GOVERNMENT CONTRACTS: IMPLIED INVALIDITY RESULTING FROM VIOLATION OF CONFLICT OF INTEREST STATUTE

SECTION 434 of the United States Criminal Code prescribes criminal sanctions against a government agent or officer who is directly or indirectly interested in the pecuniary profits or contracts of any corporation with which he transacts business for the Government.[1] In *United States v. Mississippi Valley Generating Co.*,[2] the Government asserted this conflict of interest provision in defense of an action for damages arising out of the Government's termination of the plaintiff's power contract with the Atomic Energy Commission.[3] The Court of Claims found no violation of section 434 and allowed the plaintiff recovery.[4] The Supreme Court reversed, ruling that a conflict of interest did exist and that nonenforcement of the contract was necessary to vindicate the public policy underlying the statute.

The statutory violation arose out of the conduct of Adolphe Wenzell, employee of a financing institution, who was retained[5] by the

[1] 18 U.S.C. § 434 (1958). "Whoever, being an officer, agent or member of, or directly or indirectly interested in the pecnniary profits or contracts of any corporation, joint-stock company, or association, or of any firm or partnership, or other business entity, is employed or acts as an officer or agent of the United States for the transaction of business with such bnsiness entity, shall be fined not more than $2,000 or imprisoned not more than two years, or both."

This is substantially the form of the original enactment, 12 Stat. 696 (1863), which was adopted following disclosure of fraud on the part of government agents in the procurement of war materials during the Civil War. In the 1863 enactment, however, the same sanctions were stated conjunctively.

Other conflict of interest provisions are fonnd in Title 18, §§ 202 (bribery of government official), 216 (fraudulent procurement of government contract by officer or Congressman), 281, 283, 284, 1914 (double compensation).

[2] 364 U.S. 520 (1961).

[3] The Government raised six defenses in the Court of Claims. The other five were: lack of authority, lack of mutuality, failure of respondent to obtain all the necessary regulatory approval, illegality of the financing agreements required by the contract and failure to comply with the Atomic Eenergy Act of 1954, 42 U.S.C. § 2204 (1958). The Court found it unnecessary to consider these defenses in view of their determination of the conflict of interest question. 364 U.S. at 525.

[4] 175 F. Supp. 505 (1959).

[5] Wenzell's first association with the Budget Bureau was in 1953 when he made a financial analysis of the Tennessee Valley Authority. He submitted his final report in September, and was not re-employed by the Bureau until January 18, 1954, after the exploratory negotiations concerning the proposed project were under way. During these periods, the consultant, Adolphe Wenzell, remained in the employ of the financing

Budget Bureau as a part-time financial consultant during the formative negotiations[6] between the AEC and plaintiff, a combine of private utility companies. The consultant left the Government's employ prior to the submission of the proposal which ultimately resulted in the contract.[7] When it later became apparent that the facilities were no longer needed,[8] the AEC notified the plaintiff that the Government desired rescission. During several months of negotiation, the parties failed to reach a satisfactory cancellation agreement; consequently, the AEC unilaterally terminated the contract, contending that it was unenforceable. The

institution, First Boston Corporation, and continued to receive his regular salary. Although he was not paid by the Government, he was given a sustenance allowance of ten dollars per day plus his transportation expense. 364 U.S. at 533, 534.

[6] Wenzell's first official activity was on January 20, 1954. On that date, he attended a meeting, as representative of the Budget Bureau, attended by AEC representatives and the presidents of two public utility companies—Dixon and McAfee. There, the Government's intention to have the facilities constructed in the Memphis area was made clear. McAfee was discouraged over the choice of location, and subsequently withdrew. Dixon agreed, at this meeting, to make a study of the cost factors of the proposed facilities, proceeding on his own after McAfee's withdrawal.

Early in February, Dixon asked Wenzell for an estimate of what the interest rates on the then current market would be for financing a project similar to one First Boston had financed a few years earlier. Wenzell gave Dixon an oral estimate on February 14th, and a conforming written estimate on February 23d. This estimate was employed in both of the proposals submitted by Dixon and Yates (chairman of the board of a public utility company, who had been persuaded to join the project on February 20th).

