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¶ 9 SETTLEMENT AGREEMENTS: Latest Decision In *Pratt & Whitney* Saga A Step In The Wrong Direction

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The latest installment in Pratt & Whitney's 40-year dispute with the Defense Contract Management Agency over indirect cost allocation did nothing to advance the analysis of Cost Accounting Standards compliance. *Secretary of Defense v. Pratt & Whitney*, 160 F.4th 1224 (Fed. Cir. 2025), 68 GC ¶ 7. Instead, the U.S. Court of Appeals for the Federal Circuit deferred those issues while narrowing Contracting Officers' authority to settle cost disputes prospectively and raising doubts about whether contractors can trust the Government to uphold such agreements.

In 2021, the Armed Services Board of Contract Appeals called this case "the *Jarndyce v. Jarndyce* of the cost accounting world" in reference to Charles Dickens's cautionary tale about the waste and misery of endless litigation. Five years later, the dispute is no closer to resolution, and this new opinion makes it harder for contractors and agencies to avoid future *Jarndyce*-style morasses.

Decades-Old Accounting Dispute Settled, Then Unsettled

Since 1984, Pratt, now a division of RTX Corp., and the DCMA have been searching for a method of accounting for Pratt's business model that is both CAS-compliant and reasonably equitable. After years of litigation, they reached a compromise in 2006. But the Government changed its mind in 2013, declaring the agreement invalid and asserting claims against Pratt for overpayments resulting from Pratt's compliance with the agreed-upon cost treatment.

Now, while the Federal Circuit has declined to weigh in on the proper accounting treatment in this new decision, the court agreed with the Government that a portion of the 2006 agreement was invalid because it did not meet the administrative requirements of advance agreements under Federal Acquisition Regulation 31.109. The court remanded to the board to determine quantum based on the accounting treatment that—against the wishes of both parties—the board had chosen.

While it will take time to determine the full impact of *Pratt & Whitney*, the court has arguably narrowed the "wide degree of latitude" COs have been given to enter into and administer contracts and to "try to resolve all contractual issues in controversy by mutual agreement at the contracting officer's level." *Sikorsky Aircraft Corp. v. United States,* 105 Fed. Cl. 657, 677 (2012). The implication of this opinion is that advance agreements under FAR 31.109 are now the *only* means by which a contracting officer and a contractor can bind the Government to a prospective resolution of a disputed cost treatment. Further, the party wishing to enforce the prospective aspect of a settlement agreement now bears the full risk of any mistakes in contract formation or implementation that could be construed as violations of the FAR or the CAS by the party attempting to evade their obligations.

Accounting Puzzle

This long-running courtroom drama has been fueled by a deceptively simple question: what is the cost of certain parts used by Pratt to build engines for commercial airplanes? Pratt designs, manufactures, and services jet engines for both the Department of Defense and commercial airlines. The Government reimburses Pratt for overhead costs properly allocated to cost-plus federal contracts. Pratt chose to allocate its overhead pool across contracts based on the material costs associated with each contract in accordance with CAS 418-50. The amount charged to the Government is determined by two factors: total size of the overhead pool and percentage of the pool allocated to Government contracts rather than commercial operations. The Government's share of the overhead pool decreases as the material costs associated with Pratt's commercial business increase. Thus, the Government benefits when commercial engine parts are assigned higher prices.

Pratt obtains parts for its commercial engines from three sources. It is simple to price the parts that Pratt manufactures in-house or buys from suppliers. The accounting conundrum arises in valuing "collaborator parts" contributed by partner companies under long-term revenue sharing agreements. Unlike military contracts with guaranteed sales, commercial jet engine programs are high-risk projects that can take 15 years to generate profit. Pratt began recruiting manufacturing partners in the late 1970s to share risk and reduce upfront investment. Under these collaboration agreements, partners earn a share of the eventual revenue stream by providing an equivalent share of the parts needed to develop and build the engines. Pratt pays collaborators their program revenue share less "Drag," a negotiated percentage to compensate Pratt for program management expenses, marketing and sales efforts, customer warranties, and other administrative costs. Collaborators are paid their proportional share of a sale regardless of whether any of the parts they contributed were used in the product sold.

