In the previous article we discussed some of the background issues underlying the dispute between Raytheon Space and Airborne Systems (SAS) and the government. Chief among those issues was how to calculate "increased costs in the aggregate" when a contractor makes concurrent changes to its cost accounting practices. Raytheon SAS was litigating three (3) separate sets of changes—Disclosure Statement Revision 1, Revision 5, and Revision 15. We concluded the previous article by noting a complete victory for Raytheon with respect to its Revision 1 changes, as Judge O'Connell **ruled** that, under the pre-2005 environment, when a contractor made simultaneous (or "concurrent") changes to cost accounting practices, the contractor was permitted to use the impact from changes where the government saved money to offset the impacts from changes where the government did not save money. Because three of Raytheon SAS' Revision 1 changes resulted in cost savings while only one resulted in a cost increase—and the aggregate cost savings were greater than the single cost increase—the government suffered no cost increase in the aggregate, and thus had no claim against Raytheon SAS.

The critical finding that led to Raytheon's victory on its Revision 1 set of changes was that the rules were silent (at that time) regarding how to handle concurrent changes in cost accounting practice and how to calculate increased costs in the aggregate when there were concurrent changes. Judge O'Connell spent roughly seven pages (out of his 29-page opinion) discussing the fact that the CAS Board never defined the phrase "increased costs in the aggregate" and, since the regulations were silent on the topic at the time, the only option left to him was to look at the parties' course of dealing and performance in order to discern what the contractual expectations were. He wrote –

We find CAS Working Group Item 76-8, the DCMC and DCAA manuals, and the proposed regulation to be quite informative in identifying the 'context and intention' of the parties when they made their bargain. These documents also indicate a clear course of performance between the government and CAS-covered contractors on prior contracts concerning the treatment of simultaneous changes.

(Internal citations omitted.)

Thus, like Boeing, Raytheon SAS was permitted to offset its concurrent changes because that was the expectation of the contracting parties at the time.

As we noted in the previous article, Judge O'Connell was left to piece together the parties' intent because of a lack of activity by the CAS Board. According to the Judge, the CAS Board had a duty to "fill the gap" left in the regulations. Indeed, he found that the CAS Board recognized that duty; yet the Board failed to fulfill its obligation despite recognizing the need for action for more than fifteen years. He wrote –

In the CAS statute, Congress has left a gap concerning the offset of simultaneous changes. Based on: (1) the absence of any language in the CAS Board regulations that address the offset of simultaneous accounting changes; (2) the CAS Board's abandonment of its rulemaking effort; and (3) the CAS Board's long-stated desire to address this issue, we conclude that the CAS Board has not yet 'filled the gap' in the statute by issuing regulations.

(Internal citations and footnotes omitted.)

As we shall see, the CAS Board's dereliction of its acknowledged duty proved fatal to some of Raytheon's arguments with respect to its two other sets of Disclosure Statement Revisions.

In its Disclosure Statement Revision 5 (effective January 1, 2005 but submitted July 8, 2005), Raytheon SAS made only one change to cost accounting practice. It submitted a GDM cost impact a bit more than a year later (April, 2006) that calculated a cost increase of $153,000 to flexibly-priced contracts and a cost decrease of $117,900 to fixed-price contracts. As was the case with the Revision 1 changes, DCAA never completed an audit. (The parties disputed the reason for the lack of timely audit completion. We were there at the time and we have our own opinion, which would not be prudent to share publicly.) As was the case with the Revision 1 changes, DCAA issued a ROM that included a 30 percent adder to Raytheon's calculations, in order to protect the taxpayers. Thus, DCAA told the CFAO that the cost impact was $352,170, to which the CFAO added compound interest and demanded that Raytheon SAS pay the government $512,732. Unsurprisingly, Raytheon SAS opted to litigate the government's demand for payment.

Raytheon argued, among other things, that the cost impact analysis showed the cost impact was immaterial. As Raytheon saw things, flexibly priced contracts had been impacted by a trivial $153,000, which was a laughably small percentage of its multi-billion dollar business base. Judge O'Connell didn't buy that argument. However, given his subsequent ruling on the methodology used by DCAA to calculate the cost impact, he agreed that the issue of whether the CFAO should have waived further action based on the materiality of the cost impact would

be litigated at trial.

