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REPORT

Cost Accounting Standards

Dictionary Trumps Expert Witnesses in Interpretation of CAS: The Federal Circuit's Ruling in *Rumsfeld v. United Technologies Corp.*

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In *Rumsfeld v. United Technologies Corp., Pratt & Whitney* ("*UTC*"),[1] the United States Court of Appeals for the Federal Circuit held that trial judges may not consider expert testimony when interpreting the Cost Accounting Standards ("CAS"), since such an interpretation is an issue of law. This decision has surprised many in the government contracting legal community because it is inconsistent with: (a) the trial judge's "gatekeeper" role in determining the admissibility of expert testimony; (b) the historical use of expert testimony in cost matters by the Federal Circuit and its predecessor Court of Claims; and (c) the Federal Circuit's endorsed use of expert testimony in patent infringement cases. By this decision, the Federal Circuit has created great doubt as to the means for interpreting CAS and other cost regulations as well as the role of expert witnesses on issues of law.[2]

The Matter at Issue

The specific issue addressed in *UTC* was the proper allocation under CAS of UTC's indirect expenses between its government contracts and its commercial aircraft engine programs. UTC had numerous "collaboration agreements" with foreign suppliers on several commercial programs. Under these agreements, UTC did not pay a predetermined price for the collaboration parts. Instead, the foreign supplier received a share of the revenues generated by UTC's commercial sales. For accounting purposes, UTC treated these collaboration agreements as joint ventures. As such, the payments to the foreign suppliers were treated as an adjustment to UTC's revenue and not as a cost. For purposes of allocating its indirect expenses between its government contracts and its commercial programs, the payments were excluded from UTC's cost bases for the commercial programs. The government argued that the payments to the foreign suppliers should be treated as costs for purposes of allocating indirect costs under CAS,

[1] *Rumsfeld v. United Technologies Corp., Pratt & Whitney*, 315 F.3d 1361 (Fed. Cir. 2003), *cert. denied*, 2003 U.S. LEXIS 8329 (Nov. 10, 2003) (79 FCR 78, 339; 80 FCR 510).

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[2] The decision is critiqued in 17 Nash & Cibinic Report ¶ 15 DEFINING "COST": Using Smoke and Mirrors.

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which would have the effect of increasing the cost bases of UTC's commercial programs, thereby increasing the portion of UTC's indirect cost pool allocated to its commercial programs and reducing the allocation to UTC's government contracts. Thus, the central issue in *UTC* is whether the payments made under the collaboration agreements were ''costs'' for purposes of CAS.

The ASBCA Decision

The Armed Services Board of Contract Appeals determined that the term ''cost'' was not defined in CAS. The Board heard extensive expert testimony from both parties, as to the proper definition of ''cost.''[3] Relying in part on this testimony, the Board adopted the definition of ''cost'' found in generally accepted accounting principles (''GAAP''). Indeed, use of this GAAP definition of cost had previously been endorsed by the Federal Circuit in *Riverside Research Institute v. United States*.[4] Applying the GAAP definition, the Board determined that the payments to foreign suppliers were not ''costs'' under CAS, and therefore, should not be included in UTC's allocation bases. The government appealed to the Federal Circuit.

The Federal Circuit Decision

The Federal Circuit's analysis began with a strong statement regarding the Board's use of expert testimony.

> The issue in this case is whether CAS required Pratt [UTC] to include a ''cost'' for collaboration parts in its allocation bases used to allocate overhead. Resolution of this question requires us to interpret CAS. Contrary to the Board's approach, the central issue we confront—the interpretation of CAS—is an issue of law, not an issue of fact. . .The views of the self-proclaimed CAS experts, including professors of economics and accounting, a former employee of the CAS Board, and a government contracts accounting consultant, as to the proper interpretation of those regulations is simply irrelevant to our interpretive task; such evidence should not be received, much less considered, by the Board on the interpretive issue. That interpretive issue is to be approached like other legal issues—based on briefing and argument by the affected parties.[5]

It is worth pausing here to note that, notwithstanding the court's admonition to resolve these issues ''based on briefing and argument by the affected parties,'' the subject of the use of experts apparently was not raised by the parties' briefs, but instead was raised by the court *sua sponte*. As a result, the court did not have the benefit of the parties' thinking on the critical determination in this case.

If a trial judge has discretion to consider expert legal testimony on questions of law in a patent case, it is difficult to understand why the judge should not have the same discretion when interpreting CAS. In both instances, the judge can benefit from hearing the opinions of those with specialized training and experience.

