EQUITABLE LIMITATIONS ON GOVERNMENT COUNTERCLAIMS FOR COMMON-LAW FRAUD

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ABSTRACT

In the past, when asserting a common-law fraud counterclaim in the U.S. Court of Federal Claims, the government has argued that it was entitled to rescission of a contract "tainted" by fraud and disgorgement of all monies paid under the contract. The government's requests did not merely seek disgorgement of profits, but, rather, sought to recover all amounts paid under the contract, while also retaining the work provided by the contractor.

A recent U.S. Supreme Court decision, however, forecloses such a recovery for a common-law fraud claim. In *Liu v. Securities and Exchange Commission*, the Supreme Court explored the limitations on the use of disgorgement as an equitable remedy and explained that, when disgorgement is ordered as an equitable remedy, a court must deduct legitimate expenses from the amount that is to be disgorged. As discussed in this article, the principles articulated in *Liu* apply equally to a common-law fraud claim in the Court of Federal Claims and, in most cases, preclude disgorgement of amounts that exceed a contractor's profit.

TABLE OF CONTENTS

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I. INTRODUCTION

In *Liu v. Securities and Exchange Commission*, the U.S. Supreme Court explored the limitations on the use of disgorgement as an equitable remedy.[1] The Supreme Court explained that, when disgorgement is ordered as an equitable remedy, a court must deduct legitimate expenses from the amount that is to be disgorged.[2] This decision is significant because a failure to deduct legitimate expenses from the amount that is to be disgorged would provide the prevailing party with a windfall by allowing that party to recover all monies paid under the contract, while also retaining all the benefits provided under the contract.

When the U.S. government asserts a common-law fraud counterclaim in the U.S. Court of Federal Claims (COFC) and requests rescission and disgorgement as remedies, the government is requesting equitable relief. As such, the government's request is subject to the traditional limitations on equitable relief, including those discussed in *Liu*. Yet, in the past, the government has asserted, and the COFC has entertained, requests for disgorgement of all monies paid under a contract because of common-law fraud, regardless of the expenses incurred by the contractor in connection with performance of the contract.[3]

This article begins with a discussion of common-law fraud, rescission and disgorgement, and the Supreme Court's decision in *Liu*. The article then explains that, when the government requests rescission and disgorgement as

1. Liu v. Sec. & Exch. Comm'n., 140 U.S. 1936, 1940 (2020).
2. *Id.* at 1949–50.
3. *E.g.*, Coast-To-Coast Fin. Corp. v. United States, 60 Fed. Cl. 707, 710–11 (2004).

remedies for a common-law fraud counterclaim, the government is requesting equitable relief. Next, this article asserts that, because the government is requesting equitable relief, that relief is subject to the traditional limitations on equitable relief, including the limitations discussed in *Liu*. The COFC, therefore, should reject requests for disgorgement of all monies paid under a contract as a remedy for common-law fraud, unless the wrongdoer did not incur any legitimate expenses in connection with the contract.

II. BACKGROUND

As discussed below, the Supreme Court's decision in *Liu*, although rendered in the context of a U.S. Securities and Exchange Commission (SEC) civil enforcement action, is relevant to the litigation of issues involving federal contracts because the government, when asserting a common-law fraud counterclaim in the COFC, has sometimes requested rescission of the contract and disgorgement of all monies paid under the contract.[4]

A. Common-Law Fraud

Common-law fraud occurs when there is a knowing or reckless misrepresentation of a material fact that deceives a party and induces the party to act, which causes the deceived party to suffer an injury.[5] It is a subsection of tort law.[6] Common law claims are rooted in law created by court decisions, as opposed to being devised by statute. That said, the COFC lacks jurisdiction over tort claims asserted by contractors *against* the government,[7] including common-law fraud claims.[8]

However, when these claims are brought *by* the government, COFC possesses jurisdiction for and can hear tort cases, including common-law fraud claims, under 28 U.S.C. § 1503.[9] Indeed, the U.S. Court of Claims, the

4. *Id.*

5. *See* Square One Armoring Servs. Co. v. United States, 152 Fed. Cl. 536, 545 (2021).

6. Elizabeth W. Fleming & Rebecca Clawson, *Fraud Counterclaims in the Court of Federal Claims: Not So Fast, My Friend*, 46 Procurement Law. (2011) ("Fraud is an action in tort for damages at the common law."); *see also* Schweitzer v. United States, 82 Fed. Cl. 592, 595 (2008) (stating that common-law fraud claims sound in tort).

7. *See* 28 U.S.C. § 1491(a)(1) ("The United States Court of Federal Claims shall have jurisdiction to render judgment upon any claim against the United States . . . in cases *not* sounding in tort." (emphasis added)); *see also* Brown v. United States, 105 F.3d 621, 623 (Fed. Cir. 1997) ("The Court of Federal Claims is a court of limited jurisdiction. It lacks jurisdiction over tort actions against the United States." (citations omitted)).

8. *See*, *e.g.*, Nesselrode v. United States, 127 Fed. Cl. 421, 434 (2016).

9. *See* 28 U.S.C. § 1503 ("The United States Court of Federal Claims shall have jurisdiction to render judgment upon any set-off or demand by the United States against any plaintiff in such court."); *see also* Barrett Refin. Corp. v. United States, 242 F.3d 1055, 1062 (Fed. Cir. 2001) (discussing the claims, including tort claims, that the government may bring under 28 U.S.C. § 1503); Tenn. Mech. Inst., Inc. v. United States, 145 Ct. Cl. 344, 351 (1959) ("Hence, under 28 U.S.C. [§] 1503, the Court of Claims can grant a judgment to the United States on a counterclaim based upon a plaintiff's tortious conduct."); Erie Basin Metal Prods., Inc. v. United States, 123 Ct. Cl. 433, 436–37 (1952) (interpreting 28 U.S.C. § 1503 as empowering the Court of Claims to hear any claims that the United States government may assert against the plaintiffs that are suing it).

predecessor to the U.S. Court of Appeals for the Federal Circuit, stated that, under 28 U.S.C. § 1503, "the [g]overnment may set up a counterclaim even though . . . it states a claim of a type (*e.g.* tort) of which we would not have jurisdiction if sought to be maintained by a plaintiff."[10] Additionally, COFC decisions have found that government common-law fraud counterclaims are not subject to the six-year statute of limitations set forth in 28 U.S.C. § 2501.[11]

The government may raise a common-law fraud counterclaim independent of other fraud-related counterclaims that it may assert, such as counterclaims arising under the Special Plea in Fraud statute, 28 U.S.C. § 2514,[12] or the False Claims Act, 31 U.S.C. §§ 3729–31.[13] To succeed on a common-law fraud counterclaim, the government must prove:

> (1) a representation of a material fact, (2) the falsity of that representation, (3) the intent to deceive or, at least, a state of mind so reckless as to the consequences that it is held to the equivalent of intent (scienter), (4) a justifiable reliance upon the misrepresentation by the party deceived, which induces him to act thereon, and (5) injury to the party deceived resulting from reliance on the misrepresentation.[14]

The government must "prove the elements of its common law fraud counterclaim by clear and convincing evidence in order to prevail on the merits."[15] Moreover, the mere presence of fraud is not sufficient to satisfy the requirements of common-law fraud.[16] Rather, the government must demonstrate that the fraud is a "but-for cause of the outcome to satisfy the requirements of common-law fraud."[17]

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10. Cont'l Mgmt., Inc. v. United States, 527 F.2d 613, 616 n.2 (Ct. Cl. 1975); *see also* Cherry Cotton Mills, Inc. v. United States, 327 U.S. 536, 539 (1946) (holding that Congress intended to grant set-off and counterclaim jurisdiction to the Court of Claims, so that the U.S. government could have all its disputes adjudicated in one suit); Frantz Equip. Co. v. United States, 122 Ct. Cl. 622, 628–29 (1952) (citing *McElrath v. United States*, 102 U.S. 426, 439–40 (1880)).

11. *See* LW Constr. of Charleston, LLC v. United States, 139 Fed. Cl. 254, 282 (2018) ("[T]his court, in line with these previous decisions, including the recent unpublished Federal Circuit *Strand* decision, agrees that the statute of limitations set forth in 28 U.S.C. § 2501 does not bar, in and of itself, the government from proposing its common law fraud counterclaim, which, as discussed further below, is permitted by the exception in 28 U.S.C. § 2415(f) (2012).").

12. *See* Long Island Savs. Bank, FSB v. United States, 503 F.3d 1234, 1244 (Fed. Cir. 2007) (distinguishing between common law fraud claims and fraud claims brought under 28 U.S.C. § 2514).

13. *See*, *e.g.*, Oasis Int'l Waters, Inc. v. United States, 134 Fed. Cl. 405, 448 (2016) (discussing a government counterclaim arising under the False Claims Act).

