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NEW GOVERNMENT COMPLIANCE PROGRAM

(Editor's Note. Last November 12 the FAR Council issued a final rule, effective December 12, establishing a new "Contractor Business Ethics Compliance Program and Disclosure Requirements." Using the Council's own words, it represents a "sea change" over how the government regulates the contractors and subcontractors providing its goods and services. Since passage of the new rule, there has been a flurry of articles written on the meaning of the rules and what government agencies and contractors need to do to comply with these significant changes. Government agencies, government contractor employees, law firms and consulting firms are rushing to understand the practical requirements of the new rules. (Disclosure: our firm, in partnership with other law firms, is also rushing to understand the rules in order to help our clients comply with the new rules.)

The new rules are at this point not entirely clear and are, in fact, inconsistent on how these obligations are to be implemented. It is probable that specific agencies will be issuing their own guidelines so it is likely that contractors working with various agencies will need to live with multiple implementation rules. The following article reflects the thoughts of many of the recent articles being written by compliance specialists including John Chierichella and Louis Victorino of Shepard, Mullin, Richter & Hampton LLP in the Dec 17th issue of the Government Contractor; James Fontana (Alion Science and Technology Corp), Scott Hommer and Peter Riesen (both of Venable, LLP) in the Jan. 2009 issue of Contract Management and; Karen Manos of Gibson, Dunn & Crutcher LLP in the January 2009 issue of the CP&A Report.

♦ Essential Elements

The rule has four primary elements:

1. All contractors and subcontractors (we will refer to both categories as "contractors" unless we indicate otherwise), including those providing commercial item goods and services, must establish and promote "awareness of a code of conduct."

2. All contractors must disclose in writing to the agency inspector general, with a copy to the contracting officer, any violation of certain fraud related criminal statutes or the civil False Claims Act (FCA) if they have "credible evidence" of such violations.

3. The rules provide for suspension and debarment for any "knowing failure" of a "principal" of a contractor to timely disclose to the government "credible evidence" of those same events or of a "significant overpayment," even if the event occurred before the effective date of the new rule.

4. Large companies with noncommercial-item contracts must implement a comprehensive "internal control system."

♦ New FAR Clause

A modified FAR clause – FAR 52.203-13 – has been introduced to incorporate the new changes. It is to be included in all new federal procurements that exceed $5 Million and have a performance period longer than 120 days. The coverage applies to all contracts covered by FAR including contracts for commercial items, small business contracts and those performed overseas. Though other types of non-FAR covered contract vehicles such as grants, cooperative agreements or other transaction agreements are not covered there is nothing to prevent inclusion of the rule on these types of contract vehicles. For multiple award and ID/IQ contracts the $5 million threshold is measured by the contract's total value, not the individual task or delivery orders. FAR provisions dealing with mandatory commercial item contracts and subcontracts have also been modified e.g. FAR 52.212-5(e)(1)(i) and 52.244-6. The clauses require flow down of the requirements to subcontracts and lower tier subcontracts valued at $5 million with performance over 120 days. The definition of a "subcontractor" is broadly defined as any "supplier, distributor, vendor or firm that furnishes supplies or services to or for a prime contractor or other subcontractor" so it applies to even agreements with distributors and their sources for supplies and services provided under the General Services Administration's Multiple Award Schedule contracts.

Code of Conduct

Any contract that incorporates the new clause must develop and implement a "written code of business ethics and conduct" and "make a copy of the code available to each employee engaged in performance of the contract." The new rule does not mandate the content of the code but it is pretty clear it must cover normal federal contracting concerns e.g. gratuities, kickbacks, personal conflicts of interest, procurement integrity, mischarging, overcharging, internal reporting or misdeeds, etc. Though many contractors already have corporate-wide codes of conduct they may not be sufficient to cover federal contract-specific areas.

Contractors can decide how best to "make the code available" to employees. Providing a hard copy certainly satisfies this requirement while posting an electronic copy of the code on the company's intranet should be sufficient. The requirement is that it be in "plain view" where it is not buried in a pile of other hard or electronic copy.

In addition to the code of conduct the FAR clause requires all contractors to "exercise due diligence to prevent and detect criminal conduct" and "promote an organizational culture that encourages ethical conduct and commitment to compliance with the law." Though the clause does not describe how a contractor is to accomplish these things any approach likely should include an effective training program and periodic internal reviews. These requirements apply to all contractors where, as we see below, additional steps are required by noncommercial-item contractors to maintain internal controls.

Mandatory Disclosure of Wrongdoing

In a major departure from prior practice the new FAR clause requires a "timely" disclosure in writing to the cognizant agency inspector general office, with a copy to the CO, upon discovery of "credible evidence" that "principal, employee, agent or subcontractor of the Contractor has committed" either a federal criminal violation involving fraud, conflict of interest, bribery or the gratuity laws or a False Claim Act violation. Let's break down these elements.

Companies holding multiple award contracts must disclose both to the ordering agency's IG and the IG responsible for the basic contract. A "principal" is defined as an "officer, director, owner, partner or person having primary management or supervisory responsibility within the business." An "agent" is any person authorized to act on behalf of the company.

