THE GOVERNMENT CONTRACTOR®

THOMSON WEST

Information and Analysis on Legal Aspects of Procurement

Vol. 49, No. 40 **October 31, 2007**

Decisions

¶ 419

ASBCA Rules On Allowability Of Legal Cost Related To Sexual Harassment Case

Tecom, Inc., ASBCA 53884 & 54461, 2007 WL 2899660 (Sept. 21, 2007)

Legal costs incurred to defend and settle a sexual harassment lawsuit are allowable, the Armed Services Board of Contract Appeals held, declining to apply the standard for allowability announced in *Boeing North Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002), 44 GC ¶ 112; 44 GC ¶ 203, for costs related to allegations of other types of wrongdoing. In addition, the Board held that the settlement payment was not an unallowable cost under Federal Acquisition Regulation 31.205-15, fines, penalties and mischarging costs.

During performance of a cost-reimbursement contract for military housing maintenance, a former employee sued Tecom alleging sexual harassment related to her work on the Government contract. The lawsuit and the underlying events were not linked "in any way to any allegations of submission of false claims, misrepresentation or fraud" against the Government, the Board said.

Without admitting wrongdoing, Tecom settled the litigation and later sought reimbursement from the Government for a $50,000 settlement, charged directly to the contract, and $96,163 in legal expenses, charged as a general and administrative expense. Tecom said the costs related to the employee's layoff, which she alleged to be retaliation for filing a sexual harassment charge. Tecom disputed the allegations but advised the Government that settlement was a prudent business decision because it would have cost double to litigate the case.

After the contracting officer refused to reimburse these amounts, Tecom requested a final decision on its claim for reimbursement. The CO did not issue a final decision, and Tecom appealed to the Board. Tecom also appealed a CO's decision on a Government claim asserting entitlement to repayment of legal fees that had been reimbursed as part of Tecom's G&A expenses. That appeal, filed at the U.S. Court of Federal Claims, was transferred to the Board and consolidated with Tecom's appeal of the denial of its claim.

Boeing North American v. Roche—The Government pleaded an affirmative defense asserting that under *Boeing* the costs of defending and settling the sexual harassment lawsuit were unallowable unless Tecom proved that the settled claim had "very little likelihood of success on the merits." The Government also argued that the settlement payment was unallowable because it was "similar or related to a penalty for wrongdoing" and thus unallowable under FAR 31.205-15, fines, penalties, and mischarging costs. The parties filed motions for summary judgment on these issues.

After a lengthy discussion of the case law preceding *Boeing*, the Board's analysis focused on the trial and appellate history of that case, which governed the issues in *Tecom*. In *Boeing*, the Government disallowed legal costs incurred to litigate and settle a shareholder's derivative suit against the directors of the predecessor corporation, Rockwell International Corp. The shareholders alleged that the directors had not instituted adequate controls and fostered a "corporate climate" that encouraged employee misconduct under federal contracts and resulted in criminal and civil penalties and fines.

The shareholder suit alleged five instances reflecting misconduct: (1) Rockwell entered into a consent decree in a False Claims Act civil action alleging that it mischarged the Government for work on the Space Shuttle contract, (2) Rockwell pleaded guilty and paid a $5 million fine to re-

solve criminal charges that Rockwell made false statements related to work under a Government contract; (3) Rockwell and two employees were indicted for fraud, mail fraud and making false statements, (4) an FCA qui tam action alleged that Rockwell permitted employees to use Government assets for personal gain and (5) Rockwell pleaded guilty to four felony violations of federal environmental laws and paid a $18.5 million fine.

After the CO denied the claim, Boeing appealed to the ASBCA, which denied the appeal on the basis of allocability, without addressing allowability. *Boeing North Am., Inc*., ASBCA 49994, 00-2 BCA ¶ 30,970; 42 GC ¶ 331. Following the rationale in *Caldera v. Northrop Worldwide Aircraft Servs*., 192 F.3d 962 (Fed. Cir. 1999); 41 GC ¶ 430; 42 GC ¶ 1, the ASBCA held that it 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 element of the third party allegations." Boeing therefore did not meet its burden of proving the allocability of the costs as required by FAR 31.201-4(c), the ASBCA held in that case.

