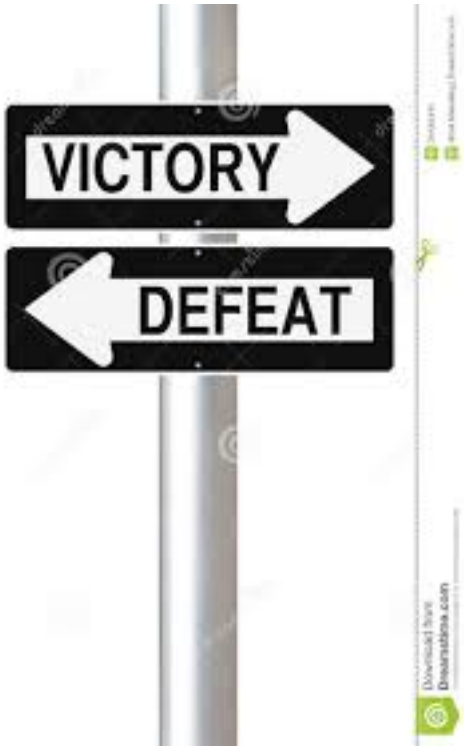

In a recent decision at the Armed Services Board of Contract Appeals, Administrative Judge O'Sullivan taught Coherent Logix, Inc. (CLX) a couple of important lessons. Readers should review the Judge's **decision** and learn those lessons for themselves. In the meantime, here's an article on some of those lessons.

CLX is small business, located in Austin, Texas. "Its principal business focus is on creating technology for high performance data processing using a scalable embedded processor platform." Whatever that means. Our point is: CLX is the kind of small, agile, innovative technology company that the DoD has focused on courting. One of the lessons here is that, unless the DoD starts to relax some of the regulatory requirements applied to these small, agile, innovative technology companies, it's going to lose them. But that's not really the focus in this article.

CLX submitted its annual final indirect cost billing rate proposal for its FY 2007 on August 13, 2008. Apparently it sat fallow for a long time, but eventually auditors from the Defense Contract Audit Agency (DCAA) got around to reviewing it for adequacy. We strongly suspect it was found to be inadequate, but we don't know for sure. In any case a revised proposal was submitted on June 19, 2013—nearly five years after the original submission. DCAA audited the proposal and found it included unallowable costs. $82,396 of those unallowable costs were expressly unallowable – namely, $68,894 for legal fees associated with patents, plus "costs of exhibition at trade shows (advertising costs), travel costs exceeding per diem, undocumented

first class airfare, and costs of meals determined to be entertainment."

Oops!

We've written about expressly unallowable costs **before**. We wrote—

… it is important for contractors to 'scrub' their proposals to establish final billing rates (also known as 'incurred cost proposals') to ensure that they are not claiming expressly unallowable costs. They are required to certify that they have excluded such costs and, if the Contracting Officer determines that the proposal contained expressly unallowable costs despite that certification, then penalties and interest may be imposed.

Accordingly, readers will be unsurprised to learn that—

On 21 November 2014, the Defense Contract Management Agency (DCMA) administrative contracting officer (ACO) issued his final decision finding that CLX had included expressly unallowable costs in its 2007 submission, consisting of the $68,894 in patent legal fees and $13,204 in other expressly unallowable costs. The ACO assessed a Level One penalty of $73,912 on the portion of these costs allocable to covered contracts, and added interest of $17,239, for a total of $91,151. He also stated that while he had carefully considered CLX's request for waiver of the penalty under FAR 42.709-S(c), he had determined that CLX's request did not meet the FAR criteria for waiver of the penalty. In particular, the ACO stated that the unallowable costs were not inadvertently incorporated into the proposal, but were included because CLX believed them to be allowable.

CLX disputed the ACO's Contracting Officer's Final Decision (COFD), asserting that the ACO erred in failing to waive the penalties and, in any case, the ACO's COFD was barred by the Contract Disputes Act's six-year Statute of Limitations (CDA SoL).