Though the clause does not require disclosure of the credible evidence underlying the disclosure, the new rule may require it as a practical matter. First, the contractor must provide "full cooperation" which includes complete response to government auditors and investigators' requests for documents which will most probably include documentation that formed the basis for the contractor's assertion that credible evidence exists. Moreover, the changes to suspension and debarment rules clearly indicate that credible evidence must be provided.

Commentators have expressed particular concern about the requirement to disclose if a contractor concludes evidence of an FCA violation exists. To prove an FCA violation the government must usually show a contractor, either directly or indirectly through a higher-tier contractor "knowingly" submitted to the government a claim that was false and material or made a false statement related to a payment. However, it is very difficult to determine whether "credible evidence" of an FCA violation exists. That is one big reason why juries are empanelled – two sides simply have different views of what constitutes credible evidence. However, under the new rule, contractors must effectively prejudge the credibility of the evidence and risk serious consequences if their judgment is later challenged. Several problems with the new disclosure requirements have surfaced:

1. Any disclosure by a contractor can constitute admission that "credible evidence" of a violation exists. Such an admission can be quite detrimental later on. For example, when negotiating a settlement the government attorneys can point to an admission of credible evidence for a violation creating a hardened position or juries can be advised about a contractor's admission of credible evidence which can be used as a sufficient basis to infer liabilities. Given these, some commentators indicate disclosure should be framed "protectively" claiming the disclosures were made out of an abundance of caution rather than any subjective certainty.

2. Failure to disclose constitutes a breach of contract or at least failure to comply with its obligations. The new rule creates a kind of "back door" FCA liability where failure to disclose credible evidence of an FCA violation becomes, in itself, an actual FCA violation.

3. Contractors need a comprehensive approach to collecting information from company personnel to ensure relevant information is gathered to comply with the new rules to locate and evaluate information. Such a burden can be onerous for some companies.

4. Disclosure under the rule is not considered a "public disclosure," which precludes pursuit of a qui tam proceeding so the mandatory disclosures can present a risk that qui tam actions will follow. (Qui tam actions are civil actions brought under the authority of the False Claims Act where a plaintiff – most often a contractor employee – brings action on behalf of the government and shares in any monetary recovery.)

Suspension and Debarment

Failure to make the required disclosures constitutes a distinct cause for suspension or debarment. The suspension and debarment provisions of the new rule are quite insidious. Whereas the rules discussed thus far cover disclosure requirements of criminal or FCA violations and explicitly excludes disclosure requirements for overpayments (because FAR 32.001 adequately covers this) the new rule covering conditions for suspension and debarment includes the broader requirement to disclose "significant overpayments." The broader obligation not only expands the items to be disclosed but applies whether or not the affected contracts include the new FAR clauses and covers wrongdoing occurring prior to the effective date of the new rule. So now, if a company has credible evidence that criminal or FCA violations or significant overpayments occurred even before Dec. 12, 2008 on either a current contract or contract that is within three years of final payment, failure to disclose provides a basis for suspension or debarment and that actual disclosure made to avoid suspension or debarment can provide the basis of criminal prosecution or an FCA complaint.

In recognizing these risks the FAR Council explicitly limited suspension and debarment disclosure requirements to contractors' "principals." However, the Council has made explicit their intent to "interpret broadly" the definition of principal to include "compliance officers or directors of internal audit."

Most attorneys are advising contractors to carefully plan any disclosures since the new rule does not protect them against the possibility of government prosecution, civil complaint or qui tam actions based on the disclosures.

Internal Investigations

The new rule counsels strongly in favor of prompt internal investigation if a company suspects wrongdoing – indeed it requires such a response. The Council has replaced "reasonable grounds to believe" with the term "credible evidence" to indicate a higher standard of disclosure meaning the contractor should have some time for a preliminary examination to determine its credibility before deciding to disclose. The rule makers rejected a request the new rule identify a time period for a mandatory disclosure. There is no obligation to carry out a complex investigation but the contractor is only required to take "reasonable steps" it considers to be sufficient to determine whether credible evidence exists. The term reasonable is not defined but some commentators caution that given the potential legal consequences of an admission of credible evidence of a violation, contractors should not feel pressured by the rule to be improvident or inadequately evaluate the credible evidence.

Internal Control System

The modified FAR clause imposes significant additional requirements on large businesses performing noncommercial-item contracts. Specifically they are required to have (1) an ongoing business ethics awareness and compliance program and (2) an internal control system. The new rule outlines the minimum a contractor must do to meet the requirements. It should be noted that though these additional requirements do not strictly apply to small businesses and commercial-item contractors all contractors risk suspension and debarment for failure to disclose wrongdoing so as a practical matter, the following requirements should be viewed as applicable to all contractors.

As for an awareness program the new rule requires that the program should include "all reasonable steps to communicate periodically" by conducing effective training programs and otherwise disseminating information appropriate to an "individual's respective roles and responsibilities." The rule states the trainings "shall be provided to the contractor's principals and employees…agents and subcontractors." Though the council did not outline the nature of an adequate training program it did briefly state "the business ethics training courses may cover appropriate education on the civil FCA as well as other areas such as conflict of interest and procurement integrity and other areas determined to be appropriate by the contractor, considering relevant risks and controls." So effective training should be tailored to the number, nature and size of the federal contracts and subcontracts a company has.

