ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
SplashNote Systems, Inc.	)	ASBCA No. 57403
	)	
Under Contract No. FA8650-04-C-1615	)	

APPEARANCE FOR THE APPELLANT: Mr. Scott Tse
President & CEO

APPEARANCES FOR THE GOVERNMENT: E. Michael Chiaparas, Esq.
DCMA Chief Trial Attorney
Carol L. Matsunaga, Esq.
Senior Trial Attorney
Defense Contract Management Agency
Carson, CA

OPINION BY ADMINISTRATIVE JUDGE GRANT
PURSUANT TO RULE 12.3

Appellant SplashNote Systems, Inc. (SplashNote) appeals the government's final decision of 26 July 2010 that SplashNote owes the government $84,950 in previously paid but unallowable indirect costs. SplashNote has elected the Board's accelerated procedure under Rule 12.3 and the parties agreed to submit the appeal for decision on the record pursuant to Rule 11. We have jurisdiction under the Contract Disputes Act, 41 U.S.C. §§ 7101-7109; only entitlement is before the Board, as the parties agree on quantum. For the reasons stated below, the appeal is denied.

SUMMARY FINDINGS OF FACT

1. On 13 May 2004, the Air Force awarded SplashNote a $750,000 cost reimbursement contract (Contract No. FA8650-04-C-1615) to develop an "Interactive Portlet Technology for the Collaborative Enterprise" (R4, tab 1 at 1-2). As characterized by SplashNote, the goal of the portlet technology was to enable users of an existing Air Force collaboration system to assemble interactive applications to facilitate team collaboration (app. br. at 5). Cost allowability under this contract was determined in accordance with the FAR cost principles in effect on the date of award, pursuant to FAR clause 52.216-7, ALLOWABLE COST AND PAYMENT (DEC 2002) (R4, tab 1 at 12).

2. In its fiscal year (FY) 2005, ending 31 October 2005, SplashNote charged three categories of costs to overheard and G&A that the government later found to be unallowable: 1) deferred independent research and development (IR&D) costs ($59,417); 2) a bonus paid to SplashNote president, chief executive officer, and majority owner Mr. Scott Tse ($34,168); and 3) meals incurred locally in 2005 to discuss recruiting with professional colleagues ($478)[1] (R4, tab 2 at 8-10; compl. ¶ 40). The portion of these costs allocable to this contract is $84,950 (R4, tab 6 at 4).

3. On 21 April 2010, the government issued a demand for payment for $84,950 (R4, tab 6). On 26 July 2010, the contracting officer issued a final decision, finding that SplashNote owed the government $84,950 in previously paid unallowable costs (R4, tab 8). On 21 October 2010, SplashNote appealed this decision to the Board.

Audits and Reviews

4. Shortly before the award of this contract, the Defense Contract Audit Agency (DCAA) conducted a pre-award survey audit of SplashNote's accounting system and on 28 April 2004 concluded that it was acceptable for award (R4, tab 12 at 1-2).

5. DCAA also conducted a post-award accounting system review in 2006, issuing an initial report on 1 February 2007 and a follow-up report on 9 January 2008 after further review in 2007. The first report found SplashNote's system inadequate for accumulating and billing costs; the follow-up report reviewed SplashNote's corrections of deficiencies and found the accounting system adequate. (R4, tab 20 at 1-2, tab 22 at 1)

6. DCAA did not audit SplashNote's incurred cost submission for FY 2004, based on a risk assessment, although DCAA did review the submission for mathematical errors, certification, unusual items and other concerns, and provisional billing rate adjustments. In its report dated 29 June 2007, DCAA found no significant exceptions based on this review. (R4, tab 21 at 1)

Deferred IR&D

7. The deferred IR&D costs charged to the contract were the result of IR&D costs incurred in 2000-2001 to develop "Application Builder" IP technology software, which SplashNote asserts was the precursor to that required for the Air Force portlet system (compl. ¶ 3; app. br. at 2-5). SplashNote capitalized these costs in 2000 and 2001, then amortized the capitalized costs in 2002-2005, charging the 2005 year amortized costs to

[1] DCAA also questioned $38 in interest charges, which SplashNote conceded, and $51 in bid and proposal overhead, which will be automatically adjusted when overhead rates are finalized (see R4, tab 3, ¶¶ 5, 6).

the portlet contract (compl. ¶¶ 11, 12). The portlet contract did not contain a provision allowing deferred IR&D costs to be charged to it (R4, tab 1).