At the inception of an engine program, Pratt and its partners negotiate a "manufacturing target cost" (MTC) for each part, a notional value used internally to keep track of partners' annual contributions. Pratt conceptualizes collaboration agreements as functionally equivalent to joint ventures. Originally, the company viewed collaborator parts as consignment goods and assigned them zero monetary value when calculating the material cost base for its commercial operations. Instead, Pratt reduced the total overhead pool by the amount it was paid by collaborators in Drag before allocating overhead across contracts. In 1992, the DCMA asserted that Pratt's treatment of collaborator parts was not CAS compliant.

Litigation Does Not Lead To Clarity

The dispute eventually reached the ASBCA, which found in Pratt's favor in 2001, determining that the CAS did not require Pratt to assign material costs to collaborator parts. *United Technologies Corp.*, ASBCA 47416*,* 01-2 BCA ¶ 31,592, 2001 WL 1123980. The Federal Circuit overturned the decision in *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361 (Fed Cir. 2003), an opinion also written by Judge Dyk, the author of this new *Pratt & Whitney* decision. The court held that Pratt had to assign cost to collaborator parts based on the amount paid for the parts in the current period and remanded for the board to determine how to calculate that amount. See *Defining "Cost": Using Smoke and Mirrors,* 17 N&CR ¶ 15, for John Cibinic's analysis of what he termed a "man bites dog" case because the Government was the party contending that a cost was incurred.

Settlement

Pratt reached a compromise with the DCMA in 2006. Pratt agreed to pay $283,000,000 to settle CAS 418 noncompliance claims covering the period from 1984 through 2004. By a concurrent Accounting Practices Agreement (APA), the DCMA agreed that going forward, Pratt would use MTC values to include collaborator parts in the material cost base and would no longer reduce the total overhead pool by Drag.

In a "Letter of Adequacy and Compliance" accompanying the APA, the Divisional Administrative Contracting Officer determined that eliminating Drag credits to the overhead pool complied with the CAS and the FAR. A Defense Contract Audit Agency disposition notice explained:

> [T]he DACO concurs with [Pratt's] argument that crediting the overhead pool for "DRAG" no longer serves any equitable or valid accounting purpose because including a proper cost for collaboration parts in the [overhead] base will now cause those parts to draw their commensurate share of overhead. Thus, continuing to credit the [overhead] pool for DRAG in this new circumstance would effectively result in a windfall for the Government.

The DACO also determined that using MTC as the cost of collaborator parts did not comply with the CAS, but it had "practical advantages" and the effect of its use was immaterial to the Government. Under the APA, the Government reserved the right to reconsider Pratt's use of MTC if the noncompliance became material. The DACO and the DACO's supervisor at the DCMA approved the settlement agreement and the APA.

Unsettlement

Détente lasted until a whistleblower report alleging the settlement terms unfairly favored Pratt prompted a new audit by the DCAA. In December 2013, a new DCMA CO asserted that CAS 418 and *Rumsfeld* required Pratt to value collaborator parts by Gross Revenue Share (GRS), a collaborator's percentage of the list price of engines sold, rather than by MTC. Additionally, the DCMA found that Pratt must reduce the overhead pool by the amount it received from collaborators in Drag payments. The DCMA asserted that the APA was invalid when signed and therefore not binding on the Government. To the shock of no one, more litigation ensued.

ASBCA Upholds Accounting Practices Agreement, Chooses Own Accounting Method

In a 2021 decision on entitlement, the board agreed with the Government's contention that the APA did not comply with FAR 31.109's requirements for advance agreements. *Pratt & Whitney, a division of Raytheon Technologies Co.,* ASBCA 59222, 21-1 BCA ¶ 38,104, 2021 WL 8086052, *recons. denied*, 22-1 BCA ¶ 38,199, 2022 WL 6731864. However, it held that because the APA was still a valid contract supported by consideration, the Government's Drag credit claim was barred by accord and satisfaction. In this regard, the board found that, while FAR 31.109 provides a mechanism for the formation of a binding agreement without the exchange of consideration, that authority was not necessary to validate a litigation settlement agreement supported by consideration. In denying the Government's motion for partial reconsideration, the board stated:

> The government cites no authority for its conclusion that a properly formed agreement must comply with FAR 31.109 if it is to address future costs…while FAR 31.109 provides a method for the government and contractors to agree to the treatment of costs in future periods, it does not provide that it is the exclusive method of addressing future costs. In fact, FAR 31.109 expressly provides that "an advance agreement is not an absolute requirement" and the absence of an agreement will not affect the treatment of costs. FAR 31.109(a). As we held in our decision, we look to the substance of the agreement, and are not bound by labels applied by the parties. *Pratt & Whitney*, 22-1 BCA ¶ 38,104 at 185,084 (quoting *Paradigm II, LLC, d/b/a JB Carpet & Upholstery Care*, ASBCA No. 55849, 09-1 BCA ¶ 34,070 at 168,464).

