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Focus

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Feature Comment · The Federal Circuit's Decision in *Boeing North American*: Better, But Still Wrong

The Federal Circuit's recent decision in *Boeing North American, Inc. v. Roche*, 283 F.3d 1320 (Fed. Cir. 2002), 44 GC ¶ 112, has once again changed the rules for the allowability of legal costs. Although the decision helpfully corrects the accounting error of *Caldera v. Northrop Worldwide Aircraft Services, Inc.*, 192 F.3d 962 (Fed. Cir. 1999), 18 FPD ¶ 136, 42 GC ¶ 430, it commits its own legal error that, if not corrected, will likely cause further mischief. This Feature Comment analyzes two of the most significant aspects of the *Boeing* decision: its rejection of the erroneous notion that a cost is allocable only if there is some benefit to the Government for incurring the cost, and its surprising expansion of the "legal and other proceedings" cost principle to make costs incurred in defense of private suits settled before trial unallowable unless the contractor can show that the allegations had "very little likelihood of success on the merits."

The Confusion Engendered by *Northrop*— *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 Contracting Officer's final decision denying Northrop'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. *Northrop Worldwide Aircraft Servs., Inc.*, ASBCA 45216, 98-1 BCA ¶ 29,654.

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." The Federal Circuit agreed, holding that:

> *It is established that the contractor must show a benefit to government work from an expenditure of a 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 NWASI'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.*

192 F.2d at 972 (footnote and citations omitted). In so holding, the Federal Circuit confused the concepts of allocability and allowability.

Unlike reasonableness, which turns on a normative judgment about the nature and amount of the cost, allocability is strictly an accounting concept for logically distributing costs to cost objectives in order to accurately determine their cost. The Federal Circuit recognized this concept in *Rice v. Martin Marietta Corp.*, 13 F.3d 1563, 1565 (Fed. Cir. 1993), 12 FPD ¶ 128, 36 GC ¶ 17, explaining that:

> *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*

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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 normative judgment about whether, as a policy matter, the Government should or should not reimburse the cost. As Professor William Vatter observed in a letter regarding establishment of the Cost Accounting Standards:

Cost assignment is measurement, not an ethical or moral process. The cost attributable to an activity or product ought to be established by objective and logical operations. Ethics, fairness or justice are essential elements in human actions or negotiations, but measurement ought to be as free as possible from motivational or charismatic issues, if only because we rely on measurement to check upon qualitative and behavioral phenomena.

Moreover, all costs are allocable somewhere; there cannot be a completely non-allocable cost. The litigation costs at issue in *Northrop* were plainly allocable to the Fort Sill contract, and could not have been allocated to any other contract. However, while the total cost of a contract includes all costs allocable to the contract, the fact that a cost is *allocable* does not necessarily mean that it is *allowable*.

***Boeing North American, Inc. v. Roche* (ASBCA Applies *Northrop*)—**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 personal gain; and (5) Rockwell was the subject of a criminal investigation of alleged hazardous waste dumping and other environmental wrongs.

In response to the *Citron* suit, Rockwell's board of directors formed a "Special Litigation Committee" (SLC), comprised of directors who were not named as defendants in the suit, to investigate the allegations. Rockwell retained outside law firms to represent Rockwell, the director-defendants, and the SLC. Subsequently, the SLC issued a report concluding that although there had been past violations of federal law in Rockwell's performance of its federal contracts, there was no "pattern or overall scheme in the incidents" and Rockwell's internal controls were adequate, and, therefore, the *Citron* suit was not "justifiable or … reasonably likely to succeed."

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 general and administrative (G&A) costs in its home office overhead, which was allocated to various Government contracts. The CO disallowed the legal costs as unreasonable under Federal Acquisition Regulation 31.201-3, and unallowable under FAR 31.204(c) as being "similar or related" to costs that are unallowable under FAR 31.205-15 (fines, penalties, and mischarging costs) and 31.205-47(b) (costs related to legal and other proceedings). Boeing, as Rockwell's successor, then appealed the CO's decision to the ASBCA.