On February 25th, the combine submitted their first proposal. It contemplated formation of a new corporation, Mississippi Valley Generating Co., which would finance and construct generating facilities from which electrical power would be supplied to the AEC through the TVA. Wenzell did not participate in the initial study of this offer. When later apprised of its terms, he suggested that the cost estimates were too high. Thereafter, the AEC and TVA made a more intensive analysis, the results of which conformed to Wenzell's opinion.

While an independent study of the first proposal was being made by an official of the Federal Power Commission, the sponsors worked on a revision of their estimate. Wenzell's last activity as consultant to the Budget Bureau was on April 3d, when a meeting was held at the Bureau's offices to discuss the independent analysis and the revised estimates. At this meeting, Wenzell confirmed the cost of money estimates he had given Dixon earlier. The revised estimates were more acceptable to the AEC and the sponsors were encouraged to refine their figures. 364 U.S. at 534-39.

[7] The AEC and TVA made an intensive joint analysis of this proposal and, having secured the President's approval, the AEC negotiated a final agreement with the plaintiff. The President's authorization was based on a memorandum supplied to him by the Director of the Budget Bureau in April. The final negotiations began in July and ended in November, with a contract which was in a "general way" within the terms of the second proposal. 364 U.S. at 531.

[8] After the contract became effective, the City of Memphis had decided to construct municipal power facilities which would ease the TVA's commitments in that area and leave it free to meet the AEC's demands. This decision obviated the need for the contracted-for facilities. 364 U.S. at 532.

plaintiff then instituted suit in the Court of Claims for recovery of preparatory expenses.[9]

The government's consultant was found to have an indirect interest in the contract because of the substantial possibility that his employer, in view of its experience in the financing of similar projects,[10] would receive the financing sub-contract from the plaintiff. Thus, Wenzell's culpability arose not because of any illegal relationship with the plaintiff but because he would profit[11] if his employer should be chosen as financing agent.

The existence of such a conflict of interest casts doubt upon the validity of the resulting contract. The sanction of nonenforcement of contracts made in violation of the statute is implicit in the act and only those contracts that do not offend the policy objectives of the statute should be upheld. It appears that section 434 has three basic objectives: to insure honesty in the Government's business dealings, to insure that government contracts are fair, and to prevent the agent or officer from securing a private profit out of his transaction of business for the Government.[12] The cases relied on by the Supreme Court as precedent for the instant decision indicate two situations where these considerations made it necessary to invalidate government contracts.

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[9] This amounted, according to the Court of Claim's findings, to about 1.8 million dollars. 175 F. Supp. at 640.

[10] In 1952, First Boston Corporation, Wenzell's employer, had arranged the financing of a similar contract between the AEC and a group of private utility companies in Ohio. 364 U.S. at 555-56.

[11] Wenzell received, in addition to his salary as vice-president and director of First Boston, a bonus for new business he brought into the company. 364 U.S. at 555.

The Court of Claims interpreted § 434 to require the existence of some arrangement or commitment between First Boston Corporation and the plaintiff during Wenzell's government employment, to the effect that First Boston would receive the financing sub-contract if the proposal should result in a contract. 175 F. Supp. at 518. Since no such arrangement was found to exist, it was concluded that there was no violation of § 434. In the Supreme Court, the dissent agreed with this analysis, pointing out that the majority's interpretation of "indirect interest" injected an element of uncertainty into the statute which would make it difficult for laymen to ascertain when their conduct was within the statute's prohibitions. 364 U.S. at 568, 569.

See generally Solow, *Conflict of Interest: A Legal Nightmare*, Fortune, Jan., 1961, p. 97.

[12] "Section 434 is one of several penal conflict-of-interest statutes which were designed to prohibit government officials from engaging in conduct that might be inimical to the best interests of the general public." 364 U.S. at 548. "[I]ts primary purpose is to guarantee the integrity of the federal contracting process. . . ." *Id.* at 565.

