ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
Boeing North American, Inc.	)	ASBCA No. 49994
	)	
Under Contract No. F04704-90-C-0016	)	

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OPINION BY ADMINISTRATIVE JUDGE JAMES
PURSUANT TO BOARD RULE 11

This appeal arises from respondent's disallowance of legal costs incurred to litigate and settle a shareholders' derivative suit against the directors of the predecessor corporation, awardee of the captioned contract. The suit alleged that the directors failed to institute and enforce adequate internal controls, and fostered a "corporate climate" that encouraged employee misconduct under federal contracts and resulted in criminal and civil penalties and fines. We have jurisdiction of the appeal under the Contract Disputes Act of 1978, 41 U.S.C. § 607. The parties elected to submit the appeal for decision on the record pursuant to Board Rule 11. We decide entitlement only.

FINDINGS OF FACT

1. The Air Force awarded Contract No. F04704-90-C-0016 ("contract 16") to Rockwell International Corporation ("Rockwell") on 5 March 1990, effective 18 March 1990, for "inertial measurement units" for the Peacekeeper missile. As finally amended, contract 16's line items 1-9 and 12 were firm fixed-priced, and items 10, 11, 13 and 14 were cost reimbursable. (R4, tab 1, § B, Mods. P00006, -11, -16, -21, -22)

2. Contract 16 incorporated by reference the DFARS § 252.242-7003, "Certification of Indirect Costs (APR 1986)" clause, which required Rockwell to certify that any proposal to establish or modify billing rates or final indirect cost rates—

> does not include any costs which are unallowable under applicable cost principles of the Department of Defense . . . and are properly allocable to Defense [sic] contracts on the basis of a beneficial or causal relationship between the expenses incurred and the contracts to which they are allocated in accordance with applicable acquisition regulations.

As amended on 12 September 1991 and thereafter, contract 16 incorporated by reference the FAR 52.216-7, "Allowable Cost and Payment (APR 1984)" clause. It provided for reimbursement of those costs determined to be allowable in accordance with FAR Subpart 31.2, and the FAR 52.228-7, "Insurance—Liability to Third Persons (APR 1984)" clause, whose ¶ (g) required Rockwell to give the contracting officer (CO) immediate notice of any suit, action or claim against the contractor whose cost might be reimbursable under the contract and the risk of which was uninsured or underinsured. (R4, tab 1, §§ B, I, Mods. P00006, P00011, P00016, P00021, P00022)

3. In December 1996, Rockwell merged with a wholly-owned subsidiary of The Boeing Company and changed its name to Boeing North American, Inc. (AR4, tab A-1, "Joint Stipulation of Facts" ("JSF"), ¶ 8).

4. From 1982 to 1992, Rockwell was charged with, or implicated in, the following criminal, fraudulent or improper acts in connection with federal contracts other than contract 16 (JSF, ¶¶ 18-64):

(a) In settlement of a Civil False Claims Act suit that alleged mischarging of costs Rockwell incurred from 1975 to 1977 under a 1974, fixed-price, Air Force contract to a 1972, cost-reimbursable, NASA contract, on 30 November 1982 Rockwell entered into a consent decree that enjoined it from submitting false claims in the future. It also paid a $500,000 fine. (JSF, ¶¶ 18-26)

(b) In October 1985, Rockwell pled guilty to a criminal information alleging that in 1982 six Rockwell employees had violated 18 U.S.C. § 1001 by submitting false time cards under a 1979 Air Force contract, and agreed to pay $1 million in fines and restitution (JSF, ¶¶ 27-31).

(c) After a February 1987 indictment for failing to disclose fully to the Government the price terms of a subcontract under its May 1983 Air Force prime contract

as required by the Truth in Negotiations Act, Rockwell pled guilty to charges of violating its 1982 consent decree and paid a $5.5 million fine (JSF, ¶¶ 36-49; ex. G-2 at 3).

