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¶ 18 FEATURE COMMENT: The Most Important Cost Cases Of 2023

This article discusses noteworthy decisions of the Armed Services Board of Contract Appeals, Civilian Board of Contract Appeals, and U.S. Court of Appeals for the Federal Circuit over the past year regarding cost and pricing issues. We prioritized decisions from the latter half of 2023, except for the Federal Circuit's decision in *Raytheon Company*, which we included due to its significance notwithstanding that the decision dates from the beginning of January 2023.

***Sec'y of Def. v. Raytheon Co.*, 56 F.4th 1337 (Fed. Cir. 2023);** 65 GC ¶ 6—In this decision the Federal Circuit has made it more difficult for contractors (1) to exclude uncompensated overtime of salaried employees from unallowable lobbying cost calculations, and (2) to distinguish allowable corporate development costs from unallowable reorganization cost.

An earlier review of 2022 cases in the cost area included discussion of the ASBCA phase of this same appeal, *Raytheon Co. & Raytheon Missile Sys.,* ASBCA 59435–38, 60056–61, 21-1 BCA ¶ 37,796, in which the Board upheld Raytheon on both issues. The Board subsequently denied the Government's motion to reconsider in *Raytheon Co. & Raytheon Missile Sys.,* ASBCA 59435–38, 60056–61, 21-1 BCA ¶ 37,860 because the Government did not offer any newly discovered evidence or establish errors of fact or law. On appeal, the Federal Circuit reversed.

Lobbying Costs: The central issue at both the trial and appellate levels was not what constitutes unallowable lobbying, but rather how the contractor accounted for unallowable lobbying as well as allowable Government relations costs within its labor recording system. In the contractor's view salaried personnel were compensated only for the hours in standard work weeks while time spent outside normal business hours was not recorded in allowable or unallowable cost and thus did not result in any cost charged to Government contracts. The ASBCA agreed citing, inter alia, the contractor's disclosed Cost Accounting Standards accounting practices and common industry practice. Id. at 183,511.

In reversing, the Circuit focused on the contractor's internal documentation as well as employee testimony to the effect that "employees considered time worked outside of regular hours and on weekends to be part of their regular work duties" but that the contractor "instructed them not to report '[t]ime spent on lobby activity after the scheduled working day.' " *Raytheon*, 56 F.4th at 1339–40. In what was in fact an allocability decision, it ruled as unsupported by the evidence the Board's conclusion that the Government experienced no increased costs, and concluded that the contractor, "by ignoring after-hours lobbying, must have charged the government for unallowable lobbying costs," rejecting as "unsupported by any citation" the Board's finding that "[a]ccounting for labor costs as a function of time paid rather than time worked, is one common industry method." Id. at 1341. Without exploring the merits of the allocability issue, the Circuit thus concluded:

> Raytheon's time-paid accounting is a fiction that necessarily overcharges the government when it ignores time spent working on unallowable activities after regular business hours. Raytheon's lobbyists worked on unallowable activities after-hours and their salaries necessarily compensated them for that time. Raytheon's policies ignoring after-hours time resulted in the government reimbursing Raytheon for unallowable costs.

Id. at 1342.

In support, the court cited by analogy Federal Acquisition Regulation 31.201-6(e)(2) which addresses uncompensated overtime in the context of "directly associated cost" and advises that such time "should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal duty periods as to indicate that such activities are part of the employee's regular duties." Id. A "directly associated cost" is "any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred." 48 CFR § 9904.405-30(a)(1). Thus, the court promulgated a rule to the effect that under circumstances such as those present here, uncompensated overtime must receive an allocation of employee salaries. The treatment of uncompensated overtime is clearly one of cost allocation and thus falls within the jurisdiction of the CAS Board. It is curious that the CAS Board has not addressed it.

Despite the specific facts present in *Raytheon*, the Circuit's holding creates a risk of future disputes over "uncompensated overtime" beyond the narrow subject of lobbying cost. To be sure, the court's emphasis in the introductory section of its opinion on the compelling evidence that the after-hours efforts were both extensive and a regular component of employees' duties is not at variance with some existing guidance as to how such hours should be treated. For instance, the DCAA Contract Audit Manual, Section 6-410 (2012) states: "where the impact would be material, uncompensated overtime hours should be included in the labor reporting system." Id. The presence of comparable facts in other settings favors the view that such "uncompensated" hours should in fact be considered as compensated, and should receive an allocation of cost in the labor reporting system. Id., supra section 6-410. Cf. FAR 31.201-6(e)(2).

However, other statements in the opinion are more sweeping and suggest that the Government reimburses unallowable cost ***whenever*** salaried employees perform lobbying efforts outside normal business hours:

> Because Raytheon's incurred-cost submissions accounted only for unallowable costs incurred during regular hours and ignored after-hours lobbying, they do not accurately reflect the proportion of time that Raytheon's employees spent on unallowable activities.