Bonus

8. SplashNote corporate minutes from shortly after its establishment in 2000 reflect that employee compensation included performance bonuses (app. supp. R4, tab K). Mr. Tse's 2002 employment agreement provided compensation of salary and bonus, adjusted at the discretion of the company (R4, tab 9 at 1). SplashNote's written "Company Policies and Procedures" did not address bonuses until January 2011, after this litigation was initiated (R4, tab 25 at 9).

9. No bonuses were paid to any employees for several years. At the end of FY 2005, SplashNote decided it might be able to issue its first "profit-sharing performance bonus" (app. supp. R4, tab L at 1-2). On 1 February 2006, SplashNote determined that, because of the strong net income and cash flow for 2005, performance bonuses could be issued "taking into account the available cash flow, the performance of each employee...and the impact of his/her work on the current and future health of the corporation" (app. supp. R4, tab M at 1-2). On 1 May 2006, the CEO proposed FY 2005 bonuses for each employee based on company performance, employee performance, the importance of the employee's work in achieving corporate results, and the likely impact of the employee on the company's future (app. supp. R4, tab N at 1-2).

10. For FY 2005, SplashNote paid bonuses to Mr. Tse in the amount of $34,168, and to the other two employees, a senior and a junior engineer, in the amount of $7,718 and $6,375. Letters to these employees announcing their bonuses stated that the bonuses were being paid pursuant to the company's "Profit-Sharing Bonus Plan." (R4, tab P) Mr. Tse's bonus constituted 71% of the total bonuses paid. In its comments to DCAA, SplashNote asserts that the smaller bonuses were commensurate with the lesser contributions and part-time status of those employees, in contrast to Mr. Tse's much larger bonus (five times those individual amounts) reflecting his role as CEO and the nature of his responsibilities (R4, tab 3, § 4). Although questioning Mr. Tse's bonus as a distribution of profits, the government found Mr. Tse's total compensation ($121,000 salary plus bonus) to be reasonable (R4, tab 4 at 13). The government did not question the payment of the other two bonuses (R4, tab 2 at 9-10, tab 4 at 12-13).

11. The parties dispute whether Mr. Tse, in discussions with DCAA, said that the bonuses were a way of "netting out income;" according to the government, this statement showed that the bonus actually was a distribution of profits (R4, tab 2 at 9-10, tab 3, § 4, tab 4 at 12-13). SplashNote clarified that bonuses were considered "at the end of a year where there is a profit." In addition, SplashNote explained to DCAA that $49,550

remained in net income after the bonuses were paid, supporting SplashNote's view that the bonus was not a distribution of profit. (R4, tab 3, § 4)

12. The three employees employed by SplashNote in 2006 were also paid bonuses for that year (app. supp. R4, tab Q). Bonuses were also paid in 2007. SplashNote has never issued any dividends. (App. supp. R4, tab H at 3)[2]

Cost of Local Meals to Discuss Recruiting

13. SplashNote charged $478 to the contract in 2005 for 23 meals at local restaurants to discuss recruiting with professional colleagues. SplashNote provided some supplemental information to DCAA during the audit that showed the meals were not with job applicants. (R4, tab 2 at 9, tab 3 at 6-7; app. br. at 19)

DECISION

Deferred IR&D Costs

Cost allowability for deferred IR&D costs is set forth in FAR 31.205-18, Independent research and development and bid and proposal costs. This cost principle makes deferred IR&D costs generally unallowable, except in certain circumstances, and even in those cases, the contract to which they are allocated must provide for deferred IR&D cost allocation. Specifically the cost principle states:

> (d) *Deferred IR&D costs....*
>
> ....
>
> (2) When deferred costs are recognized, the contract (except firm-fixed-price and fixed-price with economic price adjustment) will include a specific provision setting forth the amount of deferred IR&D costs that are allocable to the contract. The negotiation memorandum will state the circumstances pertaining to the case and the reason for accepting the deferred costs.

