ARMED SERVICES BOARD OF CONTRACT APPEALS

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| Appeal of -- | ) | |
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| SRI International | ) | ASBCA No. 56353 |
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| Under Contract No. HR0011-06-C-0023 | ) | |

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OPINION BY ADMINISTRATIVE JUDGE TING

SRI International (SRI) appeals from an Administrative Contracting Officer's decision denying its claim for costs incurred in fiscal years (FY) 2005 and 2006 in maintaining a standby Letter of Credit (LOC) issued by a bank to guarantee SRI's ability to repay the entire amount of its long-term debt in those two years. The long term debt was incurred as a result of bonds issued by the California Infrastructure and Economic Development Bank which had issued bonds to fund SRI's expansion project on its campus in Menlo Park, California. The government contends that the claimed costs are unallowable under Federal Acquisition Regulation (FAR) 31.205-20 as costs of financing long-term capital. SRI maintains that the costs are allowable because they are similar to bonding costs allowable under FAR 31.205-4, and alternatively, as administrative costs of short-term borrowings for working capital allowable under FAR 31.205-27(a)(3).

FINDINGS OF FACT

Background

1. SRI is a nonprofit scientific institute with its corporate headquarters in Menlo Park, California. It performs research and development work in the areas of drug development, integrated circuit development, nanotechnologies, and light-emitting diodes to name a few. (Tr. 1/87-88) SRI's clients include the Food & Drug Administration, the

National Institutes of Health and the Department of Energy (tr. 1/87, 89). About 90% of its work is performed for the United States government (tr. 1/33).

2. SRI selected as a sample contract for purposes of this appeal, a 2005 cost plus fixed-fee contract–Contract No. HR0011-06-C-0023 effective 14 November 2005 with the Defense Advanced Research Project Agency–that called for SRI to perform work in connection with what was known as the "NIGHTINGALE" (Novel Information Gathering and Harvesting Techniques for Intelligence in Global Autonomous Language Environments) effort (R4, tab 1 at 7). Under that contract, SRI was to be paid its costs in accordance with FAR 52.216-07, ALLOWABLE COST AND PAYMENT (DEC 2002), as modified in accordance with FAR 16.307(a)(1)[1] not to exceed the "Total Estimated Cost" specified in the contract. With respect to indirect costs, SRI was to be reimbursed at billing rates established by the contracting officer or by an authorized representative (the cognizant auditor) subject to the establishment of final indirect cost rates. (R4, tab 1 at 13, 14, 19)

3. Prior to 2001, SRI had plans to seek capital to renovate and add on to two buildings on its campus (the project) (tr. 1/84). It selected Prager, Sealy & Co., LLC (Prager) as its investment banker (tr. 1/32). Prager identified the California Infrastructure and Economic Development Bank (the Infrastructure Bank) as "the authority...to issue tax-exempt bonds" for funding the project (*id.*).[2] The Infrastructure Bank is a public instrumentality of the State of California. It was established by law for the purpose of "providing financial assistance for the design, construction, financing and development of economic development facilities...located in the State of California." (App. supp. R4, tab 31 at 1)

4. In September 2003, the Infrastructure Bank issued $25 million in Variable Rate Demand Revenue Bonds (VRDR Bonds) for the SRI project. The proceeds from this bond issuance were to be used to finance or refinance the acquisition, construction, renovation, remodeling, and equipping of certain research facilities to be owned and operated by SRI. (Ex. A-13 at 9) The 2003 Series A Bonds issued in the amount of

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[1] Although it is a nonprofit organization, SRI is subject to the cost principles applicable to commercial organizations. *See, e.g.*, OMB Circular A-122 (Revised 9 June 2004), attach. C, Non-Profit Organizations Not Subject to This Circular, listing SRI.

[2] With the funds from the sale of the bonds, SRI expanded one building–Building T–by adding to both ends and remodeling the center. SRI gutted the inside of a second building–Building S–and built a new set of laboratories and clean rooms for chip design work. (Tr. 1/33-34, 87-88)

$23,720,000 are tax-exempt. The 2003 Series B Bonds issued in the amount of $1,280,000 are taxable.[3] (Ex. A-7; tr. 1/35)

SRI/Infrastructure Bank Loan Agreement

5. To issue the VRDR Bonds, the Infrastructure Bank entered into a Loan Agreement with SRI in August 2003 (ex. A-7). Article IV, Section 4.2 of the Loan Agreement provides that SRI agrees to pay the Trustee:

> [A]s a Repayment Installment, no later than 9:00 a.m. (California time) on the Business day immediately before each date on which the payment of principal of (whether at maturity or upon redemption or acceleration), premium, if any, and/or interest on the Outstanding Bonds is due, until the principal of, premium, if any, and interest on the Bonds shall have been fully paid or provision for the payment thereof shall have been made in accordance with the Indenture.... The Corporation [SRI] agrees that any amounts due as a result of the acceleration of the maturity of the Bonds shall be due and payable immediately upon such acceleration.

(Ex. A-7 at 8-9)

6. To support the payment of the principal and interest on the purchase price of the VRDR Bonds, Article IV, Section 4.6(a) of the Infrastructure Bank/SRI Loan Agreement requires SRI to deliver to the Trustee "on or prior to the Issue Date the executed Initial Credit Facility for the Bonds."[4] SRI was also required to "maintain one or more Credit Facilities, either by maintaining the Initial Credit Facility or providing one or more Alternate Credit Facilities." (Ex. A-7 at 11) Section 4.6(a) also specified the circumstances under which SRI's obligation to maintain credit facilities for the VRDR Bonds would terminate. Such circumstances include the eventuality where the Trustee receives written evidence from a Rating Agency of an "A" long-term rating or "highest short-term" rating. (*Id.*)

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[3] The Series B Bonds are taxable because the funds were to be used for building areas not eligible for tax-exempt status. The Series B Bonds had a three-year maturity period and have been retired. (Tr. 1/35-36)

[4] A "credit facility" is a financial structure which enables one to deploy financial resources (tr. 1/68).

