Unallowable costs.

Expressly unallowable costs.

Directly associated unallowable costs.

The foregoing are “flavors” of unallowable costs about which government contractors need to know. In addition to those groups, contractors need to know that the government has the right to impose penalties for inclusion of unallowable costs in proposals to establish final billing rates.

What else do contractors need to know? How about—

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The government can impose penalties equal to the amount of the unallowable cost, plus interest. These are commonly known as Level 1 penalties.

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The government can impose penalties equal to twice the amount of the unallowable cost, plus interest. These are commonly known as Level 2 penalties.

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The government can (and in certain circumstances, *must*) waive imposition of penalties and interest.

Complicated stuff, right? Well, we've written about the topic before.

Here's **a link** to a 2015 article on expressly unallowable costs.

Here's **another link** to a 2017 article on expressly unallowable costs and associated penalties.

And here's a link to **an article** discussing an ASBCA decision regarding expressly unallowable costs and imposition of penalties, with respect to The Raytheon Company. In that decision, the ASBCA addressed five separate cost allowable issues and Raytheon won on four of them.

Here's a summary of the results:

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Raytheon's appeal of penalties and interest associated with $336,900 in fractional airline expenses was sustained, meaning that the Board found those costs were not expressly unallowable.

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Raytheon's appeal of penalties and interest associated with $63,000 in other executive airplane costs was sustained, meaning that the Board found those costs were not expressly unallowable.

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Raytheon's appeal of penalties and interest associated with $200,000 paid to a software firm to design and build a Mergers & Acquisitions (M&A) database was sustained, meaning that the Board found those costs were not expressly unallowable.

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Raytheon's appeals of penalties and interest associated with roughly $395,000 in consultant

costs were sustained. The costs were alleged to be expressly unallowable because of a lack of work product (see 31.205-33(f)). In this instance, the Board went out of its way to find that the consultants' costs were not only not expressly unallowable, but also both reasonable and allowable.

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Raytheon's appeals of penalties and interest associated with roughly $225,000 in lobbyists' salaries was denied, because the Board found that such expenses were expressly unallowable.

All in all, Raytheon won on roughly $900,000 of the $1,120,000 in dispute.

Recently, Raytheon and the government were back at the ASBCA, asking the Board for reconsideration of that decision. Raytheon wanted reconsideration of the one area in which it had lost (lobbyist salaries) and the government wanted reconsideration of one of the four areas in which it had lost (fractional airline expenses). Both motions for reconsideration were denied.

But **the decision** was notable more for the discussion than the result. With respect to Raytheon's contentions, the Board found that, when read together, the FAR cost principles clearly made the salaries of employees engaged in lobbying activities to be expressly unallowable. With respect to the government's contentions, we thought the Board's discussion regarding unallowable costs and imposition of penalties to be instructive.

According to the decision—

The government contends that the Board made clear errors of law when it ruled in *Raytheon II* that Raytheon's aircraft fractional lease costs were not expressly unallowable under the parties' February 2005 Advance Agreement and thus were not subject to penalties and that, even if they were expressly unallowable, penalties were not warranted because the pertinent penalty statute and regulations do not apply to costs that are expressly unallowable under a contract.

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Regarding aircraft fractional lease costs, the CACO assessed level one/single penalties against Raytheon under FAR 42.709-1(a)(1). As noted, that FAR provision states that a penalty applies if the indirect cost at issue is expressly unallowable under 'a cost principle in the FAR, or an executive agency supplement to the FAR, that defines the allowability of specific selected costs.' It does not include the terms 'contract,' 'agreement,' or the like. … if an agency head determines that a submitted indirect cost is expressly unallowable under a "cost principle" referred to in subsection (a) [of 10 U.S.C.§ 2324], then the agency head is to assess a penalty equal to the amount of the disallowed costs plus interest. Again, for level one penalties, the statute does not use the term 'contract,' 'agreement,' or the like. The FAR 52.242-3, Penalties for Unallowable Costs clause, incorporated into the contract, is to the same effect at subsections (b) through (d) [of the statute]. *The aircraft fractional lease costs at issue were not stated to be unallowable under a FAR cost principle or executive agency supplement to the FAR.*

(Internal citations omitted. Emphasis added.)

Because the fractional aircraft lease costs were not named as being unallowable under a FAR cost principle (or FAR supplement), the government was prevented from calling them "expressly" unallowable costs and imposing penalties for their inclusion in Raytheon's proposal to establish final billing rates. Because the costs were not "expressly" unallowable, the government could not assess Level 1 penalties plus interest.

However, the government argued that Raytheon should be subject to Level 2 penalties plus interest, because an Advance Agreement executed in 2005 named the costs as being unallowable. Since the Advance Agreement was, in essence, a contract, then the FAR 31.001 definition of "expressly unallowable cost" would apply. (The definition states that an expressly unallowable cost is "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.") (Emphasis added.)

Readers should note the distinction being made by the Board in this decision between statute (10 U.S.C. § 2324), regulation (FAR 42.709-3, contract clause (52.242-3), and the FAR cost principles (FAR Part 31 and the definitions at 31.001). The distinction is crucial. The decision stated—

The plain language of the statutory and regulatory provisions regarding level one penalties does not include contracts. The contract aspect of the definition applies when level two, or double, penalties are at issue. Double penalties apply if the agency head determines that a contractor's proposal for settlement of indirect costs 'includes a cost determined to be unallowable in the case of such contractor before the submission of such proposal.'

Thus, if the government were correct that the Advance Agreement formed a contract in which fractional aircraft costs were named as being unallowable, and that contract was executed before Raytheon submitted the final billing rate proposal in which they were included, then Raytheon could be subject to Level 2—*but not Level 1*—penalties.

Unfortunately for the government, the Board found that the Advance Agreement did not name the costs as being unallowable. The decision stated, "As more fully explicated in *Raytheon II*, while Raytheon agreed not to charge a portion of its aircraft fractional lease costs to the government, it did not concede that they were unallowable under the FAR." (Internal citation omitted.)
Oops.

The Board went on to add that, in any event, the CACO never assessed Level 2 penalties "and the government did not pursue level two penalties during the hearing." Because the CACO did not assess Level 2 penalties, the Board declined to apply them.

Importantly, Judge Scott, writing for the board, stated "The assessment of penalties is not a mere matter of quantum, but rather involves entitlement under the statutory and regulatory scheme. *A claim for level two penalties is separate from a claim for level one penalties.*" (Emphasis added.) Because "there is no proper government claim for double penalties before us, as required by the Contract Disputes Act, 41 U.S.C. § 7103(a)(3), and we lack jurisdiction to entertain such a claim."

Thus, the CACO's failure to properly read the statute, regulations, and contract clause (as interpreted by the Board) created a situation where penalties and interest were unable to be assessed against Raytheon, even if the Advance Agreement had acted to invoke the definition of "expressly unallowable costs" found in FAR 31.001.

For contractors dealing with imposition of penalties and interest, we think the Raytheon appeals are must-reading.