Having found the APA enforceable, the board went on to find that the Government's CAS 418 noncompliance claim objecting to the use of MTC was not barred because the APA reserved the Government's right to reconsider if noncompliance became material. Pratt argued that MTC was the most logical measure of the cost of collaborator parts, while the Government insisted that GRS was the only metric permissible under *Rumsfeld*. The ASBCA determined that both parties were wrong, and the correct cost of parts was Net Revenue Share (NRS), the program revenue share Pratt actually paid to a collaborator after deducting Drag and accounting for discounted engine prices. The board remanded to the parties to negotiate quantum using NRS. Ralph Nash broke down the different metrics in *Postscript: Defining the Term "Cost,"* 36 NCRNL ¶ 40.

Federal Circuit Jurisdiction

The Government appealed "[t]he board's steadfast insistence on binding the United States" to "an illegal agreement that contravenes applicable procurement regulations," and both parties appealed the board's choice of NRS as the measure of collaborator part costs. The claim at issue in the appeal covered the period from 2005 to 2012. Related proceedings involving subsequent Government claims for the periods 2013 through 2017 and 2018 through 2022 have been stayed by the board.

The Federal Circuit first addressed standing. Pratt argued that the CAS 418 issue and the Drag issue were part of a singular Government claim of CAS noncompliance. Because the board had yet to rule on quantum for part of the claim, there was no final decision for appellate review. The Government argued that they had asserted two separate claims, and the court had jurisdiction to review both. The Court agreed that the MTC and Drag claims were distinct, and they had jurisdiction over the board's final decision dismissing the Drag claim but not the entitlement ruling on CAS 418 noncompliance:

> We continue to follow the long-settled rule that, where the contracting officer made a determination as to both liability and quantum, and the Board has only made a determination as to liability, the Board's decision is not final for the purposes of our appellate jurisdiction. Therefore, we do not have jurisdiction over the CAS 418 Claim.

In other words, no help would be coming from the Federal Circuit at this stage to adjudicate between MTC, GRS, and NRS.

Court Invalidates Accounting Practices Agreement

In a move that appears to curtail COs' flexibility to settle prospective cost disputes, the court sided with the Government that the APA was not a valid advance agreement and therefore was outside of the CO's authority. It is well settled that COs must have actual authority to bind the Government to contracts, and Government officials generally lack authority to enter into contracts that violate statutes or regulations, including the FAR. The portion of the APA relating to the Drag Claim, referred to as the "Drag agreement" here, stated it was entered into "under authority of" FAR 31.109. The court reasoned, "[t]he question then is whether the Drag agreement violates the FAR."

The FAR's advance agreements provision advocates for proactive "agreement on the treatment of special or unusual costs . . .. However, an advance agreement is not an absolute requirement. . .." FAR 31.109(a). The court noted:

> This provision establishes an optional pathway for contractors and contracting officers to negotiate the future treatment of costs where 'the reasonableness, the allocability and allowability . . . of certain costs may be difficult to determine' under standard FAR provisions.

Yet in the next sentence, the court concluded that "any advance agreement reflecting a negotiated treatment of unusual costs" must comply with the requirements of FAR 31.109. In so doing, the court found that "a negotiated agreement to 'prospectively' agree to the treatment of costs," is "undeniabl[y]" an advance agreement, and that it was irrelevant that the purpose of the agreement was to settle litigated claims. "We are aware of no holding that gives the contracting officer authority to disregard the FAR restrictions because a settlement agreement is involved, and the board cites to none."

Pursuant to FAR 31.109(b), an advance agreement must be "incorporated into applicable current and future contracts" and "shall contain a statement of its applicability and duration." It is undisputed that the APA was not incorporated into any contracts and did not state its duration. Despite noting the "strong public interest in enforcing settlements, especially in complex litigation," the Federal Circuit concluded that these procedural violations invalidated the agreement. It held:

> Because the FAR was the source of the contracting officer's authority and did not authorize the agreement, the Board was required to find, as a matter of law, that the contracting officer lacked the authority to execute the Drag agreement on behalf of the government. *See Johnson Mgmt. Grp.* [*CFC, Inc. v. Martinez*], 308 F.3d [1245] at 1256 n.2 [(Fed. Cir. 2002)]. Because the contracting officer lacked authority to bind the government, the Drag agreement cannot be enforced against it.

