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PENALTIES FOR UNALLOWABLE COSTS

(Editor's Note. Under pressure to close out old contracts and finalize open year indirect cost rates, the government has become more aggressive in pressing its right to penalize contractors for charging unallowable costs. Consequently, various Departments of Inspector General and audit agencies are calling on their staffs to liberally recommend penalties on unallowable costs and as consultants, we are seeing a significant increase in the government seeking penalties, often in inappropriate places. We are also observing a lot of confusion on the part of contractors and frequently receive questions on what types of unallowable costs are affected, what contracts are affected, how can penalties be challenged, what happens if the claim was inadvertent and when can we take a chance of including an uncertain cost in a proposal without risking a penalty. Fortunately, we have found a very recent article addressing penalties for unallowable costs written by Tom Lemmer and Steve Masiello of the Law Firm of McKenna & Cuneo L.L.P. in the May 1999 edition of Briefing Papers. We have based most of the following on their article with the exception of the section on DCAA Guidance where we have used both our experience as consultants and the DCAA Contract Audit Manual (DCAM) as our sources.)

The Rules

The applicable rules that call for penalties on unallowable costs are scattered among several sources- CAS 405, a 1985 statute with a 1992 revision applying to defense contracts and a 1995 statute extending penalties to all executive agencies.

◆ CAS 405

CAS 405, "Accounting for Unallowable Costs", applies to fully and modified covered contractors and requires them to identify and eliminate certain costs from proposals as well as cost-based submissions to the government *(for a more detailed account of CAS 405, see the GCA DIGEST, Vol. 1 No. 1)*. CAS 405 applies to only specific costs including (1) "expressly unallowable" costs (2) costs mutually agreed to be unallowable (3) costs designated specifically as unallowable by a CO's written decision and (4) costs not authorized by a contract or subcontract. The last three are rarely disputed and it is only the "expressly unallowable costs" that are troublesome.

CAS 405 is considered a "penalty" statute because the government can use an assertion of a CAS 405 violation to reduce the price of both a firm fixed price contract as well as a proposal to establish final rates on cost-type contracts. This CAS 405 penalty is because the CAS clause (FAR 52.230-2) is included in all negotiated contracts over $500,000. The fixed price contract can be reduced by the increased costs which is the difference between the presumably higher contract price negotiated based on inclusion of the unallowable costs and the price that would have been negotiated if the contractor complied with CAS 405.

Unlike the other rules that apply only to incurred cost proposals intended to settle overhead rates, a CAS 405 "penalty" applies to "any billing, claim or proposal applicable to a government contract". This includes forward pricing rate proposals, cost reimbursement vouchers, progress payments invoices and claims.

◆ Price Laws and Rules

Under the DOD Authorization Act of 1986, Congress established the first statutory penalty for submission of unallowable costs in indirect cost settlement proposals. The statute, 10USC #2324, provided that if there was "clear and convincing evidence" the submission included unallowable costs in violation of FAR or the Department of Defense's acquisition supplements (DFARS) a penalty in the amount of the disallowed costs plus interest would be imposed. In addition, if a proposal included an unallowable cost that was "determined to be unallowable before submission of the proposal" an additional penalty equal to two times the amount (for a 3X penalty) would be imposed. Unlike CAS 405, the penalties applied only to incurred cost submissions and hence were applicable only to cost type contracts as opposed to fixed price contracts.

◆ Current Laws and Rules

A 1992 revision to the above statute changed the language for imposing penalties for claiming "expressly unallowable costs" instead of "by clear and convincing evidence". On October 1, 1995 the Federal Acquisition Streamlining Act expanded the penalty to all executive agencies. FAR 42,709-1 and the clause

52.242-3 ("Penalties for Unallowable Costs") implemented the expansion.

Meaning of Expressly Unallowable Costs

Whether it be CAS 405 or the current penalty statutes, only certain costs trigger the penalty. Three types - costs mutually agreed to be unallowable, costs a CO's written decision has found to be unallowable, and costs outside a contract - rarely rise to a dispute. It is the fourth type - "expressly unallowable cost" - that the government most often cites as its basis for a penalty and it is this type that creates most disputes.

"Expressly unallowable cost" is really a narrow term. CAS 405.30(a)(2) defines is as "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." This same definition is used in FAR Part 31. In explaining the term, the Preamble A to the original promulgation of CAS 405, refers to "costs whose unallowability is obvious" and costs that are "obviously unallowable". CAS 405 uses "entertainment costs" as an illustration of the type of costs which the standard applies and the authors conclude the definition of "expressly unallowable cost" is limited to obvious costs that are explicitly unallowable in *all* circumstances under the FAR 31.205 cost principles.

Court and board decisions further confirm this limited definition. Case law defined expressly unallowable cost as a type of cost that a cost principle states is unallowable in its entirety, using the terms "clear beyond cavil" (Emerson Elec. Co. ASBCA 30090). In cases where specific costs can be allowable under certain circumstances (e.g. otherwise allowable bid and proposal costs exceeding ceilings, general and administrative costs allocable to unallowable costs), the courts have held "clear beyond cavil" criterion was not met. In other cases the ASBCA applied the "clear beyond cavil" criteria to circumstances when costs are always unallocable to government contracts "without exception". In other cases, specific costs such as entertainment, claim prosecution and organization costs were found to be "expressly unallowable" because, without exception, they were found to be the type of costs unallowable in *all* circumstances. Further examples cited were bad debts, amortization of goodwill and alcoholic beverage costs because they are *always* unallowable.