Infrastructure Bank/Union Bank Indenture of Trust

7. The Infrastructure Bank, as issuer of the VRDR Bonds, hired Union Bank of California, N.A. (Union Bank) as trustee to manage the fund flows resulting from the sale of the VRDR Bonds. To this end, an Indenture of Trust was entered into between the Infrastructure Bank and Union Bank in August 2003. (Ex. A-8) As SRI's investment banker, Prager sold the VRDR Bonds and deposited the proceeds with Union Bank (tr. 1/37). From this deposit, SRI drew funds to pay for the bond offering and the cost of financing (tr. 1/39, 56-57). As trustee, Union Bank collects payment for the bonds from SRI and remits the interest to the bondholders every month. It also disbursed progress payments to SRI's contractors hired for the project. (Tr. 1/36-38)

SRI/Wells Fargo Credit Agreement

8. SRI and Wells Fargo Bank, N.A. (Wells Fargo) have a "long-standing relationship" that goes "way back in time" (tr. 1/55). For some years prior to the VRDR Bond issuance, SRI had maintained a line of credit with Wells Fargo. Byron Rovegno (Rovegno), SRI's former Controller and Treasurer at the time of the VRDR Bond issuance explained the purpose for the Wells Fargo line of credit:

> We, like many businesses, sometimes need to have funds available to meet maturing obligations. And there might be a slowdown in cash receipts, for some reason, are [sic] there might be an unusual cash demand where we don't have cash sufficient to pay something. And so we can borrow against this agreement at any time for any maturing obligation.
>
> This credit agreement is -- is an overall agreement for SRI by the bank to extend credit to us for purposes of operating our business.

(Tr. 1/41)

9. Prior to the issuance of the VRDR Bonds in 2003, a Credit Agreement in the aggregate principal amount of $30,000,000 existed between SRI and Wells Fargo (ex. A-2). As amended on 2 June 2003, the SRI/Wells Fargo Credit Agreement provided under Article I, Section 1.1, the following with respect to a line of credit, and a letter of credit subfeature:

> (a) Line of Credit. Subject to the terms and conditions of this Agreement, Bank hereby agrees to make advances to Borrower from time to time up to and including

> [December[5]] 30, 2003, not to exceed at any time the aggregate principal amount of Thirty Million Dollars ($30,000,000.00) ("Line of Credit"), the proceeds of which shall be used for working capital purposes....
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> (b) Letter of Credit Subfeature. As a subfeature under the Line of Credit, Bank agrees from time to time during the term thereof to issue or cause an affiliate to issue commercial or standby letters of credit for the account of Borrower.... The form and substance of each Letter of Credit shall be subject to approval by Bank, in its sole discretion. Each Letter of Credit shall be issued for a term not to exceed two (2) years, as designated by Borrower; provided however, that...no Letter of Credit shall have an expiration date beyond the maturity date of the Line of Credit.

(Ex. A-2)

10. According to Rovegno, the SRI/Wells Fargo Credit Agreement is an "annually-renewable line of credit.... And...every year there's been some changes to the terms and conditions" and "basically it's a one-year renegotiation on the credit agreement." (Tr. 1/45-46)

11. While SRI can itself draw upon the line of credit provided by the SRI/Wells Fargo Credit Agreement, a draw upon the letter of credit is typically by a third party (tr. 1/118). In this case, as a condition for issuing the VRDR Bonds, the Infrastructure Bank/SRI Loan Agreement required SRI to deliver an "Initial Credit Facility" for the bonds (finding 6). To satisfy this condition, SRI provided a LOC under the letter of credit subfeature of its Credit Agreement with Wells Fargo (tr. 1/116). Should SRI fail to make payment in accordance with its Loan Agreement with the Infrastructure Bank, Union Bank, as the Infrastructure Bank's trustee, would look to the Wells Fargo LOC to "meet the obligation to investors" (tr. 1/114). If there is a draw by Union Bank on the Wells Fargo LOC, "at that point there would be an obligation...for SRI to reimburse the bank [Wells Fargo] for that draw" (tr. 1/119).

12. As a part of Wells Fargo's agreement to issue the LOC in favor of Union Bank, SRI and Wells Fargo entered into a Reimbursement Agreement (ex. A-6). This Reimbursement Agreement would come into effect only if there was a draw by Union Bank on the LOC (tr. 1/60).

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[5] As amended by paragraph 1 of First Amendment to Credit Agreement (ex. A-2).

13. Under Section 2(a) of this agreement, Wells Fargo agrees to issue "its irrevocable direct-pay Letter of Credit for the account of Borrower [SRI]" (*id.* at 5). Section 3(d) of the Reimbursement Agreement provides for the LOC fees in dispute:

> (d) <u>Letter of Credit Fees; Other Payments to Bank</u>. Borrower shall pay to Bank annual, continuing nonrefundable letter of credit fees...for providing the Letter of Credit, which Letter of Credit Fees shall be in an amount equal to one and one-quarter percent (1.25%) per annum of the Stated Amount on the date that any such fee is determined, less amounts drawn under the Letter of Credit which are not reinstated as of such date.

(Ex. A-6 at 7) The Reimbursement Agreement establishes a mechanism under which short-term loans can be made to SRI for the payment of interest and principal when due, or for payment of tendered bonds if not remarketed. It is designed to encourage immediate repayment of any use of the liquidity facility by SRI. (Ex. A-39 at 7). Since "reimbursement would take place immediately...the nature of the credit that's been extended by Wells Fargo is very short term in nature" (tr. 1/119). And, since SRI would have to make reimbursement provisions prior to expiration of its LOC, Wells Fargo's extension of credit through the LOC is not viewed as "a long-term credit facility...[but] a short-term credit facility" (tr. 1/121).

14. At the time SRI sought financing for its project its credit rating was not of investment grade (tr. 1/69). Taking out a LOC enhanced its credit rating. As Rovegno explained, "we substituted Wells Fargo's credit rating for ours by paying a bank fee to put this guaranty in place." (Tr. 1/70) Providing a LOC from Wells Fargo was one way of satisfying this requirement "to assure...faithful performance on the covenants and restrictions on the -- bonds" (tr. 1/43). Whether SRI will need to continue to maintain a LOC could change (tr. 1/69). As provided in the Infrastructure Bank/SRI Loan Agreement, should SRI's credit rating improve, a LOC or other kind of credit facility may not be required (ex. A-7 at 11; finding 6).

