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SECOND SERIES



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ALLOWABILITY OF LEGAL COSTS

By Karen L. Manos

The costs of contractors' legal fees have frequently been subjected to challenge by Government auditors, particularly when, in the Government's view, the costs would not have been incurred but for some prior wrongdoing. This BRIEFING PAPER provides an overview of the provisions of the two Federal Acquisition Regulation cost principles governing the allowability of costs of legal fees: FAR 31.205-33, "Professional and consultant service costs," and FAR 31.205-47 "Costs related to legal and other proceedings." In addition, the PAPER discusses how the courts and boards of contract appeals have interpreted these cost principles where the Government has challenged the recovery of a contractor's legal costs under various theories on the grounds that the costs were not allowable under or allocable to the contract.¹

Professional & Consultant Service Costs

FAR 31.205-33 governs the costs of professional and consultant services rendered by persons who are members of a particular profession or possess a special skill but are not officers or employees of the contractor.² It operates in tandem with FAR 31.205-47 and other cost principles that limit the allowability of the costs of certain activities that may require use of professionals or consultants, including FAR 31.205-3, "Bad debts"; FAR 31.205-20, "Interest and other financial costs"; FAR 31.205-22, "Lobbying and political activity costs"; FAR 31.205-27, "Organization costs";

FAR 31.205-28, "Other business expenses"; FAR 31.205-30, "Patent costs"; and FAR 31.205-38, "Selling costs." FAR 31.205-33 covers the allowability of costs of professional and consultant services generally, whereas FAR 31.205-47 covers the allowability of legal costs incurred for particular types of proceedings.³

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■ General Rules Of Allowability

Except when incurred in any of the circumstances listed in paragraph (c) of FAR 31.205-33 (making unallowable costs arising from illegal or improper business practices) and as may be limited by other applicable cost principles, the costs of professional and consultant services are generally allowable when reasonable in relation to the services rendered and not contingent upon recovery of the costs from the Government.⁴ Fees contingent upon anything other than recovery from the United States are allowable. For example, in *R-D Mounts, Inc.*, the Armed Services Board of Contract Appeals upheld the contractor's claim for legal fees that had not yet been billed by the contractor's attorneys, even though the fees were dependent upon the contractor's financial condition.⁵ The board rejected the Government's argument that the legal fees were unallowable "because the services were rendered on a contingency basis," stating that: "The contingent fees which are unallowable under [the cost principle] are those which are based on a percentage of recovery. The fees for which the claim has been made are not contingent upon recovery of the costs from the Government."⁶ On the other hand, in *RRP Construction Co.*, where a consultant who prepared the contractor's termination settlement proposal was to be paid an initial fee of \$100 plus 10% of any settlement amount, the board held that only the initial fee was allowable.⁷

Paragraph (d) of FAR 31.205-33 lists eight factors the Contracting Officer is required to consider in determining the allowability of

professional and consultant costs. These factors have remained the same since at least 1981⁸ and include such things as the necessity for contracting for the service and whether it can be performed more economically by employment; the qualifications of the individual or concern rendering the service and the customary fee charged; and the adequacy of the contractual agreement for the service.⁹ The Government has generally not fared well in challenging the reasonableness of a contractor's decision to retain professional services.

For example, *Cramp Shipbuilding Co. v. United States* involved a company formed at the request of the Navy to construct and convert naval vessels during World War II.¹⁰ The company was awarded 12 cost-plus-fixed-fee contracts, which represented more than 99% of its business. Because the company had no in-house attorneys, it retained outside counsel for all of its legal needs.¹¹ In addition, it retained the services of a public accounting firm to conduct an annual audit and prepare its financial statements.¹² Although the Navy initially reimbursed the costs as ordinary and necessary business expenses incident to the performance of the contracts, the General Accounting Office subsequently determined that the costs were unallowable and should not have been reimbursed.¹³ The Court of Claims disagreed, holding: "The expenditures in question were, it seems to us, in most cases indispensable to the operation of the plaintiff's shipyard. To do \$275,000,000 worth of business in five years without legal counsel or accounting assistance would have been reckless."¹⁴



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In *Baifield Industries, Division of A-T-O, Inc.*, the contractor retained the services of a law firm and a public accounting firm, both of which had considerable experience in Government contracting, to prepare a termination settlement proposal.¹⁵ The Termination Contracting Officer allowed only \$9,600 of the \$73,049 claimed for legal fees and \$6,000 of the \$130,653 claimed for accounting fees and disallowed the remainder as unreasonable. Among other things, the Government argued that much of the legal work was clerical or administrative and could have been performed more cheaply by the contractor's employees.¹⁶ The board concluded that it was reasonable for the contractor to "rely heavily on the experience and knowledge" of its outside counsel "for assistance, as well as guidance, in gathering and analyzing factual material relevant to support appellant's settlement problems."¹⁷ The board further observed that the Government's disallowance was "based on an unreasonably narrow view of the scope of legal services proper for use by a contractor when faced with a large, complex and thoroughly contested termination claim."¹⁸ The board similarly rejected the Government's arguments regarding the accounting fees and concluded that the entire amount claimed for both legal and accounting fees was allowable.¹⁹ The Government moved for reconsideration with respect to \$10,330 in air fares and per diem costs incurred by the contractor's Washington, D.C.-based attorneys, arguing that the Government "should not be required to bear the additional costs resulting from appellant's decision to use counsel who had to travel a considerable distance when counsel closer to appellant's records and personnel could have been retained."²⁰ The Government asked the board to "take official notice of the competence of several Dallas, Texas, law firms in public contract law."²¹ Although taking such notice, the board denied the Government's motion for reconsideration, stating that the "recognized existence of Dallas-based attorneys competent in public contract law [did] not, in itself, warrant a change in [its] decision."²²

Even when the amount at issue is relatively small, the boards have consistently deferred

to the contractor's judgment regarding the need to retain professional services. In *R-D Mounts*, for example, the contractor incurred more than \$1,300 in legal fees to defend against a subcontractor claim for \$1,200 worth of material.²³ The board held that the amount was reasonable in view of the effort expended because the suit lasted a year and required two day-long court appearances.²⁴ The board also rejected the Government's argument that incurrance of the cost was unreasonable given the small potential liability, reasoning: "In our judgment no one can be accused of being imprudent for retaining an attorney when confronted with a possible lawsuit. Moreover at the outset of litigation the extent of the legal services which will be necessary cannot accurately be predicted."²⁵

Fire Security Systems, Inc. is one of the few decisions to question professional or consulting costs based on the factors cited in FAR 31.205-33(d), and it did so only in dicta.²⁶ This case involved the contractor's appeals of 25 different claims under a \$1.5 million contract for repair of fire protection systems at a veterans hospital. One of the claims was titled "Consultant Fees" and was based on the following rationale:²⁷

As part of Fire Security's administration of this contract, particularly the resolution of delay issues, it became necessary to engage the services of a consultant. A detailed description of the consultant's activities in furtherance of contract administration is in Attachment 22. As you know, the case law allows government payment of consultant's fees when incurred "to promote contract administration." *Bill Strong Enterprises v. Shannon*, 49 F.3d 1541 (Fed. Cir. 1995). Accordingly, Fire Security hereby requests that the Government pay \$203,810.

Attached to the claim were invoices submitted by the consultant, Michael Cassin, a retired general contractor. The contractor's president testified that Fire Security used Mr. Cassin's services on all contracts of \$1 million or more or of lengthy duration to "ghost write" correspondence, but did not have a written agreement with him. The president further testified that on this project, Mr. Cassin wrote nearly 99% of the correspondence that went out under the Fire Security letterhead, in addition to

helping prepare the requests for equitable adjustment.²⁸

The board was obviously unimpressed with Mr. Cassin and the services he provided. The opinion describes Mr. Cassin's letters as wholly unprofessional, sarcastic, confrontational, and derogatory and lacking any indication that Mr. Cassin knew anything about Government contracting.²⁹ The board began its analysis by considering whether Mr. Cassin's services met the definition of "professional and consultant services" in FAR 31.205-33(a):³⁰

If we apply the factors cited in FAR, Section 31.205-33, the recovery of these costs by Appellant would be problematical, at best. Under (a), we are not convinced that Mr. Cassin is an individual "who possesses a special skill" not otherwise available within the [contractor's] organization. Without his presence at the hearing, it is difficult to assess his qualifications. The other part of the quoted phrase: "and who are not officers or employees of the contractor" raises the pertinent issue as to whether someone who authors 99% of a contractor's correspondence on a great variety of issues arising during performance is *equivalent* to an "employee of the contractor."

Then, going through subsequent paragraphs of FAR 31.205-33, the board explained why it believed the costs would not be allowable:³¹

Under (b) of the FAR clause, such costs "are allowable...when reasonable in relation to the services rendered." Again, based only on the invoices and without Cassin's testimony, it is difficult to justify \$150 per hour to ghost write nearly all correspondence on behalf of the Contractor.

Under (d) of the clause, we seriously doubt that these services meet the criteria in the following sub-paragraphs: (2) The necessity of contracting for the service, considering the contractor's capability in the particular area; (6) Whether the service can be performed more economically by employment rather than by contracting. (In the 1994-95 period, one would expect to be able to employ a top-notch office manager, experienced in Government contracting for far less than \$150 per hour). Lastly, we are not satisfied that Cassin's qualifications warrant the size of his fee. Consequently, the record in this appeal does not satisfy subparagraph (7), "The qualifications of the individual or concern rendering the service and the customary fee charged, especially on non-Government contracts." Despite his attempts, [the contractor's president] was not the appropriate individual to explain how Mr.

Cassin's services meet the above-stated criteria. That individual was Mr. Cassin himself.

Under (e) of the FAR clause, subparagraph (3) requires a determination that "[t]he retainer fee is reasonable in comparison with maintaining an in-house capability to perform the covered services, when factors such as cost and level of expertise are considered." As previously stated, based on the record and without the testimony of Mr. Cassin, we cannot conclude that the retainer fee arrangement was reasonable.

Finally, under (f) of the clause, subparagraph (1) requires evidence of the details of all such agreements, such as "work requirements, rate of compensation and nature and amount of other expenses, if any." Because there was no written agreement, there is no written scope of work for the Board to examine in order to assess the reasonableness of the hourly fee and the necessity for the services themselves. Subparagraph (2) requires "[i]nvoices or billings submitted by consultants, including sufficient detail as to time expended and nature of the actual services provided." Although [the contractor's president] was able to tie some of the services to preparation of identifiable pieces of correspondence, he could only conjecture at the reasonableness of the number of hours assigned to a "meeting," a "review of documents," etc. Again, without more detail on the invoices and/or testimony by the consultant, most of [the contractor's president's] attempts to explain and justify the amounts on the invoices were often mere conjecture.

Ultimately, however, the issue was not one of allowability under FAR 31.205-33, but "recoverability [under FAR 31.205-47] of fees paid to a consultant for providing what amounts to contract administration tasks in the performance of a fixed-price contract."³² The board observed that in the cases on which the contractor relied, "recovery was generally granted for consultant services that were specifically tied to a particular request for equitable adjustment and/or negotiations, and which efforts were seen as a benefit to the contract purpose."³³ By contrast, the contractor retained Mr. Cassin prior to the preconstruction meeting and employed him throughout the contract as a contract administrator.³⁴ The board held that the costs of "such a position, when envisioned from the start of a project through its completion, is more properly classified as a part of the overhead costs of contract administration, however much the Contractor may have been willing to pay for such ser-

vices.”³⁵ In other words, while the contractor could properly include the costs in its indirect cost pools, it could not charge the costs directly to the contract.

