

**DENTONS**



# Cost Reasonableness and Allowability Overview & Updates

Phil Seckman  
Mikaela Colvin

February 14, 2023

# Agenda

- Introduction
  - FAR Part 31 - Contract Cost Principles and Procedures
- Cost Allowability/Reasonableness Overview
  - The reasonableness analysis
    - Example Case Law
- FAR § 31.205 - Selected Cost Principles
  - Compensation, Legal Costs, and Organizational and Lobbying Costs
    - Example Case Law

# Contract Cost Principles and Procedures

## FAR Part 31

- Cost principles and procedures for:
  - Pricing contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed
  - Determination, negotiation, or allowance of costs when required by a contract clause
  - Expressly mapping out unallowable costs

## FAR Subpart 31.2

- Principles and procedures for Contracts with Commercial Organizations
- Covers cost allowability
- Includes specific allowability criteria for a number of items

# Cost Allowability Overview

- Allowable costs are limited to those defined under FAR Part 31 and refers to whether the government will pay for a particular cost incurred in connection with a government contract
- FAR § 31.201-2
  - (a) A cost is allowable only when the cost complies with all of the following requirements:
    - (1) Reasonableness
    - (2) Allocability
    - (3) Cost Accounting Standards (CAS)
    - (4) Contract terms and conditions
    - (5) FAR Part 31 Cost Principles
- Other factors affecting allowability:
  - Inconsistent accounting practices
  - Record maintenance and supporting documentation

## Cost Allowability Overview (cont.)

- Costs that are “expressly unallowable” may be subject to penalties
  - Expressly unallowable costs are those which are stated to be unallowable under an applicable law, regulation (FAR Subpart 31.2), or contract
- The importance of cost reasonableness:
  - Reasonableness is a component of cost allowability
    - Under cost reimbursement contracts, government only pays allowable costs
    - If a fixed price solicitation requires certified cost or pricing data, allowable costs are to be used to develop/support price
  - Including unallowable costs in vouchers or certain proposals may:
    - Result in cost disallowances or system disapproval
    - Subject contractors to penalties for expressly unallowable costs
    - Serve as a basis for potential fraud allegations

# Cost Reasonableness Analysis

- No presumption of reasonableness for costs incurred
  - Once the government has challenged a specific cost as unreasonable, the contractor has the burden of proof, unaided by a presumption of reasonableness, to establish the costs it incurred were reasonable
- Implications -
  - DCAA and contracting officers may attempt to substitute their *post hoc* judgment for that of the contractor
  - Increases the need to fully explain both reasonableness determinations and the context in which the determinations were made
  - Reasonableness often shown through a comparative analysis
    - i.e., the reasonableness of an executive's salary can be demonstrated by comparison to salary surveys of executives in firms of similar size

# *Mission Support Alliance, LLC v. Department of Energy, CBCA 6477-R (Oct. 20, 2022)*

- Mission Support Alliance (“MSA”) sought reimbursement of approximately \$333k under a cost-type contract for funds paid to three subcontractors for:
  - Technical and administrative support;
  - Training courses; and
  - Construction services
- MSA argued that it should not hold the burden of proof because costs sought were disallowed by the government as unallowable
  - CBCA reinforced that the contractor has the burden of proof even in government claims when reasonableness is at issue. Thus, even though the government disallowed contractor’s costs as unallowable because they were allegedly unreasonable, contractor retained the burden of proof.
  - CBCA emphasized that reasonableness inquiry is fact-intensive. The contractor must present evidence of cost reasonableness and cannot assert reasonableness as a matter of law.
    - MSA did not present adequate evidence of reasonableness so it did not meet its burden

# *Mission Support Alliance, LLC v. Department of Energy, CBCA 6477-R (Oct. 20, 2022) (cont.)*

- MSA argued that the CBCA “overlooked record evidence that ‘the disputed costs are reasonable because [contractor followed] its Purchasing System procedures...which had been reviewed and approved by DOE and its auditor..., for reviewing and approving subcontractor work and costs.’”
  - CBCA held that it did not consider contractor’s arguments that it followed its own procedures material. Proof of reasonableness should entail some independent evidence of the reasonableness of the dollars spent - not just evidence of the contractor’s compliance with its own practices.
  - Additionally, the fact that the government approved the purchasing system was probative but insufficient alone to demonstrate that costs were reasonable
- **Takeaway:**
  - Contractors bear the burden of proof in reasonableness dispute so it is important to document, in detail, reasonableness of costs
  - Contractor reliance on past government audit or scrutiny of purchasing / accounting system is of limited use in the reasonable analysis context



# Cost Reasonableness Analysis (cont.)

- “Prudent person” standard
  - FAR § 31.201-3 - “A cost is 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.”
- Reasonableness considerations
  - Is the cost ordinary and necessary for the conduct of the contractor’s business or contract performance?
  - Is the transaction consistent with:
    - Generally accepted sound business practices;
    - Arm’s-length bargaining; and
    - Federal and state laws and regulations?
  - What are the contractor’s responsibilities to the government, other customers, the owners of the business, employees, and the public?
  - Has the contractor significantly deviated from established practices?

