

ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --)
)
Fiber Materials, Inc.) ASBCA No. 53616
)
Under Contract Nos. DAAL04-86-C-0022)
 DAAL04-91-C-0031)
 DAAH01-93-C-R182)
 F40600-94-C-0004)
 DAAL01-94-C-0090)
 DASG60-96-C-0104)
 DASG60-96-C-0175)

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OPINION BY ADMINISTRATIVE JUDGE SCOTT

Appellant Fiber Materials, Inc. (FMI) appealed under the Contract Disputes Act (CDA), 41 U.S.C. §§ 601-613, from the administrative contracting officer's (ACO) final decision unilaterally establishing indirect overhead and general and administrative (G&A) rates for its fiscal years (FY) 1995 and 1996 under the subject contracts and assessing penalties for FMI's alleged inclusion of expressly unallowable costs in its indirect cost proposals. We decide entitlement only (tr. 2/17). During the hearing, the government moved to dismiss the appeal for lack of jurisdiction, claiming, among other things, that the officials who executed FMI's certificates of indirect costs did not have the requisite level of seniority. We deny the motion, and sustain the appeal in part.

Our fact findings cite regulations contained in or incorporated into the contracts. Quotations from other relevant regulations and from 10 U.S.C. § 2324, Allowable costs under defense contracts, the statute at issue, follow our findings.

FINDINGS OF FACT

FMI and Contracts at Issue

1. FMI, located in Biddeford, Maine, sells high temperature materials to the U.S. government, such as missile nose-tip and nozzle materials; engages in research and development (R&D) and energy materials testing; and sells products to the aerospace industry and to other domestic and international commercial customers, including soft carbon felt and rigid carbon board insulation materials. Mr. Walter L. Lachman, who incorporated FMI in 1969, is its chairman, chief executive officer (CEO), and chief financial officer (CFO). Mr. Maurice H. Subilia, Jr. is its president. FMI has divisions in Columbus, Ohio, and Presque Isle, Maine, and the following wholly-owned subsidiaries: Materials International (MI), located in Acton, Massachusetts, of which Mr. Lachman is president and Mr. Subilia is director; FMI Composites (FMIC), in Galashiels, Scotland, of which Messrs. Lachman and Subilia are directors; and Interemat, in Biddeford, with different management. In 1995 and 1996, Mr. Lachman owned at least 94 percent of FMI's stock. Mr. Subilia and another individual owned the rest. Mr. Lachman was chairman of FMI's board of directors. Mr. Subilia was a director along with, at some point, Mr. Stanley Paprocki, the retired president of Materials Concepts, Inc., said to be a subsidiary subsumed into FMI in 1989, at which time FMI paid Mr. Paprocki not to compete with it. It also paid him as a director. In 1995 and 1996, FMI's work was about 65-70 percent government and 30-35 percent commercial. With respect to MI, Mr. Lachman was president, he and Mr. Paprocki were directors, and Mr. Subilia was clerk. (R4, tab 13 at 24, tab 16 at 22, tab 152 at 2, tab 161, tab 239 at 1-2; tr. 3/10-15, 164, 199, 5/94-96, 109-11, 114, 156, 8/49, 9/6-13, 94)

2. The government acknowledges that FMI is a small business; its contracts are not subject to the Cost Accounting Standards (CAS), except to the extent that the Federal Acquisition Regulation (FAR) incorporates them; and FMI is responsible for selecting its cost accounting practices, as long as they are applied consistently using proper accounting procedures (R4, tabs 13, 16 at 2; tr. 4/36, 7/37-38, 120; *see also* 48 C.F.R. § 9903.201-1(b)(3); gov't br. at 92).

3. FMI's contracts at issue, which are all cost plus fixed fee and administered by the Defense Contract Management Agency (DCMA), are: (1) DAAL04-86-C-0022, awarded effective 24 February 1986 (contract 0022); (2) DAAL04-91-C-0031 (contract 0031), awarded on 4 April 1991; (3) DAAH01-93-C-R182 (contract R182), awarded on 17 June 1993; (4) F40600-94-C-0004 (contract 0004), awarded on 31 August 1994; (5) DAAL01-94-C-0090 (contract 0090), awarded on 15 September 1994; (6) DASG60-96-C-0104 (contract 0104), awarded on 26 September 1996; and (7) DASG60-96-C-0175 (contract 0175), awarded on 20 September 1996 (R4, tabs 27, 47, 75, 78, 85, 99, 113; tr. 2/30-31).

4. Contract 0022 contains Defense Federal Acquisition Regulation Supplement (DFARS) clause 252.242-7003, CERTIFICATION OF OVERHEAD COSTS (MAR 1985), which it quotes as follows, in part:

(a) Definition. "Claim" as used in this clause, means any request for payment of overhead costs including a proposal for or an agreement [on] final indirect cost rates or billing rates (including forward pricing rates used as billing rates).

(b) The Contractor's Division Vice President or equivalent must execute the certificate in paragraph (c) below for all overhead cost claims. Only upon receipt of the certificate, or specific reference to same[,] [s]hall the Contracting Officer [CO] act on the Contractor's overhead cost claim.

(c) Certificate of Overhead Costs. The certificate shall read as follows:

....

2. All costs included in this claim . . . are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense [DOD] applicable to those contracts[;]

3. This claim does not include any costs which are unallowable under applicable cost principles of [DOD] . . .

4. All costs included in this claim benefit [DOD] and are demonstrably related to or necessary for the performance of the [DOD] Contract(s) covered by the claim.

(R4, tab 27 at 17-18 of 41)

5. Contract R182 contains DFARS clause 252.242-7001, CERTIFICATION OF INDIRECT COSTS (DEC 1991), which provides in part:

(a) The Contractor shall—

(1) Certify any proposal to establish or modify billing rates or to establish final indirect cost rates;

....

(3) Have the certificate signed by an individual of the Contractor's organization at a level no lower than a vice president or [CFO] of the business segment of the Contractor that submits the proposal.

(b) Failure by the Contractor to submit a signed certificate, as described in this clause, shall result in payment of indirect costs at rates unilaterally established by the Government.

(c) The certificate of indirect costs shall read as follows:

....

2. All costs included in this proposal . . . to establish billing or final indirect cost rates . . . are allowable in accordance with the requirements of contracts to which they apply and with the cost principles of [DOD] applicable to those contracts;

3. This proposal does not include any costs which are unallowable under applicable cost principles of [DOD] . . .

4. All costs included in this proposal are properly allocable to Defense contracts on the basis of a beneficial or causal relationship between the expenses incurred and the contracts to which they are allocated in accordance with applicable acquisition regulations.

(Included in part at R4, tab 75 at 13 of 20) Contracts 0004 and 0090 incorporate this certification clause by reference (R4, tab 78 at 10 of 26, tab 85 at I.4).

6. The 1996 contracts, 0104 and 0175, do not contain a clause requiring certification of indirect costs. They incorporate by reference FAR 52.242-3, PENALTIES FOR UNALLOWABLE COSTS (OCT 1995), which provides in part:

(a) Definition. Proposal, as used in this clause, means either—

(1) A final indirect cost rate proposal submitted by the Contractor after the expiration of its fiscal year which—

(i) Relates to any payment made on the basis of billing rates; or

(ii) Will be used in negotiating the final contract price . . .

....

(b) Contractors which include unallowable indirect costs in a proposal may be subject to penalties. The penalties are prescribed in 10 U.S.C. 2324 or 41 U.S.C. 256, as applicable, which is implemented in Section 42.709 of the [FAR].

(c) The Contractor shall not include in any proposal any cost which is unallowable, as defined in Part 31 of the FAR, or an executive agency supplement to Part 31 of the FAR.

(d) If the [CO] determines that a cost submitted by the Contractor in its proposal is expressly unallowable under a cost principle in the FAR, or an executive agency supplement to the FAR, that defines the allowability of specific selected costs, the Contractor shall be assessed a penalty equal to—

(1) The amount of the disallowed cost allocated to this contract; plus

(2) Simple interest . . .

....

(e) If the [CO] determines that a cost submitted by the Contractor in its proposal includes a cost previously determined to be unallowable for that Contractor, then the Contractor will be assessed a penalty in an amount equal to two times the amount of the disallowed cost allocated to this contract.

(f) Determinations under paragraphs (d) and (e) of this clause are final decisions within the meaning of the [CDA].

(g) Pursuant to the criteria in FAR 42.709-5, the [CO] may waive the penalties in paragraph (d) or (e) of this clause.

(R4, tab 99 at 20 of 29, tab 113 at 17 of 25) Contract R182 incorporates by reference DFARS 252.231-7001, PENALTIES FOR UNALLOWABLE COSTS (DEC 1991), and contracts 0004 and 0090 incorporate by reference the April 1993 version of the clause. Like FAR 52.242-3, the DFARS penalties clause makes a CO's penalty determination a final decision under the CDA. (R4, tab 75 at 11 of 20, tab 78 at 10 of 26, tab 85 at I.5) The government refers to the penalties in the quoted paragraphs (d) and (e) of the FAR Penalties for Unallowable Costs clause, similarly described in DFARS 252.231-7001 and other regulations and in 10 U.S.C. § 2324, as "level one" and "level two" penalties. The ACO assessed only level one penalties. The government now contends that a level two penalty applies to aircraft costs, but because the ACO did not assert such a claim, we do not address it further.

7. Contract 0031 does not contain a clause requiring certification of indirect costs and does not contain the FAR 52.242-3 Penalties for Unallowable Costs clause (R4, tab 47).

8. Except contract 0022, the contracts incorporate by reference a FAR Allowable Cost and Payment clause. Contract 0031 incorporates FAR 52.216-7, ALLOWABLE COST AND PAYMENT (APR 1984) (R4, tab 47 at 9 of 13), which provides in part:

(a) *Invoicing.* The Government shall make payments to the Contractor when requested as work progresses . . . in amounts determined to be allowable by the [CO] in accordance with Subpart 31.2 of the [FAR] in effect on the date of this contract and the terms of this contract. . . .

(b) *Reimbursing costs.* (1) For the purpose of reimbursing allowable costs . . . , the term "costs" includes only—

. . . .

(E) Properly allocable and allowable indirect costs, as shown in the records maintained by the Contractor for purposes of obtaining reimbursement under Government contracts . . .

. . . .

(d) *Final indirect cost rates.* (1) Final annual indirect cost rates and the appropriate bases shall be established in accordance with Subpart 42.7 of the [FAR] in effect for the period covered by the indirect cost rate proposal.

....

(4) Failure by the parties to agree on a final annual indirect cost rate shall be a dispute within the meaning of the Disputes clause.

....

(g) *Audit*. . . [T]he [CO] may have the Contractor's invoices or vouchers and statements of costs audited. Any payment may be (1) reduced by amounts found by the [CO] not to constitute allowable costs. . . .

Contracts R182, 0004, and 0090, incorporate the July 1991 version of the clause (R4, tab 75 at 12 of 20, tab 78 at 7 of 26, tab 85 at I.1), and contracts 0104 and 0175 incorporate the August 1996 version (R4, tab 99 at 18 of 29, tab 113 at 15 of 25). Both versions contain the language quoted above.

9. Contracts 0022, 0031, and R182 incorporate by reference DFARS clause 252.231-7000, SUPPLEMENTAL COST PRINCIPLES (APR 1984) (R4, tab 27 at 17 of 41, tab 47 at 11 of 13, tab 75 at 11 of 20). Contracts 0004, 0090, 0104, and 0175 incorporate by reference the December 1991 version of the clause (R4, tab 78 at 10 of 26, tab 85 at I.4, tab 99 at 24 of 29, tab 113 at 20 of 25). The versions provide, essentially, that when cost allowability is determined under FAR Part 31, the CO shall also determine allowability under DFARS Part 231 in effect on the contract date.

Criminal Proceeding and Related Matters

10. On 8 July 1993 an indictment issued against FMI, MI, Mr. Lachman and Mr. Subilia, in the U.S. District Court for the District of Massachusetts, which charged them with one count of conspiracy to violate the Export Administration Act of 1979, 50 U.S.C.A. §§ 2410-2420, and one count of violating the Act and aiding and abetting. The defendants were accused of violating export control laws by exporting a control panel from the United States to the government of India's Defense Research Development Laboratory (sometimes DRDL), intending, and concealing the fact that, the panel would operate a production-size hot isostatic press, and failing to seek the required license from the U. S. Department of Commerce. FMIC was named in the indictment, but not charged. (R4, tab 239) In 1984 DRDL had issued a request for proposals to outfit a carbon-carbon facility in India for use in rocket and missile development, which resulted in an 18 April 1985 contract between FMIC and the Indian government, acting through DRDL, which called for FMIC, among other things, to supply the press and control panel (R4, tab 147; ex. G-3 at 3; tr. 5/93-94). After modifications to the DRDL contract, on 1 November 1987 FMIC issued a purchase order to FMI for the production

of the hot isostatic press and control panel. This led to the indictment against FMI, which had manufactured the equipment and exported it on behalf of FMIC via MI to India. The United States was not a party to the DRDL contract or to the purchase order. (Exs. A-3, A-4, G-3; tr. 4/122-23, 125, 5/98-99, 145-47)

11. Pursuant to FAR 9.407, SUSPENSION, on 13 January 1994, the Army temporarily suspended FMI, MI, Mr. Lachman and Mr. Subilia from future contracting with any executive branch agency. FMIC was suspended as an affiliate. (App. supp. R4, tab 12, exs. C, D, I) In March 1994 the Army and FMI entered into an Administrative Settlement Agreement (ASA). The Army terminated FMI's suspension, subject to conditions, including limitations upon Messrs. Lachman's and Subilia's involvement with government contracts. FMI agreed to segregate all costs incurred for it or its employees in connection with the criminal proceeding. (R4, tab 164)

12. The March 1995 criminal trial against FMI, MI, Mr. Lachman and Mr. Subilia ended with guilty verdicts against all four on all charges (app. supp. R4, tab 12, ex. G). On 15 May 1995 the Army proposed debaring the two individuals based upon their convictions. The ASA expired in March 1997 (R4, tab 164 at 4, ¶ 2; app. supp. R4, tab 12, ex. I) The Army terminated the proposed debarments, and FMIC's, MI's, and Messrs. Lachman's and Subilia's suspensions, on 17 May 1999. (R4, tab 12, exs. I, J, K; gov't br. at 18, proposed finding 67; app. reply br. at 4, proposed finding 67)