Even when the contractor limited its claim to fees solely associated with the change orders and several defined problems, the board found that it did not change the essential nature of Mr. Cassin’s services. Moreover, the board held:³⁶

In order to qualify as an allowable expense under [FAR 31.205-47], consultant costs should “promote contract administration” in such a way that both the contractor and Government benefit from the process. *Bill Strong Enterprises, Inc. v. Shannon*, 49 F.3d 1541 (Fed. Cir. 1995). This consultant promoted nothing but hostility—hardly meeting the criteria of the FAR as interpreted by the Court in *Bill Strong*.

■ Unallowable Costs

FAR 31.205-33(c) delineates unallowable costs arising from illegal or improper business practices. Specifically, paragraph (c) makes unallowable the costs of professional and consultant services performed under any of the following four circumstances: (1) services to improperly obtain, distribute, or use information or data protected by law or regulation (e.g., FAR 52.215-12, “Restriction on Disclosure and Use of Data”); (2) services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award, whether award is by the Government, or by a prime contractor or subcontractor; (3) any other services obtained, performed, or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest; or (4) services performed that are not consistent with the purpose and scope of the services contracted for or otherwise agreed to.³⁷

■ Retainer Fees

FAR 31.205-33(e) imposes additional requirements to support the allowability of retainer fees. Retainer fees are fees paid to an attorney or other professional to provide professional services for a specific period of time on an as-

requested or as-necessary basis. They should not be confused with “retaining fees” (also commonly called a “retainer”), which are commonly required by counsel upon engagement to guarantee the client’s payment for future services and which are then billed on an hourly or other agreed upon basis as the services are provided.³⁸

Kalvar Corp. v. United States provides a useful example of the type of retainer fee contemplated by FAR 31.205-33(e).³⁹ In that case, the contractor retained an attorney for a 15-month period to perform various services, including preparation, filing, and litigation of the contractor’s breach of contract suit in the U.S. Court of Claims.⁴⁰ During the course of the litigation, the court requested supplemental briefing and indicated a willingness to compensate the contractor for the costs incurred, just as it would under a termination for convenience. However, because the contractor’s attorney was providing the services pursuant to a retainer agreement, the attorney did not bill and the contractor did not pay any additional fees for preparation of the supplemental brief.⁴¹ As a result, the court denied recovery, holding that the contractor was entitled to recover only the costs it actually incurred and not the value of its attorney’s services.⁴²

■ Documentation Requirements

FAR 31.205-33(f) requires that to be allowable, fees for professional and consultant services must be “supported by evidence of the nature and scope of the service furnished.” Additionally, to establish that the work performed is proper and lawful, the costs must be supported by evidence in each of the following three categories: (1) details of the agreement and actual services performed, (2) invoices or billings, including detail as to the time expended and nature of the services provided, and (3) consultants’ work products and related documents, such as trip reports, minutes of meetings, and collateral memoranda and reports.⁴³ These detailed documentation requirements grew out of “Operation Ill Wind,” the code name for a criminal investigation conducted during the mid-1980’s by the Naval Investigative Service and Federal Bureau

of Investigation into allegations of procurement fraud and collusion between Department of Defense officials, consultants, and defense contractors, and, more particularly, a July 8, 1988 Defense Contract Audit Agency proposal to the Defense Acquisition Regulation Council. Based on its nationwide audit of contractor's consulting costs, the DCAA reported that nearly one quarter of the professional and consultant service costs it reviewed were questionable, due largely to what the DCAA perceived as a "lack of adequate agreement/work product" or "contractors' inability to produce adequate evidence of the nature and extent of services received."⁴⁴

The Notice of Proposed Rulemaking, published on October 21, 1988, would have made the three categories of documentation optional, but like the final rule, did not expressly exclude material protected by the attorney-client privilege and attorney-work product doctrine.⁴⁵ The Cost Principles Committee rejected a suggestion by the Aerospace Industries Association that the three categories be made alternative, rather than cumulative, and adopted suggestions by the DOD Inspector General and the DCAA that all three categories of the documentation requirements be made mandatory.⁴⁶ By way of explanation, the Committee's report stated:⁴⁷

In order to effectively evaluate the propriety or legality of consultant activities, one has to check the agreement, the billings and the output and compare them against each other to ensure that, for instance, the billings make sense in light of the output received. If substantial funds have been paid to a consultant and yet there is little or no evidence of work having been performed by him, then that may be an indication that the funds are being provided and employed for suspect purposes (*e.g.*, bribes). It is necessary for Government personnel to look at each of these areas in order to determine that funds are not being spent on questionable activities; the extent is to be determined on a case-by-case basis.

The Committee also rejected suggestions that it expressly exempt privileged material, stating:⁴⁸

The Committee had included language exempting attorney-client privilege material in its original draft coverage. It was removed by the DAR Council apparently because of the concern that, with lawyers now involved in many

areas of consulting, lobbying and other "non-traditional" legal activities, this exemption would be used as an excuse for not providing support for consulting costs. If the commenters' changes were adopted, it could lead to abuses of the attorney-client privilege. Contractors could avoid providing documentation on the basis that mere involvement of a lawyer creates an attorney-client privilege. While the cost principle cannot override legal privileges granted by the courts, the Committee fears that blanket exemption based on claims of attorney-client privileges would engender abuses such as those described above. We are also concerned that such an exemption might encourage ordinary consulting activities being hidden within arrangements with lawyers or law firms.

Importantly, the Cost Principles Committee recognized that the cost principle does not and cannot "override" established legal privileges. Rule 501 of the Federal Rules of Evidence provides that except as otherwise required by law, evidentiary privileges "shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." The courts of the United States have long recognized both the attorney-client privilege and attorney work-product doctrine. The attorney-client privilege protects confidential communications—including both communications from a lawyer to a client and from a client to a lawyer—made for the purpose of facilitating the rendition of legal services to the client.⁴⁹ The attorney work-product doctrine, first recognized by the U.S. Supreme Court in *Hickman v. Taylor*⁵⁰ and now codified in Rule 26(b) of the Federal Rules of Civil Procedure, protects material prepared in anticipation of litigation or for trial by or for a party or the party's representative.⁵¹ It is "designed to protect material prepared by an attorney, acting for his client in anticipation of litigation";⁵² and "provides a working attorney with a 'zone of privacy' within which to think, plan, weigh facts and evidence, candidly evaluate a client's case, and prepare legal theories."⁵³

On May 9, 2002, the DCAA issued audit guidance on the documentation requirements under FAR 31.205-33(f) that may prove problematic.⁵⁴ According to DCAA's letter, the guidance was issued in response to questions re-

garding the documentation requirements. More particularly, it states: “Some contractors have opined that documentation is required only for one of the three categories listed in FAR 31.205-33(f). Some contractors have also argued that documentation of work performed by attorneys and/or certified public accountants are exempt from the requirements of FAR 31.205-33(f).”⁵⁵ With regard to the latter issue, the guidance states:⁵⁶

Regarding the issue of whether the consultant’s work product is always an absolute requirement for cost allowability, we believe that the third category of evidence is intended to require evidential matter in support of what work the consultant actually performed (in contrast to what work is planned to be performed in category one). Although a work product usually satisfies this requirement, other evidence may also suffice. Therefore, if the auditor has sufficient evidence demonstrating the nature and scope of the consultant work actually performed, the FAR 31.205-33(f)(3) requirements are met even if the actual work product (e.g., an attorney’s advice to the contractor) is not provided. If the nature and scope of the actual work performed cannot be determined and the contractor refuses to provide the work product, the auditor should question the costs as unallowable under FAR 31.205-33(f). However, the auditor should not insist on a work product if other evidence provided is sufficient to determine the nature and scope of the actual work product performed by the consultant.

Although the guidance correctly observes that evidence other than the work product itself can satisfy the requirements of FAR 31.205-33(f)(3), it erroneously suggests that the allowability of the consultant’s costs may be conditioned on the contractor’s willingness to provide privileged work product if the auditor determines the other evidence is insufficient. Equally as troubling, the guidance states that “if the contractor claims consultant costs in its indirect cost settlement proposal and fails to provide supporting evidence required by FAR 31.205-33(f), the auditor should recommend application of the penalty provided by FAR 42.709.”⁵⁷ Neither position is supportable.

As the Cost Principles Committee’s report expressly acknowledged, the cost principle cannot override the court-recognized privileges. Nor does anything in the cost principle—much

less the underlying statute—condition the allowability of consultant costs on a contractor’s willingness to waive an applicable privilege. Indeed, by its literal language, FAR 31.205-33(f) applies only to “consultants” and not “professionals” and is therefore not applicable to attorneys. Moreover, there may be serious consequences to disclosing privileged information to the DCAA. The U.S. Courts of Appeals for the First, Third, Fourth, Sixth, and District of Columbia Circuits have held that a party who voluntarily discloses to the Government documents shielded by the attorney-client privilege or work-product doctrine waives those privileges as to third parties, regardless of whether the disclosure to the Government is made pursuant to a confidentiality agreement.⁵⁸

The DCAA’s position with regard to the imposition of penalties is similarly flawed. Penalties are appropriate only for “expressly unallowable costs,”⁵⁹ which are defined as costs specifically named as unallowable by an express provision of law, regulation, or contract.⁶⁰ In addition, the ASBCA has held that to impose penalties, “the Government must show that it was unreasonable under all the circumstances for a person in the contractor’s position to conclude that the costs were allowable.”⁶¹ Costs of professional and consultant services are not made “expressly unallowable” because the DCAA is dissatisfied with the contractor’s evidence of the nature and scope of the services performed. Nor are they “expressly unallowable” because the contractor refuses to waive an applicable privilege. Thus, the imposition of penalties for such costs is plainly inappropriate.

Costs Related To Legal & Other Proceedings

While the FAR 31.205-33 “Professional and consultant service costs” cost principle governs the allowability of costs of professional and consultant services generally, the FAR 31.205-47 “Costs related to legal and other proceedings” cost principle governs the allowability of legal costs incurred for particular types of proceedings.

The requirements of both must be considered when determining the allowability of the costs of Government contractors' legal fees.

