by Hughes as indirect cost items **allocated among all** (Emphasis added) of Hughes’s then-pending contracts, rather than directly to particular contracts. To the extent that Hughes used the overhead property in the performance of the Government contracts, it was reimbursed by the Government.”

O.k., so the contractor acquired this property and the Government reimbursed them for the property. Is this a correct statement? The Government **did** reimburse them for the property but how **much** did they reimburse them? For 100% of the cost? For 50% of the cost? For 25% of the cost? We find our answer in Item # 8 where Hughes provides us this answer. The court case states, “According to the parties’ stipulations, Hughes calculated the **percentage of its indirect costs allocable** (emphasis added) to each of its Government contracts. Hughes was then reimbursed by the Government for those indirect costs.”

Now this is an important note. Hughes was **not** reimbursed 100% by the Government for its indirect property. Rather Hughes allocated a “share” or a percentage of its **indirect** costs to the Government contracts. Why? Because

those indirect costs were allocable across many contracts, some for Government work, some for Commercial work. As such the Government only reimburses Hughes for a **portion** of the overhead property.

Under Item # 11 the court states “it is clear that title to Hughes’s overhead property passed to the Government by virtue of the Government’s payment to Hughes to reimburse it for the monies spent on such property. Having paid Hughes for the overhead property, the Government bought the property and thus acquired title.”

The court makes a very broad, sweeping statement here that the Government paid Hughes to reimburse it for the monies spent on such property. No, the Government **did not** reimburse Hughes for the monies it spent – it reimbursed Hughes for that **percentage** of the monies spent – monies that were spread across **all** of its work, both Government and commercial contracts.

Now, here is where it gets interesting. I do not understand how the court can make the statement that since the Government only paid a **portion** of the costs of that overhead property that it can have **title** to **all** of the Overhead property? What happens to all of the **other** customers that paid Hughes and have included overhead property as part of their contract costs? Do they get title also? And if so **who** gets title since **many** customers, Government included, pay a **portion** of that overhead through their contracts?

Let me reiterate this point. The contractor applies that overhead to **all** of its contracts – Government and commercial. As such there are many parties that have paid for that overhead property, **not** just the Government. Since many parties have paid for that overhead property we would be extremely arrogant to say that the Government has title – when other parties have shared in that expense! I do not believe that the court recognized this issue of the Government only paying a “percentage” even though it was clearly stated in the case.

DISPOSAL/DISPOSITION OF PROGRESS PAYMENTS INVENTORY

Let’s continue with some other issues revolving around progress payments that may cause one to go “hmmmm.” Hughes claims under Item # 10 that “Hughes did in fact, credit to the Government, the proceeds obtained from the bid sale of any remaining expensed equipment or partitions.”

One has to question why? If this property was indeed property accountable under the Progress Payments clause then the contractor acted contrary to requirements of the Progress Payments clause, FAR 52.232-16. FAR 52.232-16 stipulates under the Title paragraph (f) starting with subparagraph (4) that states:

“(4) The Contractor may sell any scrap resulting from production

under this contract without requesting the Contracting Officer's approval, but the proceeds shall be credited against the costs of performance."

No information is provided as to whether this property was in scrap condition. Remember, there were quite a few different types of property described by the contractor earlier, including "low cost laboratory and test equipment, small tools, jigs, dies, molds, patterns, taps, gauges, and similar manufacturing aids, as well as drafting equipment, lamps, calculators and blackboards. "Partitions" consists of movable office space dividers..." All of these items were in scrap condition? Interesting?

The Progress Payments clause continues under Paragraph (f)(5):

- "(5) To acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor must obtain the Contracting Officer's advance approval of the action and the terms. The Contractor shall*
- (i) exclude the allocable costs of the property from the costs of contract performance, and*
 - (ii) repay to the Government any amount of unliquidated progress payments allocable to the property. Repayment may be by cash or credit memorandum."*

Well, this is interesting. Did the contractor obtain the Contracting Officer's advance approval of the action and the terms? It would be an interesting exercise to review the actual contract files to see if there was any evidence of this required action.

And, the paragraph requires **not** a crediting of the proceeds of sale, but rather **two** actions:

1. Exclude the allocable costs and
2. Repay the Government any amount of unliquidated progress payments allocable to the property.

From the court's report Hughes only credited the Government with the proceeds. Ahhh, but the mystery continues. The Progress Payments clause continues with the closing paragraph under the Title paragraph (f). It states,

- "(6) When the Contractor completes all of the obligations under this contract, including liquidation of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not --*
- (i) Delivered to, and accepted by, the Government under this contract; or*
 - (ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause."*

It appears that if the contractor had waited until completion of the contract containing the Progress Payments clause then anything left over after delivery of all deliverables under the contract would have been the **contractor's property!** What motivation would have caused the contractor to dispose of its own property and then give the

monies realized to the Government? It doesn't make sense.

And, if the court is correct in its assertion that the Government has **absolute title** to this property – then why would the Government turn around at the end of the contract and just “hand over” anything left over at contract completion. That appears to directly conflict with the Federal Property and Administrative Services Act of 1949 and its statutory requirements for the disposal of Government Property.