Raytheon, 56 F.4th at 1343.

The Government may cite this statement in future cases involving ***any*** unallowable cost incurred as uncompensated overtime. Moreover, the future use of the opinion in litigation may not be limited to allocation of unallowable activities. If, as the court states, ignoring uncompensated overtime renders inaccurate the allocation of incurred cost data to an unallowable activity, it has the same effect on allowable cost data, including for example allocation of allowable labor cost to final cost objectives. The language of the court in *Raytheon* may thus provide support to audit challenges wherever uncompensated overtime is present.

The fact that the issue is fundamentally one of cost allocability provides one final twist. The contractor pointed out the relevance of its disclosed CAS accounting practices, but the Circuit brushed it aside stating the contractor's "CAS disclosure statements were not in evidence." Id. Issues of cost allocability are within the exclusive jurisdiction of the CAS Board. 41 USCA § 1502(a)(1). To date, the CAS Board has not issued guidance on uncompensated overtime. Should the

Board at some future date pronounce on the subject there is no guarantee it would line up with the holding of *Raytheon.*

Organization Costs: The Organization cost principle, FAR 31.205-27, identifies as unallowable the costs of "planning or executing" an organization or reorganization including a merger or acquisition. The cost principle relates back to a provision in the 1940 Treasury Guidance, TD 5000, making the legal and accounting costs of "reorganizations" unallowable. The same prohibition carried forward into the initial 1948 Armed Services Procurement Regulation (ASPR) ("organization or reorganization"). Manos, 2 Government Contract Costs & Pricing, Section 34:2, fn. 1 (June 2021 update).

In May 1969 a revised ASPR added the words "planning or executing" as modifiers to "organization or reorganization." Id. at Section 34:3. The apparent purpose of the change was to clarify that the cost disallowance extended to unconsummated reorganizations as well as transactions that were completed. Id. at Section 34.4 (citing *Dynelectron Corp.,* ASBCA 20240, 77-2 BCA ¶ 12,835). Neither the cost principle itself nor any decided case law had defined the terms "planning or executing." Case law under the cost principle predominantly addressed the definition of "organization," "reorganization," or "merger." E.g., *Navgas, Inc.,* ASBCA 9240, 65-1 BCA ¶ 4533; *Boeing Co.,* ASBCA 14370, 73-2 BCA ¶ 10,325; *Raytheon Co.,* ASBCA 57743, 17-1 BCA ¶ 36,724.

The principal underlying tension in seeking to define "planning" is between FAR 31.205-12, Economic Planning Costs, and FAR 31.205-27. The former costs are allowable but the latter are not and the word "planning" bridges the gap between them. Attempting to provide clear guidance to its personnel, the contractor prescribed a "bright line" test—planning commenced at the point the company in the case of an acquisition submitted "an indicative offer," and in the case of a divestiture made "the decision to 'go to market' with the offering materials." *Raytheon*, 21-1 BCA ¶ 37,796 at 183,524. The Board found this dividing line reasonable:

> In sum, Raytheon's "bright-line" policy represents a reasonable reading of the FAR provisions governing organization, economic planning, market planning and selling costs, and applying the *General Dynamics* [*Gen. Dynamics Corp.*, ASBCA 49372, 02-2 BCA ¶ 31,888, rev'd in part on other grounds, *Rumsfeld v. Gen. Dynamics Corp.*, 365 F. 3d 1380 (Fed. Cir 2004); 46 GC ¶ 217] standard, it was not unreasonable for Raytheon to treat the costs at issue as allowable.

Id. at 183,529.

The Circuit reversed, holding that the bright line test did not accurately identify the borderline between economic planning and organization costs, but offering little help in identifying just where that line lies, providing instead only an offering of examples:

> By only reporting time after the submission of an indicative offer or the decision to go to market with offering materials—the bright-line rules—Raytheon's corporate policies are plainly inconsistent with the regulation. As a matter of both logic and common sense, a decision on submitting an offer or to go to market cannot be made unless at least some planning for that offer or the offering materials has occurred.

Raytheon, 56 F.4th at 1343.

This language points in the direction of a dividing line at the point at which the contractor has identified at least tentatively an acquisition target or in the case of a divestiture has identified a business unit or segment to be divested. However, instead of developing this thought, the court went on to introduce a new concept—"preliminary planning:"

> Even identifying the subject of the decision involves preliminarily planning the acquisition or divestiture and is, per the regulation, unallowable. And, naturally, more preliminary planning must be involved before the Acquisition Counsel can capably decide what to do.

Id.