# **Selected Cost Principles & Recent Case Law Affecting Cost Allowability Interpretations**

# Selected Cost Principles

- FAR § 31.205 - Selected Costs
  - Discusses the different types of costs that a contractor may incur and provides guidance on the allowability of these costs
  - A primary source for DCAA when it questions a cost incurred by a contractor
- Examples of specific FAR references in this subpart include:
  - FAR § 31.205-6, Compensation for personal services
    - Subsection (m), fringe benefits
  - Legal Costs
    - FAR § 31.205-15, Fines, penalties, and mischarging costs
    - FAR § 31.205-47, Costs related to legal and other proceedings
  - FAR § 31.205-22, Lobbying and political activity costs
  - FAR § 31.205-27, Organization costs

# Compensation Costs FAR § 31.205-6

- Allows compensation costs for personal services performed in the current year
- Allowable if:
  - Reasonable for the work performed; and
  - Based upon and conforms to terms and conditions of established compensation plan or practice
- Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total
  - FAR § 31.201-3 reasonableness analysis applies in addition to factors in FAR § 31.205-6(b)
- FAR § 31.205-6(p) imposes statutory caps on compensation
  - Defines compensation as “the total amount of wages, salary, bonuses... for the fiscal year.”

## Compensation Costs (cont.)

- FAR § 31.205-6(m) allows fringe benefits
  - Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries
  - Allowable if reasonable and required by-
    - Law;
    - Employer-employee agreement;
    - Established policy of the contractor
  - Exception:
    - A portion of the cost of company-furnished automobiles that relates to personal use by employees is unallowable

# *Appeal of - Strategic Tech. Inst., Inc., ASBCA No. 61911, 2022 WL 257788 (Jan. 6, 2022)*

- CO disallowed a variety of costs including but not limited to:
  - Vendor costs and travel costs because STi failed to provide supporting documentation
  - Proposed G&A auto expenses because the costs were associated with personal use of company-furnished cars
    - Specifically, during the DCAA audit, STi provided two car titles for the auto expenses claimed, one of which was registered under a personal name
    - STi failed to provide any supporting documentation to show that the car was only used for business purposes
- The ASBCA found that the CO's determination that these costs were expressly unallowable was supported by preponderant evidence
- **Takeaway:**
  - Adequate documentation for the incurrence and use of costs can prevent otherwise allowable costs being deemed unallowable

# Fines, Penalties, and Mischarging Costs

## FAR § 31.205-15

- Unallowable if:
  - Resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations; or
  - Incurred in connection with, or related to, the mischarging of costs on government contracts and the costs are caused by, or result from, alteration or destruction of records, or other false or improper charging or recording of costs
- Exception to fines and penalties resulting from law and regulatory violations:
  - If incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the CO, costs are allowable

## Legal Costs FAR § 31.205-47

- Applies to legal costs incurred by both external and in-house attorneys and service providers
- Frequently contested due to large amounts and unfavorable circumstances
- Generally allowable if:
  - Reasonable and
  - Compliant with FAR § 31.205-33 (professional and consultant services)



## Legal Costs (cont.)

- Legal costs become unallowable under FAR § 31.205-47 for certain situations:
  - Fraud;
  - Violations of a law or regulation;
  - Criminal conviction;
  - Suspension or debarment;
  - Settled, but could have resulted in one of the above;
  - Non-fraud CDA claims;
  - Organization, reorganization, M&A;
  - Antitrust suits;
  - Patent infringement;
  - Bid protests; or
  - Suits between contractors concerning teaming agreements, JVs, etc.

