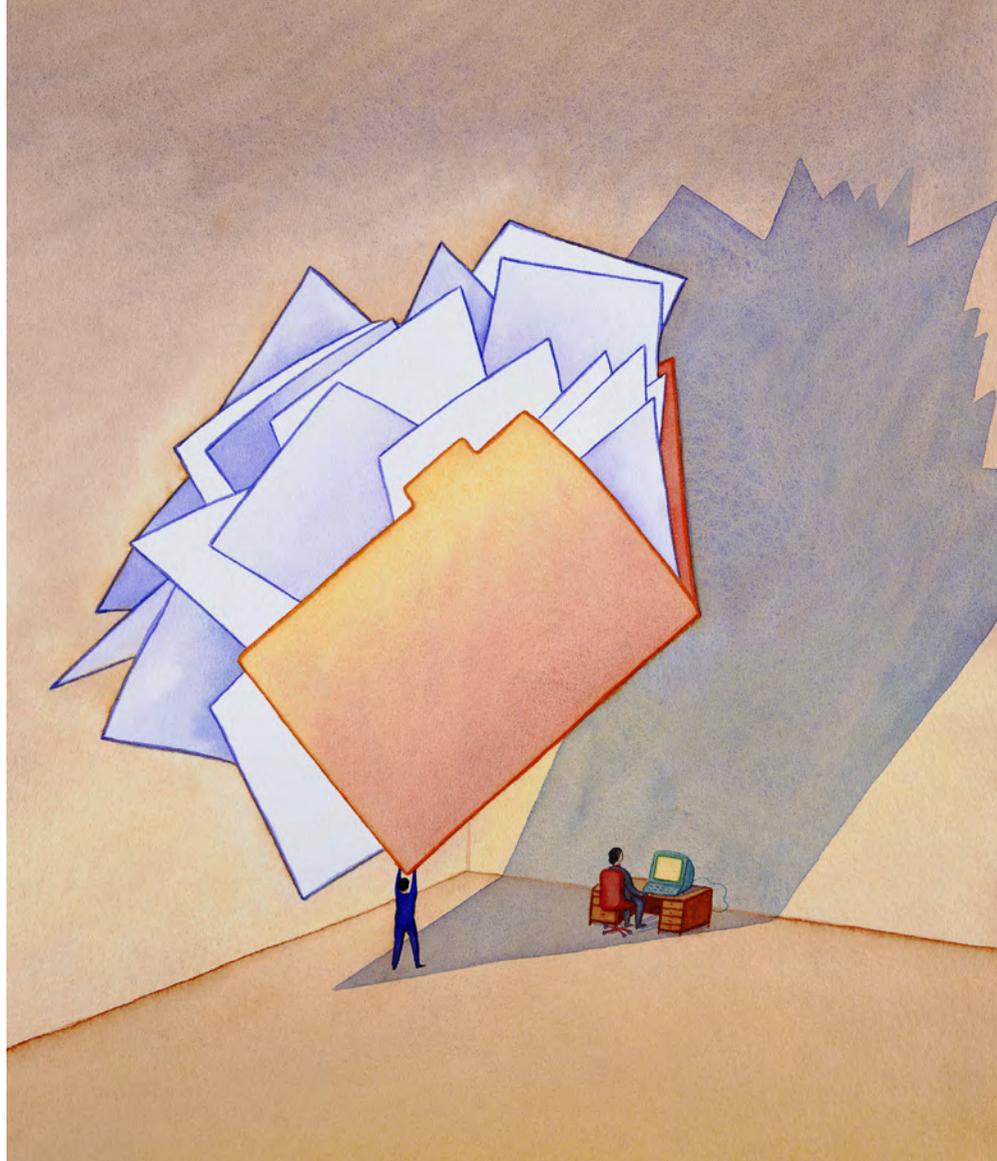


# THE UPCOMING EXPLOSION IN GOVERNMENT CONTRACT LITIGATION

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We are entering a period of unprecedented oversight of federal government contractors. New laws, regulations, and policies are adding layers of complexity to an already overly complex system. There is a growing tendency to point to government contractors of all types as the source of widespread waste, fraud, and abuse. In addition, the government is substantially increasing not only the number of employees dedicated to contract oversight and enforcement but also the authority of investigators. The one “certainty” surrounding the many changes being made is that contractors will be increasingly forced to defend themselves in both administrative and judicial forums.

