



Allowability of Legal Costs Incurred by Government Contractors

How contractors can characterize their legal costs as allowable or unallowable.

Determining whether legal costs are allowable on U.S. federal government contracts can be quite challenging

If for no other reason, the allowability of legal costs is addressed in eight separate cost principles. This veritable labyrinth of regulations typically means that the answer to the seemingly simple question, “Are these legal fees allowable?” is often met with the dreaded response, “It depends.”

Unlike many other costs addressed in the Federal Acquisition Regulation (FAR), which are either allowable or unallowable, the allowability of legal costs often depends on both the nature of the services provided and the outcome achieved. In addition, legal costs can also be “directly associated costs” to other unallowable costs. The objective of this article is to help contractors characterize their legal costs as allowable or unallowable by summarizing the pertinent factors and rules in one article.

Initially, legal costs (like all other costs) must be reasonable in nature and amount. In other words, the legal fees must not exceed the fees that a prudent business owner would have paid in support of his or her own for-profit business. More specifically, the hourly fees paid to outside counsel cannot exceed the market rate for similar legal services in the contractor’s location. Or in the case of in-house counsel, the salaries should not exceed the current limitations on executive compensation. Any costs in excess of the market rate or salary limitations will be considered unallowable.

In addition to the reasonableness standard, legal costs must also meet the criteria for allowability set forth in the FAR Part 31 cost principles. The allowability of legal costs is most generally addressed in FAR 31.205-33, “Professional and Consultant Service Costs.” Per this cost principle, the costs of services obtained to enhance a contractor’s legal position are allowable unless the legal costs were incurred:

- To improperly obtain or distribute information protected by law or regulation;
- To improperly influence a solicitation, evaluation, or award of a contract; or
- In a manner that resulted in violation of any law or regulation prohibiting improper business practices or conflicts of interest.

This means most legal costs are allowable because it is unlikely that a contractor would engage an attorney to accomplish any of these “improper” results.

The cost principle does contain other more general requirements for allowability, including:

- Written agreements specifying the services to be provided and fees to be paid,
- Written invoices that describe the work performed,
- Evidence that the provider of the legal services was qualified to do so, and
- Special rules for the allowability of retainer fees.

FAR Cost Principle	Service Type	Allowable	Unallowable
31.205-33, "Professional & Consultant Service Costs"	Services to enhance a contractor's legal position.	Unless the legal services were for the purpose of improperly obtaining protected information, improperly influencing a request for proposals, or award decision or services that result in a violation of law or regulation.	✗
31.205-47, "Cost Related to Legal and Other Proceedings"	Criminal, administrative, or civil proceedings brought by governmental entities or employee whistleblowers/quitam relators alleging a violation of a law or regulation.	If the contractor is found to be "innocent" in the proceeding.	If the contractor is found to be "guilty" in the proceeding.
	Government claims and appeals.	✗	✓
	Corporate organizational work.	✗	✓
	Defense of anti-trust suits.	✗	✓
	Defense of employee suits under Section 2 of the Major Fraud Act of 1988.	If the contractor is found to be "innocent" in the proceeding.	If the contractor is found to be "guilty" in the proceeding.
	Lawsuits between contractors, regarding teaming agreements, Joint ventures, etc.	✗	✓
	Patent infringement litigation.	✗	✓
	Legal support to third parties when not contractually required.	If the contractor is found to be "innocent" in the proceeding.	If the contractor is found to be "guilty" in the proceeding.
	Protests of government requests for proposals or awards	✗	✓
31.205-3, "Bad Debts"	Collection of bad debts.	✗	✓
31.205-20, "Interest and Other Financial Costs"	Preparing prospectuses.	✗	✓
31.205-22, "Lobbying & Political Activity costs"	Lobbying.	✗	✓
31.205-27, "Organization Costs"	Corporate organizational work.	✗	✓
31.205-28, "Other Business Expenses"	Securities work, proxy statements, SEC/shareholder reports, etc.	✗	✓
	General Counseling on patent law matters.	✓	✗
	Invention disclosures and filing/prosecuting patent applications	If required by a term of the contract.	If not required required by a term of the contract.

*To be allowable, all legal costs must be reasonable in nature and amount and have written documentation supporting the transaction. Notwithstanding any statement in this table to the contrary, legal costs are allowable to the extent they were required by a term of the contract or a written request from a contracting officer.

The bottom line, per this cost principle, is that legal fees are allowable as long as they weren't incurred for one of the prohibited activities and the contractor generated and maintained documentation of the transaction sufficient to support the charges.

If this was the only cost principle in play, almost all legal costs would be allowable and it would be easy to distinguish the ones that aren't; but as someone once said, "the FAR giveth and the FAR taketh away." For instance, the next most prominent cost principle that addresses the allowability of legal costs, FAR 31.205-47, is much less generous. This cost principle, titled "Cost Related to Legal and Other Proceedings," makes some legal costs allowable, some unallowable, and includes a third category where the allowability depends on the outcome of the legal proceeding.

