No. 07-1234

In the Supreme Court of the United States

THE LONG ISLAND SAVINGS BANK, FSB and THE LONG ISLAND SAVINGS BANK OF CENTEREACH FSB,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to The United States Court of Appeals for the Federal Circuit

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The government's brief in opposition tries to push the traditional no-cert. buttons. It does not defend the merits of the Federal Circuit's holding, presumably because the government recognizes that ruling to be indefensible. Instead, it seeks to obscure and recharacterize the holding below, in an evident effort to direct attention away from the baleful consequences of the court of appeals' aberrant and destructive rule.

That effort should not succeed. The Federal Circuit's holding is not only wrong, but clear and unequivocal in its import. As shown in the petition (at 16-24), the Federal Circuit ruled that a contract will be declared void *ab initio* whenever the government establishes "that the contractor (a) obtained the contract by (b) knowingly (c) making a false statement." App. 20a-21a. That voidness rule, which (as it did here) allows the government to keep all the contract benefits while itself breaching its contractual obligations and disclaiming liability for its breach, is flatly inconsistent with the universally recognized principles that should govern government contracts. The Federal Circuit then compounded its first error by holding that a breach of contract is *per se* material "as a matter of law" if it *either* caused the parties to enter into the contract or involved "any degree of fraud." *Id.* at 33a. This rule, too, radically departs from established contract principles, which deem a breach material only when it denies the affected party the essence of its bargain. See Pet. 24-29.

If our characterization of the Federal Circuit's rules is correct, and for the reasons below we think it

plainly is, review is imperative. These rules now govern all federal contracts of any size across the Nation. They have perverse and profoundly inequitable consequences – as is graphically illustrated by the facts of this case, where the government retained all of the contract benefits while breaching its obligations in a manner that cost petitioners hundreds of millions of dollars. And the issue presented here will arise repeatedly in the future; as a judge of the Court of Federal Claims recently described the decision below, it is "a model as to how the Federal Circuit analyzes an affirmative defense of fraud in the inception of the contract and its relationship to a prior material breach-of-contract defense." Mary Ellen Coster Williams, *2007 Government Contract Decisions of the Federal Circuit*, 57 AM. U. L. REV. 1075, 1128 (Apr. 2008). This case merits review.

A. The Void *Ab Initio* Holding Warrants Review.

The Federal Circuit held that, under federal common law, a government contract is void *ab initio* if a contractor "(a) obtained the contract by (b) knowingly (c) making a false statement." App. 20a-21a. The Brief in Opposition elides the essential problem with this holding: notwithstanding its *citation* of relevant Restatement provisions (see Opp. 9-10), the lower court's standard departs from the Restatement's rule and has never, to petitioners' knowledge, been embraced by any other court. The government makes no effort to explain how this holding can be squared with the general principles of contract law that should define federal law in this

area.[1] See, *e.g.*, *United States* v. *Winstar Corp.*, 518 U.S. 839, 895 & n.39 (1996).

The government instead (a) supplies a rationale for the outcome below that is quite different from the Federal Circuit's, contending that Conway's conduct amounted to fraud in the factum under the traditional test (Opp. 10-11); (b) denies the conflict in the courts of appeals that has been expressly acknowledged by the Federal and D.C. Circuits (Opp. 11-12); and (c) speculates that the distinction between fraudulent inducement and fraud in the factum would make no difference here (Opp. 12). Each contention is meritless.

a. The government's claim that Conway's conduct amounted to fraud in the factum is itself a radical departure from settled contract law. The government argues that the contract is void because LISB's alleged misrepresentations concerned its "essential terms." Opp. 10. But even assuming, improbably, that this is so, this argument misses the mark. The point is that the government neither does nor could assert that the purported misrepresentations in this case deprived it of the opportunity to understand (i) the *substance* of its contract with the Banks, or (ii) that it was actually entering into a contract. *Ibid.* And these are the *only* forms of misrepresentation that constitute fraud in the factum, and thereby render a contract void *ab initio*:

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[1] The accepted – and dramatically different – common-law test provides that a contract is void *ab initio* only if "because of a misrepresentation as to the character or essential terms of a proposed contract, a party does not know or have reasonable opportunity to know of its character or essential terms." Restatement (Second) of Contracts § 163 cmt. a (1981).