■ Background

Until 1989,⁶² FAR 31.205-47 was titled "Defense of fraud proceedings" and contained only definitions and what is now found in paragraph (b). Much of what is now found in paragraph (f) was contained in FAR 31.205-33. The "Defense of fraud proceedings" cost principle was added to the Defense Acquisition Regulation in 1982 in response to the ASBCA's decision in *John Doe Co.*,⁶³ a case involving the allowability of legal fees and related costs incurred by a contractor in connection with a criminal investigation of alleged labor mischarging. In that case, the Government argued that if the underlying labor costs had been recorded fraudulently, the costs of defending the validity of such costs were not allocable to the contract. The ASBCA rejected the Government's argument, stating that it ignored the distinction between the reimbursement of legal expenses as direct contract costs and the allocability of indirect general and administrative (G&A) expenses, which do not depend upon a direct relationship with a particular cost objective. The ASBCA also rejected as overbroad the contractor's argument that all legal defense costs were necessarily allowable. Although unwilling to "conclude that the reasonableness in nature and allocability of such costs may not be made to depend in some cases on the ultimate outcome of an investigation and prosecution," the ASBCA refused to accept the Government's stated basis for disallowance, holding that "such costs may not properly be disallowed simply because they are incurred in defense of such an investigation; nor may they be disallowed as not allocable, without regard to the circumstances, because some act of fraud might be established."⁶⁴

Two years later, the DAR Council approved a new cost principle, DAR 15-205.52, specifically disallowing reimbursement of costs incurred in the defense of criminal, civil, or administrative fraud proceedings brought by the Government when the action results in

(1) a conviction or judgment against the contractor, or (2) a decision to debar or suspend the contractor, or (3) is resolved by consent or compromise.⁶⁵ The cost principle required that the costs related to such proceedings (including administrative and clerical expenses, costs of legal services by in-house and outside counsel, costs of accountants, consultants, and others retained to assist the contractor, and the salaries and wages of employees, officers, and directors) be separately identified by the contractor and that payment for these costs should generally be withheld by the CO pending final disposition of the proceeding.⁶⁶ The cost principle provided, however, that the CO could make conditional payment upon provision of adequate security, or other adequate assurance, and agreement by the contractor to repay all unallowable costs, plus interest, if the costs were later determined to be unallowable.⁶⁷

When the FAR was published in 1983,⁶⁸ DAR 15-205.52 was renumbered FAR 31.205-47. Nominal changes were then made in response to the Defense Procurement Improvement Act of 1985 (part of the Department of Defense Authorization Act, 1986).⁶⁹ This Act provided that the following costs, among others, are not allowable under a covered contract:⁷⁰

Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded *nolo contendere* to a charge of fraud or similar proceeding (including filing of a false certification).

■ Major Fraud Act Of 1988

FAR 31.205-47 was significantly revised, effective April 17, 1989,⁷¹ with the implementation of the Major Fraud Act of 1988.⁷² Among other things, the Major Fraud Act amended the Federal Property and Administrative Services Act and the statutory listing of unallowable costs at § 2324 of Title 10 of the *U.S. Code* to make unallowable under a covered contract any costs incurred in connection with a criminal, civil, or administrative proceeding brought by the United States or

a state, if the proceeding (1) relates to a violation of, or a failure to comply with, a federal or state statute or regulation and (2) results in one of the following dispositions: (a) a criminal conviction or plea of *nolo contendere*, (b) a determination of contractor liability in a civil or administrative proceeding involving an allegation of fraud or similar misconduct, or imposition of a monetary penalty, (c) a final decision to debar or suspend the contractor or to rescind, void, or terminate the contract for default, or (d) a disposition by consent or compromise if the action could have resulted in one of the foregoing dispositions.⁷³

Even when the proceeding does not result in one of the enumerated dispositions, the allowable costs may not exceed 80% of the otherwise allowable and allocable costs incurred.⁷⁴ Moreover, the costs are unallowable (notwithstanding the disposition) if the proceeding involves the same contractor misconduct alleged as the basis of another criminal, civil or administrative proceeding, and the costs of that other proceeding are unallowable.⁷⁵ However, costs incurred in a proceeding brought by the United States and settled by consent or compromise may be allowed to the extent specifically provided for in the settlement agreement.⁷⁶ Costs incurred in a proceeding brought by a state may be allowed if the agency head determines that such costs were incurred as a result of a specific term or condition of the contract or specific written instructions from the agency.⁷⁷ The statute states that the term “proceeding includes an investigation,” and it adopts the cost principle’s broad definition of the term “costs.”⁷⁸

The implementation of the Major Fraud Act in FAR 31.205-47⁷⁹ exceeds the scope of the Act in three significant respects. First, the statute, but not FAR 31.205-47, is limited to “covered contracts,” which are defined as contracts in excess of \$500,000 that are other than fixed-price contracts without cost incentives.⁸⁰ The drafters’ comments accompanying publication of Federal Acquisition Circular 84-15, implementing the requirements of the Defense Procurement Improvement Act of 1985,⁸¹ noted

above, as well as a related requirements applicable to the Department of Energy,⁸² stated that: “The statute specifically applies to Department of Defense and Department of Energy covered contracts exceeding \$100,000 [subsequently increased to \$500,000]. Because of the practical necessity to establish uniform cost principles, the applicability of the revisions has been extended to all contracts to which the commercial cost principles are applicable, including the contracts of all civilian agencies.”⁸³ Presumably, the same rationale applied to the implementation of the Major Fraud Act.

Second, the statute covers proceedings brought by the United States or a state,⁸⁴ whereas FAR 31.205-47 applies to proceedings brought by federal, state, local, or foreign governments.⁸⁵ Third, the statute is limited to wrongdoing by contractors,⁸⁶ whereas FAR 31.205-47 applies to wrongdoing “by the contractor (including its agents or employees).”⁸⁷

As initially promulgated, FAR 31.205-47 exceeded the statute in a fourth respect: it made unallowable costs incurred in connection with a civil or administrative proceeding where there was either a finding of contractor liability or imposition of a monetary penalty, without regard to whether the proceeding involved an allegation of fraud or similar misconduct.⁸⁸ FAR 31.205-47 was further revised, effective January 22, 1991, to correct this error.⁸⁹ Ironically, the same revision added the word “Federal” before “Government” in paragraph (f) of the cost principle “to prevent possible confusion, since other portions of the cost principle are more broadly applicable to Federal, State, local, or foreign government proceedings,” without limiting the reach of paragraph (b) to the federal and state proceedings specified in the statute.⁹⁰

■ Qui Tam Suits

On June 20, 1994, the DCAA published audit guidance on the allowability of legal costs associated with False Claims Act qui tam suits⁹¹ in which the United States does not intervene.⁹² The DCAA concluded that FAR 31.205-

47 was inapplicable to such costs because a qui tam suit not joined by the Government is not (1) a proceeding brought by the United States within the meaning of FAR 31.205-47(b); (2) the defense against a Government claim within the meaning of FAR 31.205-47(f)(1), which the DCAA concluded encompasses only Contract Disputes Act claims; or (3) a suit under § 2 of the Major Fraud Act within the meaning of FAR 31.205-47(f)(4), which the DCAA concluded applies only when the contractor has been prosecuted under 18 U.S.C.A. § 1031.⁹³ The DCAA recommended that the costs be evaluated under FAR 31.205-33 and the general reasonableness criteria of FAR 31.201-3, using the following allowability test (not found in those provisions): “[W]hether the litigation arose from a willful and malicious violation of contract terms.”⁹⁴ Because FAR 31.205-33 does not contain a segregation of costs requirement comparable to FAR 31.205-47(g) and because the determination of whether the litigation arose from a willful and malicious violation of contract terms cannot be made until the suit has been resolved, the DCAA concluded that the contractor could include the costs in its billings as they were incurred.⁹⁵

The Department of Justice vociferously objected to the DCAA’s audit guidance, and on August 24, 1995, the DCAA published new guidance, completely reversing its earlier position.⁹⁶ Without refuting the prior reasoning or providing any explanation for the abrupt change, the DCAA’s new guidance instructed auditors to evaluate the costs of defending against qui tam suits not joined by the Government under FAR 31.205-47 as if the Government brought the suit directly. Accordingly, the guidance stated, the costs must be segregated and excluded from billings until the suit is resolved, as required by FAR 31.205-47(g).⁹⁷ Additionally, if the suit is settled, the costs would ordinarily be unallowable under FAR 31.205-47(b)(5), but may be allowed by paragraph (c) to the extent such costs are specifically allowed as part of the settlement agreement.⁹⁸ The new audit guidance was subsequently incorporated in the *DCAA Contract Audit Manual*, stating only that a “legal determination has

been made that a ‘qui tam’ proceeding is a ‘proceeding’ brought by the Federal government as that term is used in FAR 31.205-47(b).”⁹⁹

On June 20, 1996, the FAR Councils published a proposed rule to “clarify” the allowability of costs incurred in connection with qui tam suits in which the Government does not intervene and to “clarify” that the maximum reimbursement a contractor can receive for such costs (if the case is settled) is 80% of the otherwise allowable and allocable incurred costs.¹⁰⁰ The American Bar Association Section of Public Contract Law submitted comments expressing concern that “any attempt to give the proposed changes...retroactive effect is not well based in law or in fact, and would undoubtedly result in substantial, widespread litigation raising retroactive disallowance issues.”¹⁰¹ Nevertheless, the final rule was published on October 30, 1998, as a purported “clarification.”¹⁰² The drafters’ comments accompanying the final rule gave short shrift to concerns that the rule should be applied prospectively, stating: “After consideration of these comments, it is concluded that this coverage is properly characterized as a clarification.”¹⁰³ However, the drafters went on to state that they recognized that “certain Government contracting personnel and contractors may have had common misinterpretations of the regulatory coverage,” and for qui tam legal fees incurred before DCAA’s August 24, 1995 audit guidance, “if the Government contracting personnel and the contractor shared a common misinterpretation of the regulatory coverage, the contracting officer, in consultation with his or her legal advisors, should determine the appropriate treatment of those costs on a case-by-case basis.”¹⁰⁴

Because qui tam relators do not have the authority to agree that costs will be allowable, the October 1998 final rule added a new paragraph (c)(2) to FAR 31.205-47, stating that in the event a qui tam case is settled, “reasonable costs incurred by the contractor... that are not otherwise unallowable by regulation or by separate agreement with the United States, may be allowed if the contracting officer, in consultation with his or

her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.”¹⁰⁵ However, the amount may not in any event exceed 80%.¹⁰⁶

Government Challenges To Allowability & Allocability

■ Reasonableness

One ground for challenges to a contractor’s recovery of legal fees is reasonableness, which is a requirement for cost allowability. In addition to being reasonable, to be allowable, a cost must be (a) allocable to the contract, (b) accounted for in accordance with the Cost Accounting Standards, if applicable to the contract, and otherwise in accordance with generally accepted accounting principles and practices appropriate in the circumstances, (c) permitted by the terms of the contract, and (d) not limited by the specific cost principles set forth in FAR Subpart 31.2.¹⁰⁷ In general, the FAR provides that a cost is considered 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.”¹⁰⁸

In *Hirsch Tyler Co.*, the ASBCA held that legal costs incurred in an unsuccessful defense of an employment discrimination lawsuit were allowable because the costs were reasonable in amount and did not fall within any category of costs prescribed by the cost principles.¹⁰⁹ The board rejected the Government’s argument that the costs were by their nature unreasonable because the contractor was found to have violated the Civil Rights Act. Citing its earlier decision in *Hayes International Corp.*, which upheld litigation costs in an employment discrimination case resolved by consent decree without any admission of liability,¹¹⁰ the board reasoned as follows:¹¹¹

[A]n ordinarily prudent person in the conduct of competitive business is often obliged to defend lawsuits brought by third parties, some of which are frivolous and others of which have merit. In either event, the restraints or requirements imposed by generally accepted sound business

practices dictate that, except under the most extraordinary circumstances, a prudent businessman would incur legal expenses to defend a litigation and that such expenses are of the type generally recognized as ordinary and necessary for the conduct of competitive business. Accordingly, legal expenses incurred in defending civil litigation brought by a third party, regardless of the outcome thereof, are *prima facie* reasonable, unless shown to have been incurred unreasonably....

