

**THE RISKS AND EXTRA COSTS OF
FEDERAL GOVERNMENT CONTRACTING©**

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PURPOSE

This paper provides an overview for the busy executive who seeks a basic understanding of the key risks and extra costs of contracting with the federal government. The risks and costs identified in this paper are illustrative, not exhaustive.. While this paper focuses on the principal federal government contracting risks and extra costs, these risks and costs also are commonly found in state and local contracting.

BUSINESS RISKS

Government Cost Principles. Not all costs legitimately incurred in the performance of government contracts are allowable. Moreover, the distinction between direct and indirect costs is a significant concept, requiring an accounting system that clearly and consistently distinguishes the two categories. Factors important to the determination of cost allowability under government contracts are: (i) reasonableness, (ii) allocability; (iii) application of generally accepted accounting principles; (iv) contract terms; and (v) statutory and regulatory

limitations. The bottom line is that many costs incurred in the normal course of business are not recoverable under government contracts.

Contract Formation/Protests. There is a risk that even if the prospective contractor does everything right in preparing and submitting a competitive bid or proposal to the government, and is the apparent winner, a competing contractor may protest, either on the basis that the solicitation for the bid or proposal itself was flawed, or that something went awry during the government's source selection process. Protests in this competitive era are frequent. To defend against a competing contractor's protest usually means litigation or at least a form of alternative dispute resolution. The agency seeking to award the contract is likely to defend its award decision, but the winning contractor may not want to rely on the government alone. Even if a contractor is successful in defending against a protest by a competitor, there are costs involved. More importantly, the business opportunity may be lost, not because the successful offeror was at fault, but rather because the government issued a flawed solicitation or failed to follow its own regulations in the source selection process.

Conversely, the unsuccessful offeror must know when it makes sense to protest a contract to be awarded to a competitor. The "loser" has an especially tough burden in most cases because the government likely will defend vigorously its award decision. If work under the awarded contract has begun, the protestor has an even heavier burden to overturn the selection.

Authority Issues. Contract awards and contract modifications may be made on behalf of the government only by duly appointed contracting officers acting within the limits of both available funding and their delegated authority. This public policy principle of limited authority is strongly supported in the law. The contractor has the responsibility to know the scope of authority of the government official with whom it deals. To the extent that a company incurs costs based upon the directions or promises of government persons without this essential authority, the company does so at its financial risk. .

Many government program officers and engineers do not have contracting officer authority, yet reasonably may be perceived as having such authority. The concept of “apparent authority” does not apply to the government. Additionally, gaining a government ratification of an unauthorized contractual act is difficult. In circumstances where the government defense of “lack of authority” is available, the government nearly always asserts its defense.

Presumption of Good Faith. In taking certain actions, such as a termination for convenience, Government contracting officials enjoy a presumption that they act in good faith. Contractors do not enjoy a similar presumption. The burden of proving bad faith by government persons is exceptionally high. This usually means a tough, uphill battle for a contractor to successfully claim that the contractor was deceived, or treated in bad faith by the government.

Government Audit Rights. The government has the right to audit contractor books and records in specific circumstances as described in several standard

contract clauses. The most common audit situations are: (i) pre-award audits of the proposed price or estimated costs; (ii) pre-award surveys of the contractor's capability to perform the contract and of the contractor's "present responsibility" (including past performance record); (iii) functional systems reviews, such as purchasing and subcontracting systems; (iv) incurred cost audits prior to final payment and closeout; and (v) defective pricing audits to enforce the Truth in Negotiations Act. Services contractors who provide services on a time and materials basis or labor hour basis are also subject to audit.

Contract Changes. The government generally holds the unilateral right to direct changes within the general scope of the contract. (For "commercial item" contracts, agreement to the change by both parties is required.) The contractor generally is obligated to continue performance under the contract as changed, but is entitled to an "equitable adjustment" for the provable and allowable cost consequences of the change.

Convenience Termination. The government has virtually an absolute right to terminate its contracts at the government's convenience for any reason. One of the common bases to terminate a contract for convenience is when funding for the program is exhausted. The risk and cost consequences of a convenience termination should be understood before contracting.

Vehicle for Public Policy. The government uses public contracts to implement national social, economic, and environmental policy. Government contractors have special contractual obligations over and above the obligations of

businesses generally. In many circumstances, these contract requirements are required to be passed – or “flowed down” – to sub-contractors. Of course, there is a cost involved in implementing these programs and business risks in making a misstep in such implementation. In certain circumstances, the contract may be terminated for default for the contractor’s knowing failure to implement required policies. In other circumstances, the contractor may be threatened with debarment from government contracting to induce compliance. The contractor’s failure to flow down required clauses to subcontractors also exposes the contractor to sanctions.

One key requirement is the development of an affirmative action plan covering minorities and women, for contractors with 50 or more employees. Another is the annual reporting of the hiring of certain categories of veterans, regardless of the contractor’s size.

Certifications. Government contractors are required to provide a number of certifications to the Government, many of which must accompany the bid or proposal to enter into the contract. These certifications require attention to detail and precise accuracy. Casual preparation may raise criminal penalties under the False Statements Act.

