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FEATURE COMMENT: The Most Important Government Contract Cost And Pricing Decisions Of 2017

The Armed Services Board of Contract Appeals in 2017 issued five important decisions that change the landscape for cost and pricing disputes. In these decisions, the ASBCA overruled the venerable "retroactive disallowance" doctrine; held that the Government's prior material breach of contract may preclude the Government from disallowing costs the contract makes unallowable; provided a tutorial on the Federal Acquisition Regulation compensation cost principle and determining when penalties may properly be assessed; and resolved an apparent conflict between the Contract Disputes Act statute of limitations and the Allowable Cost and Payment clause.

"Retroactive Disallowance" Doctrine (*Tech. Sys., Inc.*, ASBCA 59577, 17-1 BCA ¶ 36,631; 12 CP&A Rep. ¶ 12; 59 GC ¶ 41)—For more than 50 years, both the former U.S. Court of Claims and, until recently, the ASBCA have held that the Government may not retroactively disallow costs, or retroactively disapprove a contractor's cost accounting practices, when a contractor has detrimentally relied on the Government's acquiescence or approval of those costs or cost accounting practices. See, e.g., *Litton Sys., Inc. v. U.S.*, 449 F.2d 392, 401 (Ct. Cl. 1971) ("In view of plaintiff's long and consistent use of the cost of sales method with the Government's knowledge, approval and acquiescence, plaintiff was entitled to reasonably adequate notice that the Government would no longer approve the use of that method with respect to the [cost-plus-fixed-fee] contracts."); *PACCAR, Inc.*, ASBCA 27978, 89-2 BCA ¶ 21,696 ("We have been reluctant to permit either party to benefit from retroactive accounting changes …, and have taken note of the 'commercial havoc' that could result by permitting the practice in the absence of 'peculiar' circumstances."); *FMC Corp., N. Ordnance Div.*, ASBCA 30130, 87-2 BCA ¶ 19,791, aff'd, 853 F.2d 882 (Fed. Cir. 1988) ("where such costs have been incurred pursuant to a practice acquiesced in or approved by the Government, and the contractor has reasonably believed that the Government would allow the practice to continue, the Government must unequivocally state its disapproval before disallowing further costs incurred pursuant to that practice"); *Gould Def. Sys., Inc.*, ASBCA 24881, 83-2 BCA ¶ 16,676, mot. for recons. denied, 84-3 BCA ¶ 17,666 (holding that the Government was estopped from retroactively disallowing cost of goodwill, and could only prospectively disallow such costs from the date of the Defense Contract Audit Agency Form 1, when the contractor first received formal notification that the Government would no longer allow the cost of goodwill in facilities capital computations); *Webster Contractors, Inc.*, ASBCA 24641, 83-1 BCA ¶ 16,467 ("It is well established that a retroactive disallowance of costs is improper where the contractor relied upon the prior approval of cost reimbursement to its detriment. The principle has been found to apply to the retroactive disapproval of methods of overhead calculation as well as to costs which are rendered unallowable by the accepted cost principles.") (citations omitted); *Data-Design Labs.*, ASBCA 21029, 81-2 BCA ¶ 15,190, mot. for recons. denied, 82-2 BCA ¶ 15,932 (refusing to allow the Government to retroactively disallow the cost of first-class air fare, notwithstanding the fact that such costs were unallowable under the Armed Services Procurement Regulations cost principles); *Peninsular ChemResearch, Inc. Div. of Calgon Corp.*, ASBCA 14384, 71-2 BCA ¶ 9,066 (refusing to allow the Government to retroactively disapprove the contractor's use of a single company-wide overhead pool, which had theretofore been "regularly accepted by [the DCAA] auditors").

The ASBCA most recently applied retroactive disallowance in its 2002 decision in *Lockheed Martin Western Development Laboratories*, in which it

stated: "It is well established that where the Government has consistently accepted and allowed a cost in the past, the Government may not retroactively disallow the cost." *Lockheed Martin W. Dev. Labs.*, ASBCA 51452, 02-1 BCA ¶ 31,803 (collecting cases); 44 GC ¶ 155. Even more recently, in its 2015 decision in *Raytheon Co.*, the ASBCA expressly left open the "retroactive disallowance" defense and distinguished it from equitable estoppel. *Raytheon Co.*, ASBCA 57576, 15-1 BCA ¶ 36,043, 10 CP&A Rep. ¶ 53.

However, in *Technology Systems, Inc.*, the ASBCA—in an unusual five-judge, split decision—overturned the doctrine of retroactive disallowance, holding that it is a form of estoppel and therefore requires a showing of affirmative misconduct by the Government. The majority opinion is disappointing, both because it fails to recognize the distinction between retroactive disallowance and estoppel and because it perpetuates the U.S. Court of Appeals for the Federal Circuit's erroneous dicta in *Rumsfeld v. United Techs. Corp.*, 315 F.3d 1361, 1377 (Fed. Cir. 2004); 45 GC ¶ 138—and the ASBCA's equally erroneous holding on remand—that for estoppel to apply against the Government, the contractor must show "affirmative misconduct" in addition to the traditional elements of estoppel. While other federal circuits have recognized affirmative misconduct as an exception to the rule that the Government is not bound by the unauthorized acts of its agents, the Federal Circuit's dicta have instead created a Government contracts exception to the rule that the Government is bound by the acts of its agents acting within the scope of their authority. See Manos, *Estoppel Against the Government: What Does "Affirmative Misconduct" Have To Do With It?*, 1 CP&A Rep. ¶ 1.

Technology Systems arose out of an administrative contracting officer's final decision unilaterally establishing final indirect rates and asserting a Government claim for $159,303 of allegedly unallowable costs included in Technology Systems Inc.'s (TSI) fiscal year 2007 incurred cost proposal (ICP). TSI's defense focused less upon whether the particular decisions taken by the ACO were supported by the facts and more about whether DCAA had so changed its approach, by questioning costs that it had not previously questioned, as to be unfair. TSI's primary argument was that the Government was precluded from disallowing the costs at issue by the doctrine of retroactive disallowance and/or the parties' prior course of dealing. Judge Clarke, who heard the appeal, would have sustained the appeal on that basis. However, the other four judges disagreed.