13. On 18 July 2003 the district court granted the defendants' motion for judgment notwithstanding the verdict, denied their alternative motion for a new trial, and entered judgments of acquittal. It found their conduct to be "reprehensible in the most fundamental sense," and that they had "sought -- for their own private economic advantage and heedless of the national security interests of this country -- to exploit imprecision in the regulatory regime for controlling exports," but it concluded that the regulatory provision at issue was vague and could not form the basis for a criminal conviction. *United States v. Lachman et al.*, 278 F. Supp. 2d 68, 70, 97 (D. Mass., 2003); *see also* ex. G-7, tr. at 3; app. supp. R4, tab 26. The government appealed. The defendants cross appealed on the ground that the court had not determined whether a new trial should be granted if the judgments of acquittal were later vacated or reversed. (R4, tabs 274, 275) On 25 October 2004 the U.S. Court of Appeals for the First Circuit vacated the acquittals; determined that the defendants had violated the law and reinstated their convictions; and remanded for a ruling on the defendants' motion for a new trial. *United States v. Lachman*, 387 F.3d 42 (1st Cir. 2004). The district court denied a new trial and, on 18 November 2005, imposed judgments of guilty on both counts of the indictment against each defendant. In sentencing, the court stated that the individual defendants' behavior had been atypical, but that Mr. Subilia's offense was exacerbated because he had not testified truthfully (ex. G-7, tr. at 5). On 23 November 2005 the defendants appealed to the First Circuit from the court's judgments of guilty and its

denial of a new trial. On 16 December 2005 the United States appealed from the sentences imposed upon defendants Lachman and Subilia. (Ex. A- 7)

Certificates of Indirect Costs – FYs 1995 and 1996

14. On 15 April 1997 Mr. Frank Dellasala submitted FMI's calculations of its final indirect cost rates (overhead and G&A) for FYs 1995 and 1996 to the ACO, with two sworn Certificates of Indirect Costs, which he signed as "Accounting Manager" (R4, tab 238). The certificates were in the form required by DFARS 252.242-7001 (DEC 1991) (finding 5). The indirect rates calculation for FY 1995 included \$995,743 in legal and audit costs, of which \$697,856 were shown as "Disallow[ed]," and \$228,192 in "other services" costs, identified by appellant as associated with the criminal litigation (tr. 3/30), of which \$43,348 were shown as disallowed. FY 1996 included \$701,880 in legal and audit costs, of which \$385,773 were shown as disallowed, and \$83,263 in other services costs, with \$6,097 disallowed. Appellant's fiscal year runs from 1 November through 31 October. (R4, tab 238)

15. Mr. Dellasala, a certified public accountant, who worked at FMI from January 1996 to April 1999, was its accounting and contracts manager. When he signed the cost certificates, FMI's organizational chart showed him as reporting directly to Mr. Lachman. He was not a vice president, but FMI has not had vice presidents since the early 1980's. (R4, tab 161; tr. 1/13, 14, 16, 18, 3/197, 199-202, 4/106-07, 8/49, 9/22)

16. Mr. George Towle, a senior Defense Contract Audit Agency (DCAA) auditor at the time, audited FMI's cost proposals. Before the FY 1995 audit was completed, FMI asked if it could re-submit to enable DCAA to examine its criminal proceeding costs. Mr. Towle's supervisor, Mr. Paul McGrath, authorized the re-submission. Mr. Towle understood that, although FMI knew DCAA was questioning the costs, the company wanted it on record that it deemed them allowable. (Tr. 6/62, 69, 73, 81, 84)

17. By letter of 5 October 1999, after Mr. Dellasala had left FMI, Mr. David Audie, then FMI's senior contracts administrator, submitted to the ACO revised final indirect rates calculations for FYs 1995 and 1996 and supplemental certificates of indirect costs, signed by Jennifer C. Beedy as "Legal Counsel." The letter stated that FMI had not included costs of the district court litigation in its 15 April 1997 submission; it expected to prevail; and Mr. Dominic Pettoruto of DCMA had advised that it should re-submit, with the costs included, to allow for their recovery. Mr. Dellasala testified that the letter reflected his telephone conversation with Mr. Pettoruto, who had cautioned that he was not the auditor and the costs could still be questioned. The new FY 1995 calculation again included \$995,743 in legal and audit costs, but showed only \$2,984 as disallowed, and included \$228,192 for other services, but showed only \$14,529 as disallowed. The FY 1996 calculation included \$704,079 in legal and audit costs, with

\$12,533 disallowed, and \$83,263 for other services, with \$6,455 disallowed. (R4, tab 163; tr. 2/25, 27, 4/152-53, 5/242-48, 6/56-61)

18. Ms. Beedy, FMI's general counsel, began her employment there in April, 1996. She was directly responsible to Mr. Lachman. She signed the supplemental certifications because they involved legal costs. At the time, FMI did not have a controller or an accounting manager. (R4, tab 161; tr. 3/20-22, 200, 208, 8/46, 48, 54, 9/23) She certified that only segregated costs of the district court litigation had been included in the revised indirect rates, and that they did not include any costs unallowable under the FAR or its supplements (R4, tab 163 at 0006).

19. Mr. Pettoruto, a former senior DCAA auditor, and DCMA cost price analyst who advised the ACO, recalled his conversation with Mr. Dellasala differently, but concluded that, if FMI believed that the criminal proceeding costs were or would be allowable, it had acted properly (tr. 7/144-149, 154). We find that FMI did not conceal, and specifically alerted the government, that it was including the costs in its revised submission because it considered that they would be allowable.

20. On 23 January 2004, FMI re-submitted its indirect cost proposals, with certificates of indirect costs executed by its president, Mr. Subilia (ex. A-6).

DCAA Forms 1 and Audit Reports for FYs 1995 and 1996

21. During 1998 to 2000, FMI and DCAA disagreed on FMI's indirect costs for FYs 1995 and 1996. Under DFARS 242.705-2, Auditor determination procedure, DCAA issued Forms 1, Notices of Contract Costs Suspended And/Or Disapproved, covering overhead and G&A costs. The Forms 1 at issue, dated 15 March 2000 (FY 1996) and 28 April 2000 (FY 1995), provided that FMI could request that the CO consider whether unreimbursed costs should be paid and/or it could file a claim under the contracts' Disputes clauses. (R4, tabs 3-8, 10-14)

22. On 30 May 2000 DCAA issued an audit report covering FMI's revised FY 1995 indirect cost submissions, now including the legal and "other services" costs of the criminal proceeding (R4, tab 16).

23. In the overhead pool, DCAA questioned FMI's costs for a cabin in Bridgton, Maine, totaling \$6,182 for all FMI's contracts—commercial and government—of which DCAA determined 12.7 percent were flexibly priced government contracts containing a penalties clause. It proposed a level one penalty with respect to the 12.7 percent of the questioned Bridgton cabin costs allocable to those government contracts. (*See* finding 65; R4, tab 16 at 3, 5-7, 9, 20, tab 17 at 2, tab 26)

24. In addition to \$1,650 in miscellaneous questioned G&A costs that FMI did not dispute, DCAA also questioned the following G&A costs allocable to all of FMI's contracts:

Legal and Audit	\$914,690
Other Services	107,478
Air Transport	190,215
Patent Amortization	17,241
Commissions	<u>55,425</u>
Total:	\$1,285,049

(R4, tab 16 at 10-11) FMI had claimed \$992,759 in legal and audit costs. Of the \$914,690 questioned, \$1,293 were legal costs associated with patents,¹ and \$913,397 were legal costs related to the criminal proceeding. (*Id.* at 11-12, 29) The questioned "other services" costs included \$58,178 pertaining to the criminal proceeding; \$1,215 for expert testimony in connection with a claim involving FMI and the Air Force; an unexplained \$7,500 payment to Mr. Paprocki; and \$40,471 in accrued invoices reversed in FY 1996 and placed in different accounts (*id.* at 12).² DCAA concluded that \$1,231,274 in unallowable G&A costs were subject to a level one penalty of \$263,493 (\$1,231,274 x 21.4% (percent of flexibly priced government contracts in allocation base containing penalties clauses)). In calculating the penalty, it excluded commissions, but included the \$1,650 miscellaneous costs and all other questioned costs, including for legal and other services, whether or not they pertained to the criminal proceeding. (R4, tab 16 at 18) DCAA concluded that none of the costs it questioned in its report were subject to a level two penalty (*id.* at 6, 11).

25. In the meantime, on 22 March 2000 DCAA issued its audit report based upon FMI's original and revised cost proposals for FY 1996. In the overhead pool, DCAA questioned Bridgton cabin costs totaling \$17,263, and proposed a level one penalty, based upon those costs and some costs the ACO later allowed. (*See* finding 65; R4, tab 13 at 6, 7, 10; tr. 8/121)

26. DCAA also questioned the following G&A costs:

Legal and Audit	\$495,259
Other Services	2,011
Air Transport	160,812
Commissions	45,449

¹ The parties have not distinguished these costs (and those for FY 1996) from questioned patent-related legal costs in FMI's patent amortization schedule.

² The listed costs total \$107,364—\$114 less than the \$107,478 DCAA disallowed, but the difference is immaterial.

Patent Amortization	15,305
Felt Adjustment	(507)
Adjust. For FY 95 cost	<u>(40,263)</u>
Total:	\$678, 066

(R4, tab 13 at 11) FMI had claimed \$691,546 in legal and audit costs. Of the \$495,259 questioned, \$467,148 pertained to the criminal proceeding and \$28,111 were legal costs associated with patents. DCAA concluded that the entire \$495,259 was subject to a level one penalty, although it did not state the amount. (*Id.* at 12-13, 37) The questioned “other services” costs of \$2,011 were for legal-related services in connection with the criminal proceeding (*id.* at 13). Including only the other services, air transport and patent amortization costs, DCAA concluded that \$178,128 in unallowable G&A costs were subject to a level one penalty of \$36,516 (\$178,128 x 20.5%) (*id.* at 20). DCAA concluded that none of the costs it questioned in its report were subject to a level two penalty (*id.* at 6, 12).

ACO’s Final Decisions

27. On 22 June 2001, ACO Kathy A. Winiarz issued a final decision unilaterally establishing indirect cost rates for FMI for FYs 1995 and 1996, based upon DCAA’s Form 1 findings and a meeting with, and subsequent submissions by, FMI. She found FMI indebted to the government in the amount of \$646,272, with a “potential” \$320,684 in deferred penalties for legal expenses. She demanded payment of the \$646,272, composed of \$562,525 in unallowable costs and \$83,747 in penalties. (R4, tab 20 at 1) FMI has not disputed the government’s statements that the \$83,747 in assessed penalties were for allegedly expressly unallowable air transport, Bridgton cabin, and patent amortization costs (*see* gov’t br. at 22-23, proposed finding 70G; app. reply br. at 4; *see also* finding 24 (sales commissions excluded from penalty assessment)). FMI requested an extension of time before indebtedness accrued under the decision and separate treatment for legal fees to insure fund availability if it prevailed in the litigation (R4, tab 21).

28. On 27 August 2001 ACO Winiarz rescinded the 22 June 2001 decision and issued a revised decision. She established the same indirect cost rates, but instead of calculating the amount of unallowable costs stated that, if application of the rates resulted in FMI’s indebtedness to the government, the debt was due within 30 days. However, she stated that penalties “are assessed in the amount of \$83,747 with an amount of \$320,684 in deferred penalties for legal expenses.” She demanded remittance of “monies due.” (R4, tab 24 at 1) The government has not yet attempted to collect the \$83,747 (tr. 8/199).

29. By letter dated 19 November 2001, FMI timely appealed to the Board from the ACO’s revised decision, which it described as unilaterally establishing FMI’s

FY 1995 and 1996 indirect rates and finalizing DCAA's Form 1 findings concerning FMI's incurred cost submissions for those years (Bd. corr. file).

30. The parties agree, and the record reflects, that FMI did not file its own affirmative CDA claim concerning its indirect cost proposals (tr. 8/120, 123-24; app. br. at 2, proposed finding 6, and at 24; gov't br. at 64).

Legal and Other Services Costs Pertaining to Criminal Proceeding

31. As noted, DCAA questioned \$971,575 in legal and other services costs pertaining to the criminal proceeding for FY 1995, and \$469,159 for FY 1996. Pre-trial and during trial, FMI, MI and Mr. Lachman were represented by the same law firm, whose legal fees are not segregable among the three. Post-trial they were represented by different attorneys. Mr. Subilia was represented pre-trial and during trial by a different attorney than the other three defendants. (Tr. 4/138-41)

32. FMI's by-laws provide for indemnification "to the extent legally permissible" of each director and officer, including for counsel fees reasonably incurred for the defense of a civil or criminal proceeding by reason of his position, except regarding any matter as to which he was adjudicated not to have acted in good faith in the reasonable belief that his action was in FMI's best interests (ex. G-4 at 14, ¶ 6).

33. Messrs. Subilia and Lachman testified that FMI paid for their criminal proceeding costs because it had indemnified them and because payment benefited it, and that FMI paid for MI's costs because it was in FMI's best interests. They, and possibly Mr. Paprocki, were involved in the payment decision, but there is no board resolution of record. Mr. Lachman controlled payment terms. For example, he decided that pre-trial payments for Mr. Subilia would be limited, but post-trial he had FMI pay for all of Mr. Subilia's costs. Mr. Lachman asserts that the government benefited because FMI would not be in business if it did not prevail and the government would not have a source for the materials it requires. (Tr. 3/143-44, 4/141-42, 5/106-07, 111, 114-15, 173, 6/44-45, 48-49, 9/95-96, 104-05)

34. There is no evidence that FMI was the government's sole source of the noted materials or that it was in danger of going out of business if it were convicted. Apart from its commercial business, appellant asserts that "FMI has been awarded, and has performed, government contracts since the termination of FMI's abbreviated suspension" in 1994 (app. reply br. at 26).

