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DCAA

DCAA Loses Executive Compensation Appeals

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In recent years, challenging executive compensation for government contractors under Federal Acquisition Regulation 31.205-6 has been a significant initiative of the Defense Contract Audit Agency (DCAA). Indeed, this subject has also been a particular concern of Congress.¹ To focus its efforts in this area, in 2007 DCAA formed a separate task force of experienced senior auditors under its Technical Programs division called the “Mid-Atlantic Compensation Team” (MACT). Not only is MACT an “agency-wide center of excellence,”² but MACT senior auditors also receive additional specialized training in compensation.³

Although many contractors have experienced executive compensation reviews, executive compensation

cases have rarely been litigated. For that reason, there are few decisions by the Armed Services Board of Contract Appeals (ASBCA) in this area. The leading cases had been *Techplan*⁴ and *Information Systems and Networks*,⁵ but on January 18, 2012 the ASBCA decided the appeals of *J.F. Taylor, Inc.*⁶ That decision is the subject of this article.

I. The J.F. Taylor Appeals. The relevant facts and procedural history are briefly stated. The appellant, J.F. Taylor Inc. (“JFT”), is a privately held company with a “horizontally oriented executive scheme,” including a CEO and four vice presidents with “substantially equal” responsibilities and who received equal pay.⁷ After comparing JFT’s executive compensation for fiscal years 2002 through 2005 to compensation market surveys of similarly situated contractors, DCAA determined that JFT’s executive compensation was unreasonable and that excess compensation in the amount of \$849,051 had been paid over the four-year period.⁸ Repayment of the excess amounts was demanded in several administrative contracting officer (ACO) final determinations, and JFT appealed these final determinations to the ASBCA. The appeals were subsequently consolidated.

a. Government’s Position.

MACT conducted Executive Compensation Reviews (ECRs) for the five executives of JFT for the fiscal years 2002 through 2005. The ECRs compared executive compensation reported on JFT’s incurred cost submissions with MACT’s calculation of reasonable compensation, which was based on survey data from other companies. MACT then disallowed compensation that exceeded the “reasonable compensation” amounts it had statistically determined.

¹ - FY 2012 National Defense Authorization Act; H. 1540 - limit is the salary of a Cabinet secretary (approximately \$200,000), but S. 1867 - limit is President’s salary (\$400,000). See “Senate Defense Bill Limits Reimbursement of Contractor Executive Compensation Costs,” by Deborah Billings, *BNA Federal Contracts Report*, Vol. 96, p. 558, December 2, 2011; “House-Passed DOD Authorization Bill Aims to Boost Competition in Acquisitions,” by Deborah Billings and Jessica Coomes, *BNA Federal Contracts Report*, Vol. 95, p. 571, June 7, 2011. Neither bill has been enacted.

² - “Compensation Is Not a Four-Letter Word: Coping With a DCAA Executive Compensation Review,” by Richard B. O’Keefe, Jr., *The Procurement Lawyer*, Vol. 45, Issue No. 1, American Bar Association, 2009.

³ - *Id.* Specifically, members of the MACT office were trained by “World at Work” (WAW), which was previously the American Compensation Association. WAW trains and certifies specialists in various subcategories, such as “certified compensation professional” (CCP). This information was provided by David Durante, a MACT supervisor, on November 14, 2007 in a meeting of the National Defense Industrial Association.

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⁴ - ASBCA No. 45387, 96-2 BCA ¶ 28426, 1996 WL 391461 (July 2, 1996).

⁵ - ASBCA No. 47849, 97-2 BCA ¶ 29132, 1997 WL 381263 (July 7, 1997).

⁶ - ASBCA Nos. 56105, 56322, __ BCA __, 2012 WL 261272 (January 18, 2012).

⁷ - *Id.* at 2.

⁸ - *Id.* at 6.