15. By letter dated 27 August 2003, an Irrevocable Letter of Credit (Letter of Credit No. NZS492783) in the amount of $25,353,425.00 was established under SRI's existing line of credit in Union Bank's favor for the VRDR Bonds. This LOC established a specific expiration date and future extensions at Wells Fargo's election:

> This Letter of Credit expires at our above office on September 1, 2004 but shall be automatically extended, without written amendment, to September 1 in each succeeding calendar year up to, but not beyond, September 1, 2028, unless you shall have received at your address above

> our written notice sent by registered mail or express courier that we elect not to extend this Letter of Credit beyond the date specified in such notice, which date shall be September 1, 2004 or any subsequent September 1 occurring before September 1, 2028 and be at least forty-five (45) calendar days after the date you receive such notice.

(R4, tab 5)

Evidence Relating to the Short-Term Nature of SRI's Line of Credit, LOC and Reimbursement Obligations

16. Once issued, the existence and continuation of the LOC is dependent upon the existence and continuation of SRI's line of credit with Wells Fargo (*see* ex. A-2, ¶ 1.1(b), SRI/Wells Fargo Credit Agreement, as amended 2 June 2003). As SRI's former controller explained, SRI's LOC exists "[s]o as long as our line of credit exists" and SRI's line of credit exists "for 12 months" subject to renewal or extension by Wells Fargo "one year at a time each year" (tr. 1/48). Thus both SRI's line of credit and its LOC with Wells Fargo are short-term in nature. A draw on the LOC is treated by Wells Fargo as if it were a draw on the line of credit and would reduce the available line of credit under the SRI's Credit Agreement with Wells Fargo. Even though SRI has never drawn on the LOC, should there be a draw, the draw will bear a separate interest cost above and beyond the cost of maintaining the LOC. (Ex. A-39 at 6)

17. In guaranteeing that bondholders will be paid, the LOC provided by Wells Fargo enhances the liquidity and hence the marketability of the VRDR Bonds (ex. A-13 at 10; tr. 1/66). SRI paid Wells Fargo an annual bank fee to maintain the LOC (tr. 1/76).

18. No money from Wells Fargo was used to fund the expansion project (tr. 1/46). The project was funded exclusively from the monies derived from the sale of the VRDR Bonds and drawn from Union Bank (tr. 1/44).

SRI's Accounting Treatment of Its VRDR Bond Liability

19. In accounting for the debt incurred, SRI has treated all of the $25 million worth of bond debt, which included $23,720,000 in Series 2003A VRDR Bonds (maturing 1 September 2028) and $1,280,000 in Series 2003B VRDR Bonds (maturing 1 September 2006) (*see* ex. A-8 at A-000023-24, Article II, § 2.01) as a part of its "Current liabilities." As reflected in SRI's Consolidated Financial Statements and Consolidating Information for the period ending 27 December 2003, prepared by its outside auditors, PricewaterhouseCoopers LLP, SRI accounted for all $25 million as "Current installments of long-term debt" under "Current liabilities" (ex. A-13 at 17). This treatment is explained in the Notes to Consolidated Financial Statements:

> Series 2003A and 2003B are subject to optional and mandatory sinking fund redemption and optional and mandatory tender for purchase at any time they remain at a variable interest rate. The bonds are subject to conversion to a term interest rate and mandatory tender upon such conversion. Series 2003A is subject to mandatory redemption by lot, from sinking fund payments on September 1, beginning in 2006 through 2028. Series 2003 B is subject to mandatory redemption by lot, from sinking fund payments on September 1, beginning in 2004 and ending in 2006.
>
> SRI has no obligation to make any direct payments with respect to bonds tendered for purchase. The purchase price of bonds tendered is payable only from the proceeds of the remarketing of such bonds and from amounts from a bank letter of credit, currently with Wells Fargo Bank. The letter of credit was issued to ensure payment of the bonds to the holders and to enhance the credit rating and marketability of the bonds. However, under the bank letter of credit agreement SRI would be obligated to reimburse Wells Fargo for any bonds tendered to Wells Fargo. The bank letter of credit expires on September 1, 2004, and is subject to annual renewal.
>
> Under the provisions of Emerging Issue Task Force ("EITF") D-61 *Classification by the Issuer of Redeemable Instruments That Are Subject to Remarketing Agreements*, SRI is required to present the bond obligation as a current liability, due to the debt being collateralized on a short-term line of credit. Management expects to redeem $525,000 of Series 2003B bonds in 2004.

(Ex. A-13 at 9-10) SRI's controller at the time explained more succinctly the reason for treating the Series 2003A VRDR Bonds[6] as a part of SRI's "Current liabilities:" "[E]ven though these bonds have a duration out to 2028...they can put them back on us and make us pay for them at any time." Because SRI needed to be able to pay for the totality of the bonds issued within 12 months, SRI's outside auditors determined, for "GAAP [Generally Accepted Accounting Principles] reporting purposes," that the bonds were

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[6] As noted before, the Series 2003B bonds have already been retired, and are not at issue in this appeal (tr. 1/85).

"short term in the working capital calculation...due within the next 12 months." (Tr. 1/74-75)

The Parties' Positions

20. At the hearing, Rovegno explained since the fee for the LOC was a bank fee "to provide a guaranty of faithful performance on the loan agreement" he considered the fee as a bonding cost under FAR 31.205-4 (tr. 1/75-76). FAR 31.205-4 provides, in relevant part:

> (a) ...[Bonding costs] arise also in instances where the contractor requires similar assurance. Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.
>
> ....
>
> (c) Costs of bonding required by the contractor in the general conduct of its business are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

21. James Balestieri (Balestieri), Defense Contract Audit Agency (DCAA) auditor assigned to SRI since 2001 and DCAA's lead auditor on incurred costs since 2005 (tr. 2/8), acknowledged that the fees associated with the LOC are not interest on borrowing (tr. 2/34-35). On whether the LOC fees are allowable, he applied what can be referred to as a "but for" test: "Had the bonds not existed, you would never have a letter of credit costs" (tr. 2/35). Although he acknowledged that SRI's LOC with Wells Fargo "is renewed or can be renewed...every year or every other year," he considered the LOC a long-term liability because SRI has to maintain it "for the 25-year term of the bonds" (tr. 2/36).