Consistently, the U.S. Supreme Court has held that legal fees incurred in a taxpayer’s unsuccessful defense of a criminal prosecution are deductible as “ordinary and necessary” business expenses. As the Court has stated:¹¹²

No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not “proscribed conduct.” It is his constitutional right.... In an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him.

Nevertheless, the DCAA continues to challenge the costs of legal fees on reasonableness grounds based on the nature of the underlying wrongdoing rather than the reasonableness of the contractor’s actions in defending the suit. For example, on April 13, 1995, the DCAA published audit guidance advising its auditors to question as unreasonable costs incurred by contractors in defending against stockholder derivative suits related to contractor wrongdoing.¹¹³ The DCAA’s position briefly gained support when the ASBCA held, in *Boeing North American, Inc.*, that costs incurred to litigate and settle a stockholders’ derivative suit were unallowable because the fees would not have been incurred but for the contractor’s prior violations of federal laws and regulations.¹¹⁴ In that decision, the board acknowledged that the costs of third-party proceedings, as distinct from proceedings brought by the Government, were not prescribed by FAR 31.205-47. Nevertheless, citing a November 1988 DAR Cost Principles Committee proposal that was never added to the cost principle, the board stated that “it is a guiding principle for federal agencies not to pay for the results or consequences of contractor wrongdoing.”¹¹⁵ As discussed below, the *Boeing* decision was

vacated on appeal to the U.S. Court of Appeals for the Federal Circuit.¹¹⁶

■ Allocability Based On Benefit To The Government

In the Federal Circuit appeal of the ASBCA's decision in *Northrop Worldwide Aircraft Services, Inc.*, the Government attorneys tried a new tack, arguing that the costs of an unsuccessful defense of a wrongful termination suit were not allocable and, therefore, were unallowable because there was no benefit to the Government for incurring the cost.¹¹⁷ *Northrop* involved a cost-reimbursement contract at Fort Sill, Oklahoma. The contractor discharged for poor performance four at-will employees who were working on the contract. The employees brought a wrongful termination suit in state court, claiming they were discharged for refusing to participate in contract-related fraud against the Army. An Oklahoma jury found in favor of the employees. The ASBCA reversed the CO's final decision denying the contractor's claim for reimbursement of its legal costs to defend against the lawsuit, holding that the costs were reasonable and allocable to the Fort Sill contract.¹¹⁸

On appeal to the Federal Circuit, the Army argued that "the standard for allocability is benefit to the government," and "in this case there was no benefit to the government for reimbursing a contractor for defending a lawsuit wherein the contractor was found to have wrongfully terminated employees who refused to commit fraud against the government."¹¹⁹ The Federal Circuit agreed:¹²⁰

It is established that the contractor must show a benefit to government work from an expenditure of cost that it claims is "necessary to the overall operation of the [contractor's] business." The Board erred in failing to make a determination of whether or not [the contractor's] defense of the Oklahoma lawsuit benefited the government. We can discern no benefit to the government in a contractor's defense of a wrongful termination lawsuit in which the contractor is found to have retaliated against the employees for the employees' refusal to defraud the government.

In so holding, the Federal Circuit confused the concepts of allocability and allowability.¹²¹

Unlike *reasonableness*, which turns on a qualitative judgment about the nature and amount of the cost,¹²² *allocability* is strictly an accounting concept for logically distributing costs to cost objectives to accurately determine their cost.¹²³ The Federal Circuit recognized this concept in *Rice v. Martin Marietta Corp.*:¹²⁴

The allocation of a cost deals with the accounting process of assigning costs to cost objectives.... For all or part of a cost to be allocated to a cost objective, the cost must have benefited from or have been caused by the cost objective. In sum, allocation is an accounting process for accurately ascertaining contract costs.

Allocability does not involve any judgment about whether, as a policy matter, the Government should or should not reimburse the cost. Moreover, all costs are allocable somewhere; there cannot be a completely non-allocable cost, which was the practical effect of the court's holding in *Northrop*.

The ASBCA took the rationale of *Northrop* one step further in *Boeing North American, Inc.*¹²⁵ The costs at issue in *Boeing* grew out of a minority stockholders' derivative action, captioned *Citron v. Beall*, which alleged that the directors of Rockwell International Corporation, the predecessor in interest to Boeing, "failed to institute and enforce adequate internal controls, and fostered a 'corporate climate' that encouraged employee misconduct under federal contracts and resulted in criminal and civil penalties and fines." The *Citron* complaint alleged five instances of underlying misconduct: (1) Rockwell paid a \$500,000 fine to settle a Government False Claims Act case alleging fraudulent mischarges for work performed on a Space Shuttle contract; (2) Rockwell pled guilty to criminal charges of making false statements in connection with a Government contract and was fined \$1 million; (3) Rockwell pled guilty to two counts of a grand jury indictment charging the company and two of its employees with fraud, mail fraud, and willfully making false statements in connection with a global positioning system subcontract and was fined \$5.5 million; (4) a False Claims Act *qui tam* suit was brought against Rockwell for allegedly allowing its employees to use Government assets for per-

sonal gain; and (5) Rockwell was the subject of a criminal investigation of alleged hazardous waste dumping and other environmental wrongs.

Rockwell settled the *Citron* suit by agreeing to pay a portion of the plaintiffs' legal fees, without any admission of wrongdoing, declaratory relief, or monetary damages. Rockwell included the legal fees and costs associated with the *Citron* suit as G&A costs in its home office overhead. The CO disallowed the legal costs as unreasonable under FAR 31.201-3 ("Determining reasonableness") and unallowable under FAR 31.204(c) (since redesignated paragraph (d)¹²⁶) on the basis that they were "similar or related" to costs that are unallowable under FAR 31.205-15 ("Fines and penalties") and FAR 31.205-47(b).

In upholding the CO's decision, the board, citing *Northrop*, held that costs incurred to defend against and settle the shareholders' derivative suit were not allocable because the board could "discern no benefit to the Government in a contractor's defense of a third party lawsuit in which the contractor's prior violations of federal laws and regulations were an integral part of the third party allegations."¹²⁷ Additionally, the board held that the costs were unallowable based on Rockwell's antecedent wrongdoing.

The Federal Circuit panel hearing the *Boeing* appeal did what it could to correct the obvious accounting error of *Northrop* without expressly overruling the decision, which would have required an *en banc* decision by the full court.¹²⁸ The court began by distinguishing between the concepts of allocability and allowability, correctly explaining the distinction as follows:¹²⁹

Allocability is an accounting concept involving the relationship between incurred costs and the activities or cost objectives (*e.g.*, contracts) to which those costs are charged. Proper allocation of costs by a contractor is important because it may be necessary for the contractor to allocate costs among several government contracts or between government and non-government activities.

The concept of cost allowability concerns whether a particular cost can be recovered from the government in whole or in part. Cost

allocability here is to be determined under the Cost Accounting Standards ("CAS"), 4 C.F.R. Parts 403, 410 [subsequently codified at 48 C.F.R. Parts 9903-9904]. Allowability of a cost is governed by the FAR regulations, *i.e.*, the cost principles expressed in Part 31 of the FAR and pertinent agency supplements.

* * *

In summary, the concept of allocability is addressed to the question of whether a sufficient "nexus" exists between the cost and a government contract. The concept of allowability is addressed to the question whether a particular items of cost should be recoverable as a matter of public "policy."

Then, after first stating that it "was not bound by *Northrop* on the issue of allocability under the CAS standards since the CAS issue was neither argued nor discussed in [the *Northrop*] opinion," the court held that in this case, "the CAS clearly renders Rockwell's legal defense costs allocable as part of G&A expenses."¹³⁰ The court soundly rejected the Army's "benefit to the government" theory of allocability, with the following explanation:¹³¹

Our earlier decisions in *Lockheed [Aircraft Corp. v. United States]*, 375 F.2d [786] at 794 [Ct. Cl. 1967], and *FMC Corp. v. United States*, 852 F.2d 882, 885 (Fed. Cir. 1988), relied on by the government as authority for the "benefit to the government" theory, do not supply any support for a rule that would base the allocability of a cost on the cost's "benefit to the government" as opposed to its nexus to government work.

* * *

Thus, we agree with Boeing that allocability is an accounting concept and that CAS does not require that a cost directly benefit the government's interests for the cost to be allocable. The word "benefit" is used in the allocability provisions to describe the nexus required for accounting purposes between the cost and the contract to which it is allocated. The requirement of a "benefit" to a government contract is not designed to permit contracting officers, the Board, or this court to embark on an amorphous inquiry into whether a particular cost sufficiently "benefits" the government so that the cost should be recoverable from the government. The question whether a cost should be recoverable as a matter of policy is to be undertaken by applying the specific allowability regulations, which embody the government's view, as a matter of "policy," as to whether the contractor may permissibly charge particular costs to the government (if they are otherwise allocable).

On that basis, the Federal Circuit concluded that the ASBCA “committed legal error in determining the allowability of Rockwell’s legal defense costs based on whether the costs conferred a ‘benefit [on] the Government’ and based on a ‘but for’ standard that looked solely to the fact that admitted misconduct by Rockwell formed the basis for the complaint.”¹³²

The court next turned to what it viewed as the true issue in the case, whether the legal expenses were *allowable*. The court rejected as “fundamentally flawed” the contractor’s argument “that the only professional service costs that are not allowable under FAR § 31.205-33 are those costs that are specifically disallowed under another FAR provision.”¹³³ Reaching back to the CO’s final decision for a rationale not cited by either of the parties or amicus, the court observed that “[a]lthough the FAR § 31.205 subsections covering selected costs are extensive,” they do not cover every element of cost; and, “[i]n such situations, FAR 31.204[(d)] instructs us: ‘*The determination of allowability shall be based on the principles and standards in this subpart and the treatment of similar or related selected items.*’”¹³⁴ The court used this rationale to conform its holding to the allowability holding of *Northrop* by which the *Boeing* panel said it was bound:¹³⁵

The principle announced in FAR § 31.204[(d)] supports the allowability holding of *Northrop*.... [I]n *Northrop* we addressed the question whether legal defense costs (in an action charging that the contractor wrongfully terminated several employees because the employees refused to participate in fraud against the United States) were allowable costs. Despite the existence of detailed regulations proving that professional service costs were allowable and that certain categories of legal expenses were not allowable, the regulations did not explicitly govern the allowability of the costs in the *Northrop* situation. The FAR, however, dealt with closely comparable categories of selected costs.