The DCAA disallowances were based on the methodology set forth in the ASBCA's *Techplan* decision. The ASBCA repeated this methodology in the *J.F. Taylor* decision:

In *Techplan* we found that experts in the compensation field generally accept taking the following eight steps to evaluate the reasonableness of executive compensation:

- (1) Determine the position to be evaluated.
- (2) Identify survey(s) of compensation for the position to be evaluated which match the company in terms of revenues, industry, geographic location and/or other relevant factors.
- (3) Update the surveys to a common data point for each year through the use of escalation factors.
- (4) Array the data from the surveys for the relevant compensation elements at various levels of compensation such as the average (mean) or selected percentiles and develop a composite number for each.
- (5) Determine which of the numbers to use for comparative purposes.
- (6) Apply a range of reasonableness such as 10 percent to the number or numbers selected.
- (7) Adjust the actual total cash compensation for lower than normal fringe benefits.
- (8) Compare the adjusted compensation to the range of reasonableness.⁹

Following these steps, DCAA found that the compensation for all five JFT executives exceeded the amounts MACT deemed to be reasonable for fiscal years 2002 through 2005.

b. Contractor's Position.

Relying upon expert testimony, JFT argued that the MACT evaluations were unreasonable because DCAA:

1. ignored the actual dispersion of data in the surveys and instead applied an arbitrary 10 percent range of reasonableness.¹⁰
2. ignored the differences in survey sizes.¹¹
3. should have evaluated each vice president's compensation based on the revenues of the whole company, and not just on the percentage of revenue attributed to each vice president by DCAA.¹²
4. did not initially consider financial performance, but would do so only if challenged by the contractor.¹³
5. failed to consider discriminators such as security clearances and customer satisfaction.¹⁴
6. inconsistently used industry compensation surveys over a four year period, i.e., at times comparing JFT to service companies, and at other times comparing it to engineering companies.¹⁵
7. inconsistently deemed JFT's Chief Executive as "Chairman and CEO" for some years, but only as "CEO-Non Chairman" in other years.¹⁶
8. was inconsistent with its use of the compensation surveys by failing to use the same surveys in each of the years.¹⁷

⁹ - *Id.* at 20.

¹⁰ - *Id.* at 14-15.

¹¹ - *J.F. Taylor, Inc.*, 2012 WL 261272, at 15-16.

¹² - *Id.* at 16.

¹³ - *Id.*

¹⁴ - *Id.*

¹⁵ - *Id.* at 16-17.

¹⁶ - *J.F. Taylor, Inc.*, 2012 WL 261272, at 17.

¹⁷ - *Id.*

9. was inconsistent with its use of medians vs. means amounts from different surveys, treating both as if they were the same.¹⁸

The ASBCA's decision primarily focused on the first of these arguments, e.g., the contractor's disagreements with the MACT's statistical practices for calculating the "range of reasonableness." The specific statistical shortcomings alleged by JFT are unique to the MACT evaluations of the executive compensations involved, the mathematical nuances of which lie beyond the scope of this article. The board specifically did not address JFT's other arguments, except to note that it agreed with the DCAA's percentage of revenue attribution (i.e., the board disagreed with JFT's argument No. 3).¹⁹

II. Analysis and Commentary In *J.F. Taylor*, the board referred to the eight factors set forth in *Techplan* and found that DCAA essentially followed these steps.²⁰ JFT's expert, however, challenged Step 6 in *Techplan*—MACT's 10 percent "range of reasonableness"—on several grounds of statistical shortcoming that were not presented in *Techplan*.²¹

In accounting, reasonableness is a subjective factor and not susceptible to being precisely defined (akin to defining "the reasonable man" in the law). Even the FAR defines cost reasonableness ambiguously:

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.²²

Seriously—what does THAT mean?! The definition is so vague that subjective judgments must be made, and when that occurs knowledgeable individuals in good faith can disagree. The only objective standards are the annual compensation ceilings announced by the Office of Federal Procurement Policy.²³ In the *J.F. Taylor* appeals, however, all of the disallowed executive compensation amounts were below these limits.

Because compensation evaluations below the OFPP maximums are subjective, the reasonableness of a particular number can only be determined when compared to another number or numbers, as is provided in the more particularized FAR guidance on reasonableness of compensation (which is not particularly helpful either):

Compensation not covered by labor-management agreements. Compensation for each employee or job class of employees must be reasonable for the work performed. Compensation is reasonable if the aggregate of each measurable and allocable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provision of 31.201-3 [Determining reasonableness], in testing the reasonableness of compensa-

¹⁸ - *Id.*

¹⁹ - *Id.* at 20-21.