The rule details what the government expects from a company's internal control system as a whole. In general the rules require implementation of a system

that facilitates timely discovery of improper conduct in connection with government contracts and ensures corrective measures are promptly put in place. To accomplish this the new rule requires, at a minimum:

1. Assign responsibility for the internal control system to someone "at a sufficiently high level" and with "adequate resources" to ensure program effectiveness. Though the rule does not identify who this person should be prior experiences indicate who it should not be. Director of Sales resembles the "fox guarding the henhouse" and members of the legal staff should not be considered because their participation makes it harder to invoke the attorney-client privilege when needed because of their day-to-day participation in compliance.

2. Take reasonable efforts not to hire anyone as a principal whose prior conduct may have been in conflict with the code of business ethics and conduct. The level of background checks is not specified but it should be a sound business judgment.

3. Conduct periodic reviews to detect wrongdoing including (a) monitoring and auditing to detect criminal conduct (b) periodic evaluation of the effectiveness of the internal control system and (c) periodic assessment of the risk of criminal conduct. The new rule does not state how often these reviews should be conducted but most companies should employ a combination of in-house and outside reviews. As for the "monitoring and auditing" functions, they should be conducted in accordance with generally accepted auditing principles.

4. Implement an internal reporting mechanism such as a hotline.

5. Discipline those who engage in improper conduct and those who do not take "reasonable steps to prevent or detect improper conduct." Note this goes beyond simply punishing the offender. Now companies must not only discipline those engaged in improper conduct but also individuals who did not take reasonable steps to detect improper conduct such as supervisors and higher ups. Though the Council did not explicitly suggest the level of discipline, it did note that "most corporate compliance programs assert that violations of law or company policy are grounds for dismissal."

6. Timely disclose to the cognizant IG "credible evidence" of a federal criminal violation involving fraud, conflict of interest, bribery or the gratuity rules or of an FCA violation.

7. Fully cooperate with any government agency responsible for audits, investigations or corrective actions. Though contractors have always been required to cooperate with auditors the rule expands the definition of "full cooperation." It means (a) disclosing to the government information sufficient for law enforcement to identify the nature and extent of the offense and individuals responsible (b) providing times and complete responses to government auditors and investigators and (c) providing auditors and investigators timely access to employees with information. Though certain security agencies have always required it, this last provision to provide access to employees as a general rule of the FAR is new. In response to several comments the final rule explicitly states that it is not intended to waive the attorney client privilege and that such a waiver is not required to get full credit for implementation. It also appears that the "full cooperation" requirement does not prevent contractors from indemnifying their employees for legal fees.

The new rule requires contractors to implement internal control systems within 90 days after contract award unless a CO authorizes a longer period. However contractors should not think they can wait until implementation of an internal control system before reporting "credible evidence" of wrongdoing. They are still vulnerable to suspension and debarment if they do not knowingly disclose the information. Also, the modified clauses must be flowed down to subcontractors holding subcontracts worth over $5 million and with a performance period exceeding 120 days. Though contractors need not review or approve subcontractors' codes or internal control systems, the preface to the rule states that "verification of the existence of such code and program can be a part of the standard oversight that a contractor exercises over its subcontractors."

Case Study...

CHALLENGING AN ASSERTION OF EXCESS EXECUTIVE COMPENSATION

(*Editor's Note. As part of our continuing practice to provide "real life" case studies from our consulting practice, we thought we would recount a challenge we prepared to DCAA's assertion that our client had paid its executives an excessive amount of compensation. Though not all issues described here are likely to be relevant to all contractors we thought we would still recount the arguments we put forth as an illustration of the types of*

arguments available to challenge assertions of excess compensation. As we have reported previously, excessive executive compensation is the number one issue that contractors and DCAA face. Though large contractors are normally covered by OMB executive compensation caps issued annually, all other organizations are subject to reasonableness standards where substantially lower amounts are considered appropriate.)

DCAA's Position

The local DCAA office was auditing Contractor's (we have disguised the name of our client – referred to as "Contractor" – as well as the period being audited, dollar amounts and names) 2007 incurred cost proposal and asked the DCAA Mid-Atlantic Region's Compensation Team to audit the executive compensation for reasonableness. DCAA's compensation team concluded that Contractor's four top senior executives' compensation for 2007 was unreasonable in the aggregate amount of $720,000. DCAA's conclusion was based on comparing Contractor's cash compensation paid to its senior executives with the data of four surveys, adjusted for a 10% "range of reasonableness" factor.

Our Response

In our response to DCAA's draft audit report we respectfully disagreed with their position and put forth the following arguments to support our position that the amount of executive compensation paid was reasonable. We have significantly edited our response.

♦ Failure to Take Into Account Fringe Benefit Costs

DCAA has failed to adjust its conclusions for Contractor's exceptionally low fringe benefit costs. The Compensation Team's assumption that the claimed cash compensation represents only base salary, bonus and deferred compensation is not correct. A significant amount of the cash compensation amount includes provision for fringe benefits such as holiday, vacation and sick leave as well as other normal fringe benefits. The cash compensation should be reduced to delete the fringe benefit amounts included in the executive compensation of the four senior executives.

