

## SELECTED AREAS OF COST

### Chapter 41 - Legal and Other Proceedings

#### Authoritative Sources

[FAR 31.205-47](#) Costs Related to Legal and Other Proceedings

[FAR 31.205-33](#) Professional and Consultant Service Costs

[FAR 31.204](#) Application of Principles and Procedures

[FAR 31.201-3](#) Determining Reasonableness

[FAR 31.201-4](#) Determining Allocability

[FAR 31.201-6](#) Accounting for Unallowable Costs

The allowability of costs associated with certain legal and other proceedings is addressed in FAR 31.205-47. In general, costs are allowable if reasonable in nature and amount. FAR 31.205-47 does indicate that some legal proceedings are always unallowable, some are allowable subject to a ceiling if the contractor prevails in an action, and others may be allowable and not subject to the ceiling, if the contractor prevails in regard to certain types of actions. Costs associated with legal proceedings may be unallowable if similar to proceedings specifically addressed in FAR 31.205-47 even though not specifically addressed in the cost principle. Further, costs could be unallowable based on FAR 31.205-33 Professional and Consultant Service Costs, FAR 31.201-3 Determining Reasonableness or the “similar or related costs” concept in FAR 31.204(d).

This chapter addresses the following topics:

- 41-1 General Matters Concerning Legal Costs
- 41-2 General Matters Concerning Legal Costs Addressed in FAR 31.205-47
- 41-3 Allowability of Costs based on FAR 31.205-47
- 41-4 Allowability of Costs that are Not Directly Addressed in FAR 31.205-47
- 41-5 Segregation and Withholding of Proceedings' Costs
- 41-6 Auditing Costs Associated with Legal and Other Proceedings

#### 41-1 General Matters Concerning Legal Costs

Costs of in-house legal services ordinarily cover a variety of legal activities related to the overall administration and management of the contractor's business. Contractors often account for them without further identification as part of in-house general and administrative expenses.

Outside legal services and outside support for legal services are generally considered as specific kinds of professional or consultant services. Accordingly, in addition to complying with the requirements in FAR 31.205-47, these costs are subject to the provisions of FAR 31.205-33 Professional and Consultant Service Costs. In situations

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where the services provided meet the definition of professional and consultant costs, the contractor is required to support the costs with evidence of the nature and scope of the service furnished. FAR 31.205-33(f) indicates the necessary evidence includes details of all agreements; invoices or billings; and consultant work product and related documents.

If a contractor maintains a legal capability in-house, the use of outside counsel should be limited to matters beyond the competence or workload capacity of the contractor's own legal department.

Costs incurred in connection with legal and other proceedings addressed in FAR 31.205-47 do not include the cost to settle a suit. However, such payments may still be unallowable under terms of the contract, the "similar or related costs" concept in FAR 31.204(d), or other cost principles depending on the nature of the payment (See paragraph 41-4 and the Frequently Asked Question (FAQ) below for additional information regarding this issue.).

When a contractor purchases insurance to cover their risk of liability to others, including attorney's fees, we should question any costs that the contractor claims, that the purchased insurance covers, whether or not the contractor filed a claim with the insurance company to recover the costs. We would question the costs as unallowable "actual losses" in accordance with FAR 31.205-19(d)(3), unless one of the exceptions applies. The cost of the purchased insurance should be reviewed for allowability based on the requirements in FAR 31.205-19(d).

If the contractor recovers attorney fees or other costs related to proceedings described in FAR 31.205-47(b), from any source, including payments from an insurance company to settle a claim, but still claims the costs we should question the costs in accordance with FAR 31.205-47(e)(2). In situations where a contractor receives reimbursement for attorney fees through an insurance claim and also claims the attorney's fees in its incurred cost submission we should question the costs as unallowable "actual losses" in accordance with FAR 31.205-19(d)(3) and as costs recovered from another source in accordance with FAR 31.205-47(e)(2).