22. At the hearing, Administrative Contracting Officer Craig M. Studley (ACO Studley) testified that it was his understanding that the principal purpose for the LOC was to assure fulfillment of SRI's obligations under the VRDR Bonds issued for its benefit (tr. 2/69).

Expert Testimony

23. At the hearing, SRI called James B. Query (Query) as an expert witness in the area of bond financing (tr. 1/99). Query had worked in the United States Senate as a staff economist. He subsequently worked in New York City's Controller Office as its Deputy

Controller for Finance responsible for the City's borrowings for its long-term construction program. He then became Chief of the Bureau of Financial Analysis responsible for preparing the City's operating and capital budgets. In 1986, he joined a major Wall Street investment bank's "public finance" practice. (Tr. 1/92-93) His clients included nonprofit institutions as well as government entities and municipal authorities (tr. 1/98). Query was accepted as an expert without objection from the government (tr. 1/99). We find his testimony (including his pre-filed written testimony (ex. A-39)) helpful in understanding the evidence as it pertains to the specialized area of VRDR Bond financing, an area in which neither DCAA nor the Board has expertise. *See* FED. R. EVID. 702.

24. As Query explained, a VRDR Bond such as the ones the Infrastructure Bank issued for SRI has two distinct features. The "variable-rate" feature means that "the interest rate on the security is reset frequently." Interest rates can be reset daily or weekly or longer. The periodicity of reset "can be tailored to any particular timeframe depending on the needs of both parties, investor and borrower." The remarketing agent (Prager) sets the interest rate which reflects "[the] supply-and-demand conditions in the marketplace." The second feature of a VRDR Bond is its "put feature." Since the principal investors of VRDR Bonds are money market funds, investors must have assurance that they can resell the bonds with short notice and "get their original principal amount back." (Tr. 1/94-96) In addition to supporting SRI's obligations to the Infrastructure Bank and the bondholders, we find the LOC supports liquidity essential for the sale and resale of the VRDR Bonds.

25. According to Query, "the predominant number of VRDB programs are supported by some form of liquidity support, either a line of credit or a letter of credit," and "among those choices by far the most common form of support is a letter of credit" (tr. 1/96). Thus, taking out a LOC as SRI did to secure its financial obligation to bondholders was "very typical," "very traditional," and "very recognizable and very common features to find" (tr. 1/97).

26. According to Query, LOCs are a typical form of performance guarantee in circumstances that require assurance of the ability to fulfill payment obligations at a time certain or under specific circumstances. He testified that SRI's LOC is typical of those provided by other institutions of similar credit quality and is the most readily understood and accepted form of performance guarantee required by bond investors purchasing such securities. (Ex. A-39 at 5)

27. Based on his review of SRI's financial condition in FY 03 through the period covered by the most recently available audited financial statements (31 December 2007), he found the LOC costs or fee charged to SRI by Wells Fargo for FYs 05 and 06 "comparable to what similarly circumstanced organizations...could expect to pay" (*id.* at 7).

28. Query explained that the costs of financing are usually "fixed upfront costs" (tr. 1/106). Based upon his review of all of the documents relating to the issuance of the VRDR Bonds in this case, he found that costs for maintaining the Wells Fargo LOC are not fixed upfront costs. The LOC runs for one year and needs to be renewed on an annual basis. To the extent it is not renewed, there is an obligation on SRI's part to substitute an alternate credit facility. Query opined "there's nothing upfront or permanent about it. It's a periodic charge." (Tr. 1/106)

29. The VRDR Bonds are "multi-modal" bonds. That means the Infrastructure Bank and SRI could change the periodicity of the interest rate reset from weekly to one or two years. Longer reset periodicity could eliminate the need for maintaining a LOC because there would be sufficient notice from the bondholders to sell the VRDR Bonds so that SRI could arrange for alternate forms of financing. Also, as provided for in the Infrastructure Bank/SRI Loan Agreement, SRI's financial condition could improve to a point where the Infrastructure Bank no longer requires a LOC to be maintained. (Tr. 1/107-08) For these reasons, Query explained that maintaining a LOC or other credit facility "over time" is different in kind from the costs of financing which are "paid upfront to put the financing structure in place" (tr. 1/109).

30. Query opined it was inappropriate for the ACO to characterize the LOC in his decision as a long term guarantee held in place for the life of the VRDR Bonds:

> Rather than being held in place over the life of the VRDBs however, the LOC used by SRI expires annually, and may only be renewed at the discretion of Wells Fargo. As a result, the LOC provides investors short-term liquidity for the payment of debt service and the tender of bonds over a one-year period rather than providing a guarantee of long-term debt over the life of the debt.

(Ex. A-39 at 8)

Evidence Related to the Allowability of LOC Costs

31. At the hearing, ACO Studley testified that the LOC "is there for the purposes of providing funds if in the event that...SRI is unable to meet or service it [sic] obligations under the bond" (tr. 2/69). Neither he nor any other government witness testified to any other purpose for the LOC. Although DCAA disputed the allowability of the claimed LOC costs, it did not dispute the purpose for the cost. In its 26 January 2007 memorandum on the subject, DCAA acknowledged that "[a]t the time of issuance, SRI was required to secure a ***letter*** of credit guaranteeing payment should SRI default." The

memorandum went on to say, incorrectly, that "SRI must maintain this ***letter*** of credit until the bonds are paid." (Finding 25)

32. Despite acknowledging that the purpose for conducting an incurred cost audit was to determine "whether the cost chargeable to...Government contracts are allowable, allocable and reasonable," DCAA chose not to look into the reasonableness of SRI's LOC cost. Auditor Balestieri explained:

> When we're looking at costs that are being claimed by a contractor, we first look at allowability and eligibility. If we determined that it is not allowable or not eligible we never even look at reasonableness. And in this case there was no reason in our minds to look at reasonableness.

(Tr. 2/18, 24)

33. In addition to having the LOC issued by Wells Fargo to secure its performance obligations under the VRDR Bonds, SRI had other letters of credit issued to "assure faithful obligation of a contract to a third party" (tr. 1/77). A Wells Fargo LOC was obtained to assure SRI's performance of a leased property in Albuquerque, New Mexico (ex. A-1; tr. 1/78). SRI also had a Wells Fargo issued LOC in favor of Royal Indemnity Company to secure its workman's compensation obligations (ex. A-3; tr. 1/78). The fees associated with these LOCs were included in SRI's incurred cost submissions and allowed by the government (tr. 1/78-79).

