

ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of -- )  
 )  
Security Insurance Company of Hartford ) ASBCA No. 51759  
 )  
Under Contract No. N68378-94-C-5830 )

APPEARANCES FOR THE APPELLANT: James D. Curran, Esq.  
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San Francisco, CA

APPEARANCES FOR THE GOVERNMENT: Fred A. Phelps, Esq.  
Navy Chief Trial Attorney  
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Trial Attorney

OPINION BY ADMINISTRATIVE JUDGE JAMES

This appeal arises from the contracting officer’s (CO) June 1998 final decision which denied the certified claim of the surety on the original contractor’s performance and payment bonds. The surety, who became the takeover contractor after the original contractor was terminated for default, alleged that respondent was liable for improper progress payments made to the original contractor for off-site materials. The Board has jurisdiction of the appeal under the Contract Disputes Act of 1978 (CDA), 41 U.S.C. § 607. After a four-day hearing in San Francisco, the parties have submitted post-hearing and reply briefs. The Board is to decide both entitlement and quantum (tr. 16).

FINDINGS OF FACT

1. On or about 1 October 1992 Security Ins. Co. of Hartford (SICH) and other sureties entered into an “Excess of Loss Reinsurance Agreement” with unidentified “Reinsurers” who undertook to indemnify those sureties against all losses that exceeded \$750,000 but did not exceed the bond limits, on bonds written or renewed from 1 October 1992 to 1 October 1993. That agreement defined “ultimate net loss” as all surety bond losses “after deduction of all salvages and recoveries, and reinsurance,” did not define “salvages” and “recoveries,” and required that—

All salvages, recoveries, or reinsurance payments received subsequent to any loss settlement hereunder will be applied as

if received prior to the settlement, and all necessary adjustments will be made by the parties hereto.

(R4, tab 122 at 2-3, 5-6, 20)

2. On 28 December 1992 the Navy Public Works Center, Oakland, awarded Contract No. N68378-93-C-8677 (contract 8677) to Martech USA, Inc. (Martech), for the firm, fixed price of \$1,969,345.00 (R4, tab 1 at 2-3). Contract 8677 required Martech to demolish specified materials and structures and to construct and install privacy wood fencing and garbage enclosures for 560 Capehart housing units at Hamilton Air Force Base, Novato, California (R4, tab 1 at 14-15; tr. 901).

3. Contract 8677 incorporated by reference the FAR 52.232-5 PAYMENTS UNDER FIXED-PRICE CONSTRUCTION CONTRACTS (APR 1989) clause (R4, tab 1 at 8) which provided in pertinent part:

(b) The Government shall make progress payments monthly as the work proceeds . . . on estimates of work accomplished which meets the standards of quality established under the contract, as approved by the [CO]. The Contractor shall furnish a breakdown of the total contract price showing the amount included therein for each principal category of the work, which shall substantiate the payment amount requested in order to provide a basis for determining progress payments . . . . In the preparation of estimates the [CO] may authorize material delivered on the site and preparatory work done to be taken into consideration. Material delivered to the Contractor at locations other than the site may also be taken into consideration if—

(1) Consideration is specifically authorized by this contract; and

(2) The Contractor furnishes satisfactory evidence that it has acquired title to such material and that the material will be used to perform this contract.

(c) Along with each request for progress payments, the contractor shall furnish the following certification, or payment shall not be made:

I hereby certify, to the best of my knowledge and belief, that—

....

(2) Payments to subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by this certification . . . .

4. Contract 8677's specification § 01010, ¶ 1.12, provided in pertinent part:

1.12.1 Payment for Materials Offsite

Pursuant to the paragraph entitled "Payments to the Contractor," payments may be made to the Contractor for materials stored off construction sites. However, the following conditions must be met:

....

- b. The material must be within a distance of 50 miles by streets and roads of the county of the construction site.
- c. The materials shall be adequately insured and protected from theft and exposure.
- d. The materials shall not be susceptible to deterioration or physical damage in storage or in transit to the jobsite. Payments will not be made for materials in transit to the jobsite or storage site.

(R4, tab 1 at 17)

5. The Board takes official notice that Novato is in Marin County, CA, and the distance "by streets and roads" to Marin County from Sacramento, CA, is over 50 but less than 100 miles.

