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ASBCA Confirms Narrow Definition Of 'Expressly Unallowable'

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Law360, New York (August 17, 2015, 12:15 PM ET) -- The Armed Services Board of Contract Appeals issued a precedential decision involving issues critical to the concept of an "expressly unallowable" cost under the Cost Accounting Standards and Federal Acquisition Regulation that strictly limits the government's attempts at expansive determinations. Raytheon Co., ASBCA Nos. 57576 et al. (June 26, 2015).[1] The case involves the appeal of government claims asserting violations of CAS 405 (requiring the segregation and exclusion of expressly unallowable costs from contractor submissions) and FAR penalties for the charging of allegedly expressly unallowable costs.

Definition of an "Expressly Unallowable" Cost

Both the CAS and FAR define an "expressly unallowable cost" as "a particular item or type of cost that, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable." CAS 405-30(a)(2); FAR 31.001. The finding that a cost is "expressly unallowable" under the express provisions of a FAR cost principle, rather than simply otherwise unallowable, is an important distinction because Congress has imposed penalties on contractors that include expressly unallowable costs in their submissions to the government.[2]

Dating back to the promulgation of CAS 405 in 1973, the CAS Board made clear that it intended to restrict the scope of "expressly unallowable costs" to only a narrow subset of unallowable costs that applicable laws, regulations, or contracts specifically identify, in written words, to be unallowable — i.e., there can be absolutely no question that the costs are unallowable; they are "unequivocally" so. In the preamble to the final rule publishing the CAS, the CAS Board explained:

> The Board, in its definition of an "expressly unallowable cost," has used the word "expressly" in the broad dictionary sense -- that which is in direct and unmistakable terms.
> * * *
> The Board has retained the requirement for contractor identification of costs which are unequivocally made unallowable by the express provisions of an applicable law, regulation or contract.[3]

Similarly, the legislative history of the penalties statute, as amended, makes clear that Congress intended the penalties statute to deter "fraudulent or negligent" conduct, but not to punish contractors for inclusion of unallowable costs where there might be "reasonable differences of opinion on the issue of allowability" or "when unallowable costs were included inadvertently in a submission."[4] To that end, in 1992, Congress amended the penalties statute to mirror the language used in CAS 405 to limit the type of unallowable costs subject to penalties to only "expressly unallowable costs." The final penalties rule at FAR 42.709, which implements 10 U.S.C. § 2324, thus uses largely the same language from the statute, imposing, permitting the government to "[a]ssess the penalty ... when the submitted cost is expressly unallowable under a cost principle in the FAR or an executive agency supplement that defines the allowability of specific selected costs."[5]

Despite the narrow definition of expressly unallowable costs and clear legislative and administrative emphasizing the narrowness of such definition, for years, the government has attempted to expand the application of "expressly unallowable costs" beyond its precise and narrow definition by questioning costs as expressly unallowable even if the relevant cost principle did not so explicitly state. Contractors have seen recommendations from government auditors and government claims that ignore this definition and treat all unallowable costs that may be captured under the FAR cost principles as "expressly" unallowable.

In Raytheon, the ASBCA rejected the government's attempt to apply several interpretations of the FAR cost principles that would run afoul of the clear limits of the definition of "expressly unallowable costs." The ASBCA reaffirmed that the definition of an “expressly unallowable” cost under the CAS and the FAR is narrow and discrete, holding that: an “expressly unallowable” cost “by the plain terms of the definition, must be an item of cost or a type of cost that is specifically named and stated as unallowable by law, regulation, or contract.”[6] The ASBCA further held that such costs must be identified as unallowable in “direct and unmistakable terms.”[7] Applying this narrow definition, the ASBCA found that certain bonus and incentive compensation costs were not expressly unallowable under FAR 31.205-1 (public relations and advertising costs), 31.205-22 (lobbying and political activity costs), and 31.205-27 (organization costs) because such costs are not “specifically named and stated as unallowable” under these cost principles. Where a cost is not expressly unallowable, there can be no noncompliance with CAS 405, nor can there be penalties pursuant to FAR 42.709.