(d) In 1985, a Rockwell employee stated that the manager of Rockwell's Rocky Flats facility had required him and other employees to perform personal work, valued at about $52,000, for the manager, which work was improperly charged to Rockwell's Department of Energy ("DOE") contracts. Investigations by Rockwell, DOE and the FBI confirmed the foregoing facts. Rockwell terminated the facility manager in September 1985, and was not prosecuted for its employees' acts. (JSF, ¶¶ 50-55)

(e) In 1986, DOE investigated Rockwell's storage and treatment of hazardous waste under its 1975 DOE contract No. DE-AC04-76DP 03533 to manage and operate the Rocky Flats nuclear weapons facility. In May 1988 and June 1989, the Colorado Department of Health found 32 violations of the Colorado Hazardous Waste Act. In March 1992, Rockwell pled guilty to 10 criminal violations of the Clean Water Act, for which it paid a fine of $18.5 million. (JSF, ¶¶ 56-62; ex. G-5 at 6)

5. On 26 June 1989 four Rockwell shareholders filed a "minority stockholders' derivative action," captioned *Citron v. Beall*, Case No. C728809, in the Superior Court of the State of California for Los Angeles County, on Rockwell's behalf against 14 Rockwell directors and "Does 1 through 20, inclusive" as defendants, and named Rockwell as the "Nominal Defendant" (R4, tab 2; JSF, ¶¶ 10-11). None of the "Doe" defendants was either identified or correlated with the Rockwell employees named in the lawsuits described in finding 4.

6. The *Citron* complaint alleged, *inter alia*, that:

(a) The director-defendants had participated in "a continuous course of conduct . . . in violation of their respective fiduciary duties to Rockwell (including violations of federal law and applicable Defense Department regulations) and, thereafter with various of the Doe Defendants, have engaged in a large and continuing cover-up of such violations, all of which have inflicted great damage on Rockwell" (¶ 1).

(b) Rockwell had perpetrated the frauds and false claims, *inter alia*, described in finding 4, *supra*, and its operation of the Rocky Flats Nuclear Weapons Plant subjected Rockwell to "additional and continuing legal expenses and possible debarment from government contracting" (¶¶ 3-6).

(c) The defendants conspired and engaged "in a wrongful course of conduct which was designed in an effort to insulate the Director and Officer Defendants from liability . . . and to protect their executive positions" (¶ 7).

(d) "Each of the defendants who were . . . directors of Rockwell at the time the allegedly illegal conduct took place is liable as a direct participant in, and an aider and abettor of, the wrongs complained of herein," and they "were able to and did . . . control the conduct of [the corporation's] business and employees" (¶ 13).

(e) The defendant-directors "breached their fiduciary duties to the Corporation by, *inter alia*, failing to establish internal controls sufficient to insure [sic] that the Corporation's business was carried on in a lawful manner" (¶ 14).

(f) The defendant-directors caused Rockwell to "vigorously defend" various government prosecutions alleging violations in performing federal contracts, "notwithstanding their merit" (¶ 23(e)).

(g) The defendant-directors discouraged Rockwell employees from reporting fraudulent and criminal activity by Rockwell and adopted a false "official position" that "fraudulent activity at Rockwell is isolated and limited to individual low-level employees," and made repeated false and materially misleading representations to federal courts and agencies that "adequate controls have been implemented by Rockwell to fully eradicate any procurement fraud" (¶¶ 25-26).

The *Citron* plaintiffs prayed for declaratory relief, repayment to Rockwell of unspecified damages, return of the defendant-directors' salaries and other remuneration paid by Rockwell during the term of the alleged breaches of trust and fiduciary duties, and award to the plaintiffs of attorneys', accountants' and experts' fees and expenses. (R4, tab 2)

7. On 1 November 1989, Rockwell's Board of Directors formed a "Special Litigation Committee" ("SLC") to act on its behalf in connection with the *Citron* suit, and to investigate the allegations asserted therein. Part of the SLC's mission was to report to the Board of Directors about the allegations, and to determine Rockwell's position, in *Citron*. The SLC consisted of three Rockwell directors not named as defendants in *Citron*, and was authorized to engage legal counsel, financial advisors, and other agents as deemed necessary and advisable. (JSF, ¶¶ 67-68)

8. Rockwell retained three outside law firms to represent the parties in *Citron*, namely, Rockwell, the director-defendants, and the SLC (JSF, ¶¶ 65, 66, 69).

