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# 29TH ANNUAL OUNCE OF PREVENTION SEMINAR

## Weathering the Rough Seas of Regulation



OOPS2013

# Costs

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# DCAA's Continuing Troubles

- DCAA criticized for audit quality issues
  - March 7, 2013 DoD IG Report found audit quality issues through FY 2010
  - E.g., of the sample surveyed, 0 met government auditing communication standards, 8% met quality standards, 22% met evidence standards, 26% met professional judgment standards
- Significant delays in incurred cost audits
  - DCAA's 2012 report to Congress revealed that it completed 349 incurred cost audits in 2011 and had an audit backlog of almost 25,000 incurred cost proposals (do the math – 714 year backlog)
  - While DCAA has implemented steps to address the backlog – dedicated audit teams, multiple-year audits, and low risk sampling – it is too big to be resolved quickly
  - Backlog results in document retention issues and potential Statute of Limitations problems for the government

# Statute of Limitations for Incurred Cost Claims

- The Contract Disputes Act, 41 U.S.C. §§ 7101-7109, sets forth certain prerequisites for the exercise of jurisdiction over claims, including 6-year SOL
- Claims submitted more than six years after accrual are not valid and cognizable under the CDA
- CDA does not define the term "accrual." The Board (and the Court) rely on the Federal Acquisition Regulation 33.201 definition:
- … the date when all events, which fix the alleged liability of either the Government or the contractor and permit the assertion of the claim, were known or should have been known ...
- "Contracting parties cannot establish a statute of limitations longer than that set forth in the Contract Disputes Act, where the Government is a party … [th]us, parties may set a shorter limitations period, but not a longer one." - Judge Robert Hodges, *Raytheon Co. v. United States*, No. 09-306C (April 2, 2012)
- Key takeaway: once a contracting party is aware of the basis for its claim, it is "on the clock" and should not rely on discussions or agreements with the other party to resolve a dispute or toll the statute of limitations, at the expense of preserving its claim.

# Statute of Limitations

- *Sikorsky Aircraft Corp. v. United States*, COFC Nos. 09-844C, 10-741C (July 2012)
  - Court of Federal Claims found there to be triable issues of fact with regard to contractor's SOL defense as to when the government's claim accrued, i.e., when the government "knew or should have known" of alleged CAS 418 noncompliance.
  - This case raises very interesting issue of who in the government needs to have notice of a claim for it to accrue -- a contracting officer or "other responsible actors" such as DCAA auditors?
  - FN 12: “The parties strenuously dispute who in the government must have notice of a claim for it to accrue. The government contends that, for a CAS noncompliance claim to accrue, the contracting officer must have notice. Sikorsky contends that accrual may occur when other responsible actors, purportedly including DCAA auditors, know of the claim. At this early juncture it is unnecessary to decide the question.”
  - Subsequent dispute about assertion of deliberative process privilege.

# Statute of Limitations

- *Appeal of Raytheon Co.*, ASBCA Nos. 57576, 57679 (December 17, 2012)
  - Raytheon appealed Government's claims to recover increased costs paid under government contracts, plus penalties and interest, for CAS and FAR violations relating to incentive compensation plans.
  - Good decision for contractors, though somewhat unclear.
  - DCAA audited incentive compensation plans in prior years and accepted the costs. DCAA subsequently changed its mind about what was allowable, and Raytheon argued that the final decision disallowing costs in ALL subsequent years was time-barred because the final decision was more than 6 years after initial audit report.
  - Board found that the Government's failure to bring a claim within 6 years of the audit -- in the year where there was an actual audit -- was time-barred.
  - Board did not find that all Government claims are barred if not brought within 6 years of the incurred cost submission, only that in the circumstances of thecase, where the plans at issue had been audited and accepted in a prior year, the CDA "should have known" standard began to run as to the costs of those plans when the claims including those plans were submitted.

# Statute of Limitations

- *Appeal of Raytheon Co.*, ASBCA No. 58011 (January 28, 2013)
  - Raytheon appealed COFD asserting $17 million claim arising from alleged CAS violation.
  - Here, ASBCA held that the statute began to run in 1999, when a DCMA price analyst had all the information the government needed to recognize that it had a claim for an alleged CAS violation, even though the responsible CO may not have been aware of the claim until an audit report was issued in 2006.
  - In the absence of any evidence of trickery or concealment, the government "should have known" that it had a claim based on the contractor's 1999 cost proposal that appeared to be inconsistent with its disclosed accounting practice, and that the government could not unilaterally extend the statute of limitations by failing to perform an audit that put the CO on actual notice that there might be a claim.
  - Government's claim found to be untimely, and therefore barred by the SOL. Significant case in the evolving interpretation of the CDA statute of limitations.

