GOVERNMENT CONTRACT
COSTS, PRICING & ACCOUNTING REPORT®

DECEMBER 2019 | VOLUME 14 | ISSUE 6

¶ 48 Federal Circuit Disrupts Law Of Expressly Unallowable Costs

Paul E. Pompeo and Nathaniel E. Castellano[1]

The U.S. Court of Appeals for the Federal Circuit held in *Raytheon Co. v. Sec'y of Def.*, No. 2018-2371, 2019 WL 5280873 (Fed. Cir. Oct. 18, 2019) that salaries associated with lobbying activities are expressly unallowable under Federal Acquisition Regulation 31.205-22.

In 2005, Raytheon submitted an incurred cost rate proposal. The Defense Contract Audit Agency asserted that the proposal contained expressly unallowable costs. In 2011, an administrative contracting officer issued a final decision determining that Raytheon's proposal included expressly unallowable salary costs of personnel engaged in lobbying activities. The ACO demanded that Raytheon repay the Government for these reimbursed expressly unallowable costs, and assessed penalties and interest against Raytheon. The ASBCA upheld the CO's decision, finding that the lobbying costs were subject to penalty because "[c]osts associated with certain named lobbying activities are stated to be unallowable under FAR 31.205-22" and thus "are expressly unallowable." *Raytheon Co.*, ASBCA 57743, 17-1 BCA ¶ 36,724. Raytheon appealed.

The issue on appeal involved the distinction between unallowable costs and expressly unallowable costs, in the significance of the phrase "associated with." Although many types of cost may be unallowable, a smaller subset of costs are expressly unallowable. An expressly unallowable cost is "a *particular item or type of cost* which, under the express provisions of an applicable law, regulation, or contract, is *specifically named and stated to be unallowable*." FAR 31.0001 (emphasis added). Contractors are subject to penalty if they submit to the Government any expressly unallowable cost. FAR 42.709-1(a)(1). Congress made clear that the penalty is intended for limited circumstances in which the regulations explicitly prohibit inclusion of a type of cost, providing alcohol as an example.

Implementing statutory provisions at 10 U.S.C.A. § 2324(e)(B), FAR 31.205-22 designates as unallowable costs "associated with" various lobbying and political activities. FAR 31.205-22(a). The narrow question presented to the Federal Circuit was whether salary costs "associated with" employees engaging in that lobbying activity qualify as expressly unallowable costs. The Federal Circuit affirmed the ASBCA decision.

Even though FAR 31.205-22 does not expressly name and state salary or compensation as unallowable, the Federal Circuit nevertheless held that such salary costs are expressly unallowable:

> The definition in FAR § 31.001 of an "expressly unallowable cost" refers to "a particular item or type of cost." These two categories of costs confirm that an

[1] *Paul E Pompeo is a Partner and Nathaniel E. Castellano is an Associate in the Government Contracts and National Security Practice at Arnold & Porter, Washington, D.C.*

> "expressly unallowable" cost includes more than an explicitly stated "item." Costs *unambiguously falling within a generic definition of a "type" of unallowable cost* are also "expressly unallowable." Here, salaries of in-house lobbyists are a prototypical lobbying expense. Subsection 22 disallows "costs associated with" activities such as "attempt[ing] to influence … legislation … through communication with any member or employee of the … legislature" or "attend[ing] … legislative sessions or committee hearings." Salaries of corporate personnel involved in lobbying are unambiguously "costs associated with" lobbying.

(Emphasis added.)

In rendering its decision, the Federal Circuit examined the administrative history of FAR 31.205-22. Harkening back to the predecessor Defense Acquisition Regulation, the court found that the prior regulation specifically named salaries of personnel engaged in lobbying activities as unallowable. Upon the promulgation of the FAR, however, that specific reference was removed.

Raytheon argued that, although salaries for employees engaged in lobbying activities might be unallowable, the elimination of the specific reference to salaries in the regulation removed that type of cost from the purview of an expressly unallowable cost and its penalties. The Federal Circuit seems to have misunderstood Raytheon's argument, and more broadly, the significance of the distinction between an unallowable cost and an expressly unallowable cost.

Raytheon also relied on a prior ASBCA decision, in which the board concluded that bonus and incentive compensation (BAIC) costs are not expressly unallowable under FAR 31.205-22, because the costs were not specifically named and stated in the cost principle; i.e., the "associated with" language was not sufficient to invoke the standard of expressly unallowable costs and the resultant penalty. *Raytheon Co.*, ASBCA No. 57576, 15-1 BCA ¶ 36,043.

The board had distinguished its prior decision from the present circumstance of compensation. Regrettably, in addressing this issue on appeal, the Federal Circuit stated, in dicta, that its holding effectively overturns, in part, the ASBCA's prior holding that BAIC costs associated with lobbying activities are not "expressly unallowable." Without considering the underlying rationale of the ASBCA's prior decision, the Federal Circuit was not persuaded: "That decision is not binding on this court, and in any event, is contrary to the plain language of Subsection 22 to the extent that it concludes that salaries in the form of bonus and incentive compensation for lobbying and political activities are not 'expressly unallowable.' " (In full disclosure—one of the authors of this article represented Raytheon in ASBCA No. 57576.)

The Federal Circuit's reasoning raises several implications.

First, the Federal Circuit's approach appears to contradict the plain language of the definition of an expressly unallowable cost. Whereas the FAR defines expressly unallowable costs as those "specifically named and stated to be unallowable," the Federal Circuit seems to have adopted a broader test that encompasses "[c]osts unambiguously falling within a generic definition of a 'type' " deemed unallowable. Now, instead of asking only which types of costs are specifically named and stated as unallowable, contractors must apparently also consider what types of cost unambiguously fall within generic definitions of types of unallowable costs.

This muddying of the distinction between unallowable costs and expressly unallowable costs seems inconsistent with congressional intent. The reason that Congress included the specifically named and stated language was to avoid penalizing contractors where the regulations lack specificity. The onus is on the Government to draft cost principles that are precise.

Second, the Federal Circuit's reasoning could impact other cost principles that speak in terms of costs "associated with" a particular activity. FAR 31.205-1, for example, speaks to the allowability of public relations activities "associated with areas such as advertising, customer relations, etc." FAR 31.205-27 speaks to "expenditures in connection with" business organization costs. While the Federal Circuit's decision is tied to the language of Subsection 22, the opinion's rationale may sneak into other cost principles.

DCAA is guaranteed to rely on this case to assert

that a host of costs are expressly unallowable. Notwithstanding valid concern of DCAA overreach, the Federal Circuit's conclusion should be understood as limited to FAR 31.205-22. Indeed, the Federal Circuit's conclusion seems inherently tied to its understanding of the relationship between lobbying and lobbyists: "salaries of in-house lobbyists are a prototypical lobbying expense."

Finally, this case may create implications for Cost Accounting Standard 405 compliance. That standard directs the segregation of expressly unallowable costs from billings, claims and proposals. The uncertainty that the Federal Circuit has created regarding the definition of an expressly unallowable cost—which is identical in CAS 405—could lead to an implosion of alleged noncompliances with CAS 405, itself subject to compound daily interest.