²⁰ - *Id.* at 20.

²¹ - *Id.*

²² - FAR 31.205-3. See also *J.F. Taylor, Inc.*, 2012 WL 261272, at 20.

²³ - See 41 U.S.C. § 435; FAR 31.205-6(p). The OFPP amounts for the years involved in *Taylor* are: FY2002 - \$387,783; FY2003 - \$405,273; FY2004 - 432,851; FY2005 - \$473,318. The OFPP amounts since then are: FY2006 - \$546,689; FY2007 - \$597,912; FY2008 - \$612,196; FY2009 - \$684,181; and FY2010 - \$693,951. As of this writing, no amount has yet been announced for FY 2011.

tion for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant may include, but are not limited to, conformity with compensation practices of other firms:

- (i) Of the same size;
- (ii) In the same industry;
- (iii) In the same geographical area; and
- (iv) Engaged in similar non-government work under comparable circumstances.²⁴

This is what DCAA's MACT attempted to do in this case, i.e., compare the compensation of the five executives to various compensation surveys. Where DCAA ran into trouble, however, was in applying a 10 percent "range of reasonableness" to the average (mean) of the various compensation surveys for comparable positions.

The ASBCA was persuaded by JFT's argument that the MACT's 10 percent range of reasonableness analysis was "fatally flawed [. . .] as a matter of basic statistical analysis."²⁵ This was because, among other things, MACT's analysis led to the absurd result that approximately 40 percent of all companies within the DCAA's own surveys paid their executives more than what MACT deemed to be reasonable.²⁶

For whatever reason, the government made no effort to respond to the statistical arguments made by JFT's expert.²⁷ The board also found that the government relied on an "expert witness of questionable judgment" to support its methodology.²⁸ Therefore, the board gave the government's expert "little or no weight," and adopted JFT's statistical arguments as both "credible and un rebutted."²⁹

The board's decision ultimately found DCAA's methodology to be "unreasonable," concluding that "there are statistical flaws in the government methodology for determining reasonable compensation," and that "the computations performed by [JFT's expert] to overcome those flaws are reasonable."³⁰ Accordingly, the ASBCA agreed with the modified analysis of JFT's expert, which used the same compensation surveys as DCAA but applied a data dispersion analysis instead of the 10 percent range of reasonableness. This modified analysis resulted in only \$42,437 (as opposed to \$849,051) of the executives' compensation being unallowable.³¹

IV. Conclusion. Obviously the contractor prevailed in this case because the government did not address the statistical deficiencies raised by the contractor's experts. We can only speculate what the result might have been had the government marshaled suitable expertise.

As stated earlier, the issue of executive compensation is a significant initiative for the Obama administration, and is of concern to Congress as well. Not surprisingly, government officials are very disappointed with the *J.F. Taylor* decision. However, in conversations with us, they viewed the *J.F. Taylor* case only as a setback and not a defeat. Accordingly, allowable executive compensation will likely continue to be fertile ground for litigation until objective criteria are established.

Speaking of objective criteria, the decision in *J.F. Taylor* may be legislatively overruled in that the maximum allowable executive compensation may soon be determined by Congress. Judging from the proposed legislation, the statutory limits are likely to be much lower than the OFPP amounts.³²

³⁰ - *Id.*

³¹ - *Id.*

³² - Indeed, the Commonsense Contractor Compensation Act of 2012 (S. 2198) was introduced just before this article went to press. The bill, which enjoys bi-partisan support, would impose a compensation limit of \$400,000 on all contractor employees governmentwide. See Bloomberg BNA's *Federal Contracts Report*, "Latest Developments," March 16, 2012.

²⁴ - FAR 31.205-6(b)(2).

²⁵ - *J.F. Taylor, Inc.*, 2012 WL 261272, at 20.

²⁶ - *Id.* at 15.

²⁷ - *Id.* at 21.

²⁸ - *Id.*

²⁹ - *Id.*