The court's reference to "preliminary planning" is problematic since the phrase is not found in the regulations and could further complicate the definitional task. Based on the court's language, preliminary planning takes place, not only before the events identified in the bright line test, but also even ***before*** the contractor identifies a subject to be considered for divestiture or acquisition. It thus extends, in the court's view, to a period far earlier than a decision even to consider a particular acquisition or divestiture, a period far more logically associated with long-term economic planning.

Nevertheless, the court explicitly rejects a definition of unallowable "planning" as limited to "planning for a *specific* acquisition or divestiture," offering three supporting reasons. First it notes that the contractor's bright line test is incompatible with such a definition. Id. at 1344. Second, it denies that any overlap exists between FAR 31.205-12 and 31.205-27 requiring any conflict resolution. And, third, "[e]ven if it can sometimes be difficult to determine whether a specific activity generates allowable economic-planning costs or unallowable corporate-reorganization costs," such does not justify the bright line test the contractor applied—"at points obviously later than the FAR permits." Id.

The court's reasoning rejecting target identification as an acceptable divider between corporate planning costs and reorganization costs is not compelling and suggests that we have not had the last word on the subject. The point at which the corporation by consensus has identified an acquisition target provides an alternative bright line test differentiating firm acquisition activity from inchoate corporate development activity measuring and weighing acquisitions against other forms of corporate growth. A similar modified bright line test would fix the frontier at the point of identification of a business unit to be divested. Prior to that point divestiture would be only one of perhaps several alternatives for addressing a business unit in need of corporate attention. The fact the Circuit rejected the contractor's particular bright line test here, does not detract from the utility of an alternative bright line test as benefiting sound contract administration and discouraging future disputes.

***OST, Inc. v. Dep't of Homeland Sec.*, CBCA 7077, 7103, 23-1 BCA ¶ 38,414**—The Federal Emergency Management Agency (FEMA) issued a cost-plus-fixed-fee contract to OST Inc. in 2008 requiring OST to administer certain insurance and pension fund services for the National Flood Insurance Program. The contract fee was to be paid in installments "based on the percentage of completion of work" at least monthly. The contract was repeatedly extended, and FEMA appropriated funds on an incremental basis over more than 11 years. FEMA paid OST all funds that were obligated, except for approximately $2.67 million, which were obligated for portions of the 2011 and 2012 performance periods.

OST subcontracted in 2009 with AmeriClaim Inc. (AmeriClaim). The subcontract was later assigned to AmeriTask LLC (AmeriTask), for work under the prime contract through December 2015. The subcontract was described as cost-plus-fixed-fee, but in fact, it was a cost-plus-percentage-of-cost (CPPC) subcontract, providing for payment of costs incurred plus eight percent of total subcontract cost as fee. AmeriTask invoiced OST monthly, but in 2010, it realized that it had failed to invoice for a significant amount of costs in 2009. The specific amount had not been fully determined, but AmeriTask estimated in October 2010 that from early 2009 through September 2010, unbilled amounts were somewhere between $750,000 and $925,000.

AmeriTask in 2011 hired an independent auditor to review its accounting system. The auditor concluded that its account system was compliant with Generally Accepted Accounting Principles. In August 2011, AmeriTask submitted revised invoices for 2009 and 2010 for the asserted underbilling. AmeriTask then engaged another Government contracting accountant to audit its records, methods, and practices, and in 2013, presented OST with a summary of underbillings for 2009–2012. OST requested that AmeriTask audit the 2011 and 2012 amounts, and AmeriTask then resubmitted a report of underbillings just for 2009 and 2010.

OST did not notify FEMA of this issue until February 2014, when it received the revised report from AmeriTask, which OST forwarded to the contracting officer. FEMA raised certain questions about documentations, and OST informed AmeriTask that it would resubmit the request for payment to FEMA after AmeriTask provided the requested records. In response, AmeriTask hired another firm to prepare incurred cost spreadsheets for each year, from 2009 through 2013, which AmeriTask submitted to OST on May 11, 2016. The findings showed underbillings of $1,130,664. OST did not inform FEMA of this amount, and on Feb. 28, 2017, AmeriTask submitted a certified claim for the amounts to OST.

OST, in turn, submitted the claim to FEMA on June 14, 2017, requesting a final decision, and then resubmitted the claim on June 14, 2017, adding OST's G&A markup and addressing potential procedural defects highlighted by the Government. After more than three years of silence, OST appealed on the basis of a deemed denial—coincidentally, just after the Government had finally issued a decision denying the claim in full. OST, in its complaint, increased the amount sought to $1,979,297, asserting that AmeriTask conducted another audit of its books and records and found that the claim had been understated "due to variances related to AmeriTask's overhead and G&A indirect rates." After close of discovery, both parties moved for summary judgment.

