AUDITS & DEFECTIVE PRICING:
TEN ESSENTIAL LESSONS FOR AVOIDING THE AUDIT NIGHTMARE

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Audit Disputes from **Hell**

Are These Your Goals?

• Antagonize Auditors?

• Entice Fraud Investigators?

• Waste Money & Put Your Company at Risk?

• Engender Bitter & Protracted Litigation?
How to Survive the Audit

1. Remember 5 Points of Proof
2. Preserve the Documents
3. Avoid Unnecessary Admissions
4. Fight for Judgments
5. Focus on Disclosure, Not Use
6. Beware Inconsistencies
7. Embrace your Subcontractor
8. Check the Offsets
9. Rebut the Audit
10. Battle the FCA Allegations
Remember the 5 “Points”

Government bears burden of proof for “five points” of defective pricing

1. Cost or Pricing Data
2. Data Reasonably Available
3. Not Disclosed or Known to Government
4. Government Reliance on Data
5. Causation of Increased Price

DCAA Audit Manual

14-102 The DCAA Postaward Audit Program

a. Defective pricing occurs when a contractor does not submit or disclose to the Government cost or pricing data that is accurate, complete, and current prior to reaching a price agreement. Generally, the auditor establishes the existence of defective pricing in a postaward audit by examining and analyzing the records and data available to the contractor as of the date of prime contract price agreement and comparing them with the submitted cost or pricing data.

b. The objective of a postaward audit is to determine if the negotiated contract price was increased by a significant amount because the contractor did not submit or disclose accurate, complete, and current cost or pricing data. To show that defective pricing exists, the auditor must establish each of the following five points:

1. The information in question fits the definition of cost or pricing data.
2. Accurate, complete, and current data existed and were reasonably available to the contractor before the agreement on price.
3. Accurate, complete, and current data were not submitted or disclosed to the contracting officer or one of the authorized representatives of the contracting officer and that these individuals did not have actual knowledge of such data or its significance to the proposal.
4. The Government relied on the defective data in negotiating with the contractor.
5. The Government’s reliance on the defective data caused an increase in the contract price.

Establishing these five points is a necessary prerequisite to support recommended price adjustments and provide the contracting officer with the information to achieve price reductions to contracts.
Save the Documents

When post-award audit is likely:
1. ID key players
2. Get out “hold” notice

3. Collect key documents
   • Proposals & revisions
   • Pricing workpapers
   • Negotiation records & notes
   • Price negotiation memo (PNM)
   • Data disclosures
   • Pre-award audit reports
   • Emails!!!!!

Losing with Lost Records

Audit Statute (10 U.S.C. § 2313) (duty to make records available for audit)

Whittaker Corp. (Straightline Manu.), ASBCA No. 17267, 74-2 BCA 10,938
(no proof of nondisclosure & defective pricing where audit files were lost)

Perelman Wins $1.4 Billion Total in Suit Against Morgan Stanley
(Associated Press, May 19, 2005) (adverse jury instruction due to destruction of email & noncompliance with court order)
Avoid Unchecked Admissions

Classic Admission Traps:

- **Hidden Disclosure**
  - DCAA Assist Audits
  - Audit Workpapers

- **Unreliable Data**
  - Express Limits on Data
  - Never Used in Negotiations

- **Questionable Causation**
  - PCO use of price analysis
  - Disconnect in DCAA theories

Impact of Admissions

*McDonnell Douglas Helicopter Sys.*, ASBCA No. 50341, 99-2 BCA 30546
(MDHS Chief negotiator admitted reasonable availability of data)

*Lansdowne Steel & Iron Co.*, ASBCA No. 17746, 74-1 BCA 10461 (PCO conceded contractor’s offset)

*McDonnell Aircraft Co.*, ASBCA No. 44504, 03-1 BCA 32154 (“McAir waives all defenses” to defective pricing claim except ‘reasonable availability’”)
Fighting Judgments

**War on Judgments**

- **Escalation Attacks**
  - Vendor escalation

- **Engineering Labor Judgments**
  - Stale productivity estimates

- **Software Coding Estimates**
  - Projections on coding efficiency

- **Quantitative Risk Analyses**
  - Judgments on ranges of risk

- **FAR Table 15-2**
  - Disclosure of estimating methods

**Judgments Okay**

- **Cost or Pricing Data Definition**
  - FAR § 2.101 (judgments)

- **Recognized Estimating Techniques**
  - Contract Pricing Reference Guide
  - “Educated guesses”

- **Audit Guidance (DCAM 14-104.7)**

14-104). Therefore, errors in estimates (i.e., estimated escalation factors, estimated direct labor rates, etc) generally would not result in defective pricing because these estimates represent judgments rather than factual, verifiable data (i.e., cost or pricing data).
Focusing on Disclosure

Disclosure is Key

- Disclose, disclose, disclose
- Johnson Rule: When in doubt.
- “TINA is a disclosure statute.”