Leased Aircraft Costs

35. In 1985, Mr. Lachman purchased a 1985 Raytheon Super King Air B200 for \$2,090,000, which can carry up to nine passengers. He and FMI entered into a five-year

lease dated 24 October 1985. FMI paid him \$34,000 monthly rent, and for repair, maintenance and insurance. Mr. Lachman retained tax depreciation benefits. General Electric Credit Corporation submitted a lease proposal to FMI on the same type of aircraft. Although its written proposal is dated somewhat after FMI's lease, it reflects that the lease was competitive. The parties extended the lease, with rental increases, and one reduction in exchange for FMI's refurbishing the aircraft. On 30 September 1994, they extended the lease to 24 October 1996 and reduced the monthly rental to \$10,000. In addition to its lease obligations, FMI pays for pilot training and salary, mechanic training, and fuel. Mr. Lachman fully paid for the aircraft within seven or eight years of purchase and fully depreciated it. FMI uses it for business purposes, with a few exceptions for personal use, including Mr. Lachman's. (R4, tab 14 at 3 of 5, tabs 209-14, 222; tr. 2/113-14, 136, 144-46, 154-56, 159-60, 5/84-90, 9/38-40, 42, 51-52)

36. FMI's contract proposals are based upon commercial travel costs. In FYs 1995 and 1996 the government required that standard airfare, based upon Official Airline Guide rates, be used in proposals or bids. (Tr. 2/76, 103-04)

37. None of the contracts at issue contain a requirement to use a leased airplane. FMI has never entered into any advance agreement with the CO concerning use of leased aircraft. (Tr. 2/89, 3/115, 5/29, 8/116-17)

38. In FYs 1995 and 1996, travel requests came to Mr. Subilia for authorization. FMI's travel coordinator compared the cost of flying commercially with that of using the leased plane. If the latter was more expensive, Mr. Subilia would consider whether it nonetheless made practical sense. FMI's documentation included "Company Aircraft Trip Request" and "Commercial Costs/Company Plane Costs" forms, prepared by FMI's travel office, with input from FMI's pilot, Mr. Robert Curtis, who kept a log of all leased aircraft flights and provided schedule information and fuel and maintenance costs. He did not include general ledger or insurance costs. (R4, tabs 182-84; tr. 2/122-25, 129-30, 134-35, 154-56, 160, 3/69-70)

39. FMI's 5 October 1999 revised cost submission shows air transport costs for FY 1995 of \$326,028 and, for FY 1996, of \$292,132.³ The hours flown in the leased plane totaled 150.7 and 212.3, respectively. This results in hourly use costs of \$2,163 and \$1,376, considering only the indirect costs. Mr. Subilia did not evaluate hourly costs. He deemed that Board precedent did not require it. (R4, tab 163; ex. G-1 at 17 of 30, interrogatory response 15(c); tr. 4/164-71)

40. In its 30 May 2000 supplemental audit of FMI's revised FY 1995 submission, DCAA questioned \$190,215 of the \$326,008 in air transport costs, which included

³ The stated amount of the FYs 1995 and 1996 costs varies slightly in, and within, DCAA's reports and in Mr. Subilia's analysis but the differences are immaterial.

\$120,000 in lease payments, \$40,603 for the pilot's salary, and maintenance and operational costs. FMI had claimed \$142,546 in tangible benefits from using the leased plane, based upon alternative travel costs, and intangible benefits of \$183,459. DCAA accepted FMI's evaluation of commercial flight costs and tangible benefits, less \$6,756, which the record suggests included costs for Mr. and Mrs. Lachman and Mr. Subilia deemed to be commuting costs or not allocable to government contracts (R4, tab 5 at 2 of 4, tab 17 at 5; *see also* tab 13 at 14) DCAA did not accept the alleged intangible benefits and concluded that the \$190,215 in questioned costs (\$183,459 + \$6,756) were subject to a level one penalty. (R4, tab 16 at 10, 13, 18, 31-32; tr. 6/96-99)

41. DCAA cited many reasons for disallowing the noted costs, particularly that FAR 31.205-46(e) limits costs to standard airfare unless the contract requires travel by leased aircraft or the CO approves a higher amount, neither of which applied. FMI claimed the aircraft increased its executives' productivity and enhanced customer relations, community services, security, and scheduling flexibility. DCAA found no specific significant savings; the costs were nearly three times those of commercial airline travel; and to incur them for the stated reasons was not reasonable under FAR 31.201-3. DCAA found few leased aircraft flights in FY 1995, with most under two hours; many times there were sufficient commercial flights to meet FMI's needs; and most flights were for sales and technical meetings, with some for maintenance and training. It found no customer service or community relations flights and alleged that any such costs would be unallowable under FAR 31.205-1, Public relations and advertising costs. Additionally, it deemed that the lease was not arm's-length; noted that FMI had paid \$4,004,586 to Mr. Lachman for a \$2,090,000 airplane; and concluded that cumulative billings to the government exceeded those allowable under FAR 31.205-36, Rental costs. (R4, tab 16 at 10, 13-14, 30-32)

42. For FY 1996, DCAA questioned \$160,812 of what it reported as \$291,937 in submitted air transport costs, which included the same sorts of costs claimed for FY 1995. DCAA questioned the costs for essentially the same reasons as for FY 1995. It again accepted FMI's tangible benefit analysis, but not the alleged intangible benefits, and concluded that the questioned costs were subject to a level one penalty. (R4, tab 13 at 11, 14, 30, 32; *see also* tr. 6/97-98)

43. On 2 and 5 June 2000, FMI responded to DCAA that its aircraft costs in excess of commercial airfare were more than offset by tangible and intangible benefits, citing *United Technologies Corp.*, ASBCA No. 25501, 87-3 BCA ¶ 20,193, and *General Dynamics Corp.*, ASBCA No. 31359, 92-1 BCA ¶ 24,698. FMI stressed intangible benefits, stating each audit response since 1985 has described them. It termed the plane a reasonable investment by Mr. Lachman and denied that the lease was less than arm's length. (R4, tab 17 at 5-8, tab 18 at 5-8)

44. On 17 May 2001, prior to her initial decision, the ACO met with FMI concerning the costs DCAA questioned. She considered FMI's contentions that its leased aircraft saved costs and provided intangible benefits. FMI has not alleged, and there is no evidence, that the ACO acted in bad faith when she ultimately declined to accept the questioned aircraft costs, and all other costs at issue. (R4, tab 19; tr. 8/114, 116)

45. On 8 January 2002, after the ACO's revised final decision and FMI's appeal, it submitted a supplemental response to her, with an "Air Transport Analysis" prepared by Mr. Subilia. It contended that DCAA had omitted a number of FY 1995 trips; it had ignored tangible and intangible benefits to the government; and, many times, reasonable commercial alternatives were not available or would require more trips to accomplish the visits made with one use of the leased aircraft. FMI did not specify the trip omissions or occasions when commercial aircraft were not available. (R4, tab 230)

46. Mr. Subilia determined FMI's alleged savings with respect to each passenger on each leased aircraft trip during FYs 1995 and 1996, based upon his experience and FMI's records. He used its commercial costs/company plane costs forms and "Aircraft Expenses Compilations," which he prepared annually for the preceding year. They listed travelers' names, trip dates, alleged salary savings, and the costs or estimated costs of the leased and commercial aircraft, meals, lodging, mileage, car rental, airport parking, taxis, and miscellaneous. The information came in part from FMI's aircraft trip request forms, which included departure and arrival information and passenger names, but not their relationship to FMI. Some included the trip's purpose, but many did not. They showed domestic flights, carrying from one to six passengers. Mr. Subilia described tangible benefits as savings over commercial travel costs; personnel time saved, which he measured in terms of salaries and benefits; the value of being able to work en route, to which he ascribed a time savings of fifty percent; savings in lodging, rental cars, per diem, parking fees, and the like; and enhancement of alertness and stamina, which he measured at a thirty percent savings in personnel time. His alleged intangible benefits included enhanced security; reduced stress; attraction or retention of key executives; and improving or maintaining customer relations. He assessed those benefits at forty percent of the tangible benefits. He concluded that tangible benefits in FY 1995 were \$238,269 and intangible benefits were \$95,308, totaling \$333,577. He deducted \$326,008 in leased aircraft costs, for an alleged benefit to the government of \$7,569. The tangible benefits were \$95,723 more than FMI initially claimed and the intangible were \$88,151 less. For FY 1996, the tangible benefits were said to be \$309,582 and the intangible, \$123,833, totaling \$433,415. Deducting \$291,937 in aircraft costs, the government's alleged benefit was \$141,478. The tangible benefits were \$178,457 more than initially proposed and the intangible, \$36,979 less. (R4, tabs 183, 200-202, 230 at ex. A, tab 267; tr. 2/118-25, 3/70-74, 80-86, 90-97, 115-16)

47. Each party refers to earlier audit reports in support of its position. The government introduced DCAA's 9 June 1992 audit report on FMI's FY 1988 indirect

cost submissions, including \$595,127 in air transport costs (\$408,000, lease payments). FMI alleged comparable costs of \$924,514, including \$300,684 of tangible benefits and \$623,830 intangible -- tangible being alternate travel costs; value of personnel time saved; value of working en route; savings in overnight stays and per diem; personnel time/operational reliability (baggage; boarding; disembarking); alertness; and stamina. FMI relied upon *United Technologies* and *General Dynamics, supra*. DCAA accepted \$271,455 of the alleged tangible benefits, rejecting only an unsupported portion of the claimed personnel time saved and operational reliability costs. It questioned all intangible benefits. It did not recommend penalties. (Ex. G-5 at 7, 9-11, 23-24)

48. FMI refers to its FY 1989 indirect cost proposal, in which it claimed \$446,780 of tangible benefits and \$176,960 intangible. It relied upon the same Board cases. (R4, tabs 228, 229 at 10, 13) In its 27 May 1993 audit report, DCAA questioned tangible benefits it deemed to exceed commercial air travel costs and all intangible benefits, and recommended a level one penalty (R4, tab 229 at 10, 13-14, 35). In a 6 January 1994 revision, after FMI provided more support, DCAA accepted all tangible benefits claimed, but no intangible benefits, stating that its position remained the same on all other issues. It is not clear whether it still advocated a penalty. (R4, tab 228; tr. 9/245-46, 251)

49. FMI has advocated for years that the *United Technologies* and *General Dynamics* cases support its entitlement to the aircraft costs claimed. DCAA issued the audit reports in question in 2000. FMI gave no valid reason why it waited until January 2002 to submit Mr. Subilia's analysis, which was patterned after those decisions. As we discuss below, they involved a different regulation than here, and, unlike the evidence in those cases, Mr. Subilia's after-the-fact analysis is not expert evidence. In any event, it does not justify the dramatic increase in tangible benefits claimed or convince us that FMI is entitled to any more aircraft costs than the ACO allowed.

Commissions

50. In its supplemental report for FY 1995, out of \$67,592 in commission costs, DCAA questioned \$2,037 FMI paid to Mr. William Graham and \$53,389 it paid to MI, for domestic and foreign commercial sales, respectively, of the same sorts of products FMI sells to the U.S. government. No U.S. government contracts were involved. DCAA concluded that the commissions were direct costs to be charged to the associated commercial sales orders or contracts, and that they had no causal or beneficial relationship to government work and were not allocable to government contracts. It questioned MI's commissions on the additional ground that they were not allowable under FAR 31.205-38 because its agreement with FMI precluded MI from being considered FMI's employee or selling agency. DCAA did not claim that the commission amounts were unreasonable. (R4, tab 16 at 10, 15, 33; tr. 3/10-15, 6/119, 7/43-50)

51. DCAA did not question soft carbon felt sale commissions paid to Mr. Graham and to MI. FMI alleges that it thereby allowed them as indirect costs, which is inconsistent treatment (app. br. at 17, proposed findings 70, 72, 73). However, DCAA noted that FMI removed the felt sales from its G&A pool (R4, tab 16 at 15). Its FY 1988 audit report explains that “FMI excludes from its G&A allocation base felt material, which they buy for resale to other customers. They then credit the G&A pool for any costs related to this material, such as commission and indirect labor.” (Ex. G-5 at 13-14; *see also* R4, tab 13 at 17)

52. For FY 1996, of \$59,023 in commission costs, DCAA questioned \$11,272 paid to Mr. Graham and \$30,368 paid to MI, excluding felt sale commissions removed from the G&A pool. No U.S. government contracts were involved and DCAA questioned the costs on the same bases as for FY 1995. (R4, tab 13 at 11, 15, 16, 33, 34; tr. 6/119, 6/155-58) Additionally, DCAA questioned \$3,808 of the claimed commissions on the ground that the payee was not identified (R4, tab 13 at 11, 15).

53. Mr. Graham operates Graham Associates, a sole proprietorship. He is manufacturing representative for several companies. FMI pays him a set percentage commission based upon the net sales price on invoices. DCAA has not questioned that the commissions qualify as selling costs under FAR 31.205-38(f). (R4, tab 13 at 15, 33, tab 16 at 15, 33, tab 17 at 9; tr. 3/175)

54. MI, FMI’s wholly-owned subsidiary, was established in about the late 1970’s to be an “international sales arm” for FMI (tr. 3/11-12). MI markets and sells FMI’s products to foreign companies directly and through MI’s overseas sales representatives. FMI and MI entered into an agreement, effective 1 November, 1983, executed by Mr. Lachman as president of MI and Mr. Subilia as president of FMI, under which FMI pays MI a five percent commission on the net sales price of all of FMI’s goods and services sold overseas. The parties extend the agreement periodically. (R4, tab 17 at 9, tabs 180, 220) It provides in part:

WHEREAS FMI is endeavoring to expand its export of [its] products outside the United States, and

WHEREAS MI is a Corporation engaged in the sale and export of goods and products outside the United States and having established sales representatives in various foreign countries, and

WHEREAS FMI desires to obtain the overseas marketing services of MI and MI agrees to provide such services,

NOW, THEREFORE, it is agreed that MI shall provide such export and overseas marketing services to FMI in accordance with the following terms and conditions:

....

