

Michigan Law Review

Volume 60 | Issue 2

1961

Federal Courts - Choice of Law Application of Federal Law to Government Subcontract in Federal Diversity Case

H. C. Snyder Jr.
University of Michigan Law School

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Recommended Citation

H. C. Snyder Jr., *Federal Courts - Choice of Law Application of Federal Law to Government Subcontract in Federal Diversity Case*, 60 MICH. L. REV. 219 (1961).

Available at: <https://repository.law.umich.edu/mlr/vol60/iss2/8>

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FEDERAL COURTS — CHOICE OF LAW — APPLICATION OF FEDERAL LAW TO GOVERNMENT SUBCONTRACT IN FEDERAL DIVERSITY CASE — Defendant obtained a government missile contract, and plaintiff was subcontracted to manufacture containers for the missiles. When certain changes in elements of the containers were ordered by the Government, plaintiff

demanded an "equitable adjustment" from defendant pursuant to the terms of the subcontract. Defendant paid only the costs of effecting the necessary changes. Plaintiff instituted this suit in federal district court alleging diversity of citizenship and demanding that the adjustment include, as allowed by California law, compensation for overhead losses caused by a partial work stoppage during the delay in effecting the changes. The district court characterized the contract as a government contract, held that federal rather than state law applied, and found for defendant on the merits.¹ On appeal, *held*, affirmed. Although the subcontract cannot be characterized as a government contract, federal law should be applied for its interpretation since the federal interest in national security requires a uniform federal rule for the construction of such government subcontracts. *American Pipe & Steel Corp. v. Firestone Tire & Rubber Co.*, 292 F.2d 640 (9th Cir. 1961).

The doctrine of *Erie R.R. v. Tompkins*² is that state law applies to actions in the federal courts, "except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide."³ The express exception⁴ to the rule has been found to include: suits involving rights or obligations of the government on its commercial instruments⁵ or contracts,⁶ suits involving the rights or obligations created by government instruments as between private parties,⁷ and suits in which the policy of federal statutes requires a uniform federal rule governing the transactions which they affect.⁸ Until this decision it

¹ 186 F. Supp. 904 (S.D. Cal. 1960).

² 304 U.S. 64 (1938).

³ Federal Rules of Decision Act of 1789, 28 U.S.C. § 1652 (1958): "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the federal courts of the United States, in cases where they apply."

⁴ See Comment, *Erie Limited: The Confines of State Law in the Federal Courts*, 40 CORNELL L.Q. 561 (1955); Note, *Exceptions to Erie v. Tompkins: The Survival of Federal Common Law*, 59 HARV. L. REV. 966 (1946).

⁵ *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943). For a discussion of the questionable constitutional basis for this rule, see Note, *Clearfield: Clouded Field of Federal Common Law*, 53 COLUM. L. REV. 991 (1953).

⁶ *Priebe & Sons, Inc. v. United States*, 332 U.S. 407 (1947) ("general contract law" applied without even considering state law).

⁷ *Bank of America v. Parnell*, 352 U.S. 27 (1956). It is interesting that the Court held that federal law applied only to the rights created by the bonds, and that the issue of burden of proof of good faith of defendants in presenting the bonds was held to be controlled by state law. See Note, *Federal Jurisdiction: Law Applicable to Government Instruments*, 45 CALIF. L. REV. 212 (1957).

⁸ In *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173 (1942), it was held that the question of whether a patent licensee was estopped to deny the validity of his licensor's patent and avoid a price-fixing agreement was governed by federal law because of federal anti-trust policy; and in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), federal law was held applicable to determine the validity of a note given to the Federal Deposit Insurance Corporation as part of a surreptitious scheme because of the strong policy of the statutes creating that agency to protect it from fraud.

