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CASE STUDY – AUDITOR WANTS TO QUESTION DEFERRED COMPENSATION EXPENSE

(*Editor's Note. Though our subscriber base primarily includes a wide variety of government contractors, several government audit agencies also subscribe. Occasionally we receive questions from them and we thought the following dialogue we had with the head of a state agency audit group that audits contractors for programs receiving federal funds would be instructive. We hope the following will be of interest because it (1) illuminates the mind-set of a very bright auditor and (2) addresses several interesting issues such as deferred compensation, senior executive limits and relevance of cost accounting standards to non-CAS covered contractors. The contractor and dollar amounts are disguised.*)

The contract being audited is with a state transportation agency financed with federal funds that is cost reimbursable with a downward adjustment only to indirect rates after the contractor's incurred cost proposal is audited. The contractor is a small business that provides various services and the agency is auditing an incurred cost proposal that includes $175,000 in its overhead pool for "deferred compensation." The auditor is highly skeptical of the cost, believing it is simply a fictional amount inserted to increase the contractor's overhead rate since otherwise there would be a downward adjustment to its overhead rates since its overhead rate would be significantly lower than that billed during the year. The auditor has said "it would be against public policy" to allow the cost and has put forth various grounds to challenge the cost and has asked us for our feedback.

Auditor's Positions

During our conversations the auditor expressed his intent to disallow the costs and put forth various reasons to base his disallowance:

1. The cost is unlikely to be paid since the company, at this time, seems unable to afford a deferred amount of $175,000.

2. The deferred compensation is not tax deductible and hence is not allowable.

3. There is no distinct plan for the compensation.

4. The amount does not meet the conditions of CAS 415, Deferred compensation, namely (a) the amount to be paid in the future is not a bona fide obligation because payment can be unilaterally avoided by the contractor and (b) the measurement of the future payment is not clearly made. We also discussed whether CAS 415 is relevant to the company since its small business status exempts it from CAS.

5. The deferred amount is really a form of compensation and the owner is in essence saying my time is worth $156 dollars per hour and since the owner bills the government directly for all of its time, the deferral should be considered a direct cost, not indirect. The auditor indicates that charging the deferred compensation as direct labor would have the effect of lowering, not increasing, the overhead rate (e.g. a higher direct labor base would make the denominator higher).

6. Since the owner's raw labor rate charged on its contracts is approximately $72 dollars per hour, that implies a salary of $150,000. That salary plus the deferred compensation would appear to be excessive even though it is below the senior executive compensation cap set by the Office of Federal Procurement Policy (OFPP).

7. Much smaller amounts of deferred compensation were incurred in prior years making the proposed amount in the current year an unreasonable increase.

Our Response

1. *Can't afford it.* The financial condition of the company cannot affect the allowability of the cost. There are instances, for example, where companies in bankruptcy have successfully shown they are entitled to similar costs.

2. *The deferred compensation is not tax deductible.* The contractor's accountant countered the auditor, stating that for tax purposes, the payment would be

deductible when paid so that does not mean it is unallowable. For contract costing purposes, deferred compensation is recognized when it is incurred while for tax purposes it is recognized when paid so the deferred compensation is allowable because it will presumably be deductible when paid.

3. *No plan exists*. The contractor countered this assertion indicating a plan did exist. It provided documents describing the deferred compensation plan and showed the auditor minutes of the Board of Directors meeting that approved the amount of deferred compensation.

4. *Relevance of CAS 415*. Yes and no. The auditor told us that FAR 31.201-2(b) generally states that certain cost principles do incorporate the measurement, assignment and allocability rules of selected cost accounting standards. FAR 31.205(k)(2) further states that CAS 415 will be one of the standards where FAR incorporates its rules where it states "costs of deferred awards shall be measured, allocated and accounted for in compliance with the provisions of 48 CFR 9904.415, Accounting for the Cost of Deferred Compensation." However, as we pointed out, FAR 31.201-2(b) further states only those sections of the CAS that address "measurement, assignment and allocability" rules will apply, indicating that other sections of the relevant cost accounting standards need not apply. The FAR section states "Only those CAS or portions of standards specifically made applicable by the cost principles in this subpart are mandatory unless the contract is CAS-covered." So, whether the CAS sections addressing the nature and conditions for bona fide obligations applies to the contractor is debatable – on the one hand, obligation considerations are not strictly part of the "measurement, assignment and allocability" rules of the standard that applies while on the other hand, it would seem that the discussion of obligation in CAS 415 is a reasonable basis for determining whether an actual expense is incurred and hence is allowable whether or not a contract is CAS covered.

5. *Compliance with CAS 415.* The standard contains numerous provisions and we will save a more detailed discussion for a later date. Rather, we will only briefly address the relevant sections.

(a) CAS 415-40(a) requires that the contractor "incurs an obligation to compensate the employee." If such an obligation is not incurred before payment, then the amount of deferred compensation will be the amount that is paid and the period assigned for the cost will be the period it is paid.

The contractor's provision of documentation of the deferred compensation plan and minutes of its board meeting should provide sufficient documentation that an obligation is intended. You would likely need to produce other evidence indicating the obligation is not intended.

(b) CAS 415-50(a) (1-6) lists six conditions for an obligation to be deemed to occur where the most relevant condition is section (1) that provides there is a requirement to make the future payment(s) which the contractor cannot unilaterally avoid.