Independent Contractor

This Agreement is not intended in any way to create the relationship of principal and agent or employer and employee between FMI and MI and in no circumstances shall MI be considered the agent or employee of FMI. MI shall not act or attempt to act, or represent itself, directly or by implication, as an agent of FMI

(R4, tab 180)

55. FMI responded to DCAA that the independent contractor clause is standard and intended to define the “legal/liability relationship between two companies” and not to disavow their sales relationship. It also asserted that MI’s commissions qualify as selling costs under FAR 31.205-38(c)(2). (R4, tab 17 at 8-9, tab 18 at 8-9)

56. DCAA described Mr. Graham and MI in its supplemental audit report for FY 1995 and in its FY 1996 report, respectively, as “two agents for individual sales transactions” and “two agents for domestic and foreign commercial sales” (R4, tab 13 at 15, tab 16 at 15). There is no allegation or evidence that Mr. Graham or MI exerted or proposed to exert improper influence to solicit or obtain government contracts or suggested any ability to do so. DCAA did not allege that the commissions were based upon other than arm’s length agreements, or that they involved improper practices.

57. The record does not indicate whether Mr. Graham’s or MI’s commission costs were questioned prior to FY 1995, but it suggests otherwise because DCAA did not advocate a penalty, and in the FYs 1988 and 1989 audit reports of record, DCAA did not question commission costs (ex. G-5 at 7; R4, tab 229 at 10).

58. FMI has always treated its sales commissions as indirect costs and accumulated them in its G&A expense pool. It deems them to be compensation for all of a sales agent’s work, whether or not it results in a sale. FMI likens commission costs to those of in-house selling and marketing departments. It considers them ongoing business costs that should be included in G&A even though they are calculated on a contract specific basis. (R4, tab 230, ex. B at 1-3; tr. 3/164-65, 7/120) The claimed commissions for FY 1995 and at least most for FY 1996 were for Mr. Graham and MI (R4, tab 13 at

11, 15, tab 16 at 10, 15). It is not clear whether FMI has in-house sales personnel or other sales representatives.

59. The government has not disputed FMI's assertion that the labor and material costs associated with its commission sales are included in its direct labor and G&A pools used to calculate overhead and G&A rates for government contracts, thereby reducing the portion of indirect costs they bear (R4, tab 17 at 9, tab 18 at 8; tr. 3/193).

Patent Amortization Costs

60. The subject contracts incorporate by reference, variously, two or more of the following clauses pertaining to patents: FAR 52.227-1, AUTHORIZATION AND CONSENT (APR 1984) or (JUL 1995) versions - ALTERNATE I (APR 1984); FAR 52.227-2, NOTICE AND ASSISTANCE REGARDING PATENT AND COPYRIGHT INFRINGEMENT (APR 1984); FAR 52.227-3, PATENT INDEMNITY (APR 1984); FAR 52.227-10, FILING OF PATENT APPLICATION—CLASSIFIED SUBJECT MATTER (APR 1984); FAR 52.227-11, PATENT RIGHTS—RETENTION BY THE CONTRACTOR (SHORT FORM) (APR 1984) or (JUN 1989) versions; DFARS 252.227-7034, PATENTS—SUBCONTRACT (APR 1984); and DFARS 252.227-7039, PATENTS—REPORTING OF SUBJECT INVENTIONS (APR 1990) (R4, tab 27 at 16 of 41, tab 47 at 10, 11 of 13, tab 75 at 11, 13 of 20, tab 78 at 8, 9, 10 of 26, tab 85 at I.2, I.4, tab 99 at 19, 24 of 29, tab 113 at 16, 20 of 25). However, we have not been directed to any provision in any of the contracts requiring that patent costs be incurred.

61. FMI amortizes patent costs over patents' useful lives, not to exceed 17 years. For FYs 1995 and 1996, DCAA questioned patent amortization costs consisting of patent-related legal costs of \$17,241 and \$15,305, respectively. The amount of the questioned costs allocable to flexibly priced government contracts containing penalties clauses (21.4 percent and 20.5 percent) was under \$10,000 for each of those fiscal years. DCAA found the costs unallowable under FAR 31.205-30 because FMI had not shown that they were incurred due to a government contract requirement. Further, FMI had not identified the specific nature of the claimed costs or linked them to particular patents, and some of the costs were for obtaining patents in foreign countries. DCAA recommended level one penalties, calculated at \$3,689.57 (\$17,241 x 21.4%) and \$3,137.53 (\$15,305 x 20.5%). (R4, tab 13 at 16, 20, 34, 35, tab 16 at 14, 18, 33-34, 35, tabs 225, 226, 230; tr. 5/216-17, 220-23, 6/110, 117-18, 7/64)

62. FMI responded that its "patents were developed at company expense in anticipation of use on future government and commercial programs" and that the government thereby benefited (R4, tab 17 at 4-5). FMI asserted that FAR 27.104, General guidance, and FAR 52.227-1, Authorization and consent, encourage use of commercial inventions while performing government contracts. It stated that its patents on the shape stable nose tip were used to supply a nose tip for the Navy's TRIDENT ballistic missile program; the government was still using the technology under ongoing

contracts to improve the nose tip and reduce costs; and its patents on metal matrix composite wire and high strength carbon fibers were used on several government R&D contracts. It alleged that DCAA had accepted its approach to patent cost amortization from 1973 to 1994. (*Id.* at 5) We note that the FYs 1988 and 1989 audit reports list “amortization” costs, unquestioned, but their nature and the circumstances are not of record. (R4, tab 229 at 5, 10; ex. G-5 at 4, 7)

63. At the hearing, FMI cited the same patents. Mr. Lachman also mentioned one for Flex Fram deck coating material, but stated that the government had patented about the same thing and had entered into a settlement whereby FMI gave it the patent, in return for FMI’s full use. FMI did not show that any of the named patents were on its amortization schedule and part of the costs at issue. In discovery, FMI submitted a list of patents it believed were on its schedule. A government compilation shows that some of the listed patents expired before FY 1995 and/or 1996, and some were foreign patents acquired by assignment for \$1. It is not clear whether FMI claimed costs pertaining thereto. Mr. Lachman, who approves items to be patented, was unable to identify the patents, which were not named, on FMI’s general ledger that recorded the amortization costs, and he did not know whether any of them were part of the contracts at issue. FMI’s outside accounting firm prepared the patent amortization schedule. Mr. Subilia suggested that Mr. Dellasala, or another internal accountant, could address the patent costs, but FMI did not call any accountants to testify about the matter. FMI did not identify the specific patents, or the specific nature of the associated amortization costs claimed, or show that any of the costs were incurred due to a government contract requirement, or that they were otherwise allowable. (R4, tabs 179, 225, 226, 260; tr. 5/179-80, 208, 214-23, 9/74-77, 9/101-02, 163-64)

64. There is no evidence that the claimed costs were due to a government contract requirement; or that any were of the nature described in FAR 31.205-30(a) as allowable if incurred as a government contract requirement; or that they were for general counseling services relating to patent matters, allowable under FAR 31.205-30(b); or that they were for royalties or other costs of patent use necessary for proper performance of any of the contracts at issue and applicable to contract products or processes, allowable under FAR 31.205-37(a).

Bridgton Cabin

65. The government disallowed costs for a lake cabin in Bridgton, Maine, that FMI purchased in about 1974. For FY 1995 DCAA questioned \$6,182, consisting of \$2,695 in property taxes and \$3,487 in building maintenance; for FY 1996 it questioned \$17,263, consisting of \$2,664 in property taxes, \$6,035 in building maintenance, \$3,840 in utilities, and \$4,724 in other services. The amount of the questioned costs allocable to flexibly priced government contracts containing penalties clauses (12.7 percent and 11.1 percent) was under \$10,000 for each of those fiscal years. DCAA determined that FMI’s

employees used the cabin for vacations and outings at no cost to them and described it as a recreational facility and the costs as employee morale costs. It found the costs unallowable under FAR 31.205-13(c) because the cabin had no business purpose and was used solely for recreation. For FY 1995, FMI contended that the cabin's primary purpose was for high level meetings among FMI management, consultants and customers. FMI had no documentation and DCAA could not verify that it was ever used for a business meeting. For FY 1996, FMI's records disclosed that the cabin was not used for business meetings, but was booked by its employees for 21 weeks in the year. DCAA questioned the costs on the same grounds as for FY 1995. It recommended level one penalties for FY 1995 and 1996 of \$1,187 and \$2,109 based upon Bridgton cabin costs and certain other employee morale costs the CO later allowed. (R4, tab 13 at 5, 7, 10, 33, 35, tab 16 at 5, 7, 9, 32-34; tr. 3/179) Although, as we discuss below, FAR 31.205-13(c) made recreational costs unallowable effective 1 October 1995, there is no evidence that DCAA limited its unallowable cost findings to that period or to affected 1996 contracts.

66. FMI responded that DCAA had accepted the cabin costs until FY 1990. FMI contended that they were allowable under FAR 31.205-13. It also urged that the cabin was a *de minimis* fringe benefit under FAR 31.205-6(m). It claimed a long-standing policy of making it available for employees when it was not used for business meetings; employee use was incidental to meeting use; and employee use costs were inconsequential. Lastly, FMI asserted that property taxes were fixed costs that should be recovered regardless of employee use, as well as maintenance and utility costs, such as winter plowing and heating for access by customers, consultants, employees, firemen and police. FMI has not pursued the latter argument and we do not address it. (R4 tab 17 at 1-2, tab 18 at 1-2; *see also* tr. 7/51, 127)

67. The ACO's minutes of a 17 May 2001 meeting reflect FMI's statement that, although the cabin was originally used for business, in recent years FMI allowed employee use as part of a morale effort (R4, tab 19; *see also* tr. 8/115). Similarly, in its 8 January 2002 supplemental response to DCAA, FMI no longer claimed that the cabin was used for business meetings. It persisted in its *de minimis* fringe benefit argument. It calculated the hourly rate of employees who used the cabin; compared that to annual salaries; and concluded that the benefit to employees was .72% and .34%, for FYs 1995 and 1996, respectively. It deemed this immaterial and did not account for cabin use in its employee benefit package. (R4, tabs, 230, 231; tr. 3/176-79, 184-87)

68. Mr. Lachman testified that FMI first used the cabin for business, but that, in the early 1990s, it offered it to employees without restriction. Use applications, including from subsidiary Intermat's employees, are submitted to Mr. Subilia for approval. Mr. Lachman considers the cabin to be for employee morale but not to be a recreational facility. However, the guest log, Messrs. Subilia's and Audie's testimony, and DCAA's reports, reflect, and we find, that employees use the cabin for vacations, fishing, rest,

relaxation and other recreational purposes. (R4, tab 13 at 33, tab 16 at 32, tabs 227, 259; tr. 2/56-57, 3/179-80, 183-84, 189, 6/36-37, 109, 165-66, 9/103)

69. DCAA supervisor McGrath cited FAR 31.205-14, Entertainment costs, in support of DCAA's position (tr. 7/59-62), but its audit reports did not mention it. Appellant addressed the regulation in briefing, but the government did not. We find that the government is not pursuing any contention that FAR 31.205-14 bars recovery of the cabin costs.

70. According to Mr. McGrath, the cabin is not a fringe benefit because it does not meet FAR 31.205-6(a)(b)'s threshold employee compensation requirements. Rather, FMI provided free use of a recreational facility. (Tr. 7/56, 62-63) Former DCAA auditor Towle noted that the cabin was not part of FMI's business plan and opined that it would not qualify as a fringe benefit because it is not transferable. That is, FMI does not pay employees if they elect to go elsewhere. (Tr. 6/109, 145-46, 172-75)

71. There is no evidence that FMI is required to provide the cabin to its employees by law, employer-employee agreement, or established company policy.

10 U.S.C. § 2324

The government relies upon 10 U.S.C. § 2324 and its implementing regulations.⁴ Referenced portions of the statute, as in effect as amended through 1997, provide:

⁴ The statute applies only to contracts for which solicitations were issued on or after the date of publication of implementing regulations. Defense Procurement Improvement Act of 1985, Pub. L. No. 99-145 §§ 901, 911(c), 99 Stat. 682, 685 (1985). The earliest contract at issue was awarded in 1986 (finding 3). The statute's penalty provisions were not effective until 26 February 1987, 48 C.F.R. § 231.7001 (1987). At the time, the statute and regulations called for penalties if a cost were unallowable based upon "clear and convincing evidence." 10 U.S.C. § 2324(a)(2); 48 C.F.R. § 231.7001(a)(3) (1987). That was changed to the current "expressly unallowable" standard by the National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484 § 818(a)(1)(B)(ii), (iii), 106 Stat. 2457 (1992), which made the amendments effective on the date of enactment of the Act (23 October 1992) and stated that they would apply, as provided in implementing regulations, with respect to indirect cost proposals for which the government had not initiated an audit before the Act's effective date. Subsection (j) of 10 U.S.C. § 2324, regarding the contractor's burden to prove the reasonableness of indirect costs, was not added until 1988. Codification of Military Laws, Pub. L. No. 100-370 § 1(f)(3)(A), 102 Stat. 846 (1988). The statute and regulations have been otherwise amended from time to time. Unless pertinent, we do not discuss the particulars.

(a) Indirect cost that violates a FAR cost principle.--The head of an agency shall require that a covered contract provide that if the contractor submits to the agency a proposal for settlement of indirect costs incurred by the contractor for any period after such costs have been accrued and if that proposal includes the submission of a cost which is unallowable because the cost violates a cost principle in the [FAR] or applicable agency supplement to the [FAR], the cost shall be disallowed.

(b) Penalty for violation of cost principle.--(1) If the head of the agency determines that a cost submitted by a contractor in its proposal for settlement is expressly unallowable under a cost principle referred to in subsection (a) that defines the allowability of specific selected costs, the head of the agency shall assess a penalty against the contractor. . . .

Paragraph (b)(2) describes level two penalties. A penalty assessed under subsection (b) can be waived if the contractor withdraws its proposal before the government's formal initiation of an audit and submits a revised one; the amount of unallowable costs subject to penalty is insignificant; or the contractor demonstrates that it has established procedures to preclude inclusion of unallowable costs subject to penalties and they were inadvertently incorporated. 10 U.S.C. § 2324(c). An agency head's action to disallow costs or to assess a penalty is an appealable final decision under the CDA. 10 U.S.C. § 2324(d).

At subsection (e) the statute lists unallowable costs, including:

(O) Costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States . . . to the extent provided in subsection (k).