6. The Naval Facilities Engineering Command "CONTRACTING MANUAL" of October 1987 ("NAVFAC P-68") provided in its "FOREWORD"—

Compliance with the procedures . . . prescribed herein is mandatory by all personnel concerned with the . . . administration of the particular contracts used by this

Command. Personnel are cautioned that this manual does not have the force and effect of law, as does the FAR, and therefore its provisions become binding upon contractors only to the extent set forth in the terms of a particular contract.

In NAVFAC P-68 ¶ 32.102, “PROGRESS PAYMENTS FOR CONSTRUCTION CONTRACTS,” provided—

(b) In construction contracts where it is logical to provide storage of materials on or off-site, the specifications should contain the following paragraph:

Payment for materials off-site. Payments may also be made for materials stored off construction sites . . . upon specific request from the contractor. As a condition precedent to such payments, the [CO] must be satisfied that: (1) the materials are stored in reasonable proximity to the construction site, so that transportation and attendant hazards are minimized; (2) the contractor demonstrates clear title (paid invoices); (3) the materials . . . are adequately insured and protected from theft and the elements through appropriate security measures; and (4) the materials . . . are not susceptible to deterioration or physical damage in storage or in transit to the job site . . . .

(R4, tab 203 at v, 113) Contract 8677 did not incorporate the ¶ 32.102(b) clause. NAVFAC P-68 was not published in the Code of Federal Regulations in 1992.

7. On or about 30 December 1992 Martech and SICH executed a performance bond and a payment bond, each designated “BDS-200031,” for contract 8677 (R4, tab 3).

8. On 14 January 1993, the CO notified Martech to suspend contract 8677 performance due to a bid protest on its solicitation (R4, tab 4). Bilateral Modification No. P00001, dated 8 March 1993, canceled that suspension of work notice (R4, tab 5).

9. At the 17 March 1993 contract 8677 pre-construction conference, (a) Martech and the Government did not discuss payment for material stored off-site; (b) Martech asked about an “impact cost which will be incurred due to the higher price of lumber now than before the suspension of work” and (c) respondent found that the on-site storage area designated in contract 8677 for Martech’s use was unsuitable (ex. A-10 at 1, 6-7; tr. 613-15, 622, 631-32).

10. On or about 5 May 1993 Martech notified respondent that the substituted on-site storage area was about a mile from the job site and would increase performance costs by \$111,917 (R4, tab 12; ex. A-15).

11. On 17 June 1993 respondent's Resident Engineer in Charge of Construction approved a "Field Change Request" which changed ¶ 1.12.1(b) of specification § 01010 "to allow for materials within a distance of 100 miles" due to the unsuitability of the on-site storage area (R4, tab 17; tr. 618-20). Respondent agreed that Martech could store wood and assemble wooden fence panels at its Sacramento facility (tr. 624).

12. On 6 July 1993 the CO issued unilateral Modification No. P00003, and on 8 July 1993 the CO and Martech agreed upon bilateral Modification No. P00002, which modifications, *inter alia*, changed the type of lumber and increased the contract price to \$2,196,991.00, which included compensation to Martech for the material price increase during the suspension period (R4, tabs 19, 20; tr. 633-38).

13. On 21 July 1993 Martech ordered 968,522 board feet of redwood lumber for \$558,817 from Channel Lumber Co. (Channel) of Richmond, CA, under "Job No. 93-7089" for "CAPEHART HOUSING AREA" (R4, tab 22).

14. On 30 July 1993 Martech submitted progress payment invoice No. 2 under contract 8677 for \$549,521.00, certified for payments made and to be made to subcontractors and suppliers (R4, tab 24 at 1, 3).

15. On or about 8 August 1993 David Smith, respondent's quality assurance representative (QAR) inspected Martech's Sacramento facility, determined that the lumber there was protected and stored properly, and estimated the approximate quantity of lumber for progress payment purposes (R4, tab 28 at 10; tr. 873-84).