Though it is probably true the owner could unilaterally avoid payment, similar assertions could be made against all closely held companies. If this possibility that the closely-held nature of the contractor allows it to unilaterally avoid payment were put forth as a basis to question the deferred compensation, then all such companies would not be entitled to deferred compensation, a result that would not stand up. There would probably need to be additional evidence that there is no intention to honor the obligation.

(c) CAS 415-40(b) provides that the amount of the deferred compensation will be the present value of the future benefits to be paid by the contractor.

You indicated the contractor said the deferred compensation will be paid "sometime in the future, perhaps when the company is sold." This indicates that neither a future payment was established nor was it discounted to the present period. This would seem to violate the "measurement, assignment and allocability" provisions of CAS 415.

6. *The deferred compensation should be considered direct labor*. It is true that eliminating the $175,000 deferral from overhead and adding it to direct labor base would decrease the overhead rate the contractor can apply. However, such a move would substantially increase the direct labor rate applicable to the contract. As long as all *direct* costs are reimbursable where an upward adjustment is not prohibited, your agency would be vulnerable to paying the difference between what was billed (based on a $150,000 salary) and what should have been billed ($150,000 plus the $175,000).

7. *Compensation was excessive*. When executive compensation is evaluated for reasonableness, compensation includes salary, bonuses, defined-benefit contributions for pensions and deferred compensation. You indicated that the executive compensation appeared high but was lower than the senior executive salary cap set by the Office of Federal

Procurement Policy. However, it is long established that this OFPP cap does not apply to all companies – it is based on a survey of large publicly traded companies whereas lower thresholds should apply to smaller companies. You indicate the owner receives approximately $150,000 in salary and bonus plus the $175,000 deferred compensation for a total compensation of $325,000. True, this is below the 2005 OFPP cap of $473,318 but lower thresholds commonly apply to smaller companies. You may want to compare the total compensation paid the contractor to compensation survey results of comparable companies and use that figure plus 10% as the threshold for reasonable compensation, questioning the difference.

8. *The current year amount is an unreasonable increase*. The fact that the current proposed amount varies significantly from prior year amounts does indicate it is an unreasonable increase. In order to prove the amount is reasonable, the burden should fall on the contractor to justify the increase.

In conclusion, if you are determined to disallow the deferred compensation, you would best assert that (1) it was not computed in accordance with FAR and CAS requirements (2) the total amount of compensation is unreasonable and (3) the huge increase in the current year is an unreasonable increase over prior years. This will likely result in allowing some but not all of the amount.

REVIEW OF PROCUREMENT AND COSTING ISSUES IN 2005

(Editor's Note. Since the practical meaning of most regulations are what appeals boards, courts and the Comptroller General say they are, we are continuing our practice of summarizing some of the significant decisions last year affecting grounds for successful protests of award decisions, grounds and dollar entitlement for claims and terminations and selected cost issues. This article is based on the January 2006 issue of Briefing Papers written by Miki Shager, Counsel to the Department of Agriculture Board of Contract Appeals. We have referenced the cases in the event our readers want to study them.)

Protests of Award Decisions

♦ Interested Party

To have standing to protest a procurement, a protester must be an interested party – an actual or prospective offeror whose direct economic interest would be affected by the award. A protester is not considered an interested party if it would not have been in line for contract award if its protest is sustained (*Gold Cross Safety Corp., Comp. Gen. Dec. B-269099. Unless handled by a Court we will reference Comp. Gen. Decisions with only the numeric reference.)* For purposes of challenging a past performance evaluation a protester is not an interested party where the record shows another offeror would be in-line for award *(IAP World Services B-297084).* A company that does not satisfy the small business size standard is not an interested party to a protest requesting the proposal not be set aside for small businesses *(Encompass Group LLC, B-296602).* However, a protester is an interested party even when it did not submit a proposal when the solicitation was ambiguous and internally inconsistent *(Space Exploration Technologies v US (68 Fed. Cl.).*

♦ Contract Formations

The GAO ruled that is it was not improper and was not prohibited from conducting an online reverse auction under simplified acquisition procedures where vendor prices were revealed allowing other bidders to offer lower prices (*MTB Group, B-295463)*. Cascading set-asides have come under considerable criticism lately where agencies set a procurement aside for one or more categories of small businesses (e.g. disadvantaged, HUBZone, women-owned) only after soliciting and receiving proposals from all categories of businesses making companies go through the expense of preparing proposals that may not even be considered if the company does not fit one of the categories of companies being considered. The Court did not rule on the legality of cascading set-asides noting however, the process has developed without the discipline of regulatory guidance (*Greenleaf Construction v. US, 67 Fed. Cl. 350*).

Though a competition is not required for award of task or delivery orders under Federal Supply Schedule contracts, if such a competition is held the GAO will review protests to ensure it is fair, reasonable and consistent with the solicitation. The GAO sustained a protest where the GSA issued a purchase order to a vendor whose quotation included non-Federal Supply Schedule items stating that an exemption from full and open competition for FSS contracts applies only if all goods and services included in the task or delivery order are included and priced on the schedule contract (*KEI Pearson, B-294226*). The Court also held that a mini-competition for a task and delivery order under a FSS contract does not give rise to required

debriefing requirements stipulated in FAR 15 because FAR Part 8.4, which controlled the acquisition, does not include debriefing requirements and the responses to the RFQ were not "competitive proposals" for which the statute requires debriefings (*Systems Plus v. US, 68 Fed. Cl. 206*).

