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ASBCA Disallows Legal Fees Incurred Defending Litigation

Southwest Marine, Inc., ASBCA 54234, 2005 WL 467158 (Feb. 23, 2005)

Legal costs arising from contractor's unsuccessful defense of a citizen suit that alleged violations of the Clean Water Act were not allowable because the costs were similar to costs disallowed under Federal Acquisition Regulation 31.205-47(b)(2), the Armed Services Board of Contract Appeals has ruled. Because the costs were not specifically covered under the FAR, the Board relied on the U.S. Court of Appeals for the Federal Circuit's decision, *Boeing North American Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002), 44 GC ¶ 308, to determine whether the costs were "similar or related" to costs covered by the FAR. Private parties filed suit in the U.S. District Court for the Southern District of California alleging that Southwest Marine Inc. violated the Clean Water Act, 33 USCA § 1365(a). After a bench trial, the court found SWM violated the Act by failing to implement and enforce water pollution prevention controls. SWM was penalized \$799,000, or \$1,000 for every day the firm was in violation of the CWA. The penalty was to be offset by expenditures SWM made to comply with the court's decision. And, in fact, after SWM spent over \$1 million making improvements, the court ruled that SWM was not required to pay any penalty. However, SWM was responsible for attorneys' fees awarded to the prevailing parties. These included attorneys' and experts' fees resulting from the litigation, and attorneys' fees for

the reasonable cost of monitoring SWM to ensure it remained in compliance with the CWA. The Government had the right to intervene in the matter, but did not.

SWM submitted invoices to the Navy for legal costs and outside services—including reimbursement for plaintiff's legal fees—incurred by the firm defending the CWA suit. A Defense Contract Audit Agency report questioned the allowability of these costs, alleging they were unreasonable and unallowable under FAR 31.205-47. SWM contended the costs were allowable and submitted invoices to the Navy stating that the general and administrative (G&A) rate used to compute the billings included the CWA litigation costs. The Contracting Officer disallowed the litigation costs. SWM then filed a certified claim, which the CO denied, stating the costs were not properly included in SWM's G&A base for its cost-type contracts.

SWM appealed the CO's decision to the ASBCA alleging that its costs for legal fees and related services were allowable under its Government contracts. The Government and SWM agreed that the costs at issue are not specifically addressed in the FAR. SWM contended the costs are similar to those under FAR 31.205-33—Professional and consultant service costs, and therefore allowable. The Government argued that the costs are similar to those unallowable under FAR 31.205-47—Costs related to legal and other proceedings.

The Board sided with the Government, basing its decision on the Federal Circuit's *Boeing* decision. At issue in *Boeing* was the allowability of the contractor's costs to defend and settle a shareholder's derivative suit seeking damages for alleged violations of federal law. The Federal Circuit found that the costs, as here, were not specifically covered by the FAR. The court examined the costs to determine whether the regulations addressed "similar" or "related" items of cost. See FAR 31.204(c) (2000).

The court concluded that the regulations did not address costs "similar" to those incurred by Boeing for defending a private suit charging it with wrongdoing,

but did find the costs were “related to” cost items under FAR 31.205-47(c)(2) (2000). The court held that costs related to the treatment of settlements of private suits under the False Claims Act—in which the Government does not intervene—would only be allowable if the CO determined “that there was very little likelihood that plaintiffs would have been successful on the merits.”

Here, SWM’s legal costs were incurred in connection with a civil suit alleging a violation of the CWA, which resulted in a monetary penalty. FAR 31.205-47(b)(2) makes “unallowable the legal costs incurred by a contractor in connection with a civil proceeding brought by a government entity for violation of law resulting in the imposition of a monetary penalty.” The Board opined that if the Government had brought the suit, SWM’s costs would have been unallowable under the express language of 31.205-47(b)(2).

Using *Boeing* as a guide, the Board reasoned that the subject costs were similar to those identified under 31.205-47(b)(2) because Government and private actions for CWA violations are similar: both Government and private suits are authorized by the Act; the “citizen plaintiff” acts as “private attorney general” when the Government declines to take action; in both Government and private actions, monetary penalties are available and paid not to the plaintiffs but to the U.S.; a citizen has the right to intervene in a Government action; and the Government has the same right in a citizen suit. The Board agreed with SWM that the rights of Government and private plaintiffs were not identical; however, the distinctions did not render “actions for CWA enforcement dissimilar so as to preclude the application [of 31.205-47(b)(2).]”

The Board rejected SWM’s argument that FAR 31.205-33(b), which provides for the allowability of “reasonable legal service costs under government contracts,” should apply to its costs. The Board noted that this section generally deals with the cost of services “rendered for and acquired by a contractor.” Here, the greater portion of the costs that SWM sought to recover was not for fees incurred defending the suit, but rather for legal fees paid to the CWA plaintiffs pursuant to a court order. The Board found that 31.205-33(b) did not cover reimbursement of the plaintiffs’ fees. And because these fees represented a greater percentage of the total legal costs, they could not be reasonably appor-

tioned from those costs that were properly covered by the regulation. The Board reasoned that in these instances, FAR 31.204(c), which states that the cost subsection “that most specifically deals with, or best captured the essential nature of the cost at issue,” should be applied. The Board concluded that 31.205-47(b) “best capture[d] the essential nature” of the costs, and, as discussed above, under this section the Board found the costs to be unallowable.

♦ **Practitioner’s Comment**—The Board’s decision in *Southwest Marine* has several important implications. *Southwest Marine* is the first decision to rely on *Boeing*. These cases highlight FAR 31.204(c) (now 31.204(d)), which previously saw little exposure, and will likely result in a more expansive application of the “similar or related” standard beyond litigation costs. In this regard, the Board seems to have stretched the “similarity” concept, equating citizen’s suits under the CWA with Major Fraud Act proceedings addressed in FAR 31.205-47(b). Apart from a 1998 amendment to add qui tam actions under the False Claims Act to FAR 31.205-47(b), contractors would not reasonably expect that costs incurred to defend private party litigation would be unallowable.

Southwest Marine also marks an alarming trend of disallowing legal fees incurred to defend litigation. Although not stated directly, the Board’s quote of *Boeing* (which, in turn, quoted *Northrop Worldwide Aircraft Servs., Inc.*, 192 F.3d 962 (Fed. Cir. 1999)) that “the costs of unsuccessfully defending a private suit charging contractor wrongdoing are not allowable if the ‘similar’ costs would be disallowed,” suggests that the court’s finding that *Southwest Marine* had violated the CWA may have influenced the Board’s decision to disallow the costs. Indeed, since *Northrop Worldwide*, DCAA auditors have repeatedly alleged wrongdoing as a basis to disallow litigation costs, regardless of the nature of the litigation—even basic commercial litigation has suffered such scrutiny.

It is perplexing that the Board could not apportion between the costs *Southwest Marine* incurred to defend the litigation and the legal costs of the CWA plaintiffs that the court ordered *Southwest Marine* to reimburse. The findings of fact delineate the two costs. *Southwest Marine*’s defensive legal costs differ in nature from the costs of the plaintiff’s prosecution and need not be lumped together for the

allowability determination. If apportioned, the Board could have analyzed Southwest Marine's costs of defending the suit under FAR 31.205-33. In the end, the case should be read in light of its unique facts. *Southwest Marine* should not be considered the end of allowable litigation expenses. The Board has a rich body of case law allowing the costs of defending litigation as an ordinary and necessary business expense, to the extent that the costs are reasonable.



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