

# Analysis & Perspective

## Allowable Costs

### Executive Compensation

In a test case involving a breach claim against the government asserted by General Dynamics Corp., the U.S. Court of Federal Claims held on Sept. 15, 2000, that the statutory cap on federal contractors' allowable costs for executive compensation may not be applied retroactively to a contract that otherwise does not limit the allowability of such costs, *General Dynamics Corp. v. United States*, 54 Fed. Cl. 514 (2000) (74 FCR 280). This case opens the door for similar breach of contract claims by other affected contractors. This article discusses the General Dynamics case and provides guidance for developing similar "compensation cap claims."

## Issues in Developing Breach Claims Under the *General Dynamics* Compensation Cap Decision

By RICHARD C. JOHNSON AND ROBERT S. NICHOLS

### The *General Dynamics* Test Case

#### The Contract

**O**n Jan. 29, 1996, the Department of the Navy, Naval Sea Systems Command, awarded Contract No. N0024-96C-2100 (Contract -2100), a cost-plus-fixed-fee contract, to General Dynamics Corp. (GD) for the detail design of the Virginia Class nuclear subma-

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rine.<sup>1</sup> The contract envisioned performance to occur through at least December, 2004. Incorporated into the contract was Federal Acquisition Regulation (FAR) 52.216-7 ("Allowable Cost and Payment"), which provided in part:

[t]he Government shall make payments to the Contractor when requested as work progresses . . . in amounts determined to be allowable by the Contracting Officer in accordance with subpart 31.2 of the Federal Acquisition Regulation (FAR) in effect on the date of this contract and the terms of this contract.

FAR 52.216-7(a) (July 1991) (emphasis added). The applicable FAR subpart 31.2 contained provisions establishing standards for the allowability, allocability, and reasonableness of costs incurred in cost-reimbursement contracts. Those general provisions included, *inter alia*, FAR 31.201-1 ("Composition of Total Cost"), FAR 31.201-2 ("Determining Allowability"), FAR 31.201-3 ("Determining Reasonableness"), FAR 31.201-4 ("Determining Allocability"), and FAR 31.204 ("Application of Principles and Procedures").

No provision in Contract -2100, including the incorporated FAR requirements, imposed any fixed limit on executive compensation costs. The only limitation on the allowability of such costs was the requirement that the government contracting officer find them to be reasonable under FAR 31.205.6(b), which governed the

<sup>1</sup> Contract -2100 was awarded as a letter contract and definitized in a modification dated May 9, 1996. The definitization set the total contract price at \$1,374,958,371 (including estimated cost, fixed fee, and potential performance incentives).

reasonableness of compensation for all personal services. In making this finding, the contracting officer was to consider such factors as the compensation practices of other firms of like size, in the same industry, in the same geographic area, or engaged in predominately non-government work, as well as the cost of comparable services obtained from outside sources. FAR 31.205.6(b)(1). These FAR requirements effectively made the contracting officer's determination of the reasonableness, and therefore allowability, of executive compensation costs a discretionary application of the relevant regulations.<sup>2</sup>

### The Subsequently Enacted Statute

On Nov. 18, 1997, Congress enacted the National Defense Authorization Act for Fiscal Year 1998, Pub. L. No. 105-85, 111 Stat. 1629. Section 808 of the Act imposed a cap on defense contractors' allowable costs of "senior executive" compensation by making unallowable all such costs that exceed a "benchmark compensation amount" to be determined annually by the Administrator for Federal Procurement Policy. The cap applied to all senior executive compensation costs incurred by defense contractors under covered contracts after Jan. 1, 1998, regardless of whether the contracts were executed after that date or were already in existence prior to Jan. 1, 1998. Pub. L. No. 105-85, Sec. 808(a).

Section 808 defined "covered contracts" as cost-reimbursement and fixed-price-incentive contracts in excess of \$500,000 (adjusted every five years for inflation). "Compensation" was defined as the total amount of wages, salary, bonuses, and deferred compensation for the year, whether paid, earned, or otherwise accruing. Section 808 also defined "senior executive" as (1) the CEO of the contractor or anyone acting in similar capacity, (2) the contractor's other four most highly-compensated management personnel, and (3) in the case of a contractor with components reporting directly to its headquarters, the five highest-compensated management personnel at each component. The definition of "senior executive" was amended a year later to include "the five most highly compensated employees in management positions at each home office and each segment of a contractor." The Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, Pub. L. No. 105-261 § 804(a), 112 Stat. 1920. These provisions are codified at 10 U.S.C. § 2324.

Implementing Section 808, the administrator for Federal Procurement Policy publishes in the *Federal Register* each year a "Determination of Executive Compensation Amount" pursuant to Section 808 of Pub. L. No. 105-85. That determination established a 1998 "benchmark compensation amount" of \$340,650 for allowable costs for senior executive compensation in covered contracts.<sup>3</sup> 63 Fed. Reg. 8,981 (Feb. 23, 1998).