The Board first considered whether OST had presented valid claims, concluding that it had. However, the Board rejected OST's upward revision of its claim amount. It is true that a contractor can increase or decrease the amount sought on appeal without affecting jurisdiction. However, OST's claim was based on the Government's alleged failure to pay invoices presented to it. Per the Board, there cannot be a breach of a payment clause until the appellant requests payment and the Government rejects the request. OST had not presented the amount it sought to the CO in an invoice, so there could be no breach regarding the additional amounts OST sought in excess of the original claim.

Next, the Board turned to the funding and cost limitation issues raised by the Government. FEMA argued that the claims were barred by the limitation of funds (LOF) clause, the availability of funds (AOF) clause, and the limitation of costs (LOC) clause (FAR 52.232-22, 52.232-18, and 52.232-20, respectively). Under the AOF clause, "[t]he Government's obligation under th[e] contract is contingent upon the availability of appropriated funds from which payment for contract purposes can be made." *OST*, 23-1 BCA ¶ 38,414 at 186,666. Under the LOF and LOC clauses, the estimated costs constitute a ceiling on the Government's liability, and if, at any point during performance, the contractor " 'has reason to believe that the costs it expects to incur under this contract in the next 60 days, when added to all costs previously incurred, will exceed 75 percent of ... the total amount so far allotted to the contract by the Government,' the contractor has to notify the contracting officer." Id.

OST did not provide notice but argued that exceptions applied that prevented the Government from applying the clauses anyway. First, it argued that there was available, obligated funding under the contract that had not been expended and could be used to pay the claimed amounts. But this ignores how appropriations law functions. The funds were only available for 2011 and 2012, while OST's claim incurred costs from 2009, 2010, and 2013, for which appropriated funds had been expended. FEMA is prohibited by law from using funds for one year to pay obligations generated in a different fiscal year.

Second, there is an exception where contractors have no reason to know, and cannot have known, of an imminent cost overrun. But here, AmeriTask informed OST of a potential underbilling in 2010. Additionally, the Board held that OST was responsible for ensuring that its subcontractor maintain an accounting and financial reporting system to secure timely knowledge of probable overruns before costs are incurred and to properly evaluate the financial data generated by the accounting system. Given that OST knew of the problems with AmeriTask in 2010, did not inform FEMA, and per the Board, OST "did not take immediate steps to expedite a solution to AmeriTask's problem," it cannot claim this exception. Id. at 186,669. Further, the Board noted that the exception only applies if failure to give notice is the *sole* basis for the CO's decision not to fund the overrun. Here, however, the CO denied the claim because OST did not have sufficient data to show that the costs were allowable, reasonable, and allocable, and because OST had failed to monitor its subcontractor to ensure that it had an acceptable accounting system that would report costs accurately during performance. In short, the Board found that OST was precluded from recovering for cost overruns in

2009, 2010, or 2013, but may still be able to pursue costs for 2011 and 2012.

Additionally, the Board found that aspects of the claim were likely barred by the statute of limitations. Per FEMA, OST knew or should have known of the underbilling at latest more than six years before it submitted the earlier of its two claims. OST argued that the claim was based on the Government's failure to pay invoices in 2017. But per the Board, a party cannot keep a claim alive indefinitely by "merely refraining from doing" an act within its power where the contract required the contractor to submit an invoice by a particular date. Id. at 186,670. FEMA argued that OST was required to include all costs in monthly invoices as the costs were incurred, and the Board agreed that the contracts at issue here obligated both OST and AmeriTask to invoice all costs contemporaneously with their incurrence. OST also attempted to rely on the Federal Circuit's decision in *Kellogg Brown & Root Servs., Inc. v. Murphy*, 823 F.3d 622 (Fed. Cir. 2016); 58 GC ¶ 194, for the proposition that its claim could not have accrued until it knew or could have known of a sum certain which only occurred when AmeriTask submitted its claim to OST. The Board rejected this argument, explaining that this was arguably dictum, but in any case, the reason OST could not present a sum certain until 2017 was due to the failure of it and its subcontractor, not for reasons outside its control. The statute of limitations issue may not ultimately prove fatal to OST's entire claim, but it remains to be determined which parts of the claim were incurred more than six years before OST presented the claim.

Finally, FEMA argued that recovery was barred entirely because the subcontract is an illegal CPPC contract. According to the Board, citing the Federal Circuit, "Where a subcontract violative of the prohibition [on CPPC contracts] is made—in whatever form or disguise—it is plainly invalid at least insofar as establishing an obligation on the Government to make reimbursement of an amount representing the subcontractor's claimed costs plus a percentage of such costs." Id. at 186,672 (quoting *Urban Data Sys., Inc. v. U.S.*, 699 F.2d 1147, 1151 (Fed. Cir. 1983) (quoting 33 Comp. Gen. 533, 536 (1954))). The prime contract included FAR 52.244-2, which specifically prohibits subcontracts on a CPPC basis. The subcontract was plainly a CPPC contract. However, OST argued that in fact, the parties interpreted the subcontract in practice as a cost-plus-fixed-fee, rather than CPPC contract, paying a set amount calculated at the outset of each performance period based on what the parties expected AmeriTask to bill. While the Board disagreed, finding that the subcontract was plainly an illegal CPPC contract, that does not inherently preclude recovery. Instead, it entitles the contractor "to a quantum meruit recovery for the reasonable value of the services received" by the Government. Id. at 186,673. Such amount is not necessarily the amount AmeriTask incurred, but rather, the value of the services, limited to the provable costs (i.e., the amount incurred by the subcontractor).