♦ Unbalanced Bids

A bid is unbalanced if it is based on prices significantly less than cost for some work and significantly overstated for other work and there is some reason to doubt the bid will result in the lowest overall cost. An agency may accept an unbalanced bid provided it has concluded the pricing does not pose an unacceptable risk and the price to be paid is not likely to be unreasonably high (*HMR Tech. B-295968*). *Below-cost* pricing is not prohibited and the government cannot withhold an award from a responsible bidder merely because the low offer is or maybe below cost (*York Building Services, B-296498* and *PHT Corp. B-297313*). Another case ruled that a below cost price or an attempted buy-in does not make an offeror ineligible for award (*Ben-Mar Enterprises, B-295781*). However, a contractor was properly eliminated from competition when the agency determined that there was a risk of poor performance when a contractor is forced to perform on a contract at little or no profit under a fixed-price contract (*International Outsourcing Services, B-295959*).

♦ Evaluating Negotiated Contract Proposals

The government is free to use a variety of evaluation factors in evaluating proposals. However the RFP must describe the factors and significant sub-factors to be used to evaluate proposals and their relative importance and agencies must evaluate the proposals according to the criteria established in the solicitation. A protest was sustained where the weight applied to evaluation factors in the source selection decision differed from that announced in the solicitation (*Park Tower Management, v US, 67 Fed. Cl. 548*).

The GAO addressed several protests where the agency's source selection decision was irrational or inconsistent with the administrative record. The GAO sustained a protest where the source selection authority in making its cost/technical tradeoff decision had considered advantages in the protester's proposal that would result in cost savings but did not consider other advantages that while not resulting in cost savings still furnished the government additional value (*Coastal Maritime Stevedoring, B-296627*). A protest was denied where the agency had reasonably determined that technical superiority was not worth the additional price where the GAO made the point that there was a "high burden" placed on protesters when they allege an agency's best value determination was arbitrary and capricious (*Brewbaker White Sands, B-295582*).

FAR 15.304 requires agencies to consider cost or price in evaluating competitive proposals (*R&G Food Service B-296435*). The GAO found that price was not given meaningful consideration where the agency mechanically made award without conducting a tradeoff analysis which it ruled rendered price meaningless as an evaluation factor (*The MIL Corp. B-294836)*. An agency's upward adjustment to protester's cost proposal following a cost realism analysis to reflect increased staffing was irrational since it conflicted with the agency's technical evaluation that found the proposed staffing level a strength (*Honeywell Technology Solutions, B-292354*).

♦ Past Performance

FAR 15.304 requires that past performance be one evaluation factor that must be considered in all negotiated procurements and the boards and courts are defining how this new factor will be applied. When negotiated awards are to be made with discussions offerors are to be given the opportunity to clarify adverse past performance while negotiated awards that do not provide for discussion *may* be given the opportunity to clarify past performance. An agency is not required to communicate with offerors' past performance information where discussions are not held unless there is a clear reason to question the validity of the past performance information (*Universal Fidelity Corp., B-294797*).

An agency has broad discretion in determining whether a particular contract is relevant (*Hera Construction, B-297367*). The GAO held that an agency erred in considering relevant two of the awardee's previous contracts that involved substantially smaller and less complex work scope while the protester's more relevant work as an incumbent was not considered (*Clean Harbors Environmental Svcs. B-296176*). The GAO ruled there was no requirement that an incumbent's experience be deemed more relevant (*University Research Co., v. US 65 Fed. Cl. 500*). The GAO ruled that the length or duration of an offeror's prior contract efforts logically relates to the relevance and quality of its past performance (*Chenega Technical Prdts, B-295451*). In a competition requiring offerors to provide five contracts that were the same or similar to proposed work that was performed in the past three years, the GAO ruled that an awardee's

perfect score based on a single reference that was significantly below the value of the contract at issue was improper (*Sytronics Inc. B-297346*).

♦ Discussions

The FAR 15.306 requires the CO discuss with each offeror being considered for negotiated award significant weaknesses, deficiencies or other aspects of its proposal that could be altered or explained to enhance the proposal's potential for award. Discussions should not be confused with *clarifications* which are limited exchanges with offerors to allow correction of minor or clerical errors or to clarify proposal elements. An agency may not hold discussions with one offeror without extending a similar opportunity to all other offerors (*Northwest Real Estate Svcs v US, 65 Fed. Cl. 419*). Discussions, not mere clarifications, were conducted when the agency engaged in a post-final proposal exchange with the awardee that resulted in material proposal revisions (*Lockheed Martin Simulation, B-292836*).

It was held there is no requirement that all areas of a proposal be addressed during discussions but only *significant* weaknesses (e.g. those having an appreciably increase in risk of unsuccessful contract performance (*Standard Communications, B-296972*). The GAO held that where an offeror's price is not so high as to be unreasonable or unacceptable, the agency is not required to advise the offeror its price in not competitive (*Yang Enterprises, B-294605*). Also, there is no requirement that an agency inform an offeror that its price is too high where the price is not considered excessive or unreasonable (*Cherry Road Technologies, B-296615*).

Discussions must be meaningful, equitable and not misleading. The GAO established that it is the responsibility of the agency in conducting meaningful discussions to lead offerors into areas of their proposals that need revision (*Global A 1st Flagship Co., B-297235*). The GAO ruled meaningful discussions had not occurred when it merely informed the protester its total proposed price was overstated but did not convey the magnitude of the disparity in price. The agency also failed to provide meaningful discussion when it did not address the underlying reason for the unreasonable pricing – namely the protester's misconception of the anticipated level of effort which prevented it from obtaining a meaningful understanding of the agency's concern (*Creative Information Technology B-293073*).