16. On 11 August 1993 the CO agreed to pay Martech 80% of the "value" of the lumber stored in Sacramento. On 12 August 1993 respondent approved Martech's invoice No. 2 for \$549,521, which included \$476,290 for off-site materials (item Nos. 6-7 for rough carpentry posts and board lumber, and the P00002 and P00003 lumber changes). (R4, tab 28 at 3, 6-8) On 1 September 1993 respondent paid Martech's invoice No. 2 in the amount of \$550,121.90 (\$549,521 plus \$600.90 in interest) (R4, tab 31).

17. On 31 August 1993 Martech submitted progress payment invoice No. 3, certified for payments to subcontractors and suppliers, in the amount of \$841,547, of which \$521,155 was for off-site lumber items (R4, tab 30 at 1, 4-5).

18. On 2 September 1993, QAR Robert Perricone observed Martech assembling and staining fence panels at its Sacramento facility, determined that the lumber was

adequately stored and protected, and estimated the amount of materials for progress payment purposes (R4, tab 30 at 6, tab 32 at 2; tr. 903, 906-14).

19. On 13 September 1993 respondent approved Martech's progress payment invoice No. 3, less a 10% retainage, for a net payment of \$757,392, including \$469,040 (\$521,155 - \$52,115) for off-site materials (R4, tab 30 at 4-5). On 22 September 1993 respondent paid \$757,392 on invoice No. 3 (R4, tab 36).

20. On 27 September 1993 Martech issued check No. 44737 for \$94,636.10 to Channel Lumber Co. (R4, tab 37).

21. Channel Lumber's 14 December 1993 letter to respondent stated that Martech had failed to pay "\$475,695" for lumber whose delivery Channel had completed on 9 November 1993, and which was utilized or to be utilized on the Novato Capehart Housing contract (R4, tab 42).

22. On or about 16 December 1993 Viceroy Management, Inc., SICH's "claims agent," wrote to respondent that SICH had been informed of numerous bond claims for failure of Martech to pay suppliers and subcontractors, and stating:

Based upon the foregoing, our client demands that your department refrain from disbursing any further funds to Martech, whether or not they have already been approved for payment, including progress payments, retainage or any other monies that may be due for work performed under the subject bonds until you are notified by Surety in writing to the contrary.

(R4, tab 46) Respondent made no further payment to Martech after receiving the 14 and 16 December 1993 letters (tr. 393-94).

23. On 28 December 1993 Martech notified respondent that Martech had filed a petition in bankruptcy in the District of Alaska on 19 December 1993 (R4, tabs 50, 51, 55). In February 1994 Viceroy notified respondent that Martech had ceased construction operations and was in default of bonded contract 8677 (R4, tab 64).

24. On 1 March 1994 six sureties, including SICH, entered into a "Collateral Salvage Agreement" (CSA) in which the sureties agreed upon allocations, proportioned to the total penal sums of their respective performance and payment bonds issued to Martech, and subject to semi-annual reallocation, of amounts recovered from collateral (irrevocable letters of credit totaling \$6,526,600 issued by the National Bank of Alaska to Midwest Indemnity Corp.) and other funds received on their bonded contracts, with respect to losses incurred by the sureties on such bonds. If a surety's actual bond loss was reduced by any "contract specific recovery," the CSA required that to the extent such recovery exceeded a

surety's final allocation of collateral, the surety was to rebate such recovery to the collateral pool for redistribution to other sureties. (R4, tab 123 at 1-3, 7, 14-16; tr. 337-38, 592)

25. On 3 March 1994 the CO terminated contract 8677 for default (R4, tab 77).

26. On 15 September 1994 respondent and SICH entered into a takeover agreement to complete "defaulted contract N68378-93-C-8677" for the price of its \$719,980.00 unpaid balance, including retainages. The takeover agreement provided:

1. . . . The provisions and clauses of the defaulted Contract, and the plans and specifications, are incorporated into this Agreement.

. . . .

3. The Surety agrees to . . . complete the work in accordance with the terms and conditions of the defaulted Contract . . . .

. . . .

9. The Surety and the Government reserve any and all rights each may have with respect to the assertion of or defense to any claims and/or requests for equitable adjustment, whether such claims and/or requests arise under the original Contract, this Takeover Agreement . . . and whether such claims or requests have been asserted to date or not.

(R4, tab 102 at 5-7) On 19 September 1994 the takeover agreement was designated contract No. N68378-94-C-5830 (R4, tab 104).

