ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
General Dynamics Corporation	)	ASBCA No. 49372
	)	
Under Contract No. N00024-88-C-2000	)	

APPEARANCES FOR THE APPELLANT: Richard C. Johnson, Esq
Susan C. Levy, Esq.
Kevin M. Kordziel, Esq.
Jenner & Block
Washington, DC

APPEARANCES FOR THE GOVERNMENT: Thomas B. Pender, Esq.
Chief Trial Attorney
Charles W. Goeke, Esq.
Trial Attorney
Defense Contract Management Agency
Philadelphia, PA

OPINION BY ADMINISTRATIVE JUDGE HARTY

This appeal concerns the allowability of legal expenses under Federal Acquisition Regulation (FAR) 31.205-47(b)(4) incurred by General Dynamics Corporation (GD) in defending against Government-initiated civil fraud claims (referred to collectively as the *Davis* case or *Davis* litigation). The litigation costs addressed in this appeal were incurred in defense of claims reported in *United States v. Davis*, 803 F. Supp. 830 (S.D.N.Y. 1992), *aff'd in part and rev'd in part, United States v. General Dynamics Corp.*, 19 F.3d 770 (2d Cir. 1994).[1] Overall GD incurred approximately $10 million in *Davis*-case costs from 1987 through 1994. Only the costs included in the 1991 overhead proposal are at issue here.

GD appeals the Government's decision to: (1) disallow *in toto* $3,136,392 in *Davis*-case costs that were included in GD's 1991 overall corporate overhead proposal; and (2) assess a $1,731,900 penalty under the penalty provisions of 10 U.S.C. § 2324(a) through (d), as implemented by the Department of Defense FAR Supplement (DFARS) 252.231-7001, for including the disallowed costs in the 1991 overhead cost proposal. Only entitlement is to be decided.

We sustain the appeal.

FINDINGS OF FACT[2]

Background

The conduct that led to the Government-initiated civil fraud claims stemmed from subcontractor kickbacks —the Frigitemp kickbacks —paid in connection with contracts for the construction of two liquid natural gas tankers, the construction of which was supported by subsidies from the U.S. Maritime Administration (MarAd). During the late 1970s GD built two ships commissioned by Lachmar Partners. The ships were built with a construction differential subsidy (CDS) granted to GD by MarAd pursuant to Title V of the Merchant Marine Act of 1936, as amended, 46 U.S.C. App. §§ 1151-1161 —the "Lachmar subsidies." The CDSs were intended to aid domestic shipbuilders in competing against generally lower cost foreign shipyards for business. As authorized by the Act, the amount of the Lachmar subsidies was intended to equal the difference between the price GD negotiated with the Lachmar Partners and the lower estimated cost of building the ships under similar plans and specifications in a representative foreign shipyard. In order to demonstrate eligibility for the subsidies, GD (as the shipbuilder) and Lachmar (as the ships' purchaser) were required to "submit backup cost details and evidence that the negotiated price [was] fair and reasonable." 46 U.S.C. App. § 1152(a). Ultimately, there was agreement on a negotiated base price per ship of $125,919,000, subject to escalation for increases in materials and labor. The total estimated price per ship was $155.5 million, while a foreign price of $115.5 million per ship was identified. The CDS rate was 25.48 percent for a total subsidy of approximately $79 million. 803 F. Supp. at 838.

The detailed estimates that GD submitted to MarAd in connection with the Lachmar subsidies were divided into six areas: the material cost estimate, the sphere labor estimate, the operations recurring hours estimate, the operations non-recurring hours estimate, the engineering hours estimate, and the sphere insulation and joiner estimate. The estimate for the sphere insulation and joiner work included data relating to subcontracts GD had executed with Frigitemp Corporation for the performance of sphere insulation and joiner work.

It was later established that GD's decision to award that work to Frigitemp had been influenced by the offer and payment of about $2.7 million in kickbacks by Frigitemp' s senior vice president, George G. Davis, aided by Gerald K. Lee, Frigitemp's Chairman and CEO, to James H. Gilliland and P. Takis Veliotis, two GD employees. Veliotis was the person primarily responsible for awarding the subcontracts.

Davis financed the kickbacks by creating and submitting to Frigitemp approximately $5 million in false vouchers that were ultimately charged to the Lachmar Project. Once payment on these false vouchers was received, Davis retained a portion of the proceeds and funneled the remainder to Veliotis and Gilliland through numbered Swiss bank accounts. Davis secretly diverted nearly half of the $5 million fund to himself. None of the kickbacks

directed to Veliotis or Gilliland was received by or accrued to GD in its corporate capacity. *Id.* at 865; *United States v. Davis*, 767 F.2d 1025, 1027 (2d Cir. 1985).

The Department of Justice's *Davis* Complaints

The Original Complaint After the kickback scheme was uncovered, the U.S. Department of Justice commenced proceedings in 1985 in the United States District Court for the Southern District of New York against Messrs. Davis, Lee, Veliotis and Gilliland, the individuals responsible for perpetrating the kickback scheme for violations of the Civil False Claims Act (FCA), 31 U.S.C. § 3729, and the Anti-Kickback Act (AKA), 41 U.S.C. § 51. GD was not named as a defendant. (R4, tab 21; tr. 231) The Government did not sue GD under the AKA because prior to the 1986 amendments, which applied prospectively only, the Government could only recover kickback damages from a subcontractor or a recipient of a kickback, and not from a prime contractor (803 F. Supp. at 865; 19 F.3d at 772 n.3).

The Amended Complaint In April 1987, the Government filed an amended complaint that expanded its earlier allegations against Messrs. Davis, Lee, Gilliland and Veliotis, and, for the first time, included GD in the allegations of wrongdoing. The general premise of the counts was that GD had "knowingly submitted inflated and fraudulent cost estimates to MARAD to obtain excessive government subsidies." The focus of the amended complaint was on the inclusion of "grossly inflated Frigitemp estimates for joiner and sphere insulation subcontracts" in the cost estimates submitted to MarAd to support the CDS requests. The amended complaint alleged that, in passing on the inflated Frigitemp estimates in order to show eligibility for the Lachmar subsidies, GD had: (1) as a result of a conspiracy among the defendants to award inflated Frigitemp subcontracts and charge the fraudulent costs on the Lachmar contracts as claims to MarAd, violated the FCA and was jointly and severally liable to MarAd for at least $14 million, plus interest; (2) breached its contract with MarAd and was jointly and severally liable for damages of at least $7 million, plus interest; (3) induced MarAd to grant the Lachmar subsidies based on a mistake of fact and was liable for repayment of the subsidies improperly paid; (4) fraudulently induced MarAd to enter into contracts awarding excessive subsidies to it by falsely representing that the Frigitemp subcontract estimates were "fair and reasonable" and was liable for the "excessive subsidies paid;" and (5) unjustly enriched itself by passing along to MarAd costs it would otherwise have had to absorb and was liable for the inflated costs and the "profit factor" added to the costs. (R4, tab 2)

The Third Amended Complaint On 27 October 1987, the Government again amended the complaint (styled the "Third Amended Complaint") to broaden the scope of its allegations against GD. The Third Amended Complaint questioned not just the Frigitemp estimates, but all of the estimates GD had submitted in support of the Lachmar subsidies. In Count I, the Government alleged that by failing to provide cost and pricing data to MarAd that was current, complete and accurate, GD had so materially breached its

obligations under the Merchant Marine Act, as amended, that the subsidy contracts should be rescinded and the subsidies returned with interest or, alternatively, the contract should be reformed to reflect the subsidy that would have been granted if GD had met its obligations, with the difference returned, with interest. Included in this count was the allegation that the subsidies attributable to the Frigitemp-kickback scheme were not, as a matter of law, "fair and reasonable" under the statutory CDS program and had to be returned, with interest.

Generally, the Third Amended Complaint repeated the theories for recovery of the Amended Complaint—mistake (Count II), fraud (Count III), unjust enrichment (Count IV)—but by way of remedy sought a return of the entire subsidy and in the case of the fraud count, a declaration that the subsidy contracts were void and a return of the subsidies, with interest. Included in each of these counts was a specific allegation that costs were inflated as a result of the kickback scheme. The FCA allegations (Count V) were also broadened to parallel the scope of the breach claim and alleged that when claim vouchers were submitted, GD knew that it was obtaining payment of fraudulently inflated subsidies awarded on the basis of false and fraudulent pricing data. (Though not specifically mentioned, we understand the inflation of the subsidies attributable to the kickback scheme to be a part of this count.)

As a penalty for the alleged FCA violations, the Government sought treble damages in the approximate amount of $165,000,000, plus interest, and penalties for each false claim pursuant to the FCA. Testimony at the hearing indicated the Government's claim was about $300 million based on trebling the subsidy amount and adding in the other penalties. (R4, tab 5; tr. 235-36, 318-20)

The District Court's Decision

In October of 1992, the United States District Court for the Southern District of New York issued a decision completely in GD's favor. The court treated the "Frigitemp kickbacks" separately from what the court referred to as the Government's "central claim in this case"—namely, a charge that "GD provided the Government with false-ship construction cost estimates" when GD applied for subsidies. In the court's view, the Government in substance claimed that GD had internal, lower cost estimates which it did not disclose, and that, *ipso facto*, the estimates it did submit were not fair and reasonable. The court considered the "primary issue" in the case to be "whether the proposal support that GD provided to MarAd, as part of GD's application for CDS[], satisfied the reporting requirements" of the Merchant Marine Act, and the court looked to the Truth in Negotiations Act, 10 U.S.C. 2306a (1977), by way of analogy for part of its analysis. 803 F. Supp. at 861, 863.

After a detailed examination of the evidence, the court concluded that:

> Based on the entire record in this proceeding, we find that the estimate [GD] submitted to MarAd to support the negotiated Lachmar price was objectively reasonable and fair, and consistent with existing experience at the shipyard. Moreover, with the exception of GD's estimates for Frigitemp's joiner and sphere insulation work, we find that the Government has failed to prove by a preponderance of the evidence that GD did not believe that the estimates it submitted to MarAd as part of GD's proposal support were GD's "best estimates." Finally, we find that [GD's division] truthfully reported all the underlying factual data —the actual hours incurred, the vendor quotations, the status of production at Charleston, and all other construction and finance matters —on which GD's estimates were based.
>
> . . . .
>
> We have further found that, whether analyzed objectively or subjectively, the proposal support GD provided to the Government in support of GD's CDS application was entirely proper and was not fraudulent. Accordingly, GD's proposal support cannot advance the Government's claim of liability against GD for mistake, unjust enrichment, and fraud, or render GD liable to the Government under the False Claims Act.

803 F. Supp. at 860, 862.

With respect to the Frigitemp kickback scheme, the court held that the AKA preempted the Government's FCA and federal common law remedies (breach of contract, mistake, fraud, unjust enrichment) against GD and dismissed the Government's Frigitemp claims as to GD. However, assuming GD were liable to the Government for damages suffered as a result of the Frigitemp kickbacks, the court found "for the record only" that the actual damages attributable to the kickback scheme were $5,287,600. The court relied on the accuracy of GD's revenue and delivery estimates as the basis for its damage assessment. The district court explained its methodology and computations in the following terms:

> The Government's damages for the sphere insulation and joiner work will be the difference between GD's projected revenue for the Frigitemp subcontracts, and GD's cost at delivery estimates of the Frigitemp subcontracts. The greater the projected revenue and the lower the estimated cost, the

> greater are the Government's damages. We find the projected revenue for the sphere insulation and joiner work is $5,469,000 and $l,002,800 respectively . . . . We find that GD's cost-at-delivery estimate for sphere insulation to be $2,934,000 and reject GD's contention that GD's internal sphere insulation estimate was a base price subject to escalation . . . . We also find that GD's cost-at-delivery estimate for the joiner work to have been $894,000. . . . Therefore, the resulting damages are $2,535,000 per ship for insulation and $l08,800 per ship for joiner work[, for a total of $5,287,600].

Id. at 860.

All of the counts against GD, including the Frigitemp-related counts, were dismissed and GD was awarded $60,000 in court costs. (R4, tab 10 at 73-74, 84-85)

The Second Circuit's Decision

On 4 January 1993, the Government appealed the district court's decision to the United States Court of Appeals for the Second Circuit. The Government's brief posed the two issues on appeal in the following manner: (1) "Whether the district court clearly erred in holding that GD's submissions to MarAd to obtain a Government subsidy — consisting of projected costs and cost details that drastically differed from GD's internal corporate records of the same items —were not false and did not violate the False Claims Act and the common law;" and (2) "Whether the Government is entitled to pursue its longstanding remedies under the False Claims Act and the common law notwithstanding the 1946 passage and 1960 re-enactment of the Anti-Kickback Act, a statute that does not provide the Government with a damage remedy against GD for the undisputed illegal kickbacks that were paid in this case." The issues on appeal from GD' s perspective were: "(1) whether the district court clearly erred in finding that General Dynamics' submissions to MarAd were not fraudulent; and (2) whether the district court erred in ruling that Congress intended the AKA to provide the exclusive remedy available to the government to recover costs associated with subcontractor kickbacks." Both of these issues were fully briefed by the parties on appeal and each brief treated the Frigitemp-kickback issues separately. (R4, tabs 11 at 4, 12 at 3-4)

On 17 March 1994, the Second Circuit affirmed the district court's dismissal of the Government's claims on the basis of the district court's opinion, with the exception of the "Frigitemp Claims," which the circuit court defined as "the claims premised upon the alleged Frigitemp kickbacks." 19 F.3d at 772. In the court's characterization, "[t]he main theme of the government's complaint in this action is that GD submitted false cost data and estimates . . . in support of CDS applications." *Id.* at 771. With respect to the Frigitemp

claims, the Government was seeking "recovery against GD for excess CDS[]s paid to GD resulting from false submissions made by GD to MarAd incorporating the Frigitemp kickbacks into GD's cost data." 19 F.3d at 772.

On the issue of remedies for the Frigitemp-kickback scheme, the Second Circuit reversed the district court, concluding that the AKA did not preempt remedies of the United States under the FCA and federal common law "with respect to CDS applications by GD whose cost data are tainted by kickback payments. The remedies available under the FCA and the federal common law, we add, are not limited to the amount of the kickbacks, but extend to consequential damages resulting from the payment of kickbacks," citing *United States v. Acme Process Equipment Co.*, 385 U.S. 138, 144-45, 17 L. Ed. 2d 254-55 (1966). In remanding the Frigitemp claims to the district court, the Second Circuit's opinion noted that, while GD's liability under the FCA or common law was yet to be determined, "[u]pon remand, of course, the district court is free, in its discretion, to draw upon the evidence already provided in the bench trial of this case, and upon the findings already provided by the district court regarding the damages recoverable by the government from GD in the event the Frigitemp Claims are sustained. *See* 803 F.Supp. at 860." *Id*. at 777.

