ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
General Dynamics Land Systems, Inc.	)	ASBCA No. 57293
	)	
Under Contract No. DAAM01-96-C-0028	)	

APPEARANCES FOR THE APPELLANT:

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APPEARANCES FOR THE GOVERNMENT:

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OPINION BY ADMINISTRATIVE JUDGE GRANT
ON APPELLANT'S MOTION FOR PARTIAL SUMMARY JUDGMENT

In this appeal, General Dynamics Land Systems, Inc. (GDLS) has moved for partial summary judgment, opposing the government's claim for refund of part of GDLS's allocated share of residual home office expenses of its parent company General Dynamics Corporation (GDC). Specifically, GDLS asserts that its allocated share is proper, as to the years 2003-2008, because, among other things, the government agreed to that allocation approach in an advance agreement with GDC in 2003. The government opposes this motion, asserting that the 2003 agreement is not enforceable because it violates the applicable cost accounting standard (CAS) and was entered into based on a unilateral mistake on the part of the government. GDLS has replied to the government's opposition. We have jurisdiction under the Contract Disputes Act of 1978, 41 U.S.C. §§ 7101-7109. For the reasons stated below, we deny GDLS's motion.

STATEMENT OF FACTS (SOF) FOR PURPOSES OF THE MOTION

1. GDC and the government entered into an advance agreement on 30 May 1996, seven years before the advance agreement at issue here, that addressed, in part, GDC's methodology for allocating residual home office expenses to its business segments under

CAS 403. The agreement stated that it was entered into under the authority of FAR 31.109, Advance agreements, which encourages such agreements to avoid possible later disputes on cost allocability, allowability, and reasonableness. (App. mot., ex. B)

2. CAS 403, Allocation of home office expenses to segments, establishes a formula for allocating residual home office expenses to business segments. This formula applies at certain aggregate operating revenue thresholds, unless the government and the contractor agree to a different ("special") allocation of residual expenses. CAS 403-40(c)(2), (3). CAS 403-50(c) states that this formula "must be used" because it "is considered to result in appropriate allocations...." *Id.*

3. The allocation formula is based on three factors which take into account three broad areas of management concern: employees, business volume, and "capital invested" (which the government calls "capital assets" or the "asset factor") (CAS 403-50(c)(1)). For each factor, a percent is calculated based on the segment's volume compared with the volume of all segments under the home office. These three percentages are then averaged for one overall allocation percent, to determine the specific segment share. Specifically, the regulation states:

> The percentage of the residual expenses to be allocated to any segment pursuant to the three factor formula is the arithmetical average of the following three percentages for the same period.
>
> (i) The percentage of the segment's *payroll* dollars to the total payroll dollars of all segments.
>
> (ii) The percentage of the segment's *operating revenue* to the total operating revenue of all segments. For this purpose, the operating revenue of any segment shall include amounts charged to other segments and shall be reduced by amounts charged by other segments for purchases.
>
> (iii) The percentage of the average net book value of the sum of the segment's *tangible capital assets plus inventories* to the total average net book value of such assets of all segments. Property held primarily for leasing to others shall be excluded from the computation. The average net book value shall be the average of the net book value at the beginning of the organization's fiscal year and the net book value at the end of the year.

CAS 403-50(c)(1) (emphasis added).

4. The two factors at issue in this motion are factor two, the business volume/"operating revenue" factor, and factor three, the capital invested/"tangible capital assets plus inventories" factor. The term "operating revenue" is defined in CAS 403 as:

> *Operating revenue* means amounts accrued or charged to customers, clients, and tenants, for the sale of products manufactured or purchased for resale, for services, and for rentals of property held primarily for leasing to others. *It includes* both reimbursable costs and fees under cost-type contracts and *percentage-of-completion sales accruals....*

CAS 403-30(a)(3) (emphasis added). The term "inventories" in factor three, disputed by the parties, is not defined in CAS 403, nor is the phrase "capital invested." "Tangible capital asset" is defined, as "an asset that has physical substance, more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the services it yields." CAS 403-30(a)(5).