The decision provides the following explanation for overruling the doctrine of retroactive disallowance:

> Retroactive disallowance is a theory for challenging audits whose heyday has come and gone. The theory was first set forth by the Court of Claims in *Litton Systems, Inc. v. United States*, 449 F.2d 392 (Ct. Cl. 1971). We elaborated upon it, as Judge Clarke's dissent notes, in such cases as *Gould Defense Systems, Inc.*, ASBCA No. 24881, 83-2 BCA ¶ 16,676; and *Data-Design Laboratories*, ASBCA No. 21029, 81-2 BCA ¶ 15,190. In these cases, we characterized the principle as preventing the government from challenging costs already incurred when:
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> > [T]he cost or accounting method in question previously had been accepted following final audit of historical costs; the contractor reasonably believed that it would continue to be approved; and it detrimentally relied on the prior acceptance.
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> *Gould*, 83-2 BCA ¶ 16,676 at 82,981 (citing *Data-Design*, 81-2 BCA ¶ 15,190). The last appeal in which we granted relief based upon retroactive disallowance was our 2002 decision of *Lockheed Martin Western Development Laboratories*, ASBCA No. 51452, 02-1 BCA ¶ 31,803. Prior to *Lockheed Martin*, retroactive disallowance was last used to grant relief in the 1986 case of *Data-Design Laboratories*, ASBCA No. 27245, 86-2 BCA ¶ 18,830.
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> In 1984, however, the seeds of the doctrine's diminution were sown by the Supreme Court in the case of *Heckler v. Community Health Services of Crawford County, Inc.*, 467 U.S. 51 (1984), which explicitly recognized that, "the Government may not be estopped on the same terms as any other litigant." 467 U.S. at 60. The United States Court of Appeals for the Federal Circuit (the Federal Circuit) subsequently held that "affirmative misconduct [has been recognized] as an element of an estoppel claim against the government." *Henry v. United States*, 870 F.2d 634, 637 (Fed. Cir. 1989) (citations omitted); *see also Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000) ("While the Supreme Court has not squarely held that affirmative misconduct is a prerequisite for invoking equitable estoppel against the government, this court has done so.")

(citations omitted). Being a "special application of estoppel principles," *see Gould*, 83-2 BCA ¶ 16,676 at 82,981, retroactive disallowance is thus now subject to the same affirmative misconduct requirement as other estoppel defenses. This sea-change was clearly recognized by the Federal Circuit in a case cited in Judge Clarke's dissent, *Rumsfeld v. United Technologies Corp*., [47 CCF ¶ 78,018] 315 F.3d 1361 (Fed. Cir. 2003).

In *United Technologies*, which was an appeal of one of our decisions, the Federal Circuit characterized the retroactive disallowance argument (an argument that United Technologies had advanced at the trial level, but had been unnecessary for us to reach) as being that the "government [was] estopped from contesting" the accounting determination at issue. 315 F.3d at 1377. Relying upon *Zacharin*, the Federal Circuit instructed us that "affirmative misconduct" on the part of the government would be required for the application of the principle. *Id*. at 1377 (citing *Zacharin*, 213 F.3d at 1371). On remand, we quickly dispensed with appellant's argument that the Federal Circuit had been unfamiliar with the *Litton* line of cases, and made clear that our understanding of the Federal Circuit's opinion was that retroactive disallowance is a species of estoppel and, thus, the affirmative misconduct requirement applies to it. *United Technologies Corp., Pratt & Whitney*, ASBCA No. 47416 *et al*., 06-1 BCA ¶ 33,289 at 165,055-58.

Little has happened with regard to retroactive disallowance since the decision on remand of *United Technologies*, in no small part, we believe, because affirmative misconduct is a difficult bar to clear. Nevertheless, as Judge Clarke notes, the defense was raised briefly last year when we denied a motion for summary judgment in the appeal of *Raytheon Company*, ASBCA No. 57576 *et al*., 15 BCA ¶ 36,043 at 176,055, finding retroactive disallowance to be unsupported by the undisputed facts. While it is true that we did not discuss the requirement of affirmative misconduct in *Raytheon*, that omission is far too slender a reed to support a view of the law that leaves out this critical element: in our offhand discussion of retroactive disallowance (in which we ruled in favor of the government), we did not purport to overrule our precedent in *United Technologies* nor the Federal Circuit's dictates in the same case. To sum up: there is no way to read our recent precedent or the Federal Circuit's except to include an affirmative misconduct requirement amongst the elements of retroactive disallowance. Period.

Thus, turning to the facts of this case, we readily dispose of the application of retroactive disallowance to it. Judge Clarke does not assert that there is a factual predicate for finding affirmative misconduct on the part of the government in this matter. Without that element, there is no retroactive disallowance. *United Technologies*, 06-1 BCA ¶ 33,289 at 165,055-58. Moreover, even without such a requirement, we would still find, on the facts before us, that retroactive disallowance is inapplicable to this appeal. The government's failure to challenge TSI's costs in prior audits (without more) was not enough to give TSI the reasonable belief that such costs would never be challenged in the future. This would be the case even if we were not to read the law (as we do) to require an unequivocal statement by the government that the costs were considered to be supported. *See Gould*, 83-2 BCA ¶ 16,676 at 82,981 (holding the doctrine applicable when the government "unequivocally accepts a contractor's proposed accounting treatment"). When we consider retroactive disallowance to include a requirement that the government make an unequivocal statement regarding the allowability, the case for applying this defense is even more plainly deficient here.

(Footnotes omitted).

