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Allowable Costs

Leaving Money on the Table? The Reimbursement of Business Restructuring Costs Under Federal Contracting Rules

By ANDY HOWARD

For the past several years, decreases in federal spending have forced government contractors to pay particular attention to finding ways to improve financial performance while maintaining and improving their competitiveness. Until recently, that focus resulted in corporate downsizing and other business restructurings.

Lately, the pendulum has swung the other way, and there has been a boom of business combinations. In fact, the Associated Press reports that the value of global mergers and acquisitions in 2014 reached its highest peak since 2007.²

Given this shift in business climate, it is timely to revisit generally a company's ability to recoup corporate restructuring costs under pertinent federal contracting rules and regulations. In this way, government contractors seeking to restructure or combine with other entities can evaluate whether they are leaving money on the table or, alternatively, whether the potential payoff is worth the added planning and effort.

Unallowable Organization Costs and Potentially Allowable Restructuring Costs. There is a difference between restructuring costs, which may be allowable and therefore reimbursable, and organization costs, which generally are unallowable and therefore not reimbursable. The rules governing the allowability of costs for other than CAS-covered contractors are stated in Part 31 of the Federal Acquisition Regulation (FAR) and Part 231

of the Defense Federal Acquisition Regulation Supplement (DFARS).³

FAR 31.205-27(a) defines unallowable "organization costs" as costs that are expended 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 of a business, and (3) raising capital. . . ." Examples of such costs include the costs of attorneys, accountants and brokers, among others.⁵

Stated simply, the costs incurred to form a business or to combine two or more businesses into a new corporate entity almost always are unallowable. On the other hand, common types of costs a contractor is likely to incur that may be reimbursable as restructuring costs include, but certainly are not limited to: (1) costs to maintain idle facilities or costs resulting from idle capacity;⁶ (2) employee retraining and relocation costs;⁷ (3) employee severance pay;⁸ and (6) new employee recruiting costs.⁹

The DFARS further restricts a contractor's ability to recover restructuring costs, specifically, by limiting reimbursement only to costs for "external restructuring" activities resulting from a business combination, and only where some cost savings to the Department of Defense (DoD) will result from the restructuring.¹⁰

The phrase "business combination" is specifically defined in the rules as "a transaction whereby assets or operations of two or more companies not previously under common ownership or control are combined,

² Steve Rothwell, "Bull Market for Stocks Keeps Going in 2014," *DailyFinance.com*, Jan. 1, 2015, <http://www.dailyfinance.com/2015/01/01/bull-market-keeps-going-2014/> (last visited Jan. 20, 2015).

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³ A discussion of the reimbursability of costs under the more complex Cost Accounting Standards is beyond the scope of this article.

⁴ 48 C.F.R. § 31.205-27(a).

⁵ *Id.*

⁶ 48 C.F.R. § 31.205-17.

⁷ 48 C.F.R. §§ 31.205-35, -44, -46.

⁸ 48 C.F.R. § 31.205-6(g).

⁹ 48 C.F.R. § 31.205-34.

¹⁰ 48 C.F.R. § 231.205-70(b).

whether by merger, acquisition, or sale/purchase of assets.”¹¹

“Restructuring activities” also are defined and mean, among other things, “nonroutine, nonrecurring, or extraordinary activities to combine facilities, operations, or workforce, in order to eliminate redundant capabilities, improve future operations, and reduce overall costs.”¹²

The DFARS clarifies that external restructuring activities mean “activities occurring after a business combination that affect the operations of companies not previously under common ownership or control.”¹³

The rule does not apply to restructuring activities after a business combination that affect only one of the companies not previously under common ownership or control or, when there has been no business combination, restructuring activities undertaken solely by one company.¹⁴

Further, costs associated with routine repositioning and redeployment of productive facilities or workforce are not allowable.¹⁵

General Principles of Allowability of Restructuring Costs.

The process of seeking reimbursement of otherwise allowable restructuring costs ostensibly could vary depending upon whether a contractor is seeking reimbursement under a civilian or defense agency government contract. Under DFARS rules, for example, a contractor must follow specific procedures to recover allowable restructuring costs.