Judge O'Sullivan first addressed the CDA SoL argument. She noted that Judge Dyk's **ruling** in
Sikorsky

had converted the CDA SoL argument from one of jurisdiction to one of an affirmative defense. Judge Dyk's decision, which Judge O'Sullivan was bound to follow, had the effect of flipping the burden from the Government to the appellant (in this case, CLX). Instead of requiring the Government to show why the Court had jurisdiction, CLX was required to show why it did not. CLX's arguments did not persuade the judge.

CLX argued that DCAA had audited prior years' final rate proposals and had never taken exception to any legal costs (which included patent costs), nor had DCAA objected to any IP Amortization costs (which also included legal fees associated with obtaining the patents). Judge O'Sullivan found that simply including patent-related in legal fees or in IP Amortization expense did not provide the Government with adequate notice that CLX was incurring expressly unallowable legal costs. With respect to an affidavit submitted by Gary Baggett (CLX Controller), Judge O'Sullivan wrote, "Notably, Mr. Baggett states only that CLX made books and records available in prior years that showed its patent-related legal costs, but not that patent-related legal costs were included in CLX's final indirect cost rate proposal for any year prior to its 2007 proposal."

The Judge was persuaded instead by the Government's counter-argument, which was—

[The Government's] claim could not have accrued before 1 August 2013, when CLX provided the General Ledger detail showing the patent legal costs to the DCAA. Diane Chang, a DCAA auditor, provided an affidavit in which she states that DCAA requested the General Ledger detail from CLX on 24 July 2013 and received it on 1August 2013. Ms. Chang also states that she has searched the DCAA files and did not find General Ledger detail anywhere in CLX's 13 August 2008 submission. She further states that the only information CLX provided on legal costs prior to 1 August 2013 was the single line item identifying only generic 'legal services' in the amount of $89,196.

So one lesson here is that contractors should provide maximum General Ledger account detail along with submission of their proposals to establish final billing rates, even down to transaction level detail if feasible. We realize that for any company larger than the very smallest size, that's going to be a ridiculously difficult task, but we think it's going to be the only way to defeat the Government's argument (which has now succeeded in two CDA SoL cases) that it never knew of allegedly unallowable costs until the auditor requested and saw the transaction detail.

With respect to CLX's second argument, which was it included the expressly unallowable costs

because it didn't know any better, Judge O'Sullivan was similarly unpersuaded. CLX argued that it relied on a lack of audit findings in prior DCAA audits and, once it learned its legal fees associated with patents were not allowable, it implemented remedial measures to prevent a future recurrence of such costs. The Judge found that those arguments simply did not meet the prerequisites for penalty waiver found at FAR 42.709-5(c).

In that respect, her decision followed the same logic as was used by Judge James in his August, 2012, decision on the appeal of *Inframat Corporation*. We discussed that decision in **this article**. The lesson there is that negligence does not equate to "inadvertence" with respect to penalty waiver. In order to receive a waiver, the contractor must demonstrate "to the contracting officer's satisfaction" that expressly unallowable costs were included as the result of "unintentional error, notwithstanding the exercise of due care." In other words, here's another area where having robust internal controls (including employee training on the requirements of the FAR Cost Principles) would not only tend to reduce the probability of inclusion of unallowable costs, but would also tend to increase the probability of receiving a penalty waiver should they be included.

Thus, dear readers, there are many broadly applicable lessons to be learned in this ASBCA decision. Perhaps the most fundamental lesson is that contractors, regardless of size or sophistication, must invest in internal controls and training, and in having deeply experienced personnel who understand the complex requirements of the FAR Cost Principles and how to support a DCAA audit. Some innovative, agile, technology companies are not willing to make that investment – preferring, instead, to focus on their technology (and perhaps on their marketing). Those contractors should not do business with the DoD, nor should the DoD woo them. If the DoD wants to attract such companies – as it says it does – it needs to carve-out contractual, regulatory (and perhaps statutory) exemptions for them.

In the meantime, contractors should consider the lessons offered by Judge O'Sullivan's decision and make necessary changes to their operations in order to better assure compliance or, in the case of a legal dispute, victory.