FAR 31.205-18(d)(2).

[2] The government objected to Tab H as an unsworn statement (gov't reply br. at 5-6), but we consider it adequate to support this specific finding. Other information in the statement (payment of 2006 bonuses) is corroborated elsewhere in the record (finding 12); the statement about lack of dividends being issued is not contested.

We find the deferred IR&D costs unallowable. In this case, there is nothing in the contract specifically authorizing any deferred IR&D costs to be charged to this contract as specified in FAR 31.205-18(d)(2) (finding 7), nor has SplashNote provided a copy of the negotiation memorandum to suggest otherwise. Without evidence of government agreement before contract award, these costs cannot properly be charged to the contract under FAR 31.205-18(d). We disagree with SplashNote's argument that this requirement is optional as a permissive advance agreement. The authority in FAR 31.109 for advance agreements is different from the express requirement for a contract provision in FAR 31.205-18(d)(2), and although advance agreements are optional, this contract requirement is not. Without agreement in the contract to pay for deferred IR&D, such costs are unallowable. The cases cited by SplashNote do not hold otherwise.

Second, as to SplashNote's argument concerning compliance with Financial Accouting Standards (FAS) 86 (app. br. at 9), we agree with the government that compliance with FAS 86 for financial reporting purposes does not automatically establish cost allowability under the contract and under the FAR. The FAR requirements for cost allowability include compliance with the terms of the contract and with the limitations set forth in the cost principles. FAR 31.201-2(a). The specific FAR cost principle on deferred IR&D governs allowability on this issue.

Third, SplashNote argues that the government is estopped to deny the allowability of these IR&D costs, because of other audits and reviews where the issue was not raised. SplashNote has the burden of proving the elements of this affirmative defense. *RGW Communications, Inc. d/b/a/ Watson Cable Co.*, ASBCA Nos. 54495, 54557, 05-2 BCA ¶ 32,972 at 163,335. Equitable estoppel requires a showing of: 1) misleading conduct leading another to reasonably infer that rights will not be asserted against it; 2) reliance on this conduct; and 3) material prejudice as a result of this reliance. *Mabus v. General Dynamics C4 Systems, Inc.,* 633 F.3d 1356, 1359 (Fed. Cir. 2011). When estoppel is asserted against the government, a showing of affirmative misconduct is required in addition to these elements. *United Pacific Insurance Co. v. Roche,* 401 F.3d 1362, 1366 (Fed. Cir. 2005). As discussed below, SplashNote has not met this burden.

SplashNote points to several government actions to support its estoppel claim: 1) the audit conducted in March 2004 of its accounting system; 2) the post-award accounting system review conducted in 2006 with follow-up in 2007; and 3) the review of FY 2004 costs, the report of which was issued in June 2007 (app. br. at 10-12; findings 4, 5, 6). However, none of these audits or reviews supports a finding of estoppel against the government. First, concerning the government's approval of the accounting system in 2004, the government's approval of that system cannot be viewed as an approval of the allowability of specific costs, and certainly would not constitute "affirmative misconduct" as to the allowability of these costs. Second, concerning the review of the 2004 costs, the

report of which was issued in *June 2007*, SplashNote has not proved the reliance or prejudice elements of estoppel, as reliance and prejudice cannot pre-date the action complained of. That report was issued six to seven years after the costs were incurred, three years after the contract was awarded, and two years after the contested charges were allocated to the contract. Nothing the government did or did not do in the 2007 review of the 2004 costs would have affected SplashNote's decisions about whether to incur those costs at all in 2000-2001, or how to treat those costs when the contract was negotiated in 2004, or when/how to charge those costs in 2005. Finally, the 2006 and 2007 post-award system review (and reports issued in 2007/2008) does not contribute to a showing of estoppel as it too was after-the-fact and concerned only SplashNote's accounting system for accumulating and billing costs.