had been accepted as settled that suits between private parties to government subcontracts were within the *Erie* rule and that state law would be applied;⁹ but the court's opinion makes it clear that it regards this case to be within the federal-policy category of the exception. However, the prior cases within that category involved statutes or policies of statutes which went to the merits of the controversy,¹⁰ and it is difficult to find any federal statutes which touch upon the construction of equitable adjustment provisions in government subcontracts, or which express a controlling federal policy necessitating a uniform federal rule in this situation. The court referred to the probability that the prime contract provided for an equitable adjustment, which might reflect the adjustment made under the subcontract thereby increasing the cost of national security. Although the court adverted to the policy of Congress to reduce the cost of defense, which is manifested in the Renegotiation Act,¹¹ it is apparent that the policy of the Renegotiation Act does not bear upon the construction or effect of the equitable adjustment provision of the subcontract. The act merely provides that contracts and subcontracts let under the authority of certain government agencies shall be subject to review after performance in order that excessive profits may be eliminated. Since this suit was instituted for compensation of losses, the considerations of a review to ascertain excessive profits seems somewhat remote from the issue being determined. Furthermore, under the act the function of determining excessiveness of profits is not delegated to the courts but rather is invested in the Renegotiation Board appointed by the President whose findings are subject only to redetermination by the Tax Court.¹² Since nothing in the act bears upon the issue under consideration, and no other statutes or manifestations of federal policy are suggested by the court to require the uniformity urged by the defendant,

⁹ *Ogden Elec. Co. v. Engineers Ltd.*, 151 F.2d 657 (10th Cir. 1945); *Cuneo, Disputes Between Subcontractors and Prime Contractors Under Government Contracts*, 16 *FED. B.J.* 246, 259-61 (1956); *Steele, Choice of Law, State or Federal in Government Subcontracts*, *id.* at 202. The general rule also appears to be applicable to suits brought under the Miller Act, 49 Stat. 793 (1935), 40 U.S.C. §§ 270a-270d (1958). *United States ex rel. Lichter v. Henke Constr. Co.*, 157 F.2d 13 (8th Cir. 1946); *United States ex rel. Gillioz v. John Kerns Constr. Co.*, 50 F. Supp. 692 (E.D. Ark. 1943), *rev'd. on other grounds*, 140 F.2d 792 (8th Cir. 1944). *But see Liebman v. United States ex rel. California Elec. Supply Co.*, 153 F.2d 350 (9th Cir. 1946); *United States ex rel. Glickfeld v. Krendel*, 136 F. Supp. 276 (D.N.J. 1955); *United States ex rel. Hargis v. Maryland Cas. Co.*, 64 F. Supp. 522 (S.D. Cal. 1946).

¹⁰ The language of many of the decisions suggests that the presence of a "federal question" is the basis for the choice of law decision. See *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942); *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 456 (1942); *Mitchell v. Flintkote Co.*, 185 F.2d 1008, 1011 (2d Cir. 1951).

¹¹ Renegotiation Act of 1951, 65 Stat. 7, as amended, 50 U.S.C. APP. §§ 1211-33 (1958).

¹² Renegotiation Act of 1951, § 108, 65 Stat. 21, as amended, 50 U.S.C. APP. § 1218 (1958).

there is little to support the application of federal law in this case except the statement of the court that federal interests are involved which require the protection of federal law.¹³

Assuming that the "accident" of diversity had been missing from this case, the suit probably would have been brought in a California court, since no federal question, under the rule of *Gully v. First National Bank*,¹⁴ would have been presented to confer original jurisdiction upon the federal district court.¹⁵ In the absence of a "federal question" the state court would have applied its own law, not federal law,¹⁶ and the outcome of the suit might well have been reversed. The avoidance of just such a divergence between state and federal rules of decision within the same geographical area was the prime motivation behind the *Erie* doctrine.¹⁷ Likewise, the major reason for conflict of laws rules is that fairness to the parties requires that the outcome of litigation should not be substantially affected by the choice of forum in which the suit is decided.¹⁸ Furthermore, suits brought under the Miller Act, dealing with certain

¹³ A similar interest was suggested as a basis for the application of federal law in a tort suit by the government against one who had injured a soldier. *United States v. Standard Oil Co.*, 332 U.S. 301 (1947).

