Government Contracts
& Disputes

January 18, 2017

Warning Shot Fired (Finally) at Improper DCAA Cost Disallowance Basis

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For a number of years, contractors have been required to expend substantial sums challenging baseless legal theories initiated by the Defense Contract Audit Agency (DCAA) and rubber-stamped by the Defense Contract Management Agency (DCMA) without proper exercise of its authority.

A recent decision by the Armed Services Board of Contract Appeals (ASBCA) in *Lockheed Martin Integrated Systems* (ASBCA Nos. 59508 and 59509) exposes what has been in recent years an all-too-familiar practice by the Government of questioning the allowability of contractor costs based on meritless arguments. That practice starts with the disallowance by the DCAA of costs based upon a novel "theory" which has no identifiable factual, legal or contractual basis. Then, without altering DCAA's findings, in disregard of its responsibilities under the Federal Acquisition Regulation (FAR), the DCMA wholly adopts them as the basis for the COFD and any subsequent appeal. (We provide several such examples below.) Contractors are forced to incur substantial sums that are treated as unallowable under the FAR even though the contractor should not have been forced to incur those costs in the first place.

As many are aware, this practice has evolved, in part, because DCAA has been granted expanded authority in recent years and, correspondingly, in too many cases, DCMA has become increasingly reluctant to challenge DCAA audit findings. Where they have done so, pursuant to internal policy (see Assad Memorandum, Subject: Resolving Contract Audit Recommendations (Dec. 4, 2009)), the issues are elevated to DCMA headquarters for review and, in at least one instance, a contracting officer who challenged DCAA's findings subsequently was the target of an IG investigation. The ASBCA's decision in *Lockheed Martin* may finally mark the beginning of the end for this unfair practice, which, as our examples below demonstrate, is not limited to this one reported instance.

Lockheed Case

In *Lockheed*, the government asserted breach of contract claims totaling approximately $116.8 million based upon two DCAA-originated theories: 1) direct subcontract costs were disallowed based solely on the difference between subcontract costs actually billed by prime contractor Lockheed to the government and costs determined to be unallowable in assist audits of the subcontractors performed by DCAA offices other than the Lockheed DCAA office; and 2) subcontract costs charged at the prime level deemed unallowable

because Lockheed failed to meet its alleged obligation to manage its subcontractors, including but not limited to, its failure to obtain incurred cost submissions from its subcontractors.

One would think that before a COFD is issued asserting entitlement to $116 million, the underlying legal theories would receive thorough analysis to assure they were at least credible, if not rock-solid. That type of analysis appears not to have been performed in this instance. The Board flatly rejected each government breach theory; its reasoning in each instance speaks eloquently to the problems with the Government's approach. With regard to the direct subcontracts costs issue, the Board found:

> "Based on our review, the government's claim for direct subcontract costs fails to state a claim upon which relief can be granted. The complaint offers no legal theory for its claim of disallowance nor does it provide any allegations of fact. It states conclusorily that there were questioned costs and some variances that entitle the government to disallow subcontract costs. Our pleading standard requires factual assertions beyond bare conclusory assertions to entitlement. The audit report, which was incorporated into the complaint, states that some assist audits questioned costs but does not explain on what grounds […] It also states there were differences between amounts in [Lockheed Martin Integrated Systems'] proposal and costs under subcontracts but provides no facts regarding these differences […]. More importantly, the COFD does not cite a single actual fact, only the audit report's unsupported conclusions."

With regard to the allegation of breach in charging subcontract costs at the prime level, the Board found:

> "In this case, we are presented with a claim based on a legal theory, originated by an auditor, that LMIS, as a prime contractor, had a contractual duty to retain for purposes of an incurred cost audit the same documentation that it used to substantiate its billings during the course of performance of the contract and, moreover, had a duty to initiate audits of its subcontractors' incurred costs and be able to prove during the course of an incurred cost audit that it did so. LMIS's "breach" of these *non-existent* duties is the government's only basis for asserting that the subcontract costs for which it has reimbursed LMIS are unallowable. The government does not allege that LMIS did not adequately substantiate its billings during performance of the contract, or that the subcontract services were not provided to its satisfaction, or that the costs billed were not incurred by LMIS. Rather, it has gone forward with a claim for over $100,000,000 that is based on nothing more than a plainly invalid legal theory." (Emphasis added)

The ASBCA also repeatedly noted these theories originated with the DCAA and that the DCMA added nothing to either the complaint or the COFD (e.g., "COFDs and complaint allegations add nothing to what is stated in the audit report. They simply refer to or quote from it.").