In upholding the CO's decision, the ASBCA, citing *Northrop*, held that costs incurred to defend against and settle the shareholders' derivative suit were not allocable because the ASBCA could "discern no benefit to the Government in a contractor's defense of a third party lawsuit in

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which the contractor's prior violations of federal laws and regulations were an integral part of the third party allegations." *Boeing North American, Inc.*, ASBCA No. 49994, 00-2 BCA ¶ 30,970, 42 GC ¶ 331. In addition, the ASBCA held that the costs were unallowable because

> *the underlying conduct of Rockwell ..., but for which neither the* Citron *suit nor the costs in dispute in this appeal would have arisen, comes within the "guiding principle," in the federal agency implementation of the Major Fraud Act of 1988, that federal agencies should not pay for the results or consequences of contractor wrongdoing.*

Federal Circuit Recasts *Northrop*, Rejects ASBCA's "Benefit" Analysis—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. The Court began by distinguishing between the concepts of allocability and allowability, correctly explaining that:

> *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. Cost allocability is to be determined according to the principles of FAR § 31.201-4, or under the Cost Accounting Standards ("CAS"), 4 C.F.R. Parts 403, 410, if the contract is covered by the CAS.*
>
> *The concept of cost allowability concerns whether a particular cost can be recovered from the government in whole or in part. 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.*
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> *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."*

The court then effectively recast the *Northrop* decision, stating that:

> *This panel is, of course, bound by our decision in* Northrop*, and we reaffirm here our holding in* Northrop *that a contractor's legal costs are unallowable when incurred in the unsuccessful defense of a lawsuit that involved a judicial determination that the contractor sought to induce its employees to commit fraud against the government by the contractor. Some of the language in our decision in* Northrop*, however, has caused confusion about why the costs in question were not allowable. In that case, the government urged that "where the costs arise from the defense of wrongful conduct involving ... fraud upon the government, and the legal costs are not allocable to the contract," and because there was no benefit to the government the costs were "not allowable costs of the contract."* Northrop *did not address the difference between allocability and allowability, and simply argued that the state court's judgment was not collateral estoppel, and that it was reasonable for Northrop to defend the suit based on the available evidence. Adopting the government's approach, we eventually concluded that the legal defense costs were unallowable "because the government did not benefit from [the contractor's] defense of the [state court] lawsuit...."*
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> *The government (again) urges us to adopt such an approach. However, we conclude that the government's approach is not, in fact, consistent with the regulations.*
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> *The word "benefit" is used in [FAR 31.201-4] to describe the nexus required for accounting purposes between the cost and the contracts to which it is allocated. FAR § 31.201-4(b) only requires that the cost benefit the contract to which it is allocated for the cost to be allocable. The requirement of a "benefit" to a government*

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> *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 allowable. The question of allowability 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).*

Accordingly, the Federal Circuit "agree[d] with Boeing that the word 'benefit,' as used in FAR § 31.201-4, refers to an accounting concept and does not impose a separate requirement that a cost benefit the government's interests for the cost to be allowable." 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."

Legal Defense Costs Allowable Only If Underlying (Settled) Lawsuit Lacked Merit— Relying on a basis for disallowance not argued by the Government, the Federal Circuit remanded to the ASBCA with instructions to "allow the costs only if it determines that the plaintiffs in the *Citron* lawsuit had 'very little likelihood of success on the merits' of prevailing." The Federal Circuit reached this surprising result by following the path taken in the CO's final decision. Under FAR 31.205-33, the costs of professional and consulting services are generally allowable when reasonable in relation to the services rendered and not contingent upon recovery of the costs from the Government. However, the Federal Circuit rejected as "fundamentally flawed" Boeing's argument that the only professional service costs that are not allowable under FAR 31.205-33 are those specifically disallowed under another cost principle. Citing FAR 31.204(c), the Court noted that the cost principles in FAR 31.205 do not cover every element of cost, and the failure to include any item of cost does not imply that the cost is either allowable or unallowable. In the absence of an applicable cost principle, the Court reasoned, FAR 31.204(c) requires that allowability be determined using the cost principles applicable to "similar or related" costs.

Then, continuing to rewrite *Northrop*, the Court went on to state that, "[p]roperly understood, *Northrop* and FAR §31.205-47 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." FAR 31.205-47 makes unallowable the costs incurred in connection with a proceeding brought by the government, or a *qui tam* relator under the False Claims Act, if the proceeding results in (1) a criminal conviction; (2) a civil or administrative finding of contractor liability where the case involve allegations of fraud or a monetary penalty is imposed; (3) a final decision to debar or suspend the contractor, or rescind, void or terminate the contract for default; (4) a settlement or compromise, if the proceeding could have led to any of the foregoing outcomes; or (5) not covered by one of the foregoing, but where the underlying alleged contractor misconduct is the same as that which led to a different proceeding whose costs are unallowable for one of the foregoing reasons.

The Federal Circuit 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. Additionally, because there had been no judicial determination that Rockwell's directors had failed to maintain adequate controls to prevent the occurrence of wrongdoing against the government, the CAFC concluded that there was no "direct relationship" to any unallowable costs.