DCAA is tasked with determining whether contractors' executive compensation levels are reasonable. The approach taken is to identify "executive compensation" defined as salaries, wages, bonuses, deferred compensation and pension costs for defined contribution pension plans. Other forms of compensation commonly referred to as fringe benefits are defined by DCAA in DCAM Chapter 6-413.5 as legally required payments, pensions, life and health insurance, pay for time not worked (e.g. holidays, vacation sick leave, jury duty, grieving) and other benefits (e.g. severance pay, 401(k)s, ESOPs, deferred compensation).

The compensation of the four executives that was benchmarked was based on total compensation. The root of this problem is that in prior periods, including 2007, Contractor did not separately account for certain elements of compensation for their senior executives such as vacation pay, sick leave, holidays and as well as for imputed compensation for other normal fringe benefits such as insurance and 401(k) plans. Though Contractor has subsequently adopted practices to separately identify compensation and fringe benefits costs for executives, in 2007 and earlier periods they did not do so. Rather, all relevant fringe benefits were lumped into executive compensation and as a result, Contractor's fringe benefit costs were zero.

In accordance with the *Techplan Corporation (98-2 BCA)* decision, an imputed fringe benefit rate should be computed and deducted (or in DCAA language, offset) from compensation. (*We provided an exhibit where we computed a fringe benefit rate of 33% applicable to the four senior executives and adjusted their compensation downward to reflect the fringe benefit offset.*) In addition, in prior audits DCAA took into account the fact Contractor does not distinguish between compensation and fringe benefits and adjusted the compensation and compared the result with one survey (the Wyatt survey).

Conclusion. DCAA needs to modify its conclusions by adjusting total compensation amounts for a reasonable fringe benefit rate. DCAA should take the same approach it has taken in the past, namely to adjust the cash compensation amount for low fringe benefits. We believe that if DCAA followed this approach it would reach the same conclusion it reached for the last ten years, i.e. Contractor's executive compensation levels are reasonable.

♦ Flawed Salary Surveys

We believe that there are serious flaws with two of the compensation surveys DCAA used.

Though we believe using one centralized, specially trained group of auditors is a significant improvement over using less trained, local DCAA auditors inclined to use a variety of approaches, use of a single team

does have certain disadvantages where they are inclined to take a "one size fits all" (i.e. consider all surveys equally valid) approach that does not accurately benchmark individual companies' executive compensation. Our consultant, who participated in compensation reviews in the Mid-Atlantic region when he was a DCAA auditor, informs us the team sometimes selects surveys that may not be entirely representative in order to be able to compute an average cost of several surveys. This seems to be the case here. Though taking an average is theoretically attractive, the accuracy of such an approach is dependent on how representative the surveys are with the company being analyzed – if they are not representative, they should not be used. The four surveys used here have varying levels of accurate comparables with the characteristics of Contractor and in our opinion, two should be eliminated, Jaffe and Mercer.

In our written response, which is too detailed to reproduce here, we provided a detailed analysis of the four surveys used, identifying strengths and weaknesses of each in attempting to benchmark Contractor's characteristics with the purported characteristics of the four surveys. We concluded that two of the surveys used identified compensation levels that were 50% lower than the other two surveys (comparable survey results should not differ significantly). Our analysis indicated that the reason for the large disparity in results from the four surveys used were a result of two factors: (1) Contractor's location in a particularly expensive area in California where senior technical management is in short supply could not be adequately benchmarked to one survey that measured only nation-wide averages while another measured only Mid-Atlantic companies (2) one of the surveys we asked to be discarded examined "all industries" rather than the high tech professional labor services offered by the Contractor. We requested that two of the surveys used to benchmark Contractor's executive compensation should be discarded and that two additional surveys that Contractor used should be substituted.

♦ Alternative Surveys Should Be Used

In our response we introduced two surveys we claimed were more appropriately benchmarked to Contractor. One of the surveys – Aspen Survey – though no longer published in 2007 was used by Contractor for many years while another we introduced – Radford Survey – more closely benchmarked high tech professional services. Though again too detailed to recount here we presented an analysis of why the two surveys were more closely representative of Contractor not in hopes that DCAA would substitute ours with theirs (unrealistic hope) but that they would include the findings of the two in computing average survey results.

♦ Two year data limit

DCAA stated that in spite of use of the Aspen survey in prior years it could not recognize the results of the Aspen survey in 2007 because the last year it was published – 2005 – represents data that was more than two years old and hence not appropriate for evaluating compensation in 2007. We had never heard of this "more than two year old" prohibition (in fact older surveys are fine if the results are properly escalated and the conditions are similar) and could find no discussion of it in either the FAR or DCAM so we asked DCAA for the basis of excluding a two year old survey. DCAA indicated two cases - *ISN* and *Techplan* ASBCA cases addressed the prohibition. We reread the two cases and found no mention of the two year prohibition. The only possible reference to survey data being too old is in the ISN case where 1992 survey data was referenced and the Board stated more current 1994 data from the *same survey* should have been used.

♦ Wrong Title Classification

DCAA has inaccurately identified three of four titles associated with Contractor's senior executives and then inappropriately benchmarked those incorrect job titles with its surveys.