Then recasting the *Northrop* decision to fit its rationale, the *Boeing* court stated: “Properly understood, *Northrop* and FAR § 31.205-47 taken together establish a simple principle—that the costs of unsuccessfully defending a

private suit charging contractor wrongdoing are not allowable if the ‘similar’ costs would be disallowed under the regulations.”¹³⁶

The court concluded that unlike the costs at issue in *Northrop*, Rockwell’s costs of defending the *Citron* lawsuit were not “similar” to any disallowed costs because none of the cost principles addresses costs similar to the costs of defending a contractor’s directors against charges that they tolerated inadequate controls.¹³⁷ Additionally, because there had been no judicial determination that Rockwell’s directors failed to maintain adequate controls to prevent the occurrence of wrongdoing against the government, the court concluded that there was no “direct relationship” to any unallowable costs.¹³⁸

Nevertheless, the court reasoned, when a contractor settles a suit brought by a private party, the “regulations suggest” that the allowability of legal defense costs should turn on “whether the plaintiff was likely to prevail.”¹³⁹ The court stated that “[t]his approach is most clearly reflected in the FAR regulations’ treatment of settlements of private suits brought under the False Claims Act where the government does not intervene.”¹⁴⁰ On that basis, the court concluded that FAR 31.205-47(c)(2) (dealing with *qui tam* suits in which the United States does not intervene) was an appropriate standard for determining the allowability of the costs of the shareholder derivative suit.¹⁴¹

There are three significant problems with the Federal Circuit’s decision in *Boeing*. First, FAR 31.204(d) applies when an item of cost is not covered by FAR 31.205. The costs of professional services and the costs of legal and other proceedings *are* covered by FAR 31.205, i.e., by FAR 31.205-33 and FAR 31.205-47. Moreover, FAR 31.205-33(b) states: “Costs of professional and consultant services *are allowable* subject to this paragraph and paragraphs (c) through (f) of this subsection when reasonable in relation to the services rendered and when not contingent upon the recover of the costs from the Government (but see 31.205-30 [“Patent costs”] and 31.205-47).”¹⁴² Accordingly, unless disallowed by FAR 31.205-30, FAR

31.205-47, or one of the paragraphs in FAR 31.205-33, the costs at issue in *Boeing* were not only covered by FAR 31.205, but expressly made allowable by FAR 31.205-33(b). Furthermore, because “Professional and consulting services, including legal services” was one of the 14 categories of costs required by the Defense Procurement Improvement Act to be clarified to state specifically what costs were unallowable, there is no room for the Federal Circuit to write in new limits on allowability.¹⁴³

Second, the “related” cost principle on which the court based its decision, FAR 31.205-47(c)(2), was not in effect until long after the contract under which the appeal was taken was awarded, as discussed earlier in this PAPER.¹⁴⁴

Third, and most fundamentally, in expanding FAR 31.205-47 to cover “similar” or “related” costs, the court exceeded the statutory basis for the cost principle. Because the Major Fraud Act speaks precisely to the question at issue, namely the allowability of legal defense costs in proceedings involving allegations of contractor wrongdoing, there is no room for agency discretion. In the words of the Supreme Court in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,¹⁴⁵ there is no “gap” for the FAR Councils—much less the Federal Circuit, which has no rulemaking authority—to fill.

Relying on *Boeing*, the ASBCA held in *Southwest Marine, Inc.* that costs incurred in the unsuccessful defense of a citizen’s suit for violation of the Clean Water Act were “similar” to costs made unallowable under FAR 31.205-47(b)(2) and were therefore unallowable.¹⁴⁶ According to the board’s opinion, the parties in that case agreed that the costs were “not specifically addressed under the regulations” and argued about whether or not the costs were “similar to those unallowable under FAR 31.205-47(b)(2).” If so, it was a curious strategy for the contractor to adopt; a better, or at least more accurate strategy, would have been to argue that the costs *are* specifically addressed under the regulations since the costs of pro-

fessional fees are allowable under FAR 31.205-33(b) unless disallowed by FAR 31.205-30, one of the paragraphs of FAR 31.205-33, or FAR 31.205-47. Because the costs are not disallowed by any of those provisions, they should have been treated as allowable.

■ “Direct” vs. “Indirect” Costs

Legal fees are generally treated as indirect costs and included in the contractor’s G&A expense pool because the legal services benefit the business unit as a whole.¹⁴⁷ Indeed, the “Green Book,” the cost principles published by the War and Navy Departments in 1942, listed “Professional fees and expenses for legal, accounting, and other consulting services” as a type of administration and general corporate expense related to the general management of the business.¹⁴⁸ However, several cases have held that when legal or accounting costs are incurred specifically for, and can be identified specifically with, a particular contract, they must be allocated directly to that contract.¹⁴⁹

For example, in *Jana, Inc.*, the ASBCA held that the costs of defending against a protest of the award of a contract were chargeable directly to that contract, even though the contractor included other types of legal fees in its G&A expense pool.¹⁵⁰ *Jana* involved a cost-reimbursement contract. The board noted that when the contractor had incurred costs defending against a protest of a fixed-price contract, the DCAA challenged the contractor’s inclusion of the costs in its G&A pool and insisted that the costs be allocated directly to the fixed-price contract.¹⁵¹ Similarly, in *FMC Corp., Northern Ordnance Division*, both the ASBCA and the Federal Circuit held that the costs incurred in litigating a claim under a purchase order were directly chargeable to that purchase order and could not be included in the contractor’s G&A expense pool.¹⁵²

This line of cases could present problems for recovery of legal costs under fixed-price contracts. As a practical matter, when negotiating the price of a fixed-price contract,

contractors typically do not include an estimate for litigation or investigations that may arise. Nor would the incurrence of such costs in the performance of a fixed-price contract entitle the contractor to a price adjustment, unless, for example, there was a constructive change.¹⁵³ Because criminal investigations are conducted by the Government in its sovereign capacity, there is no contractual basis, under a fixed-price contract, to claim relief.¹⁵⁴ This does not mean, however, that the costs are not reimbursable under a flexibly priced contract.¹⁵⁵

There is also a serious question whether this line of cases would withstand scrutiny under CAS 402, which requires that a contractor consistently treat all costs incurred for the same purpose, in like circumstances, as either direct costs only or indirect costs only with respect to final cost objectives.¹⁵⁶ Where the cost principles conflict with the CAS on an issue of allocability, the CAS take precedence.¹⁵⁷

■ "Claims" & "Appeals"

Legal, accounting, and consulting costs incurred in connection with the performance or administration of a contract are generally allowable and recoverable, provided the costs are reasonable in relation to the services rendered and not contingent upon recovery from the Government.¹⁵⁸ On the other hand, costs incurred in connection with the prosecution of claims against the Government have been unallowable for as long as there have been cost principles.¹⁵⁹ As noted above, the longstanding proscription against costs incurred in connection with the prosecution of claims against the Government was expanded in 1986 to include appeals as well as claims and to include the defense against Government claims or appeals.¹⁶⁰ At the same time, a parenthetical cross-reference to FAR 33.201 was added to the cost principle, limiting its reach to claims and appeals under the Contract Disputes Act.¹⁶¹ That cross-reference was subsequently changed to FAR 2.101 when then FAR Councils moved the definition of "claim" from FAR 33.201 to FAR 2.101.¹⁶² Even before the 1986 revision,

some cases held that the term "claim"—defined elsewhere in the FAR—meant only a CDA claim,¹⁶³ while several pre-FAR cases defined the term using the False Claims Act definition of a demand for money or property.¹⁶⁴

Whether a cost is an allowable cost of contract administration or an unallowable cost of defending against or prosecuting a claim or appeal depends upon the purpose for which it was incurred.¹⁶⁵ If the cost was incurred "for the genuine purpose of materially furthering the negotiation process," it should be considered an allowable cost of contract administration, even if the negotiations prove unsuccessful and litigation ensues.¹⁶⁶ Additionally, if the costs themselves are allowable, the contractor is entitled to profit on those costs, just as it is with any other element of an equitable adjustment.¹⁶⁷ On the other hand, the cost is unallowable if the "contractor's underlying purpose [for incurring it was] to promote the prosecution of a CDA claim against the Government."¹⁶⁸

There is a "strong legal presumption" that costs incurred *before* a CDA claim is submitted are allowable.¹⁶⁹ To constitute a "claim" under the CDA, there must be (1) a written demand, (2) submitted to the CO for a final decision, (3) seeking, as a matter of right, (4) the payment of money in a sum certain, the adjustment or interpretation of contract terms, or other relief arising under or relating to the contract.¹⁷⁰ In addition, if the amount sought exceeds \$100,000, the submission must be certified in accordance with FAR 33.207.¹⁷¹ Once a contractor submits a certified claim, the Government is required to pay interest on the amount found due and owing from the date that the CO receives the claim until the date of payment.¹⁷²

Moreover, because only costs associated with the "prosecution" or "defense" of a claim or appeal are unallowable, even *after* a CDA claim is submitted, the costs may still be allowable, provided they are incurred for the genuine purpose of materially furthering the negotiation process. In *Bill Strong Enterprises, Inc. v. United States*, the Federal Circuit expressly

left open the question whether costs incurred after the submission of a CDA claim “but otherwise arguably in pursuit of contract administration beneficial to the Government are per se unallowable.”¹⁷³ Cases since that time have split on the issue whether costs incurred after the submission of a CDA can be allowable, with the ASBCA holding that they can and the Court of Federal Claims holding that they cannot.¹⁷⁴ In this regard, the Court of Federal Claims’ decision in *Plano Builders Corp. v. United States*¹⁷⁵ is based on the flawed premise that the Federal Circuit’s en banc ruling in *Reflectone Inc. v. Dalton*¹⁷⁶ overruled *Bill Strong’s* test for determining whether a particular cost is a contract administration cost or a cost incidental to the prosecution of a claim. Although the Federal Circuit has not yet addressed the issue, its en banc decision in *Reflectone* is more consistent with the ASBCA’s position than the Court of Federal Claims’ position. In *Reflectone*, the Federal Circuit stated:¹⁷⁷

Finally, as we previously noted, “there is no necessary inconsistency between the existence of a valid CDA claim and an expressed desire to continue to mutually work toward a claim’s resolution.” *Transamerica Ins. Corp. v. United States*, 973 F.2d 1572, 1579 (Fed. Cir. 1992). The parties are not prevented or discouraged from settling

their differences because the first written demand for payment as a matter of right that is not merely a routine request for payment is recognized and treated as a CDA “claim.” If anything, such a rule promotes settlement by preventing procrastination.

In an analogous case concerning costs recoverable in a termination for convenience, the Court of Claims held as follows:¹⁷⁸

The contract and regulations do not say that all legal services rendered subsequent to the filing of an appeal are to be disallowed, ipso facto, for purely chronological reasons. Instead, an attorney’s services are allowable costs to the extent they consist of settlement negotiations with the contracting officer, in contrast to activities directly bearing on the appeal proceedings (such as preparation and filing of pleadings and briefs). The nature and form of the legal activities involved are more objective standards for determining if they may be reimbursed than their relationship in time to the filing of an appeal to the Board. We hold that the legal expenses incurred by plaintiff in its efforts to obtain a settlement, whether before or after the appeal to the Board, are compensable costs under the contract and incorporated regulations.

Allowing costs incurred for the genuine purpose of materially furthering the negotiation process is consistent with the Government’s policy of encouraging the resolution of claims through negotiation instead of litigation.¹⁷⁹

GUIDELINES

These *Guidelines* are designed to assist you in understanding the rules governing the allowability of legal costs under the FAR 31.205-33, “Professional and consultant service costs” cost principle and the FAR 31.205-47 “Costs related to legal and other proceedings” cost principle. They are not, however, a substitute for professional representation in any specific situation.

1. Remember that in general, where the costs are not otherwise unallowable under the cost principles, the costs of professional and consultant services must be reasonable in nature and amount and not contingent upon recovery from the Government to be allowable under a contract.

2. Be aware that legal costs incurred in connection with suits brought by your employees

other than those alleging fraud against the Government should be considered allowable. Backpay resulting from violations of federal labor laws or the Civil Rights Act of 1964 should also be considered allowable, provided it represents additional compensation for work performed for which the employee was underpaid, and is not compensation for other violations such as improper discharge or discrimination.