In conclusion, the court expressed skepticism that Pratt is not required to credit the overhead pool for Drag but remanded to the board to consider that argument.

Lose/Lose For Federal Contracting

While the Department of Justice advanced a successful argument, it's hard to imagine how this decision could be interpreted as a win for the Government as a customer. Now that the Government can retroactively disavow the terms of "an illegal contract" it bargained for, vetted, and signed, it is risky for a contractor to commit to a settlement agreement that includes prospective cost treatment, especially where future liability is likely to exceed retrospective liability. The decision also opens the door for contractors to reexamine advance agreements they regret signing in search of minor conflicts with the FAR that make the agreement invalid.

Judge Newman Got It Right

In *Pratt & Whitney*, the court cited *Johnson Management Group CFC, Inc. v. Martinez,* 308 F.3d 1245 (Fed. Cir. 2002), 44 GC ¶ 440, for the principle that unless deviations from the FAR are pre-approved by the agency head, they are not binding on the government. Would that the court had paid closer attention to Judge Newman's partial dissent in that case. She wrote:

> My concern is with the court's holding that a government agency's error of law is the sole burden of the contractor, and that the government bears neither the responsibility for its error nor the obligation to correct it to a mutually acceptable alternative. Johnson Management has been assessed the full and costly consequences of the government's error. . .. The [HUD] Board [of Contract Appeals], affirmed by this panel, simply excises the assertedly illegal contract provision, thereby significantly changing the bargain. This result is as unjust as it is unsupportable in the law of government contracting.

Judge Newman explained that the invalidated contract provision, terms for the liquidation of advanced payments, was negotiated for by an experienced CO and was reviewed and approved by a supervisory authority and agency legal counsel. The contractor accepted a lower contract price in exchange for the bargained-for terms. The advanced payment provision was voided, but the contractor was still held to all of its contract obligations. Judge Newman's dissent disagreed with that outcome based on a bedrock principle of contract law:

> If the contracting officer indeed exceeded her authority and violated the law, it is improper to place on the contractor the full and sole burden of the government's error. The remedy for unilateral mistake is not to absolve the side that made the mistake from responsibility for the consequences of its mistake, while placing the burden of the mistake on the innocent party.

Similarly in the case at issue, Pratt agreed to pay $283 million to settle retrospective claims as part of a global settlement that included the agreed-upon cost treatment going forward. The Government is now able to revoke their commitment, but Pratt cannot go back in time and reconsider its position.

Concerning Precedent

Judge Newman wrote: "When the government enters into commerce, it is bound by the rules of commerce. . .. [T]he laws of contract and the rules of fair dealing do not evaporate when the government is a party." Unfortunately, nothing in the *Pratt & Whitney* opinion is likely to remind the Government of that. Because the Court decided the Drag Credits portion of the APA was invalid based on noncompliance with FAR 31.109's procedural requirements, it did not reach the Government's argument that the contract was illegal because it agreed to a cost treatment of Drag that the DCMA and the DCAA found compliant with the CAS and the FAR at the time but that the Government later determined conflicted with the FAR 31.201-5, *Credits*.

That is a concerning position for the DOJ to take. As the ASBCA cautioned:

> The government's new argument would make advance agreements illusory. Under the government's interpretation, it can enter into an advance agreement with a contractor regarding the treatment of a certain cost that is binding on future contracts. However, if the government later changes its mind and decides that the cost treatment that it agreed to is not correct, it can disclaim the agreement under the logic that the contracting officer's actions were *ultra vires* because the contracting officer did not have authority to enter into an agreement that violates the FAR.

It's not hard to follow the Government's logic a step further to imagine the reopening of any contract that contains formerly standard provisions that the current administration now interprets as illegal. It's not necessary to envision a slippery slope to be concerned about the potential fallout of even a limited application of the *Pratt & Whitney* decision—the narrowing of the authority of COs to enter into prospective settlement agreements and the diminution of trust in executed agreements. *Jason N. Workmaster & Elissa B. Harwood*