In benchmarking the Contractor executives, DCAA used the same titles that Contractor had assigned to the four individuals many years prior to 2007 – CEO, Chief Operations Officer, Chief Marketing Officer and VP of Operations. After reading the job descriptions of each of the four executives and inquiring into the nature of their jobs, it was clear to us that Contractor years ago, without a lot of thought and unaware of any adverse consequences, assigned job titles to its senior executives. In spite of significant changes in subsequent years, those job titles were not updated and DCAA used those old, now inaccurate job titles to benchmark Contractor's compensation.

We provided the auditors printed job descriptions and detailed accounting of the nature of the four executives' jobs. The two top executives were a husband and wife team who founded the company 30 years earlier where each shared CEO duties. In addition, the wife also assumed duties of a CFO so we asserted that either

they should both be benchmarked as co-CEOs or the wife as a part CEO and part CFO. The person designated as VP of Operations was really a Chief Operations Officer (whom a VP of Ops commonly reports to) and we asserted his position should be considered COO not a significantly lower VP of Ops (where we said no such position existed in 2007). As for the person designed as Chief Marketing Officer his position had radically changed by 2007 to be President of a new subsidiary company where remarkable success was achieved (discussed below).

Conclusion. The job titles DCAA assigned to the four executives and then benchmarked, though understandable since those were the titles designated, were erroneous. More accurate job titles would be: Co- CEO and Board Chairman (some surveys allow for greater compensation for senior board members), co-CEO, Board Secretary and CFO, COO and President or CEO of subsidiary company.

♦ Wrong Percentile Used

DCAA's customary use of a default median percentile is inappropriate here. By just about any financial measurement prescribed in the *Techplan* ASBCA case and the DCAM, Chapter 6-414-4, Contractor's operations and financial performance were superior. As a result, any survey used should be measured at a minimum of the 75th percentile, not the 50th percentile that DCAA has used.

DCAA normally uses the median percentile in benchmarking salary levels, leaving the burden of proof for using a higher percentile to the contractor. The FAR, *Techplan* and *ISN* ASBCA decisions as well as the DCAM provide for using higher (and lower) percentiles based on financial performance of the company being evaluated. The DCAM identifies examples of financial performance and we have selected a sample to demonstrate Contractor's superior financial performance where we provided an exhibit demonstrating a broad range of superior performance (e.g. sales and profit increases, return on equity, return on assets, etc.).

Contractor was awarded a contract in 2008 valued at over $100,000,000 over five years, a very large increase for a $7 Million a year company. This exceptional financial performance is the result of "seeds sown" in the 2007 time period (e.g. justifying a bundling of services into one contract, demonstration of expanded technical capabilities, excellent past performance reviews, etc.). Accordingly, this exceptional financial performance should be associated with 2007 performance which provides further credence to the appropriateness of applying a higher percentile when benchmarking Contractor's compensation.

Selection of percentiles to use is also based on operations performance in addition to financial achievements. Contractor's performance ratings were consistently superior which provided the basis for being awarded its huge contract a short time later.

Conclusion. Contractor's superior technical and financial performance, reflected in both its 2007 financial statements and award of a major contract that was a result of work performed in 2007, clearly justifies use of the 75th percentile in any survey used.

♦ Wrong Compensation for President of Subsidiary Was Benchmarked

The amount of costs benchmarked for the President of the subsidiary, $300,000, includes a one-time incentive payment of $130,000 to relocate to Washington DC and run the new operations there. So, the total compensation that should have been benchmarked is $170,000 whereas the incentive payment should be evaluated on separate reasonableness grounds.

♦ Estoppel

The courts and boards will not permit retroactive disallowances of cost when the contractor can reasonably show that the contractor relied on the government's prior conduct. This principle is known as "equitable estoppel" or "estoppel" and it applies when the contractor can show a history of acquiescence or approval of a particular cost which as we have seen, was clearly approved in the past.

To prove estoppel four conditions must be present which was the case here:

(1) The government must have actual notice of all the relevant facts – DCAA was provided complete cost submissions in prior years that clearly identified executive compensation.

(2) The contractor must have reasonably relied upon the government's action or inaction - in developing its indirect expense rates for forward pricing Contractor relied on DCAA's prior unequivocal action and had it reason to believe it would be questioned, Contractor would have sought an Advance Agreement with the ACO per FAR 31.109.

(3) The government must have realized, or should have realized, the contractor's reliance - it is self evident that the government realized Contractor's reliance because contracts were closed out using indirect rates audited and approved by DCAA.

(4) The contractor would be prejudiced or suffer a loss as a consequence of the retroactive application – DCAA's proposed reduction would result in a 50% decrease of executive compensation causing a significant loss in 2007.

♦ Some Employees Would Earn More than Executives

Some of Contractor's employees would earn more or slightly less than some of the executive salaries that DCAA asserts would be reasonable.

If DCAA's position was sustained, compensation for several employees would be higher than amounts allowed for the four executives. We provided an Exhibit that showed five employees' salaries in 2007 exceeded the amount the survey allows for the bottom executive level while nine employees are within 10 percent of that benchmarked amount. One employee's salary exceeds the second benchmarked amount while three employees' salaries are within 10 percent of the benchmarked amount. The government has been very satisfied with the education and experience level of employees working on its projects, the high level of achievement and the reasonable cost. Why else would Contractor have been awarded so many contracts in the last few years.

Conclusion. It does not make sense to have non-executive employees making close to or more than executives having more than 25 years seniority with the company.