This article presents an overview of some reports issued by the Government Accountability Office (GAO), executive orders, and statutory changes that have emerged over the last two years and will result in a significant increase in government contract disputes and litigation.

## The Defense Contract Audit Agency and the GAO

The GAO fired the first shot in the new war on waste, fraud, and abuse on July 22, 2008, when the agency issued a report<sup>1</sup> charging that the Defense Contract Audit Agency (DCAA) had failed to meet professional standards at several locations studied. In that report the GAO found that “DCAA managers took actions against staff at two

locations, attempting to intimidate auditors, prevent them from speaking with investigators, and creating a generally abusive work environment.” GAO-08-857, cover page.

Even though the GAO study involved only a small number of locations, the report is a general indictment of the way DCAA conducts business. Overall, the report indicated that the DCAA had created a “culture” in which the agency put substantial pressure on its auditors to issue “clean” audit opinions. In another example, the GAO stated that there was “evidence that there was an up-front agreement between DCAA and Contractor A to limit the scope of work and basis for the audit opinion (a significant impairment of auditor independence).” GAO-08-857, p. 19.

These are just examples of more than three dozen “case details” in the report finding that the DCAA management took actions that resulted in contractors receiving favorable reports they did not deserve. The logical consequence of this finding is that, in a knee-jerk reaction, DCAA auditors will feel intense pressure to include unfavorable comments in the majority of its future audits, and supervisors will be increasingly reluctant to question or change an auditor’s unfavorable comments. An unfavorable comment in an audit can result in reduced or delayed payments, negative evaluations of past performance, and a suspension or debarment action against the contractor. As a result, contrac-

tors will be compelled to appeal adverse findings that are not supported by laws or regulations.

After the GAO report came out, the DCAA issued a policy memorandum on Dec. 19, 2008, which stated:

As further clarification, the contractor's failure to accomplish any control objective tested for in DCAA's internal control audits will or could ultimately result in unallowable costs charged to [g]overnment contracts, even when the control objective does not have a direct relationship to charging costs to [g]overnment contracts. For example, the control objective related to ethics and integrity is not directly related to charging costs to [g]overnment contracts.

DCAA Memorandum for Regional Directors, 08-PAS-043(R)

The memorandum specifically focuses on "ethics and integrity" as an example of internal control policy that "could ultimately result in mischarging to [g]overnment contracts" and notes that "[i]t is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness." The memorandum concludes by stating that auditors may no longer issue findings of "inadequate in part." Instead, the auditor may report the entire system as inadequate and recommend that the contracting officer should take corrective action.

The corrective actions available to the contracting officer include reducing or withholding progress payments and seeking reimbursement of costs. Such a finding could also result in the contracting officer initiating a suspension or debarment action against the contractor and initiation of an investigation under the federal False Claims Act (FCA), which is discussed in more detail below, as a failure to report an overpayment a contractor knew about or should have known about, can be considered a false claim.

In support of the new DCAA policy, the Department of Defense has proposed a new rule for the Defense Federal Acquisition Regulation Supplement (DFARS). This change will permit contracting officers to withhold payment for perceived deficiencies in any of the following business systems: accounting, estimating, purchasing, earned value management, material management, and property. Deficiencies in these systems will allow a contracting officer to withhold between 5 and 10 percent of payments for each system considered to be deficient; the total could reach 50 percent. 75 Fed. Reg 2457 (Jan. 15, 2010). The deadline for comments on this rule was March 16, 2010. As this article goes to press, the Defense Department had not yet published a final rule.