# Implications of SOL Decisions for Incurred Cost Claims

- What happens when an Government decision disallowing costs is time-barred?
- Are all costs included in the contractor claim allowable, regardless how clearly unallowable they may be (alcohol, charitable contributions, lobbying, etc.)?
- If a CAS noncompliance is not caught in year one, how long is the Government barred from disallowing the increased costs resulting from the noncompliance in subsequent years?

# Access to Internal Audit Reports

- December 2011 -- GAO report recommended that DCAA establish a procedure for obtaining internal audit reports from contractors to improve the dfficiency of audit planning and execution.
- August 2012 – DCAA issued guidance requiring audit offices at major contractor locations to establish a process for obtaining and monitoring DCAA's access to and use of internal audit reports and work papers, when needed.
- January 2013 – Congress directed DCAA to revise its guidance on access to contractor internal audit reports.
  - DCAA must document its rationale for requesting internal audit reports
  - DCAA must document contractor's rationale if access is denied
  - DCAA cannot use internal audits as sole basis to disapprove a contractors business system

# Business Systems Reviews

- No decisions, so far.
- Anecdotal evidence suggests that there have been a number of inadequacy findings as to accounting systems, at least, but apparently in circumstances where the contractor decided that disputing the findings was imprudent.
- In at least one case, DCMA forced the contractor to make changes based on a threat to find the system inadequate, very arguably where such a finding was unjustified.

# Developments in Cost Law: Executive Compensation Reviews

- *Appeal of Metron, Inc.*, ASBCA Nos. 56624 et al. (2012)
  - Company's comp for its executives set based on survey data
  - DCAA questioned executive compensation included in indirect rate proposals for two years
  - Government's expert agreed with Metron's that DCAA's methodology contained numerous flaws
  - Board found that Metron's comp plan set reasonable compensation levels based on achievement of pre-established management goals and metrics and that Metron had followed its plan
  - DCAA's extrapolations and adjustments of the compensation survey data were unmerited; DCAA improperly classified a number of the executives as non-executives; DCAA used unreliable surveys

# Developments in Cost Law: Legal Fees and REA Preparation Costs

- *Tip Top Construction, Inc. v. Donahue*, CAFC No. 2011-1509 (Sept. 19, 2012)
  - Federal Circuit reversed PSBCA, and held that attorney (and consultant) costs arising out of negotiations over the price of changed work were recoverable under the Changes clause.
  - PSBCA had held that work "solely directed at … maximizing [Tip Top's] recovery" did not constitute recoverable contract administration costs.
  - Federal Circuit rejected this view:
    - Simply because the negotiations related to the price of the change does not serve to remove the associated costs from the realm of negotiation and genuine contract administration costs. Consideration of price is a legitimate part of the change order process.
  - Bottom line: price adjustment held to be a part of the change order process.
  - Almost all litigation about these issues arises in construction cases, where contractors often classify costs that would be indirect in other industries as direct project costs.

# Developments in Cost Law: Legal Fees and REA Preparation Costs

- *Appeal of F. Versar, Inc.*, ASBCA No. 56857 (April 23, 2012)
  - Appeal arising out of a task order for HVAC and other work at a DoD elementary school in Fort Jackson, South Carolina.
  - Board held, probably wrongly, that costs incurred preparing REA were not allowable because the REA was prepared by the contractor's employees rather than by a professional / consultant (note that REA preparation was a very small part of the contractor claim and may not have been the subject of extensive briefing).
  - "REA preparation costs, costs of professional and consultant services incurred for the genuine purpose of materially furthering a negotiation process, and rendered by persons who are not officers or employees of the contractor, are normally contract administration costs allowable under FAR 31.205-33 ... However, here, appellant's project manager … submitted the REA, the preparation costs were primarily effort by him and appellant's off-site QA/QC manager, and there is no evidence that appellant paid for any consultant or professional services in connection with the REA's preparation … Thus, the claimed … REA preparation costs [are]not allowable."
  - Board also disallowed costs incurred preparing an REA that was never filed (but "evolved" into a certified claim) on the grounds that it considered the work part of the contractor's prosecution of a CDA claim.