Having rejected the use of expert testimony, the Federal Circuit then undertook what it regarded as the proper analysis of this question. The court agreed with the Board that CAS itself did not define ''cost.'' The court then turned to extrinsic evidence, such as ''standard dictionary definitions and pertinent regulations.''[6] From these standard dictionary definitions and the Federal Acquisition Regulation, the court determined that ''cost'' meant an ''outlay for materials purchased.''[7] The court noted that the standard dictionary definitions did not appear to be any different than the GAAP definition used by the Board. But instead of exploring the GAAP definition with expert testimony (which the Federal Circuit noted was admissible), the court sought to clarify its dictionary definition by defining the term ''purchase.'' Finding no help from either CAS or the standard dictionaries or the FAR, the court looked to the Uniform Commercial Code for the ''ordinary commercial meaning'' of the term ''sale,'' which the court found demonstrated a ''purchase.'' From this analysis the court found the term ''cost'' ''as used in CAS to be clear and unambiguous, and to include the revenue share payments made by [UTC] for the parts under the collaboration agreements.''[8]

The Federal Circuit Failed to Recognize The Trial Judge's 'Gatekeeper' Role In the Admissibility of Expert Testimony

The Federal Rules of Evidence give the trial judge broad discretion in admitting expert testimony and in determining the weight to be afforded such testimony. The Supreme Court's decisions in *Daubert v. Merrell Dow Pharmaceuticals* and *Kumho Tire Co. Ltd. v. Carmichael*,[9] make the trial judge the ''gatekeeper'' of the admissibility of expert testimony with the responsibility of ensuring that expert testimony is reliable and relevant, and grant the trial judge broad discretion in making these determinations. In proceedings before the Board, the trial judge's discretion exceeds that provided to federal district court trial judges. ASBCA Rule 20 provides that parties may offer evidence that ''would be

[3] The government called two experts—one qualified as an expert in CAS and cost accounting, the other qualified as an expert in generally accepted accounting principles (''GAAP'') and accounting practices. Pratt called three experts. The first was qualified as an expert in organizational economics and industrial organizations. The second was qualified as an expert in GAAP, cost accounting, and management accounting. The third was qualified as an expert in CAS and GAAP. The fourth was qualified as an expert in CAS, GAAP, and cost accounting.

[4] *Riverside Research Institute v. United States*, 860 F.2d 420, 422 (Fed. Cir. 1988), *modified by* 877 F.2d 952 (Fed. Cir. 1989).

[5] *UTC*, *supra*, 315 F.3d at 1369.

[6] *UTC*, *supra*, 315 F.3d at 1370.

[7] *UTC*, *supra*, 315 F.3d at 1371.

[8] *UTC*, *supra*, 315 F.3d at 1372.

[9] *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993), and *Kumho Tire Co. Ltd. v. Carmichael*, 526 U.S. 137 (1999).

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admissible under the Federal Rules of Evidence *or in the sound discretion of the presiding administrative judge or examiner*.''[10]

It appears that the Board properly exercised its gatekeeper role by considering testimony of qualified experts offered by both parties. The Supreme Court has held that an abuse of discretion standard is to be applied when reviewing a trial judge's evidentiary rulings, including on the admissibility of expert testimony.[11] The Federal Circuit applied the abuse of discretion standard in *Markman v. Westview Instruments Inc.*, when reviewing the trial court's decision to hear expert testimony on a complex question of law in a patent infringement case.[12] In fact, the *Markman* court held that it was not an abuse of discretion of the trial court to admit such testimony.

Yet, in *UTC*, the court gave no indication that it was deferring to the Board's gatekeeper role. To the contrary, the Federal Circuit assumed that the Board did not even have the authority to admit expert testimony relating to CAS. This is inconsistent with the latitude afforded to the trial judge under ASBCA Rule 20 and *Daubert*. Even more surprising, the Federal Circuit did not follow its own holding in *Markman*.

The Federal Circuit Ignored Its Precedents Demonstrating That Expert Testimony Is a Useful Aid In the Interpretation of the CAS

The court in *UTC* also ignored its own precedent on the admissibility of expert testimony pertaining to CAS. A series of Federal Circuit and Court of Claims cases demonstrates that, prior to the *UTC* decision, expert testimony was welcomed as helpful to trial judges faced with interpreting CAS. For example, in *United States v. Lockheed Corp.*,[13] the Federal Circuit affirmed a decision of the Board wherein the Board had admitted expert testimony by both parties on the meaning of ''factor'' as used in CAS 403. Similarly, in *Boeing Co. v. United States,*[14] the court affirmed a decision of the Board, which had considered expert testimony from both parties on the proper interpretation of CAS 403. The same approach was adopted by the Court of Federal Claims in *Ryan-Walsh Inc. v. United States*,[15] where the court considered expert testimony from an accountant as to the meaning and application of CAS 416.

Thus, the Federal Circuit has not previously indicated any discomfort with the use of expert testimony relating to the proper interpretation of CAS. Even in *UTC*, the court gave no indication that it believed such testimony would not be helpful. The decision appears to be based entirely on a formulaic approach to the determination of an issue of law.

Indeed, the court in *UTC* ignores the scope of its own use of extrinsic evidence to determine the meaning of ''cost.'' In *UTC,* the court used dictionaries, treatises, Financial Accounting Standards Board (''FASB'') statements, and GAAP, as well as the FAR and the Uniform Commercial Code (''UCC''). Given the breadth of sources used by the court in interpreting CAS, it is difficult to understand the justification for not allowing the opinions of experts like those proffered by the parties in *UTC*.