Claims

When contract effort exceeds the original scope of work the contractor is entitled to receive a price adjustment to the contract price. An equitable adjustment is the difference between the reasonable cost of the work required by the contract and the actual reasonable cost to the contractor of performing the changed work, plus a reasonable amount of overhead and profit. A contractor generally carries the burden of proving the amount by which a change increased its cost of performance. The following address circumstances when a claim may be justified and some issues related to quantifying the price adjustment.

♦ Breach of Contract

In its claim the government negligently prepared estimates of anticipated room reservations, the court disagreed finding that in all but one year attendance was within the band estimated by the agency and in the one year the discrepancy was no more than 1% (*The Federal Group v US, 67 Fed. Cl. 87*). An appeals board ruled that if an estimate is reasonable and based on all available date, the government will be found to have exercised due care (*Bannun Inc. v US Dept. of Justice, DOTCAB No. 4450*). In its finding the agency did use negligent estimates, the Board established the way to compute damages was so the least paid ensured the contractor suffered no loss by the breach while the most paid ensured the contractor was not put in a better position than had the contract been performed. In so doing, the Board computed an adjustment of the bid unit price to reflect the non-negligent estimate and the resulting per unit price was multiplied by the units ordered during the contract (*Spare Parts Logistics, ASBCA No. 54434*).

The following addresses what happens when the value of assets sold are less because of government's breach. A contractor asserted claims against the Dept. of Energy for failing to remove spent nuclear fuel per its agreement that diminished the sales price of two of its facilities. The court denied government arguments finding it "had to have contemplated that some facilities would be sold" and it was fair to infer that failure to adhere to its contract might result in diminution of the value of the assets (*Consolidated Edison v. US, 67 Fed. Cl. 285*). After the Space Shuttle Challenger exploded NASA announced it would not launch a telecommunications satellite where the contractor had a launch services contract. When the contractor had to sell its satellite division due to financial difficulty it asserted it had to settle for a

diminished price without the services contract. The Court rejected the government's contention that such damages were too speculative holding the proper measurement of damage was the difference between the price the satellite division would have brought with the launch services and the price the contractor received for the division without the contract (*New valley Corp.v US, 67 Fed. Cl. 277*). In another case the board held the contractor was not entitled to lost profits after the government breached its contract stating though lost profits may be recovered for breach, its was not appropriate here because (1) the contractor could not prove the breach caused any lost profits (2) the lost profits were not foreseeable and (3) the lost profits were not reasonably certain (*CACI International, ASBCA No. 53085*).

♦ Constructive Changes

A constructive change occurs when a contractor must perform work beyond contract requirements without a formal "order" to do so under the "Changes" clause. Such a change can include an *informal* order or direction of the government or by the *fault* of the government. The Court sustained the contractor's contention that the Air Force had constructively changed the contract by providing vehicles at the start of contract performance that were in "woeful condition", requiring significant effort to bring them up to the condition the contract indicated it should have been in the first place (*Tecom, Inc. v US, 66 Fed. Cl. 736*).

♦ Government Interference and Delay

Contractor's claim the contract was delayed because the government could have inspected the work 18 days earlier was rejected where the board ruled the government's inspections are for the sole benefit of the government and do not relieve the contractor of its responsibility to complete the contract on time (*Amigo Building Corp., ASBCA No. 54329*). In its contract to repair a mountain road and bridge, contractor encountered unusually heavy snow and asserted the government's need to collect and relocate native plants had delayed performance. The Board rejected the claim for delay damages stating the contractor needed to prove the government was the sole cause of the delay, which it could not (*Elting, Inc., DOTBCA No. 4448*).

♦ Equitable Adjustments

An equitable adjustment is the difference between the reasonable cost of the work required by the contract and the actual reasonable cost to the contractor for performing the changed work, plus a reasonable amount of overhead and profit. A contractor generally has the burden of proving the amount by which a change increased its costs of performing the contract. However, for a downward adjustment in contract price asserted by the government, it has the burden of proving the lower costs caused by the change (*George Sollitt Construction Co., v US, 64 Fed. Cl. 229*). Because a construction contract did not include required notices of the presence of asbestos and lead paint, despite the government's knowledge of their existence, the contractor filed a claim for the estimated costs associated with a self-insurance program to cover potential medical costs. The court ruled potential liabilities are not recoverable finding the proper measure of an equitable adjustment is the actual cost incurred and that "incurred potential liability" is not an "incurred cost" (*SAB Construction Inc. v US, 66 Fed. Cl. 77*).

♦ Contract Interpretation

In interpreting a contract, one starts with plain language where the words of the agreement have their ordinary meaning unless the parties mutually agree to an alternative meaning. If terms are susceptible to more than one reasonable interpretation then an ambiguity exists that can be patent or latent. A *patent* ambiguity is one so glaring as to raise a duty to inquire while a *latent* ambiguity is not glaring or obvious and in such cases, the court will construe the ambiguous term against the drafter of the contract when the nondrafter's interpretation is reasonable (*Tecom, Inc. v US, 66 Fed. Cl. 736*). Where the court agreed the project specifications were defective in a claim asserting defective specs., it held the ambiguities were patent and thus the contractor's failure to inquire about them barred its recovery (*Sunshine Construction v. US, 64 Fed. Cl. 346*). The contractor alleged the building of a temporary structure to anchor the wall it was contracted to repair was a change while the board disagreed, holding the absence of a line item for the structure was a patent ambiguity the contractor was obligated to clarify (*Luedtke Engrg Co., ASBCA No. 54226)*.