The Board's decision arguably errs in conflating OST with its subcontractor, AmeriTask. A prime contractor's obligations to manage its subcontractors are not the same as the prime contractor's obligations to the Government. In this case, OST's subcontractor repeatedly revised its assessment of the supposed underbilling at issue, conducting multiple audits over several years. Can OST really be said to have been aware, or able to be aware, of the claim before AmeriTask presented it with a firm amount in 2017, after its full audit? Should OST have informed FEMA that its subcontractor was vaguely alleging some issue of underbilling when the details were not clearly stated and the review was underway at best? The Board's decision strongly suggests that, particularly where LOF, LOC, or AOF funds are at issue, contractors need to inform their customers of even vague suggestions of underbilling as early as possible, or risk losing the ability to recover those amounts later. And in this case, OST will face a steep uphill battle to establish the value of the services the Government received from AmeriTask, and only for the portions of 2011 and 2012 that are not otherwise time barred.

***Allard Nazarian Grp., Inc.,* ASBCA 62413, 62414, 23-1 BCA ¶ 38,408 (July 27, 2023)**—*Allard Nazarian* is an interesting case because it stands for what should be obvious propositions, but propositions that were nonetheless challenged by the Government.

Allard Nazarian Group Inc. (Allard) purchased Scandia Manufacturing Co. Inc. (Scandia) in 2008. At that time, Scandia held three contracts relevant to the appeal, which were transferred to Allard through an approved novation agreement. These were indefinite-delivery, indefinite-quantity (IDIQ) contracts that were performed on a time and materials basis (T&M). Like most T&M contracts, these contained fixed hourly labor rates, providing that the contractor would be reimbursed for its actual hours at the fixed hourly rates. The contracts also provided for reimbursement of certain other costs, such as material costs, on the basis of actual costs incurred. The same was true of the fourth contract at issue in this appeal, which had been awarded directly to Allard. All four contracts contained FAR 52.232-7 (Payments under Time-and-Material and Labor-Hour Contracts), and the Board found that all contained FAR 52.216-7 (Allowable Cost and Payment), either expressly or by operation of the *Christian* doctrine. The reimbursable costs arguably included the actual direct costs and a pre-negotiated burden rate, rather than a traditional indirect cost rate subject to FAR 52.216-7, although that issue was not before the Board in this decision.

In 2019, the Defense Contract Management Agency issued a final decision and demand for payment from Allard due to "Allard's/Scandia's failure to submit indirect cost rate proposals for Fiscal Years 2007-2009." *Allard Nazarian Grp.*, 23-1 BCA ¶ 38,408 at 186,621. The Government unilaterally applied a 20 percent decrement to *all costs billed and paid for* under the subject contracts, including the direct, fixed rate labor costs. The Government did the same for FYs 2010–2014, applying a 16.4 percent decrement.

On appeal, Allard moved for partial summary judgment as it pertained to the Government's decrement of the fixed hourly rate charges for labor costs. The Government contended that this was appropriate because Allard's failure to submit indirect cost rate proposals rendered the Government unable to verify amounts Allard had invoiced for the entire period of time at issue.

The Board's decision recounted basic principles of T&M contracts. Per FAR 16.601, a T&M contract "provides for acquiring supplies or services on the basis of – (1) [d]irect labor hours at specified fixed hourly rates that include wages, overhead, general and administrative expenses, and profit; and (2) [a]ctual cost for materials (except as provided for in [FAR] 31.205-26(e) and (f))." Id. at 186,623. The Government pays the contractor's labor upon submission of an approved voucher based on the contract's fixed labor rates, i.e., the rates "prescribed in the contract for payment for labor that meets the labor category qualifications of a labor category specified in the contract." Id. (citing FAR 52.232-7(a)). Materials, which are defined broadly per FAR 52.232-7(b), are paid on the basis of cost, including applicable indirect costs.

The Board then addressed basic concepts of indirect cost reimbursements. Indirect costs are invoiced during performance based on estimates. After the contractor's fiscal year, it then submits "indirect-cost rate proposals, which provide a schedule of all claimed expenses," and the parties establish final annual indirect cost rates consistent with FAR subpt. 42.7. Id.; see FAR 52.216-7(d).