♦ Below Average Indirect Expense Rates

Contractor is proposing indirect rates that are significantly lower than other contractors. Accordingly, the government is receiving a significantly lower price than comparable companies are offering. To insist that Contractor pay back an additional amount representing questioned costs of excess compensation would result in severe financial harm to Contractor, which could impair performance on current contracts.

Contractor's proposed indirect cost rates are significantly lower than comparable companies doing business with the federal government. Its proposed incurred cost rates for 2007 is 65 percent for overhead and 11 percent for G&A. (We provided an exhibit comparing quite favorably Contractor's indirect rates with those of other professional services companies.)

Classic oldie…

EMPLOYEE-RELATED LITIGATION AND SETTLEMENT COSTS

(Editor's Note. Employee litigation against employers has skyrocketed. In spite of believing they have legitimate business reasons for discharging them, contractors find themselves targets of wrongful discharge actions from a variety of state, local and federal laws. At the federal level, there is no shortage of suits alleging employment discrimination, ERISA violations and suits alleging retaliatory discharge for whistleblower actions. Contractors incur costs against such suits through litigation, settlements before judgments, and payments after judgments. Though there have been a few more current cases since publication of this article that indicate somewhat less opportunities for recovery of legal and other expenses the major points and prescriptions for action are still valid. The original article was based on an article by Thomas Lemmer, Thomas Jeter and Hugo Teufel, all from the law firm of McKenna & Cuneo in a 1998 issue of CP&A REPORT.)

The overriding principle affecting recovery of litigation-related costs, settlement costs and costs resulting from an adverse decision is *reasonableness*. FAR 31.201-3 addresses reasonableness of cost. It must pass the "prudent person" rule – a cost is considered reasonable if "in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business". To determine whether a cost is reasonable, it should be (1) a type of cost recognized as "ordinary and necessary for the conduct of the contractor's business or the contract performance" and (2) should result from "generally accepted sound business practices" arrived at from "arm's length bargaining". Satisfying reasonableness criteria is essential for recovery of this type of cost and the contractor cannot begin too early to document that its employee-related actions are reasonable.

Allowability of Litigation-Related Costs

Litigation-related costs commonly include in-house and outside attorney fees, consultant fees and other inside and outside costs related to the case. In addition to reasonableness, two cost principles and a few cases determine allowability of costs related to litigation.

Professional & Consultant Services (FAR 31.205-33). This cost principle governs costs of services of outside professionals engaged to enhance a contractor's legal, economic, financial or technical positions and applies to litigation involving both the government and third parties (e.g. employees). Unless one of the enumerated exceptions is present (which would not apply here), this cost principle generally treats litigation-related costs as allowable.

Proceedings Initiated By a Government Entity (FAR 31.205-47). This regulation sets forth specific guidelines for costs related to judicial or administrative proceedings initiated by federal, state, local or foreign governments. It generally provides that a maximum of 80% of otherwise reasonable proceedings costs are allowable if the contractor prevails in the litigation or proceedings or if it settles with a specific provision permitting allowability. If the contractor does not prevail, such costs are unallowable. Though the principle has generally been limited to proceedings initiated by governmental entities, two exceptions apply for litigation instituted by private parties: (1) when an employee brings a suit alleging reprisals for a contractor found guilty of the Major Fraud Act and (2) employee qui tam lawsuits under the civil False Claims Act unless the contractor prevails or settles under certain conditions (e.g. the government did not intervene in the action and the CO determines that there was little likelihood of winning).

Case Law. In *Northrup Worldwide Aircraft Servs., Inc.* two employees won a wrongful termination claim where they alleged they were discharged for refusing to participate in a fraud against the government and were awarded $900,000 in compensatory damages and $900,000 in punitive damages in a civil suit. Though the employees worked on another contract, the contractor sought recovery of attorney's fees on a cost-type contract. The CO asserted that it would be unreasonable to reimburse the contractor for its alleged attempts to defraud the government.

The Board of Contract Appeals disagreed, finding that a litigation position may be reasonable notwithstanding an adverse verdict asserting reasonable people can differ and a quite sensible litigation position may "fail to carry the day". The Board found the legal costs both allowable and allocable as an indirect cost because it was incurred for the overall operation of the business. The authors find this decision quite favorable to contractors because it refuses to find costs associated with litigation as automatically unallowable if damages are awarded but seeks additional evidence on the reasonableness of incurring these costs.

In *Hirsh Tyler Co.*, a contractor was found to engage in sexual discrimination in its promotion practices and forced to pay back wages and attorney's fees in a civil suit. In spite of the adverse judgment, the contractor's legal fees were found to be reasonable and hence allowable on a cost-type contract because defense of the lawsuit represented prudent business practices "regardless of the outcome".

In *Hayes Intl Corp.*, the contractor incurred legal fees against employees in a racial discrimination suit brought by the Equal Employment Opportunity Commission. Because the litigation concluded by a consent decree there was no finding the contractor violated the Civil Rights Act, the Board concluded these were reasonable costs incurred by an "ordinary prudent person" and allowed the legal costs charged to its contract. Unlike the other two cases where an adverse decision did not preclude recovery of costs, the Board concluded that a finding of violation of the Civil Rights Act might have led to a different result.