On appeal, the U.S. Court of Appeals for the Federal Circuit reversed. The Board noted in *Tecom* that the Federal Circuit's analysis first explained that allowability concerns whether any part of a particular cost can be recovered from the Government. FAR pt. 31 cost principles govern allowability, and the Cost Accounting Standards govern allocability. A cost may be allocable under the CAS but unallowable under the FAR.

The Board wrote that *Boeing* reaffirmed the holding in *Northrop* and held that a contractor's legal costs are unallowable if they were incurred in unsuccessfully defending a lawsuit involving a judicial finding that the contractor sought to induce its employees to commit fraud against the Government. The Board added that, except as it may be related to allocability under FAR 31.201-1, which lists allocability as a factor in deciding whether costs are allowable, "there was no discussion in *Northrop* concerning allocability, particularly as an accounting concept under CAS." The Federal Circuit in Boeing also recognized that *Northrop* was not binding on allocability issues: "Under our established precedent we are not bound by *Northrop* on the issue of allocability under CAS standards since the CAS issue was neither argued nor discussed in our opinion." *Boeing North Am.*, 298 F.3d at 1282.

The Board also quoted part of the Federal Circuit's discussion of the "benefit of the Government" test as it relates to allocability:

> [A]llocability is an accounting concept … [the] CAS does not require that a cost directly benefit the government's interest 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 …."

Allowability of Tecom's Costs—The Board then turned to the determinative issue in Tecom, the allowability of its legal costs. According to the Board, the Federal Circuit in *Boeing* interpreted FAR 31.205-47, addressing legal costs, and FAR 31.204(c), which provided that the allowability of costs that are not addressed in specific FAR provisions should be "based on the principles and standards in the subpart and the treatment of similar or related selected items."

Quoting *Boeing*, the Board wrote that *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." In addition, the Board concluded that to be "related" under FAR 31.204(c) and 31.205-47, there must be a more direct relationship to the unallowable costs identified in FAR 31.205-47 than "merely the fact that [the costs] would not have been incurred but for the sexual harassment lawsuit." The Board found "nothing in the language of FAR 31.205-47 that renders legal costs in such proceedings unallowable if there were no charges of criminal conduct fraud, or similar misconduct, or violations of the Major Fraud Act of 1988." Quoting *Boeing*, the Board wrote that a direct relationship would have existed in *Boeing*, "if there were a judicial determination that Rockwell directors had failed

to maintain adequate controls to prevent the occurrence of the wrongdoing [fostering a corporate climate that encouraged employee misconduct, fraud, and false claims] against the government," (bracketed material added by the Board).

Because the shareholders derivative action in Boeing settled before there was a judicial determination, the Federal Circuit looked to FAR 31.205-47(b)(4), which provides that, unless the Government agrees otherwise, defense costs in a settled proceeding are unallowable if it could have led to an outcome such as conviction, contractor liability as a result of a finding of fraud or similar misconduct, monetary penalty, or debarment or suspension of the contractor. In such a case, the Federal Circuit held that for costs to be allowable, the contract must show that the allegations in the action giving rise to the incurred legal costs had "very little likelihood of success on the merits."

Addressing the allowability of Tecom's defense costs in the sexual harassment litigation, the Board concluded that standard announced in *Boeing* did not apply, and Tecom did not have to show that the sexual harassment lawsuit had "very little likelihood of success on the merits." The litigation did not involve a criminal prosecution, require a finding of contractor liability based on fraud or similar misconduct, impose a monetary penalty, require decision to debar or suspend Tecom or to "rescind or void the contract, or to terminate the contract for default by reason of the contractor's violation or failure to comply with a law or regulation." Therefore, FAR 31.205-47 did not bar reimbursement of Tecom's legal costs as part of the company's G&A expense, the Board held.

The Board also rejected the Government's assertion that FAR 31.205-15, making fines and penalties unallowable, bars reimbursement of Tecom's settlement payment. Relying on the definition of "penalty" in *Ingalls Shipbuilding Inc. v. Dalton*, 119 F.3d 972 (Fed. Cir. 1997); 39 GC ¶ 450, the Board held that the settlement was not a penalty, nor was it "related to" a penalty because there was no evidence that (1) the settlement costs were unrelated to the alleged harm to the employee, (2) the proceeds were paid to the government rather than to the employee or (3) the relevant provision of Title VII of the Civil Rights Act of 1964 was meant to address the harm to the public rather than to provide a remedy to the former employee for the alleged injury.