The Government argued before the Board that FAR 52.216-7 "applies to both the time and labor portions of T&M contracts in accordance with FAR 16.307." Id. at 186,624. This argument ignores and contradicts the plain language of the regulation. FAR 16.307(a)(1) explains that for T&M contracts, "the clause at 52.216-7 applies in conjunction with the clause at 52.232-7, but only to the portion of the contract that provides for reimbursement of materials (as defined in the clause at 52.232-7) at actual cost." The Government raised perplexing arguments to circumvent the unambiguous regulatory terms, for example, by arguing that regulatory history of versions of the clauses that are *not* in the contracts here were intended to clarify that FAR 52.216-7 is to be used in conjunction with FAR 52.232-7. This is true, but irrelevant, given that the use of FAR 52.216-7 in conjunction with FAR 52.232-7 is unambiguously restricted to the reimbursement of materials, not reimbursement of labor at the pre-established rates based on time incurred. The Government also argued that FAR 52.216-7(g) permits decrements to all billed costs, because it provides that:

> Audit. At any time or times before final payment, the Contracting Officer may have the Contractor's invoices or vouchers and statements of cost audited. Any payment may be - (1) Reduced by amounts found by the Contracting Officer not to constitute allowable costs; or (2) Adjusted for prior overpayments or underpayments.

Id. at 186,625. The Government misread this provision, which does not authorize the Government to apply an arbitrary decrement based on lack of support, but instead, permits the Government to adjust contract payments where it finds costs to be unallowable.

Even setting aside the clear inapplicability of FAR 52.216-7 to the time component of a T&M contract, it does not even permit a decrement to direct *costs* based on the Government's authority to establish indirect rates on a unilateral basis in some cases.

In sum, the Board explained:

> We see nothing in any of the regulations cited by the government that supports the proposition the government may apply or impose a government-determined final indirect cost rate upon a contractor's direct labor costs - costs that are determined by contractually mandated and agreed upon hourly labor rates. The government has not cited any other authority that specifically allows it to assess a decrement upon direct labor on a time and materials contract where the contractor has failed to submit an auditable final indirect cost rate proposal. The government's imposition of an indirect cost rate decrement upon appellant's fixed labor costs is unreasonable as not supported by the regulatory authorities cited by the government and contrary to the traditional demarcation between direct and indirect costs and the separate treatment of those costs. *See Kearfott Guidance & Navigation Corp.*, ASBCA No. 49271 et al., 04-2 BCA ¶ 32,757 at 162,028 (government not entitled to apply decrement factor to adjust G&A rate where estimated amount "is unsupported by any credible evidence in the record of reasonableness").

Id. at 186,627.

The Government made one further argument. Per the Government, FAR 52.216-7(d)(2)(iii)(K) required the contractor to submit a "[s]ummary of each time-and-materials and labor-hour contract information, including labor categories, labor rates, hours, and amounts; direct materials; other direct costs; and, indirect expense applied at claimed rates." Id. Absent this information, the Government claimed that it could not validate direct labor costs claimed and paid. This, too, was rejected. FAR 52.232-7 clearly permits the Government to audit invoices and substantiating material and reduce amounts paid that were not properly payable. As the Government recognized, that clause also includes detailed requirements for invoicing of labor costs, specifies the support required, and permits the Government to withhold amounts. The Government's interests are protected by FAR 52.232-7, without the need to reference the inapplicable FAR 52.216-7.

Having gone through this lengthy analysis and explanation of basics, the Board granted Allard's motion, and confirmed the fundamental principles underlying T&M contracts.

***Northrop Grumman Corp.*, ASBCA 62165, 23-1 BCA ¶ 38,394;** 65 GC ¶ 224—In *Northrop Grumman*, the ASBCA granted a DCMA motion for partial summary judgment disallowing a portion of the contractor's defined benefit pension plan costs. Northrop's pension plan calculated benefit payments using a formula based in part on employee compensation and did not exclude from the calculations the portion of compensation that exceeded employee compensation caps. FAR 31.205-6, Compensation for personal services, limits allowable employee compensation based on statutory caps, adjusted annually for inflation. FAR 31.205-6(p). It was undisputed that the pension plan payments themselves did not constitute "compensation" subject to the caps. The Board nonetheless ruled that the portion of pension plan payments corresponding to above-cap compensation was unallowable because the costs (1) were "directly associated costs" of unallowable above-cap compensation and (2) did not satisfy the FAR 31.201-3 "reasonableness" test.

The FAR references two categories of pension plans: "defined contribution" plans and "defined benefit" plans. See FAR 31.205-6(j)(1). "Defined contribution" pension plans are pension plans funded by employees directly, augmented by fixed contributions from their employers during the term of employment. Benefit payment amounts are determined by the total funds in the plan when the employee retires. "Defined benefit" plans, by contrast, provide participants periodic fixed benefit payments during retirement, with the employer responsible to contribute whatever amount is needed to support the plan payments, typically drawn from a general pool rather than an individual account for each employee.