The ASBCA gave short shrift to TSI's related argument that DCAA's previous audits established a course of conduct on which the contractor could rely. The decision states: "These arguments founder for the simple reason that DCAA's inaction or failure to challenge a cost in prior audits as was the case here does not 'set' any 'standard,' nor establish the 'common basis for understanding' that is necessary for TSI to prevail under this contractual theory."

TSI had somewhat more success on the merits of the disallowed costs. The ASBCA held that TSI was entitled to reimbursement for the costs of its marketing consultant, which the ACO had disallowed under FAR 31.205-33(f) based on the lack of work product. The decision states: "The government labors under the false impression that the FAR requires a consultant to create 'work product' merely for the purposes of proving its costs …. Though the FAR language in question is not as clear as we might like, it can be

read—as we read it here—to impose no such requirement."

The ASBCA also held that it was appropriate for TSI to include in its FY 2007 incurred cost submission legal costs in defending itself in connection with a Naval Criminal Investigative Service investigation several years earlier. The Government did not dispute that 80 percent of the legal fees for the investigation would otherwise be allowable, but argued that they were expensed in the wrong year. The ASBCA found that TSI was precluded from billing the costs contemporaneously with their incurrence by FAR 31.205-47(g), and it was reasonable for TSI to wait until it received its documents back from the NCIS in 2007 to be certain that the investigation was complete and no longer pending.

The ASBCA ruled against TSI on the remaining items of questioned costs. Of the most general significance, the ASBCA held that "TSI's executive bonus plan was too amorphous in its criteria for bonus award and subject to too unfettered discretion in its application to permit the inclusion of its costs in the ICP." The ASBCA concluded that, "when an executive bonus plan lacks measurable metrics and is essentially subject to the unfettered discretion of those who would benefit from it, as did TSI's, its costs are not compensable."

Judge Clarke, although concurring in the relief granted by the majority, disagreed with the reasoning and filed a lengthy dissenting opinion.

Prior Material Breach (*Kellogg Brown & Root Servs., Inc.*, ASBCA 56358 et al., 17-1 BCA ¶ 36,779; 12 CP&A Rep. ¶ 35)—Potentially restoring some of the balance lost in *Technology Systems*, in *Kellogg Brown & Root Servs., Inc.*, the ASBCA held that the Government's prior material breach can prevent the Government from disallowing costs made unallowable by the contract terms. The ASBCA's decision in the case is the latest chapter in a long-running dispute about the allowability of costs incurred by Kellogg Brown & Root Services Inc. (KBRS) and its subcontractors for private security contractors (PSCs) to accompany company officials and convoys to deliver food and supplies to U.S. and coalition troops in Iraq during military operations in 2003–2006. Starting in 2007, an Army CO withheld more than $44 million from KBRS billings under the Logistics Civil Augmentation Program (LOGCAP III) contract to recoup previously paid PSC costs that the Government determined were unallowable.

The case includes four consolidated appeals. Three of the appeals were before the ASBCA on remand from the Federal Circuit, which held that the LOGCAP III contract prohibited the use of PSCs, but remanded to the ASBCA to decide whether KBRS "properly raised its breach and remedy allegations, and if so, to rule on those contentions." *McHugh v. Kellogg Brown & Root Servs., Inc.*, 626 F. App'x 974, 978 (Fed. Cir. 2015); 10 CP&A Rep. ¶ 59. The fourth appeal was before the ASBCA following KBRS' appeal from the deemed denial of its Sept. 29, 2011 certified claim for breach of contract. Following the ASBCA's denial of the Government's motion to dismiss the fourth appeal, KBRS filed a first amended and consolidated complaint (FACC) that included the following 12 counts:

> Count I—the government's recovery on its claim is time-barred because the contracting officer's 30 January 2013 final decision was issued more than six years after the government's claim accrued, which was no later than 10 June 2005.
>
> Count II—KBRS is entitled to judgment because the Army breached its contractual obligation to provide adequate force protection and the use of PSCs was a permissible remedy.
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> Count III—the Army breached the contract by requiring KBRS to perform beyond the original scope and the use of PSCs was a permissible remedy.
>
> Count IV—the Army breached the contract by failing to comply with the FAR 16.301-3 requirement to have available adequate resources to manage a cost reimbursement contract and use of PSCs was a permissible remedy.
>
> Count V—KBRS is entitled to judgment because the contract prohibition relied on by the Army applies only in peacetime, not during war.
>
> Count VI—KBRS is entitled to judgment because the government waived the contract prohibition on the use of PSCs.
>
> Count VII—KBRS is entitled to judgment because the Army cannot reopen the firm-fixed-price subcontracts at issue.
>
> Count VIII—under a cost-reimbursement contract, KBRS is entitled to recover all of its incurred costs so long as they were not incurred due to fraud, lack of good faith, or willful misconduct.
>
> Count IX—KBRS is entitled to judgment because the Army released KBRS from all claims related to the pricing and award of the [Eurest Support Services Worldwide] subcontracts.

> Count X—KBRS is entitled to judgment because the Army contracting officer's 30 January 2013 final decision was invalid.
>
> Count XI—the Army's damages calculation is inaccurate and unsupported.
>
> Count XII—the Army acted in bad faith in its decision to recapture funds from KBRS.

The Government filed a motion to dismiss all counts, and KBRS filed a motion for summary judgment on counts II (breach of contract) and VI (waiver).

In its motion to dismiss, the Government argued that (1) some counts of the FACC failed to state a claim upon which relief could be granted, (2) the ASBCA lacked jurisdiction over other counts, and (3) the remaining counts were foreclosed by either the law of the case or the Federal Circuit's mandate. Observing that "a government claim is at the heart of the matter and KBRS' complaint consisted primarily of affirmative defenses to that claim," the ASBCA found it "appropriate with respect to certain counts to treat the government's motion to dismiss as a motion to strike affirmative defenses under Federal Rule of Civil Procedure (FRCP) 12(f) rather than as a Rule 12(b)(6) motion to dismiss."