Among other steps, the process includes a Defense Contract Audit Agency (DCAA) audit of the projected restructuring costs and of the potential savings from the restructuring resulting to DoD. DCAA’s audit report must be reviewed by the Contracting Officer (CO) or his or her designee, who will then negotiate an advance agreement with the contractor detailing the costs that will be allowed, among other matters.¹⁶

It is important to note that, for restructuring costs to be reimbursable, the audited projected savings to the government must exceed anticipated allowable restructuring costs by a factor of at least two to one or the business combination must result in the preservation of a critical capability that might otherwise be lost to the DoD.¹⁷

The FAR does not have similar detailed procedures. Rather, like all reimbursable costs, restructuring costs must be allowable under the cost principles, and they must be reasonable, meaning they do not exceed the amount that would be incurred by a prudent person in the conduct of a competitive business.

Whether a cost is reasonable depends upon a variety of considerations and circumstances, including whether the cost is one generally recognized as ordinary and necessary for the conduct of the contractor’s business or whether it is an accepted sound business practice.¹⁸

While the FAR does not explicitly adopt the process detailed in the DFARS, it does so implicitly, and contractors seeking reimbursement of restructuring costs

from a civilian agency are well advised to seek an advance agreement from the CO on the treatment of special or unusual costs to help avoid disallowance or a dispute.¹⁹

Although this is best practice, it is not an absolute requirement, and the failure to get an advance agreement on any cost will not, by itself, affect the reasonableness, allocability or allowability of restructuring costs.²⁰

Other Practical Matters. Because restructuring costs necessarily involve a sequence of events that occurs subsequent to a business combination, a contractor contemplating seeking reimbursement of restructuring costs also must consider the effects a contract novation could have on cost reimbursement. Here, there is a material distinction between a novation pursuant to FAR rules and a novation under the DFARS.

The model novation agreement provided in the FAR may foreclose any possibility of recovering restructuring costs because the model agreement contains broad waiver language that arguably forecloses a post-closing claim for restructuring costs.²¹ On the other hand, the model novation agreement provided in the DFARS recognizes that restructuring due to an acquisition and/or merger may be in the best interest of the government.

Accordingly, the DFARS provision allows costs that are associated with the restructuring to be reimbursed as long as the restructuring will reduce the overall costs to the DoD.²² Therefore, a government contractor should consider—among myriad other things—the impact of a novation agreement prior to engaging in restructuring activities.

For the avoidance of greater uncertainty, as noted above, contractors considering a business combination and expecting to incur restructuring costs are well advised to attempt to obtain an advance agreement with the cognizant CO for the contract under which restructuring costs may be reimbursed.

To that end, contractors should anticipate having to prepare a restructuring proposal, complete with forward-priced restructuring cost estimates, and implement separate charge codes to capture actual restructuring costs that can be measured against the contractor’s estimates.

All of this should be done in advance of the close of any merger or acquisition; in other words, well in advance of a contractor’s incurring any post-closing restructuring costs. In these ways, contractors considering a business combination also can factor restructuring issues, risks and costs into the deal calculus.

The information provided above is intended to reintroduce the concept of the potential reimbursement of restructuring costs resulting from a business combination.

However, the rules governing the reimbursability of costs in federal government contracting are particularly complex. Contractors contemplating seeking reimbursement of such costs are well advised to consult experienced government contracting professionals before submitting a request for reimbursement that may be rejected or worse, used as the basis of a fraud or disbursement claim.

¹¹ 48 C.F.R. § 231.205-70(b).

¹² 48 C.F.R. § 231.205-70(b).

¹³ 48 C.F.R. § 231.205-70(b)(2).

¹⁴ *Id.*

¹⁵ 48 C.F.R. § 231.205-70(b)(3).

¹⁶ 48 C.F.R. § 231.205-70.

¹⁷ 48 C.F.R. § 231.205-70.

¹⁸ 48 C.F.R. § 31.201-3.

¹⁹ 48 C.F.R. § 31.109.

²⁰ 48 C.F.R. § 31.109.

²¹ 48 C.F.R. § 42.1204.

²² 48 C.F.R. § 242.1204.