The referenced subsection (k) states in part:

(k) Proceeding costs not allowable.--(1) Except as otherwise provided in this subsection, costs incurred by a contractor in connection with any criminal, civil, or administrative proceeding commenced by the United States . . . are not allowable as reimbursable costs under a covered contract if the proceeding (A) relates to a violation of, or

failure to comply with, a Federal . . . statute or regulation, and (B) results in a disposition described in paragraph (2).

(2) A disposition referred to in paragraph (1)(B) is any of the following:

(A) In the case of a criminal proceeding, a conviction . . . by reason of the violation or failure referred to in paragraph (1).

....

(D) A final decision—

(i) to debar or suspend the contractor;

....

by reason of the violation or failure referred to in paragraph (1).

(E) A disposition of the proceeding by consent or compromise if such action could have resulted in a disposition described in subparagraph (A) . . . or (D).

....

(6) In this subsection:

....

(B) The term “costs”, with respect to a proceeding—

(i) means all costs incurred by a contractor, whether before or after the commencement of any such proceeding

The statute’s certification provisions provide in part:

(h) Contractor certification required.—(1) A proposal for settlement of indirect costs applicable to a covered contract shall include a certification by an official of the contractor that, to the best of the certifying official’s knowledge and belief, all indirect costs included in the

proposal are allowable. Any such certification shall be in a form prescribed in the [FAR].

An agency head or Secretary of the military department concerned may waive the certification requirements in an exceptional case if he or she determines that it would be in the best interests of the United States. 10 U.S.C. § 2324(h)(2).

As we discuss below, the government contends that the contractor's certifying official must be a "senior executive." In 1997, at the time of Mr. Dellasala's certifications, the statute's definition of "senior executive," at § 2324(l)(5), was:

- (A) the [CEO] of the contractor or any individual acting in a similar capacity for the contractor;
- (B) the four most highly compensated employees in management positions of the contractor other than the [CEO]; and
- (C) in the case of a contractor that has components which report directly to the contractor's headquarters, the five most highly compensated employees in management positions at each such component.

Subsection (l)(5) was amended in 1998, with respect to costs of compensation of senior executives incurred after 1 January 1999, to provide that the term "senior executives" means "the five most highly compensated employees in management positions at each home office and each segment of the contractor." National Defense Authorization Act for FY 1999, Pub. L. No. 105-261, §§ 804(a), (d), 112 Stat. 2083 (1988); *see also* 41 U.S.C. § 256 (m)(2) which contains the same language.

However, apart from the definition provisions, only subsection (e) of the statute, "Specific costs not allowable," refers to "senior executives." It provides at paragraph (P) that costs of their compensation are not allowable to the extent that it exceeds established benchmark compensation. The DFARS provisions concerning cost certifications do not refer to "senior executives" (findings 4, 5).

Subsection (j) of the statute provides that, in an ASBCA or Federal court proceeding in which the reasonableness of indirect costs for which a contractor seeks DOD reimbursement is at issue, the contractor has the burden to prove reasonableness.

REGULATIONS

The contracts were awarded in 1986, 1991, 1993, 1994 and 1996 (finding 3). The cost regulations quoted in this section are those in effect on 1 October 1996, and found in title 48 of the Code of Federal Regulations for that date, unless otherwise indicated.

Except for the 1986 contract, the contracts each contain the FAR 52.216-7 Allowable Cost and Payment clause, which provides in part that the CO is to make payments in accordance with Subpart 31.2 of the FAR in effect on the date of the contract (finding 8). The DFARS 252.231-7000 Supplemental Cost Principles clause, included in the contracts, also applies the regulations in effect on the contract date (finding 9). Unless otherwise noted, there are no material differences between the quoted 1996 regulations and those applicable on other dates.

General

FAR 31.001, Definitions, defines “Cost objective” as:

[A] function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

FAR 31.201-2, Determining allowability, provides in paragraph (a) that the factors to be considered in determining whether a cost is allowable under a government contract include: (1) reasonableness; (2) allocability; (3) standards promulgated by the CAS Board, if applicable or, otherwise, generally accepted accounting principles and practices appropriate to the circumstances; (4) the contract’s terms; and, (5) any limitations contained in FAR Subpart 31.2, Contracts with commercial organizations.

FAR 31.201-3, Determining reasonableness, as effective 30 July 1987, provides in part:

(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the [CO] or the contracting officer’s representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.^[5]

⁵ The regulation in effect as of award of contract 0022 does not contain this burden of proof language. 48 C.F.R. § 31.203-3 (1986).

(b) What is reasonable depends upon a variety of considerations and circumstances, including—

(1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;

(2) Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations.

FAR 31.201-4, Determining allocability, provides in part:

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

(a) Is incurred specifically for the contract;

(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

FAR 31.202, Direct costs, provides in part:

(a) A direct cost is any cost that can be identified specifically with a particular final cost objective. No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.

FAR 31.203, Indirect costs, provides in part:

(a) An indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. It is not subject to treatment as a direct cost

(b) Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives

. . . .

(d) The contractor's method of allocating indirect costs shall be in accordance with standards promulgated by the CAS Board, if applicable to the contract; otherwise, the method shall be in accordance with generally accepted accounting principles which are consistently applied.

Indirect Cost Certification Regulation

FAR 42.703-2, Certificate of indirect costs, issued effective 1 October 1995 (60 Fed. Reg. 42,648 (Aug. 16, 1995)), provides in part:

(a) General. In accordance with 10 U.S.C. 2324(h) and 41 U.S.C. 256(h), a proposal shall not be accepted and no agreement shall be made to establish billing rates or final indirect cost rates unless the costs have been certified by the contractor.

(b) Waiver of certification. (1) The agency head, or designee, may waive the certification requirement when—

(i) It is determined to be in the interest of the United States; and

(ii) The reasons for the determination are put in writing and made available to the public.

. . . .

(c) Failure to certify. (1) If the contractor has not certified its proposal for billing rates or indirect cost rates and

a waiver is not appropriate, the [CO] shall unilaterally establish the rates if they are necessary for continuation of the contract.^[6]

The specific cost categories at issue, listed by subject, in the order addressed by the parties, follow.

Legal Costs^[7]

FAR 31.205-47, Costs related to legal and other proceedings, provides in part:

(a) *Definitions.* “Conviction,” as used in this subsection, is defined in 9.403.

Costs include . . . administrative and clerical expenses; the costs of legal services . . . ; the costs of the services of accountants, consultants, or others retained by the contractor to assist it; costs of employees, officers, and directors; and any similar costs incurred before, during, and after commencement of a judicial or administrative proceeding which bears [sic] a direct relationship to the proceedings.

“Fraud,” as used in this subsection, means . . . (2) acts which constitute a cause for debarment or suspension under 9.406-2(a) and 9.407-2(a)

. . . .

(b) Costs incurred in connection with any proceeding brought by a Federal . . . government for violation of, or a failure to comply with, law or regulation by the contractor (including its agents or employees) are unallowable if the result is—

(1) In a criminal proceeding, a conviction;

⁶ Title 41 U.S.C. § 256(h), Contractor certification required, contains the same language at paragraph (1) concerning certification by an official of the contractor as does 10 U.S.C. § 2324(h)(1).

⁷ The regulation as in effect at the time of award of contract 0022 differs. The regulation was revised effective 22 January 1991. The differences are immaterial in view of our disposition of the legal costs issue. (48 C.F.R. § 31.205-47 (1986); 55 Fed. Reg. 52,782 (Dec. 21, 1990)).

(2) In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct.

(3) A final decision by an appropriate official of an executive agency to:

(i) Debar or suspend the contractor;

....

(4) Disposition of the matter by consent or compromise if the proceeding could have led to any of the outcomes listed in subparagraphs (b)(1) through (3) of this subsection . . . ; or

(5) Not covered by subparagraphs (b)(1) through (4) of this subsection, but where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable by reason of subparagraphs (b)(1) through (4) of this subsection.

Under FAR 9.403, Definitions, “Conviction” is defined in part as “a judgment or conviction of a criminal offense by any court of competent jurisdiction, whether entered upon a verdict or a plea.”

Leased Aircraft Costs

FAR 31.205-46, Travel costs, provides in part:

(d) Airfare costs in excess of the lowest customary standard, coach, or equivalent airfare offered during normal business hours are unallowable except when such accommodations require circuitous routing, require travel during unreasonable hours, excessively prolong travel, result in increased cost that would offset transportation savings, are not reasonably adequate for the physical or medical needs of the traveler, or are not reasonably available to meet mission requirements. However, in order for airfare costs in excess of the above standard airfare to be allowable, the applicable

condition(s) set forth in this paragraph must be documented and justified.

(e)(1) “Cost of travel by contractor-owned, -leased, or –chartered aircraft,” as used in this subparagraph, includes the cost of lease, charter, operation (including personnel), maintenance, depreciation, insurance, and other related costs.

(2) The costs of travel by contractor-owned, -leased, or –chartered aircraft are limited to the standard airfare described in paragraph (d) of this subsection for the flight destination unless travel by such aircraft is specifically required by contract specification, term, or condition, or a higher amount is approved by the [CO]. A higher amount may be agreed to when one or more of the circumstances for justifying higher than standard airfare listed in paragraph (d) of this subsection are applicable, or when an advance agreement under subparagraph (e)(3) of this subsection has been executed. In all cases, travel by contractor-owned, -leased, or –chartered aircraft must be fully documented and justified. For each contractor-owned, -leased, or –chartered aircraft used for any business purpose which is charged or allocated, directly or indirectly, to a Government contract, the contractor must maintain and make available manifest/logs for all flights on such company aircraft. As a minimum, the manifest/log shall indicate—

(i) Date, time, and points of departure;

(ii) Destination, date, and time of arrival;

(iii) Name of each passenger and relationship to the contractor;

(iv) Authorization for trip; and

(v) Purpose of trip.

Selling Costs

FAR 31.205-38, Selling costs, provides in part:

(a) “Selling” is a generic term encompassing all efforts to market the contractor’s products or services Selling activity includes the following broad categories:

. . . .

(5) Direct selling.

. . . .

(c)(1) Direct selling efforts are those acts or actions to induce particular customers to purchase particular products or services of the contractor. . . . The cost of direct selling efforts is allowable if reasonable in amount.

(2) The costs of broadly targeted and direct selling efforts and market planning other than long-range, which are incurred in connection with a significant effort to promote export sales of products normally sold to the U.S. Government, including the costs of exhibiting and demonstrating such products, are allowable on contracts with the U.S. Government provided—

(i) The costs are allocable, reasonable, and otherwise allowable under this Subpart 31.2;

. . . .

(f) Notwithstanding any other provision of this subsection, sellers’ or agents’ compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business (see 3.408-2).^[8]

⁸ The FAR 31.205-38 selling costs regulation in effect for the 1986 contract at issue differed from the amended regulation applicable to the other contracts (48 C.F.R. § 31.205-38 (1986)). Prior to award of the 0104 contract, the

The referenced FAR 3.408-2, Evaluation criteria, was under Subpart 3.4-Contingent Fees. FAR 3.408-2(a), *Improper influence*, stated that:

By definition (see 3.401), a bona fide employee or bona fide agency neither exerts nor proposes to exert improper influence to solicit or obtain Government contracts.

FAR 3.401, Definitions, provides in part:

“Bona fide agency,” as used in this subpart, means an established commercial or selling agency, maintained by a contractor for the purpose of securing business, that neither exerts nor proposes to exert improper influence to solicit or obtain Government contracts nor holds itself out as being able to obtain any Government contract or contracts through improper influence.

FAR 3.408-2(c), *Bona fide agency*, provided guidelines for evaluating whether an agency is a bona fide agency as defined in FAR 3.401. The guidelines included, in part:

(1) The fee should not be inequitable or exorbitant when compared to the services performed or to customary fees for similar services related to commercial business.

(2) The agency should have adequate knowledge of the contractor’s products and business, as well as other qualifications necessary to sell the products or services on their merits.

(3) The contractor and the agency should have a continuing relationship. . . .

(4) The agency should be an established concern that has existed for a considerable period . . . The business of the agency should be conducted in the agency name and characterized by the customary indicia of the conduct of regular business.

parenthetical reference to FAR 3.408-2 was eliminated (61 Fed. Reg. 39,186 (July 29, 1996)).

Patent Costs

FAR 31.205-30, Patent costs, provides:

(a) The following patent costs are allowable to the extent that they are incurred as requirements of a Government contract (but see 31.205-33):

(1) Costs of preparing invention disclosures, reports, and other documents.

(2) Costs for searching the art to the extent necessary to make the invention disclosures.

(3) Other costs in connection with the filing and prosecution of a United States patent application where title or royalty-free license is to be conveyed to the Government.

(b) General counseling services relating to patent matters, such as advice on patent laws, regulations, clauses, and employee agreements, are allowable (but see 31.205-33).

(c) Other than those for general counseling services, patent costs not required by the contract are unallowable. (See also 31.205-37.)

The referenced FAR 31.205-33, Professional and consultant service costs, covers the allowability, and restrictions upon recovery, of such costs.

FAR 31.205-37, Royalties and other costs for use of patents, provides in part:

(a) Royalties on a patent or amortization of the cost of purchasing a patent or patent rights necessary for the proper performance of the contract and applicable to contract products or processes are allowable unless—

(1) The Government has a license or the right to a free use of the patent;

....

(4) The patent is expired.

Employee Morale Costs

FAR 31.205-13, Employee morale, health, welfare, food service, and dormitory costs and credits, as in effect for all but the two 1996 contracts at issue, provides in part:

(a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable . . . to the extent that the net amount is reasonable. Some examples are house publications, health clinics, recreation, employee counseling services, and food and dormitory services, which include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations, or similar types of services for the contractor's employees at or near the contractor's facilities.

Effective 1 October 1995, the regulation was amended to provide in part:

(a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, except as limited by paragraphs (b), (c), and (d) of this subsection. Some examples of allowable activities are house publications, health clinics, wellness/fitness centers, employee counseling services, and food and dormitory services, which include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations, or similar types of services for the contractor's employees at or near the contractor's facilities.

. . . .

(c) Costs of recreation are unallowable, except for the costs of employees' participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness.