The ASBCA granted the Government's motion to strike counts I and X. The ASBCA found that the procuring CO timely asserted the Government's claim, in writing, by set-off and withholding in February 2007, September 2009 and March 2010. Relying on *Placeway Constr. Corp. v. U.S.*, 920 F.2d 903 (Fed. Cir. 1990), the ASBCA held that although the PCO's decisions may not have conformed to the usual CO's final decision format, including the notice of appeal rights required by the CDA, they were nevertheless formal and final actions equivalent to a CO's final decision from which a contractor could appeal. The ASBCA further held,

> KBRS could have directly appealed the PCO's withholdings but chose to file claims contesting the withholdings in order to start the running of CDA interest. Moreover, KBRS has not been prejudiced by the omission of final decision language and an explanation of appeal rights, as is evidenced by its prompt filing of certified claims and appeals from deemed denials.

The ASBCA therefore found that the affirmative defenses in counts I and X failed as a matter of law. Although harmless for KBRS given the ASBCA's other rulings in the case, the holding that a set-off or withholding is equivalent to an appealable CO's final decision is potentially problematic for contractors, particularly when combined with the recent line of ASBCA decisions holding that the omission of the required appeal language does not suspend the running of the 90-day appeal period unless the contractor can establish that it was prejudiced by the omission. It could mean that a contractor faced with a set-off or withholding will need to file an appeal, or risk forever losing its right to do so.

The ASBCA denied the Government's motion to strike counts II, III and IV. Although these counts were not presented to the CO for decision, the ASBCA held that they were affirmative defenses that did not seek adjustment of the contract terms, and therefore did not need to be presented to the CO for decision for the board to have jurisdiction under *M. Maropakis Carpentry, Inc. v. U.S.,* 609 F.3d 1323 (Fed. Cir. 2010); 52 GC ¶ 225. The ASBCA further held that counts II, III and IV were within the proper scope of the board's consideration on remand because they were asserted as affirmative defenses in KBRS' initial complaint in the fourth appeal, and have not yet been decided by the ASBCA. Although count IV was not separately asserted until KBRS filed its FACC, the ASBCA found that "it, along with Counts II and III, asserts prior material breach as an affirmative defense."

The Government moved to dismiss counts V, VI, VII and VIII as foreclosed by law of the case, the Federal Circuit's mandate or both. As to count V, the ASBCA found that Federal Circuit's "holding on appeal that the H clauses prohibited KBRS and its subcontractors from hiring PSCs by necessary implication decides the issue of whether the H clauses were applicable." The ASBCA therefore granted the Government's motion to strike the affirmative defense presented in count V. However, the ASBCA held that counts VI, VII and VIII were properly before the board on remand.

The Government argued that the ASBCA's holding in *Kellogg, Brown & Root Servs., Inc.*, ASBCA 56358, 12-1 BCA ¶ 35,001, precludes count VII: "[i]n the context of determining the reasonableness of a subcontract fixed price under a cost reimbursement prime contract, the government may properly consider the components of that subcontract fixed price." The ASBCA noted that its 2012 decision denied the parties' cross-motions for summary judgment, and in the course of doing so, it addressed KBRS' contention that the Government had no contractual right to disallow a particular component of a subcontract's fixed price:

> However, none of the authorities cited for this proposition involved the allowability of a questioned component of a subcontract fixed price as a reimbursable cost under a cost reimbursement prime contract. In the context of determining the reasonableness of a subcontract fixed price under a cost reimbursement prime contract, the government may properly consider the components of that subcontract fixed price [citing *Grumman Aerospace Corp.*, 549 F.2d 767 (Ct. Cl. 1977)].

After a hearing on the merits, the ASBCA in its 2014 decision found as a matter of fact that the PSC costs were reasonable under FAR 31.201-3(a). The ASBCA found that, "[i]n its 2012 interlocutory decision the Board's discussion of the *Grumman Aerospace* case may well have been *dicta*, since it was not necessary to the result—denying the cross-motions for summary judgment on the basis of unresolved issues of material fact." However, the ASBCA continued, "even if the Board's discussion was more than *dicta*, it did not decide the issue presented to us now," i.e., whether—

> Under applicable regulations, including the FAR, and the federal common law applicable to government contracts, the Army is barred from reopening firm-fixed price subcontracts awarded under a cost-reimbursement prime contract to contest the allowability of a particular component included in the subcontract price.

Although the ASBCA denied the Government's motion to strike count VII, it never reached the merits of the issue presented because KBRS' motion for summary judgment was limited to counts II and VI.

The ASBCA granted the Government's motion for summary judgment on count IX (the Army released KBRS from all claims related to the pricing and award of the 11 subcontracts at issue, and KBRS is entitled to recover PSC amounts associated with those subcontracts), and granted the Government's motion to strike counts XI (the Army's quantum calculation was inaccurate and unsupported) and XII (the Army acted in bad faith).

Turning to KBRS' motion for summary judgment, the ASBCA held that the Government committed the first material breach under the contract by failing to provide force protection to KBRS and its subcontractors. The ASBCA further held that the Government's prior material breach excused any subsequent contractor noncompliance with the contract's PSC prohibition. Accordingly, the board held, "the government's claims for unallowable PSC costs are precluded in their entirety and we grant summary judgment for KBRS on Count II of its FACC."

Stock Option Costs (*Luna Innovations, Inc.*, ASBCA 60086, 2017 WL 6102777 (ASBCA Nov. 29, 2017; 13 CP&A Rep. ¶ ¶ 1, 4)—At issue in *Luna Innovations, Inc.*, was the allowability of stock options that Luna awarded to its employees. Luna's stock options generally had a 10-year term, and had a strike price (the price at which the option could be exercised) equal to the current market price. After becoming a publicly traded company, Luna was required by generally accepted accounting principles (GAAP) to recognize, at the time of award, the expected future liability for the stock options, including possible appreciation. The GAAP standard in effect at the time—Financial Accounting Standards Board Statement No. 123r, *Accounting for Stock-Based Compensation*—required that the estimate of the fair value at the grant date be based on the share price and other pertinent factors, such as expected volatility. One permissible method to measure the value of stock options as identified in FAS 123r is a calculation known as the Black-Scholes model, which estimates the expected future price of the stock when the option is exercised, discounted to its present value. The model relies on five inputs: the term of the option, the current stock price, the exercise (strike) price, the risk-free rate of return, and the stock price variance. Accordingly, the valuation is based on historical stock price volatility rather than changes in the stock price after the valuation date.