When a contractor recovers the costs from another source and claims the costs but the proceedings are not specifically described in FAR 31.205-47(b) we should still question the costs. However, in that situation we should question the costs based on the "similar or related costs" concept in FAR 31.204(d) and refer to FAR 31.205-47(e)(2). The intent behind FAR 31.205-47(e)(2) is to prevent contractors from obtaining a windfall by being reimbursed for legal fees from one source and then again as a Government contract costs. Therefore, when the contractor has already received reimbursement for the costs from another source and then includes the cost in its incurred cost submission we should question the costs claimed similar to how we would if the costs were related to proceedings described in FAR 31.205-47(b).

Costs incurred in connection with legal and other proceedings that are allowable, after taking into consideration the requirements of FAR 31.205-47, or are not addressed in

FAR 31.205-47, are allowable only if reasonable, both in nature and amount, in accordance with FAR 31.201-3 Determining Reasonableness and allocable to Government business in accordance with FAR 31.201-4 Determining Allocability. (See paragraph 41-4 below.)

## **41-2 General Matters Concerning Legal Costs Addressed in FAR 31.205-47**

Legal costs are the total costs incurred, including costs that are directly associated with those proceedings, and is defined in FAR 31.205-47 as follows:

*“Costs”, include, but are not limited to, administrative and clerical expenses; the costs of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist it; costs of employees, officers, and directors; and any other similar costs incurred before, during, and after commencement of a judicial or administrative proceeding which bears a direct relationship to the proceeding.*

The proceedings covered by FAR 31.205-47 include any investigation, administrative process, inquiry, hearing, trial or appeal brought by:

- A local, State, Federal, or foreign governmental unit,
- A contractor or subcontractor employee submitting a whistleblower complaint of reprisal in accordance with 41 U.S.C. 4712 or 10 U.S.C. 2409 or
- [A third party in the name of the United States under the False Claims Act, 31 U.S.C. 3730.](#)

## **41-3 Allowability of Costs Based on FAR 31.205-47**

Costs of some proceedings are always unallowable (See paragraph 41-3.1 below) and some are allowable subject to a ceiling if the contractor prevails in the action (See paragraph 41-3.2 below). Costs of other proceedings are allowable but not subject to the ceiling if the contractor prevails in the action proceedings (See paragraph 41-3.3 below). However, even if the contractor prevails, the costs are subject to other applicable cost principles.

### **41-3.1 Proceedings Whose Costs Are Always Unallowable**

- Defense or prosecution of claims or appeals against the Federal Government (FAR 31.205-47(f)(1)). This includes the cost of preparing and presenting an appeal before a board of contract appeals (See Lear Siegler, Inc. (1979) ASBCA No. 20040, 79-1).
- Organization, reorganization, mergers, or acquisitions, or resistance to merger or acquisition (FAR 31.205-47(f)(2) and FAR 31.205-27 Organization Costs).

- Defense of antitrust suits (FAR 31.205-47(f)(3)).
- Defense or prosecution of lawsuits or appeals between contractors arising from such agreements as teaming arrangement, joint venture, dual sourcing, co-production, or similar programs. However, these costs are allowable if incurred as a result of compliance with specific terms and conditions of the contract or written instructions or approval from the contracting officer (FAR 31.205-47(f)(5)).
- Patent infringement proceedings if not required by the contract (FAR 31.205-47(f)(6)). This does not include general counseling services such as advice on patent laws and regulations (FAR 31.205-30 Patent Costs).
- Bid protest costs and costs of defending against protests are expressly unallowable whether incurred by the protester or the contractor who received the award. However, costs of defending against a protest are allowable, if reasonable and the contracting officer requested in writing that the contractor provide assistance in defending against the bid protest (FAR 31.205-47(f)(8)).

#### **41-3.2 Proceedings Whose Costs Are Allowable Subject to a Ceiling if the Contractor Prevails**

As indicated above, legal costs of some proceedings are allowable subject to a ceiling if the contractor prevails in an action. If the contractor does not prevail, the costs are unallowable.