The amended regulation applies to contracts 0104 and 0175 (finding 3).

Fringe Benefits

FAR 31.205-6, Compensation for personal services, states in part:

(a) *General*. Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance . . . It includes, but is not limited to, . . . fringe benefits Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

. . . .

(m) *Fringe benefits*. (1) Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Fringe benefits include, but are not limited to, the cost of vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans. Except as provided otherwise in Subpart 31.2, the costs of fringe benefits are allowable to the extent that they are reasonable and are required by law, employer-employee agreement, or an established policy of the contractor.

Penalties

In addition to the penalty provisions of 10 U.S.C. § 2324(b), the FAR 52.242-3 Penalties for Unallowable Costs clause incorporated into two of the contracts, and the DFARS 252.231-7001 Penalties for Unallowable Costs clauses incorporated into three of the contracts (finding 6), the government cites to FAR 42.709, which implemented the statute's penalty provisions, including the level one and level two penalties, and potential for waiver by the CO, described above⁹.

The statute does not define “expressly unallowable” costs that are subject to penalty assessments. FAR 31.001 defines an “expressly unallowable cost” as “a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.”

⁹ The DFARS clause was superseded by FAR 52.242-3 (OCT 1995) and removed effective 30 November 1995 (60 Fed. Reg. 61,586 (Nov. 30, 1995)).

FAR 42.709-5, Waiver of the penalty, cited in the FAR Penalties for Unallowable Costs clause at paragraph (g) (finding 6), provides in part:

The cognizant [CO] shall waive the penalties at 42.709-1(a) when-

....

(b) The amount of the unallowable costs under the proposal which are subject to the penalty is \$10,000 or less (i.e., if the amount of expressly or previously determined unallowable costs which would be allocated to the contracts specified in 42.709(b) is \$10,000 or less); . . .

The referenced 42.709-1(a) describes level one and level two penalties, and the referenced 42.709(b) states:

(b) This section applies to all contracts in excess of \$500,000, except fixed-price contracts without cost incentives or any firm-fixed price contracts for the purchase of commercial items.

DISCUSSION

I. Jurisdiction

The government alleges that: (1) the Board lacks jurisdiction because appellant's certificates of indirect costs were not executed by persons with the authority required by the certification clauses included in some of the contracts, and particularly by 10 U.S.C. §§ 2324(h) and (l)(5), applicable to all of them; (2) without proper certifications, the ACO's authority was limited to establishing indirect rates unilaterally and the part of her decision pertaining to penalties is a nullity; and (3) appellant did not file its own affirmative CDA claim concerning disallowed costs and must be deemed to have appealed from the ACO's decision only to the extent that it assessed penalties; thus, there is no valid CDA claim or appeal before us. The government further alleges that, even if the ACO could assess penalties absent a cost certification, the Board still would not have jurisdiction over legal cost issues because she deferred the matter of penalties pertaining to them. Lastly on jurisdictional issues, the government contends that the assessed penalties did not apply to commission costs and, if the Board has any jurisdiction, the only issue properly before it is whether the aircraft, cabin, and patent amortization costs were expressly unallowable and subject to the ACO's penalty assessments.

Appellant does not concede that Mr. Dellasala and Ms. Beedy lacked authority to execute its cost certificates, but it alleges that: (1) its re-submitted cost proposals with certificates executed by Mr. Subilia cured any deficiency; (2) regardless, any deficiency did not deprive the ACO of authority to issue a final decision because the only limits imposed by FAR 42.703-2(a) are that, without a cost certification, a CO cannot accept a contractor's cost proposal or make an agreement to establish final indirect cost rates – neither of which occurred here; and (3) the ACO's imposition of penalties and her unilateral determination of final indirect rates were both government claims that do not require a CDA certification, and the Board has jurisdiction over this appeal in its entirety.

First, with respect to certification of indirect cost rate proposals, 10 U.S.C. § 2324(h) merely requires certification by “an official of the contractor.” The government alleges that the statute's definition of “senior executive,” at § 2324(l)(5) governs the certification requirements, and that FMI's certifiers did not qualify as senior executives. However, apart from the definition section, only subsection (e) of the statute refers to “senior executives,” and that is in the context of limiting allowable costs of their compensation. It has nothing to do with certification requirements.

Four of the seven contracts at issue include regulatory certification requirements with respect to overhead or indirect costs. Contract 0022 contains DFARS 52.242-7003, calling for certification by the contractor's division vice president or equivalent, and contracts R182, 0004, and 0090 contain or incorporate DFARS 252.242-7001, calling for certification by an individual at a level no lower than a vice president or CFO of the contractor's business segment submitting the proposal. (Findings 4, 5) The other contracts do not contain certification clauses (findings 6, 7).

Although both Mr. Dellasala, FMI's accounting and contracts manager, and Ms. Beedy, its general counsel, held upper level positions at FMI, a small business (findings 2, 15, 18), we need not decide whether they qualified as proper certifiers under the regulations or whether Mr. Subilia's certifications cured any deficiency, because the certifications do not affect our jurisdiction, which derives from the CDA.

The government errs in its contention that the allegedly insufficient original cost certifications rendered the ACO's decision a nullity and not subject to CDA appeal. Cost certifications differ from CDA claim certifications. Under the CDA, 41 U.S.C. § 605(c), certification of a contractor's claim exceeding \$100,000 is a jurisdictional prerequisite. Absent certification, the claim would be a nullity upon which a CO could not render a decision that qualified as a final appealable decision. *See, e.g., Fidelity Construction Co. v. United States*, 700 F.2d 1379, 1384 (1983). The CDA's certification requirement cannot be waived. *W.M. Schlosser Co. v. United States*, 705 F.2d 1336 (Fed. Cir. 1983). An indirect cost rate certification does not carry the same strictures. In fact, even if a contractor fails entirely to certify its final indirect cost rates, the only limits imposed by FAR 42.703-2(a) and (c) are that no proposal shall be accepted and no agreement shall be

made to establish the final rates. Under the regulation in effect for FMI FYs 1995 and 1996, the CO is to establish the rates unilaterally if they are necessary for contract continuation. Similarly, under DFARS 252.242-7001(b), included or incorporated in contracts R182, 0004 and 0090, a contractor's failure to submit a cost rate certificate results in the government's unilateral establishment of the rates (finding 5). Here, the CO established appellant's rates unilaterally, as the regulations contemplate.

Furthermore, the FAR 52.242-3 Penalties for Unallowable Costs clause, included in contracts 0104 and 0175, and the DFARS Penalties for Unallowable Costs clause, included in contracts R182, 0004, and 0090, call for the imposition of penalties when applicable. Like 10 U.S.C. § 2324(d), the regulations also identify a penalty determination as a final decision within the meaning of the CDA. (Finding 6) In this case, the ACO issued a final decision under the CDA, so delineated, which both assessed penalties and set final indirect cost rates unilaterally (finding 28). Per 10 U.S.C. § 2324(d), this reflected the ACO's appealable final decision that certain indirect costs FMI proposed, including costs for which no penalties were assessed, were unallowable.

Appellant has appealed from the ACO's decision as a whole, including her unilateral determination of final indirect cost rates, the cost conclusions supporting the determination, and her \$83,747 penalty assessment (*see* finding 29). The government's disallowance of appellant's indirect costs, as reflected in the ACO's unilateral rate determination, and her imposition of penalties, are government claims subject to appeal under the CDA, without the need for appellant to file any claim of its own concerning the disallowed costs or any CDA certification. *See Brunswick Corp.*, ASBCA No. 26691, 83-2 BCA ¶ 16,794; *General Dynamics Corp.*, ASBCA No. 31359, 86-3 BCA ¶ 19,008; *Martin Marietta Corp.*, ASBCA No. 25828, 84-1 BCA ¶ 17,119 at 85,257; *General Dynamics Corp. Electric Boat Division*, ASBCA No. 25919, 82-1 BCA ¶ 15,616 at 77,105-06.

Accordingly, the Board has jurisdiction over all aspects of appellant's appeal, and the government's motion to dismiss is denied.

II. Disallowed Costs and Penalties

A. General

Appellant's contracts are not CAS-covered (finding 2). Therefore, under FAR 31.201-2(a), the allowability of its government contract costs is determined by their reasonableness; allocability; generally accepted accounting principles and practices appropriate to the circumstances; the contract's terms; and any FAR Subpart 31.2 limitations. Per FAR 31.203, appellant's method of allocating indirect costs is to accord with generally accepted accounting principles consistently applied. Under FAR 31.201-4, a cost is allocable if it is assignable or chargeable to cost objectives based

upon relative benefits received or other equitable relationship. If so, a cost is allocable to a government contract if it is (a) incurred specifically for the contract; (b) benefits the contract and other work, and can be distributed to them in reasonable proportion to benefits received; or (c) is necessary to the overall operation of the contractor's business, although a direct relationship to a particular cost objective cannot be shown.

A cost is not allowable if it cannot be allocated to a government contract, but, even if a cost is allocable, it is not necessarily allowable. The concept of allocability pertains to whether a "sufficient 'nexus' exists between the cost and a government contract" and that of allowability pertains to whether a particular cost should be recoverable as a matter of public policy. *Boeing North American, Inc. v. Roche*, 298 F.3d 1274, 1281 (Fed. Cir. 2002).

Boeing, which concerned legal costs, and which we address further below, involved contracts that were CAS-covered. The court applied the CAS to assess allocability and the FAR to determine allowability. However, in its allocability analysis, it discussed *Dynalelectron Corp. v. United States*, 545 F.2d 736 (Ct. Cl. 1976), and *Lockheed Aircraft Corp. v. United States*, 375 F.2d 786 (Ct. Cl. 1967), pre-CAS cost cases which involved the Armed Services Procurement Regulation (ASPR), a predecessor to the FAR. In fact, the court in *Boeing* adopted *Lockheed Aircraft's* description of the required nexus between an indirect cost and the government contract to which a contractor seeks to allocate the cost, as follows:

Our predecessor court [in *Lockheed Aircraft*] described the nexus required to show allocability, stating:

The criterion in the ASPR [now the FAR] for allocating indirect costs is "benefit." This is explicit in paragraph [b] of [FAR § 31.201-4], and implicit in paragraph [c]. It is a kind of common sense approach to allocation. No one would quarrel with the general proposition that it is fair to allocate to government contracts the costs of services which facilitate performance of the particular contracts or are essential to the existence and continuation of the business entity. But the burden will be on the contractor to show the benefit and a reasonable allocation among different government contracts and between government and commercial work generally. [Brackets in original]

Boeing, 298 F.3d at 1283-1284, quoting *Lockheed Aircraft*, 375 F.2d at 793-94.

The court in *Lockheed Aircraft* further stated that “[t]he requirement of relatedness is equivalent to benefit,” 375 F.2d at 794. The case involved personal property taxes levied to support community services that the parties had stipulated benefited the government’s contracts (*id.* at 795). The court found it fair and reasonable, and supported by public policy considerations, that the contractor had allocated a proportionate amount of its tax costs to its government contracts and to its commercial contracts. The court elaborated that public policy considerations could affect the allocation analysis; that not all expenditures “‘necessary’ to a business generally, and therefore beneficial to all output, should be allocated to government contracts”; and that “allocation may be denied because the necessity and benefit are too remote.” 375 F.2d at 796.

Thus, appellant bears the burden to prove that there is a sufficient nexus between its disallowed costs and its government contracts at issue to render the costs allocable to them. *Boeing; Lockheed Aircraft*. Further, appellant bears the burden of proof with respect to any cost challenged on the grounds of reasonableness with respect to all of the contracts except 0022. 10 U.S.C. § 2324(j); FAR 31.201-3(a). If a cost is allocable to a contract and is reasonable, the government normally has the burden to prove that it is unallowable due to a contract provision, statute or regulation, *Lockheed Martin Western Development Laboratories*, ASBCA No. 51452, 02-1 BCA ¶ 31,803 at 157,102. However, a given regulation may require the contractor to establish entitlement to costs. *See, e.g.*, FAR 31.205-46(d) (airfare costs in excess of standard must be documented and justified) and FAR 31.205-46(e)(2), incorporating paragraph (d) with respect to corporate aircraft costs.¹⁰

B. Legal and Other Services Costs Pertaining to Criminal Proceeding

Appellant asserts, *inter alia*, that: (1) the legal and related costs it incurred in defending itself, MI, and Messrs. Lachman and Subilia in the criminal proceeding are fully allowable, without a final judgment of conviction; (2) no part of FAR 31.205-47 bars recovery; (3) the costs are reasonable, particularly because its by-laws required payment; and (4) they were necessary to the overall operation of its business, and allocable to its government contracts, because its business could fail if it were convicted.

The government contends, among other things, that: (1) the costs are expressly unallowable under FAR 31.205-47(b) because the criminal convictions are pending and, regardless, appellant’s suspension could have led to a final decision to suspend or debar it, and the underlying misconduct in the criminal proceeding is the same as that which led

¹⁰ *See also United Technologies, supra*, 87-3 BCA at 102,207 n.13 (concerning contractor’s burden to demonstrate it met aircraft cost regulation) and *General Dynamics Corp., supra*, 92-1 BCA ¶ 24,698 at 123,264 (concerning contractor’s initial burden to show entitlement to flight costs).

to the suspension; (2) under FAR 31.201-3(a), the costs are unreasonable, because they pertain to conduct the district court found to be reprehensible and heedless of national security interests and thus in violation of public policy; (3) per FAR 31.201-3(b)(2), the costs are not reasonable because defendants Lachman and Subilia, and director Paprocki, paid by FMI, were not disinterested, and there was no “arm’s-length” corporate decision to pay them; and (4) the costs are not allocable to FMI’s government contracts.

We have considered all of the parties’ arguments, as reflected in our fact findings. We conclude that, regardless of the final outcome of the criminal proceeding, the associated costs incurred by appellant are not allocable to its government contracts per FAR 31.201-4(c) and FAR 31.202(a) because they are identified specifically with a commercial contract. Accordingly, we do not consider the questions of whether, if appellant’s costs of defending itself were allocable and allowable, its costs of defending Messrs. Lachman and Subilia, and of defending MI, would be allocable and allowable.