Few, if any, of the other types of costs found in FAR Part 31 are "obviously unallowable" or are costs whose unallowability is "clear beyond cavil" in all circumstances. When DCAA recommends or a CO imposes penalties under either CAS 405 or a statute or both, the contractor should carefully review the basis for the penalty. The cost triggering the penalty may very well be unallowable but that does not make it "expressly unallowable".

◆ Existence of a Reasonable Dispute

The first question to ask under an allegation of "expressly unallowable" is whether the type of cost is unallowable in every circumstance. The next relevant question is whether the facts surrounding the costs make is expressly unallowable. The existence of a reasonable dispute means the cost is not expressly unallowable.

A reasonable dispute exists when the contractor's position that the cost is allowable has sufficient validity to create more than a little doubt regarding its unallowability (Martin Marietta case, ASBCA 35895). If the government considers paying or in fact pays a portion of the cost, that in itself, proves the cost is not expressly unallowable because the CO has no authority to pay an unallowable cost. Other evidence indicating a reasonable dispute exists can include case law, relevant accounting guidance and the history of the cost principle involved. When these authorities create doubt whether a cost is expressly unallowable, then the cost involved cannot be expressly unallowable even if the cost is ultimately disallowed by mutual agreement by a court or by board decision.

Inadvertent Error

The current laws and CAS 405 provide for the penalty to be waived when an expressly unallowable costs was included in an indirect incurred cost proposal due to a contractor's inadvertent error. The inadvertence error is a valid defense when the contractor has established it has "appropriate policies, personnel training and an internal control and review system" in place to screen unallowable costs.

DCAA Guidance

Though similar in most respects, the following guidance to Defense Contract Audit Agency auditors covered in their manual (DCAM Chapter 6-608.4) should be considered. These include:

1. DCAA emphasizes that even if an audit report has been issued or rates have been negotiated, the government may still assess a penalty.

2. The guidance stresses that DCAA has no authority to impose a penalty. Their responsibility is limited to making recommendations for imposing penalties and for providing assistance in computing the amount of penalty. *(Editor's Note. This limitation has been significant in the past because while it was quite common for DCAA to recommend penalties, it was unusual to see COs follow through. This reluctance, of course, may diminish in the light of numerous Inspector General reports calling for more penalty impositions.)*

3. DCAA defines "expressly unallowable costs" as those costs that are expressly unallowable according to FAR and DFAR cost principles. DCAA makes no mention of the point made by the authors about "clear beyond cavil" or unallowable under "all circumstances". DCAA is likely not to take such a narrow view of expressly unallowable costs, requiring reminders of the authors' allusions to court cases that limit its application.

4. The penalty statutes and implementing regulations do not flow down to subcontracts and hence auditors should not recommend penalties for subcontracts even if the prime contracts include the penalty clause. The only exception is when a business unit passes costs to an interdivisional company that is the prime contractor when the prime contract is subject to the penalty.

5. Citing DFARS 231.7002-5, DCAA recognizes a waiver when allocation of the penalized costs represents less than $10,000 of costs allocable to covered contracts. The manual provides an example when there are $80,000 of expressly unallowable costs of one category in the G&A pool but only $8,000 of those costs are allocable to covered contracts, then the penalty should be waived. Auditors are instructed not to ignore these costs but to identify the costs and mention that the dollar threshold for imposing the penalty was not reached for that particular questioned cost category.

Recommendations

The authors suggest as guidelines the following:

1. Keep in mind penalties for cost submissions containing unallowable costs are approved only in limited circumstances. When a penalty is asserted, carefully review the government's conclusion to ensure the appropriate circumstances justify a penalty.

2. Remember the statutory penalties have always applied only to proposals to establish final indirect cost rates. They do not apply to fixed price contracts. In contrast, CAS 405 applies to any billing, claim or proposal and may result in a reduction in price of a fixed price contract.

3. Be aware of government claims a cost is "expressly unallowable". Such costs include only those costs the FAR states are unallowable in their entirety in all circumstances. A cost subject to a reasonable dispute is not expressly unallowable.

4. Understand the defense of inadvertence is available under both CAS 405 and statutory penalty provisions.

SOME IDEAS TO HELP SWAY SOURCE SELECTION OFFICIALS

(Editors Note. We are continually on the lookout for articles providing practical *insight into successful tactics to win awards. One of our acquaintances is a former contracting officer with many government agencies who has been a member of numerous source selection boards. We have asked her to write a guest article that will provide our readers with some insights from the perspective of the source selection officer. The author, Katherine Szymkowicz, is owner of The Acquisition Network (TAN), a San Francisco based consulting firm that provides acquisition assistance to Federal contractors specializing in bid and proposal preparation, protest strategy, negotiation assistance and general acquisition advice.)*

Simple methods of reducing price can and must be used on all proposals. All of us constantly struggle to cut those pennies from our bid that may give us just the competitive edge we need. The day of the low bid is, for the most part, gone; a low price is no longer enough. The price must be low and must contain the most value to the Government *in the eyes of the Source Selection Authority*. You must use price reduction methods, then explain and highlight them, illustrating not only the low price but also the value inherent in it, or it may cost you valuable points on your technical proposal. The successful price reduction is really a two-part process: first you must determine how to lower your price, then you must insure the Contracting Officer and Technical Evaluation Team understands what you did and sees its value.

