INTRODUCTION

Companies with little federal government contracting experience, before entering this special world, should understand the risks and costs of government contracting. This is a brief summary of the key risks and additional costs of contracting with the federal government. The list is not exhaustive; it is illustrative. While this paper focuses on the principal federal government contracting risks and extra costs, these are commonly found in all public contracting. Here are the key ones:

BUSINESS RISKS

Protests. There is a risk that even if the prospective contractor does everything right in preparing and submitting a competitive proposal, a competing contractor may protest against the selection of the winner, either on the basis that the solicitation itself was flawed, or that something went awry during the government’s source selection process. To defend against a protest usually means litigation or at least a form of alternative dispute resolution. Protests in this competitive era are frequent. 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 is awarded to a competitor.

The Contracting Officer. Contract awards and contract modifications may be made on behalf of the government only by duly appointed contracting officers acting within the limits of their authority. This public policy principle is strongly supported in the law. To the extent that a company incurs costs based upon the directions or suggestions of government persons without contracting officer authority, the company does so at its risk. There also is risk in acting on the oral direction of an authorized contracting officer.

In circumstances where the government defense of “lack of authority” is available, the government nearly always asserts its defense, even in circumstances where the contractor may have abided by the direction of a high-
ranking government official, such as the program manager or engineer. The concept of restricted and limited authority is a unique feature of U.S. government contracts. The concept of apparent authority does not apply to the government.

**Presumption of Good Faith.** 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 the government is exceptionally high. This usually means a tough, uphill battle to successfully claim that the contractor was deceived or treated unfairly by the Government.

**Government Audit Rights.** The government has the right to audit contractor 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 “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. Professional services contractors who provide services on a time and materials basis or labor hour basis are also subject to audit.

**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 obvious reasons to terminate the contract for convenience is where funding for the program is exhausted. The cost consequences of this event should be understood before contracting.

**Vehicle for Public Policy.** The government uses public contracts to implement social, economic, and environmental policy. In many circumstances, these policy requirements are passed down to sub-contractors. There is a cost involved in implementing these programs and business risks in making a misstep in such implementation. In certain cases, the contract may be terminated for default for the contractor’s knowing failure to implement required policies. In other circumstances, the contractor may be debarred from government contracting. Failure to flow down required clauses to subcontractors also opens a contractor to sanctions.
**Furnishing Cost or Pricing Data.** Unless an exemption applies, such as “commercial item” contracting, the Truth in Negotiations Act requires a contractor to submit cost or pricing data before the award of a prime contract awarded on the basis of other than sealed bid procedures and 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 inaccurate data, the matter may be referred for civil or criminal prosecution. Standalone services frequently are not regarded as commercial, 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 doing 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,** constrain the government to use the item only for certain specific government purposes;

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

- **Government purpose rights,** 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 with all requirements of the contract. Beyond any warranty period, the government may 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. 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.

**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
- Law suits filed against the company by employees or other individuals (**Qui tam complaints**)  
- Competing contractor allegations

The biggest risk areas:

**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 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 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 applicable for creating a conflict of interest with the government decision-maker. For example, it is illegal to enter into employment discussions with a government official who is considering your company for the award of a public contract.

**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 pursuit.

**Defective Pricing.** In circumstances where the government proves that the submittal of defective cost or pricing data was deliberate, the contractor may be prosecuted 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 professional service contractors, recording labor hours can be a risky area if not closely watched.) The government may pursue a contractor for false claims either criminally or civilly. Proving a civil false claim generally is not hard, and may be based not only on actual knowledge, but on deliberate ignorance or reckless disregard. Of course, under U.S. law, the company is liable for the acts of its employees. Huge damages and penalties may result from false claims.

**False Statements.** There are multiple opportunities for prosecution under Title 18 U.S.C. § 1001 for false statements to the government. These opportunities emerge out of the range of requirements for certifications, submittals, invoices, and proposals that must be submitted by the contractor.

**Products or Service Substitution.** The government may regard substitution of a product or service 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.
COSTS OF BEING A CONTRACTOR

Cost Accounting Standards. Under the Federal Acquisition Regulation, contractors who are awarded government work above a dollar threshold amount 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.

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 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, there are clauses in government contracts which require government contractors to follow prescribed procedures in the resolution of these matters.

Quality Assurance. The regulations require that a government contractor establish and practice 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 policies also must be passed on to subcontractors pursuant to “flow down” clauses. None of these policies adds value to the deliverables under the contract, but the cost of implementing them is borne by the contractor.

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 foreign sources. This results in a limitation on the purchase of goods outside of the United States.

**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 experts.

**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 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.

**OFFICER AND DIRECTOR PERSONAL LIABILITY**

Recent court decisions make it clear that Company officers and directors may incur personal liability for (i) lack of attention to compliance for a prolonged period of time, or (ii) through failure to follow up with an investigation and corrective responses where the officer or director has information suggesting a compliance problem that would cause a reasonable party to respond. (In short, personal liability has been found for gross neglect or conscious disregard of a known risk.)