9. In July 1990, the SLC issued a report setting forth its findings, conclusions and recommendations (R4, tab 3). That report admitted there had been past violations in Rockwell's performance of federal contracts, but found that there was no "pattern or overall scheme in the incidents." It also stated that Rockwell's internal financial and accounting controls were adequate and that the *Citron* suit was not "justifiable or . . . reasonably likely to succeed." The SLC report "concluded that maintenance of *Citron*

was not in the best interests of Rockwell or its shareholders and directed Rockwell's counsel to take steps to obtain a dismissal in favor of all defendants." (JSF, ¶¶ 71-74)

10. In September 1991, all parties to *Citron* agreed to settle the suit (R4, tab 4). The court's 29 October 1991 "Final Judgment and Order of Dismissal with Prejudice" approved the settlement, which: (a) released Rockwell and its directors from liability for all alleged wrongdoing; (b) provided no declaratory relief, monetary damages, return of the directors' salaries and remuneration, or recovery of accountants' and experts' fees and expenses; and (c) required Rockwell to pay $1.4 million of the legal fees and expenses incurred by the plaintiffs and to indemnify the director-defendants against attorneys' fees and expenses actually and reasonably incurred. (AR4, tab 31; JSF, ¶¶ 77-78)

11. Rockwell included $4,576,000.00 in its corporate overhead for fiscal years 1989, 1990, and 1991, for the legal fees, costs and settlement expenses of counsel retained by the *Citron* plaintiffs, Rockwell, the directors, and the SLC (JSF, ¶¶ 80-82). Government auditors did not point to any failure of the *Citron*-related costs to conform to Rockwell's CAS disclosure statements. (R4, tabs 14, 24) On 16 January 1996 the CO disallowed the $4,576,000 charge. On 29 February 1996 Rockwell submitted a certified claim for $161.91, comprised of the *Citron* legal fees and costs it charged to contract 16. (JSF, ¶¶ 83-84; R4, tab 26 at 4)

12. The CO's 15 May 1996 final decision on Rockwell's claim disallowed the *Citron* legal costs because they were "unreasonable" under FAR 31.201-3, and were costs, prescribed in FAR 31.204(c), that are "similar or related" to costs that are unallowable under FAR 31.205-15 (fines, penalties, and mischarging costs) and 31.205-47(b) (costs related to legal and other proceedings). The CO asserted that, but for the admitted and proven "criminal misconduct, civil fraud, and other contractor wrongdoing," the *Citron* suit would not have been filed. Therefore, it was "patently unreasonable to expect [the Government] to pay for the consequences of this wrongdoing." (R4, tab 28 at 1; JSF, ¶ 94)

13. On 9 July 1996 Rockwell timely appealed from the CO's final decision to this Board. The parties agree that this appeal is a "test case" for determining treatment of the *Citron* legal costs for purposes of all of Rockwell's contracts during the relevant period (app. br. at 3). We decide this appeal, however, based upon the clauses and FAR cost principles incorporated in contract 16, as amended, which may vary from those in other Rockwell contracts, whose terms and conditions are not in the record.

14. Relevant FAR provisions in effect on 18 March 1990 included:

31.201-6 Accounting for unallowable costs

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim or proposal applicable to a Government contract. A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is also incurred, its directly associated costs are also unallowable.

. . . .

31.204 Application of principles and procedures.

. . . .

(c) Section 31.205 does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards of this subpart [31.2] and the treatment of similar or related selected items [of cost].