Costs incurred in connection with any proceeding brought by a Federal, State, local, or foreign government, or by a contractor or subcontractor employee submitting a whistleblower complaint of reprisal in accordance with 41 U.S.C. 4712 or 10 U.S.C. 2409, for violation of, or a failure to comply with, law or regulation by the contractor (including its agents or employees), or costs incurred in connection with any proceeding brought by a third party in the name of the United States under the False Claims Act ([qui tam proceeding](#)) are unallowable, if the proceedings result in the indicated outcomes (FAR 31.205-47(b)). If it does not result in the indicated outcome, the costs are allowable subject to the ceiling addressed in FAR 31.205-47(e) discussed below:

- (1) In a criminal proceeding, a conviction.
- (2) In a civil or administrative proceeding (including a qui tam proceeding):
  - Involving an allegation of fraud or similar misconduct, a finding of liability.
  - Not involving an allegation of fraud or similar misconduct, an assessment of a monetary [penalty](#) or an order issued by the agency head to the contractor or subcontractor to take corrective action under 41 U.S.C. 4712 or 10 U.S.C. 2409.
- (3) In a proceeding held by an appropriate official of an executive agency for debarment or suspension of the contractor; rescission or voiding of a contract; or termination of a contract for default because of violation of or

noncompliance with a law or regulation, a final decision unfavorable to the contractor.

- (4) Settlement by consent or compromise of any proceeding listed in (1) through (3), which could have led to the associated outcome. However, in the event of a settlement of a suit (FAR 31.205-47(c)):
- Commenced by the United States, the costs may be allowable to the extent specifically provided in such agreement.
  - Brought by a third party in the name of the United States under the False Claims Act in which the Government did not intervene, the costs may be considered allowable if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.
- (5) Any costs of a proceeding involving the same underlying alleged contractor misconduct addressed in another proceeding whose outcome determined the costs to be unallowable by any of the reasons covered in (1) through (4). If a contractor loses, settles, or compromises one proceeding associated with alleged contractor misconduct, all litigation costs for all other proceedings related to the same misconduct are also unallowable.

#### **41-3.2.1 Allowable Cost Ceiling for Certain Proceedings**

If costs are allowable based on the outcome of a proceeding described in FAR 31.205-47(b), the maximum amount allowable is still limited to the extent that the costs (FAR 31.205-47(e)):

- Are reasonable considering the requirements and underlying cause of the proceeding;
- Have not been otherwise recovered from any source; and
- Do not exceed 80 percent of the total otherwise allowable cost. A percentage less than 80 percent could be appropriate considering the circumstances of the case and the legal work involved.

The 80 percent limit also applies to the costs related to proceedings settled by consent or compromise under the conditions described in paragraph 41-3.2(4) above. The Government limited the allowable amount to encourage contractors to incur proceedings costs responsibly, even in a winning case.

#### **41-3.2.2 Allowability of Cost for a Non-Federal Government Proceeding**

The unallowability of costs under FAR 31.205-47(b) (discussed at 41-3.2. above) or (e) (discussed at 41-3.2.1, above) for a State, local, or foreign government proceeding may be may be waived when an appropriate cognizant U.S. Government official determines that the costs were incurred either (FAR 31.205-47(d)):

- As a direct result of a specific term or condition of a Federal contract; or

- As a result of compliance with specific written direction of the cognizant contracting officer.

### **41-3.3 Proceedings Whose Cost Are Allowable and Not Subject to the Cost Ceiling if the Contractor Prevails**

Costs of the following proceedings are unallowable with the stated outcome. If the outcome is not as stated, the costs are not subject to the ceiling in FAR 31.205-47(e) discussed in paragraph 41-3.2.1 above. However, the costs are subject to the reasonableness requirements in FAR 31.201-3, the allocability requirements in FAR 31.201-4, and the requirements of any other applicable cost principles:

- Defense of suits brought by employees or ex-employees of the contractor under Section 2 of the Major Fraud Act of 1988 when the contractor was found liable or the case was settled (FAR 31.205-47(f)(4)).
- Representation of, or assistance to, individuals, groups, or legal entities that the contractor is not "legally bound" to provide, arising from an action where the party being represented or assisted was convicted of a violation of law or regulation or was found liable (FAR 31.205-47(f)(7)).