The Federal Circuit Ignored Its *Markman* Decision Allowing Expert Testimony On Legal Issues In Patent Infringement Cases

The court's refusal to consider expert testimony relating to CAS contradicts its guidance to trial judges in *Markman*.[16] In *Markman*, the Federal Circuit held that a trial court does not abuse its discretion by admitting expert legal testimony on a question of law central to all patent infringement suits—the interpretation of the patent's claims, a.k.a. claim construction. In such cases, the expert provides testimony on the meaning of the patent claims to one skilled in the art. In *Markman*, the Federal Circuit explained that this expert testimony may provide informational and educational benefits for trial judges who lack the requisite expertise to understand the technical language of a patent.[17]

If a trial judge has discretion to consider expert legal testimony on questions of law in a patent case, it is difficult to understand why the judge should not have the same discretion when interpreting CAS. In both instances, the judge can benefit from hearing the opinions of those with specialized training and experience. The CAS are complex accounting rules designed to ''achieve uniformity and consistency'' in allocating costs to government contracts. Given this complexity, expert testimony should be helpful to a judge interpreting CAS. Of course, the trial judge is free to accept or reject the expert's opinions in whole or in part, since the judge remains ultimately responsible for interpreting CAS and applying it to the facts at hand. As explained by the Federal Circuit in *Markman*:

> as to these types of opinions, the court has complete discretion to adopt the expert legal opinion as its own, to find guidance from it, or to ignore it entirely, or even to exclude it.[18]

Life After *UTC*

In light of the *UTC* decision, its not clear when it is appropriate to use expert testimony. While rejecting the use of expert testimony pertaining to CAS, the court indicated in a footnote that experts may testify on the meaning of GAAP.[19] But it appears that the Federal Circuit believes that opinions of GAAP experts may not contradict a layman's understanding of accounting.

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[10] ASBCA R. 20 (emphasis added). See *Orbital Sciences Corp.*, ASBCA No. 50171, 2000-1 B.C.A. (CCH) ¶ 30,860 (March 30, 2000) (''Rule 20 gives the presiding judge discretion beyond the Federal Rules of Evidence.'').

[11] *General Elec. Co. v. Joiner*, 522 U.S. 136, 141 (1997); *Austin Chem. Co. v. United States*, 835 F.2d 1423, 1426 (Fed. Cir. 1997) (''The weight to be accorded expert testimony is a matter for the trial court, not the appellate court, to determine.'').

[12] *Markman v. Westview Instruments Inc.*, 52 F.3d 967, 982 (Fed. Cir. 1995), *affirmed*, 517 U.S. 370 (1996) (''*Markman*'').

[13] *United States v. Lockheed Corp.*, 817 F.2d 1565, 1572 (Fed. Cir. 1987).

[14] *Boeing Co. v. United States*, 680 F.2d 132, 136 (Ct. Cl. 1982), *cert. denied*, 460 U.S. 1081 (1983).

[15] *Ryan-Walsh Inc. v. United States*, 37 Fed. Cl. 639, 651-54 (1997).

[16] *Markman*, *supra*, 52 F.3d at 981.

[17] *Markman*, *supra*, 52 F.3d at 986.

[18] *Markman*, *supra*, 52 F.3d at 983.

[19] *UTC*, *supra*, 315 F.3d at 1369, n. 6.

The Board and the Federal Circuit approached the interpretation of CAS in two very different ways. The Board followed a conventional approach. After determining that CAS did not define the term ''cost,'' the Board looked to GAAP. To understand GAAP, the Board accepted and considered expert testimony offered by both parties. In essence, having found an absence of a relevant definition in the CAS, the Board looked to other accounting principles and the opinions of experts in accounting.

Conversely, the Federal Circuit looked not to the accounting literature for the meaning of ''cost,'' but instead assumed that it was appropriate to use a broader understanding of terms left undefined by CAS. Thus, the court looked to standard dictionaries, acquisition regulations, and the UCC.

The court also gave confusing signals on the usefulness of expert testimony pertaining to GAAP. While stating that such testimony was admissible and that GAAP is a supplement to CAS, the court rejected the need to use GAAP in *UTC* because ''CAS does provide the answer when the terms 'costs' and 'material costs' are given their ordinary meaning.''[20] Yet, in *UTC*, the Federal Circuit did not find that ''ordinary meaning'' in CAS itself, but found it instead somewhere on the road from Webster's dictionary to the UCC. Moreover, the court rejected the Board's findings pertaining to GAAP, which were based in part on the testimony of GAAP experts. In doing so, the court ignored the role of the trial judge to determine the weight afforded to expert testimony and indicated that the opinions of GAAP experts have little weight if they conflict with standard dictionary definitions.

Because a CAS case is often very complex, experts play a very useful role in framing the issues and assisting the court in understanding the context of the particular CAS provision in issue. By its statement in *UTC* that expert testimony is inadmissible, the Federal Circuit has made it much more difficult to present a CAS case to a board or court.

Thus, the legacy of *UTC* is greater uncertainty with respect to interpretation of accounting rules and the general use of expert testimony on issues of law.

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[20] *Id.*

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