Specifically, costs incurred in connection with any proceeding brought by a federal, state, local, or foreign government, or by an employee, whistleblower/qui tam relator alleging that the contractor has violated a law or regulation, are unallowable if the proceeding results in:

- A criminal conviction;
- A finding of liability and monetary fine or a requirement to take corrective action in administrative proceeding;
- A decision by an agency official to:
 - Suspend or debar the contractor,
 - Rescind or void a contract, or
 - Terminate the contract for default due to failure to comply with a law or regulation;
- Disposition of the matter by a consent decree or compromise if the proceeding could have led to any of the outcomes previously listed, unless the contracting officer determines the accusing party had no chance of success; and/or
- Other findings of contractor misconduct where the costs would have been unallowable per the previously listed bullet points.

The term proceeding includes any investigation of the issue. Even if the results of the proceedings are favorable to the contractor, the legal costs still must:

- Be reasonable in relation to the complexity of the issue and potential liability,
- Be consistent with the principles governing the award of legal fees in civil actions involving the United States, and
- Not be recoverable from another party.

This is one of the few instances where the allowability of a cost cannot be determined at the time of incurrence. Legal cost incurred in connection with any of the proceedings previously described should be accounted for in a suspense account. In layman's terms, those costs can be moved to an allowable account if the contractor is found "innocent" or to an unallowable account if found "guilty." The fact that many of these proceedings will span fiscal years makes the accounting even more complicated. However, the cost principle does allow the U.S. federal government to reimburse such costs on a contingent basis with the understanding the contractor will refund the payments depending on the outcome of the proceeding.

As noted, this cost principle also describes instances where a contractor's legal costs will always be unallowable. These include:

- Defense or prosecution of claims or appeals against the U.S. federal government;
- Organization, reorganization, and merger and acquisitions, including resisting mergers and acquisitions;

- Defense of antitrust suits;
- Defense of suits brought by employees or ex-employees under Section 2 of the Major Fraud Act of 1988 where the contractor was found liable or settled;
- The prosecution of lawsuits between contractors relating to teaming agreements, joint ventures, co-production agreements, or similar arrangement of shared interests;
- Patent infringement litigation;
- Legal support of a third party that the contractor was not required to provide and the third party was convicted or found liable in a civil or administrative proceeding; and
- The cost of filing a protest or defending a protest.

Notwithstanding these restrictions, legal costs are allowable if they are incurred as required by the terms of a federal contract or pursuant to the specific written direction of the contracting officer.

Please note that for the purposes of this cost principle, cost includes not only legal fees per se, but all related costs including those involved in defense of the proceeding.

In addition to the two lengthy and complicated cost principles previously discussed, the FAR contains six additional cost principles affecting the allowability of legal costs. For instance, FAR 52.231-203 states that legal fees associated with the collecting of bad debts are unallowable. FAR 52.231-20 similarly disallows legal costs incurred in connection with preparing prospectuses. FAR 31.205-22 makes “lobbying” costs unallowable, which could include fees paid to law firms.

FAR 31.205-27 explicitly states that legal costs associated with corporate reorganizations, mergers and acquisitions, or raising capital are unallowable. This is one of the few instances in the FAR where a specific cost is expressly disallowed twice, as “organizational costs” are also addressed in FAR 52.231-47. This raises the question: “Can a contractor who charges such costs to the government be penalized twice on the theory they violated two different cost principles?” (We are just kidding, we hope!)

FAR 52.231-28 makes the normal corporation-type business expenses (e.g., issuing securities, proxy statements, required reports, etc.) unallowable and the costs for these activities are likely to include legal fees. FAR 52.231-30 states that costs incurred for general counseling regarding patent law matters are allowable but specific patent costs such as preparing invention disclosures and filing/prosecuting patent applications are unallowable unless incurred per the requirements of a federal contract. Please note that patent infringement litigation costs are unallowable per FAR 52.231-47, as previously discussed.

In an effort to simplify the allowability determination, we have prepared an “Allowability of Legal Costs” table (FIGURE 1). This table summarizes the allowability requirements and criteria for legal costs on one easy-to-follow page. However, to the extent there is any doubt regarding the allowability of the legal costs in question, the contractor should refer to the entire cost principle.

As this article demonstrates, it takes a comprehensive understanding of the regulations and knowledge of the legal services provided (and possibly the outcome achieved) to confidently state whether legal costs are allowable or not. There are ramifications when the decision is incorrect. Failure to invoice allowable legal costs hurts a contractor’s cash flow and profit. Conversely, including unallowable legal costs in government invoices will most likely result in the assessment of penalties and interest. Our last point, along the lines of “better safe than sorry,” is that the cost of obtaining professional advice on the allowability of legal costs is allowable.

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