3. Keep in mind that the costs of professional and consultant services performed under any of the following circumstances are *always unallowable*:

- (a) Attempts to improperly obtain, distribute, or use information or data protected by law or regulation or to improperly

influence the contents of solicitations, the evaluation of proposals, or the selection of sources for contract or subcontract award.

- (b) Services obtained, performed, or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest.
- (c) Services performed that are not consistent with the purpose and scope of the services contracted for or otherwise agreed to.
- (d) Defense against Federal Government claims or appeals or the prosecution of claims or appeals against the Federal Government.
- (e) Organization, reorganization (including mergers and acquisitions), or resisting mergers and acquisitions.
- (f) Defense of antitrust suits.
- (g) Defense of suits brought by your employees or ex-employees under § 2 of the Major Fraud Act of 1988 (i.e., for retaliation) where your company was found liable or settled.
- (h) Defense or prosecution of lawsuits or appeals between contractors arising from (1) an agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest, or (2) dual sourcing, co-production, or similar programs, *unless* (a) incurred as a result of compliance with specific terms and conditions of contract or written instructions from the CO, or (b) when agreed to in writing by CO.
- (i) Patent infringement litigation, unless otherwise provided for in the contract.
- (j) Representation of, or assistance to, individuals, groups, or legal entities which your company is not legally bound to provide, arising from an action where the participant was convicted of a violation

of law or regulation or was found liable in a civil or administrative proceeding.

- (k) Bid protests or defense, unless the costs of defending against the protest are incurred pursuant to the CO's written request.

4. Be aware that legal costs incurred in connection with a proceeding (including an investigation) brought by a federal, state, local, or foreign government for your company's violation of any law or regulation are unallowable if you lose—i.e., if the result is (1) a criminal conviction, (2) a finding of civil liability in proceeding involving fraud or the imposition of a monetary penalty, or (3) suspension, debarment, or termination of contract. If the proceeding could have resulted in any of these three outcomes but is settled, the costs are unallowable unless the settlement agreement specifically permits recovery. The amount of any recovery, however, may not exceed 80% of the costs. If you win, costs that would have been unallowable if proceeding had resulted in any of the three outcomes are allowable in an amount not to exceed 80%.

5. Bear in mind that in a False Claims Act *qui tam* case in which the United States does not intervene, if you settle, the costs are unallowable unless the CO determines that the *qui tam* relator had very little likelihood of success on the merits. Although the issue has not been litigated, if you win a *qui tam* suit, the costs should be considered 100% allowable.

6. While legal costs incurred in connection with defense against suits brought by nongovernmental parties other than by (1) employees under the Major Fraud Act or (2) *qui tam* relators under the False Claims Act should be considered allowable, be aware that an auditor could question these costs under the rationale of *Boeing North American, Inc. v. Roche*, and it is possible that the costs would be determined to be unallowable if you lose or settle. Although the issue has not been litigated, presumably if you won, the costs would be 100% allowable because they are not limited by any of the cost principles.

★ REFERENCES ★

- 1/ See Manos, *Government Contract Costs & Pricing* chs. 40 & 54 (Thomson-West 2004 & Supp. 2005). See generally Arnava, "Government Contract Cost Recovery," Briefing Papers No. 01-6 (May 2001); Vacketta, Yesner & Snyder, "Recovery of Legal Costs," Briefing Papers No. 93-12 (Nov. 1993).
- 2/ FAR 31.205-33(a).
- 3/ See *General Dynamics Corp.*, ASBCA No. 49372, 02-2 BCA ¶ 31,888, at 157,562, 44 GC ¶ 249 ("Currently, FAR 31.205-47 exists in tandem with FAR 31.205-33, Professional and Consultant Costs, to provide definitive guidance regarding the allowability of legal defense costs"), recons. denied, 02-2 BCA ¶ 32,020, rev'd on other grounds, *Rumsfeld v. General Dynamics Corp.*, 365 F.3d 1380 (Fed. Cir. 2004), 46 GC ¶ 217.
- 4/ FAR 31.205-33(b).
- 5/ *R-D Mounts, Inc.*, ASBCA No. 17422 et al., 75-1 BCA ¶ 11,077, at 52,745, 17 GC ¶ 425, recons. denied, 75-1 BCA ¶ 11,237, aff'd, 2 Cl. Ct. 320 (1983).
- 6/ 75-1 BCA ¶ 11,077, at 52,740 (citing *Southland Mfg. Corp.*, ASBCA No. 16830, 75-1 BCA ¶ 10,994).
- 7/ *RRP Constr. Co.*, DOTBCA 2999, 1996 WL 525405 (Sept. 10, 1996).
- 8/ DAR 15-205.31(b) (Aug. 1, 1981).
- 9/ FAR 31.205-33(d).
- 10/ *Cramp Shipbldg. Co. v. United States*, 122 Ct. Cl. 72 (1952).
- 11/ 122 Ct. Cl. at 79.
- 12/ *Id.*
- 13/ *Id.* at 92.
- 14/ *Id.* at 93.
- 15/ *Baifield Indus., Div. of A-T-O, Inc.*, ASBCA No. 20006, 76-2 BCA ¶ 12,096, at 58,086, mot. for recons. denied, 76-2 BCA ¶ 12,203.
- 16/ 76-2 BCA ¶ 12,096, at 58,105.
- 17/ *Id.* (citing *Cryo-Sonics, Inc.*, ASBCA No. 13219, 70-1 BCA ¶ 8313).
- 18/ *Id.* at 58,106.
- 19/ *Id.* at 58,112-13.
- 20/ 76-2 BCA ¶ 12,203, at 58,756.
- 21/ *Id.* at 58,757.
- 22/ *Id.*
- 23/ *R-D Mounts, Inc.*, ASBCA No. 17422 et al., 75-1 BCA ¶ 11,077, at 52,742.
- 24/ *Id.*
- 25/ *Id.* at 52,743. See also *Herman B. Taylor Constr. Co. v. General Servs. Admin.*, GSBCA No. 12915, 96-2 BCA ¶ 28,547, at 142,532 (disagreeing with the agency that the small value of a change order did not warrant use of an outside estimator, the board found that where the contractor priced the change at a little more than \$118,000, with the Government initially offering \$24,604.04, the difference was significant and warranted the contractor's retention of a claims consultant).
- 26/ *Fire Security Sys., Inc., VABCA-5559 et al.*, 02-2 BCA ¶ 31,977, at 158,014.
- 27/ *Id.* at 158,011.
- 28/ *Id.* at 158,012.
- 29/ *Id.* at 158,012-13.
- 30/ *Id.* at 158,014.
- 31/ *Id.*
- 32/ *Id.* at 158,014-15.
- 33/ *Id.* at 158,015.
- 34/ *Id.*
- 35/ *Id.*
- 36/ *Id.*
- 37/ FAR 31.205-33(c).
- 38/ See *Black's Law Dictionary* 1341-42 (8th ed. 2004).
- 39/ *Kalvar Corp. v. United States*, 587 F.2d 49 (Ct. Cl. 1978).
- 40/ 587 F.2d at 52.
- 41/ *Id.*
- 42/ 587 F.2d at 53-54.
- 43/ FAR 31.205-33(f).
- 44/ *Trueger, Accounting Guide for Government Contracts* 508-09 (10th ed. 1991).
- 45/ 53 Fed. Reg. 41,530 (Oct. 21, 1988).
- 46/ *Cost Principles Committee Report, Case 88-89* (Mar. 31, 1989).
- 47/ *Id.*
- 48/ *Id.*
- 49/ *E.g. United States v. Horvath*, 731 F.2d 557, 561 (8th Cir. 1984).
- 50/ *Hickman v. Taylor*, 329 U.S. 495, 510 (1947).
- 51/ Fed. R. Civ. P. 26(b)(3).
- 52/ *United States v. Rockwell Int'l*, 897 F.2d 1255, 1265 (3d Cir. 1990).

- 53/ *Coastal States Gas Corp. v. Department of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980); see also *Judicial Watch, Inc. v. U.S. Dep't of Commerce*, 201 F.R.D. 265, 269 (D.D.C. 2001) (the work-product doctrine "flows from a judicial desire to permit the lawyer for that party to prepare her case for trial in peace and to prevent her opponent from seeing what the party prepared for the lawyer's use as a potential reflection of the lawyer's thinking and trial strategy").
- 54/ DCAA Memorandum for Regional Directors, "Audit Guidance on Documentation Requirements Under FAR 31.205-33(f)" (02-PAC-037(R)) (May 9, 2002).
- 55/ *Id.* at 1.
- 56/ *Id.* at 5.
- 57/ *Id.*
- 58/ See *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 290 (6th Cir. 2002); *United States v. MIT*, 129 F.3d 681 (1st Cir. 1997); *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3d Cir. 1991); *In re Martin Marietta Corp.*, 856 F.2d 619 (4th Cir. 1988), cert. denied, 490 U.S. 1011 (1989); *Permian Corp. v. United States*, 665 F.2d 1214 (D.C. Cir. 1981). By contrast, the Eighth Circuit has taken the opposite approach and embraced a limited waiver exception when information is voluntarily disclosed to the Government during an investigation, reasoning that "[t]o hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to...advise them in order to protect stockholders, potential stockholders, and customers." *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (en banc). The Second Circuit has taken a middle position that turns on whether the disclosing party has entered into a confidentiality agreement with the Government. See *In re Steinhardt Partners L.P.*, 9 F.3d 230, 230-31 (2d Cir. 1993).
- 59/ FAR 42.709-1(a). See generally Lemmer & Masiello, "Penalties for Unallowable Costs," Briefing Papers No. 99-6 (May 1999).
- 60/ FAR 31.001.
- 61/ *General Dynamics Corp.*, ASBCA No. 49372, 02-2 BCA ¶ 31,888, at 157,570, recons. denied, 02-2 BCA ¶ 32,020.
- 62/ See FAC 84-44, 54 Fed. Reg. 13,022 (Mar. 29, 1989) (effective Apr. 17, 1989); see also FAC 90-3, 55 Fed. Reg. 52,782 (Dec. 21, 1990) (effective Jan. 22, 1991).
- 63/ *John Doe Co.*, ASBCA No. 24576, 80-2 BCA ¶ 14,620, at 72,117.
- 64/ *Id.* at 72,118.
- 65/ DAC 76-39, 48 Fed. Reg. 3457 (Jan. 25, 1983) (adding DAR 15-205.52, "Defense of fraud proceedings," to the cost principles effective October 20, 1982).
- 66/ DAR 15.205-52(d) (1982).
- 67/ *Id.*
- 68/ 48 Fed. Reg. 42,102 (Sept. 19, 1983).
- 69/ Department of Defense Authorization Act, 1986, Pub. L. No. 99-145, tit. IX ("Defense Procurement Improvement Act of 1985"), § 911, 99 Stat. 583, 682 (Nov. 8, 1985) (codified as amended at 10 U.S.C.A. § 2324); FAC 84-15, 51 Fed. Reg. 12,296 (Apr. 9, 1986) (revising FAR 31.205-47(b) effective April 7, 1986).
- 70/ Pub. L. No. 99-145, § 911.
- 71/ FAC 84-44, 54 Fed. Reg. 13,022 (Mar. 29, 1989) (effective Apr. 17, 1989); FAC 90-3, 55 Fed. Reg. 52,782 (Dec. 21, 1990) (effective Jan. 22, 1991).
- 72/ Major Fraud Act of 1988, Pub. L. No. 100-700, 102 Stat. 4631 (Nov. 19, 1988), (codified at 10 U.S.C.A. § 2324 and 41 U.S.C.A. § 256); see also National Defense Authorization Act, Fiscal Year 1989, Pub. L. No. 100-456, § 832, 102 Stat 2023-24 (Sept. 29, 1988) (revising 10 U.S.C.A. § 2324 shortly before enactment of Major Fraud Act).
- 73/ 10 U.S.C.A. § 2324(k)(1), (2); 41 U.S.C.A. § 256(k)(1), (2); see also *Rumsfeld v. General Dynamics Corp.*, 365 F.3d 1380, 1390 (Fed. Cir. 2004), 46 GC ¶ 217 (the Major Fraud Act "does not require or permit the apportionment of contractor costs associated with a proceeding among various claims where the proceeding is resolved through consent or compromise, and no such costs are allowable except as expressly provided by the settlement agreement").
- 74/ 10 U.S.C.A. § 2324(k)(5)(B); 41 U.S.C.A. § 256(k)(5)(B).
- 75/ 10 U.S.C.A. § 2324(k)(5)(C); 41 U.S.C.A. § 256(k)(5)(C).
- 76/ 10 U.S.C.A. § 2324(k)(3); 41 U.S.C.A. § 256(k)(3).
- 77/ 10 U.S.C.A. § 2324(k)(4); 41 U.S.C.A. § 256(k)(4).
- 78/ 10 U.S.C.A. § 2324(k)(6); 41 U.S.C.A. § 256(k)(6).
- 79/ FAC 84-44, 54 Fed. Reg. 13,022 (Mar. 29, 1989) (effective Apr. 17, 1989); FAC 90-3, 55 Fed. Reg. 52,782 (Dec. 21, 1990) (effective Jan. 22, 1991).
- 80/ 10 U.S.C.A. § 2324(l); 41 U.S.C.A. § 256(l).