Regarding express unallowability under FAR 31.205-22, which makes unallowable costs “associated with” certain lobbying and political activity, the ASBCA found that neither “bonus and incentive compensation” nor “compensation” cost “is specifically named and stated as unallowable under this cost principle, nor are such costs identified as unallowable in any direct or unmistakable terms.”[8] Similarly, under FAR 31.205-27, which makes unallowable costs “in connection with” certain organization activities, the ASBCA found that neither “bonus and incentive compensation” nor “compensation” cost “is specifically named and stated as unallowable under this regulation, nor are these costs otherwise identified in any direct or unmistakable terms.”[9] In both instances, the government argued that the broad phrases “associated with” and “in connection with” were sufficient to render bonus and incentive compensation expressly unallowable.

Under FAR 31.205-1, the ASBCA held that although the cost principle states that portions of “salaries” and “fringe benefits” are unallowable, bonus and incentive compensation costs are neither salary nor fringe benefits. The ASBCA observed that “salary” and “bonus” are identified under the compensation cost principle, FAR 31.205-6(p), as “different types of compensation,” and further, bonus costs do not fall within FAR 31.205-6(m)’s definition of “fringe benefits.”[10]

Because such costs were not expressly unallowable, the ASBCA found that the there was no violation of CAS 405’s requirement that expressly unallowable costs “be identified and excluded from any billing, claim, or proposal,” nor was the contractor subject to any penalty under FAR 42.709-1 for the inclusion of expressly unallowable costs in an indirect cost proposal. With this decision rejecting the government’s improper assertion of express unallowability under CAS 405 and related claim for penalties under FAR 42.709-1, the ASBCA greatly reduced the quantum of the government’s claim for unallowable costs. The ASBCA did hold, however, that bonus and incentive compensation costs are expressly unallowable as “pay of directors, officers and employees” under FAR 31.205-47, because under the limited circumstances of the underlying statute and administrative history of the implementing regulation “pay” incorporates such costs.[11] And, the ASBCA held that the total shareholder return element of Raytheon’s long-term performance plan was expressly unallowable under FAR 31.205-6(i).

Principle of Retroactive Disallowance and Other Defenses

To the extent the ASBCA found the government had otherwise proven entitlement to unallowable costs, the ASBCA left open for further fact finding whether the government’s claim to such costs is barred under the retroactive disallowance principle established in Litton Systems Inc. v. United States, 449 F.2d 392 (Ct. Cl. 1971). Under the retroactive disallowance principle, where the government has consistently approved of or acquiesced in the charging of costs, it is barred from disallowing such costs prior to the issuance of an authoritative notice that such costs are no longer considered allowable. Here, the ASBCA found that it has “applied the retroactive disallowance principle to bar recovery of government claims,” citing Lockheed Martin Western Development Laboratories, ASBCA No. 51452, 02-1 BCA ¶ 31,083, but “its application is largely fact-dependent.”[12] The ASBCA concluded that material factual disputes, including “whether or not the

government, with knowledge, consistently approved" the subject costs, prevented resolution on summary judgment. The ASBCA's continued recognition of this affirmative defense has the potential to limit the government's ability to assert claims retroactively for costs after approving the charging of such contract costs.

Additionally, the ASBCA reserved for consideration whether fixed price contracts should be included in the cost impact calculation under a noncompliance with CAS 405, and the particular methodology for calculating the cost impact of bonus and incentive compensation as CAS noncompliance.

This case is a follow-on to Raytheon Co., ASBCA Nos. 57576, 57679, 13 BCA ¶ 35,209, where the ASBCA held that the statute of limitations barred portions of the government's clam.

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DISCLOSURE: The authors represented Raytheon in the case and predecessor decision cited in this article.

[1] The decision was not made public until July 30, 2015.
[2] 10 U.S.C. § 2324; FAR 42.709 (implementing 10 U.S.C. § 2324).
[3] 8 Fed. Reg. 24,195 at 24,197 (Sept. 6, 1973) (emphasis added).
[4] Senate Rpt. 102-352 (Jul. 31, 1992) (report accompanying S. 3114, National Defense Authorization Act ("NDAA") for FY 1993) (amending the statutory language to mirror the language used in CAS 405 to define the type of unallowable costs subject to penalties). See also House Rpt. 102-966 (Oct. 1, 1992) (explaining that the Senate's recommended amendment to the penalties statute "clarif[ies] that a contractor will be charged a penalty only if the cost has been expressly disallowed by regulation." (emphasis added)).
[5] FAR 42.709-3(a).
[6] Slip. Op. at 21 (emphasis in original).
[7] Id.
[8] Id at 21-22.
[9] Id. at 22.
[10] Id. at 21.
[11] Id at 22-23.
[12] Id. at 31.