Settlements

An even more significant cost than litigation related costs are costs resulting from either an adverse judgment or a prejudgment settlement of employee litigation. These costs include backpay and fines and penalties imposed by statute. In addition to reasonableness, certain cost principles and case law determines allowability of these costs.

FAR 31.205-6, Compensation for Personal Services. The cost principle addresses violations of federal labor laws and Civil Rights Act of 1964. It distinguishes between rulings to pay employees additional compensation for backpay for underpaid work actually performed (allowable) and other compensation resulting from improper discharges, discrimination or other circumstances (unallowable).

FAR 31.205-15, Fines, Penalties and Mischarging Costs. This cost principle makes unallowable fines and penalties resulting from violations of or failure to comply with federal, state, local, or foreign laws. However, a Board of Contract Appeals has ruled that settlement of a discrimination suit before judgment is not unallowable under this cost principle because it was settled "voluntarily" and hence does not constitute punishment imposed by a tribunal or explicit agreement of the parties.

Case Law. The case law generally confirms that costs from both prejudgment settlements and adverse judgments are allowable if reasonable and allocable to the contract. For example, in a case alleging discrimination where the two parties settled, the government argued that recovery of the costs should depend on whether the contractor violated the law. The Appeals Board disagreed, saying the settlement agreement was not a result of a finding of unlawful practices but was a reasonable business decision to settle controversies at a minimum cost (*Ravenna Arsenal, Inc. ASBCA No. 17802*).

In another case, the contractor stipulated it had engaged in unlawful employment discrimination and the Government denied recovery of the costs of that adverse judgment. The Board sided with the contractor, saying a determination of allowability must be made on a case-by-case basis and made two points: (1) the award was for compensatory damages (actual loss) rather than punitive damages (additional cost for punishment) and (2) breaches of employment contracts are not unreasonable per se but needs a consideration of the circumstances to determine reasonableness of incurring the cost. (*Hirsch Tyler (ASBCA No. 20962*).

Lest it be assumed that all costs associated with employment law violations are recoverable, other cases demonstrate that confirmed factual findings of violations of the law are usually fatal to satisfying the reasonableness requirement for cost recovery. In one case, the Board refused contract cost recovery for an agreement for backpay and "advance" wages. The Board stated that where it is determined the costs are a product of a contractor's violation of the Civil Rights Act, both backpay and certainly pay for work not yet received by the Government should be unallowable unless it is for underpaid work actually performed (*Joint Action In Community Service, Inc., LBCA 83-BCA-18*).

Recovery Strategies

Because settling employment claims can be allowable if reasonable, contractors should take the approach of confirming the prudence of taking a settlement as well as the reasonableness of the amount settled for.

If the contractor concludes it is a good business act to settle once litigation has commenced, the best chance of achieving cost allowability is to reach an advance agreement with the Government prior to final settlement of litigation. The contractor will need to assemble a package demonstrating it was prudent to defend as well as subsequently settle in order to recoup its litigation and settlement costs. Examples of evidence that litigation was a prudent act might include (1) memorandum from corporate management that justified the decision along with advice and opinions relied on (2) synopses of evidence and legal rationales supporting the company's decision and (3) authoritative opinions by experts that these type of lawsuits should be defended.

To recover settlement costs, appropriate language of the settlement agreement must be drafted. FAR 31.205-47 states that up to 80% of the legal costs related to a government-initiated proceeding may be allowable if the company succeeds in its defense and is not assessed monetary penalties or if the company settles the case and the settlement agreement specifically provides for allowability. So, if initiated by the Government, the settlement agreement should unequivocally state the parties agree that the litigation costs are allowable. In any other settlement agreement (initiated by either the government or a third party – employee), the agreement should strongly and clearly state it (1) does not constitute or suggest an admission or finding of wrongdoing (2) is based on a rational assessment by the parties of their respective business and legal risks and (3) characterizes the settlement costs as *compensatory* (e.g. for breach of contract, emotional distress, or pain and suffering) rather than *punitive* damages. For the last point, case law indicates costs are more likely to be held allowable, whether for judgments or settlements, if they are for compensatory rather than punitive damages.

As for timing, if the contractor is inclined to settle, it is far better to do so before rather than after an administrative or judicial judgment. It will be much more difficult to recover its costs after it is clear that the contractor violated the law.

Summary

1. The degree of allowability of *litigation costs* depends on whether it is initiated by the government or a third party. When initiated by a third party, litigation costs are governed by general rules of allowability and FAR 31.205-33, "Professional and Consultant Costs", which are generally allowable. When initiated by the government, allowability of litigation costs are governed by FAR 31.205-33 and FAR 31.205-47, "Costs Related to Legal and other Proceedings" which generally provides that such costs are unallowable unless the contractor prevails in the litigation (limiting recovery to 80% of otherwise

reasonable costs). Relevant case law recognizes the reasonableness standard is a critical overlay to these cost principles. In at least two cases, legal fees were allowable in spite of an adverse judgment when it was demonstrated they were based on what a prudent business person would incur.