5. The 1996 advance agreement was entered into because of past government concerns about the number and composition of the factors that GDC used to allocate residual home office expenses under CAS 403 (app. mot., ex. B at 1).[1] The agreement specified that GDC would use the CAS 403 three factor formula, and it also addressed "contracts in process" as part of that formula (*id.* at 2, ¶¶ 3, 4). GDC's "contracts in process" account contains the accumulated cost of partially completed items under a government contract, and consists primarily of labor and material costs and related overhead and general and administrative expenses (app. mot., ex. D, ¶¶ 5, 6).[2] Specifically, the advance agreement stated that, "when calculating the asset values for the three factor formula, they [GDC] will reduce contracts in process by progress payments received, to produce net assets" (app. mot., ex. B at 2, ¶¶ 3, 4).

6. Due to material changes in GDC's business base, concerns again surfaced relating to GDC's approach to CAS 403, and on 22 November 1999, the government informed GDC that the 1996 agreement would terminate as of 31 December 1999 (R4, tab 35 at G-664; app. mot., ex. C, Parties' Stipulation of the Facts ¶ 6).

7. On 9 November 2000, the Defense Contract Audit Agency (DCAA) issued an audit report finding that GDC had improperly included deferred assets as part of the

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[1] There had also been an earlier issue of CAS 403 noncompliance concerning allocation of legal and consulting fees, though the total impact was deemed immaterial (R4, tab 33).

[2] GDC used the term "work-in-process" for a comparable account for its commercial jet business (app. mot., ex. D, ¶ 8).

"asset factor" in the three factor formula. DCAA noted that the deferred assets, such as unpaid workers' compensation claims and unpaid retiree medical expenses, did not represent either tangible capital assets or inventory.[3] (R4, tab 36 at G-680) As part of its review, DCAA examined the GDC 1997 and 1998 financial statements, including notes in those financial statements concerning contracts in process (R4, tab 36 at G-683).

8. The Defense Contract Management Agency (DCMA) issued GDC an initial determination of CAS 403 non-compliance on 12 March 2002, for the reasons set forth in DCAA's 9 November 2000 audit report, which DCMA enclosed (R4, tab 36 at G-677).

9. GDC responded on 28 May 2002, stating that the government had a "restricted" and "limited" definition of the word "inventories" and that the term should be interpreted "inclusively." GDC explained that it included "all contracts-in-process inventory—including the specific types of cost at issue here—in the asset base for application of the CAS 403 residual cost allocation formula." GDC asserted that doing so best met the intent behind CAS 403 to "represent as closely as possible the capital invested in the business," just like "any tangible capital asset or any other type of inventory account." GDC also noted that the costs at issue were included as part of contracts in process in its published financial statements and Securities and Exchange Commission (SEC) filings. (R4, tab 37 at G-690-94)

10. After further communications, in June 2003, the government and GDC entered into another advance agreement relating to CAS 403, the agreement that is the subject of this dispute. That agreement stated that "End Of Period Net Book Value of Assets is end of period Contracts in Process (less advances and payments), Inventory, and Net Property Plant and Equipment accounts." It also stated that "deferred costs are to be EXCLUDED from Contracts in Process...." (App. mot., ex. A, dated 10 June 2003, at 1, ¶ 3A, C)

11. Again a CAS 403 compliance issue arose, this time concerning treatment of unbilled receivables (amounts due GDC from the government customer that have not yet been billed to the government) (app. mot., ex. D, ¶ 4, app. reply, ex. F at 27). In a 29 August 2005 audit report, DCAA concluded that GDC was not in compliance with CAS 403, because GDC "improperly included unbilled receivables as inventory in its computation of the three-factor formula." DCAA noted that the third factor only covered

[3] Although DCAA used the term "deferred assets," later the 2003 agreement calls them "deferred costs" (app. mot., ex. A at 1, ¶ 3C). GDC referred to the unpaid claims and expenses as "liabilities" or "costs," which are later recovered as part of indirect contract costs when the liabilities are liquidated (R4, tab 37 at G-690, -693-94).

tangible capital assets and inventories, and that unbilled receivables were neither. DCAA pointed out that GDC itself did not list contracts in process as "inventory" in its own financial statements; rather GDC listed them with "accounts receivable," with inventory as a separate category. Additionally, DCAA noted that since GDC used a percentage-of-completion method of accounting for its defense contracts, these unbilled receivables were more properly classified as revenue. Finally, DCAA noted that although GDC included these unbilled receivables in the revenue factor (the second factor), by including them in the third factor as well, GDC was effectively double-counting them in calculating segment share. (R4, tab 1 at G-003-05)