- 81/ Department of Defense Authorization Act, 1986, Pub. L. No. 99-145, § 911, 99 Stat. 583, 682 (Nov. 8, 1985).
- 82/ Pub. L. No. 99-145, § 1534.
- 83/ 51 Fed. Reg. 12,296 (Apr. 9, 1986).
- 84/ 10 U.S.C.A. § 2324(k)(1); 41 U.S.C.A. § 256(k)(1).
- 85/ FAR 31.205-47(b).
- 86/ 10 U.S.C.A. § 2324(k)(1); 41 U.S.C.A. § 256(k)(1).
- 87/ FAR 31.205-47(b); see *Brownlee v. DynCorp*, 349 F.3d 1343 (Fed. Cir. 2003), 45 GC ¶ 488 (holding that the statute was ambiguous and that the regulation was a reasonable interpretation of the statute entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)).
- 88/ FAC 84-44, 54 Fed. Reg. 13,022 (Mar. 29, 1989).
- 89/ FAC 90-3, 55 Fed. Reg. 52,782 (Dec. 21, 1990).
- 90/ 55 Fed. Reg. at 52,783.
- 91/ See 31 U.S.C.A. § 3730.
- 92/ DCAA Memorandum for Regional Auditors (94-PAD-100(R)) (June 20, 1994).
- 93/ *Id.*
- 94/ *Id.*
- 95/ *Id.*
- 96/ DCAA Memorandum for Regional Directors (95-PAD-121(R)) (Aug. 24, 1995).
- 97/ *Id.*
- 98/ *Id.*
- 99/ DCAA Contract Audit Manual ¶ 7-1918.2d (Jan. 1997).
- 100/ 61 Fed. Reg. 31,790 (June 20, 1996).
- 101/ Letter from Marcia G. Madsen, Chair, Section of Public Contract Law, to Jeremy Olson, FAR Secretariat, and Sandra G. Haberlin, DAR Council (Sept. 22, 1997), available at http://www.abanet.org/contract/federal/regscmm/quitam_001.html.
- 102/ 63 Fed. Reg. 58,599 (Oct. 30, 1998).
- 103/ *Id.*
- 104/ *Id.*
- 105/ FAR 31.205-47(c)(2).
- 106/ FAR 31.2005-47(e)(3).
- 107/ FAR 31.201-2.
- 108/ FAR 31.201-3.
- 109/ *Hirsch Tyler Co.*, ASBCA No. 20962, 76-2 BCA ¶ 12,075, at 57,986.
- 110/ *Hayes Int'l Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076, at 52,731. See also *Ravenna Arsenal, Inc.*, ASBCA No. 17802, 74-2 BCA ¶ 10, 937, at 52,068 (holding that costs incurred in settling an employment discrimination suit were allowable); *John Doe Co.*, ASBCA No. 24576, 80-2 BCA ¶ 14,620, at 72,118 (refusing to categorically rule out any outcome-determination rule for allowability or allocability).
- 111/ *Hirsch Tyler Co.*, 76-2 BCA ¶ 12,075, at 57,985–86. (also concluding that the costs of satisfying the judgment awarded against the contractor were reasonable and allowable).
- 112/ *Commissioner v. Tellier*, 383 U.S. 687, 694–95 (1966).
- 113/ DCAA Memorandum for Regional Directors (95-PAD-062(R)) (Apr. 13, 1995); see 37 GC ¶ 387.
- 114/ *Boeing North Am., Inc.*, ASBCA No. 49994, 00-2 BCA ¶ 30,970, at 152,848, 42 GC ¶ 331, vacated and remanded, *Boeing North Am., Inc. v. Roche*, 298 F.3d 1274, 1274–75 (Fed. Cir. 2002), vacated and remanded, 298 F.3d 1274 (Fed. Cir. 2002).
- 115/ *Boeing North Am., Inc.*, 00-2 BCA ¶ 30,970, at 152,848 (citing Memorandum from Chairman, Costs Principles Committee, to the Director, DAR Council (Nov. 29, 1988)).
- 116/ *Boeing North Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002).
- 117/ *Northrop Worldwide Aircraft Servs., Inc.*, ASBCA No. 45216, 98-1 BCA ¶ 29,654, at 146,935, rev'd, *Caldera v. Northrop Worldwide Aircraft Servs., Inc.*, 192 F.3d 962, 962–63 (Fed. Cir. 1999); see Manos, "Feature Comment: The Federal Circuit's Decision in *Boeing North American: Better, But Still Wrong*," 44 GC ¶ 203 (June 5, 2002).
- 118/ *Northrop*, 98-1 BCA ¶ 29,654, at 146,936.
- 119/ *Northrop*, 192 F.3d at 967.
- 120/ *Id.* at 972 (footnote and citations omitted).
- 121/ The court not only confused the concepts of allowability and allocability, but cited the wrong provision of FAR 31.201-4 ("Determining allocability"). Because *Northrop* charged the costs directly to its Fort Sill contract, FAR 31.201-4(a), and not FAR 31.201-4(c) quoted by the court, applied.
- 122/ See FAR 31.201-3.

- 123/** See FAR 31.201-4. See generally Manos, supra note 1, ch. 7.
- 124/** Rice v. Martin Marietta Corp., 13 F.3d 1563, 1565 (Fed. Cir. 1993), 36 GC ¶ 17.
- 125/** Boeing North Am., Inc., ASBCA No. 49994, 00-2 BCA ¶ 30,970, at 152,848, 42 GC ¶ 331, vacated and remanded, Boeing North Am., Inc. v. Roche, 283 F.3d 1320, vacated and remanded, 298 F.3d 1274 (Fed. Cir. 2002).
- 126/** 69 Fed. Reg. 34,241 (June 18, 2004).
- 127/** Boeing North Am., 00-2 BCA ¶ 30,970, at 152,848.
- 128/** After the panel issued its decision, rehearing en banc was granted for the limited purpose of authorizing the panel to revise its opinion. Accordingly, the en banc court on July 29, 2002, vacated the judgment entered on March 15, 2002, and returned the appeal to the merits panel, which issued the revised opinion that appears at 283 F.3d 1320.
- 129/** Boeing North Am., Inc. v. Roche, 298 F.3d at 1280, 1281 (footnote and citations omitted).
- 130/** 298 F.3d at 1282, 1283.
- 131/** 298 F.3d at 1283, 1284.
- 132/** 298 F.3d at 1289–90.
- 133/** 298 F.3d at 1285.
- 134/** Id.
- 135/** 298 F.3d at 1286.
- 136/** Id.
- 137/** Id.
- 138/** 298 F.3d at 1287–88.
- 139/** 298 F.3d at 1288.
- 140/** Id. (citing FAR 31.205-47(c)(2)).
- 141/** Id.
- 142/** FAR 31.205-33(b) (emphasis added).
- 143/** See Bill Strong Enters., Inc. v. Shannon, 49 F.3d 1541, 1549 (Fed. Cir. 1995), 37 GC ¶ 141 (reasoning that “[s]ince Congress demanded that the regulations state specifically what costs are unallowable,” costs not specifically made unallowable by FAR 31.205-33(d) “are presumptively allowable if they are also reasonable”).
- 144/** 63 Fed. Reg. 58,599 (Oct. 30, 1998).
- 145/** Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984).
- 146/** Southwest Marine, Inc., ASBCA No. 54234, 2005 WL 467158 (Feb. 23, 2005), 47 GC ¶ 130.
- 147/** See, e.g., Allied Materials & Equip. Co., ASBCA No. 17318, 75-1 BCA ¶ 11,150, at 53,086 (“Generally, legal expenses are subsumed in the general and administrative expense pool. That practice is widely employed because the services are generally rendered as supportive to managerial services with the benefits spread over or flowing to a contractor’s entire business organization or business unit, including Government and industry contract activity as well as other commercial business.”); TRW Sys. Group of TRW, Inc., ASBCA No. 11499, 68-2 BCA ¶ 7117, at 32,971 (holding that domestic patent costs are properly included in G&A expense pool).
- 148/** Explanation of Principles for Determination of Costs Under Government Contracts, ¶ 40(e) (Apr. 1942) (reprinted in Manos, supra note 1, app. B); see also id. ¶ 39 (observing that these types of “expenses are incurred in connection with the general administration of the contractor’s business and the distribution of the contractor’s products, a ratable part of which, by reference to all the pertinent facts and circumstances, may reasonably be held to constitute proper items of cost incident to and necessary for the performance of the contract”).
- 149/** See Dynallectron Corp. v. United States, 545 F.2d 736, 738 (Ct. Cl. 1976) (costs of defending against suit arising out of a commercial guaranty venture are directly chargeable to that venture); P.J. Dick Inc. v. General Servs. Admin., GSBCA No. 12415, 96-2 BCA ¶ 28,307, at 141,350 (holding that accountant’s fees for providing cost or pricing data in connection with a modification were attributable to the modification and therefore a direct cost); Hewitt Contracting Co., ENGBCA No. 4596 et al., 83-2 BCA ¶ 16,816, at 83,645 (although legal fees and expenses are generally included in G&A expense pool, when incurred wholly in connection with a particular contract, they are chargeable directly to that contract); Hirsch Tyler Co., ASBCA No. 20962, 76-2 BCA ¶ 12,075, at 57,984–85 (legal fees incurred in defending against employment discrimination complaint by employee who worked exclusively on one contract are direct costs of that contract); Allied Materials & Equip. Co., ASBCA No. 17318, 75-1 BCA ¶ 11,150, at 53,075 (legal expenses incurred in connection with request for equitable adjustment are directly chargeable to contract); R-D Mounts, Inc., ASBCA No. 17422, 75-1 BCA ¶ 11,077, at 52,742–43 (legal expenses incurred in defending against a subcontractor’s claim are a direct cost of the prime contract), recons. denied, 75-1 BCA ¶ 11,237, aff’d, 2 Cl. Ct. 320 (1983); Walter Motor Truck Co., ASBCA No. 8054, 66-1 BCA ¶ 5365, at 25,166,

