United States Court of Appeals for the Federal Circuit

SECRETARY OF DEFENSE,
Appellant

v.

NORTHROP GRUMMAN CORPORATION,
Appellee

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NORTHROP GRUMMAN CORPORATION,
Appellant

v.

SECRETARY OF DEFENSE,
Appellee

2018-1945, 2018-1990

Appeals from the Armed Services Board of Contract Appeals in Nos. 57625, 60190, Administrative Judge Robert T. Peacock.

Decided: November 15, 2019

DANIEL B. VOLK, Commercial Litigation Branch, Civil Division, United States Department of Justice,

Washington, DC, argued for Secretary of Defense. Also represented by JOSEPH H. HUNT, ROBERT EDWARD KIRSCHMAN, JR., PATRICIA M. MCCARTHY; ROBERT LYN DUECASTER, Contract Disputes Resolution Center, Defense Contract Management Agency, Chantilly, VA.

DONALD B. VERRILLI, JR., Munger, Tolles & Olson LLP, Washington, DC, argued for Northrop Grumman Corporation. Also represented by GINGER ANDERS; CHARLES BAEK, STEPHEN JOHN MCBRADY, NICOLE J. OWREN-WIEST, Crowell & Moring LLP, Washington, DC.

Before PROST, *Chief Judge,* BRYSON and REYNA, *Circuit Judges.*

REYNA, *Circuit Judge.*

The Secretary of Defense appeals a final decision of the Armed Services Board of Contract Appeals finding that the United States Government improperly disallowed certain retirement benefits costs that Northrop Grumman Corporation asserts are eligible for reimbursement. Northrop Grumman Corporation conditionally cross-appeals the Armed Services Board of Contract Appeals' finding that the retirement benefit costs are unallowable under the applicable regulations because they were calculated using an improper accounting method. Because substantial evidence supports the Armed Services Board of Contract Appeal's finding that Northrop Grumman Corporation never claimed and will never claim any of the disputed retirement benefits, we affirm and do not reach the cross-appeal.

BACKGROUND

I. Post-Retirement Benefits Costs

This dispute concerns Northrop Grumman Corporation's ("Northrop") accounting of costs for providing post-retirement benefits ("PRB"). PRBs are non-pension

benefits that are made available to employees upon their retirement. Examples of PRBs include post-retirement health care, life insurance, disability benefits, and other welfare benefits. Relevant to these appeals is that PRBs can be modified or eliminated entirely, unlike pension benefits which cannot be modified by the employer.

The Federal Acquisition Regulation ("FAR")[1] permits contractors such as Northrop to seek reimbursement from the federal government for its PRB costs. Only those PRB costs that are "allowable," however, may be reimbursed by the government. Effective July 25, 1991, the FAR was amended to add FAR 31.205-6(o), which governed allowability of reimbursement of PRB costs in government contracts. This amendment required PRB costs assigned to a given year to be funded by that year's tax return deadline in order to be allowable. While the amendment permitted the use of accrual accounting[2] methods for PRB costs, it did not expressly require that any specific accounting standard be used. However, effective February 27, 1995, the FAR was amended again, this time to require the use of the accounting standards set out in the Statement of Financial

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[1] The version of the FAR in effect on July 8, 2005, applies to this case.

[2] Accrual accounting (unlike cash accounting) focuses on when transactions occur, rather than when payments are made. Because PRB plans are funded well before retirement occurs and benefits are paid out, accrual accounting relies on actuarial assumptions such as life expectancy to predict future costs while allocating those costs to current years.

Accounting Standards 106 ("FAS 106")[3] to determine allowable PRB costs in government contracts.[4]

At the time of the 1995 FAR amendment, Northrop accounted for its PRB costs using an accounting method that conformed to the requirements established by the Deficit Reduction Act of 1984 ("DEFRA") rather than FAS 106. Following the 1995 FAR amendment, Northrop continued to account for its PRB costs for government contracting purposes using the DEFRA method, even though that method was no longer in compliance with the FAR.

The DEFRA and FAS 106 both require the use of accrual accounting methods, but the actuarial assumptions underlying each method are different. The primary difference between the DEFRA method and the FAS 106 method is that the DEFRA method calculates PRB costs based on current medical costs, while the FAS 106 method calculates PRB costs to include future increases in medical costs. J.A. 32. As a result, annual PRB costs computed using the DEFRA method typically start lower and increase over time whereas annual PRB costs computed using the FAS 106 method typically start higher and decrease over time. J.A. 2.

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[3] FAS 106 as issued in 1990 is available on the Financial Accounting Standards Board's website at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220123671.

[4] After the February 27, 1995, amendment, FAR 31.205-6(o)(2)(iii) provided in relevant part that "to be allowable, PRB costs . . . must be measured and assigned according to Generally Accepted Accounting Principles." FAR 31.205-6(o)(2)(iii) (1995); *see also* 59 Fed. Reg. 67045 (Dec. 28, 1994). It is undisputed that the reference to "Generally Accepted Accounting Principles" in FAR 31.205-6(o)(2)(iii) refers to FAS 106. J.A. 3.

Between 1995 and 2006, Northrop filed disclosure statements with the government on numerous occasions, disclosing its continued use of the DEFRA method. The government was aware that Northrop was not in compliance with the FAR, but it did not object to Northrop's continued use of the DEFRA method because its use resulted in lower reimbursement costs to the government. J.A. 99. Indeed, had Northrop used the FAS 106 method between 1995 and 2005, the government would have paid an additional $253 million during that period. *See* J.A. 32; Oral Arg. at 15:18–15:34; *see also* J.A. 1000 (member of DCAA testifying that the government saved $253 million between 1995 and 2006). In addition, both the Defense Contract Management Agency ("DCMA") and the Defense Contract Audit Agency ("DCAA") informed Northrop during these years that the agencies found "no instances of noncompliance with applicable Cost Accounting Standards or with FAR Part 31 cost principles." J.A. 4; *see also* J.A. 3–6. Although not reflective of official policy, DCMA even used Northrop's continued use of the DEFRA method in its internal training documents as an example of acceptable accounting methods under the FAR. J.A. 10, 33.[5] At the time, DCMA members interpreted the FAR's requirement that FAS 106 method be used as setting a ceiling on allowable costs under the regulations, concluding that the difference between the DEFRA and FAS 106 calculations would not become unallowable even if not assigned and funded within a given year as required by FAR 31.205-6(o)(3).[6] *Id.*

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[5] Internally, there was disagreement between members of the DCMA and the DCAA about whether Northrop's continued use of the DEFRA method was acceptable.

[6] FAR 31.205-6(o)(3) provided: "To be allowable, costs must be funded by the time set for filing the Federal

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