14. Jasmine Int'l Trading & Servs., Co. W.L.L. v. United States, 120 Fed. Cl. 577, 582–83 (2015); *see also* Unigene Lab'ys, Inc. v. Apotex, Inc., 655 F.3d 1352, 1359 (Fed. Cir. 2011); Square One Armoring Servs. Co. v. United States, 152 Fed. Cl. 536, 545 (2021) (citing Unigene Lab., Inc. v. Apotex, Inc., 655 F.3d 1352, 1359 (Fed. Cir. 2011)); *LW Constr. of Charleston*, LLC, 139 Fed. Cl. at 285 (quoting *Jasmine Int'l Trading & Servs., Co. W.L.L.*, 120 Fed. Cl. at 582–83).

15. *LW Constr. of Charleston, LLC*, 139 Fed. Cl. at 284 (citing Madison Servs., Inc. v. United States, 94 Fed. Cl. 501, 510 (2010)).

16. Kellogg Brown & Root Servs., Inc. v. United States, 728 F.3d 1348, 1371 (Fed. Cir. 2013) (citing Godley v. United States, 5 F.3d 1473, 1476 (Fed. Cir. 1993)).

17. *Id.*; *see also Jasmine Int'l Trading*, 120 Fed. Cl. at 583 (stating that "the Federal Circuit held that but-for causation is required to establish a common-law fraud claim" (citing *Kellogg Brown & Root Servs., Inc.*, 728 F.3d at 1371)).

When asserting a common-law fraud counterclaim, the government may assert that the contract is void *ab initio*.[18] The treatment of contracts as void *ab initio* "is, of course, a legal fiction. In reality, an agreement, under which the parties performed, did exist prior to the court's decision that it is void."[19]

The Federal Circuit has stated that "the general rule is that a government contract tainted by fraud or wrongdoing is void *ab initio*."[20] In other words, when "there exists the type of severe legal infirmity that would preclude the parties' exchange of promises from giving rise to an enforceable agreement," the contract at issue "may be adjudged void *ab initio*."[21] In order for a government contract "to be tainted by fraud or wrong doing and thus void *ab initio*, the record must show some causal link between the fraud and the contract."[22] As discussed below in Section II.B.2, when arguing that a contract is void *ab initio* due to common-law fraud, the government has, in the past, asserted that the contract should be subject to rescission and disgorgement.[23]

The Armed Services Board of Contract Appeals (ASBCA) and the Civilian Board of Contract Appeals (CBCA) do not have jurisdiction over government fraud counterclaims arising under the Special Plea in Fraud statute or the False Claims Act.[24] The Boards, however, may address fraud counterclaims when the counterclaims do not require the Boards to make factual findings of fraud and do not assert a government "claim."[25] Due to these limitations, "[w]hen litigation is commenced before a board in a case that the [g]overnment believes involves fraud, the agency will frequently try to obtain a fraud judgment against the contractor in U.S. district court."[26] We do not address further the jurisdiction of the ASBCA and CBCA over government counterclaims, as this article focuses on government common-law fraud counterclaims brought under 28 U.S.C. § 1503, which does not apply to the Boards.[27]

18. *See* Veridyne Corp. v. United States, 83 Fed. Cl. 575, 581 (2008) ("The law on contracts void *ab initio* implicates the doctrine of federal common law fraud.").

19. Mass. Mun. Wholesale Elec. Co. v. Town of Danvers, 577 N.E.2d. 283, 5 (1991).

20. Godley v. United States, 5 F.3d 1473, 1476 (Fed. Cir. 1993) (citing J.E.T.S., Inc. v. United States, 838 F.2d 1196, 1200 (Fed. Cir. 1988)); Long Island Savs. Bank, FSB v. United States, 503 F.3d 1234, 1246 (Fed. Cir. 2007) ("[T]hat a government contract is 'tainted from its inception by fraud' and is thus 'void ab initio' . . . .").

21. *Jasmine Int'l Trading*, 120 Fed. Cl. at 583; *see also* Hume v. United States, 21 Ct. Cl. 328, 330 (1886) (stating that a contract "founded on fraud . . . is void at common law"), *aff'd*, 132 U.S. 406 (1889); LW Constr. of Charleston, LLC v. United States, 139 Fed. Cl. 254, 298 n.25 (2018) (explaining the general rule that a contract tainted with fraud is "void *ab initio*"); *Long Island Savs. Bank*, *FSB*, 503 F.3d at 1245 (affirming the general rule that government contracts contaminated by fraud are void ab initio).

22. *Long Island Savs. Bank*, *FSB*, 503 F.3d at 1250.

23. *See*, *e.g.*, Coast-To-Coast Fin. Corp. v. United States, 60 Fed. Cl. 707, 710–11 (2004).

24. *See* Laguna Constr. Co. v. Carter, 828 F.3d 1364, 1368 (Fed. Cir. 2016).

25. *See id.* at 1369 ("Here, the Board did not have to make any factual findings of fraud because it relied on Mr. Christiansen's July 2013 criminal conviction. And, the government's defense is not a 'claim' that requires a decision by the contracting officer. Therefore, the Board properly exercised jurisdiction over the government's affirmative defense.").

26. Michael J. Schaengold et al., *Choice of Forum for Federal Government Contract Claims: Court of Federal Claims vs. Board of Contract Appeals/Edition III*, Briefing Papers, Feb. 2019, at 9.

27. *See* 28 U.S.C. § 1503 (discussing the COFC's jurisdiction).

B. Rescission and Disgorgement

When pursuing a common-law fraud claim, rescission and disgorgement are possible remedies. Indeed, as discussed below, the government has repeatedly requested that contracts allegedly tainted by fraud be subject to rescission and disgorgement.

1. Defining Rescission and Disgorgement

In the legal context, the words "rescission" and "rescind" have their "ordinary use" definitions, meaning to abrogate, annul, or revoke.[28] "Rescission has the effect of voiding a contract from its inception, *i.e.*, as if it never existed."[29] In other words, rescission provides "a power of avoidance."[30]

The Federal Circuit has explained that rescission "is an equitable doctrine which is grounded on mutual mistake, fraud, or illegality in the formation of a contract."[31] Rescission is available "only when one or more of these circumstances is present."[32] Additionally, rescission ordinarily will not be invoked when money damages will adequately remedy a contract claim.[33]

Generally, there are two types of rescission: (1) legal rescission and (2) equitable rescission.[34] Legal rescission occurs when "one of the parties to the contract unilaterally cancels the contract because the other party committed a material breach of the agreement or because of some other valid reason,"[35] or when the rescission is effected by the agreement of the parties.[36] Conversely, equitable rescission occurs when a party requests that a court

28. 26 Williston on Contracts § 68:3 (4th ed. 2022).

29. Dow Chem. Co. v. United States, 226 F.3d 1334, 1345 (Fed. Cir. 2000).

30. Nebco & Assocs. v. United States, 23 Cl. Ct. 635, 642 (1991).

31. *Dow Chem. Co.*, 226 F.3d at 1345 (citing Roseburg Lumber Co. v. Madigan, 978 F.2d 660, 665 (Fed. Cir. 1992); Am. Sci. & Eng'g, Inc. v. United States, 663 F.2d 82, 87 (Ct. Cl. 1981); Pac. Architects and Eng'rs, Inc. v. United States, F.2d 734, 742 (Ct. Cl. 1974); Eden Isle Marina, Inc. v. United States, 113 Fed. Cl. 372, 483 (2013) (referring to rescission as an equitable remedy).

32. *Dow Chem. Co.*, 226 F.3d at 1345 (citations omitted); *see also* Canpro Invs. Ltd. v. United States, 130 Fed. Cl. 320, 340 (2017) (stating that rescission is an equitable remedy that may not be invoked when money damages will adequately compensate the litigant (citation omitted)).

33. *Eden Isle Marina, Inc.*, 113 Fed. Cl. at 483 (quoting *Dow Chem. Co.*, 226 F.3d at 1345).

34. Alexandra P. Everhart Sickler, *The Truth Shall Set You Free: Explaining Judicial Hostility to the Truth in Lending Act's Right to Rescind a Mortgage Loan*, 12 Rutgers J. L. & Pub. Pol'y 463, 506 (2015); 29 Samuel Williston, A Treatise On The Law Of Contracts § 73:15 (4th ed. 2021). Some commentators have questioned the utility of this distinction. *See* Samuel L. Bray, *The System of Equitable Remedies*, 63 UCLA L. Rev. 530, 555–56 (2016) ("Whatever sharp edge might exist between the remedies in theory is considerably blurred in practice, and American scholars have tended to reject the entire distinction between the two kinds of rescission as pointless."). Other commentators have argued that a distinction between legal and equitable rescission should be maintained. *See id.* at 556 n.120 ("It is not obviously absurd, however, to have two forms of rescission, one inside the system of equitable remedies and one outside of it.").