# *Tolliver Grp., Inc. v. United States*, 161 Fed. Cl. 324 (2022)

- Tolliver sought recovery of legal fees incurred in defending its performance under a firm fixed-price task order in a False Claims Act suit brought by a whistleblower
- Court held that, in this case, Tolliver’s request for attorney’s fees in *qui tam* suit satisfies the allowability standards
- The Court found that two theories made fees payable to the contractor because the FAR cost principles were applicable:
  - The task order was initially awarded as a fixed-price, level-of-effort development contract and “operate[d] as a cost-type contract with the government reimbursing Tolliver’s labor and other related costs.”
  - The government was required to perform a cost analysis to determine the task order’s price, and therefore the Christian doctrine required that FAR 31.205-47 be incorporated into the contract. Because the cost principle was incorporated into the contract by operation of law, the court held that the contractor was entitled to recover its legal costs even though the contract was fixed-price in nature, as long as the costs were reasonable, allocable to the task order, and otherwise allowable under FAR 31.205-47.
- **Takeaway:** Legal fees may be reimbursable even under a firm fixed-price contract when that contract requires cost analysis for determining the reasonableness of individual cost elements. This is the case even when the contract contains no written or implied cost reimbursement clause.

## Organization Costs FAR § 31.205-27

- Costs connected to the following are unallowable:
  - planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions,
  - resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and
  - raising capital
- Similar costs that may be allowable, if distinguished, are “economic planning costs.”
  - Economic planning costs include costs “*general* long-range management planning that is concerned with the future overall development of the contractor's business and that may take into account the eventual possibility of economic dislocations or fundamental alterations in those markets in which the contractor currently does business.”

## Lobbying and Political Activity Costs FAR § 31.205-22

- Costs associated with the following activities are unallowable:
  - Attempts to influence the outcome of any federal, state or local election, referendum, or initiative
  - Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee or other organization established for the purpose of influencing elections
  - Attempts to influence federal, state, or local legislation
  - Attempts to influence Executive Branch employees to act regarding a contract on any basis other than the merits
  - Legislative Liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when carried on in preparation for or support of the above

## Lobbying and Political Activity Costs (cont.)

- Exceptions: Costs associated with the following activities are allowable:
  - Providing a technical and factual presentation on a topic directly related to the performance of a contract to Congress or a state legislature in response to a documented request
  - State/local legislative lobbying to directly reduce contract costs or to avoid material impairment of contractor's ability to perform contract
  - Any activity specifically authorized by statute to be undertaken with funds from the contract

# ***Sec'y of Def. v. Raytheon Co., 56 F.4th 1337 (Fed. Cir. 2023)***

- Government appealed an ASBCA decision rejecting its claim that Raytheon included unallowable indirect lobbying and corporate development costs in its final indirect-cost proposals
- Federal Circuit reversed finding that the ASBCA misinterpreted Raytheon's corporate practices and policies which are inconsistent with FAR 31.205-22 and -27 and led Raytheon to charge the government for unallowable costs
- Lobbying and political activity costs are:
  - Those associated with attempts to influence the outcomes of elections, referenda, initiatives, or the introduction, enactment, or modification of legislation; and
  - Organization costs including costs associated with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions

# *Sec'y of Def. v. Raytheon Co.*, 56 F.4th 1337 (Fed. Cir. 2023) (cont.)

- Federal Circuit held:
  - Raytheon's time-paid accounting practice necessarily charged the government for expressly unallowable costs because Raytheon employees regularly engaged in after-hours lobbying and thus the salaries paid to those employees must have included compensation for lobbying activities in violation of FAR 31.205-22
  - The Federal Circuit took the position that Raytheon's employees "could have" worked fewer hours during the week to offset time spent working after hours or on the weekends
  - Raytheon's "bright-line" policy on organization costs was "plainly inconsistent" with FAR 31.205-27 because, according to the Court, the portion of salaries paid for pre-planning activities is expressly unallowable because such activities are an essential part of every corporate transaction
  - The Federal Circuit found that every decision to pursue a corporate transaction necessarily involves some preliminary planning and thus Raytheon's policy drew an unreasonable bright-line

# Thank you

DENTONS



Dentons US LLP  
1400 Wewatta Street  
Suite 700  
Denver, CO 80202-5548  
United States

---

Dentons is a global law firm driven to provide a competitive edge in an increasingly complex and interconnected world. A top 20 firm on the Acritas 2014 Global Elite Brand Index, Dentons is committed to challenging the status quo in delivering consistent and uncompromising quality in new and inventive ways. Dentons' clients now benefit from 3,000 lawyers and professionals in more than 80 locations spanning 50-plus countries. With a legacy of legal experience that dates back to 1742 and builds on the strengths of our foundational firms—Salans, Fraser Milner Casgrain (FMC), SNR Denton and McKenna Long & Aldridge—the Firm serves the local, regional and global needs of private and public clients. [www.dentons.com](http://www.dentons.com).