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Compensation

View From Brown Rudnick: New FAR Rule Extends Reimbursement Cap for Compensation Paid to Contractor Employees



By **KENNETH B. WECKSTEIN** AND **PAMELA A. REYNOLDS**

For right or wrong, over the years there have been complaints that taxpayers should not have to foot the bill for hefty salaries paid to government contractor executives and employees, which in some cases are well above the salaries paid to their government customers, members of Congress, and even the president. Like any other company, government contractors are free to pay their employees however much they choose, but the government will not reimburse compensation costs for certain employees over a specified amount set by the Office of the Federal Procurement Policy (“OFPP”) each year. To that end, the Federal Acquisition Regulation (“FAR”) Council has issued a final rule further limiting the allowability of compensation costs for government contractors. While the move has drawn criticism from private industry, it may be difficult for some to feel much sympathy. The compensation cap for 2012 was just shy of a million dollars.

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The recent final rule expanded the compensation cap to all employees that work on DoD, NASA, and Coast Guard government contracts. Previously, FAR 31.205-6(p) limited the compensation cap to the chief executive officer of the contractor, its four most highly paid executives at the company's headquarters, and the five most highly compensated employees in management positions at each home office. In June of last year, the FAR Council issued an interim rule implementing section 803 of the National Defense Authorization Act (“NDAA”) of 2012 (PL 112-81).¹ That interim rule revised FAR 31.205-6(p) to add a new subparagraph extending the compensation cap to **all contractor employees** on DoD, NASA, and Coast Guard contracts awarded after December 31, 2011. Despite objections from industry, on May 30, 2014, the FAR Council issued a final rule adopting the interim rule without any changes.²

The new rule applies retroactively to costs incurred on contracts awarded on or after the date the 2012 NDAA was enacted. That has been a major source of controversy. Among other things, industry has argued that application of new rule to contracts awarded before the rulemaking implementing Section 803 of the 2012

¹ See *Expansion of Applicability of the Senior Executive Compensation Benchmark*, 78 Fed. Reg. 28535 (June 26, 2013).

² See *Expansion of Applicability of the Senior Executive Compensation Benchmark*, 79 Fed. Reg. 31195 (May 30, 2014).

NDAA would be a breach of those contracts. In issuing the final rule, the FAR Council rejected those concerns. Among other things, the FAR Council argued that the plain text of section 803 of the 2012 NDAA required that the new rule apply to “costs of compensation incurred after January 1, 2012, under contracts entered into before, **on, or after the date of the enactment** of this Act.” (emphasis added). In addition, the FAR council noted that the final rule only applies to costs incurred on contracts awarded on or after enactment of the 2012 NDAA. A separate proposed rule addressing contracts awarded before December 31, 2011 is pending.³

Another area of concern is how the final rule will impact contractors’ ability to attract and retain employees. Note that compensation is not limited to salaries, but also includes bonuses and deferred compensation, which often are used to attract and retain talent and reward exemplary performance. Going forward, contractors will have to eliminate or eat these compensation costs to the extent that they exceed the compensation benchmark. That said, the FAR Council anticipates that the overall impact will be small. That conclusion was based on a 2013 GAO report that found that a compensation cap of \$400,000 would impact less than .4 percent of the employees covered by the new rule and less than .1 percent using the compensation caps set by

³ See *Applicability of the Senior Executive Compensation Benchmark*, 78 Fed. Reg. 38539 (June 26, 2013).

OFPP in 2010, 2011, and 2012. The current cap set by OFPP for 2012 is \$952,308, which is an increase of nearly \$190,000 over the 2011 cap of \$763,029. And the FAR Council noted that the final rule would have little impact on small businesses because small businesses generally do not offer compensation at those levels.

In the long run, it is too soon to tell how big of a hit this will be to the bottom line. Although the most recent compensation cap is set at \$952,308, that won’t be the case for long. The 2014 NDAA⁴ and the Bipartisan Budget Act of 2013⁵ contained provisions that established government contractor compensation caps of \$625,000 and \$487,000, respectively.

Going forward, contractors should review their contracts to determine which executive compensation rule applies, how their compensation practices compare, and whether to absorb the costs or lower compensation levels. Some contractors may already have incurred, and billed the government for, costs under their government contracts that now are expressly unallowable under the current FAR rule. Those contractors would need to look back at costs incurred on any DoD, NASA, and Coast Guard contracts awarded on or after December 31, 2011. If a significant amount of costs are disallowed under the new rule, contractors may want to consider challenging the retroactive application of the rule.

⁴ <http://www.gpo.gov/fdsys/pkg/BILLS-113hr3304enr/pdf/BILLS-113hr3304enr.pdf>.

⁵ <http://www.gpo.gov/fdsys/pkg/PLAW-113publ67/html/PLAW-113publ67.htm>.