Make Sure Technical & Cost Sections Are Consistent

The first thing to remember when explaining your contract pricing is to be certain that your technical proposal and your price match, not just in your eyes, but in the eyes of the evaluator as well. Obvious you say? It would seem so, but a remarkable amount of proposals are rejected for just this reason and it is often

due to unexplained pricing. When the Contracting Officer does a quick and dirty "price reasonableness" test, where staffing hours are multiplied by wage rates, the price is found to be too low to support the staffing level. The proposer finds they are suddenly outside the competitive range or receiving a letter that says "your price is too low."

You may have developed a plan that overcomes the obvious conclusion that the Contracting Officer has reached. You may have used, for example, temporary personnel, assumption of duties by professional employees, avoidance of overtime by shift work, or other cost manipulation, but it won't save you if the perception is that your cost is too low to support the technical proposal. You may have a chance to explain, but don't count on it. With your initial submittal you must be sure the Contracting Officer will find sufficient costing to support your technical proposal and will understand how you got there.

If you receive the "too low" letter, before you raise your price, look at how well your technical proposal is supported by your price. Consider an explanation of how you arrived at your price. Rather than raising your price, and finding yourself underbid, a better strategy may be to revise your staffing and leave your price as is, or merely explain the cost cutting measures that got you there.

Address Different Readers

Another thing to remember is that the proposal is seldom reviewed in its entirety by a single individual. If you have introduced a staff saving idea in one area, say Quality Control, where you are using home office personnel for tracking of deficiencies, the evaluator looking at this portion of the proposal may be impressed but you may be marked down by the individual evaluating your organizational chart because you have no on-site staff for the deficiency tracking purpose. Be sure that your explanation of cost savings appears everywhere it is relevant. This can be particularly challenging with a 50-page proposal limit, but it may mean the difference between success and second place.

The best value to the Government will be the proposal that fully marries the technical and the price proposal, creating an obvious and easily tracked association of the two. Without leading the Contracting Officer through this process, you are at the mercy of the CO's imagination.

Clearly Explain Cost Saving Measures

When explaining your pricing approaches, remember that the Contracting Officer and the technical personnel are often deficient in financial training. Things that may appear obvious to you, or that may seem too simplistic for explanation may be overlooked or misinterpreted without the explanation. An innovative approach must be explained to a level of comfort for them to view it as a positive. While you may see yourself as offering a brilliant initiative, the Government may see a threatening unknown unless you build in a level of comfort for them. Without your guidance through your price savings measures, you may actually be receiving deficiency ratings for the very things that should be assuring award!

The bottom line is if you are using creative price manipulation, explain it. Not only will it insure a proper evaluation of your price, it will illustrate your creativity and innovation as well. For example, explain how your use of a single subcontractor (small, minority owned is often even more desirable) for multiple tasks reduces mobilization and coordination cost and time. Wherever you are providing a product or supplies that must conform to Federal specifications, give the name and manufacturer, illustrating your innovation at finding the lowest priced match and your knowledge of the actual specs.

Price Cutting Ideas

Remember that every proposer except the most inexperienced has zeroed in on the basics and is likely to receive high technical ratings. It is the little things that show a more Government friendly approach that makes the Contracting Officer feel comfortable with you and makes you the selected firm.

Consider the following cost reduction approaches that tend to be highly valued by selection boards:

- Visit the site during the solicitation period to identify places for price reduction in your work plan. Usually a solicitation will fail to show opportunities for work patterns and work progression that can greatly reduce required staffing.
- Consider recycling opportunities. Positive good will with the community aside (and this is no small benefit), recycling can save the cost of disposal and provide monetary return (e.g. computer cartridges).
- Network field office computers to the home office. Using existing Internet connections, the cost of networking is negligible (under $200 per site).

Centralized data can be used in real time to keep managers up to date on the status of all contracts (by their overview of detailed information as it is entered). Increased information can cut time and travel by eliminating field visits having questionable value. In addition, clerical assistance, in the form of data entry, report preparation, etc. can be provided on a part-time basis by home office staff resulting in not having to hire an additional staff member.

• Automation opportunities should be identified for multiple application of data. Data can be entered a single time into a well planned database, and can be sorted for documentation of staff hours worked, time spent on projects, reporting required by the client, quality control overview and other creative purposes that a site may require. Other benefits of using data can be identified. For example, ease of data can lead to greater span of control by managers, thereby eliminating the need for some supervisors and better "empowering" of staff.

• Central purchasing for multiple contracts can also reduce the requirement for a dedicated staff employee at the field level while use of a central person from the home staff may only require a limited number of dedicated hours. In addition, with today's ease of delivery and nationwide service, economic ordering lots for several contracts may significantly lower supply costs.

• Programs for utility conservation can provide surprising savings and are highly valued in the light of recent studies showing government utility costs exceeding industry averages.

• Make sure your overhead and G&A rates exclude excess compensation levels (currently set at $342,986).