### **41-4 Allowability of Costs That are Not Directly Addressed in FAR 31.205-47**

The costs associated with proceedings not specifically addressed in FAR 31.205-47, including settlement costs, may be unallowable if similar to or related to proceedings that are specifically addressed or similar to those addressed in other costs principles based on the "similar or related costs" concept in FAR 31.204(d). Otherwise, they are generally allowable if allocable and reasonable in nature and amount.

When evaluating the allowability of such costs we should apply the cost principles that best capture the essential nature of the cost at issue in accordance with FAR 31.204(d). The costs are also subject to the FAR 31.201-3 reasonableness requirements and FAR 31.201-4 allocability requirements and, if related to professional or consultant services, for compliance with the provisions of FAR 31.205-33.

We should question costs associated with third party proceedings not specifically addressed in FAR 31.205-47 if they are similar or related to:

- Proceedings whose costs are addressed and disallowed in whole or in part by FAR 31.205-47;
- Costs noncompliant with the terms of the contract (FAR 31.201-2(a)(4));
- Penalties (FAR 31.205-15); or
- Backpay (FAR 31.205-6(h)).

Questioning the costs associated with proceedings not specifically addressed in FAR 31.205-47, when similar to or related to proceedings that are specifically addressed or similar to those addressed in other costs principles, is consistent with the guiding principle in the regulatory history for FAR 31.205-47 concerning wrongdoing. The Government should not pay for wrongdoing, the defense of wrongdoing, or the results or consequences of wrongdoing by contractors. Wrongdoing includes:

- Actions such as those described in FAR 31.205-47(b), (f)(4), and (f)(7),
- Intentional harm to other persons, and
- Instances where there has been a reckless disregard for the harmful consequences of an action.

### **41-5 Segregation and Withholding of Proceedings' Costs**

Contractors are required to segregate and remove from Government billings the costs related to proceedings described in paragraph 41-3.1, which are unallowable regardless of the outcome, in accordance with CAS 405 and FAR 31.201-6 Accounting for Unallowable Costs.

Contractors are also required to segregate, and contracting officers are required to withhold payment of, the costs of a proceeding whose outcome determines cost allowability until the outcome is determined (FAR 31.205-47(g)). Thus contractors should segregate costs described in paragraph 41-3.2 (FAR 31.205-47(b) and paragraph 41-3.3 (FAR 31.205-47(f)(4) & (f)(7)) as incurred, and not bill them to the Government until the outcome is determined.

The contracting officer may enter into an advance agreement to make conditional payments to the contractor for such potentially unallowable costs if the contractor agrees to repay the Government with interest if the ultimate outcome of the proceeding makes the cost unallowable.

### **41-6 Auditing Costs Associated with Legal and Other Proceedings**

If the contractor claims a significant amount of costs related to legal proceedings we should gain an understanding of the internal controls the contractor has over those costs as part of our risk assessment. When the contractor's internal controls are inadequate, we should follow the guidance in MRD 12-PAS-012(R) Audit Guidance on Auditing Contractor Business Systems and Contractor Compliance with DFARS 252.242-7006, Accounting System Administration, dated April 24, 2012, and MRD 14-PAS-009(R) Audit Guidance on Reporting Business System Deficiencies, dated June 26, 2014, regarding reporting business system deficiencies and adjust the scope of the audit, accordingly. (The guidance in the referenced MRDs will be incorporated into CAM 5-100.)

When it is determined that there is significant risk associated with the costs related to legal proceedings, we should review billings that the contractor paid related to legal services and other documents, including those related to costs that the contractor has segregated, to:

- Ensure that all known unallowable and potentially unallowable proceedings costs have been included.
- Identify other unallowable proceedings and professional service costs that the contractor has not segregated. The contractor should also segregate any in-house support costs (particularly in the legal and accounting departments) incurred for unallowable types of proceedings.
- To substantiate that the proceedings were not the result of unreasonable acts committed by the contractor in which it violated its “responsibilities to the Government, other customers, the owners of the business, employees, and the public at large,” as prescribed in FAR 31.201-3.

