The FAR cost principle at 31.206 establishes the allowability of various aspects of employee compensation. It's the longest cost principle, running from 31.205-6(a) through 32.205-6(q), and covers such diverse items as income tax differential pay, bonuses and other incentive compensation, and backpay. Among the items addressed in the cost principle is severance pay.

Severance pay is defined at 31.205-6(g) as "a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated." (We're guessing most of our readers already knew that part.) According to the cost principle, severance pay is allowable only to the extent that it is required by law, required by an employer-employee agreement, an established policy that constitutes (in effect) an implied agreement, or "circumstances of the particular employment." Except for that last part—which seems rather vague—the cost principle is fairly straight-forward. If you meet one of the four tests, the severance pay is allowable.

The 31.205-6 compensation cost principle also establishes allowability limits for certain employees. If you check out 31.205-6(p), you'll find a fairly complex set of rules that establishes, based on the agency and timing, maximum ceilings on the compensation of certain contractor "senior executives"—and then later "all employees" regardless of their title. The rules are so complex that DOD, DCAA, and contractors all agreed that a "blended rate" formula could be used to establish compensation allowability in the aggregate, rather than by individual employee. (For some discussion on blended rates, please see **this article** .)

Of particular note, 31.205-6(p) has a unique definition of compensation that applies only to that paragraph of the cost principle. According to 31.205-6(p)—

'Compensation' means the total amount of wages, salary, bonuses, deferred compensation (see paragraph (k) of this subsection), and employer contributions to defined contribution pension plans (see paragraphs (j)(4) and (q) of this subsection), for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the contractor's cost accounting records for the fiscal year.

Presumably, if an element of compensation is not included in the above list, then it may properly be excluded from calculating an individual's compensation that is subject to the 31.206-6(p) ceilings. At least, that's what we thought, until a **recent opinion** by Judge Clarke at the

ASBCA called that presumption into question.

The situation was fairly simple. In 2014, and as required by the 2014 Separation Agreement, DynCorp International (DI) made a severance payment to its CEO on the way out. The severance payment was also made pursuant to the 2010 Employee Agreement between the CEO and the company. The severance payments were made over a three-year period, in 2014, 2015, and 2016. DCAA questioned the costs because the auditors believed the severance payments were not reasonable.

Interestingly, the DCAA audit report stated that the amount of the severance payments was not significantly more than other defense contractors of similar size had made, and that DI's severance payments "were reasonable in comparison." Nonetheless, the auditors questioned the severance payments because—and we're going to quote the audit report note in full—

In our opinion, the annual compensation used in the calculation should be subject to the limit discussed in FAR 31.205-6, Compensation. FAR 31.205-6(p)(1)(i) defines compensation as, in part: "...the total amount of wages, salary, bonuses ...." *Although the severance payments do not meet the definition of compensation*
, the salary and bonus components of the severance calculations do meet this definition. Therefore, in our opinion, the FAR 31.205-6(p) limitation on allowability of compensation is an appropriate benchmark to determine reasonableness of the salary and bonus components. *Consequently, in our opinion, the salary and bonus portion of the severance payment calculation in excess of the limit in FAR 31.205-6(p)(1)(i) is unreasonable.*

(Emphasis in original quote found in the ASBCA opinion.)

To determine the allowable amount of compensation, the auditors went back to the 2010 executive compensation limit and then applied that amount to the severance pay (doubling it as required by the terms of the agreement). Thus, $7,812,098 out of $8,050,000 was questioned as compensation in excess of the ceiling in effect at the time the CEO was hired.

DynCorp disagreed but the CACO agreed with the auditors and issued a Contracting Officer's Final Decision in which he unilaterally establish DI's final rates based, in part, on the questioned severance payments.

Judge Clarke started by agreeing with DI that severance pay is not compensation as defined by 31.205-6(g). But then he took issue with DI's argument that DCAA had found the amount of compensation to have been reasonable. He wrote—

DI interprets this [the DCAA audit note we quoted above] to mean that the severance payment 'amounts' are reasonable. We do not agree. DCAA simply found that 'severance terms of twice a CEO's salary plus bonus to be reasonable.' The word 'terms' cannot reasonably be interpreted to refer to the dollar amount of the severance paid to former CEO Gaffney. We interpret the language as DCAA finding the mechanism of calculating the severance pay reasonable.

As non-lawyers, this reasoning seems confusing. To us, if the mechanism of calculating the amount is reasonable and in alignment with what other contractors of similar size do, then the result of that mechanism must also be reasonable. But as we said, we're not lawyers. So what do we know?

Even though Judge Clarke agreed that the severance payments were not subject to the exact ceilings found in 31.205-6(p), he decided that they were unreasonable in amount, because DynCorp had a responsibility to "the Government … and the public at large" under the definition of "reasonableness" found at 31.201-3(b)(3). He concluded as follows—

DI's severance payments were calculated in part using salary and bonus amounts that exceeded the statutory caps. We find that the portion of the severance payments derived from unallowable salary and bonus amounts above the statutory caps are likewise unallowable. This conclusion is just common sense, there is nothing magic about a severance pay calculation that converts unallowable salary into allowable severance payments. … Bottom line: unallowable salary cost used in a severance pay calculation results in unallowable severance costs – unallowable in, unallowable out.

So, common sense apparently trumps the plain language of the cost principles.

Nice.

As non-lawyers who nonetheless have been dealing with FAR cost principles for several decades, we must express vehement disagreement with this opinion. How Judge Clarke persuaded two other Judges of the Board to agree with him is a mystery to us.

But as we said, we're not lawyers. So what do we know?