

## Legal Costs Bite Small Business

Written by Nick Sanders

Friday, 18 January 2019 00:00 - Last Updated Tuesday, 15 January 2019 18:37

---

Founded in 1985 and located in San Diego, California, Energy/Matter Conversion Corporation (EMC2) researches, develops, and tests a nuclear fusion reactor that uses an electric field to heat ions to fusion conditions. The company received a Cost-Plus-Fixed-Fee (CPFF) contract from the US Navy in 2009, but EMC2 also had cost-type contracts going back at least to 2000. Though small, the company was clearly not a novice to government cost-reimbursement contracting.

With all that being said, it is possible that, as is the case with many small businesses growing in the performance of government contracts, EMC2 may not have fully appreciated the ruleset that comes with cost-reimbursement contracts. You know, the whole “cost allowability” thing?

We suspect that may have been the case because, in 2012, the Navy Acquisition Integrity Office (AIO) sent a “show cause” letter to EMC2 regarding certain costs that were deemed to be unallowable. That “show cause” letter was the result of an investigation and threatened debarment of EMC2 “pursuant to FAR 9.4.” The costs at issue were incurred and billed to the Navy between 2000 and 2005. Among the questionable costs was the salary of Cortine McGowen. According to the show cause letter, Ms. McGowen had told investigators that she worked as a housekeeper at the residence of EMC2 's prior owners, instead of at EMC2's offices. If she was a personal housekeeper then her salary would have been an unallowable personal expense, and not an allowable business expense.

*Let's digress here and state, for the record, that we have seen many instances where personal and business expenses are conflated on the books. All of those instances have been small businesses—sole proprietorships—where the owner(s) did not have a strong appreciation of the difference between personal and business expenses. If you are a sole proprietor (or even an S Corp.) it can happen. The job of the accountant/bookkeeper in such circumstances is to keep the personal and business expenses separate; but if the owner doesn't provide good direction, that job can be challenging. Mistakes can happen. We've seen it.*

Although EMC2 disputed that the questioned costs were unallowable, within a year it had refunded \$249,851 to the Navy.

Meanwhile, the company kept incurring costs and submitted proposals to establish final billing rates, as required by the contract clause 52.216-7 (“Allowable Cost and Payment”). With respect to its proposals for Fiscal Years 2010, 2011, 2012, and 2013. In each of those proposals—which we assume were properly certified—EMC2 included its legal expenses associated with supporting the investigation and crafting the legal settlement. With respect to FYs 2010 and 2011, DCAA (apparently) alleged that the legal costs were expressly

unallowable, but the cognizant contracting officer waived the penalties, as permitted by FAR 42.709-5(c).

*Another digression: if you are unfamiliar with expressly unallowable costs and associated penalties, we've written about them on this blog. Consider starting [here](#).*

When DCAA got around to auditing EMC2's final billing rate proposals for FYs 2012 and 2013 (an audit that commenced in 2017), it once again questioned the allowability of the legal costs, pursuant to the cost principle at 31.205-47(b)(4). In January 2018, the contracting officer agreed with DCAA that the questioned legal costs were expressly unallowable and assessed a penalty of \$53,614 (an amount that included interest). The contracting officer also rejected EMC2's request for a waiver of the penalty.

EMC2 [appealed](#) the COFD to the ASBCA. EMC2 chose not to be represented by an outside attorney before the Board and, instead, proceeded *pro se*. The company's President, Dr. Park, represented the company. We've written about this situation [before](#).

EMC2 advanced two arguments in its appeal—(1) the questioned legal costs were not expressly unallowable, and (2) even if they were expressly unallowable, the company should be entitled to a waiver (as it apparently received for its FY 2010 and 2011 proposals). As part of its arguments, the company noted that the government “failed to inform” it that the government was disallowing the legal costs in EMC2's FY 2010 and 2011 final billing rate proposals until *after* it had already submitted its FY 2012 and 2013 final billing rate proposals.