Settlement of the *Davis* Case[3]

On or about 21 March 1994, before the district court could entertain the Frigitemp claims on remand, GD, through one of its counsel, David Bohan, Esq., signaled a willingness to settle the *Davis* case for a lump sum payment of $l.61 million, an amount that GD had offered during previous settlement discussions. On or about 12 April 1994, the Government, through an Assistant U.S. Attorney, David Koenigsberg, Esq., orally responded with a counteroffer to settle the *Davis* case for $9 million. The Government arrived at its $9 million proposal by using the district court's damage calculation as a baseline, and adding $.5 million in additional damages which it believed the court had improperly excluded, and pre-judgment interest. Using various interest rate assumptions, the Government arrived at total damages ranging from $19.1 to $28.7 million. For settlement purposes, the Government used its low assessment of $19.1 million, subtracted a credit to which GD was entitled, reduced the amount by one-third to allow for risk and rounded the result to arrive at the $9 million counteroffer. (Ex. B)

During the discussion, Mr. Koenigsberg expressed the view that GD's $1.61 million offer was inadequate. In arriving at its earlier $1.61 million offer before the Second Circuit's decision, GD had assigned zero probability to losing the first issue in the Second Circuit and had assigned a 50 percent probability to its chances on the AKA issue. In Mr. Koenigsberg's view, since GD had lost on the AKA issue its settlement offer automatically should have risen to at least $3.22 million. Mr. Bohan indicated that if settlement was intended, a $9 million offer sent the wrong message. (Ex. B)

By letter dated 15 April 1994, Mr. Bohan, on behalf of GD, rejected the Government's counteroffer. On or about 19 April 1994, Mr. Bohan reopened settlement negotiations with an oral offer of $2.5 million. This prompted an oral counteroffer by the Government during a telephone conversation on 25 April 1994, lowering its demand to $5.6 million. The conversation was inconclusive. (Exs. C, D, E)

Subsequently, on 20 May 1994, GD representatives met with the Chief of the Civil Division of the U.S. Attorney's Office for the Southern District of New York to discuss settlement. From GD's perspective —as expressed in a briefing paper used at the meeting —the Frigitemp claims encompassed five theories of recovery and were reflected in five counts of the Third Amended Complaint. With respect to the breach of contract theory (Count I), GD understood the allegation to be that GD violated the Merchant Marine Act, and therefore its contracts with MarAd, by submitting false cost and pricing data. The false data stemmed from the acceptance of kickbacks by the two GD executives, which, in turn, artificially inflated the price for the ships by the amount of the kickbacks and, ultimately, the CDS amount. The mistake count (Count II) was based on the allegation that MarAd paid the CDS in the mistaken belief that GD's pricing data did not include kickbacks. The fraud count (Count III) was based on the allegation that GD's use of pricing data tainted by kickbacks constituted fraud, while the unjust enrichment count (Count IV) argued that GD was unjustly enriched by the recovery of excessive CDS payments. The FCA violations (Count V) were based on the allegation that GD's claims for payment were knowingly false and fraudulent due to the inclusion of kickbacks. GD's position on damages was that the Government's actual damages were only 25.48 percent of overpayments made to Frigitemp because CDS payments were only 25.48 percent of the ships' price. It also questioned the appropriateness of assessing pre-judgment interest. (Ex. F)

During the course of the meeting, the parties reached an oral agreement in principle to settle the case for $3.3 million, subject to approval by the appropriate Department of Justice officials in Washington, D.C. No other settlement terms were agreed upon, except that GD agreed to relinquish any claim to the court costs earlier awarded by the district court. Mr. David W. DeBruin, one of GD's counsel who argued the case on appeal and participated in the settlement negotiations, testified in this regard that court costs were a "bone of contention" for the U.S. Attorney's office because the costs would have to be paid from its operating budget. (R4, tab 43, ¶ 9; tr. 226-28, 266-68)

On or about 8 June 1994, the Government sent GD a first draft of the proposed settlement agreement. From 8 June through 15 July 1994, the parties worked to reduce their settlement in principle to a formal written agreement. On 15 June 1994, while negotiations were ongoing, the 90-day period for the Government to petition the United States Supreme Court for a writ of certiorari expired. (R4, tab 43, ¶ 11, exs. G through J) We also find that at no time during these discussions did the Government indicate the possibility that it might seek to petition for rehearing of the Second Circuit's decision or petition for certiorari to the U.S. Supreme Court (tr. 258-59).

On 15 July 1994, GD and the Government executed a written settlement agreement. The settlement agreement provided for settlement of "all claims against [GD] in the [district court action]." Paragraph 5 called for the release of GD "from any civil claim the Government has or may have under common or statutory law against [GD] on account of the incident or circumstances described in the complaints in this action." The parties agreed in the recitals that the settlement did not "constitute an admission of liability on the part of General Dynamics or a concession by the Government that its claims against General Dynamics were not well-founded." Paragraph 7 of the agreement further provided that: "This action shall be dismissed as against General Dynamics with prejudice and without costs or attorney's fees to either party." (R4, tab 15)

At no point during the settlement discussions, which took place from 21 March 1994 through 15 July 1994, did GD and the U.S. Attorney's office ever discuss the allowability of GD's costs and attorney's fees as part of GD's corporate overhead allocated to Government contracts (R4, tab 43, ¶ 16; tr. 263-66).

GD's Inclusion of *Davis*-Case Costs in its 1987 through 1991 Corporate Overhead Proposals

Shortly after the district court's 2 October 1992 decision in GD's favor, GD notified Mr. Daniel J. Bystran, the Defense Contract Management Agency (DCMA) corporate administrative contracting officer responsible for the Government's contracts with GD, that it intended to seek recovery of *Davis*-case costs. By letter dated 12 October 1992, GD advised Mr. Bystran of the district court's decision and revised its 1987 through 1991 corporate overhead proposals to include *Davis*-case costs that had previously been "set aside" in accordance with FAR 31.205-47(g). Attached to the 12 October 1992 letter was a "Certificate of Indirect Costs - CY 1987-CY 1991 Set-Aside Cost Reinstatement" signed by GD's staff vice president and corporate controller. The certificate stated in pertinent part that "[a]ll costs included in this proposal for reinstatement of legal costs previously set-aside related to [the *Davis* case] are allowable . . . ." (R4, tab 36)

In response to a request from Mr. Bystran, by facsimile transmission of 23 November 1992, Ms. Marcia Bader sent a copy of the first and last page of the district court's opinion to Mr. Bystran and Mr. Alan Lichtman, a Defense Contract Audit Agency (DCAA) auditor (R4, tab 36; Gov' t br. at 10). Ms. Bader worked for Mr. Paul W. Steckley. Mr. Steckley had been employed by GD since 1983. From 1984 through 1990 he was director of financial planning. He was corporate director of accounting from 1991 until November 1994 when he was appointed staff vice president, internal audit and Government accounting. He dealt with Mr. Bystran and the DCAA resident auditors on behalf of GD. (Tr. 355-57)

Status of the Overhead Proposals

Overall, GD claims to have incurred total legal fees and expenses of $10,804,542 in defending the *Davis* litigation from 1987 through 1994, not all of which it seeks to recover. Since quantum is not presently before us, we express no opinion on the amount of the claimed costs, including but not limited to GD's apportionment of the *Davis*-case costs for which it seeks recovery. Moreover, this appeal is only concerned with the 1991 corporate overhead proposal, although we touch on events surrounding the negotiation of other years to the extent necessary for our decision.

The 1987 and 1988 overhead proposals have been settled (ex. A-7). The details of the 1987 proposal settlement are not in the record. The 1988 proposal was settled by agreement dated 30 March 1993, after an agreement in principle on or about 12 March 1993. The settlement allowed $1,360,768 in *Davis*-case costs for that year. The 1989 proposal was negotiated against the background and in light of the 1991 overhead proposal, which became the focal point for the parties' discussion of the *Davis*-case issues that divide them. The 1990 proposal is considered to be in "set-aside" (ex. A-7). Of course, since GD operates on a calendar year basis, at the time of the 12 October letter, 1992 was not completed and the *Davis*-case costs for 1993 and 1994 were yet to be incurred (tr. 39). When the 1992 proposal was submitted, GD followed the same approach that it had followed in connection with the 1991 proposal. When the 1993 corporate overhead proposal was submitted on 25 April 1994, the *Davis*-case costs were identified as "set-aside," in what was later described by Mr. Steckley as "probably a very conservative approach" because an understanding reached with respect to the 1991 and 1992 corporate overhead proposals in a 22 April 1994 meeting did not cover the 1993 proposal (tr. 60-61; 475-76). GD also considers the *Davis*-case costs in the 1994 proposal in set-aside status. (Ex. A-7)

During 1991, the year at issue in this appeal, GD incurred overhead costs, including the *Davis*-case costs, that were ultimately allocated to many different Government contracts. The parties have included in the record excerpts from contracts that were performed during 1991, with the understanding that different statutes, regulations and provisions may be involved. The parties have agreed that the impact, if any, of these variations is reserved for quantum. (R4, tabs 1, 112 through 123; tr. 358-62) The Government has included the captioned contract as typical (R4, tab 1). This contract was awarded on 5 January 1988 for Trident submarine construction. It was active in 1991 and includes among its provisions, DFARS 52.231-7002 PENALTIES FOR UNALLOWABLE COSTS - FIXED-PRICE INCENTIVE (FEB 1987) and DFARS 52.242-7003 CERTIFICATION OF INDIRECT COSTS (APR 1986). The record also includes an excerpt from Contract No. F33657-88-C-0037 which was awarded on 21 June 1989. This contract includes among its provisions the FAR 52.216-7 ALLOWABLE COST AND PAYMENT (APR 1984), FAR 52.216-16 INCENTIVE PRICE REVISION - FIRM TARGET (APR 1984), DFARS 252.231-7001 PENALTIES FOR UNALLOWABLE COSTS (APR 1988) (for cost reimbursement items only),

and DFARS 252.231-7002 PENALTIES FOR UNALLOWABLE COSTS-FIXED PRICE INCENTIVE (APR 1988) clauses. (R4, tab 120)

Knowledge of the Appeal and Settlement of the Davis Case

Mr. Bystran did not know that the Department of Justice had appealed the district court's opinion on 4 January 1993 until he read GD's annual shareholder report in April 1993, about a week after the 30 March 1993 settlement of the 1988 corporate overhead rate proposal. Mr. Bystran testified that he was surprised and would not have settled 1988, if he had known of the appeal. Instead, he would have left the costs in "set-aside" pending the outcome of the appeal process. His discovery prompted a later conversation with Mr. Steckley during which Mr. Steckley pointed to "precedent in law that issues that are settled with the Government in overhead cannot be revisited." Mr. Bystran indicated that he "felt it might not be over with" and he wanted to see what the outcome of the appeal was. The conversation did not go into Mr. Steckley's knowledge of the status of the case. (Tr. 44-48; R4, tab 13) This conversation was followed by a letter of 30 April 1993 from Mr. Bystran to Mr. Steckley, asking for improved communications. Although the letter was focused on an unrelated cost issue, it addressed a number of items drawn from the annual report, including the *Davis* case. Mr. Bystran believed he should have learned of these matters directly from GD and not through a reading of GD's annual report. The letter asked GD to examine its processes for keeping him informed. (Ex. G-1; tr. 53-55)

Mr. Bystran recalled speaking with his counsel about what remedies might be available in connection with the settlement of the 1988 corporate overhead rate proposal. He had no specific recall of either asking his counsel to find out more about the appeal or being told by his counsel what the status was in April 1993. When pressed, he acknowledged that he never asked his counsel "to check the public record with respect to the status of the U.S. v. Davis case." He believed that it was principally the contractor's responsibility to advise him of the status, but, in hindsight, felt that if he could not rely on the contractor, he should have "double-check[ed]." (Tr. 78-85).

Mr. Steckley testified that he did not recall being aware that an appeal had been filed at the time he negotiated the settlement of the 1988 corporate overhead rate proposal with Mr. Bystran. When pressed on cross-examination, he testified that he learned about the appeal from GD's annual report, probably at about the same time Mr. Bystran got his copy of the annual report.

With respect to the appeal, he assumed that Mr. Bystran knew all about it since it was the Government's appeal. He did not have regular contact with GD's general counsel's office. He assumed that if there were any significant changes in the status of the case that he would hear from the general counsel's office. He was not surprised, however, that he had not been contacted by the general counsel's office in connection with the appeal and

acknowledged that he probably did not contact the office when he learned of the appeal. (Tr. 370-71, 421-25)

Mr. Steckley did not consider the concerns expressed in Mr. Bystran's 30 April 1993 letter to be well-founded. With respect to the *Davis* case, he felt it was Mr. Bystran's responsibility to find out about the status of the case. He recalled that Mr. Bystran did contact him and seek to reopen 1988, but that he did not agree. He emphasized that as of 30 April 1993 the costs were allowable. (Tr. 370-71, 421-25)

Between the time he learned of the appeal and 2 August 1994, Mr. Bystran was unaware of the status of the *Davis* case. He did not find out about the Second Circuit' s decision and the circumstances surrounding the subsequent settlement of the *Davis* case until after he read about the settlement in a brief article in THE WASHINGTON POST of 2 August 1994. (R4, tab 127; tr. 57-58) Consequently, he was not aware of the Second Circuit's decision at the time of an important 22 April 1994 meeting with GD representatives to discuss GD's 1991 and 1992 corporate overhead proposals. Indeed, none of the Government representatives at the meeting knew of the decision, including two key DCAA audit representatives: Mr. John C. Ames and Mr. Ronald T. Mock. Mr. Ames was DCAA's contract audit coordinator for GD. Mr. Mock was responsible for DCAA' s audits of GD from October 1993 through December 1994. Mr. Mock also learned of the *Davis*-case settlement through reading a copy of the same newspaper article. (Tr. 147-48, 157-59)

Mr. Steckley also testified that he did not find out about the settlement until sometime in late July or early August 1994 and learned of the Second Circuit's decision at the same time, although he conceded it was possible that he could have learned of the decision earlier. He did not contact his general counsel's office to keep abreast of *Davis*-case developments. He recalled the matter being raised by Mr. Bystran and acknowledged that he did not initiate the conversations himself. He felt the Government was in as good a position to know about the settlement of the case as he was. (Tr. 429-33, 335-440)

The 22 April 1994 Meeting

Both GD's original and first revised 1991 overhead proposals were submitted to the Government while the district court's decision in the *Davis* case was still pending and while the *Davis*-case costs were classified as "set aside" (R4, tabs 34-35; tr. 39-40, 366-68). GD's subsequent 12 October 1992 revision to the 1991 corporate overhead rate proposal was discussed during a 22 April 1994 meeting.

In December of 1993 GD had presented a proposal to the Government to reduce the scope of DCAA audits of the corporate office rate overhead proposals in the interests of reducing the company's own costs in connection with the Government's audit and

oversight. In return, GD would voluntarily reduce its allowable cost proposal by a mutually agreed percentage depending upon the risk in the proposal. On 22 April 1994 Mr. Steckley met with Mr. Bystran, Mr. Mock and Mr. Ames to negotiate GD's corporate overhead rate proposal for 1991 and to discuss the 1991 and 1992 corporate overhead rate proposals in the context of GD's December offer.

In the context of a "bottom line" settlement, Mr. Steckley proposed a two and one-half percent exclusion factor. One percent was intended to reflect the fact that historically the parties had negotiated a one percent disallowance in their settlements. GD proposed an additional one percent "safety" factor, plus a one-half percent penalty factor. According to a contemporaneous memorandum prepared by Mr. Steckley, the Government was prepared to accept GD's offer. However, it was concerned about the potential for unallowable divestiture costs and proposed auditing this area. GD objected to this approach; instead, it was agreed that an additional one-half percent reduction would be provided to offset the risk of unallowable divestiture activity. It was Mr. Steckley's understanding that GD would exclude "three percent from its allowable overhead cost for 1991 and 1992," that is, GD would, as explained in a letter of 29 April 1994 to Mr. Ames, "reclassify three percent (3%) of adjusted allowable costs for each year as unallowable." (A copy of the letter was furnished to Mr. Bystran.) Mr. Steckley expected the 1991 and 1992 overhead proposals to be settled within one month, substantially sooner than normal. (Tr. 176-77, 376; ex. A-1 at 1, 2)

With respect to the previously set-aside *Davis*-case costs, GD acknowledged that it had to reduce its claimed *Davis*-related costs for 1991 by 20 percent in order to comply with the 80 percent ceiling on contractor legal defense costs reflected in FAR 31.205-47(e)(3), and to provide supporting documentation. This undertaking was also reflected in the letter of 29 April 1994. The failure to apply the 80 percent ceiling has been treated as an oversight by the parties and has not figured in their dispute. (Ex. A-1; tr. 57-58)

At the hearing Mr. Bystran testified that the agreement was considered innovative at the time and promised to save the Government time and money by reducing the scope of its audits. However, Mr. Bystran testified that because Mr. Steckley felt "in his own mind" that he was including a half of one-percent for a penalty, he "distinctly said" he would not consider any amount that was offered for penalty issues as being received because he had "to assess penalties separately if we find any issues that require a penalty." With this caveat, Mr. Bystran agreed to proceed on the basis of the three percent exclusion. He did not recall anything being discussed in connection with the *Davis* case other than the applicability of the 80-percent ceiling on legal costs. (Tr. 56-59) No contemporaneous documentation supporting the contracting officer's testimony, particularly with respect to the caveat concerning the allowance for a penalty, is in the record. In addition, Mr. Bystran's trial testimony did not address the question of whether the standard exclusion was intended to account for legal fees that would otherwise be unallowable, apart from any

penalty. Moreover, he took no exception to Mr. Steckley's understanding of the 22 April agreement, apart from the penalty issue, despite the opportunity to do so.