- 8 GC ¶ 429 (“We accept appellant’s witness testimony that the accounting services in question were related only to the contract. The amount of accounting work required by appellant for this contract was all out of proportion to its normal accounting patterns and we think that it would be unfair to burden the commercial business of appellant with these costs.”). But see *John Doe Co.*, ASBCA No. 24576, 80-2 BCA ¶ 14,620, at 72,114 (costs incurred in criminal investigation of labor mischarging allowed in G&A pool); *Hayes Int’l Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076, at 52,731 (costs of defending against employment discrimination claim allowed in G&A pool).
- 150/ *Jana, Inc.*, ASBCA No. 32447, 88-2 BCA ¶ 20,651, at 104,385.
- 151/ *Id.* at 104,382
- 152/ *FMC Corp., Northern Ordnance Div.*, ASBCA No. 30130, 87-2 BCA ¶ 19,791, at 100,139, *aff’d*, *FMC Corp. v. United States*, 853 F.2d 882 (Fed. Cir. 1988), 30 GC ¶ 345.
- 153/ Compare, e.g., *Lear Siegler, Inc.*, ASBCA No. 20040, 78-1 BCA ¶ 13,110, at 64,070-71, *aff’d on recons.*, 79-1 BCA ¶ 13,687, at 67,125 (denying claim for legal costs incurred in successfully defending against defective pricing allegations) with *G.W. Galloway Co.*, ASBCA No. 17436 *et al.*, 77-2 BCA ¶ 12,640, at 61,295–96 (holding that consultant costs are recoverable as a constituent element of a request for equitable adjustment where the added technical and administrative effort was caused by the Government’s improper acts and failures to act).
- 154/ See *Orlando Helicopter Airways, Inc. v. Widnall*, 51 F.3d 258, 262–63 (Fed. Cir. 1995) (“A criminal investigation may well interfere with a contract to which the government is a party. [The contractor] enjoys no advantage over similarly situated contractors merely because its contract happens to be with the government. Perhaps if the contracting officer initiated and directed the investigation as part of contract administration then a contract claim might arise.”); see also *General Dynamics Corp. v. United States*, 139 F.3d 1280, 1286 (9th Cir. 1998) (even where the investigation started with allegations made in a negligently performed DCAA audit, the contractor had no remedy under the Federal Tort Claims Act; the Ninth Circuit reversed the district court’s holding in favor of the contractor and held that because the contractor’s harm actually flowed from the prosecutor’s exercise of discretion, the United States was immune from suit under the “discretionary function” exception to the Federal Tort Claims Act).
- 155/ *DynCorp*, ASBCA No. 49714, 97-2 BCA ¶ 29,233, at 145,430 (rejecting the Government’s argument that the sovereign acts doctrine, as articulated in *Orlando Helicopter Airways*, 51 F.3d 258 (Fed. Cir. 1995), precludes recovery of legal proceeding costs under a cost reimbursement contract because “the Government may contractually agree to pay for acts from which it, as sovereign, would otherwise escape liability”).
- 156/ See 48 C.F.R. § 9904.402-40; see also *Aydin Corp. (West) v. Widnall*, 61 F.3d 1571, 1579 (Fed. Cir. 1995) (holding that the fact that a particular foreign sales commission was extremely large (accounting for 91% of the contractor’s sales commissions for the year, while the contract for which it was paid accounted for only 19% of the contractor’s total cost input G&A allocation base), did not mean that the sales commission should be removed from the G&A expense pool and allocated directly to the benefiting contract). See generally *Manos*, *supra* note 1, ch. 63.
- 157/ See *United States v. Boeing Co.*, 802 F.2d 1390, 1394 (Fed. Cir. 1986) (holding that DAR 15-205.6(f)(2)(ii)(B), which provided that the costs of unfunded pension plans were allowable only to the extent that they were tax deductible in the year recorded, thereby effectively requiring cash basis accounting, impermissibly conflicted with CAS 412, which required accrual accounting).
- 158/ FAR 31.205-33(b).
- 159/ See, e.g., *Standard Steel Car Co. v. United States*, 67 Ct. Cl. 445, 486 (1929); see also *Explanation of Principles for Determination of Costs Under Government Contracts* ¶ 54(p) (Apr. 1942) (making “inadmissible” the costs of “[s]pecial legal and accounting fees incurred in connection with...the prosecution of claims of any kind (including income tax matters) against the United States”); *ASPR 15-205(l)* (1948 ed.) (making unallowable the costs of “[l]egal, accounting and consulting services and related expenses incurred in connection with...the prosecution of claims against the United States”).
- 160/ FAC 84-15, 51 Fed. Reg. 12,296 (Apr. 9, 1986).
- 161/ *Id.*; see *Bos’n Towing & Salvage Co.*, ASBCA No. 41357, 92-2 BCA ¶ 24,864, at 124,034 (observing that the parenthetical reference to FAR 33.201 narrowed the scope of the cost principle by making “claim” a term of art and holding, therefore, that costs incurred in unsuccessful defense against a Small Business Administration size status appeal and protest against award were allowable); accord *Bill Strong Enters., Inc. v. Shannon*, 49 F.3d 1541, 1549

(Fed. Cir. 1995), 37 GC ¶ 141 (“We hold that, by referring specifically to FAR 33.201, the amended cost principle of FAR 31.205-33 recognized the word ‘claim’ as a term of art, the meaning of which is set forth in FAR 33.201.”), overruled in part on other grounds by *Reflectone, Inc. v. Dalton*, 60 F.3d 1572, 1579 n.10 (Fed. Cir. 1995).

- 162/** FAC 2001-08, 67 Fed. Reg. 43,513 (June 27, 2002).
- 163/** See *Data-Design Labs.*, ASBCA No. 27,535, 85-3 BCA ¶ 18,400, at 92,307.
- 164/** See, e.g., *Grumman Aerospace Corp. v. United States*, 579 F.2d 586, 595 (Ct. Cl. 1978) (holding that the costs of litigating a Freedom of Information Act case against the Government were allowable because “the ASPR clause relating to ‘prosecution of claims against the Government’ covers monetary claims only (or claims for property), not demands or suits against the Government for other types of relief”); *Hayes Int’l Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076, at 52,726–27, 17 GC ¶ 157 (holding that legal costs incurred in defending against a Government cost disallowance were not costs of prosecuting a claim against the Government, but legal costs incurred in seeking an injunction against the award of a contract were).
- 165/** See *Bill Strong*, 49 F.3d at 1550.
- 166/** *Id.*
- 167/** See *Unarco Material Handling*, PSBCA No. 4100, 00-1 BCA ¶ 30,682, at 151,526 (contractor entitled to “profit on attorney and consultant fees incurred in preparing and negotiating [its] equitable adjustment request”); see also *Bruce Constr. Corp. v. United States*, 324 F.2d 516 (Ct. Cl. 1963) (term “equitable adjustment” includes profit).
- 168/** *Bill Strong*, 49 F.3d at 1550.
- 169/** 49 F.3d at 1551 (holding that the board “erred in holding that the consulting costs were unallowable because they were incurred after the contract work performance was completed,” and observing that “contract administration may continue, as it did in this case, after completion of contract work”).
- 170/** See *James M. Ellett Constr. Co. v. United States*, 93 F.3d 1537, 1543 (Fed. Cir. 1996); accord *Rex Sys., Inc. v. Cohen*, 224 F.3d 1367, 1372 (Fed. Cir. 2000) (to be a claim under the CDA, the submission must request a final decision).
- 171/** FAR 2.101; see also *Federal Ins. Co.*, IBCA 3236-3240, 96-2 BCA ¶ 28,415, at 141,929 (holding that “there was no valid CDA claim until [the contractor] submitted its properly certified claim”).
- 172/** FAR 33.208.

173/ 49 F.3d at 1551 n.9.

174/ Compare *Grumman Aerospace Corp.*, ASBCA 50090, 01-1 BCA ¶ 31,316, at 154,674 (“the mere filing of a CDA claim does not automatically require a conclusion that costs incurred thereafter are unallowable costs of prosecuting a claim against the Government”), and *Bill Strong Enters., Inc.*, ASBCA 42946 et al., 96-2 BCA ¶ 28,428, at 141,999 (on remand) (“Since only costs associated with ‘prosecution’ are unallowable, the status of a submittal as a claim under *Dawco [Constr., Inc. v. United States]*, 930 F.2d 872 (Fed. Cir. 1991) is not ipso facto determinative of allowability of costs associated therewith. Costs incurred in connection with work performance or administration of a contract are presumptively allowable if they are also reasonable and allocable.”), with *Plano Builders Corp. v. United States*, 40 Fed. Cl. 635, 642 (1998) (“after *Reflectone [Inc. v. Dalton]*, 60 F.3d 1572 (Fed. Cir. 1995)], rather than constituting a phase distinct from the prosecution of a claim, the exchange of information and negotiations between the contractor and the contracting officer are a natural part of the interactions between the parties after submission of a CDA claim, i.e., negotiations are a reasonably expected part of a contractor’s prosecution of a CDA claim”).

175/ 40 Fed. Cl. 635.

176/ *Reflectone, Inc. v. Dalton*, 60 F.3d 1572, 1579 (Fed. Cir. 1995).

177/ 60 F.3d at 1583.

178/ *Acme Process Equip. Co. v. United States*, 347 F.2d 538, 545-46 (Ct. Cl.), 7 GC ¶ 370, mot. for recons. denied, 351 F.2d 656 (Ct. Cl. 1965) (footnote omitted); accord *Baifield Indus., Div. of A-T-O, Inc.*, ASBCA No. 20006, 76-2 BCA ¶ 12,096, at 58,103 (“The expenses of efforts to settle the claim with the contracting officer are allowable; the expenses of litigating an appeal before the Board of Contract Appeals are not allowable. Thus the pendency of an appeal does not bar recovery of legal or accounting expenses incurred as part of a genuine effort to settle a termination for convenience claim with the contracting officer.”) (citations omitted), mot. for recons. denied, 76-2 BCA ¶ 12,203.

179/ See FAR 33.204; see also *Bill Strong*, 49 F.3d at 1550 (costs of negotiation are “allowable since this negotiation process benefits the Government, regardless of whether a settlement is finally reached or whether litigation eventually occurs because the availability of the process increases the likelihood of settlement without litigation”); *Transamerica Ins. Corp. v. United States*, 973 F.2d 1572, 1579 (Fed. Cir. 1992) (cited with approval in *Reflectone*, 60 F.3d at 1583).