Appellant contends that under *Boeing, supra*, and other cases, the criminal proceeding costs are allocable because they were necessary to the overall operation of its business. In *Boeing*, legal costs were incurred by Boeing’s predecessor, Rockwell International Corp. (Rockwell), in defending its directors and in paying the plaintiffs’ costs in a shareholders’ derivative suit that it eventually settled. The suit charged that Rockwell’s directors failed to establish internal controls to ensure that its business was carried on lawfully. The plaintiffs cited instances where the government had brought civil or criminal actions against Rockwell or its employees in connection with its federal government contracts. Rockwell’s special litigation committee, composed of directors not named in the lawsuit, concluded that its internal controls were adequate and that the shareholders’ derivative suit was not likely to succeed. The Federal Circuit stated that, if there is any conflict between the CAS and the FAR on the issue of allocability, the CAS governs, and the CAS rendered Rockwell’s legal defense costs allocable as part of its G&A expenses. 298 F.3d at 1283. Here, in contrast, the genesis of the criminal proceeding at issue was a commercial contract between India’s Defense Research Development Laboratory and FMIC under which FMIC was to supply a control panel and hot isostatic press to DRDL in connection with a rocket and missile development facility in India. FMIC issued a purchase order to FMI, which manufactured the equipment and exported it on behalf of FMIC via MI to India.

As we noted above, the court in *Boeing* re-affirmed the reasoning of the pre-CAS *Lockheed Aircraft* case that there must be a nexus between an indirect cost and the government contract to which a contractor seeks to allocate it, and that the contractor bears the burden to show the nexus. Further, although the contractor in *Lockheed Aircraft* was able to show a nexus with respect to personal property taxes under the regulations then in effect and its government contracts, the contractor was unable to do so in either *FMC Corp. v. United States*, 853 F.2d 882 (Fed. Cir. 1988), cited in *Boeing*, or in *Dynalectron, supra*, both of which involved legal costs.

In *FMC Corp.*, a division of FMC had accepted a purchase order from General Dynamics Corporation in connection with General Dynamics' contract with the government for work on the TRIDENT submarine. After the work was completed, FMC sued General Dynamics for alleged increased costs and reached a settlement, which it recorded on its books as income to the purchase order. It recorded the litigation costs as G&A expenses, allocating them as indirect costs to all of its government contracts. FMC argued that the legal costs should be allocable to the other contracts because they were necessary to the overall operation of its business and that the decision to litigate was a general business decision unrelated to any particular contract. It also urged that the financial benefit of the settlement was ultimately passed along by lower prices to the government, effectively its only customer, and that its experience with its TRIDENT claim had educated its personnel in government contract work. The court sustained the Board's finding that the alleged benefits to other government contracts were too remote and insubstantial to justify the pro-rata allocation of the legal fees to those contracts.

In *Dynalectron*, the contractor sought to collect a portion of outside legal expenses it had incurred in defending itself in a suit arising out of a commercial venture not connected with its government contracts. The contractor's predecessor had guaranteed that, in the event of default by an Argentine airline that had purchased airplanes from a creditor, it would either return the planes or pay the remaining debt. The contractor had charged the fees as indirect G&A expenses covering its entire business, including its government contracts. The contractor, similar to appellant here, had argued that the defense of the lawsuit was necessary to protect it from going out of business, thereby benefiting the government by allowing it to complete its government contracts. The court found this alleged benefit to be "far too remote and speculative to be relevant," and that the legal costs were not allocable to the contractor's government contracts because they did not benefit them and were not necessary to the overall operation of the contractor's business. Rather, they had a direct relationship to a particular cost objective—the commercial guaranty venture—and were properly classified as direct costs that were "identified specifically" with that venture. 545 F.2d at 738.

The court in *Dynalectron* distinguished *Hayes International Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076, upon which appellant relies. In *Hayes*, the Board held that legal fees incurred by a contractor in defense of a racial discrimination lawsuit could be charged as indirect costs to its government contracts. The court stated that there was no showing that the employees had worked only on commercial contracts and there appeared to be a relationship between their complaint and performance of the government contracts. The court concluded in *Dynalectron* that:

Plaintiff has failed to show that the legal fees had any relationship whatever to the Government contracts or their performance. Without such a relationship, the costs cannot properly be charged as direct costs or as indirect costs as a

part of the G&A costs of the contractor in its performance of the Government contracts.

545 F.2d at 739.

In the case at hand, appellant has not established that the legal costs were necessary to the operation of its business (*see* finding 34), and there is no nexus between the costs it incurred in the criminal proceeding and the contracts at issue in this appeal, or any federal government contract. The costs are identified specifically with FMIC's contract with DRDL and its purchase order to appellant for the production of the control panel and hot isostatic press. (*See* finding 10) Thus, apart from any other allocability or allowability issues that might pertain to costs separately attributable to MI and the individual defendants, under FAR 31.202, the disputed legal costs are not properly allocable as indirect costs to appellant's government contracts.

C. Deferred Legal Costs Penalty Assessment

Title 10 U.S.C. § 2324 and associated regulations, and the FAR 52.242-3 Penalties for Unallowable Costs and DFARS 252.231-7001 Penalties for Unallowable Costs clauses incorporated into some of the contracts (finding 6), provide for penalties if a contractor submits "expressly unallowable" costs (or, formerly, costs unallowable by "clear and convincing" evidence). In its original indirect cost submissions for FYs 1995 and 1996, appellant described a portion of its legal fees, and other costs pertaining to the criminal proceeding, as "Disallow[ed]" (finding 14). Before DCAA's FY 1995 audit was complete, DCAA granted appellant permission to re-submit to include the costs of the criminal proceeding. When it re-submitted, appellant noted that it had not previously included the costs, but was doing so to allow for their recovery because it expected to prevail. According to former senior DCAA auditor Pettoruto, who worked at DCMA and advised the ACO on cost issues, if appellant believed that the costs were allowable, or would become allowable, then it had acted properly in re-submitting them. We have found that appellant did not conceal, and specifically alerted the government, that it was including the costs of the criminal proceeding in its revised indirect cost rate submissions because it believed the costs would be allowable. (Findings 17-19)

In her revised final decision, the ACO noted, but deferred, a \$320,684 penalty assessment with respect to legal expenses, pending the outcome of the criminal proceeding (finding 28). Because the penalty assessment has been deferred, we do not have that issue before us.

D. Leased Aircraft Costs

Appellant alleges that the ACO abused her discretion in disallowing leased aircraft costs that exceeded what the government determined to be the equivalent costs of

commercial travel. DCAA questioned the costs on the grounds that they were not allowable under FAR 31.205-46, and that they were unreasonable, among other things. (Finding 41) Because FAR 31.205-46 is dispositive, we do not reach the issue of reasonableness or other regulations raised by the government.

Appellant relies upon *United Technologies, supra*, 87-3 BCA ¶ 20,193, and *General Dynamics, supra*, 92-1 BCA ¶ 24,698. The regulations that applied there differ from those at issue here. In *General Dynamics, supra*, 92-1 BCA at 123,227, the parties disputed whether costs of contractor-owned jets were allowable under Defense Acquisition Regulation (DAR) 15-205.46(g), Travel Via Contractor-Owned, -Leased, and -Chartered Aircraft. (CWAS), and whether various flights were allowable. That regulation provided in part that:

(1) “Cost of contractor-owned . . . aircraft,” . . . *is allowable*, if reasonable, to the extent the contractor can demonstrate that the use of such aircraft is necessary for the conduct of his business and that the increase in cost, if any, in comparison with alternative means of transportation, is commensurate with the advantages gained.

(Emphasis added) Business necessity factors to be considered included whether commercial airlines or other less costly travel means were reasonably available; the need to respond to critical situations; time savings and more effective use of key personnel; and security needs that demanded privacy for key personnel who had to work en route.

In *General Dynamics* the Board held that the contractor did not have to show that its aircraft were absolutely necessary, but only that they were helpful or appropriate in its business. The Board evaluated cost benefit analyses supported by expert evidence, unlike that of Mr. Subilia (finding 49). It determined that the contractor had shown that some of its aircraft were necessary and that advantages outweighed costs. Along with some remaining issues of reasonableness and allocability, the Board remanded quantum to the parties. 92-1 BCA at 123,255-259. The remainder of its decision pertained to the allowability of costs of various flights, with the Board focusing upon the purpose of the trips. Similarly, in *United Technologies, supra*, 87-3 BCA ¶ 20,193, the Board relied upon expert evidence and cost benefit analyses in determining the allowability of corporate aircraft costs under ASPR 15-205.46(g), the predecessor to DAR 15-205.46(g). It also considered the allowability of costs pertaining to use by various personnel.

Unlike the regulations at issue in *General Dynamics* and *United Technologies*, which started from the premise that corporate aircraft costs were allowable, FAR 31.205-46(e)(2) limits recoverable corporate aircraft costs to standard airfare unless the contract requires travel by such aircraft or the CO approves a higher amount by advance agreement or if one or more of the factors in 31.205-46(d) applies. In this case,

there was no contractual requirement for the leased aircraft and no advance agreement (finding 37). Thus, we look to paragraph (d), which starts from the premise that costs exceeding standard airfare are not allowable unless the contractor documents and justifies that standard travel would result in circuitous routing; travel during unreasonable hours; excessively prolonged travel; increased cost offsetting transportation savings; insufficient accommodation for the traveler's physical or medical needs; or insufficient availability to meet mission requirements. Additionally, paragraph (e)(2) requires that the contractor document for each company aircraft flight, at a minimum, the travel departure and arrival locations, dates and times; passenger names and relationship to the contractor; and the authorization for and purpose of the trip. Appellant's contemporaneous documentation included much of the (e)(2) information, except for the passengers' relationship to FMI, but, as noted, many times it omitted the purpose of the trips. (Findings 38, 46)

DCAA typically has accepted appellant's claimed tangible benefits of using its leased aircraft, to the extent that they were supported, and has not accepted any claimed intangible benefits (findings 40, 42, 47-48). In this case, DCAA allowed most of the tangible aircraft benefits initially claimed by appellant for FY 1995 and all of those it initially claimed for FY 1996 (findings 40, 42). Appellant's first challenge to DCAA's air transport cost disallowances, presented prior to the ACO's final decision, focused upon intangible benefits. The ACO met with appellant and considered its contentions. (Findings 43, 44) Appellant did not supplement its response to DCAA's Forms 1 with Mr. Subilia's air transport analysis until after the ACO issued her final decision and after appellant had appealed to the Board. Appellant then contended that a number of trips had not been included in DCAA's FY 1995 evaluation and that, for both years, many times, reasonable commercial alternatives were not available or would require more than one trip to accomplish all visits covered by one use of the leased aircraft. It did not specify the alleged trip omissions or occasions when commercial aircraft were not available. Appellant also charged that DCAA had ignored tangible and intangible benefits of its leased aircraft. It claimed \$95,723 more in tangible benefits for FY 1995 than originally proposed, and \$88,151 less in intangible benefits. For FY 1996, it claimed \$178,457 more in tangible benefits and \$36,979 less in intangible benefits. (Finding 46)

Under FAR 31.205-46(e)(2), the CO is accorded the discretion whether to approve a higher amount than standard airfare. The CO "may," but is not required to, do so. Appellant bears the burden to prove its allegation that the ACO abused her discretion in disallowing some of its claimed costs. In evaluating whether there was any abuse of discretion, we examine whether there was subjective bad faith; a reasonable basis for the decision at issue; the degree of discretion vested in the ACO; and whether applicable regulations were observed. *Kirk/Marstrand Advertising, Inc.*, ASBCA No. 51075, 99-2 BCA ¶ 30,439 at 150,409. Appellant has not alleged bad faith and there is no evidence of any (finding 44). We conclude that the ACO did not abuse her discretion with respect to aircraft costs. She considered the information provided to her by DCAA and by appellant prior to issuing her final decision; properly observed the requirements of

FAR 31.205-46(d) and (e)(2); and had a reasonable basis for exercising her discretion to disallow the excess aircraft costs appellant proposed. Mr. Subilia's post-ACO decision analysis does not convince us that appellant is entitled to any more aircraft costs than the ACO allowed (finding 49).

E. Penalty Assessment With Respect To Leased Aircraft Costs

DCAA questioned costs appellant attempted to justify based upon the alleged intangible benefits of its leased aircraft; concluded that a level one penalty was appropriate; and the ACO assessed the penalty on the ground that the costs were expressly unallowable under the FAR (findings 24, 26, 27, 40, 42). In *General Dynamics Corp.*, ASBCA No. 49372, 02-2 BCA ¶ 31,888 at 157,570, *rev'd in part on other grounds, Rumsfeld v. General Dynamics Corp.*, 365 F.3d 1380 (Fed. Cir. 2004), the Board reversed the CO's assessment of a penalty for the contractor's inclusion of allegedly expressly unallowable legal costs associated with civil fraud litigation brought by the government. The Board stated that:

The FAR and CAS definitions of "expressly unallowable" point to the need to examine the particular principle involved in light of the surrounding circumstances. Moreover, since Congress adopted the "expressly unallowable" standard to make it clear that a penalty should not be assessed where there were reasonable differences of opinion about the allowability of costs, we think the Government must show that it was unreasonable under all the circumstances for a person in the contractor's position to conclude that the costs were allowable. The scope of the inquiry will vary with the clarity and complexity of the particular cost principle and the circumstances involved.

The Board noted that, in assessing a penalty, the government bears the burden of proof. *Id.* at 157,569.

We conclude that, under the circumstances here, the disputed aircraft costs were not "expressly unallowable" under FAR 31.205-46(e)(2). The ACO had discretion under (e)(2), as established, to accept supported costs. We think that appellant's claim was sufficiently colorable to preclude penalties.