35. Megan Bittakis, *The Time Should Begin to Run When the Deed Is Done: A Proposed Solution to Problems in Applying Limitations Periods to the Rescission of Contracts*, 44 U.S.F. L. Rev. 755, 758 (2010); *see also* Williston, *supra* note 34, § 73:15 ("[I]n a legal rescission, one party unilaterally cancels the contract in response to a material breach on the part of the other party or for other valid reasons.").

36. Everhart Sickler, *supra* note 34, at 506.

rescind or nullify the contract.[37] The nature of the rescission, therefore, will turn on the circumstances under which the rescission occurs.

The government's request for rescission of a contract due to common-law fraud often has been accompanied by a request for disgorgement.[38] Disgorgement "is a form of '[r]estitution measured by the defendant's wrongful gain.'"[39] It requires the wrongdoer to "give up 'those gains . . . properly attributable to the [wrongdoer's] interference with the claimant's legally protected rights.'"[40] Courts have described disgorgement as "an equitable remedy that provides 'a method of forcing a defendant to give up the amount by which he was unjustly enriched.'"[41]

As further discussed below in Section II.C, in *Liu*, the U.S. Supreme Court explained that disgorgement is an equitable remedy under which a wrongdoer is required to give up the net profits earned through the fraudulent activity.[42]

2. The Government's Requests for Rescission and Disgorgement When Asserting Common-Law Fraud Counterclaims

Previously, when asserting a common-law fraud counterclaim at the COFC, the government has argued that it was entitled to rescission of a contract "tainted" by fraud and disgorgement of all monies paid under the contract because of the presence of fraud.[43]

For example, in *Kellogg Brown & Root Services, Inc. v. United States*,[44] the government asserted a common-law fraud claim arising from the receipt of kickbacks by employees of Kellogg Brown & Root Services, Inc. (KBR) from employees of KBR's subcontractor Tamimi Global Company (Tamimi) under KBR's LOGCAP III contract.[45] Under that contract, KBR had executed a subcontract referred to as "Master Agreement 3" with Tamimi, against which KBR issued "work release orders" to Tamimi.[46] One of the task orders under KBR's LOGCAP III contract that Tamimi supported as a subcontractor was

37. Bittakis, *supra* note 35, at 758.; *see also* Williston, *supra* note 34, § 73:15 (stating that equitable rescission refers to the situation when one of the parties to the contract asks the court to nullify the contract).

38. *See infra* Section II.B.2.

39. Kokesh v. S.E.C., 137 S. Ct. 1635, 1640 (2017) (alteration in original) (quoting Restatement (Third) of Restitution and Unjust Enrichment § 51 cmt. a (2010)).

40. *Id.* (omission in original) (quoting Restatement (Third) of Restitution and Unjust Enrichment, *supra* note 39, § 51 cmt. a).

41. *In re* Pre-Filled Propane Tank Antitrust Litig., 893 F.3d 1047, 1058 (8th Cir. 2018) (quoting FTC v. Bronson Partners, LLC, 654 F.3d 359, 372 (2d Cir. 2011)).

42. *See generally* Liu v. Sec. & Exch. Comm'n, 140 U.S. 1936, 1950 (2020) (citation omitted).

43. *See, e.g.*, Jasmine Int'l Trading & Servs., Co. W.L.L. v. United States, 120 Fed. Cl. 577, 582 (2015) ("Defendant raises a counterclaim for common-law fraud, contending that Jasmine's contracts are void or voidable and that the [g]overnment is entitled to rescission and disgorgement of all sums paid to Jasmine under the 0931 Contract, the 0007 Contract, and the 0050 Contract because the contracts 'were tainted by bribery, conflict of interest, and fraud.'"); *see also* Brief of the Defendants at 14, *Jasmine Int'l Trading*, 120 Fed. Cl. 577 (2015).

44. Defendant's Amended Answer and Counterclaims at 15, Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488 (2011), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).

45. *Id.*

46. *Id.* at 18.

known as "Task Order 59."[47] In total, KBR paid Tamimi $466,290,328.00 for work performed under Master Agreement 3.[48]

Before the COFC, the government presented a common-law fraud counterclaim and sought rescission and disgorgement of Master Agreement 3 and Task Order 59.[49] Regarding Master Agreement 3, which had a value of $466,290,328.00, the government argued that it was

> entitled to the rescission of the portion of the LOGCAP III contract involving all work performed by KBR through its Master Agreement 3 subcontract with Tamimi, inasmuch as that subcontract was tainted by kickbacks and it would be contrary to public policy for the [g]overnment to pay for such unlawfully awarded work. The [g]overnment is also entitled to disgorgement of all sums paid to KBR as compensation related to the tainted subcontract.[50]

The government also asserted that the kickbacks tainted KBR's Task Order 59 and that it was "entitled to disgorgement of all fees paid to KBR pursuant to Task Order 59."[51]

The "kickback scheme" that the government asserted "tainted" Master Agreement 3 involved kickbacks totaling $45,000.00.[52] The COFC described the kickback scheme as follows:

> In November 2002 Tamimi's vice-president and chief of operations, Mohammad Shabbir Khan, offered Mr. Hall [of KBR] a kickback, stating that they could "'make a lot of money together.'" Def.'s Am. Answer & Countercls. Filed Mar. 15, 2011, ¶ 114 ("Countercls."). At that time Mr. Hall did not accept money from Mr. Khan, but he also did not report the kickback offer to anyone. However, eventually, both Messrs. Hall and Holmes [of KBR] did accept kickbacks from Mr. Khan.
>
> Beginning in late 2002 through the end of 2003, Messrs. Hall and Holmes received a combined $45,000.00 in cash kickbacks from Mr. Khan. "Mr. Hall understood that the money was being provided so that Tamimi would remain in KBR's good graces and continue to get DFAC contracts from KBR." *Id.* ¶ 115. In 2003 Messrs. Hall and Holmes each accepted $5,000.00 in cash that Mr. Khan delivered to them at an airport in Kuwait. Mr. Khan also gave Mr. Hall an automated teller machine (ATM) card to withdraw cash from a bank account into which Mr. Khan had deposited another $5,000.00. Mr. Hall used the ATM card to withdraw $3,500.00 in cash. Mr. Holmes withdrew the remaining $1,500.00. Mr. Holmes accepted an additional $10,000.00 in cash from Mr. Khan, which Mr. Holmes gave to his secretary. Towards the end of 2003, Mr. Hall accepted $20,000.00 from Mr. Khan, which purportedly was to be used as an investment in a "Golden Corral" restaurant. However, Mr. Hall made no such investment, and Mr. Khan did not request that the money be paid back.[53]

Because of the $45,000.00 in kickbacks, the government requested "rescission of Master Agreement 3 and disgorgement of all funds previously paid to

47. *Id.*
48. *Id.*
49. *Id.* at 24.
50. *See id.* at 24–25.
51. *Id.*
52. *See* Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488, 491 (2011), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).
53. *Id.*

Tamimi under this agreement."[54] Therefore, the government was seeking disgorgement of $466,290,328.00 due to $45,000.00 in kickbacks.[55] Ultimately, the COFC concluded that the government had "failed to establish the requisite causation element of common law fraud,"[56] but not until after it had denied KBR's motion to dismiss the government's common-law fraud counterclaim.[57] The U.S. Court of Appeals for the Federal Circuit affirmed the COFC's determination regarding liability for common-law fraud and did not address the proper measure of damages for such a claim.[58]

Similarly, in *Jasmine International Trading & Service, Co. W.L.L. v. United States*,[59] the government argued, under a common-law fraud theory, that it was "entitled" to rescission of two contracts and multiple purchase orders issued under a blanket purchase agreement (BPA), as well as to "disgorgement of all sums paid to" the contractor under the two contracts and the purchase orders.[60] The value of the contracts and purchase orders totaled $6,774,093.00.[61] The government asserted that it was entitled to "disgorgement of all sums paid" because the contracts and purchase orders "were tainted by bribery, conflict of interest, and fraud."[62] Specifically, the contractor's chief executive officer had promised to pay a government official "$1 million in exchange for the award of [g]overnment contracts."[63] Although the contractor never paid the government official the one million dollars, it did pay the government official $1,200.00 and the government official's sister $60,000.00.[64] Based on the contractor's promise to pay $1,000,000.00 and the $61,200.00 in actual payments, the government asserted that it was entitled to recover the total value of the contracts and purchase orders, $6,774,093.00.[65]

The COFC in *Jasmine International Trade & Service, Co.* found that the government's common-law fraud counterclaim "suffice[d] to meet the pleading requirement for but-for causation" as required for common-law fraud.[66] The Court stated that "[w]hether or not the alleged fraud was, in fact, the but-for

54. *Id.* at 514.

55. *Id.*

56. Kellogg Brown & Root Servs., Inc. v. United States, 103 Fed. Cl. 714, 779 (2012), *aff'd in part, rev'd in part*, 728 F.3d 1348 (Fed. Cir. 2013).

57. Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488, 517 (2011) ("Plaintiff's motion to dismiss Count V of defendant's counterclaims for disgorgement of all moneys paid to plaintiff related to Task Order 59 is denied."), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).

58. *See* Kellogg Brown & Root Servs., Inc. v. United States, 728 F.3d 1348, 1371–72 (Fed. Cir. 2013).

59. Jasmine Int'l Trading & Servs., Co. W.L.L. v. United States, 120 Fed. Cl. 577, 577 (2015).

60. *Id.* at 582.

61. Defendant's Amended Answer to Plaintiff's Fifth Amended Complaint, and Counterclaims at 19–20, *Jasmine Int'l Trading & Servs.*, 120 Fed. Cl. 577 (2015).

62. *Jasmine Int'l Trading & Servs.*, 120 Fed. Cl. at 582.

63. *Id.* at 583 (quoting the Government's amended answer).

64. *Id.*

65. *See id.* at 582–83 ("Defendant raises a counterclaim for common-law fraud, contending that Jasmine's contracts are void or voidable and that the [g]overnment is entitled to rescission and disgorgement of all sums paid to Jasmine under the 0931 Contract, the 0007 Contract, and the 0050 Contract . . . .").

66. *Id.* at 586.

cause of the awards to Plaintiff is a matter to be determined following trial."[67] However, the case settled prior to trial.[68]

Another case in which the government asserted that it was entitled to all monies paid under a contract is *Gulf Group General Enterprises Co. W.L.L. v. United States*.[69] There, the government sought "disgorgement of all monies the United States paid for calls issued under the camp package BPA, plus costs," because the calls allegedly "were obtained by plaintiff through bribery, conflict of interest, and fraud."[70] The COFC did not determine the appropriate remedy for the government's common-law fraud counterclaim, as the COFC concluded that the government had not established liability.[71]

A request for rescission and disgorgement is often premised on the idea that it would be "unjust" to allow a person who made a misrepresentation "to retain the fruits of a bargain" induced by fraud.[72] Indeed, the idea behind the government's requests for disgorgement of all monies paid under allegedly fraud-tainted contracts appears to be that, but for the fraud, the contracts would never have existed at all (*i.e.*, the contracts should be rescinded).[73] The government reasons that, because the contracts never would have existed, the government never would have paid the contractors any money under the contracts.[74] The government, therefore, asserts that it should be entitled to recover all the money that it would not have paid but for the fraud (i.e., all amounts paid under the contracts allegedly tainted by fraud).[75]

This argument, however, overlooks that the contractors may have satisfactorily performed all the work the government required under the contracts, and that the contractors may have incurred legitimate expenses in doing so. Likewise, it fails to recognize that the government may have received benefits in the form of the contractors' work, and that the government may intend to retain, and continue to use, those benefits notwithstanding the fraud. The legitimacy of the government's argument is further addressed later in Section III.B.1.

67. *Id.*
68. *See* Stipulation of Dismissal, *Jasmine Int'l Trading & Servs.*,120 Fed. Cl. 577 (2015).
69. Gulf Grp. Gen. Enters. Co. W.L.L. v. United States, 114 Fed. Cl. 258, 267 (2013).
70. *Id.*
71. *Id.* at 356 ("In sum, the defendant has failed to prove that forfeiture is warranted under the Special Plea in Fraud statute or that the commission of common law fraud related to any of the four above-captioned cases warrants rescission and disgorgement.").
72. Roseburg Lumber Co. v. Madigan, 978 F.2d 660, 665–66 (Fed. Cir. 1992) (quoting Morgan Roofing Co., 54 Comp. Gen. 497, 498 (1974)).
73. *See* Veridyne Corp. v. United States, 83 Fed. Cl. 575, 581 (2008) ("The thrust of defendant's argument is that, but for plaintiff's alleged fraud in its estimate of performance costs for anticipated work as presented in its proposal, Mod 0023 either would have been subject to competitive bidding or never executed at all.").
74. *Id.*
75. *Id.* at 581–82.

C. The Supreme Court's Decision in Liu

In June 2020, the U.S. Supreme Court issued its opinion in *Liu v. Securities and Exchange Commission*,[76] in which the Supreme Court analyzed whether disgorgement was an equitable remedy.[77]

In *Liu*, Charles Liu and Xin Wang solicited nearly $27 million from investors that Mr. Liu and Ms. Wang had represented would go toward the construction of a cancer-treatment center.[78] Mr. Liu and Ms. Wang, however, spent nearly $20 million on ostensible marketing expenses and salaries.[79] Ultimately, the SEC investigated and brought a civil action against Mr. Liu and Ms. Wang in federal district court.[80] The district court found in favor of the SEC, and, as part of the remedy, the district court "ordered disgorgement equal to the full amount petitioners had raised from investors, less the $234,899 that remained in the corporate accounts for the project."[81] Mr. Liu and Ms. Wang appealed, and the U.S. Court of Appeals for the Ninth Circuit affirmed.[82]

The U.S. Supreme Court granted certiorari to determine whether 15 U.S.C. § 78u(d)(5) permits the SEC to seek a disgorgement award that goes "beyond a defendant's net profits from wrongdoing."[83] The statute at 15 U.S.C. § 78u(d)(5) states that, in any action brought by the SEC, the SEC "may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."

When analyzing whether disgorgement was an equitable remedy, the Supreme Court observed that it had previously "described 'disgorgement of improper profits' as 'traditionally considered an equitable remedy.'"[84] The Supreme Court further stated that "a remedy tethered to a wrongdoer's net unlawful profits, whatever the name, has been a mainstay of equity courts."[85] The Supreme Court noted that disgorgement restores the status quo, thereby "situating the remedy squarely within the heartland of equity."[86] The Supreme Court also stated that a "foundational principle" of disgorgement is that it "'would be inequitable that [a wrongdoer] should make a profit out of his

76. Liu v. Sec. & Exch. Comm'n, 140 U.S. 1936 (2020).
77. *Id.* at 1942.
78. *Id.* at 1941.
79. *Id.*
80. *Id.* at 1942.
81. *Id.* (citation omitted).
82. *Id.*
83. *Id.* (citation omitted).
84. *Id.* at 1943; *see also id.* at 1943 n.2 (citing to cases that "expressly" characterize disgorgement as an equitable remedy).
85. *Id.* at 1943 (citation omitted); *see also id.* at 1942 ("Equity courts have routinely deprived wrongdoers of their net profits from unlawful activity, even though that remedy may have gone by different names." (citations omitted)); *id.* ("[E]quity practice long authorized courts to strip wrongdoers of their ill-gotten gains, with scholars and courts using various labels for the remedy.").
86. *Id.* at 1943 (citing Tull v. United States, 481 U.S. 412, 424 (1987)).

own wrong.'"[87] Thus, the Supreme Court concluded that the SEC could seek disgorgement of profits under 15 U.S.C. § 78u(d)(5).[88]

The Supreme Court also addressed the limitations that courts have imposed on disgorgement, so as "to avoid transforming [disgorgement] into a penalty outside their equitable powers."[89] Specifically, the Supreme Court stated that, in the past, "courts limited awards to the net profits from wrongdoing, that is, 'the gain made upon any business or investment, when both the receipts and payments are taken into the account.'"[90] Stated differently, "courts consistently restricted awards to net profits from wrongdoing after deducting legitimate expenses."[91]

Regarding the SEC's disgorgement award issued by the district court and affirmed by the U.S. Court of Appeals for the Ninth Circuit, the Supreme Court noted that the district court failed to deduct expenses incurred for lease payments and cancer-treatment equipment from the amount to be disgorged by Mr. Liu and Ms. Wang.[92] The Supreme Court reiterated that "[c]ourts may not enter disgorgement awards that exceed the gains 'made upon any business or investment when both the receipts and payments are taken into the account'" and that "courts must deduct legitimate expenses before ordering disgorgement."[93] The Supreme Court stated that, on remand, the Ninth Circuit should determine whether the lease and equipment expenses should be deducted from the disgorgement award.[94]

When discussing how equity courts traditionally dealt with disgorgement, the Supreme Court identified one exception to the principles discussed above.[95] That exception applies when the claimed expenses are "dividends of profit under another name," *i.e.*, when a claimed expense, such as an unreasonably high salary paid to the perpetrator of the fraud, is not a legitimate

87. *Id.* (quoting Root v. Ry. Co., 105 U.S. 189, 207 (1882)).