12. In their respective comments following the audit report, DCAA and GDC each argued that their own approach led to the most consistent treatment of unbilled receivables, but each ultimately failed to persuade the other side (R4, tab 1 at G-005-06, 025-26). On 23 January 2006, DCMA adopted DCAA's position and issued an initial notice of potential non-compliance to GDC. DCMA acknowledged that the 2003 advance agreement recognized contracts in process as an element of the asset factor, "perhaps inadvertently," but found that this approach resulted in GDC government segments shouldering a disproportionate share of residual home office expenses. (R4, tab 2 at G-028-29)

13. GDC responded with rebuttal comments on 19 May 2006; DCAA reviewed those comments and did not change its position (R4, tabs 3, 4). Ultimately, DCAA issued its final audit report on 25 September 2007 affirming its original position of CAS 403 non-compliance, and on 25 February 2008, DCMA notified GDC that the 2003 advance agreement would be terminated effective in 30 days (R4, tabs 7, 8). This agreement is thus no longer in effect.

14. On 23 April 2010, the DCMA Defense Corporate Executive (DCE), the same person who signed the 10 June 2003 advance agreement, issued a final decision on this matter. He found that GDC was not in compliance with CAS 403-50(c)(1) from fiscal year 2003 through the (then) present because GDC improperly included unbilled receivables as inventory in the asset factor of the three factor formula (R4, tab 9 at G-101, ¶ a). (The DCE also determined that GDC was not in compliance with CAS 403 due to improperly subtracting certain customer deposits from commercial inventory in computing the three factor formula, a matter not at issue on this motion.) The decision identified a representative contract, DAAM01-96-C-0028, held by GDLS, and demanded a refund of the resulting overpayment of $135,411 ($107,213 plus $28,198 interest through May 2010) (R4, tab 9 at G-103). GDLS then appealed to this Board on 20 July 2010, where the appeal was docketed as ASBCA No. 57293.

15. GDLS moved for partial summary judgment on 15 April 2011, and as exhibits to its motion, included GDC's Form 10-K Annual Reports filed with the SEC for the years 1997 through 2002 (app. reply, exs. F-K). These publically available reports

disclosed information about contracts in process, unbilled receivables, and inventories under the heading "Notes to Consolidated Financial Statements," which were attached to and incorporated by reference into the 10-K Annual Reports (app. reply, ex. F at 40, item 8, ex. G at 28, ex. H at 21, ex. I at 14, ex. J at 11, ex. K at 10)[4]. The Notes stated that, under the heading of "Accounts Receivable and Contracts in Process," unbilled receivables were included in contracts in process (app. reply, ex. F at 27, ex. G at 31, ex. H at 20, ex. I at 46, ex. J at 81, ex. K at 50). The category "Inventories" was listed in a separate paragraph; this entry stated that "work-in-process inventories represent aircraft components..." (app. reply, ex. F at 27, ex. G at 32, ex. H at 20). As noted previously, "work-in-process" is GDC's term for the account that accumulates the cost of partially completed contract items for its commercial jet business, in contrast to the term "contracts-in-process" for the government business (app. mot., ex. D, ¶ 5-6, 8-9; SOF ¶ 5).

THE PARTIES' ARGUMENTS

GDLS moved for partial summary judgment as to the years 2003-2008, arguing that the 2003 advance agreement expressly permitted contracts in process to be included in the three factor formula, and that the government is bound by the plain meaning of the agreement. GDLS asserts there are no issues of material fact and thus the Board should find that the parties' agreement permitted GDLS to include contracts in process in the third factor. The government counters, asserting that although contracts in process could be included in the three factor formula overall, unbilled receivables could only be included as revenue (factor 2), not as inventories (factor 3). Consequently, the government asserts that the 2003 agreement is not enforceable because it violates CAS, and also because the government entered into it based on a unilateral mistake about the composition of the contracts in process account (containing unbilled receivables).

In response, GDLS argues that the flexibility and discretion inherent in both advance agreements and CAS 403 mean that the agreement, even if incorrect under CAS 403 (which GDLS does not concede), was not "palpably illegal" and thus the government is bound by it. Further, GDLS argues that the government has not proved the elements of unilateral mistake, since GDLS disclosed that it included unbilled receivables as part of contracts in process, and did not know that the government allegedly was unaware of that. GDLS concludes that the government has not presented any dispute of material fact, and thus summary judgment is appropriate to enforce the terms of the 2003 agreement.