Luna recorded the expense for stock options issued during its FY 2007 based on the fair market value of the options at the grant date, calculated in accordance with the Black-Scholes model. Although the strike price was equal to the market price when the options were issued, Luna recorded approximately $2.3 million in compensation expenses for the stock option grants using the Black-Scholes method.

DCAA issued an audit report questioning the $2.3 million as expressly unallowable costs under FAR 31.205-6(i)(1), and recommended a penalty on the proportion of the unallowable stock option costs allocable to contracts subject to penalties.

The ASBCA found the costs unallowable under FAR 31.205-6(i)(1) because the stock option costs were "calculated, or valued, based on changes in the price of corporate securities." The ASBCA reasoned that historical share price volatility, which is an input into the model, represents changes in the price of

corporate securities. Relying on dictionary definitions of "valued" and "based on," and observing that the volatility measure was one of the most important, if not the most important, inputs in the Black-Scholes model, the ASBCA held that "the output of the Black-Scholes model is unallowable because it is valued, based on changes in the price of corporate securities."

The ASBCA rejected Luna's argument that its use of the Black-Scholes model was not inconsistent with the FAR because the share price volatility it used in the model was not based on the volatility of its own stock, but rather the volatility of the stock of comparable firms since Luna had only recently become a publicly held company and lacked historical stock price volatility of its own stock. The ASBCA noted that the board rejected a similar argument in *Raytheon Co.*, ASBCA 57576 et al., 15-1 BCA ¶ 36,043. The decision states:

> In *Raytheon*, the contractor had a long-term performance plan (LTPP) that granted stock share awards to "key business leaders" upon the recommendation of Raytheon senior management. To determine compensation under the LTPP, Raytheon calculated the Total Shareholder Return (TSR) using the formula TSR = (Ending stock price + 3 years dividends) ÷ beginning stock price. Raytheon calculated the TSR for its own stock as well as for ten peer companies. Raytheon then rank-ordered the TSRs and awarded additional shares of stock to the LTPP participants based on Raytheon's relative TSR ranking, with a higher Raytheon TSR ranking generally resulting in the award of more shares of stock.

Reiterating its holding in *Raytheon*, the ASBCA found "the cost principle does not distinguish between changes in the price of a company's own securities and securities in general." Moreover, the ASBCA noted, because "Luna awarded its stock options with the strike price set equal to the market price," "any market value to the option must be based on the expectation that the market price of the underlying security will increase during the term of the option."

Importantly, however, the ASBCA held that Luna's claimed employee stock option costs were not expressly unallowable, despite having found that the costs were unallowable under the plain language of the cost principle. Although compensation "calculated, or valued, based on changes in the price of corporate securities" is specifically named and stated to be unallowable by FAR 31.205-6(i)(1), the ASBCA found there were "legitimate differences of opinion regarding the allowability of the costs at issue in this appeal." The ASBCA noted that Luna retained the services of a retired DCAA auditor in preparing its incurred cost submission. In addition, there were differences of opinion among the DCAA auditors who reviewed the costs. Although all of the DCAA auditors thought the costs were unallowable, they had different interpretations of how (and under what paragraph of the cost principle) the costs should be questioned. Therefore, the ASBCA concluded:

> Given the complexity of the circumstances, the fact that the use of the Black-Scholes model is a question of first impression, the need to review the differential equations comprising the Black-Scholes model, and the fact that there could be a reasonable difference of opinion regarding the costs, we hold that it was not "unreasonable under all the circumstances" for Luna to claim the employee stock option costs, and hold that the employee stock option costs are not expressly unallowable. *General Dynamics Corp.*, [ASBCA No. 49372,] 02-2 BCA ¶ 31,888 at 157,570; *Fiber Materials, Inc.*, 07-1 BCA ¶ 33,563 at 166,256.

The board added in a footnote: "We emphasize here that the Black-Scholes model is a widely recognized model in financial economics and is explicitly referenced in FAS 123r. We may not reach the same conclusion in review of a future contractor's use of a model simply because it is mathematically complex." One well-regarded commentator has suggested that the board's footnote "implies that the Black-Scholes model *could* result in allowable costs, but that allowability of the formula's output would somehow be dependent on the values of the inputs to the formula." Johnson and Amen, *Luna Innovations, Inc.: A Questionable ASBCA Decision on Stock Option Costs*, 13 CP&A Rep. ¶ 1. However, in context, the footnote appears more likely to mean that the complexity of the Black-Scholes model does not, by itself, necessarily mean that it would be reasonable for a contractor to conclude that costs determined using the model are allowable.

The board's decision that the employee stock options were not expressly unallowable is particularly significant because it correctly applies *Gen. Dynamics Corp.*, ASBCA 49372, 02-2 BCA ¶ 31,888; 44 GC ¶ 249, rev'd in part on other grounds, *Rumsfeld v. Gen. Dynamics Corp.*, 365 F.3d 1380 (Fed. Cir. 2004); 46 GC ¶ 217. As the *Luna* decision implicitly recognizes, *General Dynamics* narrows—rather than expands—the expressly

unallowable costs for which penalties may be assessed. The legal proceeding costs at issue in *General Dynamics* were specifically named and stated to be unallowable by FAR 31.205-47. Yet, the ASBCA held in that case that the ACO's imposition of penalties was improper because the Government had not "show[n] that it was unreasonable under all the circumstances for a person in the contractor's position to conclude that the costs were allowable."