Mr. Mock offered no testimony with respect to the penalty issue. He recalled, however, that the Government clearly apprised GD that the "previously set-aside legal costs" would still have to be audited (tr. 176). We credit this testimony, but understand it to be focused principally on the need to verify GD's compliance with the 80 percent ceiling. Of course, once the Government became aware of the status of the *Davis* case the focus changed. In any event, Mr. Mock's testimony did not address the question of how the three percent exclusion applied to the *Davis*-case costs, although it is clear that he understood that the exclusion was intended to cover potentially unallowable costs. In this regard, he did testify that a later DCAA audit unilaterally allocated certain questioned costs —not including *Davis*-case costs —to the three percent exclusion without GD's involvement (tr. 172). *See infra* at 22.

Similarly, Mr. Steckley did not recall any discussion concerning the treatment of *Davis*-related costs apart from the agreement to exclude 20 percent of the legal fees in order to comply with the ceiling. However, he testified that under his interpretation of the 22 April agreement, *Davis*-case costs that were otherwise unallowable would be covered by the three percent exclusion. In his view, the exclusion also applied to any penalty that might be assessed.

The 22 April agreement remained an agreement in principal only. It was never implemented and it was ultimately rejected by Mr. Steckley after the contracting officer issued his final decision. However, Mr. Steckley acted on the basis of his understanding of the agreement in dealing with the events leading up to the contracting officer's final decision and the contracting officer was aware of that interpretation. (Tr. 373-74, 376-77, 383-84, 427-28, 451-52; ex. A-1) We note in this regard that the Government never took exception to Mr. Steckley's interpretation of the agreement as confirmed in his 29 April 1994 letter prior to the filing of this appeal, although it had clear notice no later than 22 December 1994 of GD's position that the expenses associated with the defense of the Frigitemp kickback claims were covered by the three percent agreement (R4, tab 23).

DCAA Audit of GD's Corporate Overhead Proposals

In response to Mr. Bystran's request of 19 October 1992, DCAA initiated a review of the *Davis*-case costs. The DCAA audit was not initiated until after 23 October 1992 (tr. 125-26). DCAA's preliminary conclusions were summarized in a memorandum to Mr. Bystran dated 9 August 1994. The memorandum covered *Davis*-case costs from 1987 through 1992. DCAA concluded that in light of the district court's opinion, the *Davis*-related costs GD had claimed were generally allowable, subject to compliance with the 80 percent limitation of FAR 31.205-47(e) and the satisfactorily resolution of concerns about

whether GD's directors' and officers' (D&O) insurance would cover some of the *Davis*-case costs. (R4, tab 18)

By memorandum for the record dated 19 August 1994, DCAA memorialized the results of its audit of GD's 1991 fees and expenses of outside counsel. The report identified $3,920,337 in *Davis*-case costs, of which $784,067 was questioned based on an application of the "80 percent rule." It also recommended a formal review by DCMA of GD's D&O insurance to determine whether some *Davis*-case costs were covered by the policy. The memorandum was based on DCAA's understanding that the district court's decision remained in effect. (R4, tab 128)

The question of the scope of coverage of the D&O insurance was addressed in an exchange of correspondence between Mr. Steckley and Mr. Bystran. By letter dated 19 July 1994, Mr. Bystran was asked to provide an explanation of the D&O liability insurance coverage as it applied specifically to the *Davis*-case legal expenses incurred from 1987 through 1991 and when a claim would be made against the carrier. The letter concluded that "[t]his is determined appropriate before any further Government effort is expended to adjust allowable cost for the years in question." (R4, tab 16)

Mr. Steckley responded in a letter dated 25 July 1994. He advised that the D&O policies cover the costs of defending directors or officers, but do not cover the costs of defending the company, even if it is charged in connection with the same matter. Since legal costs incurred were on behalf of GD, it had no claim under the policies. He concluded that the costs were appropriately charged to corporate office overhead. (R4, tab 17) At the time of the exchange Mr. Bystran knew only of the appeal in the *Davis* case (tr. 64).

The Government's Response to the Settlement of the *Davis* Case

Mr. Mock's assumption that the district court's decision remained in full effect was, of course, erroneous. By the time DCAA's memorandum to Mr. Bystran was issued on 9 August 1994, not only had the Second Circuit ruled, clearing the way for the Government to pursue the Frigitemp claims, but the Government and GD had executed a binding settlement resolving the *Davis* case. The discovery that the district court's decision had been reversed in part and that GD had paid $3.3 million to halt further proceedings caused both Mr. Bystran and DCAA's Mr. Mock to reassess their initial positions concerning the allowability of GD's *Davis*-litigation costs. (Tr. 158, 161)

Mr. Mock was "surprised and shocked" when he subsequently learned of resolution of the *Davis* case. The news of the *Davis*-case settlement basically "started the audit process over again." (R4, tab 128; tr. 151-54, 156-57) Mr. Bystran read about the *Davis*-case settlement on the evening of 2 August 1994, waited a day, and on 4 August 1994, called Mr. Steckley to ask him how GD planned to treat the settlement costs. Mr. Steckley

responded that he would "not bill the $3.3 million settlement with the Justice Department." Mr. Bystran had the impression that Mr. Steckley knew about the article when they spoke. At the time of the call Mr. Bystran through that Mr. Steckley's answer was the correct one.

After the call he asked himself about the rest of the *Davis*-case costs. This led him to immediately start looking into the settlement of the *Davis* case and, through his counsel, he obtained information on the *Davis* case from the Department of Justice. He had no direct contact with the Department of Justice lawyers who represented the Government at the court of appeals or during the settlement negotiations and his understanding of the legal implications of the case came through privileged conversations with his counsel. (Tr. 65-69)

Mr. Bystran obtained and reviewed extracts of the settlement agreement GD had executed with the Government. In conducting his review, Mr. Bystran focused particularly on paragraph 7 of the settlement agreement, which provided that the settlement would be "without costs or attorney's fees to either party." He viewed the language as "sort of a general release" and considered it very important. In his mind, the reference to "attorney's fees" was very explicit and went beyond the court of appeals's reference to costs. Based on this language, Mr. Bystran concluded that paragraph 7 essentially rendered any *Davis*-case costs *per se* unallowable. When asked to address the question of whether the Frigitemp claims were separate from the rest of the case, Mr. Brystran testified that they "took it as one case." He focused on paragraph 5 of the settlement agreement. Paragraph 5 provides that: "The Government shall release General Dynamics from any civil claim the Government has or may have under common or statutory law against General Dynamics on account of the incident or circumstances described in the complaints in this action." He pointed to the use of the plural, "complaints," in the paragraph in support of his view, but did not elaborate further. He concluded that the "wording of the settlement agreement . . . was consent or compromise, and within the intent of . . . FAR 31.205-47(b)(4), so before the month of August was over with, I sent the contractor my determination that U.S. versus Davis legal costs, all of them were unallowable." (R4, tab 15; tr. 67-68)

On 26 August 1994, Mr. Bystran sent GD a letter concerning the D&O insurance coverage issue and the allowability of the *Davis*-case costs. The letter first referenced the July exchange of correspondence on the D&O insurance coverage. Mr. Bystran noted that based on its review, the Government considered the response "inaccurate in part," but concluded that it may not have an impact on the overall outcome because "[p]resumably General Dynamics sought to recover only the expenses of defending the Corporation and not the individuals that would have been covered by D&O Insurance," which was a true statement. (R4, tab 19)

With respect to the allowability of the *Davis*-case costs, the remainder of the letter, quoted in its entirety, stated:

> The Court of Appeals rendered a decision on the appeal 17 Mar 94. The court basically reversed the lower court' s interpretation of the Anti-Kickback Act remedies['] applicability to the case and ordered a new trial on the issue. General Dynamics agreed to an out of court settlement with the Justice Department.
>
> FAR 31.205-47(b)(4) requires that costs are unallowable if the result is disposition of the matter by consent or compromise if the proceeding could have led to a finding of contractor liability in a civil fraud case absent an agreement to the contrary. Since the Court of Appeals ordered a new trial on the issue related to the Anti-Kickback Act (Fraud as defined by the FAR) and General Dynamics chose to settle the case, the claimed legal expenses are unallowable.
>
> General Dynamics is requested to remove the expenses from certified claims for incurred cost and billings.

(R4, tab 19)

At the hearing, Mr. Bystran referred to the 26 August 1994 letter as "my contracting officer determination" and testified that he intended to provide a "determination that U.S. versus Davis legal costs, all of them, were unallowable." He acknowledged, however, that the letter was not intended to be a contracting officer's final decision, although it was intended to be a determination of the unallowability of all of the *Davis*-case costs. (Tr. 67-69; 93-94) We found the testimony that the 26 August letter was a determination unpersuasive. The interpretation is not supported by a reading of the letter itself, although GD was certainly "requested" to remove the costs. Moreover, it does not square with prior deposition testimony. In response to questions about the value of information he had received up to and at a 6 March 1995 meeting, Mr. Bystran had indicated that he now had all of the information necessary to come to a determination as to the allowability of the *Davis*-case costs (tr. 112-14, 116-17).

Mr. Bystran admitted that at the time he issued this letter he had not fully reviewed either the district court or Second Circuit decisions. Moreover, he had not reviewed the entire settlement agreement; he had only read excerpts provided by his counsel. At the time of his 26 August letter, he knew that there were other issues in the *Davis* case apart from the Frigitemp claims, but was not knowledgeable enough to discuss them. (Tr. 67-69, 85-86, 90-94)

GD's Final 1991 Corporate Overhead Proposal and the Government's Response

By letter dated 9 September 1994, GD's corporate vice president and controller submitted an updated, certified 1991 overhead cost proposal to the Government. The letter referred to GD's 29 April 1994 letter, which memorialized GD's view of the 22 April 1994 agreement. The letter also enclosed a "Summary of Updates to Proposed CY 1991 Overhead (Summary of Updates)." The proposal was intended to be final and was accompanied by an agreement signed by Mr. Steckley and inviting Mr. Bystran's signature. The vice president and controller's cover letter referred to the Summary of Updates and briefly described each adjustment. With respect to the *Davis* case, the letter noted that the proposal had been adjusted to reflect the "limitation of costs incurred for this matter pursuant to FAR 31.205-47(e)(3)." The *Davis*-case settlement was not addressed. With respect to the "Exclusions" identified on the Summary of Updates, the letter observed that the exclusions "[r]epresent[] an exclusion of costs determined to protect the Government' s interests given the current environment pursuant to the discussions documented within the referenced [29 April 1994] letter." The letter also stated that the "adjustments" were "covered by the Certificate of Indirect Cost." (R4, tab 20)

GD's Summary of Updates shows that GD reduced the *Davis*-case costs by 20 percent in the two accounts reflecting those costs in order to comply with the 80 percent limitation of FAR 31.205-47(e)(3). This adjustment was designed to produce in the case of the *Davis*-case costs, the "adjusted allowable costs" for the year referred to in GD's letter of 29 April 1994, memorializing the 22 April 1994 agreement (tr. 470-71). The Summary of Updates also shows that GD "reclassif[ied] three percent (3%) of adjusted allowable costs for the year as unallowable," as it promised to do in the 29 April letter. GD reduced each of the accounts in the overhead cost pool by three percent, for a total reduction of $2,743,970. We find that this reduction was intended to reflect the agreement in principle reached at the 22 April 1994 meeting to reclassify three percent of adjusted allowable costs for each year as unallowable as part of a bottom line settlement. We also conclude that GD's certification must be understood in the context of its understanding of the 22 April 1994 agreement.

Mr. Steckley was in possession of Mr. Bystran's 26 August 1994 letter when he prepared the 9 September letter for GD's corporate vice president and controller. He had referred the 26 August letter to outside counsel for advice, but did not believe he had received a response at the time of the September reply. He testified that he had not construed the Government's 26 August letter as indicating an intent to disallow all of GD' s *Davis*-case costs. Instead, he interpreted the letter as indicating that the Government considered unallowable only those costs expended to defend GD's position as to the Frigitemp claims the Second Circuit had remanded to the district court. He focused on the last sentence of the third paragraph of the letter: "Since the Court of Appeals ordered a new trial on the issue related to the Anti-Kickback Act (Fraud as defined by the FAR) and

General Dynamics chose to settle the case, the claimed legal expenses are unallowable." At the hearing, Mr. Bystran did not rule out this interpretation, although it was not his intent to limit his "determination" that *Davis*-case costs were unallowable to just the Frigitemp claims. He emphasized the use of the phrase, "settle the case," in the sentence to support his intent. (R4, tab 20; tr. 91-92, 380-82) Though Mr. Steckley's interpretation may not have been what Mr. Bystran intended, we conclude that it was not an unreasonable reading of Mr. Bystran's 26 August letter.

Moreover, in Mr. Steckley's view, GD had been successful on the false estimates claims and was entitled to recover the *Davis*-case costs attributable to that effort. He also testified that he did not reclassify the costs of the Frigitemp claims as unallowable or put them in set-aside because, in his view, the "costs would have been included within the 3 percent exclusion that we agreed to." (Tr. 380-82)

Mr. Bystran testified that he "quickly looked" at the 9 September proposal when he received it and "saw that instead of 100 percent being removed like I had directed on August 26th, the contractor only removed 20 percent." He was uncertain whether the letters had crossed in the mail and felt that he better "air this matter immediately." On 13 September 1994, he called Mr. Steckley to discuss his concerns. Mr. Bystran testified that once he learned that GD had received his letter before it sent the 9 September 1994 letter, he told Mr. Steckley that since you proposed the cost after you got my "written determination" of unallowability, "then double penalties may apply later." He recalled that Mr. Steckley disputed the unallowability of the *Davis*-litigation costs and indicated that full support would be provided shortly. Mr. Steckley had no specific recall of this conversation, but did remember conversations with Mr. Bystran during this time period during which Mr. Bystran indicated that all *Davis*-case costs were being questioned, while Mr. Steckley was "talk[ing] about the costs associated with the kickback case." Although Mr. Steckley did not recall any discussion of penalties during these conversations, GD's subsequent 22 September 1994 letter confirms that penalties were the subject of discussions subsequent to the 9 September letter. However, Mr. Steckley emphasized that he was unconcerned about any penalties being assessed because GD's Frigitemp-related defense costs were relatively small, and easily fit within the "3 percent standard exclusion," which was "designed to cover all unallowable costs." (Tr. 70-71, 383-84, 451-52)

By letter dated 22 September 1994, Mr. Steckley responded to Mr. Bystran's letter of 26 August 1994, with a detailed statement of GD's position, prepared with the assistance of outside counsel. GD maintained that "it is and has been General Dynamics' position that the legal expenses of the Davis litigation are allowable under FAR §§ 31-205.33 and 31-205.47." It argued broadly that "[d]isallowance of these costs would be grossly unfair to the company, which prevailed in full on the principal claims asserted by the Government." Specifically, GD asserted that:

> The Davis litigation consisted of two entirely separate Government claims against General Dynamics, the "false estimate" claims and the "kickback" claims. Of these, the false estimate claims dwarfed the kickback claims.
>
> With respect to the false estimate claims, in which the Government sought over $300 million in damages, General Dynamics prevailed in full and without qualification. . . . Thus, the ultimate settlement of the relatively minor kickback claims was not in any sense a "compromise" of the principal claims advanced by the Government. Since the overwhelming bulk of the legal expenses had been incurred in defending the false estimate claims, they are allowable under FAR.
>
> . . . .
>
> There can be no doubt but that the Company substantially prevailed in the litigation as a whole, and on that basis, should be entitled to include all of the costs of the litigation as allowable costs.