<sup>2</sup> Although various earlier annual appropriations or authorization acts contained some compensation limits, none applied to Contract -2100. See note 9 and accompanying text.

<sup>3</sup> The benchmark is tied to each contractor's fiscal year and applies to costs incurred after January 1st of each year. See, e.g., 66 Fed. Reg. 22,266 (May 3, 2001) ("This benchmark compensation amount is to be used for contractor fiscal year 2001, and subsequent contractor fiscal years, unless and until revised by OMB. This benchmark compensation amount applies to contract costs incurred after Jan. 1, 2001, under covered contracts . . .").

Similar amounts were set for subsequent fiscal years.<sup>4</sup> Any executive compensation cost allocable to a covered contract and greater than the applicable benchmark became unallowable.

### The Claim

On Oct. 5, 1998, General Dynamics submitted to its corporate administrative contracting officer (CACO) a certified claim related to Contract -2100 under the Contract Disputes Act of 1978 (CDA), 41 U.S.C. § 601, et seq. The claim asserted that:

By applying the new executive compensation cap to contracts entered into before the effective date of Section 808 . . . , the government is unilaterally reducing the amount it agreed to pay General Dynamics for its efforts and is thereby breaching those contracts. . . . The Government's breach of contract with respect to executive compensation costs affects numerous contracts between the Government and General Dynamics' subsidiaries. As a test case, General Dynamics has selected [Contract -2100] that was executed when no compensation cap was in effect.

The CACO denied the claim on Dec. 2, 1998, on the ground that he did "not have the authority to waive statutorily imposed requirements."

On Jan. 29, 1999, GD filed a complaint, captioned *General Dynamics Corp. v. United States*, for breach of contract in the U.S. Court of Federal Claims. In briefs and oral argument before Senior Judge Thomas J. Lydon, GD contended that the government breached Contract -2100 by enacting Section 808 of the FY 1998 defense authorization act, thereby changing the contractual cost-reimbursement scheme.

The government did not dispute that the statutorily mandated benchmarks reduced the reimbursable costs the government must pay for senior executive compensation allocable to the contract. The government, however, argued as a defense that the compensation cap did not breach the contract because there was no "unmistakable" promise that the government would not exercise its sovereign authority to limit reimbursable executive compensation costs under existing contracts.

### The Rulings

In a lengthy opinion issued Sept. 15, 2000, Judge Lydon found the government in breach. The court first applied the reasoning of *U.S. v. Winstar Corp.*, 518 U.S. 839 (1996), and *Yankee Atomic Electric Co. v. United States*, 112 F.3d 1569 (Fed. Cir. 1997), to find that Section 808 was not a "public and general" act and, therefore, that the government could not rely upon the "unmistakability" rule as a defense to the breach claim. Next, the court construed the plain language of the contract and found no valid basis for imposing a cap on allowable executive compensation costs:

[t]he contract language is clear and unambiguous—the provisions of FAR 31.2 in effect on the date of this contract, which were incorporated into Contract -2100 through FAR 52.216-7, govern the determination of allowable compensation costs. The statutory cap violated this contract provision. The court finds, therefore, that the FY 98 Authorization Act breached Contract -2100.

<sup>4</sup> See, e.g., 66 Fed. Reg. 22,266 (May 3, 2001) (2001 benchmark of \$374,228); 65 Fed. Reg. 30,640 (May 12, 2000) (2000 benchmark of \$353,010); 64 Fed. Reg. 28,529 (May 26, 1999) (1999 benchmark of \$342,986).

Id. at 546. The court, based on this ruling, ordered summary judgment for GD on the issue of liability.

Following this initial decision, the parties negotiated for more than a year on the issue of damages. The Department of Justice (DOJ) took the position that each year's claim for damages under the 1997 Act was a separate claim that did not accrue until expiration of the year involved. Under this view, the six-year CDA statute of limitations, 41 U.S.C. § 605(a), would begin to run at the end of each year for which a damages claim comes into existence under a pre-November 1997 contract. Judge Lydon sided with the DOJ, and the parties negotiated a partial stipulation.

On Nov. 14, 2001, Judge Lydon ordered the government to pay GD \$1.53 million as compensation for the reductions in cost reimbursements under the test contract for calendar years 1998-2000. See *General Dynamics Corp. v. United States*, No. 99-45 C (Fed. Cl. filed Nov. 14, 2001). The order also addressed the 2001-2004 claims:

Those claims obviously cannot be made, and the CO cannot make a determination, until the costs are actually accrued. Moreover, the "benchmark compensation amount" on allowable senior executive compensation costs is set annually by the Administrator for Federal Procurement Policy, according to the 1997 statute, so the cap for the latter years of the contract has not yet been set. Accordingly, there is no hard figure from which to calculate prospective damages for future years. Indeed, the breaching statute could be amended or repealed in the interim, thereby eliminating the legal basis for any future claims. For the above reasons, it is clear that all the events establishing the liability of the government for the uncompleted years of Contract -2100 have not yet occurred. Accordingly, plaintiff is not entitled at this time to seek compensation for the contract years 2001, 2002, 2003, and 2004, as no claims concerning these years have yet to accrue.