27. SICH's 2 October 1995 letter submitted a Request for Equitable Adjustment to the CO, alleging that respondent improperly had paid Martech \$997,445 for off-site lumber under Martech's invoices 2 and 3 on contract 8677 (R4, tab 109).

28. SICH's letter dated "31 October 1995" submitted a 29 November 1995 CDA certification and amended its claim to \$1,005,511.50, including \$8,066.50 in claim preparation costs (R4, tab 113).

29. Channel's 7 December 1995 letter to respondent stated that Channel received three payments "on this project": (i) Martech check No. 44737 for \$94,636.10, (ii) Viceroy check No. 1270 for \$351,262.00, and (iii) Connecticut Ins. check No. 902743 for

\$129,433.00 (ex. A-113). (The appeal record does not explain why these three payments, totaling \$575,331.10, exceeded Martech's \$558,817, July 1993 lumber order to Channel (see finding 13).) Martech's accounting records state that check No. 44737 paid Channel a total of \$94,636.10 under "job 937089" (R4, tab 113 at 112). We find that Channel received Martech's \$94,636.10 payment under contract 8677.

30. On 13 December 1995 the CO received SICH's "31 October 1995" certified claim. The CO's 22 June 1998 final decision denied SICH's claim in its entirety. (R4, tab 119) On 18 September 1998 SICH timely appealed from that final decision, which we docketed as ASBCA No. 51759.

31. At the hearing, over respondent's objections, the Board accepted appellant's witness, Donald Costello, based on his 20 years of experience in administering Navy construction contracts, in performing such contracts while in private industry, and his study of construction in the Naval Civil Engineer Corps course "Construction Contract Administration and Management," as an expert in Navy-industry customs, practices and trade usages regarding the requirements for progress payments for off-site materials (tr. 158-63; ex. A-156 at 1-4). Mr. Costello opined that to satisfy the FAR 52.232-5(b)(2) requirement for "satisfactory evidence that it has acquired title" to off-site material, possession of such material is not sufficient; a contractor must prove "ownership" thereof (ex. A-156 at 15). Mr. Costello opined that "ownership" requires "paid invoices" because: (a) NAVFAC P-68, ¶ 32.102(b), required "paid invoices" as satisfactory evidence of "clear title" to off-site materials (ex. A-156 at 15-17) and the ¶ 32.102(b) clause, though not in contract 8677, required NAVFAC COs to demand "paid invoices" prior to paying progress payments for off-site materials (tr. 242-443); and (b) the Navy Civil Engineer Corps' "Student Guide" (which was not set forth or incorporated in contract 8677 and was not a published regulation) taught that progress payments for off-site materials "may . . . be authorized if . . . [t]he contractor demonstrates clear title to the material (paid invoice)" (ex. A-146 at 2, ex. A-156 at 22-23).

32. Mr. Costello recalled only one instance in which a contractor billed the Navy for off-site materials, but he could not recall whether that contractor submitted a "paid invoice" to support the payment (tr. 184-85). He testified regarding Navy-contractor trade usage and course of dealing with respect to off-site materials:

Q And so it's possible that you, as a contractor . . . billed the Navy for materials stored offsite and didn't provide a paid invoice, is that right?

A . . . when I'm . . . the contractor, even though I'm very well aware of what the Government is supposed to do, that there are times when I will push that envelope within normal reason, normal bounds of the contracting industry and I will

request payment for things that might not be quite properly in accordance with the Government's guidelines. But if I can get away with it, then that's one for me. . . .

If I'm able to manipulate the system due to the incompetence or the laxity or whatever on the Government side and get them to pay something that their regulations say they shouldn't . . . then shame on them.

Q . . . it would be within the normal bounds of the contracting industry to request from the Government a payment for materials offsite without submitting an invoice, is that right?

A It would be within the normal bounds of the industry to perhaps not be aware of the requirement or if they are aware of the requirement, to hopefully ignore it . . . . They . . . know how to manipulate the system within acceptable bounds . . . . And if they have a contract administrator on the Government's side who is not up to snuff, then they're going to work him. And that's the type of thing that happens.