34. SRI has not sought reimbursement for any of the costs typically viewed as costs of financing. These costs include underwriting fees, legal fees, other financial advisory fees, trustee and paying agent fees, remarketing fees, rating agency fees and the costs relating to the printing and distribution of offering circulars. (Ex. A-39 at 8)

<u>Events Leading to Issuance of the CO's Decision</u>

35. The DCAA audits SRI's incurred cost submission every year. It did so in 2003 when SRI first included the Wells Fargo LOC costs associated with the issuance of the VRDR Bonds. (Tr. 1/79) Because DCAA lacks resources to audit every element of an incurred cost proposal, it identifies areas of costs it would examine based on "risk assessments" (tr. 2/9, 51). According to Balestieri, DCAA did not question SRI's LOC cost in 2003 because "we didn't look into it" (tr. 2/17, 33). DCAA did not question SRI's LOC cost before 2005 (tr. 1/80, 2/20).

36. ACO Studley was first assigned as Administrative Contracting Officer for SRI in 2005. The first SRI incurred cost audit he dealt with was DCAA's 2004 incurred cost report. (Tr. 2/50) On 22 June 2006, SRI submitted to ACO Studley its certified final

indirect cost rate proposal for cost incurred in SRI's fiscal year 2005 (FY 05), ending 31 December 2005 (R4, tab 8 at 1).

37. DCAA issued a report (Audit Report No. 4281-2005N10100001) on SRI's proposal on 29 September 2006 (R4, tab 8). The report questioned, among other costs, $365,900 in "claimed bank charges for securing a letter of credit related to the sale of bonds." DCAA took the position that "[t]he claimed bond expenses represent expressly unallowable financing costs per FAR 31.205-20." (*Id.* at 10) FAR 31.205-20, Interest and other financial costs, reads as follows:

> Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, and costs of preparing and issuing stock rights are unallowable....

As reflected in the audit report, SRI had earlier argued that "[t]he standby letter of credit serves as a performance bond, and was required by the issuer...as a condition of issuing the Variable Rate Demand Revenue Bonds." According to SRI, "Should SRI default on the Variable Rate Demand Revenue Bonds, the bank will pay the issuer using the standby letter of credit, just as would be the case if SRI had obtained a performance bond." SRI had also contended should there be a draw on the LOC, "there would be interest and costs attendant to refinancing the debt," and in that case, the costs of maintaining the LOC would be allowable under FAR 31.205-27(a)(3) as "administrative costs of short-term borrowings of working capital." (R4, tab 8 at 13) FAR 31.205-27, Organization costs, provides, in relevant part:

> (a) ....[E]xpenditures in connection with—
>
> ....
>
> (3) raising capital (net worth plus long-term liabilities), are unallowable.... [E]xcluding administrative costs of short-term borrowings for working capital....

38. While acknowledging that performance bond costs are generally allowable, the audit maintained that "this 'performance bond'" had "nothing to do with [government] contract performance" (R4, tab 8 at 15). The audit also maintained that inasmuch as SRI was required to obtain and maintain a LOC for the entire 25-year term to support long-term financing, the costs to "secure the letter of credit represents expressly unallowable financing costs per FAR 31.205-20" (*id.*).

39. ACO Studley furnished the audit to SRI on 30 October 2006 and asked for its comments (R4, tab 9). SRI's 20 November 2006 reply explained that a letter of credit was used because "to the bondholders a letter of credit is the same as a guarantee or insurance policy." SRI went on to explain: "The very essence of the credit facility, whatever type, is to insure performance by SRI or the bondholders can recover from the guarantor." (R4, tab 10 at 3)

40. At ACO Studley's request, DCAA provided a memorandum addressing SRI's 20 November 2006 response. DCAA's 26 January 2007 memorandum stated that "the ***letter*** of credit fees are unallowable costs in accordance with FAR 31.205-20" because "[a]t the time of issuance, SRI was required to secure a ***letter*** of credit guaranteeing payment should SRI default because SRI's credit rating was not high enough to issue the bonds without the ***letter*** of credit. SRI must maintain this ***letter*** of credit until the bonds are paid." DCAA asserted "Had SRI not borrowed funds via issuance of the bonds, the annual fees for the ***letter*** of credit would not have been incurred." (R4, tab 11 at 3) (Emphasis in original)

41. DCAA issued Audit Report No. 4281-2007N19200001 on 12 March 2007. With respect to SRI's claimed FY 05 costs for maintaining a LOC, the audit took the position that the costs are unallowable because "SRI must maintain this ***letter*** of credit until the bonds are paid." (R4, tab 13 at 2)

42. After considering SRI's and DCAA's positions, ACO Studley issued his "initial determinations" on a number of costs SRI claimed in its FY 05 incurred cost proposal on 3 April 2007 (R4, tab 15). With respect to the $365,900 of "Bond Expenses," ACO Studley stated "I have determined DCAA's conclusion is correct, the costs are unallowable...financing cost pursuant to FAR 31.205-20" (*id.* at 1).

43. By e-mail sent on 7 May 2007, SRI forwarded its response to ACO Studley's initial determination (R4, tab 17). SRI's response, written by its outside counsel, said that "[c]ontrary to DCAA's argument, performance bonds do not have to be used in conjunction with a *U.S. Government* contract...to be allowable." SRI argued that DCAA's reliance on FAR 31.205-20 was misplaced because "SRI has not used and does not intend to use the letter of credit to finance anything." SRI said that FAR 31.205-20 would be invoked if there were a draw on the LOC, and then there would be interest and cost attendant to refinancing the debt, and the LOC costs would be allowable under FAR 31.205-27(a)(3) as "administrative costs of short-term borrowings for working capital." (*Id.* at 3) Later, SRI notified ACO Studley by e-mail on 13 July 2007 that its 7 May 2007 response constituted its final position on the unresolved issues arising out of the 29 September 2006 incurred cost audit (R4, tab 19).