. . . .

31.205-15 Fines, penalties, and mischarging costs.

(a) Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

(b) Costs incurred in connection with, or related to, the mischarging of costs on Government contracts are unallowable. Such costs include those incurred to identify, measure or otherwise determine the magnitude of the improper charging, and costs incurred to remedy or correct the mischarging, such as costs to rescreen and reconstruct records.

31.205-33 Professional and consultant service costs.

(a) *Definition*. Professional and consultant services, as used in this subpart, are those services by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Examples include those services acquired by contractors . . . in order to enhance their legal . . . positions . . . .

(b) Costs of professional and consultant services are allowable subject to this paragraph and paragraphs (c) through (h) of this subsection when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see 31.205-30).

(c) Costs of professional and consulting services performed under any of the following circumstances are unallowable:

(1) [Services involving improper use of protected data.]

(2) [Services intended to influence a solicitation or source selection improperly.]

(3) Any other service obtained, performed, or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interests.

(4) Services performed which are not consistent with the purpose and scope of the services contracted for or otherwise agreed to.

(d) Costs of legal . . . services . . . incurred in connection with organization and reorganization, . . . defense of antitrust suits, defense against Government claims or appeals, or the prosecution of claims or appeals against the Government . . . are unallowable. . . .

(e) Costs of legal . . . services . . . incurred in connection with the defense or prosecution of lawsuits or appeals between contractors [arising from teaming, dual sourcing, co-production or similar agreements generally are unallowable].

(f) In determining the allowability of costs . . . in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the contracting officer shall consider the following factors, among others:

(1) The nature and scope of the service rendered in relation to the service required.

(2) The necessity for contracting for the service, considering the contractor's capability in the particular area.

(3) The past pattern of acquiring such services and their costs, particularly in the years prior to the award of Government contracts.

(4) The impact of Government contracts on the contractor's business.

(5) Whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly when the services rendered have little relationship to work under Government contracts.

(6) Whether the service can be performed more economically by employment rather than by contracting.

(7) The qualifications of the individual or concern rendering the service and the customary fee charged, especially on nongovernment contracts.

(8) Adequacy of the contractual agreement for the service [*e.g.*, description, time, rate, termination].

. . . .

31.205-47 Costs related to legal and other proceedings.

(a) *Definitions.* . . . "Penalty," does not include restitution, reimbursement, or compensatory damages.

"Proceeding," includes an investigation.

(b) Costs incurred in connection with any proceeding brought by a Federal, State, local or foreign government for violation of, or a failure to comply with, law or regulation by the contractor (including its agents and employees) are unallowable if the result is –

(1) In a criminal proceeding, a conviction.

(2) In a civil or administrative proceeding, either a finding of contractor liability or imposition of a monetary penalty.

(3) A final decision by an appropriate official of an executive agency to--

(i) Debar or suspend the contractor;

(ii) Rescind or void a contract; or

(iii) Terminate a contract for default by reason of a violation or failure to comply with a law or regulation;

(4) Disposition of the matter by consent or compromise if the proceeding could have led to any of the outcomes listed in subparagraphs (b)(1) through (b)(3) of this subsection . . .

> (5) Not covered by subparagraphs (b)(1) through (b)(4) of this subsection, but where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable by reason of subparagraphs (b)(1) through (b)(4) of this subsection.

15. A November 1988 DAR Committee Report to implement the Major Fraud Act of 1988, Pub. Law 100-700, cited a "guiding principle" that the "Government should not pay for wrongdoing, the defense of wrongdoing, or the results or consequences of wrongdoing by contractors." The Report proposed to add to FAR 31.205-47(b):

> (5) Not covered by (1) through (4) above, but where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable by reason of (1) through (4) above

The report explained the meaning of the foregoing provision as follows:

> [I]f the alleged wrongdoing resulted in more than one proceeding, and not all [proceedings] were pursued to a final conclusion, but one was and resulted in the cost of that proceeding being disallowed by virtue of this paragraph (b), then the costs associated with all proceedings centered on that common wrongdoing are unallowable.

