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CLIENT ALERT

ASBCA Finds Stock Option Costs Based on Black-Scholes Model Unallowable

Jan.22.2018

In Luna Innovations, Inc. (ASBCA No. 60086), the Board determined that Luna's stock option costs were unallowable (but not expressly unallowable) pursuant to FAR 31.205-6(i), because such costs "constitute[d] compensation that [were] determined by changes in stock prices." Specifically, the Board concluded that Luna's stock option costs were unallowable because they were "valued using the Black-Scholes model," which relies upon five inputs, including the stock price variance. According to the Board, the Black-Scholes model not only "values" a stock option, but "the value is 'based on' share price volatility." Indeed, the Board found that "the volatility measure is one of the most important, if not the most important, inputs into [such model], such that the compensation is 'based on' on [sic] asset volatility." Though the Board concluded that such costs were unallowable, it did not agree with the Government that they were expressly unallowable. In this respect, the Board recognized "significant differences" existed between the Black-Scholes model that Luna used and "the TSR equation at issue in *Raytheon* and *Exelis*," namely that the latter "determined the number of shares to be awarded based explicitly on the change in share prices during the evaluation period." The Board also pointed out that "the use of the Black-Scholes model [was] a question of firm impression" and "there [were] legitimate differences of opinion regarding the allowability of the costs at issue in this appeal."For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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