44. Thereafter, ACO Studley rendered his determination on SRI's FY 05 incurred cost proposal. In his 20 July 2007 letter, he determined the "Bond Expenses/Letter of

Credit" cost unallowable under FAR 31.205-20 for the reason that "the letter of credit was required in order to guarantee payment on bonds unrelated to government contract requirements should SRI default." (R4, tab 20 at 2) With respect to SRI's "Bond Expenses" he indicated that because "the letter of credit was required in order to guarantee payment on the bonds should SRI default," the claimed cost should be "considered an unallowable financing cost pursuant to FAR 31.205-20." While ACO Studley touched upon FAR 31.205-27(a)(3) as it applied in other circumstances, he did not address FAR 31.205-27(a) as it applied to the fees claimed. (R4, tab 21)

45. By letter dated 18 September 2007, SRI submitted a $618,317[7] certified claim for "costs incurred by SRI in maintaining a standby letter of credit and hosting an employee award dinner."[8] The claim said that the claimed costs were included in its final indirect cost rate proposals for FY 05 and 06, and SRI was continuing to incur the same types of costs, and the question of whether the costs are allowable would be a recurring one. The letter said SRI had selected Contract No. HR0011-06-C-0023 as a "test" contract for purposes of its claim. (R4, tab 23)

46. SRI's claim disagreed with ACO Studley's determination that the costs incurred to maintain the LOC are unallowable under FAR 31.205-20. It argued that the LOC should be considered a performance bond and therefore allowable under FAR 31.205-4(b) and (c). It argued that the costs are also allowable under FAR 31.205-27(a)(3) as "administrative costs of short-term borrowings for working capital." The claim asked for an ACO's decision (1) affirming that the costs of the LOC are allowable, and (2) that including such costs in SRI's indirect cost pools is not noncompliant with CAS 405. (R4, tab 23 at 1)

47. ACO Studley acknowledged receipt of SRI's certified claim. He advised SRI by letter dated 16 October 2007 that his decision would be issued within 120 days pending receipt within 60 days of the "bases of estimate and computations to support the amount claimed of $618,317 for fiscal years 2005 and 2006." (R4, tab 24) SRI provided the required submissions by letter dated 30 November 2007. An accompanying attachment shows SRI's claimed $338,133 in "Bond Expenses" for FY 05 and $271,488 for FY 06. (R4, tab 25, attach. 1)

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[7] This amount included other disputed costs. The amount of LOC costs claimed for FY 05 was $338,133 and for FY 06 was $271,488 for a total of $609,621 (ex. A-32, attach. 1).

[8] As reflected in ACO Studley's decision of 14 March 2008, his 12 February 2008 determination found the costs associated with the Mimi Award Dinner an allowable expense and SRI's treatment of the expense in compliance with CAS 405 (ex. A-37 at 3).

48. ACO Studley's decision was issued on 14 March 2008 (R4, tab 29). His decision was qualified to the following extent:

> Although the claim is certified and refers to the total questioned amount of $618,317.00, that amount represents the total amount of questioned costs for FY 2005 and FY 2006, not the amount that is allocable to the test contract. In fact, it is currently impossible to determine a sum certain that is allocable to the test contract in FY 2005 or FY 2006 until the indirect rates for those years are settled/determined. Furthermore, the rates cannot be determined until the allowability of the letter of credit costs is determined. Consequently, I am not accepting the certified claim as a claim for a sum certain. Rather, I am treating the claim as a claim requesting an interpretation of contract terms – specifically, whether the letter of credit costs are allowable under the FAR Cost Principles as incorporated into contracts according to Allowable Cost and Payment clause, FAR 52.216-7.

(R4, tab 29 at 1, 2) The amount SRI claimed and the amount DCAA questioned—$618,317[9]—included SRI's LOC costs for FY 05 ($338,133) and FY 06 ($271,488) plus $8,697 for a 2005 dinner (R4, tab 25, attach. 1). Thus, only $609,621 relates to SRI's LOC costs allocable to all SRI government contracts for FY 05 and FY 06. DCAA has not taken the position that the $609,621 amount is not allocable to SRI's government contracts, only that the costs are unallowable. We do not view the amount allocable to the "test" contract and the fact that amount could not be determined pending settlement of a final rate consequential or affecting our jurisdiction in this appeal.

49. The decision rejected SRI's argument that "the cost of obtaining the *letter of credit* should be considered part of SRI's general costs of required bonding" allowable under FAR 31.205-4. ACO Studley rejected SRI's argument that "the costs of establishing the *letter of credit*" an allowable under FAR 31.205-27(a)(3) because "the financing at issue here is...in support of SRI's 'long-term' capital development plan" and "[a] guarantee held in place during the duration of the bond obligation by an annual fee" would, in any case, be "an associated cost of raising long term capital." (*Id.* at 3, 4) (Emphasis in original)

50. SRI timely appealed the ACO decision on 17 March 2008. The Board docketed the appeal as ASBCA No. 56353. By letter dated 18 June 2008, government

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[9] DCAA's calculation is actually $1 off. $338,133 + $271,488 + $8,697 equals $618,318.

counsel advised the Board that he wanted to clarify the government's position and that he had notified SRI "the [claimed] costs are unallowable but not expressly unallowable" and "there is no CAS 405 noncompliance" (ex. A-47). FAR 31.001 defines "Expressly unallowable cost" to mean "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."

## DECISION

Because SRI used a "test" contract—Contract No. HR0011-06-C-0023—to bring this appeal, the government contends the claimed amount of $618,317 was not a sum certain reflecting the amount SRI claimed under the "test" contract (gov't br. at 32). The government contends therefore that our jurisdiction is limited to "the contract interpretation question on the allowability of the letter of credit costs" (*id.* at 33).[10] The government apparently does not understand the purpose for citing the "test" contract. The claimed amount was not based on the "test" contract alone. SRI used the "test" contract as a representative or sample contract to bring this appeal. SRI's claim plainly states a sum certain (finding 45). The government itself admits "SRI claimed $618,317 for costs incurred in maintaining a [LOC] and hosting an employee award dinner"[11] (gov't br. at 30). Accordingly, our jurisdiction is not limited to an interpretation "on the allowability of the letter of credit costs" (gov't br. at 33).