Id. at 2. Based on this rationale, Judge Lydon dismissed the 2001 to 2004 claims without prejudice.

This order allowed the government to appeal the Sept. 15 summary judgment ruling on the issue of liability. The government filed its appeal to the Federal Circuit Court of Appeals on Jan. 11, 2002, but inexplicably dropped it 19 days later.

## Implications of the Decision

The judgment in *General Dynamics Corp. v. United States*, now final,<sup>5</sup> paves the way for contractors to recover on similar claims related to contracts to which the government has retroactively applied Section 808 of the FY 1998 Authorization Act. It also permits subcontractors who have complied with the "benchmark compensation amounts" to submit claims for their full executive compensation costs on certain subcontracts. This section describes the mechanics of such claims.

### Contracts Qualifying for a 'Compensation Cap Claim'

The only contracts qualifying for a compensation cap claim are those that are covered by Section 808 and to

<sup>5</sup> Although there is no circuit court decision ultimately deciding the matter, Judge Lydon's decision on the Winstar issue is persuasive and has been quoted at length with approval in a subsequent Court of Federal Claims decision, *Grass Valley Terrace v. United States*, 51 Fed. Cl. 436, 440 (2002). The authors doubt that any court or contract disputes board will decline to follow the reasoning of this decision.

which the cap was applied retroactively. A valid claim, therefore, requires a contract that: (a) is cost-reimbursement or fixed-price-incentive, (b) is in excess of \$500,000 (subject to a possible upward adjustment), (c) was entered into before Nov. 18, 1997 (the date of the FY 1998 Authorization Act), and (d) includes or incorporates contract language, such as FAR 52.216-7,<sup>6</sup> establishing a mechanism for determining the allowable amount of executive compensation costs without a cap. Needless to say, this is not all there is to it. There are a few complications that each contractor must address.<sup>7</sup>

### Post-Jan. 1, 1998, Contract Modifications

Executive compensation allocable to contract modifications under covered contracts may or may not be included in a compensation cap claim, depending on the nature of the modification. In the authors' judgment, modifications resulting from unilateral government action, such as a change order and the exercise of an option, do not represent new procurement and should be considered part of the original contract for compensation cap purposes. For example, the government enters into a cost-reimbursable contract on Nov. 1, 1997, ordering \$1 million of aircraft components with options. On Jan. 2, 2000, the government exercises an option to order an additional \$2 million of components. Any application of the Section 808 cap to the additional work would be invalid, as the date of the contract preceded enactment of the statute; the contractor had no choice to accept or reject the option exercised.

The same result would appear to apply where a contract was entered into before Nov. 18, 1997, and the government orders additional work under the contract after the date of enactment by means of a unilateral change order. However, a different result would obtain, in the authors' opinion, in the case of a bilateral modification adding new work by mutual agreement. Such a modification would be more akin to a new contract, and the reasoning of *General Dynamics Corp. v. United States* would not appear to apply. The contractor in that situation was not obligated to accept the new work and to sign the modification.

### Pre-1997 Annual Compensation Caps

At various times prior to Jan. 1, 1998, four different annual compensation caps were in effect, and it is possible that one of these earlier caps could affect a contract otherwise eligible for a compensation cap claim. Without attempting to address all of the complications,<sup>8</sup> the basic points to consider in regard to these earlier caps are as follows.

1. The four earlier caps were all *annual caps*, applying only to contracts entered into between specific dates.

<sup>6</sup> The applicable clauses, FAR 52.216-7 and 52.216-16, are mandatory.

<sup>7</sup> Additionally, as a practical matter, breach claims should be filed only where significant executive compensation costs have been incurred after Jan. 1, 1998. Such costs are usually included in indirect costs that may be allocated to various contracts. Thus, unless the post-Jan. 1, 1998 cost incurrence is significant, the allocable breach damages will likely be quite small.

<sup>8</sup> For a lucid explanation of the applicability of earlier caps, see David B. Dempsey, *Statutes and Regulations Governing Allowable Executive Compensation*, CP&A Report, Feb. 1998, at 3, 6-12.

2. The periods to be concerned about are: April 15 to Sept. 30, 1995; July 1 to Sept. 30, 1996; and Oct. 1, 1996, to Sept. 30, 1997.