# Developments in Cost Law: Cost Reasonableness

- *KBR v. U.S.*, 103 Fed. Cl. 714 (2012)
  - Using DCAA Form 1, government suspended $41.1 million associated with a cost reimbursement contract to build a dining facility in Iraq.
  - Government alleged that KBR caused higher-than-necessary subcontract costs because it did not conduct reasonable negotiations with its subcontractor.
    - E.g., the KBR negotiator had not followed standard KBR negotiation policies and procedures, had unreasonable negotiation objectives, included errors and deficiencies in the price negotiation memorandum.
  - Based on evidence of reasonableness presented at trial, Court concluded that KBR demonstrated the reasonableness of approximately ¼ of the suspended costs, and thus was entitled to reimbursement of $11.5 million.

# Developments in Cost Law: Cost Reasonableness

- *KBR v. U.S.*, 107 Fed. Cl. 16 (2012)
  - Using DCAA Form 1, government disallowed $12.5 million associated with a cost reimbursement contract to build a dining facility in Iraq.
  - KBR argued for an alternative standard for reasonableness; Government argued – and the Court agreed – that FAR 31.201-3 alone provides the standard for determining reasonableness of costs.
  - The Court found that KBR failed to demonstrate that another dining facility subcontractor's costs were reasonable because KBR's subcontract administrator failed to adequately negotiate the price, his price negotiation memorandum was flawed, and KBR failed to provide a price basis for comparison.
  - KBR entitled to $4.2 million of the disputed $12.5 million, reflecting, in part, KBR's ability to demonstrate that reasonableness using an after-the-fact price reasonableness analysis conduced by an expert.

# Developments in Cost Law: Cost Reasonableness

- *Appeal of Kellogg Brown & R*oot, ASBCA No. 56358 (2012)
  - KBR appealed the denial of its claim for $19.6 million for private security services for one of its dining facility subcontractors.
  - While the ASBCA found that there was no prohibition under the prime contract against the use of armed private security companies without express permission of the theater commander, the Board found genuine issues of material fact about whether, at the time of subcontract award, a component of the fixed prices for the security companies was reasonable as to both the need for and amount of that component.
  - The Board rejected KBR's argument that the Government has no contractual right to disallow a particular component of a subcontract fixed price, but can consider only the allowability of the total subcontract price.

# Developments in Cost Law: CAS Compliance

- *Sikorsky Aircraft Corp. v. United States*, COFC Nos. 09-844C & 10-741C (March 2013)
  - Sikorsky failed to demonstrate that the Government had actual or constructive knowledge of a potential claim under CAS 418 (court had declined to grant summary judgment on this issue in July 2012).
  - But, Government unable to demonstrate Sikorsky's noncompliance with the CAS 418.
  - Court of Federal Claims denied the Government's $80 million claim for alleged CAS 418 violation.

# DOE Contractor Legal Costs

- DOE has just issued a final rule addressing its handling and reimbursement of contractor legal costs (78 Fed. Reg. 25795, May 3, 2013)
  - Applicable to management and operating ("M&O") contractors; cost reimbursement contractors with contracts over $100 million; other contractors with contracts over $100 million that include cost reimbursable elements of over $10 million.
  - DOE can direct the contractor to initiate litigation against third parties, despite possible ethical problems for the contractor's counsel and the fact that the resulting legal costs will be found allowable.
  - Requires DOE approval of legal settlements involving contractor payments of $25,000 or more.
    - DOE approval also required for subcontractor and third party insurance settlement payments.
  - Limits reimbursement of costs for retaining legal counsel.
  - Compliance with the rule does not guarantee that costs will be allowable; allowability rules in FAR and DEARS will still apply.

# "Obamacare" Cost Issues

- FAR 31.205-41 provides that all excise taxes on employee benefits that are listed in Subchapter D, Chapter 43, of the Internal Revenue Code are expressly unallowable on Government contracts
- All of the excise taxes imposed by the Affordable Care Act are included in that subchapter, including
  - Excise tax for failing to offer insurance to some employees and
  - Excise tax on offering "rich" plans to employees
  - (See Sections 4980H and 4980I of the Code)

# Questions?

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