> Fraud in the execution [*i.e.*, factum] * * * entails deceiving a party to an agreement as to the very nature of the instrument it signs *so that the party actually does not know what he is signing, or does not intend to enter into a contract at all.*

Laborers' Pension Fund v. *A&C Envtl., Inc.*, 301 F.3d 768, 779 (7th Cir. 2002) (emphasis added, internal quotation marks omitted).[2] Accord, *e.g.*, *Langley* v. *F.D.I.C.*, 484 U.S. 86, 93 (1987) ("fraud in the factum * * * is the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents"). No court applying the traditional standard could have found that the conduct at issue amounted to fraud in the factum – as is well demonstrated by the government's failure to cite a single case finding a contract void *ab initio* in circumstances like these.[3]

b. Although not contesting that the Federal and D.C. Circuits dispute whether fraudulent misrep-

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[2] By contrast, "[f]raud in the inducement occurs when fraud induces a party to assent to a commitment that the party understands but to which the party would not otherwise have assented; the promisor knows what it is signing but its assent is induced by fraud." *A&C*, 301 F.3d at 779.

[3] Significantly, the government itself has heretofore consistently argued that Conway's conduct constituted fraudulent *inducement*. See Appellant's Br. at 2 (Statement of Issues: "Whether the trial court erred * * * in refusing to impute knowledge of fraud in the inducement of a Government contract * * *"); Appellant's Br. in Opp'n to Reh'g at 2 ("We explained that [LISB] had fraudulently induced the contract * * *"); Appellant's Br. in Opp'n to Renewed Reh'g Pet. at 7 ("The Panel properly held that a contract induced by fraud is void *ab initio*").

resentation should render a government contract void *ab initio* (see Pet. 19-22), the government claims that the D.C. Circuit's comprehensive critique of the Federal Circuit's view (see *United States ex rel. Siewick* v. *Jamieson Sci. & Eng'g, Inc.*, 214 F.3d 1372 (D.C. Cir. 2000)) was not part of the decision's holding. But it was.

The *Jamieson* court considered *both* (i) whether the contract at issue was void *ab initio* (*id.* at 1377), and (ii) whether it was voidable (*id.* at 1377-78). As to the first (the issue implicated here), the D.C. Circuit squarely held that the undisclosed conflicts of interest alleged by the *qui tam* relator did not render the contract void *ab initio*. It was in the course of this discussion that *Jamieson* described its disagreement with the Federal Circuit. *Id.* at 1377. The division between these circuits is therefore plain. *Jamieson*'s subsequent statement that it was unnecessary to reach an "ultimate answer" as to the quite different question of the contract's *voidability* (*id.* at 1378) should not obscure that fact.[4]

Moreover, a conflict in the circuits is not essential to justify review of this case. Because the Federal Circuit has exclusive appellate jurisdiction over almost all government contracting claims, that court's conclusion that "a [g]overnment contract tainted by fraud or wrongdoing is void *ab initio*"

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[4] The Fifth Circuit's decision in *Hayes International Corp.* v. *McLucas*, 509 F.2d 247, 263 n.26 (5th Cir. 1975), is equally in conflict. That court squarely rejected the appellant's argument that an illegal conflict of interest attributable to a government contractor rendered the underlying contract void *ab initio*. It is of no moment to the precedential force of the ruling that it came in a footnote, and did not further address whether the contract should be deemed voidable. See Opp. 11-12.