FAR 31.205-6(p) defines "compensation" as the "total amount of wages, salary, bonuses, deferred compensation [excluding pension costs], and employer contributions to defined contribution pension plans." Notably, "employer contributions to *defined contribution* pension plans" are the only pension costs included. Defined *benefit* pension plan payments are not addressed in FAR 31.205-6(p) and are not considered "compensation" subject to the cap.

Northrop Grumman offered a defined benefit pension plan for certain company executives, referred to as a "top hat" plan, which was calculated in a typical manner for such plans based in part on total compensation in addition to years of service and other factors. Northrop included payments made under that plan in its allowable costs for fiscal year 2012. In a 2017 audit report, DCAA questioned the portion of Northrop's defined benefit pension plan costs "based on unallowable salary in excess of the FAR 31.205-6(p) compensation" and asserted that such costs were "directly associated with expressly unallowable costs under FAR 31.205-6(p)." *Northrop*, 23-1 BCA ¶ 38,394 at 186,556. DCMA disallowed the costs in a 2019 CO's final decision, and Northrop appealed.

Northrop argued on appeal that its defined benefit pension plan payments are made allowable by FAR 31.205-6(j), which says that "Pension costs are allowable subject to" CAS 412, CAS 413, and other "cost limitations and exclusions" in subparagraphs (j)(2)-(6) that Northrop said did not apply to the pension costs in question. *Northrop*, 23-1 BCA ¶ 38,394 at 186,558. The Government countered that 31.205-6(j)(5) says pay-as-you-go pension costs such as Northrop's "are allowable *to the extent they are not otherwise unallowable*," and thus permitted challenges based on other cost principles. Id.

The ASBCA agreed with the Government that neither the allowability language in FAR 31.205-6(j) nor the exclusion of defined benefit pension plan payments from capped compensation prevented the costs from being challenged as directly associated costs or on reasonableness grounds.

The Board first considered the Government's argument that the portion of the pension payments corresponding to above-cap compensation was "directly associated" with unallowable above-cap compensation costs. CAS 405 provides the following definition:

> *Directly associated cost* means any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred.

48 CFR § 9904.405-30. The FAR cost principles use an identical definition, and go on to state that "When an unallowable cost is incurred, its directly associated costs are also unallowable." 31.201-6(a). The Board concluded that the challenged portion of Northrop's pension payments was "generated solely as a result of" unallowable above-cap compensation costs and that Northrop would not have incurred those costs had it not incurred employee compensation costs above the allowable limits. *Northrop*, 23-1 BCA ¶ 38,394 at 186,559–186,562. Northrop argued that it could readily have excluded above-cap compensation from the pension benefit calculations and arrived at the same result by adjusting other multipliers. The Board said it would not speculate about other ways Northrop could have structured its plan but would only consider the actual pension plan at issue in the appeal. Because that plan was explicitly calculated based on compensation, including compensation above the FAR limits, the costs were directly associated costs. *Northrop*, 23 BCA ¶ 38,394 at 186,561.

The pension costs at issue in this case arguably do not have as close a nexus to the underlying unallowable costs as normally found with directly associated costs. The pension plan payments are not a cost that flows naturally from an unallowable cost or activity, as typical directly associated costs do, such as travel or salary expenses associated with lobbying activities or entertainment, or legal and collection costs associated with bad debts. Rather, the pension plan payments only relate to employees' compensation (including unallowable above-cap compensation) because the contractor chose to use a formula benchmarked to compensation. The Board held, however, that because the directly associated costs would not have been incurred but for the underlying unallowable cost and varied incrementally with the unallowable cost to which they relate, that was sufficient to satisfy the FAR and CAS tests for a directly associated cost.

Directly associated costs differ from other unallowable costs, because disallowance of directly associated costs generally requires a finding of materiality: "When a selected item of cost under 31.205 provides that directly associated costs be unallowable, such directly associated costs are unallowable **only if determined to be material in amount**." FAR 31.201-6(e)(3) (emphasis added). See Manos, 2 Government Contracts Costs & Pricing § 66:3 ("In contrast to other types of unallowable costs, which are unallowable irrespective of the dollar amount, directly associated costs are treated as unallowable only if material in amount."). The FAR instructs that materiality determinations should consider: "(i) The actual dollar amount; (ii) The cumulative effect of all directly associated costs in a cost pool; and (iii) The ultimate effect on the cost of Government contracts." FAR 31.201-6(e)(1). There is an exception to the materiality test: it need not be applied "in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy." FAR 31.201-6(e)(3).