Furnishing Cost or Pricing Data. Unless an exemption applies, such as “commercial item” or “adequate price competition” contracting, the Truth in Negotiations Act requires a contractor to submit and certify the accuracy, currency and completeness of its cost or pricing data, before the award of a

covered prime contract or contract modification expected to exceed \$550,000. Because the statute requires that the cost or pricing data be “accurate, complete, and current” and that the data be certified, there is a substantial risk that, upon later government audit, the government will claim a dollar-for-dollar price reduction under the contract because it has discovered “defective cost or pricing data.” Should the government believe the contractor deliberately provided flawed or incomplete data, the matter may be referred for civil or criminal prosecution. Not all commercial-type services are regarded as “commercial” to qualify for an exception, and therefore may involve the Truth in Negotiations Act requirements.

Rights in Technical Data and Computer Software. Most companies have some technology or technical approach that gives them an advantage over their competitors. In contracting with the government, the government will often seek to obtain the contractor’s technical data — recorded information, such as blueprints, designs, and processes — for the delivered technology or process, and, more importantly, the government also often seeks rights in these data. There are essentially four types of rights the government may obtain:

Unlimited rights, which means the government can do anything it pleases with the item, the component, the process, or the software, including providing the data to your competitor;

Limited rights, which constrain the government to use the item only for certain specific government purposes;

Restricted rights, are the analogue to limited rights, but apply only to computer software;

Government purpose rights, where the rights are limited rights that turn into unlimited rights after a specified period of time.

Unless a company is alert to the risks of protecting its rights in technical data and computer software, there is a serious risk of unwittingly giving up some or all of its rights.

Warranties. The Federal Acquisition Regulation provides for a number of warranties that may be incorporated into prime contracts, including warranty of services and warranties of systems and equipment. In general, these provide that the prime contractor warrants that all supplies or services are free from defects and will conform to all requirements of the contract. Even beyond any warranty period, the government may pursue a claim against the contractor for “latent defects.” To the extent that the contractor’s warranty to the government depends on the integrity of subcontracted items or services, the prime contractor should obtain a warranty from the vendor or supplier.

Strict Compliance Under U.S. Government Contracts. The government is entitled to “strict compliance” with the technical requirements of the contract. Unlike the commercial world where industry standards are acceptable, the government contract specifications trump industry standards. In this regard, it does not matter that the service or item actually furnished is equal to or superior

to that described in the contract specifications. Strict compliance means exactly that, and there are serious risks for noncompliance.

Federal Supply Schedule Contracting. The federal government spends billions of dollars each year on technology, supplies, and services for purchase by federal agencies through federal supply schedules, maintained principally by the General Services Administration and Department of Veterans' Affairs. These schedules identify technology, supplies, and services available to authorized buyers, and allow federal agencies to buy essentially "off-the-shelf" items by issuing simple orders instead of contracts. Ordering agencies order directly from the schedule, with delivery of the order being made directly to the ordering agency at the price stated on the schedule, or lower price if negotiated. Schedule contract awards are indefinite-quantity, indefinite delivery, fixed-priced contracts to commercial companies for a fixed time period.

In order to obtain a Schedule contract, a company is required to submit information about its current commercial sales practices, including pricing provided to commercial customers. Also, subject to limited exceptions, the contractor is required to give its most favored discount price to the government. A failure to provide accurate, current, and complete commercial pricing information or to provide the best price to the government will result in a re-pricing of government sales under the contract.

RISKS OF PENALTIES AND SANCTIONS

The risks of penalties and sanctions in performing a government contract are substantial. Typical sources of allegations of contract fraud and contractor improprieties are:

- Government audits, inspections, and investigations
- Government regulators' (e.g., OSHA) reports
- Internal employee reports
- Whistleblower suits filed against the company by current or former employees or other individuals (*Qui tam* complaints)
- Competing contractor allegations/suits

The biggest risk areas:

Mischarging. There is a firm obligation on government contractors to charge the government only that amount which is allowed under the contract, the law, and regulations. The contractor must be prepared to prove its charges to the government, often being subject to a rigorous post-contract audit. There are serious criminal, civil, and administrative remedies available for the government to pursue in circumstances where the government has reason to believe that mischarging has occurred.

Business Courtesies. There are a number of statutes and regulations which make it illegal to provide *gratuities* to government persons. The distinctions between a legal business courtesy and an illegal gratuity can be subtle. The

penalties and sanctions associated with providing illegal gratuities to government persons include denial of contract award, cancellation of the contract, criminal prosecution, and debarment from federal government contracting.

Kickbacks. A federal statute makes it illegal for a vendor or supplier to provide anything of value to a contractor or higher-tier subcontractor for or because of favorable consideration. A kickback may be anything from cash or gifts, to entertainment, to work on a home or vacation cabin, to employment of friends or relatives, or to anything else of value. The statute imposes an affirmative obligation on the government contractor to establish and enforce measures to prevent kickbacks within its organization. Stiff monetary penalties are assessable for violation of the federal Antikickback Act.