Causes of Government Approach

Meritless cases such as this one are likely the result of two factors. First, they are often driven by the pressure of the running of the statute of limitations (SOL). In several of examples below, that was the impetus. It was certainly a factor in *Lockheed*, as the COFD was issued one day before the running of the six-year SOL as measured by Lockheed's ICP submission.

Second, this practice also appears to be the result of DCMA's failure to exercise its responsibility over DCAA. This failure is contrary to the regulations. DCMA's authority in this area is well-established as the FAR charges the CO or delegated contract administration office (CAO) with responsibility for determining the allowability of costs. (See FAR § 42.302(a)(7).) Further, DCAA audit opinions are advisory only, and DCAA recommendations are not binding on federal agencies. (See *General Elec. Co. v. United States*, 84

Fed. Cl. 129, 136 n. 12 (2008), and Defense Contract Audit Agency Manual (DCAAM), § 1-102(a),(b).) In addition, FAR § 33.211 requires that, with regard to claims, the contracting officer must review the facts, get assistance from legal and other advisors, coordinate with the contracting office and prepare a written decision. It is the CO who has the sole authority to decide or resolve all claims (FAR § 33.210).

In recent years, however, as discussed above, there appears to be increasing evidence of Contracting Officers being reluctant to "take on" DCAA, and instead rubber-stamping audit findings rather than having to go through the more difficult internal process of resolving differences of view as to the merits of alleged cost disallowances prior to issuing a COFD.

Other Examples Exemplify the Depth and Breadth of This Problem

The scenario laid out in *Lockheed* is no outlier. A survey of other available examples serves to demonstrate the variety of questionable DCAA theories that the agency has aggressively relied upon to disallow costs in recent years, including the following.

- Facing an expiration of the SOL, DCAA attempted to require the contractor to undertake a cost justification effort it knew could not be completed before the statute expired. Specifically, DCAA required the contractor to provide detailed documentation at the lowest component level for the cost of materials issued from inventory at weighted average cost, an effort that would require digging through multiple levels of accounting records. When the contractor informed DCAA that the request would require three people working full time for at least six months, DCAA took the position that the contractor's incurred cost proposal (ICP) was not adequately supported in violation of FAR § 52.216-7 and, accordingly, the contractor was considered to be a "high risk" contractor. Based on this determination, the ACO made a unilateral determination that the high risk contractor's indirect rates must be decremented by 16.2 percent based upon a "DCAA agency-wide decrement factor" (theretofore unknown to exist and with a basis that is a mystery). This resulted in cost disallowances totaling $5 million, (resolved years later for a tiny fraction of that amount).

- With regard to the same contractor for its FY08, DCAA/DCMA took the position, without having performed an audit of FY08, that if the contractor was high risk in FY07, it must be in FY08 as well, and issued a COFD asserting unallowable costs of close to $1M based on an alleged DCAA agency wide decrement factor of 2 percent.

- In another case, DCAA sought to disallow 100 percent of subcontractor costs based on isolated documents missing from the contract files despite the existence of numerous other documents that supported the costs. For example, DCAA disallowed the entirety of significant subcontract costs based on the sole fact that copies of the modifications in the files were unsigned by both parties. DCAA ignored other documents that supported the costs and the subcontractor's performance of the tasks. Indeed, there was no claim by DCAA that the subcontract work had not been performed or was poorly performed. Nevertheless, they disallowed the entire cost.

- Under pressure from a looming SOL date, DCAA disallowed costs in an audit for FY07 based solely upon a decrement factor found in its FY05 audit. However, the FY05 audit had been rescinded by DCAA in its entirety.

Conclusion and Advice

One would hope that now that this *Lockheed* opinion has been issued, the government will exercise much greater restraint and will not advance legal theories that are unsupported by contract terms, the FAR or case precedent, but which require the contractors to expend large amounts of defense costs that are not recoverable in the absence of the Board or court imposing sanctions for advancing frivolous arguments, an event rarely invoked in the Government Contract world.

While this case does not immediately end these DCAA practices, it obviously can support a contractor's early challenge. This case may serve as the leverage to convince DCAA to rethink its rationale prior to the incurrence of excessive costs on both sides. Accordingly, we urge clients to be vigilant when DCAA issues its findings and be aware that the agency's rationale is subject to increased scrutiny and challenge, particularly now that this case has been decided so forcefully for contractors.

If you have any questions about the content of this Alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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