When the government disallows costs on the basis of a FAR cost principle, the burden is on the government to prove that the costs are unallowable. *Lockheed Martin Western Development Laboratories*, ASBCA No. 51452, 02-1 BCA ¶ 31,803 at 157,102; *Johnson Controls World Services, Inc.*, ASBCA Nos. 46674, 47296, 96-2 BCA ¶ 28,464 at 142,166 (where there is no dispute over reasonableness or allocability of incurred costs charged to a contract, the government bears the burden of proving that the costs are of the type made specifically unallowable by regulation or contract provision).

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[10] A contractor's money claim does not qualify as a Contract Disputes Act (CDA) claim unless it is submitted to the CO in a sum certain. *Essex Electro Engineers, Inc. v. United States*, 960 F.2d 1576, 1581-82 (Fed. Cir. 1992), *cert. denied*, 506 U.S. 953 (1992); *Lockheed Martin Aircraft Center*, ASBCA No. 55164, 07-1 BCA ¶ 33,472 at 165,933.

[11] SRI claimed $338,133 for the LOC cost it incurred in FY 05 and $271,488 it incurred in FY 06 (finding 45). The disputed costs for the employee award dinner, making up the balance of the $618,317 claimed, were resolved (app. reply br. at 3 n.2).

FAR 31.205-20 Is Inapplicable Because SRI's Financing is Treated Not as Long-Term Liabilities But as a Part of its Short-Term Liabilities

In disallowing SRI's LOC costs for FYs 05 and 06, the government relies solely on FAR 31.205-20. In pertinent part, this cost principle disallows "costs of financing...capital." "Capital" is defined to mean "net worth plus long-term liabilities." In accounting for the debt incurred, SRI has treated all of the $25 million worth of bond debt, which included $23,720,000 in Series 2003A VRDR Bonds (maturing 1 September 2028) and $1,280,000 in Series 2003B VRDR Bonds (maturing 1 September 2006) as a part of its "Current liabilities."[12] As shown in SRI's Consolidated Financial Statements and Consolidating Information for the period ending 27 December 2003, prepared by its outside auditors, PricewaterhouseCoopers LLP, SRI accounted for all $25 million as "Current installments of long-term debt" under "Current liabilities." As SRI's former controller explained, the bonds could be put back on SRI and SRI could be made to pay for them at any time. According to SRI's outside auditors, this treatment is consistent with Generally Accepted Accounting Principles (GAAP) and is required by EITF (Emerging Issue Task Force), Topic No. D-61.[13] (Finding 19) Thus, even though the Series A Bonds have a maturity date of 2028, from an accounting standpoint, SRI's financing of its renovation project has actually been, and is, raising capital in the short-term, not long-term.

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[12] "Current liabilities" is an accounting term of art which means short-term debts due in less than one year. Current liabilities are what a company currently owes to its suppliers and creditors, for example "accounts payable," "accrued expenses," (*e.g.*, marketing and distribution expenses that are billed on a set schedule and have not yet come due), income tax payable, short-term notes payable, and the portion of long-term debt that may come due in a given year. *Greystone Community Reinvestment v. Berean Capital*, 638 F.Supp.2d 278, 282 n.4 (D. Conn. 2009).

[13] EITF Topic No. D-61, "Classification by the Issuer of Redeemable Instruments That Are Subject to Remarketing Agreements," discusses the appropriate balance sheet classification of debt in the circumstances in which (1) the debt has a long-term maturity (for example, 30-40 years), (2) the debt holder may redeem or put the bond on short notice (7-30 days), (3) the debtor has a remarketing agreement that states that the agent will make its best effort to remarket the bond when redeemed, and (4) the debt is secured by a short-term letter of credit that provides protection to the debt holder in the event that the redeemed debt cannot be remarketed. *See Tax-Exempt Bonds – Accounting and Auditing Considerations in the Current Environment*, May 2008, authored by an ad hoc group of AICPA members, www.aicpa.org/InterestAreas/AccountingAndAuditing/ARS_article14.pdf.

The government has not challenged as inappropriate SRI's treatment of the full amount of its long-term bond debt as a part of its "Current liabilities." It has not explained why FAR 31.205-20 disallowing the cost of financing—which specifically defines capital as "long-term liabilities"—is applicable in view of that treatment. We conclude that FAR 31.205-20 is inapplicable to disallow the fees SRI paid for the LOC required to secure its long-term bond debt in the short-term (one year).

The LOC Costs are Allowable under FAR 31.205-27(a)(3) as Administrative Costs of Short-Term Borrowings for Working Capital

SRI contends that "even if the Letter of Credit were considered a mechanism for financing or refinancing capital, the costs of maintaining the Letter of Credit would still be allowable under FAR 31.205-27(a)(3), as administrative costs of *short-term borrowings* for working capital" (app. br. at 29-30).

As in the case of FAR 31.205-20, FAR 31.205-27(a)(3) disallows the costs of "raising capital." Also, as in the case of FAR 31.205-20, FAR 31.205-27(a)(3) defines capital to mean "net worth plus long-term liabilities." FAR 31.205-27(a)(3), however, excludes from its coverage "administrative costs of short-term borrowings for working capital."

SRI's LOC was issued as a subfeature of its $30 million line of credit from Wells Fargo (findings 9, 11). SRI uses its Wells Fargo line of credit to meet maturing obligations, unusual cash demand and other working capital requirements (finding 8). Borrowing from the Wells Fargo line of credit reduces the amount available for further borrowing (finding 16). The Wells Fargo line of credit was and is available to SRI should there be a draw on the LOC. A draw on the LOC is treated by Wells Fargo as if it were a draw on the line of credit available under the SRI/Wells Fargo Credit Agreement and triggers the terms of SRI's Reimbursement Agreement with Wells Fargo. Should the LOC be drawn upon, the draw will bear a separate interest cost above and beyond the cost of maintaining the LOC. (Findings 12, 16)

After the initial financing was put in place in 2003, SRI maintained the LOC to provide investors short-term liquidity for the payment of debt service and the tender of bonds over a one-year period rather than providing a guarantee of long-term debt over the life of the debt (finding 30). For making the line of credit available in the event a bond tender occurred or a draw became necessary, Wells Fargo charged a fee or administrative cost (finding 13). This bank fee was charged on an annual basis, and was charged for FYs 05 and 06. In other words, because SRI carries the full amount of its outstanding VRDR Bond debt each year as one of its "Current liabilities," capital is not being financed in the long-term, and hence there is no financing of any "long-term liabilities." SRI's ability to meet its obligations in the short-term is backed by the Wells Fargo LOC made available through the payment of an annual fee. Thus, SRI's claimed LOC costs—

the annual fees charged—qualify as administrative costs of short-term borrowing (from the line of credit) for working capital allowable under FAR 31.205-27(a)(3).[14]

In short, although SRI's VRDR Bond debt is long-term (25 years), the financing of that debt is short-term: SRI's Consolidated Financial Statements treat the full amount of the debt as one of its "Current liabilities," payable within 12 months. This short-term or current liability is collateralized or guaranteed by a bank LOC. This LOC, issued by Wells Fargo in FYs 05 and 06, is also short-term, being renewable each year.