Raytheon also argued that the CFAO should have found the change to cost accounting practice to be "desirable and not detrimental" and, because the CFAO did not do so, the CFAO abused his discretion. Again, Judge O'Connell was not persuaded by Raytheon's argument, because the decision was inherently discretionary. There was no evidence of bad faith, and so the CFAO did not abuse his discretionary authority.

(As a side note, we non-attorneys here at Apogee Consulting, Inc. have a hard time understanding how Judge O'Connell reconciled his correlation of "abuse of discretion" with "evidence of bad faith" given the Supreme Court's upholding of the Federal Circuit's decision in *Penner Installation Corp.* that the Contracting Officer must perform a "quasi-judicial" role in equitably arbitrating disputes between the government and the contractor. But perhaps that's just us.)

To sum up the Revision 5 situation, Judge O'Connell decided it much the same way he had decided the Revision 1 changes—with the exception that certain aspects (involving computation of the cost impact and materiality) would have to be litigated at trial.

The Revision 15 set of changes presented the most difficult challenge. Raytheon SAS submitted its revised Disclosure Statement on November 1, 2007, to be effective January 1, 2008. The GDM cost impact analysis of those changes was submitted on February 26, 2010—more than two years after the Disclosure Statement was submitted. (That timing sounds bad, until one realizes that Raytheon was waiting for the cognizant Federal Agency Official (CFAO) to request the cost impact, as CAS clause 52.230-6 provides.)

There were three (3) individual changes described in Revision 15. Raytheon's GDM cost impact analysis showed that one change "caused a $251,500 decrease to flexibly-priced contracts and an increase of $195,200 to fixed-price contracts" while the other two changes "had the opposite effect." According to Raytheon's calculations, change 2 (communications) "caused an increase of $47,800 to flexibly-priced contracts and a decrease of $41,600 to fixed-price contracts" whereas change 3 (inventory maintenance) "caused an increase of $36,000 to flexibly-priced contracts and a decrease of $17,400 to fixed-price contracts." DCAA recognized that the aggregate or net effect of all the changes, when considered together, was to *decrease* costs to the government in the amount of $304,000. However, because of the then-recent rule changes to FAR 30.606, DCAA maintained that the impacts of the three

changes could not be combined. Instead, each had to be considered individually. Using that logic, DCAA calculated a cost increase to the government of $157,080 related to two of the three changes. As Judge O'Connell wrote—

DCAA recognized that the [REDACTED] change resulted in decreased costs to the government of $446,700 ($251,500 + $195,200). However, it stated that '[t]here is no requirement for any adjustment related to this unilateral accounting practice change since adjustments are only made if changes result in increased costs to the Government.'

In other words, as DCAA saw things, the FAR rules permitted the government to cherry-pick which changes would result in a contract adjustment and which changes would be ignored. Naturally, any changes that were favorable to the government and resulted in cost savings would be ignored (*i.e.*, the price of FFP contracts would not be increased if the contractor shifted costs to its FFP contracts). In contrast, changes that were unfavorable to the government and resulted in cost increases, no matter how minute, would result in demands for payment with interest calculated from the date of the change (even if the government intentionally delayed its audit so as to increase interest payable).

Interestingly, the CFAO sought to recover $172,363 (which included interest) be adjusting a contract that had been awarded to Raytheon SAS in 2004 – *well before the troublesome FAR changes had been implemented* .
That created a problem that Raytheon sought to exploit in its legal arguments, and led to an interesting result in the decision issued by Judge O'Connell. He wrote –

Revision 15 did not go into effect until 1 January 2008. This would suggest that, in addition to contracts like Contract II that predate the issuance of FAR 30.606, this revision also applied to some contracts executed after the April 2005 effective date of the regulation. In fact, Raytheon estimates that about two-thirds of the contracts subject to Revision 15 were executed after the regulation went into effect. Raytheon's Revision 15 appeal thus raises the issue of how we should analyze the Revision 15 changes when that revision applies to contracts executed both before and after the issuance of FAR 30.606.

Judge O'Connell split the baby and said that the old FAR (that permitted offsets between changes) applied to impacts on contracts awarded under the old FAR rules, while the new FAR (that prohibited offsets between changes) applied to impacts on contracts awarded under the new FAR rules. He wrote: "The accounting changes that Raytheon made in 2008 do not

change the nature of the bargains that the parties struck pre-FAR 30.606. Accordingly, our decision in Boeing means that the contractor can offset the Revision 15 contracts that the parties executed prior to 8 April 2005, the effective date of FAR 30.606."