The arguments were unavailing. Judge Sweet, writing for the Board, found that the costs were both expressly unallowable and that EMC2 was not entitled to a waiver of penalty and interest. With respect to EMC2's argument that the legal costs were not expressly unallowable, he wrote—

The express provisions of the FAR specifically state that costs incurred in connection with any proceedings—including investigations—brought by the government for a violation of the law that result in disposition by compromise are unallowable if “the proceedings could have led to

debarment.' FAR 31.205-47(a)-(b). Here, EMC2 incurred the legal costs in connection with the DOJ and AIO investigations for a violation of the law. Moreover, EMC2 disposed of the investigations by compromise when it refunded the Navy \$249,850.90 in 2013. Further, the investigations could have resulted in debarment, as the Navy informed EMC2 in the December 10, 2012 letter. Because there is no genuine issue of material fact suggesting that it was reasonable under all of the circumstances for a person in EMC2's position to conclude that the legal costs were allowable, there is no genuine issue of material fact but that the legal costs were expressly unallowable.

(Internal citations omitted.)

A bit of commentary on the above. Of course, we are not attorneys so what do we know? But we remember a bit of [controversy](#) we reported on this site a few years ago regarding the definition of "expressly unallowable cost." The definition used above by Judge Sweet seems to come straight out of the DCAA audit guidance. That same DCAA audit guidance was criticized by real attorneys at Crowell & Moring for a significant departure from the definition found in CAS 405.

Now, you might argue that, as a small business, EMC2 wouldn't be subject to the requirements of CAS 405. But you'd be wrong. First, the phrase "expressly unallowable cost" is defined in the FAR (see 31.001, Definitions). Second, FAR 31.201-6 ("Accounting for Unallowable Costs") requires that all contractors subject to the cost principles comply with the requirements of CAS 405, regardless of whether they are actually CAS-covered. 31.20106(a) states "The practices for accounting for and presentation of unallowable costs must be those described in 48 CFR 9904.405, Accounting for Unallowable Costs." Therefore, while we are not attorneys, we suspect that, had an attorney been arguing the case, that attorney might have asserted that the Board was making an error of law. But as we previously stated, what do we know?

Back to the case at hand.

With respect to EMC2's argument that the penalty should be waived, Judge Sweet wrote—

The government also is entitled to judgment as a matter of law on EMC2's claim that it was entitled to a penalty waiver because there is no genuine issue of material fact suggesting that

## Legal Costs Bite Small Business

Written by Nick Sanders

Friday, 18 January 2019 00:00 - Last Updated Tuesday, 15 January 2019 18:37

---

EMC2 had adequate policies, training, controls, and review systems, and that it inadvertently incorporated the legal costs into [its final billing rate proposals].

As part of the decision, it was noted that “EMC2 cannot avoid the penalty by placing the burden of identifying and disallowing the legal costs on the government.”

To the argument that EMC2 was entitled to a waiver because it had updated its policies and procedures, Judge Sweet wrote—

EMC2 also asserts that it updated its accounting policies on January 26, 2017. However, EMC2 points to no evidence to support that assertion. Even if it had, that would not be a basis for a penalty waiver. In order for the penalty waiver to apply, a contractor must have policies established at the time it submitted its erroneous [final billing rate proposal]. FAR 42.709-5. Thus, even if EMC2, as it has alleged, updated its policies on January 26, 2017 this was after its submission of the 2012/2013 [proposals] on June 30, 2016 and it cannot avail itself of the penalty waiver. Indeed, by asserting that it did not update its policies to address the error until January 26, 2017, EMC2 effectively concedes that it did not have adequate policies in place at the time it submitted the 2012/2013 [proposals] on June 30, 2016.

(Internal citations omitted.)

*Another digression: if you want to read about waivers and how that all works, check out [this article](#)*

.

Judge Sweet also disposed of EMC2’s argument that it should only pay a penalty on unallowable costs associated with the value of the compromise. In other words, since its settlement was only 55% of the amount of originally questioned costs, it should only have to pay 55% of the penalty (and interest) amount. Citing to a *General Dynamics* case, the Judge found EMC2’s arguments unpersuasive.

Let’s sum this story up.

A small business—what looks like a sole proprietorship—grows through receipt of cost-reimbursable government contracts. The company appears to not fully understand the accounting requirements associated with those contracts and, as a result, it makes some mistakes with respect to claiming unallowable costs as allowable costs. It gets investigated and, although it settles its legal problems, it compounds and complicates its situation by claiming the legal costs associated with its problems as allowable costs, in contravention of FAR Part 31 requirements. The company believes imposition of penalties is wrong so it appeals to the ASBCA. It represents itself before the Board. It loses on a government motion for summary judgment.

The end.

*One final digression: growing companies tend to not appreciate the changing risks in their environment. We wrote about that phenomenon [over here](#) . If you are a growing small business, or a large business with a growing supply chain, we suggest you check it out.*