The Committee Report also proposed to add a ¶ (f)(5) to FAR 31.205-47 to make unallowable any costs incurred in connection with—

> [p]rosecution of lawsuits with third parties alleging improper activities related to Government contracting or defense of lawsuits with third parties alleging improper activities related to Government contracting where the contractor was found liable or settled[.]

(ex. A-32) The 29 March 1989 interim FAR 31.205-47 revision, published in 54 Fed. Reg. 13022, 13024-25, included ¶ (b)(5) (and added "subparagraphs (b)" before the phrase "(1) through (4) of this subsection"), but eliminated the proposed ¶ (f)(5) quoted above without explanation. (Ex. A-33)

16. Rockwell's by-laws required it to indemnify a director sued in a derivative lawsuit against attorneys' fees and expenses incurred in connection with the defense or settlement of such suit, if the director acted in good faith and in a manner he reasonably

believed to be in, or not opposed to, Rockwell's best interest, provided the director was not adjudged liable to Rockwell (JSF, ¶ 7).

17. The record contains no evidence that Rockwell even attempted to reasonably proportion the "benefits" of the disputed costs to contract 16 and other work, in accordance with FAR 31.201-4(b).

DECISION

I.

Appellant argues that the disputed costs are: (i) ordinary, necessary and allowable "professional services" costs under FAR 31.205-33(b) to defend against a third-party lawsuit; (ii) reasonable in relation to the services rendered, pursuant to FAR 31.201-3 and 31.205-33(b); (iii) allocable because they conferred benefit on Rockwell, in accordance with FAR 31.201-4; and (iv) in accordance with generally accepted accounting principles and practices of government contractors, consistent with the terms of contract 16, and not limited or disallowed by any FAR cost principles, including FAR 31.205-33(c) and (d) regarding certain unallowable professional and consultant service costs.

Respondent contends that, "but for" the antecedent criminal convictions and civil fines (finding 4), the *Citron* suit would have had no basis, and thus the disputed legal fees and costs would not have been incurred. Respondent argues further that the disputed costs are: (1) unreasonable in nature, pursuant to FAR 31.201-3(a); (2) not allocable for lack of a "beneficial" relationship between the disputed expenses and contract 16; (3) "similar or related" to costs rendered unallowable by FAR 31.205-15 and 31.205-47(b), and so unallowable pursuant to FAR 31.204(c); and (4) "directly associated" with the unallowable costs of Rockwell's antecedent criminal and civil litigation, and hence unallowable pursuant to FAR 31.201-6(a).

To determine whether the disputed costs are allowable, the principles for consideration are: (1) reasonableness, (2) allocability, (3) CAS Board standards, (4) contract 16's terms, and (5) FAR subpart 31.2 limitations. *See* FAR 31.201-2(a). Since we decide this appeal on the ground of allocability, we need not address the remaining principles.

II.

With respect to ***allocability***, FAR 31.201-4 provides:

> A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received

> or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—
>
> (a) Is incurred specifically for the contract;
> (b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or
> (c) Is necessary to the overall operation of the business, although a direct relationship to any cost objective cannot be shown.

Contract 16 additionally required Rockwell's costs to be "properly allocable . . . on the basis of a beneficial or causal relationship between the expenses incurred and the contracts to which they are allocated," as prescribed by DFARS § 252.242-7003 in April 1986 (finding 2). Appellant bears the burden of proving that a cost is allocable. *See Lockheed Aircraft Corp. v. United States*, 375 F.2d 786, 794, 179 Ct. Cl. 545, 558 (1967).

The disputed costs are not allocable to contract 16 on the two most direct bases provided in FAR 31.201-4(a) and (b). Such costs were not incurred specifically for contract 16, which was awarded in March 1990 (finding 1), more than eight months after the *Citron* litigation had begun in June 1989 (finding 5). Moreover, the record contains no evidence that Rockwell ever attempted to reasonably proportion the "benefits" of the disputed costs to both contract 16 and other work (finding 17). Accordingly, we focus our attention on FAR 31.201-4(c).