On Dec. 19, 2008, the DCAA issued a memorandum titled "Denial of Access to Records,"<sup>2</sup> which states that the data required by auditors should be (1) "readily available," (2) provided within a "reasonable time," and (3) available "upon request," unless there are "extenuating circumstances." The memorandum and its instructions also state that support "includes access to personnel." Given the overall nature of the memorandum and instructions, the DCAA will require contractors to give the agency the documents,

personnel, and other support needed to conduct an audit.

On March 13, 2009, the DCAA issued another memorandum,<sup>3</sup> which stated the following: "Certain unsatisfactory conditions related to actions of [g]overnment officials will be reported to the Department of Defense Inspector General in lieu of reporting the conditions to a higher level of management." DCAA Memorandum for Regional Directors, 09-PAS-004 (R), p. 1.

The primary purpose of this memorandum seems to be to intimidate contracting officers into accepting the findings of the DCAA's audit or risk an audit by the department's inspector general. Because a government agency's contracting officer is the only individual authorized by law to make decisions regarding contract requirements or a contractor's performance, this DCAA memorandum appears to be designed to reduce the independence of the contracting officer, regardless of whether, in the contracting officer's judgment, the findings are warranted. The danger to contracting officer's independence is shown by the following comment in the memorandum:

An example might include a situation where the contracting officer purposely excludes DCAA from performing or completing an audit to avoid a negative report (e.g., audit report with an adverse opinion). Another example may be where a contracting officer ignores a DCAA audit report and takes an action that is grossly inconsistent with procurement law and regulation (e.g., awards a contractor unreasonable or excessive costs and/or profit)."

DCAA Memorandum for Regional Directors, 09-PAS-004 (R), p. 1.

By using this example, the DCAA is putting contracting officers on notice that, if the contracting officer does not support a DCAA finding, the DCAA will take action against the agency's contracting office. This outcome will have a chilling effect on the contracting officer's independence, because it will create a new burden on already overworked contracting officers, which, in turn, will require them to defend themselves against DCAA allegations that the contracting officer's action was improper.

The pressure on the DCAA to issue negative findings was further increased by the release of a 153-page GAO report on Sept. 23, 2009, entitled "Widespread Problems with Audit Quality Require Significant Reform." GAO-09-468. The overall nature of this report is shown by the title of the first two appendixes to the report; Appendix I: Internal Control System Audits Did Not Meet Professional Standards, and Appendix II: DCAA Does Not Perform Sufficient Work to Identify and Collect Contractor Overpayments.

The message of the report is clear: The DCAA is not doing its job. In order to correct this impression, the DCAA will be compelled to implement policies and procedures that will result in substantially more adverse findings in its audits. Given the intense criticism of DCAA management for overriding or ignoring the work done by auditors and the possibility that contracting officers will be reported for failing to enforce the DCAA's findings, valuable checks and

balances have been taken out the system. The only place left to serve as a check on an overly enthusiastic auditor will be in the courts and administrative boards.

### Executive Orders and Memorandums

Shortly after taking office, President Obama issued a number of executive orders that will have a substantial impact on government contractors. Although all these orders are focused on increasing government efficiency and strongly emphasize fighting waste, fraud, and abuse, the executive orders tend to shift the burden to contractors to prove they are in compliance, to put pressure on agencies to find wrongdoing on the part of the contractors, and to reduce barriers to bringing claims and actions against government contractors.

On Jan. 21, 2009, the President issued a memorandum stating that, when agencies review requests under the Freedom of Information Act (FOIA), “[a]ll agencies should adopt a presumption in favor of disclosure, in order to renew their commitment to the principles embodied in FOIA, and to usher in a new era of open [g]overnment. The presumption of disclosure should be applied to all decisions involving FOIA.” It is interesting to note that this memorandum is focused on restoring trust in the government by specifically stating that information should not be kept confidential because of the possibility that public officials will be “embarrassed” or because of “speculative or abstract fears.”