(R4, tab 21 at 1, 5) Though, as indicated above, GD was arguing the allowability of the costs of the Frigitemp claims based on its overall success in the *Davis* case, the letter also suggested that if the false estimates claims and the "substantially unrelated kickback claims that ultimately were settled" were treated separately and the costs apportioned, GD would still be entitled to a substantial recovery: "If the issue were viewed this way, General Dynamics would still be entitled to 95 percent or more of its legal expenses that related to the false estimate claims." (R4, tab 21 at 6)

With respect to the possible imposition of a penalty —a subject not mentioned in Mr. Bystran's 26 August 1994 letter —GD "emphatically" disagreed "with the suggestion" that its inclusion of the *Davis*-case costs "violates DFAR § 231.7002-1 and subjects General Dynamics to a penalty." General Dynamics reasoned that:

> There has been no "determination" that these fees constitute an unallowable cost. Your August 26, 1994 letter, which "requested" that General Dynamics remove these costs from its certified claims for incurred cost and billings, is not a determination. It merely set forth the Government's position regarding a debate that has been going on for some time. Certainly, that was our reasonable understanding of the purpose of your letter. The Company continues to maintain that these costs are allowable; we fully intended to respond formally to

> your August 26 letter, as we now have done; and we expected — and continue to expect —that we will be able to reach a favorable resolution of this matter with you.

Thus, in GD's view, Mr. Bystran's letter of 26 August was a "request[]," not a determination, that GD remove the costs and "merely set forth the Government's position regarding a debate that has been going on for some time." (R4, tab 21 at 6; tr. 384-85)

There is no evidence in the record that the contracting officer ever responded to Mr. Steckley's 22 September 1994 letter.[4] Moreover, there is no evidence in the record that the contracting officer ever addressed the substance of the penalty issue with GD in writing until his final decision. DCAA, however, did address the penalty issue.

On 27 September 1994, DCAA issued its final audit report to Mr. Bystran. With respect to the *Davis*-case costs, the report acknowledged the 20 percent reduction in order to meet the 80 percent limitation of FAR 31.205-47(e)(3). With respect to the exclusions, DCAA observed that "the exclusions represent $2,743,970 of unallowable costs that the contractor removed from the submission . . . ." The report then went on to identify amounts from certain accounts which DCAA determined to be "unallowable and would comprise the exclusions in [GD's] 9 September 1994 revised submission[.]" Having assigned costs up to the amount of the three percent exclusion, DCAA questioned the five percent or $156,815 of the total *Davis*-case costs that GD had identified as attributable to the Frigitemp kickback claims and recommended that Mr. Bystran's counsel review the percentage for accuracy. There is no indication in the report why DCAA chose not to treat the Frigitemp claims amounts as part of the exclusion and no testimony was offered on this point by the Government's witnesses. DCAA did not question the remaining 95 percent of the *Davis*-case costs —the false estimates claims element.

The report expressed the view that the $156,815 in questioned legal costs "are believed to be subject to the penalties provided in DFARS 252.231-7001." The amount of the first level penalty was identified as $156,815, equal to the amount of the disallowed cost. The report further observed that "the contractor may be subject to the second level penalty since the CACO [Mr. Bystran] sent a letter to the contractor dated 26 August 1994, which could be considered a determination of unallowable costs prior to the submission of the recertified Corporate Overhead Proposal dated 9 September 1994." The report computed a second level penalty of $313,630, equal to two times the disallowed costs and in addition to the level one penalty, for a total penalty of $470,445. DCAA offered to provide recommendations on interest on unallowable costs when it received the contracting officer's determination on the penalty to be assessed. (R4, tab 22 at 3, 9, 12; tr. 166-67, 170)

By letter dated 12 December 1994, Mr. Bystran sent the DCAA audit report of 27 September 1994 to Mr. Steckley. The letter identified the costs comprising DCAA's

breakdown of the three percent exclusion. With respect to the DCAA recommendation concerning the $156,815 in *Davis*-case costs, Mr. Bystran observed that "[t]his is a DCAA recommendation" and "does not represent the view of the CACO. This issue is pending legal review by [DCMA]." GD was requested to respond to the "details" in the letter, together with any "rebuttal" by 13 January 1995 (R4, tab 22; tr. 102-04)

By letter dated 15 December 1994 to Mr. Steckley, Mr. Bystran took the same position with respect to DCAA's final audit report dated 29 September 1994, covering the 1992 corporate office overhead proposal. DCAA's report had taken the same approach that it had taken in the audit report on the 1991 corporate overhead rate proposal with respect to the assignment of costs to the three percent exclusion, the five percent of legal expenses related to the Frigitemp element of the *Davis* case, and had proposed the same level of penalties. (Ex. A-2)

Mr. Steckley had not previously seen DCAA's breakdown, nor had he discussed it with DCAA. (R4, tab 22; tr. 387-88) By letter dated 22 December 1994, Mr. Steckley replied to both of Mr. Bystran's letters. He stressed GD's belief that the $156,815 in legal expenses identified in the 1991 proposal were "included in the three percent exclusion rate to which you, DCAA and General Dynamics agreed" and also took exception to DCAA's allocation of the $2.7 million to the specific costs. He said the same rationale applied to 1992 and emphasized that "it was agreed that a three percent exclusion factor would be used to protect the Government's interests while avoiding costly audit effort." (R4, tab 23)

Mr. Bystran testified that the 22 September 1994 letter was the first time he received anything from GD explaining the *Davis*-case court decisions and what the claims were. Based on a consideration of GD's position, he could see at the time that the parties were "going to be polarized." However, because "retrenching and saying that I won' t review what you have to say . . . would be arbitrary and capricious on my part," he could not refuse to review what GD had to say. Nevertheless, he still believed that all of the costs were unallowable because GD had settled by "consent or compromise." While he would listen to what was said, the Government's focus was on trying to settle any open years that were in negotiation or issue a final decision. (Tr. 70-73) At the hearing, he observed in this regard, in the context of the 1989 overhead proposal, that if they had numerous issues and the *Davis* case was only one of them, it was "theoretically highly likely" that in a "concession on total costs for the year," they could reach their objective of having the *Davis*-case costs disallowed, provided the amount involved was not too large. However, the amount of the *Davis*-case costs was too large. (Tr. 143-44)

The parties continued to discuss their positions into the following year in the context of the open corporate overhead proposals without any material progress. Mr. Bystran maintained his position that all of the *Davis*-case costs were unallowable, while Mr. Steckley believed that only the costs associated with the Frigitemp claims were

for consideration and those costs were covered by the three percent exclusion. GD no longer argued that the Frigitemp claims costs were allowable on the grounds that GD had substantially prevailed on the entire *Davis* case, as it had in its 22 September 1994.

Messers. Steckley and Bystran met again on 6 March 1995 to discuss the *Davis*-case costs in the context of attempts to reach a resolution of GD's 1989 corporate overhead proposal. The 6 March 1995 meeting was attended by GD counsel, including Mr. DeBruin. Mr. Raymond J. Eichman also attended on behalf of the Government. Mr. Eichman was a contract specialist who had been asked by Mr. Bystran to assist him in negotiating GD's 1989 corporate overhead rate proposal. During the meeting GD explained its position in detail.

The 6 March meeting was followed by a letter from GD's outside counsel dated 22 March 1995, explaining in further detail the company's position. GD agreed that "the legal fees and costs associated with the kickback case are unallowable," but argued that "those associated with the false estimates case are allowable to the extent provided in FAR 31.205-47." GD argued that the allowability of the costs rested on two grounds. First, each case —the false estimates case and the kickback case —constituted a different "proceeding" as that term is defined in FAR 31.205-47. Second, the intent of the regulation is that the underlying conduct should govern allowability. Since the false estimates case involved conduct unrelated to the kickback case and since the allegations were proven to be without foundation in law or fact, the cost of defending against these allegations should be allowable. It concluded that because the false estimates case was resolved in GD's favor on the merits prior to settlement, the legal defense costs pertaining to that case were fully allowable.

The letter also included an estimate that placed the total 1991 *Davis*-case costs at $3,863,112 (as opposed to the original set-aside amount of $3,920,337). (These estimates do not take into account the 80 percent limit of FAR 31.205-47(e)(3).) Of the total costs, $323,308 was estimated to relate to defense of the Frigitemp claims (as opposed to the previous estimate of $156,815), while the remaining $3,539,804 was estimated to relate to the defense of the false estimates case. (R4, tabs 22, 24; ex. A at 11-13; tr. 392-93)

Ultimately, GD was unsuccessful in persuading Mr. Bystran to change his mind. Mr. Bystran testified that his view "in no way" changed from 26 August 1994 until he issued his final decision in September 1995. (Tr. 141-42) After the 6 March meeting the parties had further discussions and made progress on some issues involved in the 1989 corporate overhead rate proposal, but were unable to bridge their differences with respect to the *Davis*-case costs. This led to a recommendation that the rates be unilaterally determined and by letter dated 26 July 1995, Mr. Bystran made a unilateral determination of GD' s 1989 corporate indirect cost rates, citing the FAR 52.216-7 ALLOWABLE COST AND PAYMENT (APR 1984) clause. The determination was based on the understandings reached during the negotiations, apart from consideration of the *Davis* case. The *Davis*-case costs

were excluded in their entirety. The letter stated that the determination did "not address the issue of penalties, which will be addressed in a separate action shortly." (R4, tab 26)

By letter dated 25 August 1995, GD asked that the unilateral determination be put in the form of a contracting officer's final decision. The letter emphasized that the "[c]ompany's position at all times was that it would agree to certain reductions in allowable costs in order to facilitate settlement" only if the Government agreed to allow a "major portion" of the *Davis* costs (R4, tab 27). GD subsequently renewed its request for a final decision so that it could bring the issue "to a head." In response, the Government decided to issue a final decision on the 1991 overhead proposal (tr. 198-99).

The Contracting Officer's Final Decision

On 20 September 1995, Mr. Bystran issued a contracting officer's final decision. The decision stated that "all legal costs associated with the [*Davis*] proceeding are expressly unallowable" pursuant to FAR 31.205-47 because "[f]inal disposition of [the *Davis* litigation] was by consent and compromise" (R4, tab 28 at 1, 2). The contracting officer specifically rejected GD's position that the *Davis* litigation involved two separate and distinct issues, and characterized the *Davis* case instead as "one single proceeding with several factually related claims all based in Fraud," and all of which "stemmed from contract actions with the United States Maritime Administration." The decision stated that if the "District Court and Appellate Court proceedings are deemed different, then the underlying alleged misconduct (Fraud) ties all related costs together as expressly unallowable costs since the costs of one proceeding are expressly unallowable," citing FAR 31.205-47(b)(5). (R4, tab 28 at 2)

Additionally, Mr. Bystran assessed a penalty of $1,731,900, allegedly representing the costs allocable to covered contracts, pursuant to DFARS 252.231-7001 PENALTIES FOR UNALLOWABLE COSTS. The propriety of the amount assessed is reserved for quantum. We note for the record that the decision states that the assessment was based on a determination that covered contracts amounted to 55.22 percent of *Davis*-case costs for 1991.

In assessing the penalty, the contracting officer reasoned that: (1) as a result of the settlement agreement, all legal costs associated with the *Davis* case were expressly unallowable; (2) GD had notice that the contracting officer considered the costs unallowable; and (3) GD, nevertheless, submitted an updated proposal on 9 September 1994, which included the costs. (R4, tab 28; tr. 75)

Mr. Bystran acknowledged at the hearing that GD did not in any way conceal the fact that it was billing the *Davis*-case costs after the district court's ruling in October of 1992 (tr. 130). He felt a penalty was appropriate because the general release language of the settlement agreement and the specific reference to each party bearing its own attorney's

fees "seemed to be the complete and sole mission [sic admission] by General Dynamics [] that they were not going to get their attorney's fees." He also considered it important that GD "had released the Justice Department" since "[t]he Justice Department had the best knowledge in the Government on what all of U.S. versus Davis was." In any event, he felt that the matter was resolved by "consent or compromise" within the meaning of FAR 31.205-47(b)(4) and/or (5). If it was one proceeding, it was covered by (b)(4) and if it were two proceedings, it was covered by (b)(4) and (5); the outcome was the same.

Mr. Bystran also believed that the penalty assessment may have been "lenient" because GD had proposed the costs after his 26 August 1994 determination of unallowability and double penalties could have been assessed. In reaching his decision on the penalties, he received and relied on advice of his counsel. (Tr. 74-76, 125-26, 130-31, 138).

GD timely appealed the contracting officer's final decision. In addition, after receiving the final decision, Mr. Steckley withdrew GD's offer to exclude three percent of the 1991 corporate overhead costs. The overhead costs were eventually audited by DCAA and at the time of the hearing Mr. Steckley and Mr. Eichman had negotiated a preliminary settlement disallowing between $200,000 and $300,000, as opposed to the original exclusion of $2.7 million. The *Davis*-case costs were set-aside from the settlement in light of the appeal. (R4, tab 26; tr. 400-01)

DISCUSSION

GD asks the Board to determine that: (1) the Government's refusal to allow the costs incurred in defending the false estimates portion of the *Davis* litigation in its 1991 overhead proposal was erroneous; (2) GD's actions in connection with its 1991 overhead cost proposal do not support the imposition of a penalty. We deal first with the question of the allowability of the *Davis*-case costs and then we address the propriety of the penalty assessment.

Allowability of the *Davis*-Case Costs

Pertinent Statutes and Regulations

We include in the appendixes relevant text from the pertinent statutes and regulations. The parties have focused on FAR 31.205-47 as in effect on 22 January 1991 since this is the version that was cited in the contracting officer's letter of 26 August 1994 (tr. 96). We include here the key provisions of that regulation and make reference to the appendix for the more complete text:

(a) Definitions.

. . . .

"Fraud," as used in this subsection, means (1) acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents, (2) acts which constitute a cause for debarment or suspension . . . and (3) acts which violate the False Claims Act, 31 U.S.C., sections 3729-3731, or the Anti-Kickback Act, 41 U.S.C., sections 51 and 54.

. . . .

(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 or employees) are unallowable if the result is –

. . . .

(2) In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct;

. . . .

(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 (3) of this subsection (but see paragraphs (c) and (d) of this subsection); or

(5) Not covered by subparagraphs (b)(1) through (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 (4) of this subsection.

(c) To the extent they are not otherwise unallowable, costs incurred in connection with any proceeding under paragraph (b) of this subsection commenced by the United States that is resolved by consent or compromise pursuant to an

> agreement entered into between the contractor and the United States, and which are unallowable solely because of paragraph (b) of this subsection, may be allowed to the extent specifically provided in such agreement.
>
> . . . .
>
> (e) Costs incurred in connection with proceedings described in paragraph (b) of this subsection, but which are not made unallowable by that paragraph, may be allowable to the extent that:
>
> . . . .
>
> (3) The percentage of costs allowed does not exceed the percentage determined to be appropriate considering the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate. Such percentage shall not exceed 80 percent. However, if an agreement reached under paragraph (c) of this subsection has explicitly considered this 80 percent rule, then the full amount of costs resulting from that agreement shall be allowable.