With respect to the post-2005 FAR rules, Raytheon SAS argued that the FAR Councils "exceeded their authority by acting in an area that Congress had reserved exclusively to the CAS Board." This was an argument we've raised ourselves in one or more articles on this blog. The argument is basically that the public law that authorized the CAS Board exclusively reserved to that entity the authority to interpret its Standards and regulations and to define the term "aggregate increased costs to the Federal Government." Because the FAR Councils, instead of the CAS Board, defined that term in its FAR 30.606 revisions, they were a legal nullity.

Unfortunately for Raytheon SAS (and armchair lawyers such as ourselves), the Judge was not persuaded by that argument. He spent nearly six pages discussing the CAS Board's authority before concluding that the FAR Councils did not usurp the CAS Board's authority because, in essence, the CAS Board ceded it to the FAR Councils through inaction. The logic Judge O'Connell used to reach his conclusion is illuminating while also being troubling to those of us who favor an "independent" Cost Accounting Standards Board. We're going to quote at some length. As always, internal citations and footnotes will be omitted.

The question in this case is whether the FAR Councils, in issuing FAR 30.606, have overstepped their authority. Put another way, we are being asked to invalidate a FAR provision even though a CAS Board regulation on this topic, if ever issued, might state the exact same thing. Or, put yet another way, we are being asked to rule that a regulation is invalid even though the official entrusted with statutory authority to do so, the OFPP Administrator, has not taken any action. …

If Raytheon's argument is correct, then FAR 30.606 would have been just as unlawful if it had authorized the offsetting that Raytheon seeks. This is so because the purported grant of exclusive authority to the CAS Board would have prevented the FAR Councils from addressing the issue in any way. Thus, contracting officers would face a legal vacuum in determining whether to offset the cost impact of multiple changes because neither the statute, nor the cost accounting standards, answer this question. …

We hold that FAR 30.606 does not impermissibly intrude on authority reserved exclusively for

the CAS Board. We reach this conclusion because we do not read the grant of authority to the CAS Board in § l503(b) as being so broad that it prevents the FAR Councils from issuing regulations that provide guidance to contracting officers who may be faced with an accounting change that affects hundreds of contracts. While Congress has granted clear authority to the CAS Board to define aggregate increased costs in § l503(b), we cannot ignore the fact that the grant of authority is not as strong as the exclusive authority granted in §1502(a) with respect to the measurement, assignment, and allocation of costs. By including specific language in § l502(a)(l) that it did not include in § l503(b), we presume that Congress acted intentionally. The wording of § 1503(b) allows for a coexistence between the CAS Board, whose primary concern in the measurement, assignment, and allocation of costs, and the executive agencies that must administer highly complex contracting arrangements. …

In addition to addressing simultaneous unilateral accounting changes within the same business segment (the situation we have here), agencies may also have to address whether the following types of offsets should be allowed: changes that are not simultaneous; changes that are within the same company but for different business segments; changes that are all compliant changes but are for different categories of compliant changes, that is, required, unilateral, and desirable changes; and whether compliant changes may offset non-compliances. Ultimately, the FAR Councils determined to allow the combination of some types of changes, but mostly took a hard line against offsetting. *Due to the lack of any guidance from Congress or the CAS Board that addresses offsetting multiple changes, we are unwilling to disturb the actions of the FAR Councils.*

(Emphasis added.)

We are disappointed in the foregoing because it points to the consequences from a do-nothing CAS Board, or perhaps one that is less than fully independent. Judge O'Connell made much of the actions of the CAS Board's Chair – that same person who also acts as Administrator of the Office of Federal Procurement Policy – yet did not explore whether that individual had an inherent conflict of interest that prevented the exercise of independent judgment and action. We're are emphatically not alleging that any such conflict existed; but when where a single individual wears "two hats" and the authority of one hat is used to ratify the actions of the other hat, we have concerns. And we think Judge O'Connell could have explored that situation a bit more before conflating the authority of the OFPP Administrator with the authority of the CAS Board Chair. Using that logic, the rest of the CAS Board might as well not even exist. There is no reason for them to vote, since the CAS Board/OFPP Administrator has all the authority that s/he needs to act (or to refrain from acting).