Terminations for Convenience

In a contract where the contractor agreed to a cost share of 20% in exchange for the government waiving its right to claim title to certain inventions, the lower court ruled the contractor could recover only 80% of its allowable termination costs, rejecting the contractor's argument the cost-sharing provision

applied only if the contract was completed. On appeal, the higher court sided with the contractor saying it was entitled to recover all of its costs ruling the termination clause's requirement to pay "all cost reimbursable" defined the type of costs not the amount of the costs (*Jacobs Engrg Group v. US, 434 F.3d 1378*). The court ruled the contractor was not entitled to recover fee on completed subcontractors' work that was cost plus fixed fee work but was entitled to profit on subcontract work that was firm fixed price, stating the different outcomes were required by the "plain meaning" of the separate FAR clauses applicable to cost type and fixed price contracts (*Lockheed Martin Corp. v England, 424 F.3d 1199*). The Board rejected contractor's claim for stand-by preaward burdened labor costs but allowed the claim for stand-by preaward equipment costs as long as the contractor could prove the preaward costs were allowed in accordance with FAR 31.205-32, Preaward costs (*MIG Corp., ASBCA No. 54451*). (*Editor's Note. The commentator indicates that the board seems to be applying FAR cost principles rather than the fairness principles set forth in FAR 49.201. The board also recognizes the contractor may be able to amortize start up costs over the terminated and unterminated parts of the contract.*)

Costs

Costs of successfully defending against a qui tam suit where the US does not intervene is limited to 80% (*Fluor Hanford v. US, 66 Fed. Cl. 230*). Costs incurred in an unsuccessful defense of a citizen's suit for violation of the Clean Water Act were "similar" to costs made unallowable by FAR 31.205-47(b)(2) where either a monetary penalty is imposed or contractor liability to fraud or similar misconduct results from civil or administrative proceedings (*Southwest Marine ASBCA No. 54234*). Contractor was entitled to repayment of progress payments that were mistakenly transmitted to the contractor's formerly designated bank after the contractor notified the government that payments should be transmitted to another bank (*SAS Bianchi UGO, ASBCA No. 53800*). Where the CO erroneously disallowed certain costs when it negotiated a fixed price contract the court ruled the contractor was not entitled to reimbursement ruling not every allowable cost must be specifically represented or recaptured in a fixed price contract. The court said unlike a cost reimbursement contract the focus of a fixed price negotiation is on total price rather than individual costs. The FAR cost principles provide a "frame of reference for negotiating total overall price, the goal of the negotiation is not to remunerate the contractor for each individual allowable cost but rather to reach a fair and reasonable price based upon the universe of costs" (*Information Systems & Networks Corp. v. US, 64 Fed. Cl. 599*). The government was bound by a CO's oral agreement to allow a cost that was made unallowable by FAR 31.205-36(b)(3) – Rental costs – because there was not "plain illegality" and the CO's interpretation of the cost principle was not "clearly unreasonable" (*MPR Assocs. ASBCA No. 54689*).

STATUS OF PROCESSING SECURITY CLEARANCE APPLICATIONS

(*Editor's Note. We have been seeing problems with some of our clients and subscribers who are seeking business requiring security clearances for employees. In spite of a significant increase in new opportunities for secure work with the Defense Department, Department of Homeland Security and other agencies, there is an apparent shortage of qualified personnel with security clearances, creating problems with proposals, contract performance and increasing compensation required to attract these individuals. The problem seems to be that new and renewal applications for confidential, secret and top secret clearances are not being processed. We have reported on some recent cessations of processing applications and thought we would provide a more detailed account of what is happening as well as a brief discussion on the impact on contractors and some suggestions on how to weather this problem. We have relied on a recent commentary in the May 24 issue of The Government Contractor written by James McCullough and Courtney Edmonds of the law firm of Fried, Frank, Harris, Shriver & Jacobson LLP.*)

Partly because it is taking 160-370 days, on average, to complete standard background investigations for a security clearance, depending on type of clearance, the GAO reported there was a backlog of approximately 232,000 applications as of June 2005. New opportunities for supply and services contracts provided by secure employees has caused an increase in clearance requests where the proportionate increase in top secret clearances (requiring more time and effort to process) have contributed to the long delays and heavy backlog. Other contributing factors that have created a kind of "perfect storm" for the backlog are lack of full reciprocity (acceptance of security clearances granted by another agency), a shortage of personnel to handle the required investigations and adjudications processes and dramatic increases of information covered by the

security classification system that increases the number of government and contractor personnel who must obtain clearances. These circumstances prompted the GAO to designate DOD's security clearance programs as a "high-risk" area as of January 2005.

The Applications Process

DOD and the Office of Personnel Management (OPM) generally rely on a personnel security clearance process that includes five stages: pre-investigation, investigation, adjudication, appeals and reinvestigation. In the pre-investigation stage, if a government agency determines that a position requires federal employees or contractor personnel to have access to classified information, the agency or contractor must submit the individuals' personnel security questionnaire (the "application") for review by OPM.