(Appendix II.B)

The General Position of the Parties

GD argues that the *Davis*-case costs incurred in defense of the false estimates element of the case are allowable overhead costs, subject to the 80 percent limitation of FAR 31.205-47(e)(3), because GD's defense was successful. GD has not argued that the Frigitemp claims could not have resulted in liability and it is undisputed that the *Davis*-case costs associated with the defense of the Frigitemp claims are unallowable. In GD's view, apportionment of costs between the successful and unsuccessful elements, with the costs of the former being allowed, would be entirely consistent with the intent of Congress. By analogy, it points to the Supreme Court's decision in *Hensley v. Eckerhart*, 461 U.S. 424, 434-35, 76 L. Ed. 2d 40 (1983) (authorizing apportionment of attorney's fees for the prevailing party although the act in question was silent).

The Government, on the other hand, argues that all of the *Davis*-case costs are *per se* unallowable because the case was resolved by "consent or compromise" under FAR 31.205-47(b)(4) or under (b)(5), if one concludes that more than one proceeding is

involved. It also questions the idea of apportionment, emphasizing that there is no provision requiring it. It argues that if the contractor is responsible for some material wrongdoing, all costs directly related to the proceeding are disallowed. It maintains that the Government was not given the task of having to prevail on all charges in a case in order to trigger total unallowability. It also takes exception to the argument that the *Davis* case consisted of two unrelated elements, emphasizing that "the same legal theories were used in support of both the Frigitemp claim and the claims with respect to the other individual cost estimates." (Gov' t br. at 38; Gov' t reply br. at 2)

Basic Considerations

Under the "American rule," each party ordinarily bears its own attorney's fees (*see Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 247, 44 L. Ed. 2d 141 (1975)), absent explicit statutory authority, such as the Equal Access to Justice Act, for example, to the contrary (*Key Tronic Corp. v. United States*, 511 U.S. 809, 819, 128 L. Ed. 2d 797 (1994)). Nevertheless, the expenses incurred by a party in litigation are recognized costs of doing business and the cost principles promulgated by the Government over the years have uniformly recognized the allowability of contractor legal fees, within certain parameters. And, we have recognized that legal costs incurred by a contractor in connection with its overall business may in appropriate cases be included in indirect cost pools chargeable to Government contracts. *See, e.g., Hayes International Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076 at 52,723-25; *Allied Materials & Equipment Company, Inc.*, ASBCA No. 17318, 75-1 BCA ¶ 11,150 at 53,086; and *Hirsch Tyler Company*, ASBCA No. 20962, 76-2 BCA ¶ 12,075 at 57,983-85. Currently, FAR 31.205-47 exists in tandem with FAR 31.205-33, Professional and Consultant Costs, to provide definitive guidance regarding the allowability of legal defense costs.

Several interrelated questions are presented. The basic question, of course, is whether GD's legal proceedings costs may be apportioned for purposes of cost allowability when some of the claims succeed and others fail. There is also the question whether the settlement of the *Davis* case operated as a "consent or compromise" under FAR 31.205-47(b)(4). The answer to this question requires not only an interpretation of the 1994 settlement agreement, but an understanding of the FAR 31.205-47 cost principle and its statutory basis. Underlying all of these issues and central to their resolution is the question whether the *Davis*-case can fairly be said to have involved two distinct elements. We deal with this question first.

The *Davis*-case Claims

The *Davis*-case involved multiple claims stemming from alleged activity that would meet the definition of "fraud" in FAR 31.205-47(a). Both the FCA and AKA are specifically mentioned as within the meaning of the definition. However, it seems clear to us that the activities that gave rise to the claims are quite different and fall into two distinct

categories. On the one hand, there are what the court of appeals labeled the Frigitemp claims —namely, the claims premised on the Frigitemp-kickback scheme. The initial focus was on the individual defendants and alleged violations of the AKA and the FCA based on the scheme. The amended complaint added GD and, while the AKA did not provide a remedy vis-a-vis GD, sought recovery on the basis of the FCA or common law remedies, asserting that the kickbacks resulted in grossly inflated subcontract estimates for the joiner and sphere work. It is evident that but for the kickback scheme, the Frigitemp claims would not be viable.

The false estimates claims, on the other hand, were first advanced in the third amended complaint and became the "main theme" of the Government's case. The false estimates claims questioned all of the cost data and estimates that GD submitted in support of the CDS application based on variances from various GD internal cost estimates. GD's overall exposure was significantly greater, potentially $300 million by one estimate. It could be said that the Frigitemp claims were subsumed in the false estimates claims in the sense that the variance between the allegedly inflated joiner and sphere estimates and GD's internal estimate of expected costs would be accounted for in the recovery that the Government would obtain if its theory were accepted. However, if the effects of the kickback scheme were removed from the calculation, the Government's false estimates claims for the joiner and sphere work would still be viable to the extent the estimates unaffected by the kickback scheme exceeded the various GD internal cost estimates. Thus, the false estimates claims do not depend upon the continued viability of the Frigitemp claims.

As the excerpts from the district court's opinion make clear, GD prevailed completely on the false estimates claims. The district court specifically found that "[GD's division] truthfully reported all the underlying factual data —the actual hours incurred, the vendor quotations, the status of production at Charleston, and all other construction and finance matters —on which GD's estimates were based." And, in this regard, the court even relied on the accuracy of GD's revenue and delivery estimates as the basis for its "for the record only" computation of damages the Government might have suffered as a result of the Frigitemp kickbacks.

In summary, we do not believe that the false estimates claims, which have been analogized to violations of the Truth in Negotiations Act, and the Frigitemp claims stem from the same wrongdoing.[5] The dismissal of the false estimates claims was affirmed on appeal, while the claims based on the Frigitemp-kickback scheme were remanded for hearing. In this context it would be disingenuous to treat the *Davis*-case as simply involving "several factually related claims all based in Fraud" and all "stemm[ing] from contract actions" with MarAd, as the contracting officer's final decision would have us do (R4, tab 28 at 2). The Government's complaints reflect a distinction, the parties maintained the distinction in the trial and briefing of the case, and, more importantly, both the district court

and the court of appeals recognized the distinction. We believe it would be a mistake for us to ignore it here.

Apportionment of *Davis*-case Costs

GD's search of the legislative and regulatory history leads it to conclude that neither Congress nor the regulators dealt with a situation "where there were two distinct fraud claims in one lawsuit and the contractor completely prevailed on one claim prior to settling the other, much smaller claim." It maintains that the intent of Congress was to disallow "defense of fraud" costs where the contractor either has been found to have engaged in wrongdoing or has compromised a fraud claim, but to allow the costs where the contractor has prevailed.

There is no real dispute that Congress intended to permit recovery, albeit with significant limitations, when a contractor's defense is successful. This intent, it has been pointed out, is evident in the limitation of allowable costs to 80 percent of the costs incurred. *See* 10 U.S.C. § 2314(k)(5)(B) and FAR 31.205-47(e)(3). *See also DynCorp*, ASBCA No. 49714, 97-2 BCA ¶ 29,233 at 145,430 (Congress' objective in passing the Major Fraud Act was to provide for limited recovery of contractor legal defense costs). It is also plain that there can be no recovery for an unsuccessful defense. The focus is on contractor wrongdoing or misconduct. One of the "guiding principles" motivating the DAR Council committee responsible for recommending changes to implement the Major Fraud Act was that the "Government should not pay for wrongdoing, the defense of wrongdoing, or the consequences of wrongdoing by contractors" (R4, tab 88, 29 November 1988 Memorandum for the Director, DAR Council Report, Subject: DAR Case 88-310, Allowability of Litigation Costs, at 3), quoted with approval in *Boeing North American, Inc.*, ASBCA No. 49994, 00-2 BCA ¶ 30,970 at 152,848, *vacated on other grounds*, *Boeing North American, Inc. v. Roche*, 282 F.3d 1320 (Fed. Cir. 2002). This emphasis is also reflected in 10 U.S.C. § 2324(k)(5)(C), which bars recovery of proceeding costs that would otherwise be allowable if they are unallowable in another proceeding "involving the same contractor misconduct," and in its implementation in FAR 31.205-47(b)(5) (proceeding costs unallowable "where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable . . . .") *See also DynCorp*, ASBCA No. 49714, 00-2 BCA ¶ 30,986 at 152,931, *aff'd on reconsid.*, 00-2 BCA ¶ 31,087 (reviewing the legislative history that led to the adoption of 10 U.S.C. § 2324(k)(5)(c)).

One thing both parties seem to agree on is that the issue of apportionment is not specifically addressed in any of the pertinent legislative or regulatory history and we have found no specific references. However, on the surface, apportionment would seem appropriate if Congressional intent is to be fully served where, as here, the claims stem from distinct types of conduct and the contractor has prevailed on the distinct claim elements not involving the same wrongdoing. From an examination of the history that is

available and focusing on the language of the statute and regulation, we believe that apportionment is required under the circumstances of this case.

Under 10 U.S.C. § 2324 (Appendix I.C) and FAR 31.205-47, it is the outcome or "result" of the proceeding or, in the event of settlement, "disposition of the matter," that is of critical importance. And, in this regard, we believe that the provisions authorizing settlements point to the answer to the question of whether apportionment is prohibited. Under 10 U.S.C. § 2324(k)(3), "[i]n the case of a proceeding referred to in paragraph (1)" —a civil proceeding in this case —

> that . . . is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the *costs incurred by the contractor in connection with such proceeding that are otherwise not allowable as reimbursable costs under such paragraph may be allowed to the extent specifically provided in such agreement.* [Emphasis added]

This statutory theme is reflected in FAR 31.205-47(c):

> To the extent they are not otherwise unallowable, costs incurred in connection with any proceeding under paragraph (b) of this subsection commenced by the United States that is resolved by consent or compromise pursuant to an agreement entered into between the contractor and the United States, and which are unallowable solely because of paragraph (b) of this subsection, may be allowed to the extent specifically provided in such agreement.

Under the FAR 31.205-47(e)(3) implementation of 10 U.S.C. § 2324(k)(5)(B)(i) and (ii), the 80 percent ceiling may be exceeded, provided the settlement agreement "explicitly considered this 80 percent rule." If the agreement has explicitly considered the ceiling, then "the full amount of costs resulting from that agreement shall be allowable."

There is no hint in the language used in 10 U.S.C. § 2324(k)(3) that an apportionment is prohibited. On the contrary, the implication in 10 U.S.C. § 2324(k)(3) is that some proceeding costs might be allowable at the time of settlement, for it is the "costs incurred by the contractor in connection with such proceeding that are *otherwise not allowable as reimbursable costs*" that are expected to be the subject of the settlement. Moreover, as the Government has conceded —correctly, in our view —costs could be apportioned by agreement of the parties. The costs to be apportioned may even be unallowable and the 80 percent ceiling may be exceeded.

We appreciate the pragmatic considerations that prompted the flexibility provided by 10 U.S.C. § 2324(k)(3) to fashion appropriate settlement agreements. We believe, however, the settlement latitude provided carries with it an understanding that apportionment is not *per se* objectionable on general policy grounds. Indeed, a recognition that the goal of not rewarding a contractor for potential wrongdoing may yield to a pragmatic settlement, one which compensates a contractor for otherwise unallowable costs, argues for apportionment in those instances where a contractor has completely prevailed on separate claims, not involving the same wrongdoing as the claims being compromised, unless the settlement agreement precludes recovery.

Consent or Compromise Under FAR 31.205-47(b)(4)

The argument has focused on FAR 31.205-47(b)(4) and we agree that it is pivotal. Since we are dealing with a "civil proceeding" involving an allegation of "fraud or similar misconduct" covered by subparagraph (b)(2), under subparagraph (b)(4), costs are unallowable when there is a "disposition of the matter by consent or compromise if the proceeding could have led" to ". . . a finding of contractor liability . . . ." The Government's principal argument is based on its understanding of the meaning of the word "proceeding," as used in the regulation (and by implication in the statute).

At the outset, we agree with the Government that there is only one "proceeding" involved here and that is the *United States v. Davis* proceeding, which includes the appeal process. Though a separate proceeding notion was indicated in GD's letter of 22 March 1995, we do not understand this to be GD's current position (*cf*. app. reply br. at 5-6), as the Government has suggested (Gov' t br. at 38). If it were, we would not agree. However, as we have emphasized, it is the result or, in this case, the "disposition" that is key. Consequently, we do not place the same importance on the word "proceeding" that the Government does.

In our view, the word "proceeding" is used in a general sense and focuses on the process employed in a particular proceeding, typically a legal proceeding. Black's Law Dictionary offers a helpful definition: "The regular and orderly progression of a lawsuit, including all acts and events between the time of commencement and the entry of judgment." BLACK' S LAW DICTIONARY 1221 (7th ed. 1999); see also WEBSTER' S THIRD NEW INTERNATIONAL DICTIONARY 1807 (1986) ("proceedings" *pl*: the course of procedure in a judicial action or in a suit in litigation").

Used in the general sense, the word "proceeding" focuses on the form and manner of conducting business by the tribunal or investigatory body. The emphasis is on process as opposed to substance. This is evident in the definition of "proceeding" suggested by the Government in its citation to *Rice v. United States*, 356 F.2d 709, 712 (8th Cir. 1966) (meaning of "proceeding" in context of criminal statute making it an offense to impede or

intimidate "any witness in any proceeding pending before any department or agency of the United States"):

> "Proceeding" is a comprehensive term meaning the action of proceeding —a particular step or series of steps, adopted for accomplishing something. This is the dictionary definition as well as the meaning of the term in common parlance. Proceedings before a governmental department or agency simply mean proceeding in the manner and form prescribed for conducting business before the department or agency, including all steps and stages in such an action from its inception to its conclusion.

Moreover, the statutory and regulatory emphasis has been placed on identifying the various proceedings, either by type (civil, criminal, or administrative) or by jurisdiction (federal or state). And, by virtue of the Major Fraud Act of 1988, the type of "proceeding" was expanded to "include[] an investigation." Thus, we do not understand the word "proceeding" to be aimed at the substance of what is at stake in the proceeding.

The focus of the Major Fraud Act is on the "disposition" of the "proceeding," whether it be criminal, civil or administrative. "Disposition" looks to the outcome of the proceeding, and invites an examination of the substance of what was in controversy in the proceeding. In this context, "to dispose" may mean "to arrange or settle a matter finally or definitively: make disposition; *esp*: to regulate the fate or condition finally or definitively . . . ." WEBSTER' S THIRD NEW INTERNATIONAL DICTIONARY 654 (1986). This idea is elaborated on in FAR 31.205-47(b)(4) in the phrase, "disposition of the matter." The word "matter" refers to the substance of the proceeding. "Matter" can broadly be defined as "a subject (as a fact, event or course of events or a circumstance, situation, or question) of interest or relevance" or "something that is the subject of disagreement, strife or litigation." WEBSTER' S THIRD NEW INTERNATIONAL DICTIONARY 1394 (1986). GD suggests that "matter" could be given a narrow definition as referring to a specific claim, citing, for example, a Black's Law Dictionary definition of "matter:" "Substantial facts forming basis of claim or defense; facts material to issue; substance as distinguished from form; transaction, event, occurrence; subject-matter of controversy." BLACK' S LAW DICTIONARY 822 (5TH ED. 1979); *see also Richman Brothers Records, Inc. v. U.S. Sprint Communications Co.*, 953 F.2d 1431, 1439-40 (3d Cir. 1991), *cert. denied*, 505 U.S. 1230 (1992) (using Black's definition of "matter" to define the word more narrowly than "action" and concluding that "matter" referred to a specific claim rather than the entire case). We think the broader definition is intended here and, in our view, it encompasses the narrower definition suggested by GD. The use of the term "matter" invites an examination of what was involved in the proceeding, that is, the substance of the proceeding. Because the usage is generic, the term can encompass a single claim or multiple claims or charges, which may or may not stem from the same wrongdoing.