¹⁴ 299 U.S. 109 (1936).

¹⁵ *But see* Forrester, *The Nature of a "Federal Question,"* 16 TUL. L. REV. 362 (1942).

¹⁶ This is graphically indicated by the federal-state split on the meaning and effect of Exec. Order 9001, 6 Fed. Reg. 6787 (1941), as amended, Exec. Order 9296, 8 Fed. Reg. 1429 (1943), which provided that government contractors shall not use contingent fee agents to procure their contracts and shall warrant in their contracts that such agents have not been used. The federal courts which have considered claims by such agents for compensation under contingent fee contracts have uniformly held such contracts void and unenforceable. *Le John Mfg. Co. v. Webb*, 222 F.2d 48 (D.C. Cir. 1955); *Mitchell v. Flintkote Co.*, 185 F.2d 1008 (2d Cir. 1951); *Bradley v. American Radiator & Standard Sanitary Corp.*, 159 F.2d 39 (2d Cir. 1947); *Browne v. R. & R. Eng'r Co.*, 164 F. Supp. 315 (D. Del. 1958), *rev'd on other grounds*, 264 F.2d 219 (3d Cir. 1959); *Weitzel v. Brown-Neil Corp.*, 152 F. Supp. 540 (D.W.Va. 1957), *aff'd*, 251 F.2d 681 (4th Cir. 1958); *Ballard v. Tingue Mills*, 128 F. Supp. 683 (D. Conn. 1954). At the same time the state courts, with near unanimity, have construed the Executive order as merely providing a penalty against contractors for breach of the required warranty and have allowed enforcement of the claims of such agents. *Buckley v. Coyne Elec. School, Inc.*, 343 Ill. App. 420, 99 N.E.2d 370 (1951), *cert. denied*, 342 U.S. 927 (1952); *Gendron v. Jacoby*, 337 Mich. 150, 59 N.W.2d 128 (1953); *Ebeling v. F. J. Swaine Mfg. Co.*, 357 Mo. 549, 209 S.W.2d 892 (1948); *A. H. Haeseler Bldg. & Contracting Co. v. John J. Dupps Co.*, 129 N.E.2d 383 (Ohio Ct. App. 1954). *But see* *Federal Pac. Elec. Co. v. McAdams*, 207 Misc. 525, 139 N.Y.S.2d 418 (N.Y. City Ct. 1955). See Annot., *Duty of State Courts To Follow Decisions of Federal Courts, Other Than the Supreme Court, on Federal Questions*, 147 A.L.R. 857 (1943).

¹⁷ See Mr. Justice Brandeis' majority opinion, 304 U.S. 64, 71-80 (1938). The doctrine of *Erie* was held to apply to suits in equity in *Ruhlin v. New York Life Ins. Co.*, 304 U.S. 202 (1938). In *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941), it was held that federal courts must also apply the conflict of laws rules of the states in which they sit.

¹⁸ GOODRICH, *CONFLICT OF LAWS* § 4 (3d ed. 1949).

types of government subcontracts,¹⁹ may present the same federal interest in national security which is here involved, and yet Congress has seen fit to allow state law to apply in those cases.²⁰ Since there is no clearly defined federal statutory policy which requires a uniform federal rule applicable to this case, and the Rules of Decision Act²¹ appears to require the application of state law in the absence of such a clearly defined federal policy, it would seem that, congressional intent also militates against this expansion of the exception to the *Erie* doctrine.

H. C. Snyder, Jr.

¹⁹ Under 49 Stat. 794 (1935), 40 U.S.C. § 270b (a) (1958), "every person who has furnished labor or material" is given the right to sue contractors covered by § 270 (a). § 270b (b) provides: "Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing, in the United States District Court for any district in which the contract was to be performed and executed and not elsewhere, irrespective of the amount in controversy in such suit"

²⁰ See cases cited note 9 *supra*, indicating that state law has been applied in determining rights and obligations under these contracts with more than twenty-five years of congressional acquiescence.

²¹ 28 U.S.C. § 1652 (1958).