88. *Id.* at 1945. In doing so, the Supreme Court distinguished its opinion in *Kokesh v. Securities & Exchange Commission*, in which the Supreme Court concluded that "SEC disgorgement" in an enforcement action brought under 28 U.S.C. § 2462 was a "penalty within the meaning of § 2462." Kokesh v. Sec. & Exch. Comm'n, 137 U.S. 1635, 1643 (2017). The Supreme Court found that the SEC disgorgement was a penalty because, in actions brought under § 2462, the disgorged funds were not provided to the victims of the fraud, and SEC disgorgement "is imposed as a consequence of violating a public law and it is intended to deter, not to compensate." *Id.* at 1644. In *Liu v. Securities & Exchange Commission*, the Supreme Court stated that the SEC disgorgement in *Kokesh* "seemed to exceed the bounds of traditional equitable principles." *Liu*, 140 U.S. at 1946. The Supreme Court in *Liu* distinguished *Kokesh* by stating that *Kokesh* decided whether a disgorgement order in an SEC enforcement action constitutes a penalty for purposes of 28 U.S.C. § 2462, while *Liu* was addressing whether "the SEC may seek 'disgorgement' in the first instance through its power to award 'equitable relief' under 15 U.S.C. § 78u(d)(5), a power that historically excludes punitive sanctions." *Id.*

89. *Liu*, 140 U.S. at 1944 (citation omitted).

90. *Id.* at 1945 (quoting Rubber Co. v. Goodyear, 76 U.S. 788, 804 (1870)).

91. *Id.* at 1946.

92. *Id.* at 1950.

93. *Id.* at 1949–50 (quoting *Goodyear*, 76 U.S. at 804).

94. *Id.* at 1950 (citation omitted).

95. *See id.* at 1945–46.

business expense.[96] To utilize that exception, a court must ascertain "whether expenses are legitimate or whether they are merely wrongful gains 'under another name.'"[97] If a court finds that the exception applies, the court is not required to deduct those expenses from the disgorgement award.[98]

III. ANALYSIS

As discussed above in Section II, when asserting common-law counterclaims related to government contracts, the government has sometimes requested rescission and disgorgement as remedies and has requested that the contractor repay all the monies paid under the contract. As discussed below, the government's request for rescission and disgorgement of a contract allegedly tainted by fraud is a request for equitable relief. Although equity is "flexible," it "is confined within the broad boundaries of traditional equitable relief."[99] Thus, in most cases, the COFC should reject requests that a contractor repay all monies paid under a contract due to common-law fraud because such an award usually would exceed the traditional bounds of a rescission and disgorgement award.

A. When Requested in Connection with a Common-Law Fraud Counterclaim, Rescission and Disgorgement Are Equitable Remedies.

To determine whether the government's requested remedies of rescission and disgorgement constitute equitable relief, a court would need to analyze whether the remedies "fall[] into 'those categories of relief that were *typically* available in equity.'"[100] In doing so, courts should examine the "true character" of the action, not the label given to the action by the parties.[101] Courts, therefore, "must look to the remedy sought and determine whether it is legal or equitable in nature."[102]

The common-law fraud principles applied in the United States today are derived from English courts.[103] Those principles were aptly summarized in a decision in 1898 as follows:

96. *See id.* (quoting *Goodyear*, 76 U.S. at 803).
97. *Id.* at 1950 (quoting *Goodyear*, 76 U.S. at 803).
98. *Id.* at 1945–46, 1949–50.
99. Grupo Mexicano de Desarrollo S.A. v. All. Bond Fund, Inc., 527 U.S. 308, 322 (1999).
100. *Liu*, 140 U.S. at 1942 (emphasis in original) (quoting Mertens v. Hewitt Assocs., 508 U.S. 248, 256 (1993).
101. St. Bernard Par. Gov't v. United States, 142 Fed. Cl. 504, 543 *recons. denied*, 143 Fed. Cl. 676 (2019).
102. *In re* Tech. Licensing Corp., 423 F.3d 1286, 1287 (Fed. Cir. 2005).
103. *See* Browning v. Nat'l Cap. Bank of Washington, 13 App. D.C. 1, 16 (1898) (stating that "the [fraud] principle thus stated [by the U.S. Supreme Court] appears to be strictly in accordance with the rulings of the English courts upon this subject"); *see also* William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Hous. L. Rev. 121, 167 (1997) ("The majority of American common law on fraud is consistent with *Derry* and the English law . . . .").

> According to the decisions of those [English] courts, made in many cases, if a party undertakes positively to assert that to be true which he does not know to be true, and which he has no sufficient or reasonable grounds for believing to be true, in order to induce another to act upon the faith of the representation, and the representation is acted upon and it turns out to be false, and the person who has acted upon the representation has been deceived to his damage, he is entitled to maintain an action for the deception. For whoever pretends to have positive knowledge of the existence of a particular fact, or state of things, when in truth he knows nothing about it, does in reality make a wilful [sic] representation which he knows to be false; and if such representation is made in order that another may rely upon it, and act upon it, and it is acted upon, and damage results therefrom, the person making the representation is in principle guilty of wilful deception and fraud.[104]

As explained by the U.S. Court of Claims, "[u]nder the common law, fraud vitiated the contract and allowed, in the absence of any equitable considerations at least, recovery of actual damages sustained as a result of the fraud."[105] For example, in an early American common-law fraud case involving the sale of "diseased sheep," the court explained that the plaintiff was "entitled to such damages as necessarily and naturally flow from the [fraudulent] act of the defendants."[106] The common-law, therefore, "did not permit recovery of money paid on a contract induced by fraud, unless actual monetary damage was sustained as a result of the fraud."[107]

English courts of equity, however, developed a rule providing that a contract induced by fraud is "void."[108] Early decisions from courts in the United States followed this rule,[109] with Samuel Williston, author of the well-known treatise *Williston on Contracts*, remarking in 1911 that "the redress which

104. *Browning*, 13 App. D.C. at 16.

105. Paisner v. United States, 150 F. Supp. 835, 838 (Ct. Cl. 1957) (Whitaker, J., dissenting); *see also Browning*, 13 App. D.C. at 15 ("[W]here a representation of a fact, susceptible of actual knowledge, is recklessly made, the party making it being indifferent how the truth of the matter really stands, and damage results, the party should be held liable."); Seth E. Lipner, *From the Professor: Assessing Damages in Bond Cases*, 24 PIABA B. J. 97, 101 (2017) ("At common law, the typical measure of damages for fraud-in-the-inducement in the sale of a chattel is the (inflated) price paid for the object minus the actual value of that object on the date of the purchase").

106. Jeffrey v. Bigelow & Tracy, 13 Wend. 518, 523 (N.Y. App. Div. 1835) ("That damage is not the mere difference between a diseased sheep and a healthy one, but the damage sustained by communicating the disease to the plaintiff's flock.").

107. *Paisner*, 150 F. Supp. at 839.

108. *See* Carter v. Boehm, 97 E.R. 1162, 1164 (King's Bench 1766) ("The keeping back such circumstance is a fraud, and therefore the policy is void."); *see also* Becker, Moore & Co., Inc. v. U.S. Fid. & Guar. Co., 74 F.2d 687, 688 (2d Cir. 1935) ("[I]t has been settled law for more than a century and a half, that such collateral misrepresentations, though honestly made, will avoid a policy." (citations omitted)); Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 Vand. L. Rev. 349, 366 n.63 (1984) ("Courts of equity usually granted the rescission and restitution remedy since law courts were slower to recognize fraud in the inducement." (citing 5 A. Corbin, Contracts § 992, § 1102 (1964)).

109. *See*, *e.g.*, Monad Eng'g Co. v. Stewart, 78 A. 598, 600 (Del. 1910) ("It is a well-known principle of law that fraud avoids a contract."); Crooker v. White, 50 So. 227, 228 (Ala. 1909) ("Misrepresentation constituting fraud which will authorize the rescission in equity of a contract must relate to a fact material to the interests of the other party."); U.S. Waterworks Co., Ltd. v. Borough of Du Bois, 176 Pa. St. 439, 442 (1896) (indicating that rescission could be effected "by a court of equity").

equity gives for fraud is rescission."[110] More recently, tribunals have consistently referred to rescission as an equitable remedy for fraud.[111] In fact, the U.S. Court of Appeals for the Federal Circuit has stated that rescission "is an equitable doctrine which is grounded on mutual mistake, fraud, or illegality in the formation of a contract."[112]

As further stated by the Federal Circuit, "[b]ecause rescission is essentially an equitable remedy, it will not ordinarily be invoked where money damages—in this case damages for breach of contract—will adequately compensate a party to the contract."[113] The Federal Circuit's position that rescission should not be invoked when money damages adequately compensate the party is consistent with "the traditional rule that courts will not grant equitable relief when money damages are adequate."[114] The refusal to provide equitable relief, including rescission, when money damages adequately remedy a claim makes sense, as money "damages are always the default remedy for breach of contract."[115]

When the government requests rescission as a remedy for common-law fraud related to a government contract, the government's request for rescission is not a request for monetary damages; in asking that the court rescind the contract, the government is asking for a return to the status quo before the fraudulent action occurred.[116] This is a request for equitable rescission, as opposed to legal rescission, because the government is requesting that the court rescind the contract due to common-law fraud.[117] Thus, when the

110. Samuel Williston, *Liability for Honest Misrepresentation*, 24 Harv. L. Rev. 415, 427 (1911); *see also* C. C. Langdell, *The Northern Securities Case and the Sherman Anti-Trust Act*, 16 Harv. L. Rev. 539, 552 (1903) ("It is undoubtedly a common thing for a court of equity to rescind a transaction between two persons which has been procured by the fraud of one of them, *i.e.*, to compel the tort-feasor to restore what he has received from the person defrauded, upon the latter's restoring to him what he gave in exchange, equity thus restoring both parties to the situation that they were in when the fraudulent transaction took place.").