By contrast, the ASBCA seems to have missed the point in *Exelis Inc.*, ASBCA 58966, 17-1 BCA ¶ 36,708, when it held that the costs of Exelis' TSR incentive compensation were expressly unallowable and subject to penalties even though at least four of the 11 contractors with similar plans treated the costs as allowable. The ASBCA rejected Exelis' argument that the assessment of penalties was inappropriate because it was not unreasonable under all the circumstances for a contractor in Exelis' position to conclude the TSR compensation costs were allowable since other contractors also concluded that similar costs were allowable. The decision states: "While some contractors may have concluded that costs similar to Exelis's TSR compensation costs were allowable, more contractors reached the opposite conclusion (finding 33). In any event, such extrinsic evidence cannot trump the plain language of the cost principle." If "extrinsic evidence" of a reasonable basis for disagreement "cannot trump plain language of the cost principle," the *General Dynamics* holding on penalties would be superfluous.

Post-Retirement Benefit Costs (*Northrop Grumman Corp.*, ASBCA 60190 (ASBCA July 13, 2017; 12 CP&A Rep. ¶ 43)—After the parties were unable to agree on quantum, the ASBCA sustained the appeal in *Northrop Grumman Corp.,* concluding that the Government suffered no damages from Northrop Grumman Corp's. (NGC) noncompliance with FAR 31.205-6(o) and, therefore, the Government's cost disallowance was improper.

In its earlier decision on entitlement, *Northrop Grumman Corp.,* ASBCA No. 57625, 14-1 BCA ¶ 35,501, aff'd on recon., 14-1 BCA ¶ 35,743; 9 CP&A Rep. ¶ 13, the ASBCA held that NGC's use of the Deficit Reduction Act of 1984 (DEFRA) method of valuing its post-retirement medical benefit (PRB) costs, rather than the method prescribed by Statement of Financial Accounting Standard (FAS) 106, violated FAR 31.205-6(o). After deciding entitlement, the ASBCA remanded to the parties to determine quantum.

As amended effective Feb. 27, 1995, FAR 31.205-6(o)(2)(iii) requires that accrued PRB costs must be measured and assigned according to GAAP. In addition, PRB costs must be funded by the contractor's federal income tax return date to be allowable. Although the DEFRA method is acceptable for federal income tax purposes and complies with Cost Accounting Standard 416, GAAP require use of the FAS 106 method.

Unlike FAS 106, the DEFRA method does not factor in expected future increases in medical costs—due to either plan participants' increased use of medical services, or the general increase in the cost of services—until the year in which the resulting cost increases are experienced. Because of this difference, keeping all other factors the same, the annual costs computed under DEFRA tend to start lower and increase over time, while those computed under FAS 106 tend to start higher and decrease over time.

NGC implemented FAS 106 for financial reporting purposes on Jan. 1, 1991, but it continued to use the DEFRA method for Government contract cost accounting purposes. Thus, its PRB costs were less than they would have been if NGC had used FAS 106. In 2006, as it was approaching the "crossover" point at which the DEFRA costs would exceed the FAS 106 costs, NGC considered amending its PRB plan to limit the impact of future increases in medical costs (and therefore stay below the FAS 106 ceiling), but continuing to account for PRBs in accordance with DEFRA.

However, the corporate administrative contracting officer (CACO) refused to enter into an advance agreement with NGC to permit the continued use of DEFRA or approve the implementation of FAS 106 for Government contract cost accounting purposes on Nov. 1, 2006. Nevertheless, effective Nov. 1, 2006, NGC adopted the FAS 106 method for Government contract accounting purposes and a PRB plan design change that capped future benefit increases for participants in all of its PRB plans, including the plan at issue in the case. The combined effect of these two changes was to reduce PRB costs substantially for Government contract accounting purposes in periods after the changes.

Several months later the CACO issued a notice of intent to disallow costs, contending that, as of Feb. 27, 1995, NGC was required to use the FAS 106 method to measure and assign its PRB costs, and the PRB costs that would have been assignable to prior years using the FAS 106 method, but that were not funded,

paid or otherwise liquidated by the tax return date, were not allowable in any subsequent year. DCAA subsequently issued an audit report concluding that over $253 million worth of PRB costs were unallowable because of NGC's failure to fund PRB costs that would have been assignable under the FAS 106 method from Feb. 28, 1995 to Oct. 31, 2006.

In its quantum decision, the ASBCA found that NGC's DEFRA method of accounting did not assign, to any year prior to 2007, any portion of the $253 million identified as unallowable in the DCAA audit report. On the contrary, the ASBCA found that NGC's 1995–2006 PRB costs were lower than they would have been under FAS 106. Specifically, if NGC had used the FAS 106 method, the 1995–2006 costs would have been approximately $253 million more.

At some future point, costs calculated using the DEFRA method would exceed FAS 106 calculated costs, barring reduction in PRB plan benefits. However, the ASBCA found that because of the plan design change that reduced PRB benefits, NGC never would charge the $253 million of unfunded PRB costs. Therefore, the ASBCA concluded, the Government suffered no damages from NGC's use of DEFRA from 1995–2006 for Government accounting purposes.