Finally, we note also that the word "matter" takes the place of the earlier reference in the same provision to "charges." As the Government has noted, Defense Acquisition Circular 76-39, which promulgated the "Defense of Fraud Proceedings" cost principle in October 1982 as DAR 15-205.52(a) (Appendix II.A.), used the word "charges," which are the subject of the proceeding. The prefatory comments refer to each of the covered proceedings as an "action" and explain that the costs are to be disallowed if the "action . . . results in a conviction or judgment against the contractor or . . . is resolved by consent or compromise." (R4, tab 125) "Action" in this usage would be equated to "proceeding," while, in our view, "charges" refers to the substance of the proceeding.

The word "charge" was subsequently used —to the same effect, in our view —in 10 U.S.C. § 2324(e)(1)(C) when the Defense Procurement Improvement Act of 1985 (Appendix I.A.) was adopted: "Costs incurred in defense of any civil . . . fraud proceeding" were unallowable "where the contractor is found liable or has pleaded nolo contendere to a charge of fraud . . . ." The Government notes that the original House version of the legislation provided for unallowability "unless the contractor is found not to be liable in any way for the alleged fraud." This language was dropped in favor of language which, with slight revision, led to the language reflected in the statute: "where the contractor is found liable for fraud or has pleaded nolo contendere to a charge of fraud." The amendment offered "more orthodox statutory language" to "state [] in a positive rather than in a rather convoluted negative. And it meets the situation of eliminating the phrase ' in any way' which seems to suggest that the adverse action can be taken if there is no finding of fraud or plea of nolo contendere —And I do not think that was what was really intended." (*Full Committee Consideration of H.R. 2419, S.J. Res. 108, H.R. 2554, H.R. 2397: Hearings before the House Committee on Armed Services*, H.A.S.C. No. 99-32 at 67, 73-74 (1985) (Remarks of Congressman Bateman, sponsor of the amendment); R4, tab 50) The Government argues in reliance on the comments of the amendment's sponsor that the language was adopted simply for reasons of style and clarity (Gov' t br. at 25). From this premise, it finds support for its argument that from the inception of the regulatory and statutory coverage, the intent was to bar recovery if any aspect or part of the civil proceeding resulted in a determination of liability.

We are not persuaded that finding a meaning in questionable language that was not adopted is a sound way to understand the language actually used. However, it seems to us that the elimination of the phrase "in any way" rules out a determination of unallowability short of a finding of liability or plea of nolo contendere under this provision. Moreover, the deletion of the phrase, when viewed against the slim history that is available, could also be used to suggest an intent to distinguish between matters that are resolved in the contractor's favor and those that are not.

Finally, we agree with the Government's observation that it would be unreasonable to assume that in passing the Major Fraud Act, Congress "would not have known that a legal

proceeding commonly contains more than one issue, count or claim . . . ." (Gov' t reply br. at 2) However, our analysis of the pertinent statutory and regulatory history in light of this understanding has led us to a different conclusion than the one urged by the Government. Indeed, the use of the term "charges" in the original 1982 cost principle, which became the basis for subsequent legislation, showed an awareness that a proceeding can involve multiple, and we would say, potentially separate, matters.

In summary, Congress intended to permit recovery of legal defense costs when a contractor was successful, while insuring that a contractor not be rewarded for wrongdoing. To properly reflect these dual goals, we believe apportionment is required for those claims in a proceeding on which the contractor has prevailed and which do not involve the same wrongdoing as the claims that are compromised, unless the settlement agreement provides otherwise. Consequently, we hold the Major Fraud Act of 1988, as implemented by FAR 31.205-47(b)(4), requires apportionment of contractor legal defense costs between unsuccessful and successful claims of the Government when the successful claims do not stem from the same wrongdoing as the unsuccessful claims, and there is a reasonable basis for apportionment of the costs.

Effect of the 1994 Settlement Agreement Under FAR 31.205-47(e)

The Government has further argued that while apportionment by agreement is permissible, it may only be authorized by the agreement (Gov' t br. at 38). We think a requirement that apportionment must be expressed in the agreement before there can be a recovery goes too far. It would not square with what we understand to be Congress' intent to permit recovery where the contractor has already completely prevailed on claims stemming from separate unrelated allegations of wrongdoing by the time a settlement is reached. We do agree, however, that the agreement must be consulted before making a determination and that under its terms recovery or apportionment might be ruled out.

The Government argues that GD' s *Davis*-case costs are unallowable because of paragraph 7 of the July 1994 settlement agreement that: "This action shall be dismissed as against General Dynamics with prejudice and without costs or attorney's fees to either party." This is also the provision relied on by the contracting officer in his "reading" of the meaning of the settlement agreement, albeit a reading based on a review of less than the entire agreement. In the Government's view, GD released the right to bill the Government for the expenses. It urges not to look behind what it says is the clear meaning of the agreement.

There is a difference between an award of attorney's fees as an item of ancillary relief or damages in a particular litigation and the allowability of attorney's fees as a contract cost pursuant to contract provisions allowing such reimbursement. The former are generally prohibited, as discussed below, while the later are not. And, we view "costs" borne by a party in a court proceeding from the same perspective.

A provision like paragraph 7 is typical in settlement agreements generally, although GD's branding the provision "boilerplate" tends to obscure the fact that it must be given meaning. Looking only to the settlement agreement, we would conclude that: (1) costs and attorney's fees were not included in the settlement consideration; and (2) neither party would bear the other's costs or attorney's fees as a byproduct of the suit itself. With respect to the attorney's fees, the general language used is a short hand way of reflecting the applicability of the American Rule: the prevailing litigant is ordinarily not entitled to attorney's fees from the loser. Insofar as the United States is concerned the American Rule, and the exceptions to it, is embodied in 28 U.S.C. § 2412. The provision prohibits an award of attorney's fees as an element of relief against the United States, unless one of the statutory exceptions is available or, a fee-shifting statute, like the Equal Access to Justice Act, for example, requires a different result. With respect to costs, 28 U.S.C. § 2412(a) also provides that a judgment for costs, as enumerated in 28 U.S.C. § 1920, may be awarded to a prevailing party in any civil action by or against the United States. "Costs" in this context refers to such things as docket fees, printing and copying fees, court reporter fees, witness fees and compensation for court appointed experts or interpreters. Here, the parties plainly agreed to handle "costs" the same way as attorney's fees.

Based on our reading, the provision only speaks to attorney's fees and costs that would otherwise be direct damages or an item of ancillary relief. The general language used simply does not reach the question of the allowability of the *Davis*-case costs when included in GD's corporate overhead. Moreover, the parties' stipulation confirms that the allowability of *Davis*-case costs as an element of an indirect cost recovery was never discussed. And, with respect to "costs," the discussion did not go beyond GD's willingness as part of an overall settlement to give up a judgment for costs in the face of DOJ's funding concerns.

In addition, the parties never discussed the false estimates claims during their settlement discussions. At the time of settlement, GD had prevailed entirely on the false estimates claims and, as the parties have stipulated, the Government's time for seeking further review had expired. The agreement purported to dispose of "all claims against [GD] in the [district court action]" and release GD "from any civil claim the Government has or may have under common or statutory law against [GD] on account of the incident or circumstances described in the complaints in this action." The false estimates claims would be covered by the broad general release language. However, the broad release language would not bring the false estimates claims within the ambit of the "consent or compromise" provisions of FAR 31.205-47(b)(4) since the proceeding "could [not] have led to" a finding of liability on the false estimates claims at the time of settlement.

In summary, the general language used referred to attorney's fees and costs as an element of ancillary relief or damage. The settlement agreement contained no express statement precluding GD from charging *Davis*-related costs to overhead accounts allocable

to its federal contracts. By the Government's own admission, it never sought during settlement negotiations to preclude GD from including legal fees in its overhead pool. As our decisions confirm —and as Congress itself recognized in enacting the Major Fraud Act —inclusion of attorney's fees in contractor overhead pools is a standard practice, and one that the Government could have anticipated GD would follow in the absence of any express prohibition.

Accordingly, we conclude that GD is entitled to recover the *Davis*-case costs included in its 1991 corporate overhead proposal associated with its successful defense of the false estimates claims, subject to the 80 percent limitation of FAR 31.205-47(e)(3).

Propriety of the Penalty Assessment

Pertinent Statutory and Regulatory Coverage

The penalty provisions of 10 U.S.C. § 2324 (Appendix I.D.) were a response to Congressional concerns that there was little incentive for contractors to eliminate unallowable costs from complex cost submissions. The broad purpose of the penalty provisions (as restated in the conference report accompanying the 1993 Defense Authorization Act amendment) was "to ensure that contractors, rather than the Government bear the burden of assuring that contractor submissions for reimbursement of costs on government contracts do not include unallowable costs." (H.R. Conf. Rep. No. 102-966, 728, *reprinted in* 1992 U.S.C.C.A.N. 1769, 1819; R4, tab 81)

Congress was concerned with ending what Congressman Bill Nichols, Chairman of the Investigations Subcommittee, and an author of the penalty provision, referred to as a "cat-and-mouse game," namely, "a game in which the cost of an item is submitted regardless of whether it's allowable, and the burden is placed on the Government auditors to identify and disallow the item." *Review of Allowable Costs in Overhead Submission[s] of Defense Contractors*: Joint Hearings before the Seapower and Strategic and Critical Materials Subcommittee and the Investigations Subcommittee of the House Comm. on Armed Services, 99th Cong. 52, 60 (1985); R4, tab 49.[6]

Since the audit of GD's 1991 overhead proposal was initiated on or after 23 October 1992, the DFARS implementing regulations (Appendix II.C) in effect on 9 September 1994 and at the time of the contracting officer's 20 September 1995 final decision provided for the imposition of a penalty equal to the amount of the disallowed cost, plus interest if applicable, if "the cost is *expressly unallowable* under a FAR or DFARS cost principle that defines the allowability of specific selected costs . . . ." (DFARS 231.7002-1(a)(1)) (Emphasis added) Moreover, if the cost had been determined to be unallowable for the particular contractor before proposal submission, a penalty of two times the amount of the disallowed cost, plus interest if applicable, could be imposed.[7]

The General Position of the Parties

The Government seeks to justify the penalty on the grounds that GD continued to include *Davis*-case costs in its 1991 corporate overhead proposal, even though the contracting officer had already "determined" in his 26 August 1994 letter that the costs would be disallowed. In the Government's view, the *Davis*-case expenses fall squarely within the meaning of "expressly unallowable under a FAR . . . cost principle" (DFARS 231.7002-1(a)(1)), pointing to FAR 31.205-47(b)(4) as the regulatory source for its position.

The Government also argues that GD's conduct during the submission and discussion of its cost proposals evidenced the type of conduct Congress was trying to eliminate when it provided for the penalties and underscores the validity of the assessment of the penalty. It says that once GD submitted its notice of intent to bill, it made no effort to keep the Government advised of subsequent developments that directly affected allowability. The consequences were significant: first, the contracting officer settled the overhead proposal for 1988 without knowing that the case was on appeal; second, "DCAA completed its audits of the 1991 and 1992 proposals and, for all intents and purposes, found Davis expenses to be allowable, not knowing the Davis case had been appealed, reversed and remanded in part, and finally settled." Moreover, the GD official who had direct responsibility for submission of the overhead proposals testified that he learned about the settlement, but took no steps to notify the Government. "It was only through happenstance that the Government learned of it." (Gov' t br. at 50-51)

GD argues that the contracting officer gave great weight to an incorrect understanding of the language used in the settlement agreement. It asserts that it was never advised until it received the final decision that the contracting officer considered the *Davis*-case costs "expressly unallowable," although the Government made "vague threats" that penalties would be assessed. It contends that the purpose of the penalty provisions was to give contractors an incentive not to conceal costs, but at the same time not to punish good faith differences of opinion over cost allowability issues. Because it clearly advised the Government of its treatment of the *Davis*-case costs and argued its position on allowability in good faith, it contends that the imposition of a penalty was improper and contrary to the purpose of the regulation. (App. br. at 64-66; app. reply br. at 2-4)

We conclude that the Government has failed to establish its entitlement to a penalty.

The Basis For Our Review

Under 10 U.S.C. § 2324(d)(1) and (2), the assessment of a penalty under 10 U.S.C. § 2324(a) is treated as a final decision and may be appealed in accordance with the Contract Disputes Act, 41 U.S.C. § 605-613. On appeal, the Government bears the burden of proof

since it is its claim. Our review is *de novo*. *See, e.g., Kinetic Builders v. Peters*, 226 F.3d 1307, 1318 (Fed. Cir. 2000); *Assurance Co. v. United States*, 813 F.2d 1202, 1206 (Fed. Cir. 1987); *Wilner v. United States*, 24 F.3d 1397 (Fed. Cir. 1994) (*en banc*); *Space Age Engineering, Inc.*, ASBCA No. 26028, 82-1 BCA ¶ 15,766 at 78,032.

The "Expressly Unallowable" Standard

The penalty provisions adopted in the Defense Procurement Improvement Act of 1985 called for penalties when there was "clear and convincing evidence" that a cost was unallowable. *See* P.L. No. 99-145, § 911(a), 8 November 1985, 99 Stat. 682. However, on 23 October 1992, the National Defense Authorization Act for Fiscal Year 1993 prospectively changed the "clear and convincing evidence" standard to require a determination that "a cost submitted by a contractor in its proposal for settlement is expressly unallowable." *See* Pub. L. No. 102-484, § 818(b), 23 October 1992, 106 Stat. 2458.

The adoption of an "expressly unallowable" standard was prompted by a concern that the "clear and convincing evidence" standard would require the assessment of a penalty even where there were reasonable differences of opinion on the issue of unallowability. The proposal originated in the Senate and was adopted in conference. As stated in the Senate Report accompanying its version of the 1993 Defense Authorization Act,

> [c]urrent law, 10 U.S.C. § 2324, requires a contractor who submits a proposal for settlement of costs to pay a penalty if the submission contains unallowable costs. This serves an important deterrent to fraudulent or negligent submissions. *As presently worded, however, the statute required that penalties be assessed even when there are reasonable differences of opinion on the issue of allowability or when unallowable costs were included inadvertently in a submission*. The committee recommends a provision which would revise current law. Under the revision, penalties would be applied if the submission contains indirect costs that are expressly unallowable under the Federal Acquisition Regulation or the Defense Federal Acquisition Supplement. [Emphasis added]

(S. Rep. No. 102-352, at 237 (1992); R4, tab 82. *See also* H.R. Conf. Rep. No. 102-966, 728, *reprinted in* 1992 U.S.C.C.A.N. 1769, 1819; R4, tab 81)

What constitutes an "expressly unallowable" cost for purposes of 10 U.S.C. § 2324 and the implementing DFARS regulations is not specifically defined. FAR 31.001 and Cost Accounting Standard (CAS) 405.20(a)(2) both define an "expressly unallowable" cost as

"a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable." GD has drawn attention to the CAS Board's preamble to CAS 405.20(a)(2), which suggests that a cost is not "expressly unallowable" where the contractor had made a "good faith effort" at compliance with applicable cost principles. (R4, tabs 97-98)

We do not believe the determination of "express unallowability" can turn solely on whether the contractor made a "good faith effort" to comply with the particular cost principle involved, although subjective good faith is important. We think Congress intended the standard to be an objective one. The FAR and CAS definitions of "expressly unallowable" point to the need to examine the particular principle involved in light of the surrounding circumstances. Moreover, since Congress adopted the "expressly unallowable" standard to make it clear that a penalty should not be assessed where there were reasonable differences of opinion about the allowability of costs, we think the Government must show that it was unreasonable under all the circumstances for a person in the contractor's position to conclude that the costs were allowable. The scope of the inquiry will vary with the clarity and complexity of the particular cost principle and the circumstances involved. Under 10 U.S.C. § 2324(e)(1)(F), for example, the "costs of alcoholic beverages" are unallowable and may leave little room for debate, short of a discussion of alcohol levels. On the other hand, the analysis required under 10 U.S.C. § 2324(k) is far more complicated and the answer not necessarily obvious, particularly when a settlement agreement must be consulted. *See also* 10 U.S.C. § 2324(e)(1)(N), now (e)(1)(O).