The *Northrop* opinion does not address the materiality of the challenged pension plan costs. Without stating so explicitly, the decision suggests that any allowance of pension payments derived from above-cap compensation would be contrary to public policy, citing Congress's intent in the underlying statutes to cap compensation for Government contractor employees. *Northrop*, 23-1 BCA ¶ 38,394 at 186,564–186,565, n. 17; National Defense Authorization Act for Fiscal Year 1998, P.L. 105-85, § 808, 111 Stat. 1629, 1636 (1997); National Defense Authorization Act for FY 2012, P.L. 112-81, § 803, 125 Stat. 1298, 1305 (2011). The Board agreed with the Government that "[i]f Congress intended to limit the Government's payment of contractor employees during their working years, it is an absurd conclusion that Congress intended for the very same employees, upon retirement, to receive an unlimited benefit payment simply because NG utilized a pay-as-you-go defined-benefit pension plan." *Northrop*, 23-1 BCA ¶ 38,394 at 186,565.

In any case, the ASBCA also held, as an alternative basis for upholding the disallowance, that Northrop failed to establish that its pension costs were reasonable under FAR 31.201-3. That section states that "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business," and refers to a number of factors relevant to reasonableness. FAR 31.201-3(a)–(b). The Board ruled that Northrop's inclusion of above-cap compensation in calculating its pension benefit payments failed to meet factor (b)(3): "The contractor's responsibilities to the Government … and the public at large."

In so doing, the Board relied on its earlier decision, *DynCorp Int'l LLC*, ASBCA 61950, 20-1 BCA ¶ 37,703, which disallowed certain contractor severance payments on grounds that the payment amounts were calculated in part based on employee compensation, without adjustment for applicable caps. Severance payments, like defined benefit pension plan payments, are not a form of compensation directly covered by the FAR employee compensation cap. Nevertheless, the *DynCorp* Board held that, to the extent the severance payments derived from above-cap compensation, they were unallowable because they were not reasonable, specifically because they failed to satisfy the contractor's responsibilities to the Government and the public "not to claim salary costs over the statutory limit." *DynCorp*, 20-1 BCA ¶ 37,703, at 183,043; FAR 31.201-3(b)(3). The Board viewed severance payments derived from above-cap compensation as a form of loophole, which it sought to close: "[T]here is nothing magic about a severance pay calculation that converts unallowable salary into allowable severance payments …. Bottom line: unallowable salary cost used in a severance pay calculation results in unallowable severance costs—unallowable in, unallowable out." Id. at 183,043–044.

Applying the same reasoning in *Northrop Grum-*

man, the Board found that “the methodology utilized by appellant to determine its pension benefit payments is unreasonable as the formula does not exclude the over-the-cap compensation and results in increased pension costs based upon unallowable bonus and salary.” *Northrop*, 23-1 BCA ¶ 38,394 at 186,565. The Board was unpersuaded that the statutory language or regulatory history indicated an intention not to impose *any limits* on defined benefit pension plan payments just because such payments are not directly subject to the compensation cap. Id. at 186,566–567. The regulatory history seemed to suggest the Defense Acquisition Regulations Council committee only excluded defined benefit plan payments so that the overall compensation limits would align with Securities and Exchange Commission benchmark data used to establish the amount of the caps. Id. The Board did not identify any other reason to limit the application of *DynCorp* to severance payments, either.

The reasonableness inquiry examines the nature and amount of costs that a hypothetical prudent businessperson would incur. Defined benefit pension plan payments and severance payments are not inherently unreasonable in nature. And a contractor’s responsibility not to pay compensation over a statutory limit does not, in and of itself, impose any limit on the amount of defined benefit pension plan payments or severance payments that are not subject to the cap. If pension and severance payments are generally consistent in nature and amount with what other businesses in the commercial marketplace are providing, they should arguably pass the reasonableness test. After all, the pension plan and severance amounts could have been calculated on a different basis independent of compensation and reached the same result. *Northrop Grumman* and *Dyncorp* suggest, however, that the Board may view payments derived from above-cap compensation as, in effect, attempts to circumvent the statutory limits.

Contractors are well advised to structure compensation that is not subject to the FAR employee compensation limits at FAR 31.205-6(p) so that payment amounts bear no mathematical relationship to—and are otherwise completely independent of—capped compensation. That should improve the likelihood that the costs will be fully reimbursed.

By statute, the cost principles must “define in detail and in specific terms those costs which are unallowable, in whole or in part, under covered contracts.” 10 USCA § 3745. When costs are challenged even though they fall outside the “detailed and specific terms” made unallowable by the cost principles, that makes it more difficult for contractors to operate. *Northrop* and *Dyncorp* demonstrate that in practice optics matter and the Board may interpret the cost principles broadly to curb contractor practices viewed as contrary to underlying public policy interests—though as Northrop pointed out, by doing so the Board may risk going beyond interpreting regulations to effectively promulgating them, encroaching on the proper role of the FAR Council.

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