• Consider proposing an accelerated schedule that can actually reduce your costs. If overhead, project management, reduced material storage, reduced cost of equipment rental and other reduced costs more than offset the cost of acceleration (possible costs of overtime), offer an accelerated schedule to the Contracting Officer without revealing that it will save you money. You will be a hero for the time saved and a winner for the competitive price. Everyone wins.

• Solicitations that require mandatory staffing, for example "on-site supervisor", rarely specify the duties for the position. Make the position a productive supervisor (or, alternatively, designate one of your original workers as a supervisor) which will cut down unnecessary staff.

• Consider centralizing some functions (e.g. Quality Assurance) that reduce the cost to a single contract and conceivably increase the effectiveness of the function.

• Check the clauses in Section I to see if there is the potential for bi-weekly payments (usually available to small businesses). More frequent billings can be cited as means to reduce financing costs.

• Purchase open tickets at a reduced cost to the site, rather than purchasing the high cost ticket for last minute trips. Explain how you time the trips for maximum impact (perhaps planning your first trip during startup) and send only the two individuals who are required, but explain why those two are better than one. This is the kind of attention to detail that the Government likes and that will set you apart from your competitors. Rather than questioning your ability to meet the required number of times, the Evaluators are awarding you important points.

Any of these ideas can be the innovation that sets you above your competitor, making you first instead of a close second. Your cost savings and the resulting price are only as valuable as the opinion of the Technical Evaluation Team. Walk the Government through your wise and creative cost and price reduction measures, and show the Contracting Officer and their evaluation team that you have the proposal that is the best value. With that perception, how can you lose!

(Editor's Note. For additional cost reduction ideas, see our article "Tactics to Lower Bid Prices" in Vol. 1 No. 2.)

A-76 COMPETITIONS

(Editor's Note. For efforts to streamline government and save money, the federal government is turning to privatization to meet its public service needs. Privatization is a broad term currently in popular use that refers to having private entities perform activities traditionally performed by the public sector. Outsourcing is a predominate form of privatization and is expected to create unprecedented opportunities for contractors to participate. The following is based on an article we recently encountered by Michael Charness and James Farnsworth of the law office of Vinson & Elkins in the October 1999 issue of Government Contract Audit Report as well as our experience helping clients compete for public versus private competitions. This article is intended to provide a basic understanding of the rules future outsourcing competitions are likely to follow.

Background

Outsourcing is a long practice. In 1966, the Office of Management and Budget (OMB) issued Circular A-76 establishing the policy and procedures for converting

government performance of commercial activities to the private sector. A-76 intended to determine if it is more economical for the federal agency currently performing the commercial work to continue or for either another federal agency or private sector contractor to take over the activity. The A-76 Supplemental Handbook sets forth specific provisions including how to conduct cost comparisons of what it costs the government versus the private sector to perform the same activity. *(This is very important since the cost structures of industry sometimes vary considerably from the public sector (e.g. rent is not paid on government facilities). The handbook seeks to adjust proposed prices to put the private versus public bidders on a more "equal footing".)*

Until 1994, use of A-76 to outsource government functions was generally limited. However, faced with the need to modernize its weapons under restraints of limited budgets, the Department of Defense, backed by Congress, has renewed its outsourcing efforts with an eye to turning over the savings to weapon modernization. DOD plans to study 230,000 positions that can be outsourced under A-76, expecting to save $11.2 billion by 2005.

Renewed interest in outsourcing was spurred by the enactment of the Federal Activities Inventory Reform (FAIR) Act in late 1998. FAIR requires federal agencies to list activities eligible for privatization and outsourcing and make this list available to the public. FAIR does not mandate outsourcing these activities but rather directs agencies to review activities for outsourcing opportunities, including A-76 procurement. The first FAIR list was expected this fall.

The A-76 Process

The A-76 process is similar to traditional government procurement with one notable exception: in addition to usual competition between private parties, the private party that prevails over other private parties must then compete with government agencies to win a contract.

The A-76 process begins when an agency notifies Congress it will conduct an A-76 study for a particular commercial activity currently performed by the agency. The activity may be specific, such as maintenance services at a military base, or general to encompass all activities at a facility such as an arsenal or depot. The agency then develops a performance work statement (PWS) for the activity.

Based on the PWS, the government issues a solicitation to potential offerors in the private sector. A-76 permits use of any traditional government procurement method including sealed bids or negotiated procurement. The government also uses the PWS to conduct a management study to determine the best way an agency can organize itself to perform the specified work which is called its most efficient organization (MEO). The government then prepares an in-house cost estimate for performing the work under its MEO. The management plan and in-house cost estimate are provided to the contracting officer and are sealed until proposals are received from the private sector.

The selection process generally involves three steps. First, the government evaluates the private sector offers and chooses a winner from among them under the announced procurement method that generally follows federal acquisition regulation procedures. Second, the government may review the private sector winner's technical proposal and adjust its MEO and in-house cost estimate to match the level of performance included in the private sector winner's proposal, a step that essentially gives the government a "second bite of the apple". As one would expect, this step has been criticized for favoring the public sector's proposal but it is still included as part of A-76 on the grounds it permits comparison of like technical proposals. Third, the government conducts a cost comparison between the private sector winner's cost proposal and the government's in-house cost estimate.

