Hello. It's been a while. For those who've asked where I've been, the truth is I've been where I always am, right here behind the monitor. I've been busy—too busy to update this blog—and there hasn't been much I've wanted to say. It's been a weird time in government contract cost accounting and compliance.

But today I want to talk about the January, 2023, decision at the Court of Appeals (Federal Circuit) in the matter of **Secretary of Defense v. Raytheon Co .** It's a puzzling opinion and I've been letting it marinate for a while. Keep in mind that nobody over here is an attorney, so our opinions—such as they are—should be taken with a large grain of salt. If you want cogent legal advice, pay for it.

Background

I wrote about the original 2021 decisions at the ASBCA here on this blog. There was a lot to write about, and it took me four (4!) separate articles to do so. Here's **a link** to the first article, from April, 2021.

To recap:

There were myriad issues at both the Raytheon Home Office and at the Raytheon Missile Systems (RMS) segment. There were allegations of violations of CAS 405. There were allegations that expressly unallowable costs had been claimed. There were allegations of insufficient supporting documentation. In total, the government sought roughly $15 million. The ASBCA sustained substantially all of Raytheon's appeals of various Contracting Officer Final Decisions. It was a big victory.

The government appealed two (of the many) issues to the Federal Circuit. Both issues were Home Office issues. One issue dealt with "Corporate Development" costs and the other issue dealt with "Government Relations" costs. The ASBCA's decisions on both issues were reversed by the Federal Circuit.

Let's discuss.

Corporate Development

According to the original ASBCA decision—

Raytheon's Corporate Development department was responsible for working with its business units in strategic development and growth opportunities, including strategic analysis of a business' capabilities to market its products and services to the government and function in government work. Where there were gaps in business' capabilities, Corporate Development would work with them to determine the right ways to fill the gaps, either through, inter alia, internal investment, research and development, licensing of intellectual property (IP), partnerships or acquisitions. This process was known as 'gap analysis.' Working with Raytheon's businesses on M&A and divestitures was not Corporate Development's primary role but was part of its work to find strategic growth initiatives.

Corporate Development made proposals for acquisitions or divestitures to the Acquisition Council which, in 2007 and 2008, consisted of senior Raytheon leaders, including the Chief Executive Officer, Chief Financial Officer, General Counsel and Vice President of Corporate Development. Raytheon declared its intentions regarding potential acquisitions and divestitures through the Acquisition Council. Corporate Development did not know which route Raytheon was going to follow until after the Acquisition Council made its decision. Occasionally, even after an Acquisition Council decision, Raytheon would change course based upon information developed during the acquisition or divestiture process.

(Internal citations omitted.)

In other words, one of Corporate Development's role was Mergers, Acquisitions, and Divestitures—i.e., external activities that would "fill the gaps" between current company capabilities and what the experts believed the government was going to want and/or need in the future. Reminder: the cost principle at FAR 31.205-27 ("Organization Costs") makes that stuff unallowable. ("… expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) resisting or planning to resist the reorganization of the corporate structure of a business or a

change in the controlling interest in the ownership of a business … are unallowable.")

Raytheon had policies and procedures to help its people distinguish between allowable economic planning costs and unallowable M&A activities. Consistent with its records and policies, Raytheon self-disallowed 50 percent and claimed the other 50 percent as being allowable non-M&A activities. DCAA disagreed and asserted that 100% of all Corporate Development costs were unallowable. The CACO agreed with DCAA and told Raytheon that not only were the costs unallowable, they were expressly unallowable—meaning that Raytheon owed the government penalties and interest. The CACO threw in a CAS 405 noncompliance, as well.

On appeal, the Board found that the Government had not met its burden, writing—

DCMA has not carried its burden to prove by a preponderance of the evidence that the amount of unallowable hours withdrawn by Raytheon's personnel, which is supported by documentation and credible witness testimony (see, e.g., findings 41-45, 57-58, 60), from its CY 2007 and 2008 incurred cost proposals was inaccurate, nor that any of the included Corporate Development costs were unallowable, let alone expressly unallowable and subject to penalties. Thus, DCMA has also not met its burden to prove that Raytheon violated CAS 405 regarding those costs.

The Federal Circuit disagreed with that position, finding that "ample evidence before the Board established that at least some of Raytheon's 'allowable' pre-decision salary costs related to planning mergers, acquisitions, or divestitures." The Federal Circuit concluded—

Because the Board erred as a matter of law in concluding that Raytheon's corporate-development policies were consistent with the FAR, its factual determination that the government was not charged for unallowable costs because Raytheon's employees complied with those policies is also legally incorrect. We therefore reverse the Board's conclusion and remand for the Board to determine the amount of unallowable costs improperly charged to the government. We again recognize that Raytheon's policies make this a difficult task, but we reiterate our view that Raytheon should shoulder the burden its policies created.

Our Thoughts

The Federal Circuit essentially ruled that the Government didn't have to prove anything. Simply finding that Raytheon's policies and procedures led to the incurrence of expressly unallowable costs was sufficient to prevail. The fact that the Government was unable to quantify the amount of expressly unallowable labor costs stemmed from Raytheon's policies, apparently.