The Government's arguments fail to account for the fact that the *Davis*-case costs simply were not hidden in any of GD's proposals. Everything was in the open. From the time of GD's notice that it was seeking recovery of its *Davis*-case costs in view of the district court's favorable decision forward, the Government knew precisely what GD was doing with respect to the costs. Moreover, the *Davis*-case costs were, in fact, allowable from the time of the district court's opinion until, at the earliest, the Second Circuit ruled. Only the Frigitemp claims were remanded for trial; the district court was otherwise affirmed. Thus, in the absence of a predetermination of unallowability, no part of the *Davis*-case costs were, in fact, "unallowable," let alone "expressly" so. It is only when the settlement agreement is signed that the question is properly posed.

We also do not agree with the Government's assertion that GD "promoted a distorted view" of the *Davis* case and "persisted in mischaracterizing the case" to DCAA and the contracting officer "as consisting of two unrelated claims when in reality the supposed ' kickback' claim was part and parcel of the Government's basic claim that MarAd was defrauded through the submission of false estimates." (Gov' t br. at 51) This matter was the subject of serious and reasonable disagreement between the parties and, as already indicated, our analysis of the statutes, the regulations and the settlement agreement has led us to conclude that GD's basic position with respect to apportionment and the

allowability of the costs associated with the false estimates claims is sound. Without discounting the Government's interpretation, we believe that by any measure, GD's position was a reasonable one insofar as the false estimates claims are concerned. Consequently, we conclude that the Government has failed to establish that these costs were "expressly unallowable."

The Frigitemp claims, however, require a different analysis. The settlement of the *Davis*-case left open the question of whether the Frigitemp claims, if not compromised, "could have led to" a "finding of contractor liability" (FAR 31.205-47(b), (4)). The record does not indicate that an argument based on showing that the Frigitemp claims could not have led to a finding of liability was ever advanced, although GD's letter of 22 September does allude to the fact that GD had several defenses available to it with respect to the Frigitemp claims when it settled the *Davis*-case. Instead, the 22 September 1994 letter argued that the proceeding costs of the Frigitemp claims should be allowed because GD had substantially prevailed in the *Davis*-case as a whole. This is an argument without merit in light of the clear regulatory guidance. The absence of an argument for allowability of the Frigitemp claims based on a showing that the claims could not have led to a finding of liability could lead one to conclude that the Government had made a *prima facie* case for the imposition of a penalty in the case of the costs associated with the Frigitemp claims. We need not resolve this issue, however, in view of the parties' negotiations in April 1994 and our understanding of the contracting officer's 26 August 1994 letter and GD's 9 September overhead proposal.

The Contracting Officer's 26 August 1994 "Determination"

First, there is the question of the effect to be given to what the contracting officer has referred to as his 26 August 1994 "determination." Mr. Steckley interpreted the 26 August 1994 letter as indicating that the Government considered unallowable only those costs expended to defend GD's position as to the Frigitemp kickback claims. We found Mr. Steckley's testimony credible and the interpretation not an unreasonable reading of the letter.

More importantly, nowhere are the words, "determination," or "expressly unallowable," used and the letter concludes with a simple, precatory request that the costs be removed. The letter also came at a time when the contracting officer had made only a cursory review of the issues. Moreover, as Mr. Bystran's deposition testimony indicated, his responses as late as March 1995 could reasonably lead one to believe that the allowability of *Davis*-case costs was still an open question. It may be that Mr. Bystran never changed his mind from the time he issued the 26 August 1994 letter until his 20 September 1995 final decision. However, this is not the message the Government sent during the course of its discussions with GD during the months following the 26 August letter. In summary, the 26 August letter cannot fairly be viewed as a "determination."

Under 10 U.S.C. § 2324(b)(2) the submission of a proposal after a determination of unallowability has been made in the case of a particular contractor may lead to the imposition of a double penalty. In this sense, it could be said that a prior determination would end any further discussion of reasonable differences and a contractor would have to resort to the dispute resolution process. The Government has not argued that this was the basis for its penalty determination and the contracting officer did not testify that it was, although he did express the view that a double penalty would have been warranted. If the Government intended the letter to have those consequences under 10 U.S.C. § 2324(b), it had the obligation to spell out that intent in unmistakable terms.

The 9 September 1994 Overhead Proposal

We are not persuaded by Government counsel's contention that GD's submission of the 9 September 1994 revised proposal reflects the same type of conduct that motivated Congress to pass the penalty provisions. Everything was in the open with respect to the *Davis*-case costs. There was no cat-and-mouse game. As we have found, Mr. Steckley's understanding of what the three percent exclusion entailed was reasonable, even though it was an interpretation the Government may not have completely shared (assuming Mr. Bystran's recall of excluding any penalty amount that might be assessed is correct). The three percent exclusion provided a "cushion" for the costs associated with the Frigitemp claims and its 9 September proposal must be understood in light of the three percent exclusion. A reasonable person could think at the time of submission that the Frigitemp costs were covered by the April 1994 agreement, particularly in view of the contracting officer's 26 August 1994 letter. In this context, the three percent exclusion had the effect of removing the Frigitemp costs from the proposal. Under the circumstances, the Government has not proved that the imposition of a penalty under 10 U.S.C. § 2324, as implemented, is justified.

The Parties' Conduct During the Negotiations

We think the Government's focus on GD's conduct during the negotiations of the various overhead proposals —specifically the failure to keep the Government apprised of *Davis*-case developments —to bolster its position is misplaced. First, the contracting officer never purported to assess a penalty on this ground and it is the basis for the contracting officer's assessment that must be our starting point. Second, if this were the basis for the decision, it would not be supportable under 10 U.S.C. § 2324(b) and the implementing regulations.

With respect to the settlement of the 1988 proposal, the Government has not asked for a finding that GD's Mr. Steckley was aware of the situation at the time of settlement and sought to keep it from the Government and we have not made one. However, Mr. Bystran could have followed-up on *Davis*-case developments with the Department of Justice through his own counsel. Moreover, from the time Mr. Bystran received actual

notice in April 1993 of the appeal by the Department of Justice on behalf of the Government, he was in a position to determine the status of the appeal at anytime. It was his responsibility to keep abreast of developments and, in the context of a negotiation, we think it is unreasonable to expect the other party to discharge this responsibility.

He was also in a position to insist that the matter remain in "set-aside" under FAR 31.205-47(g) insofar as any open years were concerned, as he testified he would have done in connection with the 1988 proposal, if he had known of the appeal. Though the parties did discuss returning the Davis-case costs to set-aside status, nothing came of those discussions. Whether it would have been prudent to do so once a settlement of the *Davis*-case was achieved, so that the parties could try to work through their differences, is not a judgment for us to make.

We conclude that the assessment of a penalty was improper.

DECISION

The appeal is sustained. GD is entitled to recover the *Davis*-case costs included in its 1991 corporate overhead proposal associated with its successful defense of the false estimates claims, subject to the 80 percent limitation of FAR 31.205-47(e)(3), but not the costs associated with the defense of the Frigitemp claims. This matter is remanded to the contracting officer for the determination of quantum. The contracting officer's assessment of a penalty under 10 U.S.C. § 2324 was unjustified and GD is entitled to recovery of that amount in its entirety to the extent it may have been withheld.

Dated: 10 June 2002

MARTIN J. HARTY
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

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

I concur

EUNICE W. THOMAS
Administrative Judge
Vice Chairman
Armed Services Board
of Contract Appeals

NOTES

[1] Related actions include, *inter alia*, *United States v. Davis*, 666 F. Supp. 641 (S.D.N.Y. 1987) and *United States v. Davis*, 767 F.2d 1025 (2d Cir. 1985).

[2] The Rule 4 file includes supplements by both parties which were numbered consecutively. Our references are to the Rule 4 file without differentiation as to who sponsored the document. (Tr. 5-6)

[3] Unless otherwise indicated the findings in this section are drawn from the parties' Stipulation of Agreed Facts Regarding the Settlement of *United States v. Davis*, 85 Civ. 6090 (S.D.N.Y.), dated 12 February 1997 (R4, tab 43, exs. A through J).

[4] At the hearing Mr. Bystran testified that at the time he "felt" the 22 September 1994 letter was an admission that five percent of the *Davis*-case costs were unallowable and that this admission was in "direct conflict" with GD's certification that there were no unallowable costs in the proposal (tr. 73). This subject was not developed further in testimony and there is no contemporaneous evidence in the record that the adequacy of GD's certification was or ever became an issue between the parties. Moreover, we see no reason to give any weight to an observation made in the context of a sharply contested case in the absence of a discussion of the significance of the reference to the 29 April 1994 letter and the Government's own awareness of GD's understanding of the 22 April 1994 agreement. We note also that at the time of the 22 September 1994 letter, GD still maintained that it was entitled to recover all of the *Davis*-case costs since it had substantially prevailed.

[5] Whether separate instances of wrongdoing are involved will depend on the circumstances involved in the particular matter. We have referred to the Frigitemp elements of the *Davis*-case as the Frigitemp claims because this is the way the Court of Appeals referred to the element and we have applied the same reference to the false estimates element of the case. In addition, we have used the plural, "claims," because of the presence of both statutory and common law causes of action based on the same subject matter. However, the determination of whether separate claims are involved is one way to approach the answer to the question of whether the same or separate misconduct is involved. As the Court of Federal Claims observed in *American Telephone and Telegraph Co. v. United States*, 48 Fed. Cl. 156, 158 (2000), "Modern procedural law defines a claim as ' an aggregate of facts which in various combinations, all comprising a common core or nucleus of the facts, may

support a number of substantive legal theories with corresponding remedies,' " quoting the RESTATEMENT (SECOND) OF JUDGMENTS § 24 CMT. C (1982). In the same vein, the Federal Circuit has said in the context of claim certification under the Contract Disputes Act that "[t]o determine whether two or more separate claims, or only a fragmented single claim exists, the court must assess whether or not the claims are based on a common or related set of operative facts. If the court will have to review the same or related evidence to make its decision, then only one claim exists." "On the other hand, if the claims . . . will necessitate a focus on a different or unrelated set of operative facts as to each claim, then separate claims exist . . . ." *Placeway Const. Corp v. United States*, 920 F. 2d 903, 907 (Fed. Cir. 1990). When approached from this perspective, one cannot fairly say the false estimates claims and the Frigitemp claims involve a common or related set of operative facts.

6 *See also Audit Practices in the Department of Defense*: Hearing before the Senate Armed Services Subcommittee on Defense Acquisition Policy, 99th Cong. 2 ("And I think that some may argue, rightfully so, that the present system does create the wrong incentives. Perhaps it invites the contractor to submit everything and anything, because the larger the amount of submitted expenses the larger the likely amount to be paid by the Government. That kind of system is obviously wrong and it needs to be changed so that . . . [requesting] costs that are clearly unallowable will not be so painless for the contractors."– Remarks of Subcommittee Chairman Dan Quayle). (R4, tab 52)

7 GD's contracts included the DFARS penalty clauses as in effect prior to 23 October 1992. The parties have not addressed this issue and neither do we in view of the effective date of the 1993 Defense Authorization Act amendment, which turns on the date the audit of the overhead proposal is initiated (P.L. No. 102-484, § 818, 23 October 1992, 1992 U.S.C.C.A.N. (106 Stat. 2315) 2457-58).

Appendix I – Excerpts From Pertinent Statutes

A. The Defense Procurement Improvement Act of 1985

The Defense Procurement Improvement Act of 1985, 10 U.S.C. § 2324, "Allowable costs under defense contracts," provided at subsection (e)(1)(C), in relevant part, for the disallowance of:

> (C) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

(Pub. L. No. 99-145, § 911, 99 Stat. 682-83 (1985); R4, tab 44)

B. Section 832 of the National Defense Authorization Act for Fiscal Year 1989

Section 832 of the National Defense Authorization Act amended 10 U.S.C. § 2324(e)(1) to add the following pertinent provisions:

> (N) Except as provided in paragraph (2), costs incurred in connection with any civil, criminal, or administrative action brought by the United States that results in a determination that a contractor has violated or failed to comply with any Federal law or regulation if the action results in any one of the following:
>
> (i) In the case of a criminal action, a conviction (including a conviction pursuant to a plea of nolo contendere).
>
> (ii) In the case of a civil or administrative action, (I) a determination by the Secretary of Defense that the violation or failure to comply was knowing or willful, and (II) the imposition of a monetary penalty.
>
> (iii) A final decision by an appropriate official of the Department of Defense to debar or suspend the contractor or to rescind, void, or terminate a contract awarded to such contractor if such decision is based on a determination by the Secretary of Defense that the violation or failure to comply was knowing or willful.

(2) If a civil, criminal, or administrative action referred to in paragraph (1)(N) is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the contractor's costs that are otherwise not allowable under paragraph (1)(N) may be allowed to the extent provided in such agreement.

(Pub. L. No. 100-456, § 832, 102 Stat. 2023 (1988); R4, tab 68)

C. The Major Fraud Act of 1988

The Major Fraud Act of 1988 imposed criminal penalties for procurement fraud. The Act also revised 10 U.S.C. § 2324 and provided parallel coverage for civilian agencies. Section 2324(e)(1)(C) was left unchanged. However, 10 U.S.C. § 2324(e)(1)(N) and other pertinent provisions were revised. The pertinent provisions of 10 U.S.C. § 2324 follow:

(e)(1)(C) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

. . . .

(e)(1)(N) Costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State, to the extent provided in subsection (k). [Later renumbered (e)(1)(O) in 1989 by the National Defense Authorization Act for Fiscal Years 1990 and 1991, Pub. L. No. 101-189, § 853(a), 29 November 1989, 1989 U.S.C.C.A.N. (103 Stat. 1352) 1518.]

. . . .

(k)(1) Except as otherwise provided in this subsection, costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States or a State are not allowable as reimbursable costs under a covered contract if the proceeding (A) relates to a violation of, or failure to comply with, a Federal or State statute or

regulation, and (B) results in a disposition described in paragraph (2).

(2) A disposition referred to in paragraph (1)(B) is any of the following:

(A) In the case of a criminal proceeding, a conviction (including a conviction pursuant to a plea of nolo contendere) by reason of the violation or failure referred to in paragraph (1).

(B) In the case of a civil or administrative proceeding involving an allegation of fraud or similar misconduct, a determination of contractor liability on the basis of the violation or failure referred to in paragraph (1).

(C) In the case of any civil or administrative proceeding, the imposition of a monetary penalty by reason of the violation or failure referred to in paragraph (1).

(D) A final decision by the Department of Defense—

(i) to debar or suspend the contractor;

(ii) to rescind or void the contract; or

(iii) to terminate the contract for default;

by reason of the violation or failure referred to in paragraph (1).

(E) A disposition of the proceeding by consent or compromise if such action could have resulted in a disposition described in subparagraph (A), (B), (C), or (D).

(3) In the case of a proceeding referred to in paragraph (1) that is commenced by the United States and is resolved by consent or compromise pursuant to an agreement entered into by a contractor and the United States, the costs incurred by the contractor in connection with such proceeding that are otherwise not allowable as reimbursable costs under such paragraph may be allowed to the extent specifically provided in such agreement.

. . . .

(5)(A) Except as provided in subparagraph (C), costs incurred by a contractor in connection with a criminal, civil, or administrative proceeding commenced by the United States or a State in connection with a covered contract may be allowed as reimbursable costs under the contract if such costs are not disallowable under paragraph (1), but only to the extent provided in subparagraph (B).