The competition between the private sector and the government does not follow FAR – cost is the only factor in determining who performs the commercial activity. Even the cost comparison is not a straightforward comparison. The government's cost estimate is given an advantage by requiring the private sector's bid to be 10 percent or $10 million lower than the government's cost estimate, whichever is lower.

If the private sector winner fails to overcome the government's cost advantage and is not awarded the A-76 contract, it has the right to file an administrative appeal and if that fails, to seek a review of the decision by the General Accounting Office (GAO). In the past year, both the GAO and federal courts have issued several decisions that seek to clarify the A-76 process.

Recent A-76 Decisions

1. A recent GAO decision limited its ability to hear protests to agency noncompliance "with applicable procedures in its selection process or inconsistent with the solicitation criteria". Further, a successful protest

must show that the failure to follow established procedures could have "materially affected the outcome of the cost comparison." The GAO will not consider protests that challenge A-76 policies or the government's development of the MEO.

2. To challenge the cost comparison between the private sector and the MEO, the protester first must file an administrative appeal with the procuring agency and exhaust all administrative remedies. Challenges limited to the private sector competition need not require full exhaustion of remedies

3. Several GAO decisions have revealed problems with the A-76 process. During the private sector competition, best value rather than mere low price concerns often lead to offerings of innovative approaches that are technically superior even if lowest cost is sacrificed. To win the private versus public competition, however, recent cases have reinforced the prohibition of considering non-cost factors making sure that only lowest cost prevailed. As a result, the private firm may be proposing a solution that is not lowest cost while the government will be inclined to propose the bare minimum technical levels to ensure low cost, giving the government an advantage over the solution that originally was devised to win a best value competition.

4. In recent Courts decisions, federal employees have challenged decisions to outsource jobs that they could lose but most of the time they have been unsuccessful.

CHANGES AND DELAYS – OPPORTUNITIES FOR PRICE ADJUSTMENTS

(Editor's Note. Requests for contract price adjustments due to changes to contracts and delays provide about the only opportunity to increase compensation on a fixed price contract. You do not need to be an expert in government contracting rules and regulations to be able to determine and present a claim against the government. The key question is: Is the performance of the contract different than I planned when I bid the contract? If it is and the difference in performance is increasing the time or cost of performance then you may be entitled to receive additional compensation for the additional time or cost needed to perform the contract. In this article we try to identify those events that will justify a price increase due to the government changing or delaying the work required to perform the contract. This is the third article in a series addressing changes and claims. Previous articles addressed what constitutes a "constructive change" (Vol. 1. No. 1) and how to quantify the contract price adjustment (Vol. 2 No. 2). The next article will address how to effectively present the proposed claim. The source for this article is both our own experience as well as a favorite text of ours, Accounting for Government Contracts, edited by Lane Anderson and published by Mathew Bender.)

Many changes and delays occur in the performance of normal government contracts, some of which justify a contract price increase.

Changes

The so-called changes clause, FAR 52.243-1, gives the government the right to make changes to its contracts while providing an equitable adjustment to the price of the contract for resulting increases or decreases in the cost or time required to perform the contract.

Changes are divided into two groups: (1) express change orders, usually expressed in a formal way and (2) constructive changes. "Constructive changes" are the most common and most contentious because they are usually not formal or in writing nor do they specify an explicit change. We have discussed the common occurrences that give rise to a constructive change in Vol. 1, No. 1 of the GCA DIGEST *(let us know if you would like to have a copy of it)*.

◆ **Express Change Orders**

A change in contract requirements can originate by either the contractor or government and such changes vary by agency in required formality. When the change originates from the contractor in DOD, the contractor documents the effects of the change in an Engineering Change Proposal (ECP) using designated forms (e.g. DD 1692 through DD 1692-6). Changes in civilian agencies tend to be more informal, often having no prescribed procedures or written directive. Each agency also has different procedures for express changes initiated by the government. For DOD, the same forms are used followed by ECPs. In 1992, DOD issued a new clause, DFARS 252.243-7000, requiring additional documentation for ECPs over $500,000. The new requirements stated that when the government issued a request for an ECP, a not-to-exceed price and an adjustment to the delivery schedule was requested along with a completed SF 1411 (the form is no longer required but the information contained in the form still is) and a signed Certificate of Current Cost or Pricing Data when the price was agreed upon.

◆ How are Changes Processed

The agency considers a change and if it is perceived to benefit the government an express change order is issued. In the military departments, the decision to issue a change order is made by a changes board sometimes called a "Configuration Control Board". In most civilian agencies, a changes board is a rarity, leaving the decision to either the original procurement team or for significant dollar changes, to a higher level of authority in the agency.

Once the decision is made, the agency sets aside funds necessary for the changed work. If the change order is unpriced, the estimated amount of funds are "committed" to that contract. Commitment of funds involves setting aside, or earmarking funds without going through a formal obligation process. If the change is priced beforehand, the agency makes a definite assignment of funds to the contract and reports the amount as a firm obligation of the government.

Once an express change is approved, the CO becomes the person responsible for determining the form of the additional contractual documentation. The CO will decide whether to issue a "unilateral" or "bilateral" change. The unilateral change will contain no mention of price or time impact of the change. To avert an open-ended change, most agencies will seek a bilateral agreement where the price and time impact is specified.