2. As for *settlements* or *adverse judgments*, costs of backpay for work actually performed, even if resulting from a violation of law, are clearly allowable. Costs for work not performed, along with fines and penalties are unallowable. Otherwise, the costs of paying judgments or settlements may be allowable. If it is clear that a contractor has violated the law, it is more difficult to recover resulting settlement costs than if it is less certain. Further, settlement costs and judgments are more likely to be allowable if they are compensatory rather than punitive. Accordingly, the best opportunity for recouping costs rests in early settlement, prior to judgment or damaging findings with the payment being characterized as compensatory if possible.

RECENT DECISIONS ON TRAVEL AND RELOCATION

(*Editor's Note. Though only three parts of the Federal Travel Regulations provisions formally apply to government contractors – combined per diem rates, definitions of meals and incidentals and conditions justifying payment of up to 300% of per diem rates – many contractors choose to follow the FTR either because some contracts call for incorporation of it or auditors and contractors consider it to be the basis for determining "reasonableness." This feature is a continuation of our effort to present new changes or decisions likely to affect contractors' travel and relocation expenses.*)

Reimbursement for Going Home Allowed Even if "Home" Changes

Robert was transferred from Portland, Oregon to Anchorage, Alaska for a two year assignment after which he informed his agency he intended to retire. He was informed he was entitled to "return to point of hire" relocation expenses for employees, family members and household goods to return to the original residence upon completing duties outside the continental United States (FTR 302-1.1). Nonetheless, his agency denied his request for reimbursement asserting Robert intended to maintain only a vacation property in Oregon while keeping his residency in Alaska. In his appeal Robert asserted he intended to keep his original residence in Oregon and spend winters in Alaska and the Board ruled Robert is entitled to payment to his place of residency at the time of transfer regardless of where he intends to actually reside at separation of government service. The Board noted that prior rulings found that return relocation benefits are payable even if the employee returns to a location other than his original place of residency with the only limitation being the reimbursement cannot exceed what it would have cost to return to the original place of residence *(CBCA 1112-RELO).*

Must Reimburse Agency for Relocation if Reasons for Leaving is Within His Control

Benjamin entered into a 12-month service agreement to provide work for the Veterans Affairs (VA). The terms of the agreement included a stipulation that Benjamin would be responsible for repaying costs of his relocation if he left the position before completing 12 months of service unless the separation was a result of (1) induction into the Armed Forces (2) permanent or semi-permanent illness or death not due to misconduct (3) compelling personal reasons beyond the employee's control and acceptable to the VA or (4) failure to qualify for the position. Benjamin left after five months where in his resignation letter cited "personal issues and a family matter" and stated his time was a "wonderful experience." The Board sided with the VA stating it was within its authority to determine Benjamin should pay the full amount due citing FTR 302-2.13 that states unless there are "reasons beyond your control and which must be accepted by the agency" the relocation costs must be reimbursed. The Board has long held that agencies have the discretion to determine what constitutes "reasons beyond an employee's control" and it will not question the agency's decision if it had a reasonable basis. The Board noted Benjamin put forth several reasons for leaving after being billed for the relocation at different times – "personal issues and family matters", then asserting his stepfather's poor health was his reason for leaving without providing any evidence and finally alleging problems with his supervisor and other employees in spite of saying his experience was "wonderful." The Board found the VA was reasonable where Benjamin did not provide evidence of his stepfather's ill health or problems at his workplace (*CBCA 1294-RELO*).

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Responsible for Additional Costs if Car Rented From Non-Authorized Rental Company

In his travel to a NSA conference, Marian rented a car from E-Z Rent-A-Car rather than her agency's contract travel office, CTO. When Marian returned the car there was a scratch and he was charged $1,039 for the damage, which NSA refused to pay because the CTO was not used. Marian maintained the NSA travel office advised her that she could make her own car reservation and that the CTO's standard question of whether she wants CTO to make the car and hotel reservations implied that use of CTO was optional. Citing FTR Sec. 301-10.450, the Board sided with the NSA stating when authorized personnel must use the agreement in place at their location and that Sec 301-10.453 specifies that "employees are responsible for any additional cost resulting from unauthorized use of a commercial rental automobile." Here the arrangement CTO made with the government included full liability and vehicle loss and damage for the traveler so the additional damage costs had to be paid by Marian (*CBCA 1207-TRAV*).

TDY Can't Substitute for a Permanent Change of Duty

Stephen was notified he had been selected to take a position in Washington DC from abroad in Dec 2007. He asked that his permanent transfer be delayed until Dec. 2007 so his children could complete their school year and that time spent in DC before Dec be considered temporary duty and that his family take temporary housing in October in Europe in anticipation of their move in December. Though his agency approved the Inspector General's office intervened and rejected his invoices for $17,000. In his appeal the Board said Stephen should not have been assigned TDY before Dec because he had been performing his duties since August where there was no expectation of returning abroad to perform additional work (his position was filled by someone else), ruling Washington DC became Stephen's permanent duty station in Aug. and hence he could not be on TDY. As for temporary duty for his family, the Board noted that temporary housing is limited to a maximum of 30 days immediately prior to final departure to a new post. However it noted that agency provisions allowed for an extended stay for a maximum of 60 additional days if the head of the agency or their designee determines there are compelling reasons and since Stephen's permanent transfer was retroactively changed to August this was exactly the type of "compelling reason" that would justify the 60 day extension for his family (*CBCA 1214-RELO*).

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