



Executive Compensation – Tales and Lessons Learned from a Recent Battle

Stephen R. Dooley
Senior Trial Attorney, DCMA

Daniel J. Kelly
Partner, McCarter & English LLP

March 13, 2013

The Dispute – The Contractor

- Owner-operated engineering services firm with 15 to 20 employees doing business for 20 years.
- Located in New England.
- Annual revenues in last five years fluctuating under \$10 million mark.
- Business has multiple U.S. Government customers providing highly technical and specialized research and services.

The Dispute – The Executive

- Majority Owner of Business.
- Degreed and Experienced.
- Serves as President, CEO, CFO, COO, Marketing Director, Director of Business Procurement, Chief Scientist and Senior Technical Manager.

The Dispute – How Compensation Established

- Executive Sets Own Compensation.
- No Active Board of Directors .
- No Formal Compensation Plan.
- Compensation in Form of Salary, Bonus, Contributions to Retirement Plan and Fringe Benefits.
- Largest Portion Paid in form of Bonus – And Paid Only if Company Meets Budget.
- Bonus Paid in Following Fiscal Year.

The Dispute – The Dilemma

- 2006 Compensation First Questioned in DCAA Audit Report in 2008.
- Negotiations in Fits and Starts Delaying DCMA Unilateral Determination of Indirect Rates and Disallowance of Costs until November 2011.
- Nothing to Appeal until June 2012 Demand for Payment.
- Now have 6 Years of Significant Unallowable Costs.

The Legal Issues --The Statutory Ceiling

- Allowability for all employees is capped by statute (10 U.S.C. 2324(e)(1)(p) and 41 U.S.C. 256(e)(1)(p)) at a benchmark established by OMB; See FAR 31.205-6(p).
- Does not limit pay, only allowability.
- Current benchmark is \$763,029 (total wages, salary, bonuses and other compensation).
- For 2006 – benchmark was \$546,689.

Side Note – Mounting Pressure on Congress to Change Cap

- 5/18/2012, House rejected an amendment to HR 4310, the 2013 NDAA, that would have limited allowable compensation to \$400,000 (President's salary).
- 12/4/2012, Senate passed 2013 NDAA including an employee pay cap of \$230,700 (Vice President's salary).
- 1/2/13 Final Reconciled Bill Signed by President Removed Cap But Required GAO to Report to Congress on Effects of Reducing Allowable Costs of Compensation .

The Legal Issues – Start with FAR

FAR 31.205-6 Compensation for Personal Services

- a) *General.* Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle.
 - 1) Compensation for personal services must be for work performed by the employee in the current year; no retroactive adjustment.
 - 2) The total compensation for individual employees or job classes of employees must be reasonable for the work performed.

FAR 31.205-6(a)

- 3) Compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.
- 6) Special consideration for compensation to "certain individuals" – owners of closely held corporations. Compensation cannot be a distribution of profits and cannot be in excess of costs that are deductible as compensation under Internal Revenue Code.

FAR 31.205-6

- (b)(2) Reasonableness measured by relevant factors – conformity with compensation practices of other firms.
 - Of the same size
 - In the same industry
 - In the same geographic area
 - Engaged in similar non-Government work under comparable circumstances

FAR 31.205-6(f)

- Bonuses and incentive compensation are allowable provided they are paid under an agreement before services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment.

The Defense Contract Audit Manual – Audit Guidelines for Executive Compensation – DCAM 5-803.1 and 6.414

- Addresses FAR's statement that special consideration must be given to owners, executive and high risk employees.
- Provides that positions are best evaluated by comparison to positions with comparable rank, function, and responsibility to other firms of similar size (6.414.3(d)).

DCAM 6.414-3(g) – Survey Data

- Provides that if the contractor used survey data to establish executive pay, auditor should review the surveys to determine if they are representative of relevant labor market or industry. Look at whether it is statistically reliable, appropriate positions are used, percentile used is based on performance; if no demonstrated performance – was the median used (6.414.3(g)).
- Provides that surveys used by contractors should be validated using a secondary source. Use of only one survey “is not adequate in most cases.” Preference to use a secondary survey to which contractor has access. Do not use free internet salary surveys.

DCAM 6.414-3(g)(3) -- The Mid-Atlantic Compensation Team and its Process

- DCAM requires the auditor to request assistance from the MACT when compensation expense is significant.
- DCAM states that MACT will use process delineated in Techplan Case No. 41470, 96-2 BCA 28426 (July 2, 1996 – Judge Eunice W. Thomas).

DCAM 6.414-3(h) – How the ASBCA Did It in Techplan

1. Determine the position to be evaluated.
2. Identify surveys that “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.
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.”

DCAM 6.414-3(h) – How the ASBCA Did It in Techplan

NOTE: “Use of other percentiles is necessary only if the contractor’s performance . . . Is quantitatively and measurably above or below average.”

5. Use average or median data to be utilized as an initial position prior to performing a detailed financial performance analysis.
6. Apply a range of reasonableness such as 10%. DCAA Policy is to use 10% as range of reasonableness – citing as being supported by Information & Networks Corporation, ASBCA No. 47849, 97-2 BCA 29132 (July 7, 1997 Judge Carroll C. Dicus).