Delays

There are two categories of delay: (1) Compensable delays where contractors are entitled to be paid and also receive extensions of the contract delivery date and (2) Excusable delays where contractors are not entitled to recover costs due to delays but do extend the contract delivery date. Since we are focusing this series on increasing compensation, we will concentrate on compensable delays.

The government has numerous reasons to delay contracts and has numerous contract clauses that grant the government authority to bring about such delays. For construction and architect-engineer contracts the government uses suspension of work clauses (e.g. FAR 52.242-14). It has other delay of work and/or stop work clauses for other contracts such as supplies, research and development, services and facilities acquisitions (e.g. FAR 52.242-15, 52.242-17). An important distinction to keep in mind is that the stop work order clauses (e.g. FAR 52.242-15) provides an "equitable adjustment" but the government delay of work clause (e.g. FAR 52-242-17) provides only an "adjustment". The distinction is significant because the "equitable adjustment" allows the contractor to recover both costs and profit while the "adjustment" allows only recovery of costs.

◆ Decisions on What Constitutes Compensable Delays

The courts have established the common instances of government delays that both entitle and do not entitle contractors to additional compensation:

1. *Delay in Issuing Notice to Proceed.* The amount of delay must be "unreasonable." The failure to issue a notice to proceed due to a protest against the award is not considered "unreasonable" and hence not compensable.

2. *Delay in Making the Worksite Available.* The general rule is that the government is not liable for delays in making worksites available unless the contractor can show the delays were the government's fault or there was an express warranty by the government to furnish the site at a particular time. Examples of government fault under the suspensions clause included the government was negligent in keeping the work on schedule or the government failed to urge contractors to perform with adequate speed. However, where the government is diligent in trying to overcome extraneous causes of delayed access, it will not be found liable for delay.

3. *Delay Due to Interference with Contractor's Work.* Where it can be shown the government was at fault for interfering with the work, relief will be granted under the suspensions clause. Examples of findings for the contractor is government ordered changes at the work site resulted in a loss of efficiency and hence increase in costs or the government erroneously directed the contractor to correct certain problems.

4. *Delay in Obtaining Government Approvals.* Unreasonable delay in obtaining required government approvals are grounds for a compensable delay. For example, government's unreasonable delay in approving shop drawings was grounds for relief but not when the contractor's submittal of drawings were late.

5. *Delay in Providing Funding.* Preferential treatment of one contractor over another in funding has been found to be grounds for additional compensation under suspension of work clauses. When a contract depends on successive appropriations, failure of Congress to appropriate funds is not grounds for a compensable delay while an agency's failure to request funds or

advise the contractor of funding status is grounds for compensation. Failure to obtain bank financing is, of course, not grounds.

6. *Delay in Inspecting Work*. A determination of unreasonable delay in the inspection process is to be settled on a case by case basis. Compensable suspensions have been found when the short working hours of a government inspector caused an unreasonable delay. When a suspension clause is not present, the courts have held unreasonable delay in inspecting is a breach of the implied duty to cooperate.

7. *Delay in Issuing Changes*. Though the government is entitled to a reasonable period of time to decide whether to issue a change order, it is liable to the contractor for unreasonable delays which have been defined as delays that impose a substantial additional cost upon the contractor.

◆ Proving the Length of Compensable Delay

The contractor is entitled to recover costs under the suspension of work clause only for delays that are unreasonable in duration. If the delay is the government's fault, the contractor is entitled to compensation for the entire period. If the delay is the result of the government exercising a contractual right, the contractor is entitled to compensation for only the unreasonable portion of delay. The contractor usually has the burden of proving the delay is unreasonable unless the evidence for the cause of delay is in the sole possession of the government in which case the government has the burden of proof the delay was reasonable. Situations where the contractor was entitled to recover for the entire period of delay include a delay caused by: (1) inclusion of incorrect labor standards in the contract (2) obtaining a subdivision plan from a municipality that could only be obtained by the procuring agency (3) very late issuance of a notice to proceed and (4) defective government specifications.

It has been held by the courts to be irrelevant that the contractor is able to accelerate its performance to meet the scheduled completion despite the delay. If the delay is unreasonable, the contractor is entitled to recover all acceleration costs. A contractor that finishes a job late is entitled to recover for government-caused delays measured from the time the contractor could have reasonably expected to complete performance, even if that time occurs earlier than the completion date stated in the contract. In these cases, the contractor must show proof it intended to complete work early.

No recovery will be granted when both the contractor and government are at fault (i.e. so-called "concurrent" delays). The contractor has the burden of proof to show the government delays were not "concurrent or intertwined" with other causes of delay and the contractor did not contribute to the delay. In such cases, however, the government is not entitled to liquidated damages either.

Recoverable costs for an excusable delay include the reasonable costs arising from idle employees and equipment, escalations of material and labor costs, losses in efficiencies or productivity and unabsorbed overhead. The contractor must make an effort to mitigate the effects of a delay and when the contractor has the ability to shift labor force to other work even lengthy government delays may not be considered unreasonable. On the other hand, where close and ongoing cooperation with government is needed in order for the contractor to perform contract work, even delays of one hour may be considered unreasonable.