111. *See*, *e.g.*, Larionoff v. United States, 533 F.2d 1167, 1181 (D.C. Cir. 1976) (discussing Tucker Act jurisdiction and stating that "[r]escission is an equitable remedy" (citing Richardson v. Morris, 409 U.S. 464, 465 (1973)); Kenney, AGBCA No. 79-119, 80-2 BCA ¶ 14,650 ("[R]escission is an equitable remedy not governed by the terms of the contract."); *cf.* Abraham S. Goldstein, *Conspiracy to Defraud the United States*, 68 Yale L. J. 405, 408 n.8 (1959) ("Equity will grant rescission of a contract induced by the same type of fraud . . . ." (quoting Green, *Fraud, Undue Influence and Mental Incompetency*, 43 Colum. L. Rev. 176, 177–79 (1943)).

112. Dow Chem. Co. v. United States, 226 F.3d 1334, 1345 (Fed. Cir. 2000) (citing Roseburg Lumber Co. v. Madigan, 978 F.2d 660, 665 (Fed. Cir. 1992); Am. Sci. & Eng'g, Inc. v. United States, 663 F.2d 82, 87 (Ct. Cl. 1981); Pac. Architects and Eng'rs, Inc. v. United States, F.2d 734, 742 (Ct. Cl. 1974)).

113. *Dow Chem. Co*., 226 F.3d at 1345.

114. *See* Alliant Techsystems, Inc. v. United States, 178 F.3d 1260, 1271 (Fed. Cir. 1999).

115. Securiforce Int'l Am., LLC v. United States, 879 F.3d 1354, 1361–62 (Fed. Cir. 2018) (quoting United States v. Winstar Corp., 518 U.S. 839, 885 (1996) (plurality opinion)).

116. See Rumley v. United States, 285 F.2d 773, 776 (Ct. Cl. 1961); *see also* First Fed. Sav. Bank of Hegewisch v. United States, 52 Fed. Cl. 774, 797 (2002) ("The remedy of rescission allows a party to seek disaffirmance of a contract and the return to the status quo that existed before the transaction was executed." (quoting First Hartford Corp. Pension Plan & Trust v. United States, 42 Fed. Cl. 599, 616 (1998)).

117. Bittakis, *supra* note 35, at 758.

government requests that a contract be rescinded because of common-law fraud, the government is requesting that the COFC award equitable relief.[118]

In the context of a common-law fraud claim, the government's request for rescission often is paired with a request for disgorgement.[119] Rescission, on one hand, "contemplates a return by the parties to the status quo,"[120] while disgorgement "is a form of '[r]estitution measured by the defendant's wrongful gain.'"[121] In cases at the COFC, the government has premised its requests for disgorgement on the idea that allowing the contractor to keep the monies it was paid for work performed under an allegedly tainted contract would allow the contractor to be unjustly enriched and would allow the contractor to profit from its wrongdoing.[122]

Similarly, early disgorgement remedies were based on the concept that a wrongdoer should not be allowed to profit from its wrongdoing.[123] Likewise, the argument that a contractor should not be allowed to be unjustly enriched "is rooted in the equitable principle that a person shall not be allowed to enrich himself unjustly at the expense of another."[124] As the U.S. Supreme Court has explained, a remedy measured by a wrongdoer's gain "has been a mainstay of equity courts."[125] Indeed, the U.S. Supreme Court acknowledged that disgorgement is "traditionally considered . . . equitable."[126] Thus, the government's request for disgorgement, which typically is paired with a request for equitable rescission and asserts that the contractor should not be allowed to benefit from a contact it allegedly obtained through fraud, is a request for equitable relief.

In sum, when the government requests rescission and disgorgement as remedies for its common-law fraud claim under a government contract, it is requesting equitable relief.

B. The COFC Generally Should Reject Requests for Disgorgement of Amounts That Exceed the Contractor's Net Profit.

For the reasons set forth below, in most cases, a rescission and disgorgement award that requires a contractor to repay all monies paid under a contract

118. *See*, *e.g.*, Gulf Grp. Gen. Enters. Co. W.L.L. v. United States, 114 Fed. Cl. 258, 267 (2013).

119. *See* Section II.B.2 *supra*.

120. *Rumley*, 285 F.2d at 776; *see also First Fed. Sav. Bank of Hegewisch*, 52 Fed. Cl. at 797 ("'The remedy of rescission allows a party to seek disaffirmance of a contract and the return to the status quo that existed before the transaction was executed.'" (quoting *First Hartford Corp. Pension Plan & Trust*, 42 Fed. Cl. at 616 (1998)).

121. Kokesh v. S.E.C., 137 S. Ct. 1635, 1640 (2017) (alteration in original) (quoting Restatement (Third) of Restitution and Unjust Enrichment § 51 cmt. a (2010)).

122. *See*, *e.g.*, Defendant's Amended Answer and Counterclaims at 24, Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488 (2011), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).

123. *See* Liu v. Sec. & Exch. Comm'n, 140 S. Ct. 1936, 1943 (2020) (quoting Root v. Ry. Co., 105 U.S. 189, 207 (1882)).

124. Kamdem-Ouaffo v. PepsiCo Inc., 657 F. App'x 949, 953 (Fed. Cir. 2016) (quoting *Georgia Malone & Co. v. Rieder*, 19 N.Y.3d 511, 516 (2012)).

125. *Liu*, 140 U.S. at 1943.

126. *Id.* at 1940 n.1 (omission in original) (quoting Tull v. United States, 481 U.S. 412, 424 (1987)).

should be rejected because it typically would exceed the traditional bounds of a rescission and disgorgement award.

1. A Rescission and Disgorgement Award Must Take into Account the Wrongdoer's Legitimate Expenses.

Courts have discretion when fashioning equitable relief.[127] However, when granting equitable relief, courts are guided by the traditional use of the equitable remedy,[128] and the court's discretion "must be exercised consistent with traditional principles of equity."[129] Equitable relief, therefore, "is confined within the broad boundaries of traditional equitable relief."[130] In fact, the U.S. Supreme Court has stated that "[e]quitable relief in a federal court is of course subject to restrictions: the suit must be within the traditional scope of equity as historically evolved in the English Court of Chancery . . . ."[131] This limitation on equitable relief has been applied by the U.S. Court of Claims, which explained that the "general principles of equity are applicable in a suit by the United States to secure the cancelation of a conveyance or the rescission of a contract."[132]

Traditional principles of equity provide that, when the equitable remedies of rescission and disgorgement are requested under a common-law fraud theory, courts may not enter disgorgement awards that exceed the wrongdoer's net profits, after accounting for legitimate business expenses.[133] Yet the government, when asserting that a contractor obtained a contract through fraud, has on multiple occasions, requested repayment of all monies paid under the contract.[134] These requests generally should be rejected because "[c]ourts may not enter disgorgement awards that exceed the gains 'made upon any business or investment, when both the receipts and payments are taken into the account.'"[135] The COFC, therefore, must "deduct legitimate expenses" when

127. United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483, 495 (2001).

128. Angel Reyes & Benjamin Hunter, *Does the FTC Have Blood on Its Hands? An Analysis of FTC Overreach and Abuse of Power after* Liu, 68 Buff. L. Rev. 1481, 1500 (2020) ("In modern American law, the use of equitable remedies is based on their traditional, historical use.").

129. eBay Inc. v. MercExchange, LLC, 547 U.S. 388, 394 (2006); *see also* Fed. Trade Comm'n v. AMG Cap. Mgmt., LLC, 910 F.3d 417, 435 (9th Cir. 2018) (O'Scannlain, J., concurring) (discussing the "Supreme Court's repeated admonitions that the equitable powers of federal courts must be hemmed in by tradition").

130. Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 322 (1999).

131. Guar. Tr. Co. of N.Y. v. York, 326 U.S. 99, 105 (1945).

132. Pan Am. Petroleum & Transp. Co. v. United States, 101 Ct. Cl. 114, 137 (1944) (citations omitted).

133. Liu v. Sec. & Exch. Comm'n, 140 U.S. 1936, 1949–50 (2020).

134. *See, e.g.*, Defendant's Amended Answer and Counterclaims at 15, 25, Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488 (2011) (seeking "disgorgement of all moneys paid to KBR for direct costs, indirect costs, fixed fees, and award fees related to any work release upon Master Agreement 3"), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013); Veridyne Corp. v. United States, 83 Fed. Cl. 575, 581 (2008) (stating that the government sought to recover "the $31,134,931.12 it paid pursuant to" the contract due to fraud); Section II.B.2 *supra*.