The administrative costs of short-term borrowing for working capital are specifically made allowable under FAR 31.205-27(a)(3). In the context of this cost principle, the Wells Fargo LOC backed by a $30 million line of credit was the working capital SRI borrowed for the purpose of collateralizing or guaranteeing its ability to pay off the full amount of the bond debt in the short-term. The bank fees SRI paid in FYs 05 and 06 are the administrative costs of borrowing. We conclude the costs are allowable under FAR 31.205-27(a)(3).

Maintaining a LOC is Different in Kind from the Typical Costs of Financing

Even if providing an initial credit facility in the form of a LOC could be considered a cost of financing, the government's argument to the effect that the LOC is long-term (finding 41) ignores the distinction between putting financing in place versus providing short-term assurance of repayment obligations and liquidity support in subsequent years after financing was in place and the VRDR Bonds were issued.

As SRI's expert explained, costs of financing are typically fixed and upfront. Since the LOC costs are neither fixed (*see* finding 13) nor upfront and could vary from year to year, they differ in kind from the typical costs of financing. Thus, maintaining a LOC or other credit facility "over time" is different in kind from the costs of financing which are "paid upfront to put the financing structure in place." (Findings 28, 29) The government has offered no contrary evidence.

Having concluded the LOC costs are allowable under FAR 31.205-27(a)(3), we need not consider whether SRI's LOC costs would be allowable as bonding costs under FAR 31.205-4.

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[14] SRI's pre-filed expert testimony states "the Contracting Officer has previously allowed SRI's claim for reimbursement of the administrative costs related to unused balances on the line of credit" (ex. A-39 at 6). The government acknowledges "SRI accurately states that the ACO determined the line of credit costs were allowable under FAR 31.205-27(a)(3)" (gov't reply br. at 40).

Has SRI Proved that Its LOC Costs Incurred for FYs 05 and 06 are Otherwise Allowable?

FAR 31.201-2 provides that a cost is allowable only when the cost complies with all of the following requirements: "(1) Reasonableness. (2) Allocability. (3) Standards promulgated by the CAS Board, if applicable, generally accepted accounting principles and practices appropriate to the circumstances. (4) Terms of the contract. (5) Any limitations set forth in this subpart." The government has not contended that the amounts claimed for FYs 05 and 06 are not allocable to the government contracts existing in those years. The government has conceded that SRI's claim was not in violation of CAS 405 (finding 50). The government has not contended that the claimed costs are contrary to any contract terms. To the extent the government contends the claimed costs are unallowable under FAR 31.205-20, we have reached a contrary conclusion for reasons stated above. This leaves the question of whether the costs claimed are "reasonable."

DCAA has chosen not to look into the reasonableness of the claimed costs (finding 32). Based on his review of SRI's financial condition in FY 03 through the period covered by the most recently available audited financial statement (31 December 2007), SRI's expert found the charges to SRI by Wells Fargo for FYs 05 and 06 are "comparable to what similarly circumstanced organizations...could expect to pay" (finding 27). The government did not challenge this testimony.[15] We conclude the LOC costs (fee) SRI incurred for FYs 05 and 06 were reasonable under the circumstances.

We conclude that the LOC costs SRI incurred in FYs 05 and 06 are allowable for the following reasons. First, FAR 31.205-20 is inapplicable to disallow the LOC costs because SRI treated the full amount of its long-term VRDR Bond debt as a part of its "Current liabilities" not as its "long-term liabilities," and the government has failed to show this treatment is inappropriate. Second, paying an annual fee (the LOC costs) for a one-year bank LOC for the purpose of collateralizing or guaranteeing its ability to repay the full amount of its long-term VRDR Bond debt in the short-term (one year) qualifies as administrative costs for short-term borrowing for working capital allowable under FAR 31.205-27(a)(3). Third, the LOC costs in dispute are not fixed and upfront costs and are therefore different in kind from the typical costs of financing.

The government has failed to carry its burden in proving that SRI's LOC costs are of the type made specifically unallowable by regulation or contract provision. Because SRI's claimed costs meet the requirements for allowability under FAR 31.205-27(a)(3)

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[15] SRI's written expert testimony was pre-filed on 31 March 2009, over a month before the hearing in May 2009. SRI's expert testified at the hearing and was made available for cross-examination. The government chose not to cross-examine. (Tr. 1/125)

and FAR 31.201-2, we hold that SRI's LOC costs (bank fees) incurred in FYs 05 and 06 ($609,621 ($338,133 + $271,488)) are allowable.

Accordingly, this appeal is sustained in the amount of $609,621 with interest pursuant to 41 U.S.C. § 611 running from the putative receipt date of 21 September 2007.

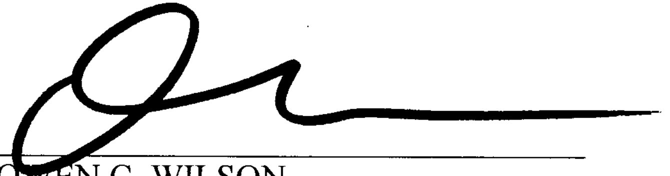
Dated: 18 February 2011

PETER D. TING
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

CAROL N. PARK-CONROY
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

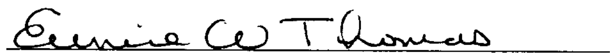


OWEN C. WILSON
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

I concur



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. 56353, Appeal of SRI International, rendered in conformance with the Board's Charter.

Dated:

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