(Editor's Note. If you think you have grounds for pursuing an equitable adjustment or want to pursue a claim, we will be happy to recommend counsel we have been successful with.)

COST AND PRICING ISSUES UNDER THE SERVICE CONTRACT ACT

(Editor's Note. More and more contractors are coming under the wage guidelines of the Service Contract Act (SCA). Increasing use of service contracting along with increased privatization of many government functions means the SCA will become more significant than ever. Though the provisions of the Davis Bacon Act appear to be widely known, we find a significant lack of understanding of the requirements under the SCA. As the SCA clause and wage determinations find their way into more contracts, there will be more and more traps for unwary contractors to fall into with onerous consequences for noncompliance. We came across a good article in the November 1998 issue of the Government Contract Audit Report written by Schlomo Katz and Daniel Abrahams of the firm Epstein Becker & Green, P.C. that we thought would provide a good basic understanding of the SCA. We recommend our article be distributed to human resources personnel as well as others concerned with cost and pricing issues.)

The purpose of the McNamara-O'Hara Service Contract Act (SCA) of 1965 is to prevent service workers from becoming casualties in the competitive wars between government contractors. The SCA

requires payment of specified minimum wage rates and fringe benefits to employees working on government service contracts and subcontracts.

A federal agency intending to award a contract covered by SCA must notify the Department of Labor (DOL), which then must issue one or more wage determinations (WDs). The WD become a part of the awarded contract and specifies the minimum wages and benefits a contractor must pay. The penalties for violation of the SCA – even for unknowing violations – are stiff including three-year debarments from government contracting unless "unusual circumstances" exist. Several parties are on the lookout for compliance including not only the DOL but also the contracting agency and unions having jurisdiction.

Price Adjustment

SCA regulations require the labor department issue a new WD prior to exercising a contract option on the yearly anniversary date of a multi-year contract subject to annual appropriated funds and every two years for multi-year contracts not subject to annual appropriated funds. When a new WD is incorporated into a contract, the contractor is entitled to a price adjustment by the new WD (FAR 52.222-43 and 52.222-44).

When a price adjustment is justified and what costs are to be included is a case of controversy at this time and has been a source of frequent litigation. Under the clauses mentioned above, a price adjustment includes only increased wages and fringe benefits, not applicable overhead, general and administrative cost or profit. So, the contractor can recover only wages and fringe benefits and not overhead, G&A or profit applied to the increases. When these clauses are absent from the contract, however, a contractor might be entitled to an equitable adjustment on the basis of a "constructive change" to the contract and as such, entitled to overhead and profit (See Geribuni Services Co. ASBCA No 14686). At this time, it is unclear whether the "Christian Doctrine" applies to these clauses. *(Editor's Note. The "Christian Doctrine" provides that mandatory government contract clauses required by law or regulation are deemed to be a part of the contract even if they were not incorporated into the contract. In recent years, Boards and Courts have been determining which clauses are and are not covered by the Christian Doctrine and it has not yet been determined whether the SCA clauses are included under the Doctrine.)*

Since overhead, G&A and profit are not recoverable on new WDs the authors recommend contractors include in their offers for option years an estimate for these applicable items. If a WD is added to a contract for the first time in the middle of a contract year, the resulting price adjustment should include overhead, G&A and profit (see Lockheed Support systems, Fed. Cl. 1996). If the contract always included a WD but the contractor is not in compliance, no price adjustment is allowed for coming into compliance.

Collective Bargaining

The DOL has two ways it can determine the wages and benefits payable under a given contract. One is by surveying prevailing wages in applicable trades in the contract's geographic market. Alternatively, a contractor replacing an incumbent that was subject to a collective bargaining agreement (CBA) is required to pay employees at least the same wage rates and fringe benefits that the predecessor would have had to pay. This includes the obligation to pay any prospective increases called for by the agreement. Even if a contractor is its own successor, the CBA negotiated during one year is the basis for SCA obligations the next year since the DOL considers each option year a new contract for SCA purposes.

The successor contractor rule is limited to wages and benefits. Successor contractors are not required to adopt the seniority systems, grievance procedures, expense reimbursement or work rules of the predecessor. It makes sense to examine CBA's of your competitors before bidding to determine what parts of their agreements are binding on you and which ones are work rules or other nonbinding requirements.

If a new CBA is entered into after a negotiated procurement is awarded or either a contract option is executed or a contract period is extended, its terms will not be recognized if work begins within 30 days of the award, option period or extension. Also, new changes to a CBA will not be effective under the successor's contract if notice of the agreement is not communicated to the agency within 10 days of opening formally advertised bids.

Vacation Pay

WD usually set vacation benefits which normally varies according to the number of years of service. For example, many WDs allow one week or five days of vacation for one year of "continuous service". Accordingly, if an employee has less than one year they would not be eligible for vacation. If that employee quits after six months the contractor would have no obligation to pay for accrued vacation under the SCA (though they may be required to under certain state laws).

The contractor must provide vacation rights when the employee was with the present contractor or a predecessor contractor at the same federal facility. The contractor must provide the benefit either in vacation time or payment before the employee's next anniversary date, before the contract is completed or before the employee leaves. DOL's interpretation prevents employees from accruing unused vacation, holding time in a leave bank and carrying it forward into subsequent years of service.