Left unstated in the Appellate decision was the fact that Raytheon had already self-disallowed 50 percent of its Corporate Development costs. DCAA (and the Contracting Officer) asserted that 100% was unallowable—an assertion that was contradicted by testimony. So what is the correct amount to disallow? The Federal Circuit was silent on that, remanding to the Board to make that finding. Presumably, the right value is somewhere between 50 and 100 percent.

At the end of the day, Raytheon published a "bright-line" to aid its employees in accurate timekeeping. The ASBCA found the line to be reasonable, but the Federal Circuit disagreed. According to the Federal Circuit, simply identifying M&A targets—whether or not an offer was ever made or due diligence ever initiated—was itself unallowable. Okay. We get that.

In that regard, you could craft an analogy to FAR 31.205-47 ("Legal and Other Proceedings"). When does a legal proceeding start? Does it start when the claim or appeal is filed, or when a demand letter is received? Or does it start before the official "proceedings" start. We have long grappled with that question. Given the Raytheon decision, we suggest that unallowable costs associated with legal proceedings likely start before that time; perhaps at the moment somebody says "we're going to court on this one."

Something to think about?

Government Relations

The term "Government Relations" encompasses a number of activities, but prominent among them is *lobbying—i.e.,* the effort to influence senior military officers and Congress folks to fund programs that are important to the contractor. FAR 31.205-22 makes lobbying and other political activity costs unallowable, but provides exceptions for certain specified activities. Among the exceptions is the effort to provide Congress with technical and factual information

related to performance of one or more of the contractor's contracts.

In a similar fashion to how it handled unallowable Corporate Development costs, Raytheon self-disallowed lobbying expenses. However, its methodology relied on labor records. In the original ASBCA decision, the Board found that—

For the lobbying cost withdrawal calculation, Raytheon established a ratio of unallowable hours worked by the Government Relations employees to their total hours worked. The ratio's numerator was the total number of unallowable hours reported by the lobbyists. The denominator was the total number of work hours available during a given year to the employees who reported unallowable hours, based upon a 40-hour work week less vacation and holidays. Dividing the numerator by the denominator yielded a percentage—the lobbying disallowance factor. Raytheon applied this factor to what it deemed to be Government Relations' recoverable expenses (including the salary and fringe benefits paid to its lobbyists and their administrative staff) to determine the costs associated with unallowable lobbying activities under FAR 31.205-22.

The problem with the above, according to the Federal Circuit, was that Raytheon failed to account for all lobbying hours expended by its employees. Both the numerator and denominator were inaccurate—they were both undercounted by the labor hours that Raytheon employees failed to record. (Though the Federal Circuit elided any mention of the problem with the denominator.)

Total-time accounting is popular among Government contractors—though proper treatment of uncompensated overtime is tricky. The point here is that there is no regulatory requirement that mandates total-time accounting; in particular, Raytheon eschewed it for many years—perhaps decades—requiring instead that its employees only record a 40-hour work week. That position, though accepted by the ASBCA, proved to be Raytheon's undoing at the Federal Circuit.

Once again, though the Board found the Government had failed to carry its burden, the Federal Circuit disagreed, asserting that, because some labor hours were unrecorded, and that those unrecorded hours were lobbying and therefore unallowable. The Federal Circuit opined that "Raytheon, by ignoring after-hours lobbying, must have charged the government for unallowable lobbying costs."

The Federal Circuit opinion added—

Raytheon's time-paid accounting is a fiction that necessarily overcharges the government when it ignores time spent working on unallowable activities after regular business hours. Raytheon's lobbyists worked on unallowable activities after-hours, and their salaries necessarily compensated them for that time. Raytheon's policies ignoring after-hours time resulted in the government reimbursing Raytheon for unallowable costs.

Our Thoughts

We would have liked to see the Federal Circuit align its opinion with the requirements of CAS 405 and FAR 31.201-6 ("Accounting for Unallowable Costs"). It is unsurprising that no mention was made of those requirements, because they might have undercut the legal position espoused by the Federal Circuit.

(e)(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with paragraph (e)(1) of this subsection (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. *Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are a part of the employee's regular duties.*

(Emphasis added.)

In our view, a materiality analysis needed to be made by the Government. It might be based on interviews of personnel engaged in lobbying, or else by requiring employees to keep logs of after-hours efforts. Because no materiality analysis was performed, nobody knows whether Raytheon was required to record the unallowable lobbying costs of its employees who were engaged in after-hours efforts.

But none of that mattered to the Federal Circuit. Eschewing facts once again, the Judges preferred their own legal theory in which compensation covered both the standard 40 hours/week and after-hours efforts. In other words, the more total hours worked, the more employees should have been compensated. As a popular commercial once said: “That’s not how this works. That’s not how any of this works.”

We think that the Federal Circuit opinion conflates hourly and salaried compensation—a distinction clearly made by CAS 405 and the cost principle quoted above. As such, we would assert a legal error was made. But what do we know?

Conclusions

We don’t really care for this decision. However, unless Raytheon appeals to SCOTUS and the decision is overturned there (highly unlikely) it is the official interpretation. This decision deals with two issues—unallowable M&A activity and unallowable lobbying activity. Accordingly, it’s limited to those two areas. But the lesson is clear: when employees are engaging in unallowable activities, they need to record ALL time worked. *Period.* (We think legal proceedings are worth considering in this light as well as the other two areas specifically covered.)