3. The earlier caps apply only to the portions of the contract funded by a particular appropriation or to funding provided during a particular period. Thus a long-term, flexibly-priced contract entered into during one of the periods enumerated above will be covered by the applicable cap only to the extent of the funding of the particular year in which the cap was enacted.<sup>9</sup>

4. The individuals covered and the compensation ceilings under the earlier annual statutes vary from statute to statute.

### Statute of Limitations Issues

As noted, *supra*, the CDA statute of limitations, 41 U.S.C. § 605(a), requires that all claims be submitted within six years of the date that the claim accrued. The accrual date for a compensation cap claim, however, is uncertain due to inconsistent positions taken by the DOJ in *General Dynamics Corp. v. United States* and the Federal Circuit's decision in *Franconia Assoc. v. United States*, 240 F.3d 1358 (Fed. Cir. 2001), now pending review by the Supreme Court *sub. nom. Grass Valley Terrace v. United States*, 122 S. Ct. 802 (Jan. 4, 2002) (77 FCR 52). Again, the DOJ's view in *General Dynamics* was that each year's claim was separate and accrued at the expiration of the year involved. *Franconia*, however, supports the opposite position—that the claims accrue when the breaching legislation is enacted.

In *Franconia*, the plaintiffs entered into loan agreements with the Farmers' Home Administration. Congress subsequently enacted legislation eliminating certain of the plaintiffs' contractual benefits. Several years later, the plaintiffs filed actions in the Court of Federal Claims contending that the government was in breach by no longer being able to fulfill its contractual promises. Addressing the applicable six-year statute of limitations, 28 U.S.C. § 2501, the Federal Circuit found that the breach claims accrued on the date the legislation was enacted, and, thereby, terminated the government's promise under the contract, not on a subsequent date when the government's agent would be unable to fulfill that promise.

*General Dynamics* and *Franconia* are governed by different six-year statutes of limitations, see *Motorola, Inc. v. West*, 125 F.3d 1470, 1472-73 (Fed. Cir. 1997), but the issue as to the date of accrual for such claims appears to be identical. The Supreme Court granted *certiorari* to consider this precise issue; oral argument was held April 15. Given the unsettled status of this is-

<sup>9</sup> For defense contracts entered into between Oct. 1, 1996, and Sept. 30, 1997, the \$250,000 cap applies only to flexibly-priced contracts to the extent funded by FY 1997 funds. See Dempsey, *supra* note 9, at pp. 8-10.

sue, the prudent contractor should timely file any compensation cap claim to avoid a possible statute of limitations bar after Nov. 18, 2003, the six-year anniversary of the FY 1998 defense authorization act.

### Applicability of Cap to Subcontracts

Some subcontractors have automatically decremented their executive compensation cost submissions to prime contractors as part of implementing the cap across the board. Such a decrement is not required, in the authors' view, because the executive compensation cap cannot be applied retroactively to a subcontract by either the government or the prime. Section 808, by its own language, applies only to contracts "entered into by the head of an agency," 10 U.S.C. 2324(1)(1)(a), but agency heads and their delegates do not enter into subcontracts. Furthermore, the statute nowhere addresses subcontracts or purports to apply to subcontractors.

If the government attempted to apply the cap retroactively to a subcontract through the prime, the subcontractor arguably could bring a claim directly against the government under the sponsorship of the prime contractor. See *Arnold M. Diamond, Inc. v. Dalton*, 25 F.3d 1006, 1009 (Fed. Cir. 1994); *Erickson Air Crane Co. of Washington, Inc. v. United States*, 731 F.2d 810, 813 (Fed. Cir. 1984). Likewise, if a prime contractor attempted to apply the cap to a subcontract retroactively, the subcontractor would have a breach claim against the prime, assuming the subcontract itself contained no provision for such a cap.

Accordingly, there appears to be no bar to subcontractors who have complied with the cap submitting the balance of their otherwise-allowable executive compensation costs to their primes for reimbursement under open, flexibly-priced subcontracts. The prime, in turn, should be able to pass the cost on to the government, since the statutory cap appears to be inapplicable to subcontract costs. However, with promulgation of the new FAR rule on the compensation cap on Feb. 23, 1998, the cap would become applicable to subsequently-awarded subcontracts governed by FAR cost principles.

### Conclusion

The decision in *General Dynamics* established that retroactive caps on executive compensation, as required by the FY 1998 defense authorization act, constitute a breach of contract by the government. Contractors that have suffered losses as a result of this breach are entitled to file claims for damages. However, a contractor preparing such a "compensation cap claim" must: ensure that the underlying contract is qualifying, consider any contract modification and subcontracts, and observe the statute of limitations—which may expire as early as Nov. 18, 2003.

Although the authors have no precise data, the legitimate breach claims could well be significant in amount.