F. Commission Costs

DCAA questioned domestic commercial sales commissions paid to Mr. Graham, a sales representative for appellant and other companies. It also questioned commissions paid to MI, appellant's wholly-owned subsidiary, for overseas commercial sales. The

products sold were of the same sort appellant sells to the U.S. government, but no U.S. government sales or contracts were involved. The government asserts that the commissions should have been charged directly to the sales order or contract concerned; they had no causal or beneficial relationship to government work; and they were not allocable to appellant's government contracts. Further, because appellant's agreement with MI provides that it was not to be considered appellant's agent or employee under any circumstances, the government contends that MI's commissions do not qualify as allowable selling costs under FAR 31.205-38(f). It does not contend that Mr. Graham's commissions are unallowable costs or that his or MI's commissions were unreasonable. For FY 1996, the government also questioned \$3,808 in commissions to a payee appellant had not identified. (Findings 50, 52-54)

Appellant responds that MI's commission costs are allowable under FAR 31.205-38(f) because MI qualifies as its selling agency. It asserts that it properly charged MI's and Mr. Graham's commissions as indirect costs under its consistent, acceptable, accounting practice, and that they are allocable to its government contracts because they benefited all of its work and were necessary to the overall operation of its business. Appellant claims a sufficient nexus between the commission costs and its government contracts because it could not survive unless it continually seeks and obtains new business; and because the government benefits from the reduced overhead burden made possible by a broader business base.

We first address whether MI's commissions are allowable selling costs. If not, the indirect cost categorization and allocability issues are immaterial with respect to MI. Under FAR 31.205-38(c)(2), the costs of selling efforts incurred in connection with significant efforts to promote export sales of products normally sold to the U.S. government are allowable on government contracts if they are allocable, reasonable and otherwise allowable under Subpart 31.2. However, FAR 31.205-38(f) provides that commission costs "are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business." The regulation does not define "selling agencies" or "maintained by the contractor," but, as in effect for most of the contracts at issue (finding 3 and n.8), the regulation referred to FAR 3.408-2 for clarification. FAR 3.408-2(a) referred, in turn, to FAR 3.401 for the definition of bona fide agency.

Under FAR 3.401, a bona fide agency is an established commercial or selling agency, maintained by the contractor for the purpose of securing business, that neither exerts nor proposes to exert improper influence to solicit or obtain government contracts, nor holds itself out as able to obtain them through improper influence. FAR 3.408-2(c) provided guidelines for evaluating whether a selling agency is a bona fide agency as defined in FAR 3.401, including that the fee should not be exorbitant; the agency should have adequate knowledge of the contractor's products and business; the contractor and

the agency should have a continuing relationship; the agency should be an established concern; and the business of the agency should be conducted in the agency name.

MI satisfies the “bona fide” agency criteria. It was established in the late 1970’s to be appellant’s international sales arm. As appellant’s wholly-owned subsidiary, it has a continuing relationship with appellant and adequate knowledge of its products and services. MI’s commission agreement provides for the export, sale and marketing of appellant’s products overseas. The Board has declined to allow commission-type payments under a sales agreement between a contractor and its wholly-owned subsidiary when the agreement is at less than arm’s length and the contractor retains control over the sales. *The Garrett Corp.*, ASBCA Nos. 13024, 13182, 69-2 BCA ¶ 7797. However, no cost irregularities have been alleged here. DCAA did not contend that MI’s commissions were the result of other than an arm’s length agreement, or that they involved any improper practices. (Finding 56)

The portion of the commission agreement identifying MI as an independent contractor that will not act as appellant’s agent or employee reinforces that MI is to conduct business in its own name. DCAA itself described MI as an agent for foreign commercial sales (finding 56). There is no allegation that it proposed to exert any improper influence to obtain government contracts (*id.*), which is the focus of the FAR’s “bona fide agency” requirements. Thus, while not appellant’s “agent” in the sense that it could act in appellant’s name and bind it for legal purposes (*see* findings 54, 55), MI nonetheless qualifies as a “selling agency” maintained by appellant under FAR 31.205-38(f) and its commissions are allowable costs.

The government has established that there was no payee identified with respect to \$3,808 in FY 1996 commission costs claimed by appellant (finding 52). Appellant has not presented any evidence concerning those costs. We are unable to evaluate whether the payee qualifies as a bona fide employee or established selling agency maintained by appellant. Accordingly, the \$3,808 in costs is disallowed. *Cf. KAL M.E.I. Manufacturing and Trade Ltd.*, ASBCA No. 40597, 92-1 BCA ¶ 24,411 at 121,855.

As to whether appellant properly categorized Mr. Graham’s and MI’s commissions as indirect costs and included them in its G&A pool, thereby allocating them in part to its government contracts, the government has acknowledged that appellant is responsible for selecting its cost accounting practices, as long as they are applied consistently using proper accounting procedures (finding 2). Appellant has always treated commissions as indirect costs. It deems them to be compensation for all of a sales agent’s work, whether or not it results in a sale. It likens the commission costs to costs of in-house selling and marketing departments. (Finding 58) The record does not indicate whether Mr. Graham’s or MI’s commission costs were questioned prior to FY 1995, but it suggests otherwise, because DCAA did not assert that any penalty applied, and DCAA did not question such costs in FYs 1988 and 1989 (finding 57).

Commissions are properly categorized as indirect costs when the contractor has consistently treated them as such and the circumstances warrant. *Daedalus Enterprises, Inc.*, ASBCA No. 43602, 93-1 BCA ¶ 25,499 at 127,012. We find appellant's consistent practice of treating its sales commissions as indirect costs and accumulating them in its G&A pool to be acceptable. We also conclude that there is a sufficient nexus between the costs and appellant's government contracts because the commission sales yield a broader business base and a reduction in the percentage of indirect costs the government bears; the development, promotion and sale of the same sorts of products FMI sells to the government, which results in the commissions, benefit all of FMI's work; and the costs are necessary to the overall operation of FMI's business (*see* findings 50, 58, 59). Therefore, the commission costs are properly allocable to appellant's government contracts.

G. Patent Amortization Costs

The government contends that appellant's patent amortization costs, consisting of patent-related legal costs, are expressly unallowable under FAR 31.205-30 because they were not incurred as a government contract requirement, and that level one penalties apply. Appellant alleges that the government has the burden to prove that the patent amortization costs were not required to perform a government contract and it has not done so. Appellant also alleges that the costs should be allowable because of significant benefits that accrue to the government from appellant's patented technologies.

DCAA found that there was no evidence that appellant had incurred any of the claimed patent-related costs due to a government contract requirement and that it had not identified the nature of the costs, except that some involved obtaining foreign patents (finding 61). In response to the government's threshold showing, appellant did not support its claimed costs.

We have not been directed to any provision in any of the contracts that requires that appellant incur patent costs (finding 60). While appellant named patents that had been used on government contracts and from which the government was said to have benefited, it did not show that any of the referenced patents were on its amortization schedule and part of the costs at issue. It did not identify the specific patents or the specific nature of the associated patent amortization costs claimed or show that any of the costs were incurred due to any government contract requirement or were otherwise allowable. Any amortization costs of the Flex Fram patent Mr. Lachman named would not be recoverable in any event, per FAR 31.205-37(a)(1), because the government owns that patent. (Findings 61-63)

There is no evidence that the claimed costs were due to a government contract requirement; or that any were of the type allowable under FAR 31.205-30(a) if incurred

as a requirement of a government contract; or that they were for general patent counseling services allowable under FAR 31.205-30(b); or that they were for royalties or other costs of patent use necessary for proper performance of any of the contracts at issue and applicable to contract products or processes, allowable under FAR 31.205-37(a) (finding 64).

Appellant appears to allege that its patent amortization costs should be accepted as indirect costs regardless of whether they are allowable under FAR 31.205-30. It alleges that the government benefited from its patents, and that DCAA accepted its approach to patent cost amortization from 1973 to 1994 (finding 62). This is irrelevant to whether the specific patent amortization costs at issue are allowable. For example, in *Rocket Research Co.*, ASBCA No. 24972, 81-2 BCA ¶ 15,307, the contractor was a small business that relied heavily upon patents. Government contracts were the major portion of its business. It claimed costs of independent patent counsel, which it had included as patent amortization costs and placed in its engineering overhead pool as indirect expenses. DCAA questioned the costs on the ground that, during the years in question, none of the contractor's government contracts required the use of its patents. The Board noted that the predecessor to FAR 31.205-30 had been amended in 1971 specifically to disallow all patent costs not necessary to a particular contract's performance and that "[n]othing in the history of the provision or in the literal language of the clause, as promulgated, warrants a distinction between direct and indirect patent costs." *Rocket Research, supra*, 81-2 BCA at 75,797.

H. Patent Amortization Costs Penalty Assessment

Based upon appellant's unallowable patent costs of \$17,241 and \$15,305, included in its indirect cost submissions for its FYs 1995 and 1996, respectively, DCAA recommended level one penalties of \$3,689.57 and \$3,137.53 (findings 24, 26, 61). In her final decision the CO assessed level one penalties, which included penalties for unallowable patent costs (see findings 27, 28). However, the questioned costs at issue allocable to appellant's flexibly priced government contracts were less than \$10,000 for each of those fiscal years (finding 61). Although the FAR 52.242-3 Penalties for Unallowable Costs clause contained in two of the contracts¹¹ provides that the CO "may" waive penalties pursuant to the criteria in FAR 42.709-5, that regulation provides that the CO "shall" waive the penalties when the amount of the unallowable costs subject to the penalty is \$10,000 or less. Thus, regardless of the allowability of the claimed patent

¹¹ The government alleges that the CO could have assessed penalties regardless of whether appellant's contracts at issue contained or incorporated a penalties clause. Because she did not do so, we do not reach that question. We note that including all flexibly priced contracts, regardless of whether they included a penalties clause, would not change the result herein.

costs, the CO was required under FAR 42.709-5 to waive any penalty. Thus, no penalty is warranted for FYs 1995 or 1996.

I. Bridgton Cabin Costs

The government urges that appellant's costs for its cabin in Bridgton, Maine, are expressly unallowable recreation costs under FAR 31.205-13(c) and that level one penalties apply. Appellant responds that the costs are employee morale expenses under FAR 31.205-13(a), allowable under both the FY 1995 and 1996 versions of the regulation, and/or are allowable as fringe benefits under FAR 31.205-13(m)(1) (findings 65-67). At the hearing, the government also suggested that the costs were unallowable as entertainment expenses under FAR 31.205-14, but it has not pursued that argument and we do not address it (finding 69).

DCAA described the cabin as a "recreational facility" and the costs as employee morale costs. It found the costs unallowable under FAR 31.205-13(c) on the grounds that the cabin had no business purpose and was used solely for recreation. After initially contending that the cabin was used for business meetings, appellant acknowledged that, in FYs 1995 and 1996, and for some time prior thereto, it had allowed employees to use the cabin at no cost. It asserted that this was for employee morale and also qualified as a *de minimis* fringe benefit, which it considered to be immaterial and thus did not include in its employee benefit package. (Findings 65-67) We found that employees use the cabin for recreational purposes (finding 68).

The government makes no distinction in briefing between FAR 31.205-13, as in effect prior to FY 1996, and the amended regulation, effective 1 October 1995. Prior to amendment, FAR 31.205-13(a) allowed reasonable costs incurred on "activities" designed to improve working conditions, employer-employee relations, employee morale, and employee performance. "Recreation" is listed among the allowable activities. That the term "activities" includes structural facilities, is demonstrated by the fact that health clinics, dining facilities, and living accommodations are included. Because the Bridgton cabin is used for employee recreational purposes, appellant's FY 1995 associated costs are allowable.

The amended regulation covers only the 1996 contracts 0104 and 0175, awarded on 26 September 1996 and 20 September 1996, respectively, and which incorporate the FAR Penalties for Unallowable Costs clause (findings 3, 6). The regulation provides that "[c]osts of recreation are unallowable," with listed exceptions that do not apply here. FAR 31.205-13(c). Therefore, appellant's FY 1996 Bridgton cabin costs, to the extent allocable to those two contracts, are not allowable as employee morale costs under FAR 31.205-13(a).

With respect to appellant's contention that the cabin costs are allowable as fringe benefits under FAR 31.205-6(m)(1), the regulation focuses in its title and in its introductory paragraph (a) upon "[c]ompensation" and "remuneration." It describes fringe benefits in paragraph (m)(1) as "allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries." The types of fringe benefits listed do not include, and are not similar to, use of a recreational facility. Moreover, the paragraph limits allowable fringe benefits to those "required" by law, employer-employee agreement, or an established policy of the contractor. There is no evidence of any such requirement concerning the cabin (finding 71). Accordingly, appellant's FY 1996 Bridgton cabin costs, to the extent allocable to contracts 0104 and 0175, are not allowable as fringe benefits under FAR 31.205-6(m)(1).

J. Bridgton Cabin Costs Penalty Assessment

Based upon appellant's allegedly unallowable Bridgton cabin costs of \$6,182 and \$17,263, included in its indirect cost submissions for its FYs 1995 and 1996, respectively, and certain other questioned employee morale costs the CO later allowed, DCAA recommended level one penalties of \$1,187 and \$2,109 (finding 65). The level one penalties assessed by the CO included penalties for unallowable cabin costs (*see* findings 27, 28). As we have found, the FY 1995 costs were allowable under FAR 31.205-13(a) then in effect. In any event, the questioned costs for FYs 1995 and 1996 allocable to appellant's flexibly priced government contracts were less than \$10,000 each year (finding 65), such that, under FAR 42.709-5, the CO was required to waive any penalty. Thus, no penalty is warranted with respect to the cabin costs.

III. Cost Summary

The government correctly disallowed the disputed legal costs, leased aircraft costs and patent amortization costs for FYs 1995 and 1996. The government's disallowance of commission costs for FYs 1995 and 1996 was improper, except for its disallowance of \$3,808 in unidentified commissions. The government's disallowance of the Bridgton cabin costs for FYs 1995 and 1996 was improper, except for those FY 1996 costs allocable to contracts 0104 and 0175. None of the assessed penalties are valid. We do not reach the issue of deferred penalties pertaining to legal costs.

DECISION

The government's motion to dismiss for lack of jurisdiction is denied. The appeal is sustained to the extent stated and otherwise is denied. We remand remaining quantum issues to the parties for resolution.

Dated: 17 April 2007

CHERYL L. SCOTT
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

I concur

MARK N. STEMLER
Administrative Judge
Acting Chairman
Armed Services Board
Of Contract Appeals

EUNICE W. THOMAS
Administrative Judge
Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 53616, Appeal of Fiber Materials, Inc., rendered in conformance with the Board's Charter.

Dated:

CATHERINE A. STANTON
Recorder, Armed Services
Board of Contract Appeals