If it is only a lien or security interest on the property, or what I prefer to refer to as a “protectionary title,” i.e., where the Government takes title to an item to protect its financial investment due to the **financing** of the contract ala a mortgage on a house or loan on a car, then I could understand that the Government would relinquish this protectionary title. Now, let me rant for just a moment and describe one interpretation of what Hughes and the court claim. Since the court used the Progress Payments clause as the capstone on the issue of whether the Government has title to overhead property let me use that clause to make my point.

Fact – The Progress Payments clause (FAR Part 32 and 52.232-16) is used with Fixed Price Contracts as a method of **financing**.

Fact – The Progress Payments clause vests title to all residual property in the **contractor** at contract **completion** (FAR 52.232-16(f)(6)).

Fact – Hughes claims to have credited the Government with proceeds from the sale of the “overhead” property. (See item # 10).

With those facts from the case stated then consider the following analogous scenario using a little inflammatory rhetoric:

1. You take out a mortgage to **finance** your house.
2. You finish making all mortgage payments, i.e., you **COMPLETE** your contract with the financing organization. You have title to the house.
3. Upon the sale of the house you give all the money made in the sale back to the bank, i.e., you credit the bank.

Huh? Something is wrong with that reasoning – not on my part, rather on the court's decision!

MY CONCLUSIONS

I can agree with the court that Government Furnished Property, as defined in FAR 45.101, is Government Property under FAR 52.245-2 and 52.245-5, and should not be subject to taxation by the state.

I can agree with the court that Contractor Acquired Property, as defined in FAR 45.101, is Government Property under FAR 52.245-2 and 52.245-5, and should not be subject to taxation by the state.

I can even go so far as to agree with the court that property, as defined under the Progress Payments clause (FAR 52.232-16(d)), which is generally referred to as Progress Payments Inventory is property whose title **temporarily** vests in the Government should not be subject to taxation by the state.

I **cannot** agree that property charged to overhead or indirect is Government property and **not** subject to state taxation. Property charged **indirect** is **not** Government Property – rather that property is the contractor's property.

IMPLICATIONS or PANDORA'S BOX

I would like to play one last “what if” game with you folks, the readers. If we agree to live by and abide by this state court's ruling, i.e., that property charged indirect is Government property and that the Government has **absolute title**, again, as decided by the court, then how is this property to be controlled?

My response – in accordance with the Government Property clauses of FAR 52.245-2 and FAR 52.245-5!

Now, I know you are going to say, “Wait – this case was decided based upon the Progress Payments clause, FAR 52.232-16 – where property is controlled under paragraph (f) in accordance with sound industrial practice!”

Not so fast – this case made the claim that overhead property under **cost reimbursement** type contracts with the **Government Property Clause** vested title in the Government – therefore, the provisions of FAR 45.5 are incorporated by reference, and now I want **that** property controlled in accordance with the Cost Reimbursement Government Property clause. Remember, the court said that the Government had **absolute** title and as such, this overhead property was Government property under both **cost reimbursement** and **fixed price contracts**.

With this in mind:

How does the contractor have to maintain records of the property? – In accordance with FAR 45.5.

How does the contractor have to identify this property? – FAR 45.5.

How does the contractor have to maintain this property? – FAR 45.5.

How does the contractor have to physically inventory this property? – FAR 45.5.

How does the contractor have to dispose of this property? Through the Plant Clearance disposal process as required by the Government property clauses of FAR 52.245-2 and 52.245-5 (And let's throw in 52.245-7, -10 and -11 for good measure).

And here ladies and gentlemen is the “coup-de-gras” to the courts decision. If the court is correct and the Government has absolute title to all property charged as “overhead” or indirect – then the Government has title to **everything in the contractor's plant or location or factory!** That's right – the Government has **absolute** title to

everything, because **everything**, unless it is unallowable, is either charged direct or indirect:

and if it is charged **direct** under a Cost Reimbursement type contract the Government has absolute title,

and if it is charged **indirect** under a Cost Reimbursement type contract or Fixed Price type contract then the Government has absolute title – **as determined by this court case. Wow!**

WARNING

Now, do I really believe this, that is, do I believe the above paragraph?

No, not at all!

I **do** believe that the Government has title to Government furnished property under both Fixed Price and Cost Reimbursement type contracts.

I **do** believe that the Government has title to Property acquired under a Cost Reimbursement type contract and charged direct.

I **do not** believe that the Government has title to property acquired by the contractor and charged to a Government contract as an **indirect cost!** That is contrary to the fundamental tenets of principles of contracting and the express statements I have discussed in my analysis.

I hold out hope that the Federal Government does not embrace this state court decision, as its implications are far-reaching and enormous to both the Government and industry. I believe that the court tried to understand our world of Government Property but, it was lead down a primrose path of erroneous logic and out of context readings of the clauses that surround Government property and the financing of Government contracts.

Bottom line – the court rendered its opinion, and now you have mine. I urge you to continue your study of this wonderful field and perform a careful analysis of the court case and this analysis in your quest for the truth.

Good luck and God Bless! ◆

1 Please note that for these two clauses they are comparing apples and oranges. If we truly wanted to compare Cost Reimbursement with Fixed Price we should use the same clausal requirements FAR 52.245-5 for CR and FAR 52.245-2 for FP. Instead, they divert the reader from a TITLE provision under the Government property clause to a TITLE provision under a FINANCING clause.

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