✦ **Practitioner's Comment:** The Board has done a great service to the entire Government contracts community by clarifying what has been a murky area since the Federal Circuit's decisions in *Northrop* and *Boeing*. Indeed, given the detailed analysis the Board applied to *Northrop* and *Boeing*, one can only wonder if the Board was chomping at the bit for this opportunity.

Since the Federal Circuit's decisions in *Northrop* and *Boeing*, the Government has taken these decisions as license to challenge the allowability of a broad range of litigation costs and the settlement of lawsuits—employment cases, subcontract disputes, etc.—because, by virtue of being sued, the contractor inherently was engaged in some wrongdoing in the eyes of the Government. And, if there is any generic form of "wrongdoing," under the Government's interpretation of the decisions, the costs are unallowable. Moreover, if the case is settled, regardless of whether it involved the type of proceeding specified in FAR 31.204-47(b), the Government has held contractors to prove the amorphous "very little likelihood of success on the merits" standard to recover those costs, effectively requiring contractors to proving the case in court and thus deterring the judicial preference for settlement of disputes. Thus, it is not surprising that the Government took the position that it did in *Tecom*.

The Board has held, however, that a proper reading of the *Northrop* and *Boeing* decisions, particularly with a plain reading of the regulations the Federal Circuit interpreted in those cases, does not permit the broad application that the Government seeks. Rather, those decisions, and more particularly *Boeing*, which applied the "similar or related" standard from FAR 31.204(c) (now 31.204(d)), hold that only the costs of proceedings of the type specifically delineated in FAR 31.205-47(b) are unallowable. This holding is not preclusive and is wholly consistent with the Board's 2005 decision in *Southwest Marine, Inc.*, ASBCA 54234 05-1 BCA ¶ 32892, 47 GC ¶ 130, in which the Board held that the legal costs arising from a contractor's unsuccessful defense of a citizen suit alleging violations of the Clean Water Act were unallowable, because they were similar to costs disallowed under FAR 31.205-47(b)(2). In *Southwest Marine*, the board held that the scheme set forth in the Clean Water Act was much like a *qui tam* action under the False

Claims Act, the violation of which is specifically cited in FAR 31.205-47.

The Board's decision is also consistent with the long-held proposition that costs of defending and settling litigation have been allowable as an ordinary and necessary business expense, to the extent the costs are reasonable. See, e.g., *Information Sys. & Network Corp*, ASBCA 42659, 00-1 BCA ¶ 30665 (subcontract disputes); *Hirsch Tyler Co.,* ASBCA 20962, 76-2 BCA ¶ 12075 (employment discrimination); *Hayes Int'l Corp.*, ASBCA 18447, 75-1 BCA ¶ 11076 (employment discrimination). The Board stated the policy most eloquently in *Hirsch Tyler*:

> an 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 of 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.

Thus, the *Tecom* decision is consistent with this long held precedent.

The unfortunate aspect of *Tecom* is, that by deciding the restrictions on allowability as set forth in *Boeing* do not apply, the Board never reaches the question of settlements and the "very little likelihood of success on the merits" standard as it applies to settlement of only those specific types of proceedings in FAR 31.205-47(b). In *Boeing,* the Federal Circuit provided no guidance for the standard, rejecting both Boeing's position that only those costs incurred in a frivolous defense should be disallowed and the Government's recommendation that costs that would not have been incurred "but for" the contractor misconduct should be disallowed. *Boeing* at 1289. So, this remains a mystery.

Finally, the Board properly determined that the settlement in *Tecom* was not tantamount to an unallowable fine or penalty under FAR 31.205-15. Clearly, the Government used this as an alternative argument. Indeed, it seems to be the defense *du jour*, as the Government has asserted that a variety of costs otherwise addressed under other cost principles, such as the Taxes cost principle, are unallowable fines or penalties.

✦

This Practitioner's Comment was written for THE GOVERNMENT CONTRACTOR by* Paul E. Pompeo, *a partner in the Government Contracts Practice of Arnold & Porter, LLP. He is also Co-Chair of the Accounting, Cost & Pricing Committee for the Public Contract Section of the ABA.