See generally, McElwain & Vorenberg, *The Federal Conflict of Interest Statutes*, 65 HARV. L. REV. 955, 966 (1952).

In *Rankin v. United States*,[13] the plaintiff as a contracting agent for the Government, leased office space from a firm in which he was a partner. Although the Treasury Department refused to accept the lease, the plaintiff caused the Works Progress Administration district office to occupy the space for over a year. The Government refused to pay rent, and the plaintiff brought suit for a reasonable rental value. The Court of Claims denied recovery, stating "[I]t would be strange indeed to allow plaintiff to recover . . . when the statute makes it a crime punishable by fine and imprisonment for him to act for the Government and deal with himself."[14] The court concluded that since recovery could not be based on an express contract, it could not be founded on an implied contract.[15]

Michigan Steel Box Co. v. United States,[16] illustrates the second situation. There the Superintendent of the Rural Free Delivery Service was paid a substantial sum for securing a government contract for the plaintiff. In a suit to recover the purchase price of mail boxes supplied under the contract, The Court of Claims held that "no right growing out of a contract made in violation of a penal statute will be enforced at the insistence of a *party participating in the wrong*."[17]

In *Rankin*, the plaintiff violated the statute by acting in the dual capacity of government agent and private contracting party.[18] In *Michigan Steel Box*, the conflict of interest arose from the illegal "kick-back"

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[13] 98 Ct. Cl. 357 (1943).

[14] *Id.* at 361.

[15] Nonenforcement under these circumstances is consistent with the policies underlying § 434. It can hardly be expected that the agent will be loyal to the Government when he is dealing with himself, and the opportunity for partiality and fraud is apparent. Such transactions are forbidden in the law of agency and trusts. See, *e.g.*, Raymond v. Davies, 293 Mass. 117, 199 N.E. 321 (1936); Taussig v. Hart, 58 N.Y. 425 (1874); *In re* Browning's Estate, 172 Misc. 647, 15 N.Y.S.2d 864 (1941). See also, RESTATEMENT (SECOND), AGENCY § 387 (1957); RESTATEMENT (SECOND), TRUSTS § 170, comment *h* (1957).

[16] 49 Ct. Cl. 421 (1914). In Crocker v. United States, 240 U.S. 74 (1916) (alternate ground), the same government agent arranged a similar "deal" with the plaintiff. Under the resulting contract, a number of mail satchels were delivered to the Post Office Department. When the Government later learned of the agreement, it terminated the contract and refused to pay for the satchels delivered. The plaintiff sued on the contract and was denied recovery.

[17] 49 Ct. Cl. at 440 (Emphasis added).

[18] *Accord*, Miller v. Ammon, 145 U.S. 421 (1892) (contract for sale of liquor invalidated where plaintiff-vendor had no license as required by law); Bank of United States v. Owens, 27 U.S. 526 (1829) (contract for loan of money invalidated where the agreed-on interest exceeded the legal limit).

agreement between the plaintiff and the government official.[19] Thus, in both cases, the conduct of the party seeking relief resulted in the invalidation of the contract in question.

The Court of Claims opinion in the instant case distinguished the above decisions and relied instead on the Supreme Court's decision in *Muschany v. United States.*[20] There the War Department employed an agent to secure options from certain landowners. The agent's compensation was five per cent of the vendor's price. A number of such options were secured, but the resulting contracts were invalidated because the prices were allegedly unfair. The Government defended the vendor's suit to enforce one of these purchase agreements on the ground that the contract was invalid because the agent's interest was antagonistic to the Government's. No conflict of interest was found, however, because the plaintiff was not a private corporation or partnership in which the agent had an interest and the intent of section 434 was to bar a government agent "from receiving pay from a third party for assisting that third party to secure a government contract."[21] The Court held that because no fraud was shown in this particular contract, the likelihood of public disadvantage was not sufficiently menacing to warrant nonenforcement; it is "a matter of public importance that good faith contracts of the United States should not be lightly invalidated."[22] This result underscores two significant factors: the agent's interest was obviously adverse to that of the Government; the Court disregarded this antagonism because the contract was fair and the plaintiff had presumably acted in good faith.[23]

The allusion in *Muschany* to the policy favoring enforcement of good faith government contracts suggests a justification for the Court

[19] In agency law, such a secret agreement, concomitant the contract between the third party and the principal, raises a presumption of unfairness. The principal, in this situation, has alternate remedies. He can either rescind the contract or affirm it and recover the secret profit from the agent, regardless of whether the principal suffered a loss. RESTATEMENT (SECOND), AGENCY, §§ 312, 313, comment *i* (1957). See also 41 U.S.C. 31 (1958).