There is some confusion over what constitutes "continuous service" when there is a break in the continuity of service. No fixed time has been set for determining whether there is a break in service but rather the DOL calls for a determination of the reasons why an employee's absence occurs. Regulations and court decisions have provide that a "break in service" does not occur in the following cases: an employee was granted a leave; an interim period occurs between contracts during which government employees perform the work; a facility closes for three months for renovations. In another case, it was decided that a break in service had not occurred despite a facility's being closed for renovations for 11 months.

Fringe Benefits

SCA WDs include prevailing fringe benefits for the various classes of service employees. Such benefits include medical or hospital care, pensions on retirement or death, compensation for injuries or illness resulting from occupational activity, insurance, vacation and holiday pay.

For a contractor to discharge its obligations, the fringe benefits must be "bona fide" - "require the employer who extends such a benefit to incur a present cost or the risk of a future cost". Thus the test of a "bona fide" benefit is "cost incurred by the employer" not "benefit received" by the employee.

Health and Welfare Benefits

WDs can include one of two different health and welfare (H&W) amounts. The lower H&W amount, which became $1.39 per hour on June 1, 1998 is a fixed amount for every hour of work. This payment is for hours up to 40 hours per week or 2,080 hours per year, including vacation, holidays sick pay and any other hour paid. It must be made in cash, fringe benefits, or a combination for every pay period for every employee.

The higher H&W amount is $2,56 average per hour worked. This is an average rate per hour and is counted as straight time and overtime worked, not hours paid. Thus vacation, holiday, and sick leave is not counted. The requirement is only for an average of H&W payments – in cash or fringe benefits – to all employees working contract wide. Thus some employees could receive more or less than the average, even possibly zero as long as the average is met.

Following numerous lawsuits, DOL moved to phase in a singe H&W hourly rate to be paid on a per hour basis similar to the lower-level rate. The new single rate will not be implemented until June 1, 2000. Meanwhile, existing contracts and follow on work covered by the $2.56 per hour rate will be "grandfathered" at that rate until inflation brings the new unified H&W rate to a higher level. Any new contracts will use the new, lower rate which is $1.39 per hour at present but will change annually.

Self-Insurance Programs

Unfunded self-insured fringe benefit plans (other than such benefits as vacations and holidays, which are normally unfunded) which contractors make "out of pocket" payments as expenses arise rather than irrevocable contributions to a trust or other funded arrangement, are not normally considered "bona fide" plans for SCA purposes. A contractor, however, can request approval by the administrator of an unfunded self-insurance plan in order to allow credit for payments under the plan to meet fringe benefit requirements of the act. In considering whether such a plan is bona fide, the administrator will consider factors such as whether the benefit can be reasonably anticipated, whether there is a legally enforceable commitment to provide the benefit, whether the plan has been carried out under a financially responsible program and whether employees received notice in writing. At the administrator's discretion, they may direct assets to be set aside and preserved in an escrow account or that other protection be afforded to meet future obligations.

Even if an unfunded self-insurance plan qualifies as "bona fide", this does not mean the fringe benefit requirements are met. Only payments actually made by the employer can be counted, not the value of the plan. While all payments made for employees under the plan can be counted against the $2.56 average hourly requirement, only payments made for an individual employee can be counted against the $1.39 per hour H&W requirement.

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Conformance

When a WD included in a solicitation or contract omits categories of service employees the contract intends to employ, that contractor must classify the employees in a way that results in payment of appropriate wages and fringe benefits. The classification chosen must provide a reasonable relationship between the unclassified employees and the classifications listed in the WD based on comparing appropriate level of "skill required and the duties performed".

Contractors can obtain guidance on conforming rates from the way jobs are rated under federal pay systems or other WDs issued for the same general locality. Contractors can also rely on standard wage and salary administration practices that rank various job classifications by pay grade based on point systems or other job factors. Rates may be conformed by looking at similar occupational categories and increases in the rate may be extrapolated by looking at average increases under the WD.

Ideally, a contractor should do a mini-conformance as part of its bid pricing. A contractor must institute its conforming rates procedures before employing a person in a missing job classification. Within 30 days after employment, the contractor must prepare a written report of the proposed conforming action for unclassified employees for submittal to the CO. The contractor must also discuss proposed conforming rates with unclassified employees or their representatives and address any agreements or disagreements in the report. A Standard Form 1444, "Request for Authorization of Additional Classification and Rate" should be submitted in requesting approval of conforming rates.

Next the CO is required to submit the contractor's report, along with the agency recommendations to the Wage & Hour Administrator for review. The SCA regulations state that the Administrator should approve, modify or disapprove the proposed rates within 30 days after which the decision is transmitted to the contractor who then must give a copy to affected employees. The contractor must then pay those employees in accordance with the Administrator's decision. If the contractor disagrees with the decision, it can appeal it to the Labor Department's Administrative Review Board.

Difficulties with Pricing

The problem with arriving at conforming rates is the contractor must second-guess the Administrator because the decision may require a higher wage rate and level of fringe benefits than the contractor bid in its proposal. If that occurs, the contractor must pay the higher rate without receiving a contract price adjustment. If possible, the contractor should seek a clarified WD including the omitted classifications before it bids.

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