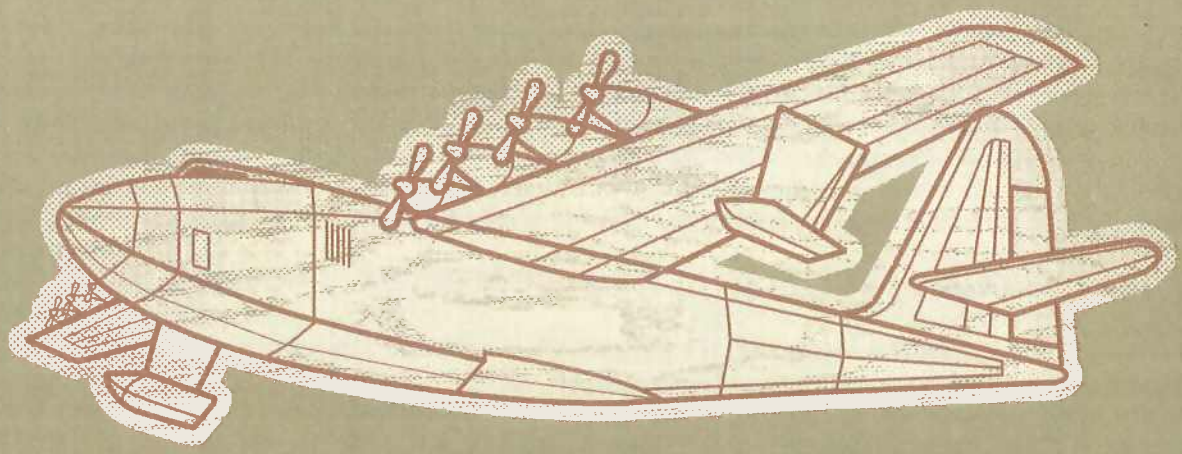
Big Risks, Big Rewards in Government Contracts

Dancing With the World's Biggest Customer

By George D. Ruttinger

The federal government is the largest buyer of products and services in the world. The magnitude of potential revenues and profits from government contracting, together with the trend towards ever-increasing purchases of commercial services by the federal government, has lured many large commercial firms to join experienced government contractors in seeking a foothold in this enormous market. However, as recent experience has starkly illustrated, significant risks accompany the rewards of contracting with the federal government. Such risks include government audits, inspections and investigations; whistleblower suits filed by current or former employees; and challenges by competitors to contract awards.



Understanding the fundamental rules and regulations applicable to government contracting can help companies minimize these risks, while reaping the rewards. Avoiding the risks requires implementing a compliance program that includes training for company employees on the rules and regulations, as well as periodic internal audits to ensure compliance.

Senior executives at companies that are entering, or continuing to participate in, the government market would be wise to acquaint themselves with these rules. Many are designed to ensure that the government chooses among competing products and services on the merits, rather than because of favoritism or financial interest of government personnel. Statutes and regulations designed to restrict operation of the "revolving door" between government agencies and private firms have gained prominence over the past year, in the light of criminal convictions of a senior Air Force acquisition official and a senior executive at a large aerospace defense firm for engaging in prohibited employment discussions at the same time the Air Force official was negotiating a multi-billion dollar acquisition with the company.

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This and other abuses have led to the formation of a multi-agency Procurement Fraud Working Group that will monitor and investigate suspicious activity in the context of government procurements. These developments highlight and underline the need for strong and vigilant compliance programs.

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Not all costs legitimately incurred in the performance of government contracts are allowable. Moreover, direct costs and indirect costs are real and significant concepts, and an accounting system must clearly and consistently distinguish them. Factors important for determining whether costs should be allowed under government contracts are reasonableness, allocatability, applicability of generally accepted accounting principles, contract terms, and statutory and regulatory limitations. Charging of costs that are not allowable or cannot be allocated result in claims for contract price reductions, or even government investigations.

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 pre-award audits of the proposed price or estimated costs; pre-award surveys of the contractor's capability to perform the contract and the contractor's "present responsibility" (including past performance record); functional systems reviews, such as purchasing and subcontracting systems; incurred cost audits prior to final payment and closeout; and "defective pricing" audits to enforce the Truth in Negotiations Act (discussed below). Contractors that provide services on a time-and-materials basis or labor-hour basis are also subject to audit.

INACCURATE DATA CAN LEAD TO CRIMINAL CHARGES

Unless an exemption applies (like that in "commercial item" or "full and open 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 as such, there is a substantial risk that, upon later government audit, the government will claim a dollar-for-dollar price reduction because it has discovered that the contract price was inflated by submission of "defective cost or pricing data." Should the government believe the contractor deliberately provided inaccurate or incomplete data during contract negotiations, the matter may be referred for civil or even criminal investigation.

The government has virtually an absolute right to terminate its contracts at its convenience for any reason, including when funding for the program is exhausted. When a contract is terminated for convenience, the contractor is entitled to recover costs incurred plus a reasonable profit on its performance to date, but is not entitled to lost profits on uncompleted work. Even profit on performance to date may be reduced or eliminated if the contractor was in a loss position

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at the time of termination. The risk and cost consequences of a convenience termination should be understood before contracting.

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 subcontractors. Of course, there is a cost involved in implementing these programs, and there are 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 being barred from government contracting to induce compliance. The contractor's failure to flow down required clauses to subcontractors also exposes the contractor to sanctions.

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GOVERNMENT MAY SEEK CONTRACTOR IP RIGHTS

Most companies have some technology or technical approach that gives them an advantage over their competitors. In contracting with the government, the government often will 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. One of them is "unlimited," which means the government can do anything it pleases with the item, the component, the process, or the software — including providing the data to a company's competitor. Unless a company is alert, it runs a serious risk of unwittingly giving up some or all of its rights.

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" — defects that were not discoverable by reasonable test or inspection at the time of acceptance. This creates a risk of post-contract liability not customarily faced under commercial contracts.

The government is entitled to "strict compliance" with the technical requirements of the contract. In the commercial world, industry standards are acceptable, but 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.

Before wading into the huge and potentially lucrative government marketplace, the alert company must educate itself about and establish safeguards against the likely pitfalls. Consider the example of large defense contractors: They formed the Defense Industry Initiative, and through it they have committed themselves to comply with applicable government regulations and standards of conduct, and to implement best practices in government contracting. All the member firms have established strong compliance programs designed to train employees in regulatory requirements, monitor their compliance, and implement corrective measures when violations are detected. All firms that decide to pursue the rewards of government contracting would be wise to implement such robust prophylactic programs.

George D. Ruttinger is a partner in the Washington, D.C., office of Crowell & Moring, where he practices in the area of government contract litigation and counseling. He has also managed complex, multi-forum litigation, particularly in the field of antitrust.

Richard J. Bednar, senior counsel with Crowell & Moring, assisted in the preparation of this article.