Conflicts of Interest. In order to protect the integrity of the procurement process, there are serious penalties and sanctions where the government decision maker has a conflict of interest. For example, it is illegal to enter into employment discussions with a government official who is substantially involved in administering your contract, or who has authority to award a public contract to your company. Conflicts of interest, and appearances of conflicts of interest, occur frequently and are dealt with severely.

Collusive Bidding/Bid Rigging. The Sherman Antitrust Act applies to government contracting and provides for both criminal and civil sanctions. Bid rigging and collusive pricing have been favorite targets of federal criminal investigators, and many prosecutions and debarments have resulted from this

illegal conduct. Government contractors have an affirmative duty to ensure its agents and employees avoid contacts with competitor personnel that may be perceived as collusion on marketing, pricing, or bidding.

Defective Pricing. In circumstances where the government establishes that the contractor's submittal of defective cost or pricing data was deliberate, the contractor may be prosecuted criminally for false statements or false claims or pursued civilly for false claims.

False Claims. There are severe sanctions for submitting a false claim to the government. (For service contractors, recording and claiming costs based on labor hours can be a risky area and must be closely watched.) The government may pursue a contractor for false claims either criminally or civilly. Proving a false claim may be based on actual knowledge of the falsity as well as on deliberate ignorance or reckless disregard. Of course, under U.S. law, the company can be criminally and civilly liable for the acts of its employees performed in the scope of employment, or for acts which benefit the company. Huge damages and penalties may result from false claims.

False Statements. There are multiple risks of prosecution under Title 18 U.S.C. § 1001 for false statements to the government. These risks emerge out of the many requirements for certifications, submittals, invoices, and proposals that must be submitted by the contractor to the government. Every such submittal bears the risk of being regarded as a false statement.

Products or Service Substitution. The government may regard substitution of a product or service or omission of a required test procedure required by contract specifications as a willful act and, therefore, punishable criminally either under the False Claims Act or the False Statements Act. This is an area of high risk, requiring government contractors to be especially alert in assuring strict compliance with contract terms. The contractor is responsible to the government to ensure the integrity of the product and service, as well as the integrity of the related paperwork. The government also looks to the contractor to assure vendor and supplier quality procedures. Civil penalties may also result in addition to criminal penalties.

EXTRA COSTS OF BEING A GOVERNMENT CONTRACTOR

Cost Accounting Standards. Under the Federal Acquisition Regulation, contractors who are awarded certain government contracts above a specified dollar threshold are responsible for ensuring that their cost accounting system measures up to the government standards as expressed, *inter alia*, in the Cost Accounting Standards. There are 19 Standards to ensure uniformity and consistency in measuring, assigning, and allocating costs to contracts with the federal government. These must be learned and understood before taking on substantial government work.

Government Contract Cost Principles and Procedures. Not all business costs incurred by a contractor are allowable under government contracts. Cost allowability generally depends on the factors of reasonableness, allocability, the

contractor's accounting practices, the terms of the particular contract, and limitations in laws and regulations.

Contract Financing. The contractor has the principal obligation for ensuring adequate financing to perform government contracts. There are, however, mechanisms for obtaining progress payments based on costs and for obtaining contract funding through payment assignments to lending institutions. The cost of pursuing funding under these circumstances must be taken into consideration.

Disputes and Appeals. There are established regulatory mechanisms for processing disputes and appeals under government contracts, but they may be quite costly. In general, clauses in government contracts require government contractors to follow prescribed procedures in the resolution of these matters.

Quality Assurance. The regulations require that a government contractor establish and follow specified levels of quality assurance in the performance of government contract work. The government will, from time to time, evaluate the acceptability of the contractor's quality assurance practices.

Socio-economic Programs. As discussed briefly above, the government requires its contractors to implement social, economic, and environmental programs. In many cases, the implementation of these programs also must be passed on to subcontractors pursuant to "flow down" clauses. Implementation of these policies does not add intrinsic value to the deliverables under the contract,

but the cost of implementing them is borne by contractors and subcontractors alike.

Foreign Acquisition. Certain statutes — such as the Buy American Act — have the result of making it impracticable for government contractors to acquire materials and services from certain foreign sources. This results in a limitation on the purchase of government contract materials and components from sources outside of the United States, and a potential corresponding cost increase.

Subcontracting Procedures. In certain circumstances, the government's advance consent to subcontracts is required. In other circumstances, the government will perform a "contractor's purchasing system review," pursuant to which the contractor's system for purchasing will be scrutinized in detail by a team of government expert auditors.

Government Property. In many circumstances, the government will provide property for use in the performance of the government contract or the contractor will be expected to acquire property necessary to perform its government contracts. In both of these situations, there are elaborate rules that the contractor must follow in managing government property and accounting for that property at contract completion.

CONCLUSION:

Before wading into the huge and potentially lucrative government market, the alert business organization must first learn what are the pitfalls and likely increased administrative and operational costs involved. This paper identifies the key areas about which more should be known and understood.

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