But we're not done with this decision yet. After the bad news comes some good news.

Raytheon SAS introduced a novel argument. Raytheon argued that DCAA's methodology "double-counted" the cost impact and would lead to a double recovery of costs—a windfall that was clearly prohibited by the CAS Regulations. According to Judge O'Connell—

Raytheon contends that the government is seeking a double recovery on all three revisions because it seeks recovery for not only the increase in costs allocated to flexibly-priced contracts but also the corresponding decrease in costs allocated to fixed-price contracts. … Raytheon emphasizes that it incurred the same amount of costs after this change. … Under Revision 1, Raytheon reduced the costs allocated to fixed-price contracts by $281,100 and increased costs to flexibly-priced contracts by $313,200. Although the government has not challenged Raytheon's assertion that these are the same costs, it nevertheless contends that these two figures should be added together to ascertain the principal amount of its Revision I damages, that is, $594,300

Raytheon SAS provided a simple table to illustrate its point (you can find that table on page 26 of the decision). Judge O'Connell explained the hypothetical situation thusly—

Raytheon provides a simple example to illustrate what it views as the unfairness of the government's position. It posits a world where the Revision I change applies only to two contracts, one fixed-price, one flexibly-priced, both at one million dollars. It then reduces the allocation to the fixed-price contract by $300,000 as a result of the property accounting change and increases the flexibly-priced contract by the same amount … Under this scenario, if no adjustments are made to the contracts, the government would pay $2.3 million for goods or services for which it expected to pay only $2 million. This would violate the statutory bar that the government not pay increased costs in the aggregate. But this [same] statute also prohibits the government from recovering greater than the aggregate increased cost to the government. As Raytheon points out in its brief, if the government recovers $300,000 it seemingly would be made whole because the government would receive the same goods or services as before the accounting change and it would still pay a total of $2 million. According to Raytheon, any recovery beyond $300,000 would violate the bar on recovering more than the aggregate cost increase.

This is an important new argument not previously adjudicated before (to our knowledge). Raytheon was, in essence, challenging the long-held government position that it was entitled to

recover cost decreases to fixed-priced contracts in addition to cost increases to flexibly priced contracts. In support of its position, the government cited to the CAS Regulations themselves, at 9903.306(b). However, Judge O'Connell was not persuaded and wrote that—

The government's position runs afoul of the prohibition in § 1503(b). Going back to Raytheon's simple example of a world with one fixed-price and one flexibly-priced contract valued at one million each, the government's position would allow it to recover (or simply not pay) $300,000 on each contract. Thus, although it originally contracted to pay a total of $2 million, after the accounting change it would receive the same goods or services for a total of $1.7 million. This is the very definition of a windfall and is just as inequitable as if no adjustments were made and Raytheon received $2.3 million for this work.

Accordingly, we hold that under § l503(b) the government may recover the increased costs allocated to flexibly-priced contracts, but it may not also recover those same costs when they are removed from the allocation to fixed-price contracts, and grant Raytheon summary judgment on this issue.

In conclusion, Raytheon "won some and lost some" and some decisions were deferred to a trial on the merits. Let's recap this complex – and very important – decision. (A decision which is almost certain to be appealed.)

Revision 1 – Government sought $1,176,600. Raytheon will have to pay nothing. Victory for Raytheon SAS.

Revision 5 – Government sought $512,732. Raytheon will have to pay not more than $153,000 (plus interest), which is the portion of the impact applicable to flexibly priced contracts. There will be a trial to adjudicate the application of a 30 percent mark-up factor by DCAA and whether the CFAO should have found the cost impact to be immaterial.

Revision 15 – Government sought $172,363. Raytheon will have to pay not more than $83,800 (plus interest), which is the portion of the impact applicable to flexibly-priced contracts. However, to the extent that the impact applies to pre-2005 contracts, Raytheon will be permitted to offset the impacts, which will reduce that value by roughly one-third. In addition, there will be a trial to adjudicate the application of a 30 percent mark-up factor by DCAA and

whether the CFAO should have found the cost impact to be immaterial.

As we noted in the **prior article** (Part 1 of 2), Raytheon is one of the few big defense contractors that seems to be willing to litigate its positions, when it believes that is positions have merit. Based on this decision (which is really three decisions in one), it is apparent why Raytheon is willing to go to court when it believes the government is wrongfully demanding money from it.