During the investigation phase OPM or one of its contractors conducts an investigation of the employee using government-wide standards established under Executive Order 12968, set out in the Federal Register 40245 (Aug. 7, 1995). For initial and reinvestigations of confidential or secret clearances, investigations gather much of the required information electronically while for top secret clearances investigators must obtain additional information though time-consuming activities such as review of police and court records as well as background interviews. During the adjudication stage, relying on information in the investigative report, an adjudicator determines whether the applicant is eligible for access to classified information at the level requested. If the adjudicator determines the investigative report is "clean" (no potential security issues) they determine eligibility and forward the determination to the requesting agency. If the application has "issues" (e.g. information that might disqualify the individual such as foreign connections or drug/alcohol problems) it is sent to the Defense Office of Hearings and Appeals for DOD agencies or the OPM's Investigative Services Suitability Adjudications Branch for non-DOD agencies where a legal sufficiency review takes place and a written Statement of Reasons (SOR) is issued to the application enumerating the reasons for denial. The applicant then has 20 days to respond where the appeals stage begins if they choose to appeal. Finally in the reinvestigations stage the agencies maintain security clearance records for cleared personnel, track expiration dates and conduct reinvestigations according to applicable instructions.

Efforts to Speed Up the Processing

Since the January 2005 "high risk" designation there have been many steps taken to clear up the backlog. Congress mandated that starting December 2006 (1) each authorized adjudicative agency must make a determination on at least 80 percent of applications within an average of 120 days (90 days to complete investigations and 30 days to complete adjudication) and (2) all security clearance background investigations and determinations completed by an authorized agency must be accepted by all other agencies. OPM has stated it will take on a limited role of centralizing certain security clearance functions where it said it will hire an additional 400 employees and contractors to conduct investigations and the Defense Security Service (DSS) stated it would transfer 1,600 of its employees to OPM. Finally, the Office of Management and Budget announced it is taking several steps to improve not only the quantity but also quality of investigations and that it would issue interim clearances under certain circumstances to reduce the impact of the backlog but this step has had limited benefits because agencies need not accept interim clearances when requesting bids and proposals.

Current Situation

In spite of actions to reduce the backlog, DOD had to take two actions that brought the security clearance applications to a standstill. First, on April 6. 2006 DSS notified contractors that because of funding constraints and high number of investigations designated as "priority" it would no longer process contractor requests for priority handling of security clearance applications. Second, April 25, DSS stopped processing all security clearances for government contractors due to an "overwhelming" volume of requests and funding constraints. Following an uproar from industry and the House, DSS announced on May 16, 2006 it had found some additional funding that would enable it to restart processing initial secret requests but that it would not process initial requests for top secret clearances and requests for period reinvestigations until it found more funding. In addition, the 2006 defense authorization bill has provided that there will be a restriction of revoking expired contractor security clearances for the rest of 2006. In spite of this, the authors conclude there is no significant improvement in processing security clearance applications in the current period. In fact, a recent FAR interim rule requiring additional background checks be made to obtain identification badges necessary for contractor

personnel to enter certain government facilities and have access to federal information technology systems (see Fed. Reg. 211, Jan. 3, 2006) will exacerbate the backlog problem.

Outlook on Industry

The delays in processing security clearance applications have serious consequences for contractors. Delays can result in increased costs for performing classified contracts, problems retaining the best personnel, delays in performance, negative past performance ratings, underutilization of labor who are waiting months for their clearances and having discouraged employees seek other employment opportunities. The backlog does not appear to by improving any time soon. The clearance backlog has had a major impact on contractors' ability to attract and retain qualified personnel where contractors attempt to recruit away competitors' employees with security clearances. To attract cleared personnel in this highly competitive environment contractors often need to engage in aggressive tactics to attract and retain employees (e.g. bonuses of $10,000). DCAA has recently addressed this issue in a memo to its auditors stating under certain contracts, if a contractor needs to use reasonable bonuses and other incentives they are usually allowable.

To minimize potential financial and performance impacts from the backlog the authors recommend a few approaches to identify, attract and retain cleared personnel. Contractors should try to hire recently retired government employees and former military members who have active security clearances. They should begin the recruiting and security clearance application process as soon as possible for upcoming procurement opportunities. To retain the services of cleared personnel, contractors need to ensure these personnel are fairly compensated and that such compensation is compliant with FAR (e.g.. FAR 31.205-6(b)(2)).

RECENT DEVELOPMENTS IN DEFECTIVE PRICING

(*Editor's Note. About ten years ago, defective pricing audits were a major focus of government contracting officers and auditors. Whereas most of the attention was on large contracts (after all, that was where there was the greatest dollar return for the effort) with little attention on subcontracts, we are seeing a significant increase in auditing not only smaller prime contracts but also subcontracts worth as little as $550,000. The increased attention on smaller contracts and subcontracts is likely a result of less audit demands for auditors' time and periodic DODIG reports that DCAA is not doing enough defective pricing reviews. Whatever the reason, contractors with little or no experience in defective pricing audits (or the more euphemistic title "post award reviews") need to get up to speed. We thought it would be a good time to briefly discuss the basics and recent developments in the area of defective pricing.*)

Some Basics of Defective Pricing

The Truth in Negotiations Act (TINA) covers defective pricing. TINA requires prime contractors and subcontractors to submit cost or pricing data for contracts or pricing actions (e.g. a contract change or modification) in excess of $550,000 and to certify the data is accurate, complete and current. A waiver to this requirement exists under one of five conditions: (1) adequate price competition exists (2) commercial items are acquired (3) prices are set by law or regulation (4) a waiver is granted when the government deems prices are fair and reasonable (e.g. submission of "other than cost or pricing data") or (5) a modification is made for acquisition of a commercial item. We recommend contractors seek one of these waivers whenever possible. What is and is not "cost or pricing data" and when and how this data should be brought to the attention of the "government" is a source of almost unending litigation. For example, cost data refers to facts (e.g. actual labor rates, hours expended, price quotes from vendors, records of incurred costs) while estimates and judgment (e.g. budgets, profit plans, methods of performance) are not considered facts and hence not data that must be divulged (though the facts upon which estimates and judgments are based are considered data).