(Tr. 185-86)

33. CO Mark Lutkenhouse testified that, in the exercise of his discretion, he approved payment of Martech invoices under contract 8677 for off-site materials because the wood was in Martech's possession in Sacramento in the quantities invoiced; the material was fenced and protected; Martech was pre-fabricating wooden panels off-site making them unusable for resale and Martech certified that it had paid or would pay its subcontractors for such materials from progress payments received (tr. 655-57).

#### PARTIES' CONTENTIONS

SICH contends that (i) only paid invoices are satisfactory evidence of title to off-site materials under FAR 52.232-5(b)(2), as NAVFAC interpreted such requirement in its P-68 Contracting Manual and other extra-contractual documents; (ii) a contractor's "possession" is insufficient to prove its title to such materials; (iii) the CO had no discretion to authorize payment for off-site materials without Martech's prior evidence of satisfactory title thereto; and (iv) SICH was injured by the full amount of progress payments for off-site materials and such injury was not diminished by credits asserted by respondent or by payments to SICH pursuant to the CSA or reinsurance agreement.

Respondent argues that (i) the theory of *pro tanto* discharge does not provide an independent basis for ASBCA jurisdiction to adjudicate the surety's claim, and equitable subrogation is the sole basis for Board jurisdiction to adjudicate this dispute; (ii) SICH first notified the Government of Martech's failure to pay subcontractors and suppliers on 16 December 1993, many weeks after respondent had paid progress payments 2 and 3, so SICH cannot establish liability by equitable subrogation; (iii) based on the CO's reasonable exercise of discretion to determine what was satisfactory evidence of title to off-site materials, respondent properly paid the invoices for progress payments 2 and 3; and (iv) SICH's alleged damages exceed any harm resulting from payments for off-site materials.

## DECISION

### I.

Respondent argues that *pro tanto* discharge provides no CDA jurisdiction of this appeal; the only valid jurisdictional basis is equitable subrogation; and equitable subrogation is unavailing because SICH did not notify respondent of Martech's default prior to payment of progress payments 2 and 3. Respondent so argued in its earlier motions to dismiss and for summary judgment in ASBCA No. 51759. We denied those motions in our decisions of 11 July 2000, 00-2 BCA ¶ 31,021, and 17 July 2001, 01-2 BCA ¶ 31,519, respectively. We stated the basis for our ruling in 00-2 BCA at 153,212:

The Federal Circuit did not discuss the jurisdictional basis for National's lawsuit [in *National Surety Corp. v. United States*, 118 F.3d 1542 (Fed. Cir. 1997)]. However, the lower court decision under review – 31 Fed. Cl. 565, 569 (1994) – stated that the appeal was taken from a deemed denial of the contractor's "properly certified claim" pursuant to 41 U.S.C. § 605(c)(5). At an earlier procedural juncture, the contractor alleged COFC jurisdiction under the CDA, 41 U.S.C. §§ 601 *et seq.* 20 Cl. Ct. 407, 409 (1990).

For purposes of this motion, we construe Security's claim of improper progress payments for offsite lumber as an allegation of a material departure from the terms of contract 8677. Accordingly, we hold that Security has standing to bring this ASBCA appeal on the ground of *pro tanto* discharge.

Respondent cites no legal authority holding that *pro tanto* discharge provides no CDA jurisdiction of an appeal, to justify departure from our prior decisions. It is not reasonable or logical to hold that the ASBCA lacks CDA jurisdiction when a surety bases its claim on a judicially recognized theory other than equitable subrogation, such as *pro tanto* discharge.

## II.

SICH contends that possession does not establish satisfactory evidence of title to off-site material under FAR 52.232-5(b)(2); only “paid invoices” constitute satisfactory evidence of title to such materials. So opined Donald Costello, SICH’s expert in Navy-industry customs, practices and trade usages regarding the requirements for progress payments for off-site materials. Mr. Costello based his opinion on statements in ¶ 32.102(b) of NAVFAC P-68 and a Naval Civil Engineer Corps’ Student Guide. (Finding 31)

A tribunal is not bound to accept even uncontradicted opinions of an expert if they are intrinsically nonpersuasive or do not comport with the documents or transactional facts in the record. *See Sternberger v. United States*, 401 F.2d 1012, 1016, 185 Ct. Cl. 528, 535-36 (1968). We do not accept Mr. Costello’s opinion for several reasons.