Nonetheless, because the agencies have been directed to resolve doubts in favor of disclosure, this memorandum is likely to increase the number of FOIA requests for sensitive and/or confidential contract information. As a result, contractors will test the new policies in an effort to obtain information that will assist them in understanding how their competitors build and price proposals. Consequently, the targets of those requests will be compelled to file suit under FOIA to stop the release of information that may give companies insight into their competitors’ bidding practices and procedures.

On Jan. 30, 2009, the President issued an executive order prohibiting contractors from including costs related to collective bargaining. The order stated that these costs are not allowable if they are incurred by a contractor to encourage an employee “to exercise or not to exercise, or concerning the manner of exercising, the right to organize and bargain collectively through representatives of the employees’ own choosing. Such unallowable costs shall be excluded from any billing, claim, proposal, or disbursement applicable to any such federal [g]overnment contract.” It is likely that this order will result in many disputes over the allowability of costs in virtually all contracts with companies that have collective bargaining agreements or are involved in efforts to establish such agreements. Given the recent criticism of the DCAA as found in the GAO report discussed above, auditors will be pressured to disallow costs that may be related to a collective bargaining agreement in order to avoid the appearance that the auditor is favoring the contractor. This outcome will result in a substantial increase in litigation, because the courts will be used to clarify rules that agencies are unable to clarify themselves.

A memorandum issued by President Obama on March 4, 2009, noted that a 2008 GAO study of 95 major defense acquisition programs “found cost overruns of 26 percent, totaling \$295 billion over the life of the projects.” Therefore, the President ordered the development of

[g]overnment-wide guidance to assist agencies in reviewing, and creating processes for ongoing review of, existing contracts in order to identify contracts that are wasteful, inefficient, or not otherwise likely to meet the agency’s needs, and to formulate appropriate corrective action in a timely manner. Such corrective action may include modifying or canceling such contracts in a manner and to the extent consistent with applicable laws, regulations, and policy.

When read in its entirety, this order seems to imply that all overruns are the result of contractors’ inefficiency or fraud. Consequently, this policy is likely to result in a substantial number of contract terminations for which the courts will be required to determine if “overruns” were caused by the contractor or the government and whether the government or the contractor must bear the burden of the disputed costs.

In a memorandum issued on Jan. 20, 2010, the President directed the IRS to conduct a review of all “certifications of non-delinquency” that were submitted by government contractors since the requirement was implemented in 2008. The IRS was directed to provide the President a report on the overall accuracy of contractor certifications within 90 days of the memorandum. This order is likely to increase litigation as disputes arise over the accuracy of the data collected by the IRS.

Finally, on March 10, 2010, the President issued an executive order titled “Finding and Recapturing Improper Payments.” In this memorandum, the President announced his administration’s plan to expand the use of “payment recapture audits,” which he defined as “a process of identifying improper payments paid to contractors or other entities whereby highly skilled accounting specialists and fraud examiners use state-of-the-art tools and technology to examine payment records and uncover such problems as duplicate payments, payments for services not rendered, overpayments, and fictitious vendors.” These audits are likely to result in significant disputes about the propriety of various payments, and these disputes will have to be resolved in court.

### Statutes and Regulations

On May 20, 2009, the President signed the Fraud Enforcement and Recovery Act (FERA),<sup>4</sup> which substantially modified the False Claims Act, making it easier for private citizens to bring suit against contractors in the name of the government and to recover a portion of the damages as well as attorneys’ fees. The revised FCA, in combination with the changes discussed above, are likely to result in a significant increase in lawsuits related to the FCA.

In addition to making it easier for a private citizen to

bring an action under the FCA, FERA added \$165 million to the federal budget for investigating false claims and also established a federal task force aimed at increasing the government's ability to investigate false claims. A false claims suit can arise from a false statement in any of the dozens of certifications a contractor is required to execute—from failure to strictly comply with the terms and conditions of an individual contract to submitting an improper pay request.