Even though the contractor signed a Certificate of Current Cost or Pricing Data the contractor may have inadvertently included "defective" data in the proposal that the government relied upon in negotiating a contract award. If the government can prove the contract or subcontract price is overstated because of its reliance on the defective data both the prime contractor, and through its flowdown clauses, the subcontractor is subject to a reduction in its contract price. Even though a contract price may be the result of many factors other than defective data (e.g. negotiating skills, perceived market conditions, etc.) the presumption is, short of evidence to the contrary, the government overpaid by the amount of the defective data and the adjustment is equal to the

amount by which the cost or pricing data was overstated. In calculating the adjustment, the government usually recognizes offsets which means that if a contractor *understates* some cost or pricing data submitted in support of its proposal then that amount can be used to offset any overstatement the government claims exists.

Significant Developments

As we are fond of saying, the practical meaning of most regulations are what court and agency guidance they are. Some recent cases and agency guidance highlight this notion.

- **United Technologies Corp. (ASBCA No. 51410)**

In the 1980's the Air Force held a competition between Pratt & Whitney and General Electric for the $10 billion market for F15 and F16 fighter jet engines needed for a six-year period. When DCAA tried to initiate a defective pricing audit on the first year contract the Air Force initially resisted saying the contracts between Pratt and GE were awarded on a competitive basis and hence such an audit was inappropriate. As the years passed the Air Force resistance faded and DCAA commenced defective pricing audits generating 30 audit reports spanning over a decade. By 1998 the Air Force issued a final decision seeking $95 million but the amount escalated until it reached the current amount of $299 million. There were two decisions, one addressing a variety of issues affecting what constitutes cost or pricing data and another decision made in reconsideration whether the Air Force actually relied on what was asserted to be defective cost or pricing data. (*Editor's Note. For our discussion of the initial decision we have relied on a Commentary in the February 23, 2005 issue of The Government Contractor written by David Bodenheimer of the law firm of Crowell & Moring LLP while our discussion of the reconsideration is based on Commentary in the May 2005 edition of the Procurement Law Advisor written by Terrence O'Connor who practices law in Alexandria, VA..)*

The Initial Decision

1. Vendor quotes not used in BAFO. The Air Force contended that disclosed vendor quotes were not used in the pricing of its Best and Final Offer which the Board rejected saying TINA is not a "disclosure statute" and its plain language does not obligate a contractor to use any particular cost or pricing data to put together its proposal. This was consistent with prior cases (e.g. Hughes Aircraft Co – "contractor does not have to either itself use the cost information or analyze it for the government") and DCAA guidance (TINA "does not require a contractor to use such data in preparing its proposals").

2. Proposal was not certified. The Air Force argued that Pratt certified its BAFO proposal, which triggered TINA liability for alleged "misstatements" in the proposal. The Board stated it was unaware of any statute, regulation or contract provision that obligates the contractor to certify its BAFO proposal as opposed to its initial offer. Further, the Board stated the proposal itself was not cost or pricing data because it was a "mix of judgments" how to perform the work at a price covering anticipated cost and profit.

3. Escalation estimate is a judgment. For material escalations used in its pricing, the Air force asserted Pratt used inconsistent escalation rates. The Board ruled the material escalation factor used was in essence a judgment as to future material costs and was therefore not cost or pricing data.

4. Data not available prior to certification. In response to an audit request in 1993, Pratt prepared a retrospective summary explaining some pricing of unquoted parts in the original 1983 proposal where the Air Force then asserted defective pricing for alleged errors in this summary. The Board ruled that "reconciliation errors" made 10 years after the original proposal did not have any connection to cost or pricing data certified in 1983. It quoted Muncie Gear Works (ASBCA No. 18184) – "no defective pricing for data unavailable until after contract award."

Decision on Reconsideration

This part of the case revolved around whether the government did or did not rely on the defective data. As discussed above, the Air Force had seen Pratt's initial offer but not the data in the BAFO so it had not relied on the defective BAFO data which was the basis for the Air Force's defective pricing claim against Pratt. The decision shows how the process works. First the government starts with a presumption that "the natural and probable consequence of defective cost or pricing data is to cause an overstated price." As a result, a contractor must overcome this presumption, which Pratt did. It was able to prove that neither DCAA, the Air Force price analyst, the CO nor the cost panel that reviewed the BAFO prior to award relied on the data and the government was unable to show the defective cost or pricing data caused an increase in the contract price.

Next the board addressed the issue of whether the defective pricing resulted in increasing the price of the options the Air Force exercised following the BAFO – were any of the options based on the defective BAFO data? Again the Board ruled that lack of reliance was fatal to the Air Force. First, before examining any options, the Air Force received different offers and those offers, not the BAFO, were the basis of the option exercises and contract award to Pratt and second, the CO for the options was new and had not seen the defective BAFO data. The Board concluded the Air Force had failed to prove defective pricing for the contracts.

