In a recent decision, the U.S. Court of Federal Claims decided that Tolliver Group was entitled to increased costs on its firm, fixed-price contract with the U.S. Army. We discussed that decision **here** . What made the decision so interesting (to us, at least) was that the additional costs in question were legal expenses incurred by Tolliver in successfully defending against a relator's *qui* tam suit under The False Claims Act.

In rejecting Tolliver's initial claim for the legal expenses, the contracting officer asserted (among other things) that the expenses were not allocable to the contract. They were found to be not allocable because "they were not incurred specifically for the contract and did not provide the government with a benefit." That got us thinking about the allocability of legal expenses.

Generally, legal expenses are treated as being indirect costs. Whether incurred by in-house counsel or external counsel, such costs are typically treated as General and Administrative (G&A) expenses. The question is: Under what circumstances may legal costs be direct costs of a contract? Neither CAS nor FAR provide any kind of guidance regarding the allocation of legal expenses. Let's say that Tolliver consistently treated its legal expenses as being part of its G&A expense pool. How could it then request reimbursement for its costs as if they were direct costs of the Army contract without violating CAS 402? (Remember, CAS 402 requires that the same costs be treated the same way—as being either direct or indirect costs—when incurred for the same purpose in like circumstances.) Thus, to show that these particular legal expenses were direct in nature, Tolliver would have to show that the purpose and/or circumstances differed.

The Court did not address this point in its decision. So we don't really know how Toliver would have handled the situation. Perhaps Toliver was not subject to CAS? Or perhaps it could show that all False Claim Act defense costs consistently were allocated to the contract(s) that gave rise to the litigation. Again, we do not know.

Here's what we do know: There are legal precedents for what we imagine Tolliver's cost accounting treatment of these legal expenses may have been.

In 1988, the ASBCA found that a protester's legal costs incurred in defending against a protest from the losing offeror were direct costs of the contract, despite the contractor's consistent practice of including all other legal expenses in its indirect cost pools. What appeared to persuade the Board were the findings that (1) the costs were incurred in connection with a

specific contract and did not benefit any other contract, (2) because the costs did not benefit any other contract they could not be treated as indirect costs for allocation to those contracts, (3) the contractor had no choice but to defend against the bid protest, and (4) DCAA audit guidance at the time considered protest-related costs as being direct costs rather than indirect costs. (See *Jana, Inc.*, ASBCA No 32447, Mar 11, 1988, 88–1 BCA ¶ 20,651.)

Also in 1988, the Court of Appeals (Federal Circuit) considered an ASBCA decision regarding a contractor's inclusion of legal expenses related to litigation between two contractors in its G&A expense pool, despite that litigation relating solely to one particular subcontract. The ASBCA found that, because the legal expenses were incurred specifically for, and could be identified specifically with, the subcontract, the costs were not indirect costs of government contracts. The contractor argued that the decision to litigate was a general business decision and that all its contracts benefited to some extent from the litigation. The contractor also noted that the legal expenses had been incurred after the end of the subcontract's period of performance. The ASBCA was not persuaded, deciding that the alleged financial benefit to other government contracts was too remote and insubstantial to justify allocation through general and administrative expenses. The Appellate Court upheld the Board's decision. (See *FMC Corp v US* , US Ct of App for the Fed Cir, No 87–1423, Decision Aug 5, 1988, affg ASBCA 1987, 87–2 BCA ¶ 19,791.)

Based on those two decisions, you might conclude that the Courts have favored direct allocation of legal expenses—especially litigation expenses. But since those two decisions, the allocability of legal expenses has become somewhat muddied.

The first decision that muddied the field was *Caldera v. Northrop Worldwide Aircraft Services, Inc.* , 192 F.3d 962 (Fed.Cir.1999). In that case, the Appellate Court held that Northrop's litigation defense costs "were not allocable under FAR § 31.201-4" because the government did not benefit from Northrop's defense of the [state court] lawsuit That decision was problematic because it appeared to conflate the concepts of *allocability* and *allowability*. Nonetheless, the ASBCA cited to it when it found against a subsequent appeal brought by The Boeing Company.

Thus, the second decision was *Boeing North American, Inc. v. Roche*, (Fed.Cir. 2002). In that

appeal, Boeing argued that that under the FAR no benefit to the government need be shown for a cost to be allocable, even if a nexus to a particular contract is necessary for a cost to be allocable. The Federal Circuit found that “Here the CAS clearly renders Rockwell's legal defense costs allocable as part of G & A expenses.” Further, the Court wrote—

Our earlier decisions [Lockheed and FMC Corp. v. US] relied on by the government as authority for the ‘benefit to the government’ theory, do not supply any support for a rule that would base the allocability of a cost on the cost's ‘benefit to the government’ as opposed to its nexus to government work. … Thus, we agree with Boeing that allocability is an accounting concept and that CAS does not require that a cost directly benefit the government's interests for the cost to be allocable. The word ‘benefit’ is used in the allocability provisions to describe the nexus required for accounting purposes between the cost and the contract to which it is allocated. The requirement of a ‘benefit’ to a government contract is not designed to permit contracting officers, the Board, or this court to embark on an amorphous inquiry into whether a particular cost sufficiently ‘benefits’ the government so that the cost should be recoverable from the government.

Therefore, in *Boeing*, the Court found that the litigation expenses were allocable to government contacts in general via the G&A expense allocations. That being said, the costs were still disallowed. (*Cue sad trombone sound.*)

Looking at the totality of the cases, we here at Apogee Consulting, Inc. – WHO ARE NOT ATTORNEYS AND ARE NOT OFFERING LEGAL ADVICE – would say that litigation expenses can be differentiated from other “normal” legal expenses and allocated to the contract or contracts that gave rise to their incurrence. Litigation costs (and other legal expenses) that are not caused by, and which do not benefit a particular contract while benefiting all contracts, may be retained in the G&A expense pool for allocation.

That’s about the best we can figure it out.