## Frequently Asked Question

**Question:** How do we apply the “similar or related costs” concept in FAR 31.204(d), the reasonableness criteria in FAR 31.201-3, and the allocable criteria in FAR 31.201-4 to costs related to legal and other proceedings that FAR 31.205-47 does not directly address?

**Answer:** To address this question we will use as an example a situation where a contractor pays what we consider to be an excessive amount to settle a case and then claims the costs as a G&A expense.

FAR 31.205-47 deals with costs, which bear a direct relationship to the proceeding. Those costs do not include the cost to settle a suit. Therefore, we would need to look to other cost principles when determining the allowability of the settlement costs the contractor claimed. As discussed in paragraph 41-1 above, settlement payments may be unallowable under terms of the contract, the “similar or related costs” concept in FAR 31.204(d), or other cost principles depending on the nature of the payment. The audit team should review the settlement agreement to establish the purpose behind the payment. For example, if the contractor made the payment to avoid employment-related proceedings, and the payment is punitive in nature and reflects a punishment for the contractor’s actions, and it is not to compensate the individuals harmed by the contractor’s actions, the settlement would be similar to a penalty. If that is the case, we should question the costs based on the “similar or related costs” concept in FAR 31.204(d). The costs are similar to the cost of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, which are unallowable in accordance with FAR 31.205-15.

If, in this situation, we do not have a basis for questioning the excessive settlement payment based on FAR 31.205-47, another cost principle regarding specific types of costs, or the “similar or related costs” concept in FAR 31.204(d), to be allowable the

costs still needs to be allocable in accordance with FAR 31.201-4 and reasonable in accordance with FAR 31.201-3. In order to determine whether the costs are allocable and reasonable we need to examine the facts and circumstances. Documentation that the team could examine would include attorneys' invoices, plaintiffs' complaints, settlement agreements, memoranda/documents justifying decisions made by corporate management, and advice or opinions relied upon by decision makers.

In accordance with FAR 31.201-4, costs are allocable to a Government contract if it is incurred specifically for the contract; benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown. If based on a review of the documentation supporting the costs we determine that the cost does not meet any of the listed criteria we should question the costs that the contractor allocated to its Government contracts. For example, if the case that was settled is clearly related to the contractor's non-Government contracts, the costs should not be included in the contractor's G&A expense pool. The costs should only be allocated to the contractor's work to which the case is related.

If the cost is allocable to the contractor's Government contracts, it is still also subject to the reasonableness requirement in FAR 31.201-3. FAR 31.201-3 provides that, "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." The determination of reasonableness must be supported by a review of the underlying facts, contractor's strategy, and the analysis of the cost of settlement versus court costs. In order to question the costs, we need to establish, based on the facts and circumstances, that the cost exceeded "that which would be incurred by a prudent person in the conduct of competitive business."

## Call out

**Costs** – Includes all costs which would not have been incurred but for the proceeding. ([Return](#))

**In-house** - Includes salaries and related fringe benefits as well as the costs of secretarial and other support services, space, utilities, and library services. ([Return](#))

**Before** - Includes when a contractor: (1) anticipates and begins to prepare for a proceeding before it has been officially notified that the government has initiated a proceeding and (2) is conducting its own investigation or inquiry before initiating a proceeding. ([Return](#))

**A third party in the name of the United States under the False Claims Act** - This is referred to as a "qui tam" proceeding and a legal determination has been made that such a proceeding (whether or not the Government elects to intervene) is a "proceeding brought by the Federal Government." ([Return](#))

**31 U.S.C. 3730** - The False Claims Act specifically allows private citizens to bring suit to recover and restore funds to the Government which were obtained by fraudulent contractor practices. ([Return](#))

**Qui Tam Proceeding** - A proceeding brought to court by a private citizen (third party) on behalf of the Government. ([Return](#))

**Penalty** - Does not include restitution, reimbursement, or compensatory damages. It also does not include payments to make a unit of government whole for damages or the interest accrued on the damages. A penalty is in the nature of a punitive award or fine. ([Return](#))

**Stockholder Suit** - A stockholder suit may be brought by stockholders to protect their own interests or on behalf of the corporation to protect the interests of all the stockholders of the corporation. ([Return](#))