We have considered SplashNote's other arguments and find them unpersuasive.

Bonus

For Mr. Tse's bonus to be allowable, it must meet the criteria of FAR 31.205-6(f). Specifically, it must be paid pursuant to either an "agreement entered into...before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment," and the basis for the bonus award must be supported. Further, the bonus must also meet the criteria of FAR 31.205-6(a)(6), which governs certain specified individuals. The version of this cost principle in effect on the date of award states:

> (6) (i) Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include:
>
> (A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors or members of their immediate families;...
>
> ....
>
> (ii) For these individuals, compensation must –
>
> (A) Be reasonable for the personal services rendered; and
>
> (B) Not be a distribution of profits (which is not an allowable contract cost).

FAR 31.205-6(a)(6). We do not need to decide whether SplashNote demonstrated the existence of a bonus agreement or a bonus plan as required by FAR 31.205-6(f) because, regardless, we find that Mr. Tse's bonus was a distribution of profits and thus unallowable.

In *Lulejian and Associates*, the Board looked at several factors to assess when a bonus was actually a distribution of profits: whether any dividends were declared (*i.e.*, whether the bonus was actually a disguised dividend), how large a share of the bonus pool was allocated to the top executive(s), and how "substantial" the rest of the compensation was. *Lulejian and Associates, Inc.,* ASBCA No. 20094, 76-1 BCA ¶ 11,880 at 56,945 (ASPR 15-205.6(a)(2)(i) provided that "Determination should be made that such compensation is reasonable for the actual personal services rendered rather than a distribution of profits"). Because there were no dividends declared, the top four executives garnered 51% of the bonus pool, and their compensation was otherwise substantial, the Board found certain bonus costs unallowable. *Lulejian,* 76-1 BCA ¶ 11,880 at 56,945. Here, like *Lulejian*, SplashNote declared no dividends, and Mr. Tse's share of the bonus money was great--71% (findings 10, 12). Although DCMA determined Mr. Tse's total compensation to be reasonable, the bonus itself still must not be a distribution of profits, and the presence of the other two factors suggests that it was.

The letters to the employees announcing that their bonuses were being paid pursuant to the company's "Profit-Sharing Bonus Plan" also support the conclusion that Mr. Tse's bonus was a distribution of profits. We are not persuaded by SplashNote's argument that the bonuses for the other employees were not questioned whereas Mr. Tse's was; allowability of their bonuses is not restricted by the "distribution of profits" prohibition, which is limited only to the designated individuals. SplashNote's additional point that it can only pay bonuses in years where there are profits goes more to whether or not it has a bonus plan that it consistently followed, not whether paying a bonus to Mr. Tse in a profitable year constituted a distribution of profits. Additionally, even if SplashNote demonstrated that it had a bonus agreement or an established bonus plan which it consistently followed (which we do not decide), the lack of specificity, constraints, or parameters contributes to the conclusion that Mr. Tse's bonus was a distribution of profit. Consequently, Mr. Tse's bonus of $34,168 is unallowable.

Meals to Discuss Recruiting

SplashNote argues that the cost of meals to discuss recruiting with professional colleagues is allowable under any one of three cost principles: FAR 31.205-34, Recruitment costs; FAR 31.205-46, Travel costs; and FAR 31.205-43, Trade, business, technical and professional activity costs. We disagree as to all three.