The ASBCA's quantum opinion provides a more analytically sound interpretation of FAR 31.205-6(o) than its previous entitlement opinion and warrants quoting at length. The opinion states:

> We consider that FAR 31.205-6(o), properly construed, establishes a cost allowability "ceiling," and focuses on whether the contractor *overcharged* the government for PRB costs in its relevant cost-related submissions. There is no dispute that for more than a decade preceding the "transition" NGC did not. From the onset of the FAR requirement in 1995 through 2006, NGC's use of the DEFRA method resulted in the contractor annually charging the government *less* than it could have claimed had it elected to use the FAS 106 methodology for government accounting purposes during those pre-transition years. For that decade, the government unsurprisingly did not object. In fact, the government was well aware that appellant continued to use the DEFRA methodology but repeatedly approved its use as being in compliance with regulatory criteria. The drafters' comments accompanying promulgation of the pertinent revisions of FAR 31.205-6(o) further indicate that other CAS-compliant accrual methods were not prohibited by the regulation. Although we determined in the "entitlement phase" that the government was not bound by its acquiescence and did not waive compliance with the FAR in the pre-transition years, the parties effectively interpreted the cost principle to provide that PRB "costs" computable using FAS 106 criteria served as a "ceiling" on allowability, while permitting use of DEFRA to the extent that DEFRA-measured, accrued and assigned costs did not exceed that "ceiling." Only when the 2006 "transition" issues arose did the government first advocate its current theories. ...
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> The government interpretation advocated in this appeal regarding the pre-transition years also contradicts the general rule regarding the quantum consequences of noncompliance prescribed in FAR 31.201-2(c). That provision states, "When contractor accounting practices are inconsistent with this Subpart 31.2, costs resulting from such inconsistent practices *in excess* of the amount that would have resulted from using practices consistent with this subpart are unallowable." Here, NGC failed to comply with the FAR requirement that allowable costs be accrued in accordance with FAS 106 criteria where an accrual methodology was used by the contractor to determine its allowable PRB costs. Although appellant failed to use the proper accrual methodology, there is no evidence or government contention that the amount accrued by appellant pursuant to DEFRA in the pre-transition years *exceeded* the amount of costs that would have been allowable applying FAS 106 or even an amount calculable for the Plan using the "pay-as-you-go" methodology. In fact, precisely the opposite is true. Moreover, as discussed more fully below, because of the 2006 Plan amendment, recovery of the amount disallowed by the government will never be sought or claimed by appellant in the post-transition years. There is no *excess* to disallow.
>
> More fundamentally from an accounting perspective, the government interpretation assumes that NGC properly could, should, and in fact was *required* to, charge/claim unincurred PRB costs in relevant cost/pricing-related submissions during the pre-transition years. Although the government recognizes that the approximately $253 million "excess" FAS 106 costs in dispute were never claimed or included in any incurred

cost or forward pricing proposals for the years in question, it contends that appellant, nevertheless, "incurred" those costs by "operation of law" in accordance with the express requirements of the FAR. No precedent in support of this novel concept is cited.

The government disregards fundamental concepts related to cost "incurrence" and misfocuses on an "allowability" regulation rather than the NGC Plan itself. The foundational assumption of the government interpretation is erroneous and illogical insofar as it relates to the pre-transition years.

Compliance with FAR 31.205-6(o) was only one of the criteria for allowability. Perhaps most basically, to be allowable, the contractor must incur the costs in dispute. Compliance with the government's interpretation of FAR 31.205-6(o) would have placed NGC in violation of that key prefatory requirement for allowability. Appellant did not "incur" the disputed costs in the pre-transition years and, as discussed below, will not "incur" them in the post-transition years as a consequence of the 2006 Plan amendment. If NGC had included non-incurred costs in its various cost, pricing and claim submissions during the pre-transition years, it faced their disallowance for that reason as well as other possible adverse consequences and penalties. ...

The government relies heavily on NGC's failure to fund the excess computable in the pre-transition years using FAS 106 precepts. According to the government, appellant thereafter lost the right to assign, fund and recover the excess in subsequent fiscal years. For government contract purposes, PRB costs must be properly assigned and timely funded to be allowable. Here there is no dispute that NGC fully and timely funded the incurred amounts assigned *by it* to FYs 1995-2006 in accordance with Plan requirements. The government myopically alleges that appellant should have "assigned" more than required by the Plan to each of those years. However, if PRB costs are not incurred, there is no requirement to assign, much less fund, "phantom" costs. There is no evidence or allegation that a major contractor such as NGC would be unable or otherwise fail to fund properly incurred, measured and assigned costs. NGC funds what it properly accrues and assigns. The funding prong of the allowability test has obvious purposes. The requirement ensures that there is no shortfall in the amount funded versus the amount measured, assigned and accrued. Here the government interpretation focuses on funding while disregarding the basics of cost incurrence. Again, it would have been improper for NGC to "assign" and claim costs in excess of the amount incurred….

As established by the only expert actuarial testimony in the record, we have found that any adverse cost consequences resulting from the change to FAS 106, and potential inclusion of costs properly assignable to the pre-transition years, were reversed and removed as a result of the Plan amendment. The government will not pay the pre-transition "costs" in dispute. They were not, and will never, be incurred, accrued, or assigned. The disputed post-transition FAS 106 costs were not included in the transition obligation having been eliminated prior to its calculation as a consequence of the 2006 Plan amendment. The unrebutted expert testimony to that effect was corroborated by the persuasive testimony of appellant's former senior actuary whom we have found to be highly credible, as well as the only government actuary addressing the issue. The government has failed to sustain its burden of proving that any of the disallowed amount was or will be amortized as part of the transition obligation and claimed during the post-transition years. Its argument is founded on theoretical constructs that have no factual basis or evidentiary support here. In this case, the government's concerns were legitimate, albeit its legal and factual analysis was faulty. NGC removed properly objectionable portions of the transition obligation via the 2006 Plan amendment before computing that obligation. That amendment should have assuaged and eliminated the government's valid concerns here. ...

The contractor has never, and will never, claim, and the government will never pay, amounts disallowed by the final decision. That disallowance was improper as were the associated deductions taken by the government with respect to the amortized amounts of the transition obligation assigned during the post-transition years.

The ASBCA therefore sustained NGC's appeal.

CDA Statute of Limitations Applicability to Direct Costs (*Sparton DeLeon Springs, LLC*, ASBCA 60416, 17-1 BCA ¶ 36,601, mot. for recons. denied, 17-1 BCA ¶ 36,764; 12 CP&A Rep.