“The plain language of the Act does not obligate a contractor to use any particular cost or pricing data to put together its proposal. Indeed, TINA does not instruct a contractor in any manner regarding the manner or method of proposal preparation.”

United Technologies Corp., 04-1 BCA 32,556 at 161,024

Disclosure – Not Use

- **DCAA Practice**
  Common complaint that contractor did not “use” cost or pricing data

- **Against DCAA Policy**

14-104.7 Errors in Cost or Pricing Data

TINA addresses only the submission of cost or pricing data. It does not require a contractor to use such data in preparing its proposals or for there to be a relationship between the proposals and the conclusions that can be drawn from such data. Furthermore, the certification relates only to the cost or pricing data. The offeror does not certify its proposal. Therefore, under TINA, the proposal does not constitute cost or pricing data and, therefore, does not have to be free from mathematical errors.
Beware Inconsistencies

**Common Contradictions**

- **Documents vs. Testimony**
  - Premium on records
- **Then vs. Now**
  - Negotiation context vs. post-award
  - *Lockheed Martin, d/b/a Sanders, 02-1 BCA 31,784*
- **Half of Two-Way Error**
  - Government ignores favorable errors
  - *Sparton Corp., 67-2 BCA 6539*
- **Liability vs. Damages**
  - Kaleidoscope theories = no damages
  - *American Machine & Foundry, 74-1 BCA 10409*

**Contradictions Kill**

Mr. Rhodeback’s statements of reliance on BAFO cost or pricing data at trial were unsupported by any contemporaneous project records. Those records of the CO that were adduced—and that we discussed above—show that competitive forces, rather than the defective 1983 BAFO cost or pricing data were relied upon to make the awards and to exercise the options for additional purchases for FYs 86-90. In the face of such credible, contemporaneous evidence, we believe that Mr. Rhodeback’s unsupported trial statements to the contrary were unpersuasive.

*United Technologies Corp., 05-1 BCA 32,860*
Subcontractors & Defective Pricing

- **Get Indemnified**: Prime contractor liability
- **Watch the Clock**: Statute of limitations
- **Beware 2-Front War**: “5 Points” of Proof

Subcontractor

Prime Contractor
Checking Offsets

**Offsets are Great if . . .**

- Five Points of Proof
  - Mirror image of defective pricing
- Certified Offsets
  - Get audit help
  - Avoid 18 U.S.C. § 1001
- Offset Not Knowingly False
  - Barred if “known to be false”
  - 10 U.S.C. § 2306a(e)(4)(B)(i)
- Not FCA Case
  - FCA law undecided
  - DOJ will fight to the death

**“Intentional” Offsets**

- **DCAA Practice**
  Commonly calls all offsets “intentional” because contractor was “aware”
- **Against DCAA Policy**
  - Avoid 18 U.S.C. § 1001
  - Offset Not Knowingly False
    - Barred if “known to be false”
    - 10 U.S.C. § 2306a(e)(4)(B)(i)
  - Not FCA Case
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Rebutting the Audit

Contractor’s Rebuttal

- Contract Disputes Act
  - 41 U.S.C. §§ 601-613
  - Encourages resolution, not litigation

- Regulatory “Due Process”
  - FAR § 15.407-1(d)
  - Contractor opportunity to respond

- Contractor Rebuttal
  - Get the documents
  - Scour the audit
  - Tell your story

3rd Party Oversight

- ADR Policy (FAR § 33.204)
  “Agencies are encouraged to use ADR procedures to the maximum extent practicable.”

- ADR Procedure (FAR § 33.214)
  - Objective: inexpensive & expeditious
  - Agreement (e.g., ASBCA form)

- Other Ideas
  - Contracting Officer as Neutral
  - Government Counsel as Gatekeeper
Battling Fraud Allegations

TINA ➔ Fraud

- TINA Certification
  - “current, accurate & complete”

- Emergency Contracting
  - Procuring agencies in a hurry

- Expanding FCA Market
  - DOJ involvement
  - Inspector General audits
  - Qui tam allegations

FCA Landmines

- Elements of Proof
  - More or Less? (e.g., “reliance”)
  - FCA + TINA? Like J.T. Construction

- Presumption of Causation
  - Benefit of TINA presumption?
  - U.S. ex rel. TAF v. Singer (4th Cir. 1989)

- False Estimates
  - Objective falsity vs. subjective estimates
  - Harrison v. Westinghouse (4th Cir. 1999)
Questions?

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