Concerning the recruitment cost principle, the parties focus on two of the six enumerated allowed costs: travel costs of employees engaged in recruiting personnel, and travel costs of applicants for interviews. FAR 31.205-34(a)(4), (5). However, these two categories, by their terms, are linked to the travel cost principle, which allows costs incurred for lodging, meals, and incidental expenses only to the extent that they do not exceed the maximum per diem rates set forth in the Federal Travel Regulation (FTR) or the Joint Travel Regulations (JTR). FAR 31.205-46. The FTR only authorizes per diem payments for travel of more than 12 hours; the JTR prohibits per diem payments within the permanent duty station limits or within the employee's commuting area, with very limited exceptions. FTR 301-11.1(c); JTR, vol. II, chap. 4, part B, § C4552, ¶ C.1.a. Since the travel regulations do not allow reimbursement for local meals, these costs are not allowable under either the recruitment cost principle or the travel cost principle. SplashNote's distinction that these meal costs are actual costs, not per diem payments, is irrelevant for purposes of this analysis (app. reply br. at 15).

SplashNote also argues that these meals are allowable under FAR 31.205-43, Trade, business, technical and professional activity costs. This cost principle states in relevant part:

> Trade, business, technical and professional activity costs.
>
> The following types of costs are allowable:
>
> ....
>
> (c) When the principal purpose of a meeting, convention, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity:
>
> (1) Costs of organizing, setting up, and sponsoring the meetings, conventions, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs;
>
> (2) Costs of attendance by contractor employees, including travel costs (see 31.205-46); and
>
> (3) Costs of attendance by individuals who are not employees of the contractor, provided;
>
> (i) Such costs are not also reimbursed to the individual by the employing company or organization, and
>
> (ii) The individual's attendance is essential to achieve the purpose of the conference, meeting, convention, symposium, etc.

FAR 31.205-43(c). SplashNote asserts that recruiting was discussed at these meal meetings, that recruiting discussions qualify as stimulation of production or improved productivity, and that "any expenses incurred outside of the office in the service of the company" are "legitimately reimbursable expenses." Thus, according to SplashNote, the meal costs are reimbursable under this cost principle. (App. br. at 19; app. reply br. at 16)

The difficulty with SplashNote's argument is the lack of information in the record to support compliance with the cost principle. We do not know why so many meals were necessary to discuss recruiting (finding 13), whether all meal meetings were with different people, who Mr. Tse met with and what organizations they represented, what was discussed, and, even if recruiting was discussed, whether that was the principal purpose of the meeting, as opposed to general business and social conversation. The only record information consists of statements by SplashNote after the issue was raised and contested in the audit, even there without specifics on these points. The absence of information about these meal meetings stands in contrast to the details provided in *Cotton & Company*, EBCA No. 426-6-89, 90-2 BCA ¶ 22,828 at 114,628 (meal cost allowed under the cost principle based on evidence about attendees and purpose of meetings). *See also Lulejian and Associates,* 76-1 BCA ¶ 11,880 at 56,949 (disallowing cost of meals of internal company officials to discuss new business ventures, and cost of meals where company executives met with outside counsel, as not meeting the criteria of the cost principle).

The FAR requires contractors to maintain records and supporting documentation adequate to show that costs comply with the applicable cost principles. FAR 31.201-2(d). The parties contest the significance of this regulation, with the government arguing that SplashNote has not provided evidence that these costs qualify as business meeting costs and SplashNote asserting that it could have provided receipts for all meals if they had been requested sooner (gov't reply br. at 9-10; app. br. at 19). However, our concern here is less with receipts to show costs were incurred, which is not disputed, and more with whether the criteria of the cost principle were met. Without the type of information noted above, we cannot say that these meal costs qualify as subsistence costs of "organizing, setting up, and sponsoring" a meeting, as required by the cost principle. Certainly we disagree with the over-broad statement that "any expenses incurred outside of the office in the service of the company" are reimbursable (app. reply br. at 16). General assertions that recruiting was discussed at meal meetings, which is all we have to rely on, do not provide an adequate foundation to show compliance with the criteria of the cost principle. Consequently, we cannot conclude that these meal costs are allowable under FAR 31.205-43.

CONCLUSION

For the reasons stated above, the appeal is denied in its entirety.

Dated: 29 November 2011

Elizabeth M. Grant

ELIZABETH M. GRANT
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

Eunice W Thomas

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. 57403, Appeal of SplashNote Systems, Inc., rendered in conformance with the Board's Charter.

Dated:

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