ARE UNPAID PROMISSSORY NOTES "INCURRED COSTS?"

In an interesting case, the Armed Services Board of Contract Appeals ("ASBCA") was asked to rule on a government claim seeking to deny payment to Cellular Materials International, Inc. for $206,416 in general and administrative ("G&A") costs for promissory notes given to the contractor's consultant, Mr. Haydn Wadley. *Cellular Mat'ls Int'l, Inc.*, ASBCA No. 61408, Dec. 28, 2021. The relevant contracts were awarded by the Defense Advance Research Project Agency, provided for payment of cost plus a fixed fee, and included FAR 52.216-7, Allowable Cost and Payment.

Cellular submitted final indirect cost proposals for 2010-14, and after being advised by the Defense Audit Agency ("DCAA") that its proposals were "low risk" and would not be audited, Cellular revised its indirect cost proposals to add $425,000 ($85,000 per year in promissory notes) in G&A costs for consultant Wadley. Mr. Wadley was Cellular's largest shareholder, owning 39% of the shares.

DCAA performed an audit and questioned all $425,000 in consultant costs because Cellular could not provide support to include sufficient detail on time expended by the consultant and nature of the actual services. The Contracting Officer issued a final decision, unilaterally establishing final indirect cost rates and asserting a demand for payment of $425,000 for Mr. Wadley, stating that evidence of the nature and scope of the service was inadequate. Consumers appealed, and produced 31 canceled checks, about which the government agreed that $191,249 were allowable costs for payments made to Mr. Wadley. The remaining amount was in dispute, and in an affidavit, Cellular's CEO and Mr. Wadley stated that the promissory notes did not provide for interim payments, or contain a date for repayment, other than that they were payable five days after demand. Mr. Wadley did this due to "his belief in the future potential of Cellular," and had not demanded payment of the disputed amount.

FAR 52.216-7 provides:

> (b) reimbursing costs.
> (1) For the purpose of reimbursing allowable costs…,the term costs includes only—
>
> > (i) Those recorded costs that, at the time of the request for reimbursement, the Contractor has paid by cash, check or other form of actual payment for items or services purchased directly for the contract;
> >
> > (ii) When the contractor is not delinquent in payment costs of contract performance in the ordinary course of business, costs incurred, but not necessarily paid, for –
> >
> > [](F) Properly allocable and allowable indirect costs, as shown in the records maintained by the Contractor for purposes of obtaining reimbursement under Government contracts

FAR 31.001, also relevant here, provides that "actual costs means…amounts determined on the basis of costs incurred, as distinguished from forecasted costs…" The FAR does not provide further guidance as to when a cost may be considered to have been incurred and when it is merely forecasted.

The Board ruled in favor of the government and against Cellular. The Board's review of case law indicated that determining when a cost is incurred requires an intensive examination of the facts. The Board noted that it was undisputed that more than 9 years after execution of the first promissory note, Consultant Wadley had not demanded payment. The Board considered the question of when a cost is "incurred" and concluded that a future expense must be "more than merely likely or probable" to be an incurred cost. In this situation, the consultant had not demanded payment—a demand which is required before payment is due. Mr. Wadley had never demanded payment, and Cellular's liability to pay had not attached because Mr. Wadley had not taken the action to trigger the obligation. The Board concluded that the consulting costs were best described as "forecasted" costs, but not incurred costs.

Takeaway. If a contractor seeks to identify a cost as "incurred" it will need to show that the contractor has an actual obligation, and any preconditions to that cost must have been met. In this case, there has to be a demand for payment.

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