Subcontractor Defective Pricing Liability

(*Editor's Note. We have used some of the points presented in a September 2004 Briefing Papers article by Steven Masiello and Phillip Seckman of the law firm of McKenna Long & Aldridge LLP.*) The authors assert that recent case law has had the effect of moving away from an emphasis on putting the government and contractor on an equal footing, which was the original purpose of TINA, to one where the prime contractor is the government's insurer against defective pricing by the subcontractor. (*Though we will refer to "prime contractors" it should be understood that the discussion below also applies to upper tier subcontractors in their relationship with lower-tier subcontractors.*) The prime contractor's liability to the government for subcontractor defective pricing has traditionally been a case-by-case examination of the facts of whether the prime contractor was aware of or was in receipt of the subcontractor's certified defective cost or pricing data. When the prime was in receipt of the defective data that was "reasonably available" then the prime contractor was usually stuck but when it was not reasonably available to the prime then most cases generally ruled the government was not in an advantaged position and therefore there was no liability for defective pricing. This policy has changed following more recent cases where now the prime contractor is held liable whether or not it had reasonable access to defective data, assigning the prime contractor "strict liability" which essentially gives it the burden of being the insurer against any inflated price experienced under its subcontracts. In *McDonnell Aircraft (ASBCA No. 44504)* the prime unsuccessfully repeatedly requested its subcontractor to provide cost or pricing data and in spite of having a lack of knowledge of flaws in the cost or pricing data it was found liable for defective pricing. In *Aerojet (291 F.d1328)* the prime contractor was also held liable despite its negotiator's lack of knowledge concerning bids that were contained in a locked bid box at the time of the government price agreement. In these two cases, the Board and Court ruled that even where the prime contractor acts with due diligence to unsuccessfully obtain cost or pricing data the prime contractor is still liable for their subcontractor's defective pricing data where the author stresses the prime contractor becomes, in effect, the insurer of defective pricing.

The authors address the practical implications of this shift from both the prime and subcontractors' point of view. Since the government will go after the prime contractor for its subcontractors' defective pricing the question becomes how the prime contractor can protect itself from having to pay for the defective pricing liability caused by the subcontractor. The authors state a simple flow down of the Price Reduction clause of FAR 52.215-10 has significant limitations because the wording of the flow-down, when the terms like "government" is replaced by "contractor" and the term "contract" is replaced by "subcontract" will have the effect of limiting recovery for a prime contractor as of the date for subcontract price agreement not the prime contract agreement date certified by the prime. Further problems occur when the subcontractor refuses to provide cost or pricing data to the prime due to concerns about revealing its cost rates to future competitors. In such cases, the prime contractor must rely on government audits of these proposals where cases law has cast doubt whether such disclosure satisfies the duty of the prime to disclose.

The authors suggest a couple of options to protect the prime: (1) a *preaward agreement* that requires all subcontractors to submit cost or pricing data directly to the government in lieu of submitting it to the prime and that such submission satisfies the subcontractors' duty to disclose under its subcontract and that the subcontractor consents to a government audit and dissemination of the finding to the prime contractor and (2) an *indemnification agreement* where the subcontractor pays the prime contractor for any loss incurred as a result of defective pricing related to the subcontractor's cost or pricing data. However, since such an indemnification agreement can be an onerous subcontract term, the subcontractor may want to resist providing indemnification for all loss by, for example, (a) ensuring that the goods or services provided represent one of the exemptions from TINA (e.g. commercial item) (b) attempt to limit liability such as limiting indemnification only to cost or pricing data submitted as of the date of subcontract agreement (c) ensure liability for defective pricing only if the

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government seeks a price reduction for the defective data at the prime contract level and (d) a demand that the subcontractor be notified in a reasonable time before any agreement is made at the prime or higher tier level as well as timely notification of any defective pricing claim.

SAIC Alerts

(*Editor's Note. The following discussion is based on a commentary in the April 27, 2005 edition of The Government Contractor written by Karen Manos of the law firm of Howrey LLP.*) In pricing many of its proposals, the large contractor Science Applications International Corp. applies a risk factor to proposed hours based upon its Internal Quantitative Risk Analysis (QRA) designed to identify such risk factors as "internal inefficiencies, inoperable equipment and unanticipated delays." In a highly unusual action, the Air Force issued two alerts to its buying offices asserting SAIC engaged in defective pricing and proposed (and achieved) higher profit margins in failing to disclose the QRA and resulting variance hours. In support of its position one of the alerts alluded to FAR Table 15-2 Instructions saying it requires contractors to submit "any information reasonably required to explain your estimating process including (1) the judgmental factors applied and the mathematical or other methods used in the estimates, including those used in projecting from known data and (2) the nature and amount of any contingencies included in the proposed price."

The commentator says the alerts, in addition to "besmirching" the reputation of a highly reputable major contractor, are flawed. First, contrary to the position in the notices, a contractor's judgmental risk assessment is not cost or pricing data. The commentator alludes to *Litton Systems (ASBCA No. 36509)* where standard hours based on industrial engineer estimates and a "delay factor" based on estimates of personal fatigue and delay applied to standard hours were deemed "pure judgment" rather than a mix of fact and judgment and hence not cost or pricing data. While facts on which a risk assessment is based is cost or pricing data, neither the risk assessment itself nor the fact it exists is cost or pricing data. Second, allusion to FAR 15-2 Instructions is inappropriate because that section does not define cost or pricing data which is defined in FAR 2.101 which specifically states it "does not include information that is judgmental, but does include the factual information from which judgment was derived." Finally, the Air Force is wrong in its assertion that higher profit margins had to be disclosed, arguing parties do not negotiate a profit margin on fixed price contracts but rather negotiate a price based on "total price" not individual elements of cost or profit.

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