[4] Page numbers are the page numbers as downloaded, not the Form 10-K page numbers.

DECISION

Summary judgment may be granted only where there is no genuine issue of material fact and the movant is entitled to judgment as a matter of law. *Mingus Constructors, Inc. v. United States*, 812 F.2d 1387, 1390 (Fed. Cir. 1987). The movant has the burden to establish the absence of disputed material facts; once done, the non-moving party must set forth specific facts, not conclusory statements or bare assertions, to defeat the motion. *Pure Gold, Inc. v. Syntex (U.S.A.), Inc.*, 739 F.2d 624, 626-27 (Fed. Cir. 1984).

As a preliminary matter, we note that the parties do not dispute, and we agree, that the 2003 agreement included contracts in process as part of the *third* factor of the three factor formula. Although the agreement does not explicitly refer to factor three (as opposed to one of the other two factors), it uses the term "net book value" which only appears in factor three. (SOF ¶ 10); *see also* DCMA letter dated 23 January 2006 ("the June 10, 2003 agreement recognizes (perhaps inadvertently) CIP as an element of the *asset portion* of the three-factor-formula") (R4, tab 2 at G-028, tab 9 at G-101) (emphasis added).

Whether the government is bound by its agreement to include unbilled receivables (part of contracts in process) in factor three depends on whether the DCE was acting within the scope of his authority in agreeing to that. Government agents acting within the scope of their authority bind the government by their agreements, even if those agreements reflect erroneous conclusions of law. *Broad Ave. Laundry & Tailoring v. United States*, 681 F.2d 746, 748-9 (Ct. Cl. 1982) (CO had actual authority to make a mistake of law in agreeing to pay the contractor for new wage rates that in fact were only valid for future contracts); *Honeywell Federal Systems, Inc.*, ASBCA No. 39974, 92-2 BCA ¶ 24,966 at 124,409 (COs had authority to make a potentially "incorrect" commerciality determination, as within the scope of their authority to ensure fair and reasonable pricing). Relevant factors include the extent of discretion afforded the CO and the degree to which the CO knowledgeably exercised that discretion. *See, e.g., Raytheon Co.*, ASBCA Nos. 51652, 53509, 03-2 BCA ¶ 32,337 at 159,968-69 (TCO had authority not to apply a termination loss adjustment factor, based on her considered determination that the condition precedent in the FAR for applying the factor had not been met); *MPR Associates, Inc.*, ASBCA No. 54689, 05-2 BCA ¶ 33,115 at 164,112 (ACO authorized to disregard cost principle limitation for related party lease expenses for a party who changed status during the course of the lease).

In contrast, when a government agent acts outside the scope of his authority, the government will not be bound by the mistaken legal position the agent agreed to. *Johnson Management Group CFC, Inc. v. Martinez*, 308 F.3d 1245, 1257 (Fed. Cir. 2002) (CO not authorized to agree to a clause "squarely in conflict with the requirements of the FAR"); *Federal Crop Insurance v. Merrill*, 332 U.S. 380, 386 (1947) (government

agent acted outside of the scope of his authority in agreeing to crop insurance coverage for spring wheat reseeded on winter acreage when such insurance was contrary to the "clear meaning of the regulation"); *Institutional and Environmental Management, Inc.*, ASBCA Nos. 32924, 34948, 90-3 BCA ¶ 23,118 at 116,072 (CO had no legal basis for agreeing to pay what was "unambiguously denied by the contract and the applicable regulation" and contractor could not legally keep such payments). These cases involving a direct conflict with the regulations are distinguishable from those where there is no prohibition, stated expressly or by inference, to prevent the CO from entering into the agreement in question. *Johnson Management*, 303 F.3d at 1257; *cf. Broad Ave.*, 681 F.2d at 749 ("we assume there is nothing in the Service Contract Act to make it illegal to pay above the prevailing wage"); *Teledyne Continental Motors*, ASBCA No. 22571, 85-3 BCA ¶ 18,472 at 92,787 (the modification "imposed no requirement which was illegal and was arrived at by both parties with full knowledge of the contentious issues involved").