135. *Liu*, 140 U.S. at 1950.

ordering disgorgement as an equitable remedy.[136] As the U.S. Supreme Court has explained, failing to deduct legitimate expenses when ordering disgorgement "would be 'inconsistent with the ordinary principles and practice of courts of chancery.'"[137]

Additionally, ordering disgorgement of all monies paid under a contract, regardless of legitimate expenses, would result in a windfall for the government. When applying the common law, federal courts have, for many years, attempted to "to develop and establish just and practical principles of contract law for the federal government."[138] Notably, in the cases discussed above, the government has not offered to return the goods or services provided under the contract at issue, to the extent that doing so is even possible, when requesting rescission and disgorgement. Instead, in its request for a return to the purported status quo, the government would be seeking to keep all the work provided under the contract, while also recovering all the monies paid under the contract. This result would run afoul of the traditional equitable limitations of disgorgement and would result in a windfall to the government because the government would essentially be receiving goods and services at no cost.[139] This windfall could be significant if the government, for example, were allowed to recover $466,290,328.00 as a remedy for a common-law fraud counterclaim based on $45,000.00 in kickbacks, as the government attempted to do in *KBR*.[140]

Moreover, failing to deduct legitimate expenses before ordering disgorgement would impermissibly transform equitable remedies (rescission and disgorgement) into penalties. For instance, as noted, the government in *KBR* sought disgorgement of $466,290,328.00 based on $45,000.00 in kickbacks.[141] The government argued it was entitled to $466,290,328.00 because "it would be contrary to public policy for the government to pay for such unlawfully awarded work."[142] The government, at least in *KBR*, appears to have been improperly using a common-law fraud counterclaim to punish conduct that contravened public policy.[143]

The "basic function" of rescission, however, "is manifest in the requirement that one who seeks rescission return any benefits that he received from the misrepresenting party; rescission does not seek to punish the defendant but merely to force him to return his profits."[144] Indeed, the U.S. Court of Claims has stated that, "while the perpetrator of the fraud has no standing to

136. *See id.*
137. *Id.* at 1949–50 (quoting Tilghman v. Proctor, 125 U.S. 136, 145–46 (1888)).
138. Nat'l Presto Indus., Inc. v. United States, 338 F.2d 99, 111 (Ct. Cl. 1964).
139. See *Liu*, 140 U.S. at 1950.
140. *See* Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488, 491 (2011), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).
141. *See id.*
142. Defendant's Amended Answer and Counterclaims at 15, *Kellogg Brown & Root Servs., Inc.*, 99 Fed. Cl. at 488, *aff'd*, 728 F.3d at 1348.
143. *Id.*
144. Brian Barnes, *Against Insurance Rescission*, 120 Yale L. J. 328, 344 (2010).

rescind, he is not regarded as an outlaw."[145] The U.S. Supreme Court also has stated that disgorgement is not intended to be a penalty.[146] That rescission and disgorgement are not penalties makes sense, as "equity never 'lends its aid to enforce a forfeiture or penalty.'"[147] Thus, a rescission and disgorgement award requiring repayment of all monies paid under the contract, regardless of the costs incurred during performance or the value the government received from such performance, would exceed the purpose of those equitable remedies and transform rescission and disgorgement into penalties.

If the government intends to seek a remedy for fraud that punishes the wrongdoer, it must do so through an action at law.[148] For example, the government could seek to penalize the wrongdoer for its fraud by bringing a counterclaim under the False Claims Act, which expressly contemplates civil penalties and treble damages.[149] In fact, the government has sought damages equal to the entire value of the contract under the False Claims Act.[150] The government, therefore, has remedies other than a common-law fraud counterclaim that it can use to punish fraud.

Finally, one counterargument that could be made regarding the above analysis is that *Liu* involved the SEC's ability to request "equitable relief" under 15 U.S.C. § 78u(d)(5) and, therefore, does not apply to common-law counterclaims brought by the government under 28 U.S.C. § 1503.[151] The Supreme Court's decision in *Liu*, however, was not limited to equitable relief sought

145. Pan Am. Petroleum & Transp. Co. v. United States, 101 Ct. Cl. 114, 137 (1944).

146. *See* Liu v. Sec. & Exch. Comm'n, 140 U.S. 1936, 1949 (2020). Moreover, even if disgorgement could be used as a penalty, the government's request in *KBR* for disgorgement of $466,290,328.00 based on $45,000.00 in kickbacks would still be problematic. The Eighth Amendment to the U.S. Constitution prohibits "excessive fines," and courts have construed the Eighth Amendment as applying "to civil penalties that are punitive in nature." United States v. Aleff, 772 F.3d 508, 512 (8th Cir. 2014). A punitive civil penalty or "punitive forfeiture violates the Excessive Fines Clause if it is grossly disproportional to the gravity of a defendant's offense." Daewoo Eng'g & Constr. Co. v. United States, 557 F.3d 1332, 1340 (Fed. Cir. 2009) (quoting United States v. Bajakajian, 524 U.S. 321, 334 (1998)). Requiring disgorgement of $466,290,328.00 because of $45,000.00 in kickbacks seemingly would amount to a grossly disproportionate forfeiture that violates the Eighth Amendment.

147. *Liu*, 140 U.S. at 1941 (quoting Marshall v. Vicksburg, 82 U.S. 146, 149 (1872)); Mertens v. Hewitt Assocs., 508 U.S. 248, 270 (1993) ("As this Court has long recognized, courts of equity would not . . . enforce penalties or award punitive damages . . . .").

148. *See* Tull v. United States, 481 U.S. 412, 422 (1987) ("A civil penalty was a type of remedy at common law that could only be enforced in courts of law. Remedies intended to punish culpable individuals, as opposed to those intended simply to extract compensation or restore the status quo, were issued by courts of law, not . . . equity." (citing Curtis v. Loether, 415 U.S. 189, 197 (1974)); Thomas L. Casagrande, *Permanent Injunctions in Trade Secret Actions: Is a Proper Understanding of the Role of the Inadequate at Law/Irreparable Harm Requirement the Key to Consistent Decisions?*, 28 AIPLA Q. J. 113, 138 (2000) ("Legal remedies include damage awards designed to compensate plaintiffs (compensatory damages) and punish defendants (punitive damages).").

149. *See* 31 U.S.C. § 3729(a).

150. *See, e.g.*, United States v. R.J. Zavoral & Sons, Inc., No. 12-668, 2014 WL 5361991, at *15 (D. Minn. Oct. 21, 2014) ("Based on these facts, where the benefit of the Section 8(a) program is to benefit small businesses controlled by socially and economically disadvantaged individuals, the [g]overnment is entitled to argue to the jury that it received no value under the Contract and that the proper measure of damages is the amounts paid to Defendants.").

151. *See Liu*, 140 U.S. at 1940.

under 15 U.S.C. § 78u(d)(5). Rather, the decision analyzed the traditional bounds of disgorgement when sought as an equitable remedy, including in cases that did not arise under 15 U.S.C. § 78u(d)(5).[152] Thus, the principles discussed in *Liu* apply to equitable disgorgement requests generally, including the government's requests for disgorgement that are brought in the COFC under 28 U.S.C. § 1503.

In sum, when awarding rescission and disgorgement as equitable relief for a common-law fraud counterclaim, the COFC must deduct legitimate business expenses from the award. In most cases, doing so will result in the government receiving disgorgement awards that are less than the total amount of money paid under the contract.

2. The Court of Claims Decision in *K & R Engineering Co.* Does Not Provide a Basis for Requiring, as a Result of Common-Law Fraud, a Contractor to Repay All Amounts Paid Under a Contract.

In the past, the government has relied on a Court of Claims' decision from 1980, *K & R Engineering Co. v. United States*,[153] when requesting disgorgement of all monies paid under the contract because of common-law fraud.[154]

In *K & R Engineering Co. v. United States*, the government "counterclaimed to recover the amount it already paid plaintiff under" three contracts.[155] The government alleged that the contracts were awarded in violation of the "conflict-of-interest statute," 18 U.S.C. § 208(a), because a government employee and two officers of a company entered into an agreement whereby the government employee would be paid twenty-five percent of all profits earned under the contracts awarded by the government employee to the company.[156] The Court of Claims determined that the arrangement between the government employee and the contractor violated the conflict-of-interest statute.[157]

Regarding the government's counterclaim, the Court of Claims stated that "[e]ffective implementation of the conflict-of-interest law requires that once a contractor is shown to have been a participant in a corrupt arrangement, he cannot receive or retain any of the amounts payable thereunder."[158] According to the Court of Claims, "[t]he policy underlying the conflict-of-interest statute requires that the contractor be required to disgorge the amounts received under the tainted contract."[159] The Court of Claims concluded that, under the "federal conflict-of-interest law," a contractor which "has participated in an illegal conflict-of-interest situation is not entitled to retain the amounts received under the tainted contract."[160]

152. *See id.* at 1942–46.
153. *See* K & R Eng'g Co., Inc. v. United States, 616 F.2d 469, 470 (Ct. Cl. 1980).
154. *See* Veridyne Corp. v. United States, 83 Fed. Cl. 575, 582 (2008).
155. *K & R Eng'g Co.*, 616 F.2d 469, 476.
156. *Id.* at 472.
157. *See id.*
158. *Id.* at 476.
159. *Id.*
160. *Id.* at 477.