The ¶ 32.102(b) clause set forth in NAVFAC P-68, and the Navy Civil Engineer Corps Student Guide, upon which Mr. Costello relied, were not referenced in contract 8677, or published in the Federal Register (findings 6, 31). The NAVFAC P-68 ¶ 32.102(b) clause providing that “the specifications should contain the following paragraph” (finding 6) was not a mandatory construction contract provision, but rather was “directory,” *see New England Tank Indus. of N.H. v. United States*, 861 F.2d 685, 694 (Fed. Cir. 1989).

Application of P-68 provisions generally is not mandatory. It was within the CO’s “broad authority” or discretion not to apply the P-68 paid invoice requirement. In *Phillips National, Inc.*, ASBCA No. 53579, 02-2 BCA ¶ 31,881, where the parties disputed the contract’s IDIQ maximum quantity clause, we stated:

Further, we find nothing illegal in the Navy’s modification of P-68’s Maximum Quantities and FFP / IQ clauses. The P-68 manual itself notes that it is not regulatory and that it provides general guidance only. Internal procedures are promulgated for the benefit of the Government and do not create any rights in a contractor.

02-2 BCA at 157,510.

SICH argues that *Webb Electric Co. of Florida, Inc.*, ASBCA No. 40557, 93-2 BCA ¶ 25,715, supports its interpretation that FAR 52.235-5(b)(2) requires “paid invoices” as satisfactory evidence of title to off-site materials. There, the CO required paid invoices to establish ownership of material delivered *on site* but not yet incorporated into the construction pursuant to a prior practice well known to the contractor and set forth in “a published regulation,” the 1988 Air Force FAR Supplement, § 36.292, which was sent to the

contractor before it bid on the contract. The Board upheld the CO's use of such regulation and prior practice. 93-2 BCA at 127,942-43. SICH's reliance on *Webb* is misplaced, because it did not construe any requirement for paid invoices for *off-site* material, and it relied upon a published regulation known to the contractor before contract award, facts not present in the instant dispute. Thus, when a contractor had no notice of a prior unpublished instruction requiring proof of payment to a supplier of material stored on site, it was not a reasonable exercise of discretion for the CO to exclude work from the progress payment estimates on the ground of such non-payment to the supplier. *See C. Lawrence Const. Co., Inc.*, ASBCA No. 45270, 93-3 BCA ¶ 26,129 at 129,888.

The requirement for paid invoices in NAVFAC P-68 and Naval Civil Engineer Corps' Student Guide provisions is inconsistent with Mr. Costello's description of the Navy-industry trade usage and course of dealing with respect to satisfactory evidence of title to off-site materials. Mr. Costello could not cite a single instance of NAVFAC requiring a contractor to provide a "paid invoice" to show title to off-site material. Indeed, according to Mr. Costello, Navy construction contractors "manipulate the system" to avoid submission of such paid invoices. (Finding 32)

The FAR 52.232-5(b) provision that material delivered "at locations other than the site may also be taken into consideration" by the CO in estimating materials requires the CO's reasonable exercise of discretion. We hold that the CO's consideration of Martech's possession and protection of the off-site lumber in Sacramento, its certifications that it would pay its suppliers and subcontractors timely, and its off-site prefabrication of the lumber into panels unusable for resale (finding 23) was a reasonable exercise of his discretion in determining that Martech had furnished "satisfactory evidence" that it had "acquired title" to such lumber. We further hold that SICH has not proved that there was a material departure from the terms of contract 8677.

For the foregoing reasons, we deny the appeal.

Dated: 27 August 2002

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DAVID W. JAMES, JR.  
Administrative Judge  
Armed Services Board  
of Contract Appeals

I concur

I concur

MARK N. STEMLER  
Administrative Judge  
Acting Chairman  
Armed Services Board  
of Contract Appeals

EUNICE W. THOMAS  
Administrative Judge  
Vice Chairman  
Armed Services Board  
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 51759, Appeal of Security Insurance Company of Hartford, rendered in conformance with the Board's Charter.

Dated:

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EDWARD S. ADAMKEWICZ  
Recorder, Armed Services  
Board of Contract Appeals