As to whether the DCE was acting within the scope of his authority to enter into this agreement, we look to the record to see if it is adequate for the Board to make this determination. Although GDLS assumes (for purposes of the motion) that the 10 June 2003 agreement violated CAS 403, that assumption does not answer the question of whether the violation was within the DCE's authority to make. The answer to that question requires an understanding of whether the agreement *did* violate CAS 403, and if so, in what manner and to what degree. As outlined below, we do not think that the record is adequately developed for us to determine, as a matter of law, whether agreeing to include unbilled receivables (as part of contracts in process) in factor three was outside the scope of the DCE's authority.

A number of unanswered accounting questions underlie the issue of the DCE's authority to agree to something that violates CAS 403. Fundamentally, the record is not clear about what unbilled receivables are for purposes of CAS 403—revenue or capital invested. As to whether they can be both, although GDLS argues that double counting is a "red herring" and that in any event it is "done routinely" and is "unavoidable" under CAS 403 (app. reply at 20), there is no evidence from either party on this point. Key to this dispute is a sound understanding of what "inventories" is for CAS 403 purposes, how that concept relates to the overarching "capital invested" factor, and what flexibility is inherent in that concept. From an accounting perspective, it is not clear if unbilled receivables and inventories can be treated one way for CAS 403 purposes and another way for financial statement purposes. Similarly, the relationship of unbilled receivables to the percent-of-completion method of accounting is not clear, a matter of some importance since operating revenue is defined to include a percent-of-completion method of accounting and GDC uses that approach for its government business. Finally, there are disputes and/or inconsistencies in the record about how GDC handles its government and commercial business lines in terms of unbilled receivables or the equivalent, whether the treatment is consistent, or even whether it has to be.

GDLS argues that the lack of a CAS 403 definition of "inventories" (or contracts in process or unbilled receivables for that matter), and the absence of any clear requirement or prohibition concerning these issues, shows that the DCE had the discretion to construe the formula rightly or wrongly. However, the CAS formula rests on an underlying foundation of accounting terms and concepts that go beyond CAS 403 itself. Examining this foundation will enable a better assessment of what CAS 403 requires concerning treatment of unbilled receivables, and ultimately, whether the DCE was acting within the scope of his authority or not. Even with a fully developed record, views can differ as to how obvious a violation is; on a partially developed record, additional care is warranted. *Johnson Management*, 308 F.3d at 1262 (dissent questions whether the legal error was "as conspicuous as my colleagues state"); *Lord Corp.*, ASBCA No. 54940, 06-2 BCA ¶ 33,314 at 165,169 (even if appellant had "discharged its burden as movant, discretion would still counsel denial of the motion because 'the legal issues can be intelligently resolved only upon a fully developed record'").

On summary judgment, we draw all inferences in favor of the non-moving party, in this case the government. Given the points noted above, we cannot determine from the current record, with adequate confidence to say as a matter of law, whether the DCE's agreement to include unbilled receivables in factor three (as part of contracts in process) was within his authority to make. *AM General LLC*, ASBCA No. 53610, 07-1 BCA ¶ 33,498 at 166,021 (record falls short of what is necessary to establish whether appellant's manufacturing overhead pool violated CAS); *Kaman Precision Products, Inc.*, ASBCA Nos. 56305, 56313, 10-2 BCA ¶ 34,529 at 170,286 (the number of disagreements about the meaning of contract terms precluded resolution on summary judgment).

In view of our decision that we cannot at present rule as to whether the government was bound by its agreement, we need not address the second government defense of unilateral mistake.

CONCLUSION

For the reasons set forth above, we conclude that the record is inadequately developed for us to determine as a matter of law whether the government is bound by the 10 June 2003 advance agreement, as something within its authority to do, even if that agreement contained an incorrect application of CAS 403. Consequently, we deny GDLS's motion for partial summary judgment.

Dated: 21 September 2011

Elizabeth M. Grant

ELIZABETH M. GRANT
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

Mark N. Stempler

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

I concur

Eunice W. Thomas

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

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 57293, Appeal of General Dynamics Land Systems, Inc., rendered in conformance with the Board's Charter.

Dated:

CATHERINE A. STANTON
Recorder, Armed Services
Board of Contract Appeals