As reflected in the above quotations, the court in *K & R Engineering Co.* was addressing a counterclaim arising under a statute prohibiting conflicts of interest in the award of government contracts.[161] The government did not assert a common-law fraud counterclaim; indeed, the term "common law" does not appear in the decision, and there is no discussion of the elements of common-law fraud.[162] Nor did the court in *K & R Engineering Co.* purport to adhere to the traditional limitations of equity, as is required when awarding equitable relief.[163] The Court of Claims was not focused on returning the parties to the status quo, as the court does when awarding equitable rescission, or ensuring that the contractor did not profit from its wrongdoing, as the court does when ordering disgorgement. Instead, the Court of Claims specifically focused on the conflict-of-interest statute, its "[e]ffective implementation," and "policy considerations."[164] Thus, *K & R Engineering Co.* is distinguishable from common-law fraud counterclaims because, in that case, the government was not asserting a common-law fraud counterclaim.

Moreover, effective implementation of a statute and the policy considerations around deterring fraud cannot override the traditional limitations on the equitable remedies of rescission and disgorgement.[165] In *K & R Engineering Co.*, the Court of Claims did not deduct legitimate expenses from the government's award because requiring repayment of all money paid under the contract would, in the Claims Court's view, protect "the integrity of the federal procurement process."[166] As discussed above in Section III.B.1, however, a court must deduct legitimate expenses when ordering disgorgement, regardless of whether doing so furthers the goal of protecting the procurement process. Additionally, the Court of Claims reasoned that requiring the company to repay all amounts paid under the contracts would punish contractors that engaged in fraud.[167] But, as discussed above, disgorgement cannot be used to punish.[168]

161. *See* Kellogg Brown & Root Servs., Inc. v. United States, 99 Fed. Cl. 488, 515 (2011) ("In *K & R Engineering* the Court of Claims held that the plaintiff violated the conflict-of-interest statute, *see id.* at 474, and rejected the plaintiff's argument that such a violation should not preclude contract enforcement when the government was not adversely affected by the conflict of interest, *id.* at 475."), *aff'd*, 728 F.3d 1348 (Fed. Cir. 2013).

162. *See generally K & R Eng'g Co.*, 616 F.2d at 469.

163. *See id.* at 475.

164. *Id.* at 476.

165. *See* Guar. Tr. Co. of N.Y. v. York, 326 U.S. 99, 105 (1945) ("Equitable relief in a federal court is of course subject to restrictions: the suit must be within the traditional scope of equity as historically evolved in the English Court of Chancery . . . .").

166. *K & R Eng'g Co.*, 616 F.2d 469, 476.

167. *Id.* ("To deny the government recovery of amounts paid under such tainted contracts would reward those contractors who can conceal their corruption until they have been paid."). The current version of the conflict-of-interest statute, 18 U.S.C. § 208 (2018), provides that any person who violates section 208(a) "[s]hall be subject to the penalties set forth in section 216 of this title." 18 U.S.C. § 208(a) (2018). That section provides that a person who engages in the prohibited conduct "shall be subject to a civil penalty of not more than $50,000 for each violation or the amount of compensation which the person received or offered for the prohibited conduct, whichever amount is greater." 18 U.S.C. § 216(b) (2018). Thus, the statute provides a basis for requiring a wrongdoer to disgorge all compensation received because of the prohibited conduct.

168. *See supra* Section III.B.1.

The Court of Claims' decision in *K & R Engineering Co.*, therefore, does not provide a basis for expanding a disgorgement award beyond the traditional limitations of equity, and its continued vitality—especially after *Liu*—is unclear.[169]

3. Applying the Traditional Limitations of Equity When Assessing Government Common-Law Fraud Counterclaims Will Not Result in Wrongdoers Profiting at the Government's Expense

An argument could be made that, when the COFC finds that the government has succeeded on its common-law fraud counterclaim, a decision denying disgorgement of all monies paid under the contract would lead to the contractor profiting at the government's expense.

Disgorgement, however, specifically addresses the concern that a wrongdoer should not profit at another's expense.[170] Only "legitimate" expenses incurred by the wrongdoer are to be deducted from the amount that the wrongdoer is required to pay.[171] In *Liu*, for example, the Supreme Court indicated that, on remand, the court may require the wrongdoers in that case to disgorge costs incurred in connection with "ostensible marketing expenses and salaries," while the wrongdoers might not be required to disgorge costs incurred for "lease payments and cancer-treatment equipment."[172] A contractor, therefore, would not be able to retain profits on its fraudulently obtained contract, and the government, under a common-law fraud counterclaim, would be able to recover all monies paid under the contract except for monies that went toward items or services that have "value independent of fueling a fraudulent scheme."[173]

Furthermore, the Supreme Court has long held that a wrongdoer may not retain "dividends of profit under another name."[174] Accordingly, if a contractor unreasonably inflates its expenses to reduce the amount it is required to disgorge because of common-law fraud, a court could look behind the contractor's representation that it incurred certain expenses and require disgorgement of unreasonable expenses. The equitable remedy of disgorgement does not permit a wrongdoer "to diminish the show of profits by putting in unconscionable claims for personal services or other inequitable deductions."[175]

169. *See* Veridyne Corp. v. United States, 83 Fed. Cl. 575, 586 (2008) ("The case law, properly read, does not support defendant's argument that the appropriate remedy for any contract that is void *ab initio* is forfeiture of monies already paid or the denial of recovery in *quantum meruit* or *quantum valebat*.").

170. Liu v. Sec. & Exch. Comm'n, 140 U.S. 1936, 1943 (2020) (stating that a "foundational principle" of disgorgement is that it "'would be inequitable that [a wrongdoer] should make a profit out of his own wrong'" (quoting Root v. Railway Co., 105 U.S. 189, 207 (1882)).

171. *Id.* at 1949–50 (quoting Rubber Co. v. Goodyear, 76 U.S. 788, 804 (U.S. 1870)).

172. *See id.* at 1950.

173. *See id.*

174. *Goodyear*, 76 U.S. at 803.

175. *Liu*, 140 U.S. at 1945 (quoting *Root*, 105 U.S. at 203).

The Supreme Court also "has carved out an exception when the 'entire profit of a business or undertaking' results from the wrongful activity.'"[176] If a contractor obtains a contract through fraud, and does not incur any legitimate expenses in connection with performance of the contract, the contractor, under a rescission and disgorgement theory, would be required to disgorge all monies paid under the fraudulently obtained contract.[177] Application of "that exception requires ascertaining whether expenses are legitimate or whether they are merely wrongful gains 'under another name.'"[178] Consequently, the exception may not apply if the contractor incurred legitimate expenses when providing goods or services to the government under the contract obtained through common-law fraud.

IV. CONCLUSION

Considering the U.S. Supreme Court's decision in *Liu v. Securities and Exchange Commission*,[179] it would be inappropriate to order, as a remedy for a common-law fraud counterclaim, disgorgement of all monies paid under a contract obtained through fraud, unless the contractor did not incur any legitimate expenses in performance of the contract. The COFC, when crafting equitable relief, must be mindful of the traditional limitations on disgorgement as discussed in *Liu* and other binding precedent.

Moreover, a common-law fraud counterclaim is not a panacea for all the adverse effects of fraud, as the equitable remedies of rescission and disgorgement are only intended to restore the status quo and ensure that the wrongdoer does not profit at the counterparty's expense. When pursuing alleged fraud by a contractor, the government has multiple options other than a common-law fraud counterclaim (*e.g.*, the False Claims Act) that it can use to punish and penalize the perpetrators of fraud. Equitable relief, however, is not to be used as a vehicle for punishment or to provide the government with a windfall.

176. *Id.* (quoting *Root*, 105 U.S. at 203).

177. *See id.* at 1950 ("It is true that when the 'entire profit of a business or undertaking' results from the wrongdoing, a defendant may be denied 'inequitable deductions' such as for personal services." (quoting *Root*, 105 U.S. at 203)).

178. *Id.* (quoting *Goodyear*, 76 U.S. at 804).

179. *Liu*, 140 U.S. at 1936.