(App. 20a) (internal quotation marks omitted)), will have an immediate nationwide effect.

c. The government insists that "review also is not warranted because even if the contract was not void *ab initio*, the Assistance Agreement was voidable at the government's election" and petitioners would therefore be left empty-handed in either event. Opp. 12. This argument ignores both the trial court's rejection of the government's claim (App. 198a), and the government's express abandonment of this issue on appeal. See Appellant's Br. at 5 n.2. More fundamentally, the government's legal premise is wrong. Even *if* a rescissionary remedy is available to the government, petitioners would be entitled to substantial relief denied to them below: when a contract is disaffirmed, *both parties* are entitled to be restored to their pre-contract positions. See, *e.g.*, *Kamerman* v. *Curtis*, 33 N.E.2d 530, 532-33 (N.Y. 1941). Here, that restoration would have to take into account more than a decade of petitioners' ultimately successful efforts to turn around Centereach – fundamentally the same events at the heart of the trial court's $436 million damages calculation. See App. 120a-168a. Accordingly, even assuming *arguendo* that the value of cash and assets contributed by the government would be relevant to that equitable adjustment, the difference to petitioners between having *some remedy* and *no remedy* would be enormous.[5] Review is plainly warranted.

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[5] The government's argument that the trial court has already considered and rejected petitioners' right to restitutionary relief (Opp. 12) is a red herring. The trial court simply resolved that actual injury was a more appropriate measure of contract damages than restitution. See 60 Fed. Cl. 80, 96 (2004).

B. The Material Breach Holding Warrants Review.

The Federal Circuit's material breach holding likewise is a destructive one that rests on an aberrant interpretation of contract law. The court held that LISB's purported breach of contract, which it described as being Conway's submission of his false certification, was material because (a) the court perceived a "causal link" between the compliance representation and contract formation (App. 29a, 31a), and alternatively (b) because its "case law holds that any degree of fraud is material as a matter of law." App. 33a. The Federal Circuit thus reduced its materiality analysis to a determination whether fraud took place in formation of the contract and to a review of "causation" (*ibid.*), ultimately holding that the "breach" was material because "had the [petitioners] stated the truth about Conway, they would not have received the contract." App. 31a.

Contrary to the government's claim (Opp. 13), the Federal Circuit's focus on causation is completely at odds with general principles of contract law. See Restatement (Second) of Contracts §§ 241(a)-(e) (1981). The Restatement test, generally followed by the courts of appeals (see Pet. 27-28), requires a multi-factor analysis of the effect of a breach on the *performance* expected by the parties. See Pet. 26. In contrast, the Restatement nowhere suggests that the effect of a breach on the *formation* of a contract (whether or not the breach is related to fraud) is at all relevant to the materiality analysis.[6] The Federal Circuit's holding, which relied *expressly and*

[6] Little wonder – it is nonsensical to say that a contract can be breached (let alone materially) before it comes into being.

exclusively on the conclusion that LISB's compliance representation affected formation of the contract, thus represents a substantial departure from settled contract principles.

The government defends this ruling principally by rewriting the Federal Circuit's holding. It dismisses the Federal Circuit's statement that "any degree of fraud is material" as dictum. Opp. 13 (internal quotation marks omitted). As to the rest of the court's analysis, the government suggests that the opinion is consistent with contract principles because the court "specifically held that petitioners' breach was material because the government did not receive the benefit of its bargain under the contract, *i.e.*, sound management of the bank." *Ibid.* This statement is bewildering; no hint of this purported holding appears in the Federal Circuit's opinion.

Nor could the Federal Circuit reasonably have adopted the holding attributed to it by the government. It would be astonishing if, following open bidding and lengthy negotiation, the government had agreed to cede $122 million and highly favorable accounting treatment (essentially a cash substitute) in exchange for just "(1) honest and full disclosure, and (2) safe and sound management." Opp. 15.[7] In truth, there was far more to the deal. As with all of the *Winstar* agreements, the government sought to "avoid the insurance liability [of the failing S&Ls, totaling some $85 billion] by encouraging healthy thrifts and outside investors to take over ailing institutions." *Winstar*, 518 U.S. at 847. By agreeing to take over Centereach, LISB assumed a $625 million portion of that potential

[7] Neither term appears in the contract documents.

liability. See App. 113a. Moreover, it remains undisputed that the responsible government regulators viewed petitioners' management as "sterling" (App. 123a), that they *never* concluded that the Banks had been operated in other than a safe and sound manner, and that the Centereach rescue was a success. See Pet. 7-10. Accordingly, unless one accepts the government's *ipse dixit* that the "very essence" of its purpose in executing the agreement was to obtain morally blameless management for Centereach (Opp. 15), there can be no doubt that the government obtained substantially what it desired – LISB's assistance in solving the Centereach piece of the savings and loan crisis.