[20] 324 U.S. 49 (1945).

[21] *Id.* at 67.

[22] *Id.* at 66.

[23] In the *Mississippi Valley Generating Co.* case, the Chief Justice said, "*Muschany* did not involve a contract which resulted from an illegal transaction [because no conflict of interest was found], and it is consequently understandable that the contract there in question was enforced." 364 U.S. at 564. However, in *Muschany,* both the agent and the vendor were interested in securing as high a purchase price as possible. Therefore, even if this particular agent acted in good faith, the danger of dishonesty and unfairness seems as great, if not greater, than in the instant case.

of Claim's holding in the instant case. The representatives of the plaintiff were not guilty of culpable conduct, inasmuch as they did not have any "kick-back" arrangement with Wenzell nor was he in any sense their agent. To the contrary, Wenzell's interest arose out of the possibility that his employer would be asked to arrange the financing of the contract. Moreover, the Government conceded that the final contract was fair.

The Supreme Court disregarded these factors, however, stating that the policy expressed in section 434 "leaves no room for equitable considerations."[24] It is true that nonenforcement insures that the government agent does not achieve an unfair advantage. Yet, the private contracting party suffers a severe economic loss, even though he is free from fault and the contract is fair. In declaring the contract unenforceable, the Court seems to have overlooked the countervailing policy, expressed in *Muschany*, of enforcing good faith government contracts. The Court, instead, stated that the public must be protected from the corruption "which might lie undetectable beneath the surface" of a contract "tainted" by a conflict of interest.[25] But since an extensive joint analysis of the plaintiff's proposal was made by the AEC and TVA *after* Wenzell was no longer associated with the Budget Bureau, this proposition seems inappropriate to the case.

In view of the conceded fairness of the contract, it is pertinent to inquire what alternate remedies were available to the Government. The most obvious would be criminal prosecution of the consultant under section 434. Also, since the consultant violated his fiduciary duty, a civil action could be brought to recover any profit accruing to him. This remedy is available even though the Government suffers no pecuniary loss from the transaction.[26]

Although nonenforcement in the instant case averts the evils section 434 was designed to guard against, it does so at the expense of the policy favoring enforcement of good faith government contracts The adoption of a blanket rule of nonenforcement in all cases was not re-

[24] 364 U.S. at 565. This statement was taken from the dissenting opinion of Judge Jones in the Court of Claims. 175 F. Supp. at 533.

[25] 364 U.S. at 565.

[26] "If an agent receives anything as a result of his violation of a duty of loyalty to his principal, he is subject to a liability to deliver it, its value, or its proceeds, to the principal." RESTATEMENT (SECOND), AGENCY § 403 (1957). *Cf.*, MacIsaac v. Pozzo, 81 Cal. App. 2d 278, 183 P.2d 910 (1947); Walsh v. Atlantic Research Associates, Inc., 321 Mass. 57, 71 N.E.2d 580 (1947); Hey v. Cummer, 89 Ohio App. 104, 97 N.E.2d 702 (1950).

quired by congressional mandate[27] and policy considerations do not compel it. Where the contract is fair and the party seeking to enforce it did not participate in the wrong, the more reasonable course would seem to limit the Government's remedy to action against the offending party.

[27] Congress has never expressly provided for invalidation of government contracts where the government contracting agent has violated § 434 or its predecessors. However, in 18 U.S.C. § 216, the President is expressly authorized to invalidate government contracts secured for any person by a Congressman who receives in return a pecuniary benefit. Section 216 also provides criminal sanctions for both parties to such an agreement.