Prior to the passage of the FERA, a false claim had to be made with the intent to get money from the government. The FERA deletes that FCA provision and replaces it with the explanation that false claim involves making a false record or statement that is “material to a false or fraudulent claim.”<sup>5</sup> This new standard introduces substantial flexibility, which increases the likelihood that a false claims suit will be successful. Because FCA actions can be brought by a disgruntled employee, the slightest deviation from the strict requirements of a contract could result in litigation being brought against a contractor.

Perhaps the most significant impact of the FERA is the provision that gives the U.S. attorney general the right to delegate the authority to issue a Civil Investigative Demand (commonly known as a CID) and the Justice Department the right to share information it obtains from a CID with the individual who brought the suit. On March 24, 2010, the attorney general delegated the authority to issue CIDs to the U.S. attorney for cases that are delegated to that office. 75 Fed. Reg. 56, p. 14072. This will make it substantially easier for the government to investigate FCA claims.

### Coming Soon to Contractor Near You

The U.S. Department of Labor is considering implementing a new program, referred to as the High Road Contracting Plan, which would make a contractor's labor policy a key element in evaluating bids and proposals. An article written by Robert Brodsky that appeared on [GovernmentExecutive.com](http://GovernmentExecutive.com) on April 1, 2010, discussed the reasons this program is under consideration. In his article, Brodsky noted that two congressional representatives had asked the GAO “to quantify the taxpayer burden associated with a certain company if they pay so little that workers and their families qualify for federal safety-net benefits.”<sup>6</sup> Even though, on the surface, conducting such a study makes sense, if the results lead to implementation of the High Road Contracting Plan, government contractors can expect a significant increase in bid protests, contract disputes, suspensions and debarments, and false claims acts suits. Under this initiative, each negotiated procurement would include an evaluation factor that rates the following items:<sup>7</sup>

- Whether the contractor pays a “livable wage,”
- Whether the contractor provides “quality, affordable health insurance,”
- Whether the contractor has “an employer-funded retirement plan and paid sick leave,” and
- Whether the contractor is in compliance with federal and state tax and labor laws.

If this policy is implemented, there is a strong likelihood that there will be disputes over the interpretation of these terms and application of the criteria to the contract award. Because these issues will become another factor that must be considered in selecting a contractor, they will be subject to review by the GAO and the courts. In addition, the application of these standards could be considered a constructive suspension or debarment giving rise to numerous lawsuits challenging these rules.

Finally, in the area of labor, it is important to note that the Office of Federal Contract Compliance Programs has received funding to increase its oversight of various affirmative action regulations and policies. One of the areas on which the office will be focusing will be the state and local contracts that have been funded by the American Recovery and Reinvestment Act. Because the act not only requires compliance with numerous federal laws that may not traditionally apply to state and local government contracts but also contains complicated reporting requirements, it is likely that many contractors will face adverse action by the U.S. Department of Labor.

### Conclusion

We are entering an era of unprecedented government control over government contractors and the public employees that oversee contracting; it is an era during which suspicion of wrongdoing attaches to virtually all contractors. The public assumption that the system is rife with fraud, corruption, and waste puts intense pressure on our political leadership to develop policies and procedures that appear to guarantee that taxpayers are protected from the slightest possibility of misuse or abuse of public funds. There is also intense pressure to ensure that public funds are spent in a socially responsible manner without regard to the additional costs contractors are forced to incur in order to correct agency actions that may be unreasonable.

The various reports, executive orders, memorandums, and statutes discussed in this article are just the tip of the iceberg. Over the next few years, we will see many more regulations aimed at creating the appearance that government contractors are providing the best pay and benefits packages to their employees while ensuring that the government consistently gets the best possible products for the goods and services it pays for. Even though, on the surface, this goal sounds promising, when the policy is implemented in a way that unduly shifts the burden (and cost) to contractors to prove that they are in full compliance with everything, contractors will be forced to rely on the court to protect them from unfair and unreasonable government actions. **TFL**

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