Appellant contends that subparagraph (c) of FAR 31.201-4 is the applicable allocation principle for consideration. The court in *Lockheed* held that the benefit required by DAR 15-201.4(iii) (which is essentially identical to FAR 31.201-4(c), which requires that a cost be "necessary for the overall operation of the business, although a direct relationship to any cost objective cannot be shown") be given a broad, general scope. Thus, a personal property tax based on income from commercial contracts, whose "[p]ayment was not voluntary," was necessary and benefited an Air Force contract. 365 F.2d at 796, 179 Ct. Cl. at 565. Similarly, in *Hayes International Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076 at 52,724, legal fees incurred to defend a suit by employees who complained of the contractor's discriminatory conduct, which suit concluded with a consent decree containing no finding of a contractor violation, were allocable because "necessary to the overall operation of the business." However, neither *Lockheed* nor *Hayes* decided the allocability of legal fees which would not have been incurred but for antecedent contractor wrongdoing, as in the instant appeal.

Though not prescribed in the FAR cost principles, *Lockheed* stated that a "but for" criterion could be determinative of allocability only if an across-the-board allocation

contravened an announced Government policy. 375 F.2d at 798, n.15, 179 Ct. Cl. at 566, n.15. We cannot say that the federal policy in March 1990 was to disallow legal costs and expenses arising from third party proceedings, as distinct from such costs arising from proceedings brought by federal, state, local or foreign governments. Nonetheless, it is a guiding principle for federal agencies not to pay for the results or consequences of contractor wrongdoing. (Finding 15)

In *Caldera v. Northrup Worldwide Aircraft Services, Inc.*, 192 F.3d 962 (Fed. Cir. 1999), the contractor discharged three inspectors during the performance of an Army cost-reimbursement contract at Fort Sill. Those employees won a state court judgment for compensatory and punitive damages for retaliatory discharge due to their refusal to engage in fraud under the same contract. The Army disallowed the contractor's legal fees incurred to defend the law suit. The ASBCA sustained the appeal, finding insufficient proof of fraud. The Federal Circuit reversed, holding that collateral estoppel gave preclusive effect to the state court's judgment, which necessarily found that the inspectors were discharged in retaliation for refusing to engage in fraud, and that the legal fees were not allocable to the Fort Sill contract under FAR 31.201-4. The Federal Circuit could "discern no benefit to the government in a contractor's defense of a wrongful termination lawsuit in which the contractor is found to have retaliated against the employees' refusal to defraud the government." 192 F.3d at 972.

Northrup may be distinguished from this appeal, since the issue of wrongdoing under other, distinct federal contracts was not presented to the Federal Circuit. Nevertheless, the underlying conduct of Rockwell, described in finding 4, but for which neither the *Citron* suit nor the costs in dispute in this appeal would have arisen, comes within the "guiding principle," in the federal agency implementation of the Major Fraud Act of 1988, that federal agencies should not pay for the results or consequences of contractor wrongdoing.

The rationale of *Northrup* can properly extend to the facts of this appeal so as to bar the allocability of the disputed costs under FAR 31.201-4(c). We can discern no benefit to the Government in a contractor's defense of a third party lawsuit in which the contractor's prior violations of federal laws and regulations were an integral element of the third party allegations. We hold that appellant has not met its burden of proving the allocability of the disputed costs.

We deny the appeal.

Dated: 8 June 2000

DAVID W. JAMES, JR.
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

I concur

MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

MICHAEL T. PAUL
Administrative Judge
Acting Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 49994, Appeal of Boeing North American, Inc., rendered in conformance with the Board's Charter.

Dated:

EDWARD S. ADAMKEWICZ
Recorder, Armed Services
Board of Contract Appeals