(B)(i) The amount of the costs allowable under subparagraph (A) in any case may not exceed the amount equal to 80 percent of the amount of the costs incurred, to the extent that such costs are determined to be otherwise allowable and allocable under . . . [the Federal Acquisition Regulation]

(ii) Regulations issued for the purpose of clause (i) shall provide for appropriate consideration of the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate.

(C) In the case of a proceeding referred to in subparagraph (A), contractor costs otherwise allowable as reimbursable costs under this paragraph are not allowable if (i) such proceeding involves the same contractor misconduct alleged as the basis of another criminal, civil, or administrative proceeding, and (ii) the costs of such other proceeding are not allowable under paragraph (1).

. . . .

(2) In subsection (k):

(A) The term “proceeding” includes an investigation.

(B) The term “costs,” with respect to a proceeding--

(i) means all costs incurred by a contractor, whether before or after the commencement of any such proceeding; and

(ii) includes --

(I) administrative and clerical expenses;

(II) the cost of legal services, including legal service performed by an employee of the contractor;

(III) the cost of the services of accountants and consultants retained by the contractor, and

(IV) the pay of directors, officers, and employees of the contractor for time devoted by such directors, officers, and employees to such proceeding.

(C) The term "penalty" does not include restitution, reimbursement or compensatory damages.

(Pub. L. No. 100-700, § 8, 19 November 1988, 1988 U.S.C.C.A.N. (102 Stat. 4631) 4636-38; R4, tab 72.) There have been no subsequent material changes to the provisions quoted above that are pertinent to our consideration here. *See* 10 U.S.C.A. § 2324 (West 1998 and Supp. 2001)

D. The Penalty Provisions of 10 U.S.C. § 2324

The penalty provisions of 10 U.S.C. § 2324 in effect as of 23 October 1992 provided, in pertinent part, as follows:

(a) The Secretary of Defense shall require that a covered contract provide that if the contractor submits to the Department of Defense a proposal for settlement of indirect costs incurred by the contractor for any period after such costs have been accrued and if that proposal includes the submission of a cost which is unallowable because the cost violates a cost principle in the Federal Acquisition Regulation or the Department of Defense Supplement to the Federal Acquisition Regulation, the cost shall be disallowed.

(b)(1) If the Secretary determines that a cost submitted by a contractor in its proposal for settlement is expressly unallowable under a cost principle referred to in subsection (a) that defines the allowability of specific selected costs, the Secretary shall assess a penalty against the contractor in an amount equal to—

(A) the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted; plus

(B) interest (to be computed based on regulations issued by the Secretary) to compensate the United States for the use of any funds which a contractor has been paid in excess of the amount to which the contractor was entitled.

(2) If the Secretary determines that a proposal for settlement of indirect costs submitted by a contractor includes a cost determined to be unallowable in the case of such contractor before the submission of such proposal, the Secretary shall assess a penalty against the contractor, in an amount equal to two times the amount of the disallowed cost allocated to covered contracts for which a proposal for settlement of indirect costs has been submitted.

(c) The Secretary shall prescribe regulations providing for a penalty under subsection (b) to be waived in the case of a contractor's proposal for the settlement of indirect costs when—

(1) the contractor withdraws the proposal before the formal initiation of an audit of the proposal by the Federal Government and resubmits a revised proposal;

(2) the amount of unallowable costs subject to the penalty is insignificant; or

(3) the contractor demonstrates, to the contracting officer's satisfaction, that—

(A) it has established appropriate policies and personnel training and an internal control and review system that provide assurances that unallowable costs subject to penalties are precluded from being included in the contractor's proposal for settlement of indirect costs; and

(B) the unallowable costs subject to the penalty were inadvertently incorporated into the proposal.

> (d) An action of the Secretary under subsection (a) or (b)—
>
> (1) shall be considered a final decision for the purposes of section 6 of the Contracts Disputes Act of 1978 (41 U.S.C. § 605); and
>
> (2) is appealable in the manner provided in section 7 of such Act (41 U.S.C. § 606).

(The Defense Procurement Improvement Act of 1985, Pub. L. No 99-145, § 911, 8 November 1985, 1985 U.S.C.C.A.N. (99 Stat. 583) 682-83, as amended by the National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484, § 818, 23 October 1992, 1992 U.S.C.C.A.N. (106 Stat. 2315) 2457-58)

The Federal Acquisition Streamlining Act (FASA), Pub. L. No. 103-355, § 2101, 13 October 1994, U.S.C.C.A.N. (108 Stat. 3243) 3306-07, made only technical changes to the penalty provisions. However, FASA extended substantively identical penalty provisions to the civilian agencies (*see* 41 U.S.C. § 256(a) through (d)). It also required that a uniform implementing regulation be issued in the Federal Procurement Regulation, while providing that Department of Defense regulations implementing 10 U.S.C. § 2324 would remain in effect until implemented in the FAR. Section 2101(e) of FASA, 108 Stat. 3309. The penalty provisions of 10 U.S.C. § 2324 have not changed substantively since the passage of FASA. *See* 10 U.S.C. § 2324(a) through (d) (1998 & West Supp. 2001).

Appendix II – Excerpts From Pertinent Regulations

A. DAR 15-205.52, Defense of Fraud Proceedings

Regulatory coverage preceded statutory coverage. On 20 October 1982, the Secretary of Defense promulgated a new cost principle, DAR 15-205.52, that specifically addressed the allowability of costs incurred in defense of fraud proceedings. Under DAR 15-205.52(a), otherwise allowable legal costs were designated as unallowable in the following circumstances:

> Costs incurred in connection with defense of any (1) criminal or civil investigation, grand jury proceeding or prosecution, (2) civil litigation, or (3) suspension, debarment or other administrative proceedings, or any combination of the foregoing, brought by the Government against a contractor, its agent or employee, are unallowable when the charges, which are the subject of the investigation, proceedings, or prosecution, involve fraud on the part of the contractor, its agent or employee, as defined in (b) below, and result in conviction (including conviction entered on a plea of nolo contendere), judgment against the contractor, its agent or employee, or decision to debar or suspend, or are resolved by consent or compromise.

"Fraud," for purposes of DAR 15-205.52, was defined in subparagraph (b) as:

> (1) acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents, (2) acts which constitute a cause for debarment or suspension . . . and (3) acts which violate the False Claims Act, 31 U.S.C., sections 3729-3731, or the Anti-Kickback Act, 41 U.S.C., sections 51 and 54.

With respect to the treatment of costs in the event of a resolution by consent or compromise, DAR 15-205.52(d) provided:

> (d) In circumstances where the charges of fraud are resolved by consent or compromise, the parties may agree as to the extent of allowability of such costs as a part of such resolution.

(Defense Acquisition Circular (DAC) 76-39, 20 October 1982; R4, tab 125)

The text of DAR 15-205.52, with negligible changes, was incorporated into the original version of FAR 31.205-47 that went into effect in April 1984. (48 Fed. Reg.

42,327 (19 September 1983); R4, tab 85) FAR 31.205-47 was, by its terms, made applicable to both defense and civilian agency contracts. FAR 31.205-47 was reissued by Federal Acquisition Circular (FAC) 84-12, effective 20 January 1986. (51 Fed. Reg. 2,665 (17 January 1986); R4, tab 86) The substance of the provisions quoted remained unchanged.

B. FAR 31.205-47, Costs Related to Legal and Other Proceedings

The passage of the Defense Procurement Improvement Act of 1985 (Appendix I. A.) prompted "nominal changes" to FAR 31.2 in April of 1986. FAR 31.205-47 was amended to meet the requirements of the Act to provide for unallowability:

> when the charges, which are the subject of the investigation, proceedings, or prosecution, involve fraud *or similar offenses (including filing of a false certification)* on the part of the contractor, its agents or employees, and result in conviction (including conviction entered on a plea of nolo contendere), judgment against the contractor, its agents or employees, or decision to debar or suspend, or are resolved by consent or compromise. [Emphasis added]

Neither the definition of "fraud" nor the coverage regarding the extent of allowability of costs when resolution by consent or compromise is involved was changed (FAC 84-15, 7 April 1986; R4, tab 87).

The passage of the Major Fraud Act of 1988 (Appendix I. C.) led to a rewrite of FAR 31.205-47, which not only incorporated changes mandated by the Act, but also consolidated legal and related cost allowability rules and dealt with certain allowability issues. Interim coverage went into effect on 17 April 1989. (FAC 84-44, 54 Fed. Reg. 13,024 (29 March 1989); R4, tab 92) Comments on the interim regulation were obtained and evaluated. A number of minor and technical changes were adopted on 21 December 1990, with an effective date of 22 January 1991. (FAC 90-3, 55 Fed. Reg. 52,782 (21 December 1990); R4, tab 95) Specifically, the definition of "costs" at FAR 31.205-47(a) was clarified to describe only general categories of costs, rather than particular types of costs within the category. FAR 31.205-47(b)(2) was modified to clarify a distinction in the Major Fraud Act between cases involving allegations of fraud or similar misconduct and those that do not. Finally, the word "Federal" was inserted in FAR 31.205-47(f) to avoid confusion. (Memorandum of 11 May 1990 for the Director, Civilian Agency Acquisition Counsel from the Director, Defense Acquisition Regulatory System; R4, tab 94)

The 22 January 1991 version of FAR 31.205-47 states:

(a) Definitions.

" Conviction," as used in this subsection, is defined in 9.403.

. . . .

"Fraud," as used in this subsection, means (1) acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents, (2) acts which constitute a cause for debarment or suspension . . . and (3) acts which violate the False Claims Act, 31 U.S.C., sections 3729-3731, or the Anti-Kickback Act, 41 U.S.C., sections 51 and 54.

. . . .

"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 or 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 where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct;

(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 (3) of this subsection (but see paragraphs (c) and (d) of this subsection); or

(5) Not covered by subparagraphs (b)(1) through (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 (4) of this subsection.

(c) To the extent they are not otherwise unallowable, costs incurred in connection with any proceeding under paragraph (b) of this subsection commenced by the United States that is resolved by consent or compromise pursuant to an agreement entered into between the contractor and the United States, and which are unallowable solely because of paragraph (b) of this subsection, may be allowed to the extent specifically provided in such agreement.

. . . .

(e) Costs incurred in connection with proceedings described in paragraph (b) of this subsection, but which are not made unallowable by that paragraph, may be allowable to the extent that:

(1) The costs are reasonable in relation to the activities required to deal with the proceeding and the underlying cause of action;

(2) The costs are not otherwise recovered from the Federal Government or a third party, either directly as a result of the proceeding or otherwise; and

(3) The percentage of costs allowed does not exceed the percentage determined to be appropriate considering the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate. Such percentage shall not exceed 80 percent. However, if an agreement reached under paragraph (c) of this subsection has explicitly considered this 80 percent rule, then the full amount of costs resulting from that agreement shall be allowable.

(f) Costs not covered elsewhere in this subsection are unallowable if incurred in connection with –

(1) Defense against Federal Government claims or appeals or the prosecution of claims or appeals against the Federal Government (see 33.201)

. . . .

(g) Costs which may be unallowable under 31.205-47, including directly associated costs, shall be segregated and accounted for by the contractor separately. During the pendency of any proceeding . . . the contracting officer shall generally withhold payment of such costs. However, if in the best interests of the Government, the contracting officer may provide for conditional payment upon provision of adequate security, or other adequate assurance, and agreement by the contractor to repay all unallowable costs, plus interest, if the costs are subsequently determined to be unallowable.

(R4, tab 95) FAR 31.205-47 remained unchanged until 1996 when it was amended by FAC 90-41, effective 7 October 1996, 61 Fed. Reg. 41,466 (8 August 1996). It was further amended by FAC 97-9, effective 29 December 1998, 63 Fed. Reg. 58,587 (30 October 1998), and FAC 97-21, effective 19 January 2001, 65 Fed. Reg. 80,255 (20 December 2000). None of the subsequent changes are pertinent to our consideration here.

C. DFARS Subpart 231.70, Penalties for Unallowable Costs As in Effect 27 May 1994

231.7000 Scope of subpart.

(a) This subpart implements 10 U.S.C. 2324(a) through (d). It covers the assessment of penalties against contractors which include unallowable indirect costs in—

(1) Final indirect cost rate proposals, or

(2) The final statement of costs incurred or estimated to be incurred under a fixed-price incentive contract.

(b) This subpart applies to all DoD contracts awarded after February 26, 1987, in excess of $100,000, except fixed-price contracts without cost incentives.

(c) The status of the Government's audit of the final indirect cost proposal will determine whether penalties should be assessed under sections 231.7001 or 231.7002. An audit will be deemed to be formally initiated when the Government provides the contractor with written notice that audit work on a specific final indirect cost proposal has begun or the Government holds an audit entrance conference with the contractor.

231.7001 Audits initiated before October 23, 1992.

If the Government formally initiated an audit before October 23, 1992, penalties shall be assessed under 10 U.S.C. 2324(a) through (d), as added by the National Defense Authorization Act for Fiscal Year 1986 (Pub. L. No. 99-145) . . . .

231.7002 Audits initiated on or after October 23, 1992

If the Government initiates an audit on or after October 23, 1992, penalties shall be assessed under 10 U.S.C. § 2324(a) through (d), as amended by section 818 of the National Defense Authorization Act for Fiscal Year 1993 (Pub. L. 102-484).

231.7002-1 General

(a) Under 10 U.S.C. 2324(a) through (d), as amended by section 818 of Pub. L. 102-484, the following penalties apply:

(1) If the cost is expressly unallowable under a FAR or DFARS cost principle that defines the allowability of specific selected costs, the penalty is equal to—

(i) The amount of the disallowed costs allocated to contracts that are subject to this subpart for which an indirect cost proposal has been submitted, plus

(ii) Interest on the paid portion, if any, of the disallowance.

(2) If the cost was determined to be unallowable for that contractor before proposal submission, the penalty is two times the amount in paragraph (a)(1)(i) of this section.

(b) These penalties are in addition to other administrative, civil, and criminal penalties provided by law.

(c) It is not necessary for unallowable costs to have been paid to the contractor in order to assess a penalty.

. . . .

231.7002-3 Assessing the penalty.

Unless a waiver is granted pursuant to 231.7002-5, the cognizant ACO shall—

(a) Assess the penalty in 231.7002-1(a)(1), when the submitted cost is expressly unallowable under a FAR or DFARS cost principle that defines the allowability of specific selected costs; or

(b) Assess the penalty in 231.7002-1(a)(2), when the submitted cost was determined to be unallowable for that contractor prior to submission of the proposal. Prior determinations of unallowability may be evidenced by—

(1) A DCAA Form 1 . . . which the contractor has elected not to appeal and was not withdrawn by DCAA.

(2) A contracting officer final decision which was not appealed.

(3) Prior ASBCA or court decision involving the contractor, which upheld the cost disallowance.

(4) Any determination of unallowability under FAR 31.201-6 [Accounting for unallowable costs].

(48 C.F.R. § 231.7000 to 7002-3 (1994); R4, tab 110)

FAR coverage had not been adopted at the time of the contracting officer's 20 September 1995 final decision. FAR 42.709 was promulgated by FAC 90-31 of

15 August 1995, effective 1 October 1995, 60 Fed. Reg. 42,648 (16 August 1995) and has not been changed since promulgation. The coverage adopted the substance of DFARS subpart 231.70 (1994). *See* FAR 42.709 (2001). In view of the FAR coverage, DAC 91-9, 30 November 1995, removed subpart 231.70 from the DFARS. (60 Fed. Reg. 61,586, 61,598 (30 November 1995; R4, tab 111).

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. 49372, Appeal of General Dynamics Corporation, rendered in conformance with the Board's Charter.

Dated:

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