

## E-ALERT | Government Contracts

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### RETROACTIVE COMPENSATION CAPS: HOW CONTRACTORS CAN RECOVER FOR BREACH DAMAGES

As the [Washington Post reported on May 7](#), the Obama Administration is seeking to replace the existing statutory formula for reimbursing contractor executive pay under cost-type contracts, which currently sets the limit at \$763,000, with one that would link contractor reimbursement to the pay of Cabinet officials, which is now \$199,700. Several members of Congress have sponsored similar proposals to lower the “allowable” amount of executive compensation. These proposals follow on the heels of Congress broadening the applicability of the compensation cap in its enactment of the National Defense Authorization Act for Fiscal Year 2012.

The Court of Federal Claims has established that such statutorily-mandated retroactive changes to contract terms can result in contractual breaches by the Government, entitling contractors with covered contracts to financial recoveries. Contractors should be aware of this potential entitlement and how best to preserve and pursue their rights.

#### BACKGROUND

FAR Subpart 31.2 contains provisions establishing standards for the allowability, allocability, and reasonableness of costs incurred in cost-reimbursement contracts. Those general provisions include, *inter alia*, FAR 31.201-1 (“Composition of Total Cost”), FAR 31.201-2 (“Determining Allowability”), FAR 31.205-3 (“Determining Reasonableness”), and FAR 31.204 (“Application of Principles and Procedures”).

Prior to 1997, no provision of FAR Subpart 31.2 imposed a fixed limit on employee compensation costs for cost-type contracts. On November 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 made unallowable the costs of compensating “senior executives” that exceed a “benchmark compensation amount” to be determined annually by the Administrator for Federal Procurement Policy. The statutory cap applied to all senior executive compensation costs incurred by defense contractors under covered contracts regardless of when they were entered into.

#### ESTABLISHMENT OF BREACH ENTITLEMENT

General Dynamics successfully challenged this cap. On October 5, 1998, General Dynamics submitted a certified claim to its corporate administrative contracting officer under the Contract Disputes Act of 1978, 41 U.S.C. § 601 et seq. The claim asserted that: “By applying the new executive compensation cap to contracts entered 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 CACO denied the claim, and General Dynamics filed a complaint in the Court of Federal Claims.

In a lengthy opinion (*General Dynamics v. United States*, 54 Fed. Cl. 414 (2000)), Judge Lydon found the Government in breach based upon 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). Judge Lydon ordered the Government to pay General Dynamics \$1.53 million for the reductions in cost reimbursements under a single test contract. The ruling established that retroactive statutory caps on compensation can constitute a breach of contract by the Government. Contractors that suffered losses resulting from such breaches were entitled to file claims for damages under qualifying contracts.

## NEW BREACH CLAIMS

Notwithstanding the clear precedent from the *General Dynamics* case, the Defense Authorization Act for FY 2012, enacted December 31, 2011, extended the existing executive compensation cap beyond top executives to all contractor personnel beginning January 1, 2012. While contractors must obey the compensation cap as a cost limitation, the extension creates a new breach of cost-type contracts that predate the extension by disallowing costs that are made allowable under the cost principles that apply to those contracts, and may well entitle affected contractors to recover lost compensation costs as breach damages.

An [article](#), co-authored a decade ago by Robert Nichols (now of Covington & Burling LLP), provides further analysis and guidance for developing “compensation cap claims.” These recoveries can easily be worth millions of dollars to large companies. And if the Obama Administration or certain members of Congress succeed in changing the formula to reduce further the reimbursement of such costs, the quantum of these claims could increase dramatically.

The mechanics and nuances of developing breach claims under the *General Dynamics* case law apply to this latest set of breaches in the same way that they did a decade ago.

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If you wish to discuss how your company might recover amounts lost under the current and future compensation caps, please contact the following members of our government contracts practice group:

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