DCAM 6.414-3(i) – Should a Contractor Get More Than 110% of Median

“For an executive with responsibility for overall management . . . , such a proposal may be justified by clearly superior performance, as documented by financial performance that exceeds the particular industry’s average.” Part (i) notes that the 75th percentile was justified by performance in Information & Networks Corporation, ASBCA No. 47849, 97-2 BCA 29132.

DCAM 6.414-3(i) – What is Financial Performance

- Revenue Growth
- Net Income
- Return on Shareholder's Equity
- Return on Assets
- Return on Sale
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

A Note About Techplan

- Closely held corporation with revenues in \$10 to \$14 Million.
- Examining compensation Robert Matteucci – Experienced and degreed; CEO, COO, CFO, Controlling Shareholder and Chairman of the Board.
- Provided research, analysis, engineering support and high technology services.
- No written policies on compensation; Mr. M set his own level.

Techplan (continued)

- Board looked determining reasonableness under 31.205-6 (1984).
- Parties presented compensation experts. Techplan steps established based on expert testimony; Board liked the 4 surveys proposed by Mr. M (including Mercer and Radford).
- Board accepted 75% percentile finding business to be above average based on testimony on company's "stature" in highly competitive community, profitability, growth, credibility with customers, and quality of work.
- Board then agreed since "compensation is not an exact science" to add 10% to the 75% percentile to establish an upper limit.

The 2012 ASBCA Cases – Challenging the DCAM Methodology

- J.F. Taylor, Inc., ASBCA Nos. 56105, 56322; 2012 ASBCA LEXIS 3 (January 18, 2012) (Judge Shackelford); Motion for Reconsideration Denied, 2012-2 BCA 35,125 (August 14, 2012).
- Metron, Inc., ASBCA Nos. 56624, 56751, 56752; 2012-2 BCA 35,066 (June 4, 2012) (Judge Peacock).

J.F. Taylor, Inc.

- Contractor's Expert testified: DCAM methodology has "look of an objective mathematical model for determining unallowable executive compensation, there is no substance behind this scientific veneer."
- The Board agreed.

Anatomy of J.F. Taylor

- Small closely held family owned business providing engineering services and trainers to military customers.
- At stake – 4 years of executive compensation over period 2002-2005. DCAA MACT concluded that \$848,050 was unreasonable. DCAA recalculated indirect rates. ACO issues unilateral determination of indirect rates and demanded repayment of \$589,600 for amounts based on provisional billings for 4 years.

J.F. Taylor – Basis For Attack

1. Statistical samples in surveys are flawed. Reliance on median ignores amount of dispersion in survey data (e.g., wide disparities at high and low ends). Median is not a good predictor of “reasonable compensation”.
2. Rote application of 10% Range of Reasonableness is not always an adequate adjustment. In this case, contractor’s expert argued that a proper statistical and financial analysis of the survey data should have yielded a finding of 95% (finding “reasonable compensation” to have only been exceeded by \$42,437).

J.F. Taylor – Board's Finding

- Techplan 8-step analysis is reasonable.
- The 10% Range of Reasonableness is not inflexible – must take into consideration the data dispersion in the surveys government uses to evaluate reasonableness.
- A rigid application of 10% without regard to the actual amount of dispersion is not statistically valid and is unreasonable.

Metron

- One survey alone can “best fit” a contractor’s circumstances – and contractors are not necessarily required to use more than one survey.
- DCAA extrapolates results from a survey at its peril if there is no access to the survey data.
- Factors other than financial performance justify a higher percentile.

Anatomy of Metron

- Small closely held business that provides high technology solutions to military customers.
- 4 senior employees in question were experienced, degreed and served multiple functions (technical, business development, and administrative).
- Company had an established executive compensation plan which relied upon the median Radford Executive Survey to set base salary. Incentive compensation was provided to reward superior performance.
- Company submitted analysis of survey, compensation plan and periodic reports to DCAA to justify compensation.

Metron -- Board's Finding

- Payments at the 50th to 75th percentiles were reasonable because of accomplishments and performance of the firm and its executives.
- Board highlighted testimony of expert on Company's unique talent and education requirements, sophisticated level of technical capabilities and ability to meet performance objectives.
- Use of multiple surveys to “average” was inappropriate when one of the surveys fit. DCAA looked to Radford, Watson Wyatt, ERI and WTPF (regional) surveys.
- Government's extrapolations, adjustments, and regressions of the survey data were statistically flawed.

Issues in Our Case

- What Survey was Appropriate
 - Company relied on ERI; DCAA used Wyatt, Mercer and Jaffe (regional – mid-Atlantic)
- What Job Description was Appropriate
 - CEO, President, Highest Paid Executive
- What Percentile was Appropriate
- What Range of Reasonableness was Appropriate
- Should Bonuses Paid After FY Be Allowed

Lessons Learned

- Mediation Works!
- Need a Written Compensation Plan.
- Find the Right Survey; Use More Than One.
- Create a Robust Record When Applying the Plan to Individual Compensation.
- Need Buy-In by Outside Professional and Objective Board of Directors.
- Need Disclosure to DCAA and DCMA.
- Must Appreciate Risks Because Audits Take Years.
- A Contractor Need Not Accept Median Plus 10%.