¶¶ 15, 39; 59 GC ¶ 28)—The ASBCA's decision in *Sparton DeLeon Springs, LLC* addresses, for the first time, the apparent conflict between paragraph (g) of the Allowable Cost and Payment clause at FAR 52.216-7 and the CDA's six-year statute of limitations. The CDA requires that "each claim by the Federal Government against a contractor relating to a contract shall be submitted within 6 years after the accrual of the claim." 41 USCA § 7013(a)(4)(A). FAR 33.201 defines "accrual of a claim" as "the date when all events, that fix the alleged liability of either the Government or the contractor and permit assertion of the claim, were known or should have been known." On the other hand, for cost reimbursement contracts, FAR 52.216-7(g) gives the Government the right to audit and make adjustments for prior overpayments "[a]t any time or times before final payment"—which could be far longer than six years after the costs were reimbursed and/or first determined to be unallowable.

The ASBCA granted summary judgment for Sparton, holding that the Government's claim for reimbursement of an alleged overpayment of direct costs under a cost reimbursement contract was time-barred because the CO's final decision asserting the claim was issued more than six years after the Government paid Sparton's interim vouchers for the costs and Sparton subsequently submitted a final indirect cost rate proposal that did not include the disputed costs.

The decision states that by Jan. 10, 2007, the Government had paid Sparton's interim vouchers that included breakdowns of certain intra-company "Jackson Engineering Support Costs" allegedly incurred at its Jackson, Mich. plant. On March 5, 2007, and Jan. 29, 2008, respectively, Sparton submitted its final indirect cost rate proposals for its FYs 2006 and 2007. Both proposals included a Schedule I, Cumulative Allowable Cost Worksheet, but the Jackson costs were not listed in either Schedule I. In September 2013, DCAA issued audit reports on the indirect cost rate proposals, noting that the proposals did not include the Jackson costs. On Aug. 12, 2014, after the parties had executed final indirect rate agreements for contractor FY 2006 and contractor FY 2007, the CO requested that Sparton submit final vouchers and supporting documentation. Sparton responded by submitting the final vouchers, which included the previously invoiced and paid Jackson costs.

On Oct. 26, 2015, the CO issued a final decision demanding that Sparton repay the Jackson costs, and stating:

> After reviewing the final voucher submission, I noticed certain costs that were not included in [Sparton's] Incurred Cost proposals for [contractor FY] 2006 or [contractor FY] 2007. These additional costs were supposedly payments made to your former Jackson, Michigan facility that closed in 2006. I contacted your company for information that would establish that these additional costs are allowable. To date, despite repeated requests, your company has not provided information that establishes these additional costs were actually incurred or paid by [Sparton]. You have provided only a spreadsheet showing that the Government paid [Sparton]. There is no proof whatsoever that [Sparton] was billed for work, or more importantly, that [Sparton] paid these costs in connection with any Government contracts.

After appealing the CO's final decision to the ASBCA, Sparton moved for judgment on the pleadings, or summary judgment, that the Government's claim is time-barred under the CDA's six-year statute of limitations. The Government argued in response that it was not put on notice of its overpayment claim until Sparton submitted final vouchers in response to the CO's 2014 request, because although the final vouchers include the already-paid Jackson costs, those costs were not included in the updated Schedule I forms of Sparton's revised final indirect cost rate proposals. However, the ASBCA found "no genuine dispute that the government knew or should have known of that discrepancy no later than 29 January 2008." The ASBCA found this was so for two reasons:

> First, there is no genuine dispute that the government knew or should have known of the Jackson costs as early as 10 January 2007, by when it paid those costs pursuant to the interim vouchers that, even according to the government's brief, included information related to the Jackson costs (gov't resp. at 24). Second, there is no genuine dispute that the government knew or should have known by 29 January 2008 that Sparton had not included the Jackson costs in its indirect cost rate proposals, because that is the date by when Sparton first submitted the indirect cost rate proposals, each of which included a Schedule I that did not include the Jackson costs.

The decision further states:

> Looked at another way, the government's overpayment claim is based upon the contention that [the] Jackson costs were "insufficiently sup-

> ported" …, and that, according to the contracting officer, there is no proof that Sparton's predecessor paid those costs in connection with any government contract. However, if that is true, it was no less so on 10 January 2007, by when the government paid those costs pursuant to the interim vouchers.

The ASBCA also noted that, "[w]ithout expressly arguing that FAR clause 52.216-7(g) trumps the CDA's six-year statute of limitations, the government invokes that clause, contending that it 'allows the contracting officer to adjust any prior overpayments'" at any time or times before final payment. The ASBCA rejected this argument, stating:

> If the government means that FAR clause 52.216-7(g) provides more than six years after accrual to assert an overpayment claim as long as final payment has not been made, we are not persuaded. Of course, the CDA's six-year statute of limitations is no longer jurisdictional. Because a party may waive an affirmative defense, the six-year statute of limitations does not bar us from entertaining a claim that is asserted after the expiration of the limitations period where a non-claimant does not raise the statute of limitations as an affirmative defense. In addition, parties to a government contract may voluntarily waive certain rights, even certain statutory rights. However, we are not persuaded that FAR clause 52.216-7(g) limits the applicability or availability of the CDA's six-year statute of limitations in appeals from government overpayment claims; that clause does not even address the statute of limitations. [Internal citations omitted].

Finally, the ASBCA rejected the Government's argument that summary judgment was inappropriate because there has been no discovery and the Government has not had an opportunity to determine whether the interim vouchers contained the necessary supporting documentation. The ASBCA found that "[w]hether the interim vouchers contained the necessary supporting documentation is something that the government should be able to substantiate on its own, without having to conduct discovery; at least, the government provides no indication why that is not the case."

Conclusion—Although 2017 saw no Federal Circuit decisions on cost and pricing issues, these five decisions by the ASBCA resolve—for better or for worse, until and unless the Federal Circuit holds to the contrary—important issues of first impression that will have an impact on future cost and pricing disputes within the ASBCA's jurisdiction.

This Feature Comment was written for The Government Contractor* by Karen Manos, *partner and chair of Government Contracts practice at Gibson, Dunn & Crutcher, LLP.