Nevertheless, the Court reasoned, where the contractor settles a suit brought by a private party – where the costs of an unsuccessful defense would have been disallowed – the "regulations suggest" that the allowability of legal defense costs should turn on "whether the plaintiff was likely to pre-

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vail." 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." FAR 31.205-47(c)(2) provides that such costs are allowable only "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." The Court then concluded that this was an appropriate standard for determining the allowability of the costs of the shareholder derivative suit.

***Boeing* Creates Further Uncertainty**—There are two significant problems with the Federal Circuit's decision in *Boeing*. First, in expanding FAR 31.205-47 to cover "similar" or "related" costs, the Court ignored the statutory basis for the cost principle. Second, the "related" cost principle on which the court based its decision was not in effect until long after the contract under which the appeal was taken was awarded.

In order for a regulation to have the force and effect of law, it must be promulgated pursuant to a statutory grant of authority and in compliance with any required rulemaking procedures. *E.g., Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988). The Supreme Court in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984), articulated a two-step approach to analyzing whether an agency action is authorized by law. First, the reviewing court must determine "whether Congress has directly spoken to the precise question at issue." And if "the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." It is only when "the statute is silent or ambiguous" or "explicitly [leaves] a gap for the agency to fill" that a reviewing court ever reaches the second step of the *Chevron* inquiry. Under the second prong of the *Chevron* analysis, the reviewing court should defer to an agency's interpretation of a statute it administers if the interpretation "is reasonable and consistent with the statute's purpose."

The statutory basis for FAR 31.205-47 is found in 10 U.S.C. § 2324 and 41 U.S.C. §256. Those statutes provide, in pertinent part, that:

> *costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding* commenced by the United States or a State *are not allowable as reimbursable costs under a covered contract if the proceeding (A) relates to a violation of, or failure to comply with, a Federal or State statute or regulation, and (B) results in a disposition described in paragraph (2). [emphasis added]*

The referenced paragraph (2) includes the same five dispositions discussed above in connection FAR 31.205-47. The statutes further provide that if a proceeding

> *commenced by the United States … is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the costs incurred by the contractor in connection with such proceeding that are otherwise not allowable as reimbursable costs under such paragraph may be allowed to the extent specifically provided in such agreement.*

Because the statutes speak 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 *Chevron*, there is no "gap" for the FAR Council – much less the Federal Circuit, which has no rulemaking authority – to fill. For that reason, the Federal Circuit's expansion of the cost principle was improper.

The Federal Circuit also erred in giving retroactive effect to FAR 31.205-47(c)(2), which was first added to the cost principles in 1998. The 1989 contract at issue in *Boeing* included the Allowable Cost and Payment clause, which expressly incorporates the cost principles in effect at the time of contract award. (The Federal Circuit in footnote 1 of the *Boeing* opinion mistakenly states that the applicable cost principles are those in effect at the time the costs were incurred.) Although acknowledging that FAR 31.205-47(c)(2) did not exist in 1989, the Court stated that it was designed "to clarify the proper

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interpretation" of the cost principle as it relates to *qui tam* suits in which the United States does not intervene. The Court noted that the American Bar Association Section of Public Contract Law submitted comments critical of the FAR Council's intent to retroactively apply the new rule because it was plainly a substantive change and not a mere clarification. Without making any effort to independently determine whether the amendment effected a substantive change, the Court simply noted that the DAR Council rejected the ABA's suggestion, and stated it was therefore "clear that FAR 31.205-47(c)(2) applies retroactively and merely clarifies how the FAR principles, as they existed prior to 1998, applied to the allowability of costs related to the defense of qui tam suits brought under the False Claims Act." Ironically, in *Charles G. Williams Construction, Inc. v. White*, 271 F.3d 1055 (Fed. Cir. 2001), 43 GC ¶ 460, the Federal Circuit criticized the ASBCA for just this sort of *ipsi dixit* reasoning, stating that it was the function and responsibility of the ASBCA to determine for itself whether the contractor had established its case. Yet, the ASBCA's deference to the contract auditor in *Williams* is no more an abdication of its judicial responsibility than the Federal Circuit's deference to the DAR Council's promulgation comments.

In summary, although the Federal Circuit's decision in *Boeing* helpfully clears up the confusion engendered by *Northrop*, it improperly expands FAR 31.205-47 beyond the statutory authority of the regulators. For that reason, application of the decision by COs and auditors will undoubtedly lead to further disputes.

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