It bears emphasis that the government's bizarre recharacterization of the contract should not deflect the Court's focus from the erroneous and harmful legal rules announced by the Federal Circuit; we describe the contract simply to confirm that the government cannot be accurately depicting the legal holding below. The fundamental point is that the Federal Circuit *did not* consider the materiality question under anything like the Restatement test. It instead concluded that the asserted importance of LISB's compliance certification to the *formation* of the contract made the resulting "breach" material. This creates a profound conflict with contract law principles recognized everywhere else.

C. The Federal Circuit's Decision Will Have Grave And Inequitable Consequences For Government Contractors.

The government has remarkably little of substance to say about the sweeping implications of the Federal Circuit's decision. The government declares repeatedly that this case involves the sort of

contract addressed in *Winstar* (Opp. 2, 16-17), but that observation is wholly beside the point. Whatever the volume of continuing *Winstar* litigation, the decision below involves *general* contract rules that will apply to *every* substantial claim for contract damages against the United States. See Pet. 30. Nor does the government contest that countless government contracts require broad compliance representations much like the one at issue in this case, or offer a single word about the inherent difficulty of ensuring that every statement in such a certification is correct. See Pet. 31-32. The government thus seems to recognize that, under the Federal Circuit's rules, a single false statement in such standard certifications can cause the contracts in which they appear to be declared void or materially breached at their inception, with profoundly unfair remedial consequences. And the government evidently concedes that quasi-contract remedies such as *quantum meruit* will not be available to soften the blow of these harsh forfeiture rules. See Pet. 33-34.

Where the government does object, its protestations do not persuade. It is not true, for example, that government contractors have labored under these harsh contract rules, or their equivalent, for over 50 years. See Opp. 16 (citing *Little* v. *United States*, 152 F. Supp. 84, 87 (Ct. Cl. 1957)). The panel's initial decision in this case (App. 38a-68a) extended *Little*'s holding *for the first time* to alleged misrepresentations occurring during contract formation. See Jerry Stouck & Robert A. Caplen, *The Forfeiture Of Claims Act Today*, 07-9 BRIEFING PAPERS 1, 4 (Aug. 2007). Moreover, that profoundly erroneous initial decision was vacated at the direction of the full court. See App. 2a.

And while the government asserts that petitioners' warplane hypothetical "is not remotely analogous" to this case, (Opp. 16) – presumably in the sense that banks and warplanes are quite different – it does not deny that total forfeiture would follow under the decision below if a defense contractor were to build a $436 million warplane that perfectly met the government's specifications, but the contractor's compliance representation in procuring the contract were later found wanting.[8] See Pet. 31. In addition to being clearly at odds with general contract principles, this result cannot be squared with the approach selected by the political branches to address contract infirmities of this kind, and accordingly is of great concern to the government contracting community. See Br. for *Amicus Curiae* National Defense Industrial Ass'n, at 13-18.

In short, nothing the government has said blunts the force of petitioners' argument for review. Wholly apart from the $436 million at stake in this one case, the decision below settled national rules of considerable importance. Those rules threaten to disrupt the government contracting process by jettisoning established contract principles in favor of

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[8] The analogy is apt. LISB provided valuable services to the government in assuming responsibility for Centereach and its liabilities, and was stripped by the government's breach of a substantial portion of its compensation – the right to record supervisory goodwill in place of cash on its books. And the government's cavalier pronouncement that the punitive result below is warranted because the contract and associated government funds were "procured by fraud" (Opp. 17) only underscores our point. Under general contract principles, that accusation should mark the beginning of the analysis, not the end.

a novel and poorly considered approach. This Court's intervention is clearly warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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