On March 23, 2012, Lockheed Martin **agreed** to pay $15.8 million to settle allegations that the company mischarged the U.S. government for "perishable tools" used on major aircraft programs, including the F-22 and the F-35. What caught our eye was not necessarily the size of the settlement (it's rather small as such things go) but, instead, it was the fact that it was LockMart's subcontractor (Tools & Metals, Inc., or TMI), that did the actual mischarging. LockMart just added burden and fee to the subcontractor's costs, and invoiced the government. Normally, it's rather difficult to establish liability under the civil False Claims Act (FCA) for (presumably unknowingly) passing on improper costs to the government.

As many readers are likely aware, the civil **False Claims Act** was amended in 1986 to establish defendant liability for "deliberate ignorance" and for "reckless disregard" of the truth. So to prove that LockMart was liable, the government needed to show that it acted in deliberate ignorance or with reckless disregard for the accuracy of TMI's invoices. That is not as difficult as showing *scienter* (*i.e.* , knowing intent), but it's not especially easy to do either.

Readers also need to understand that the government typically holds the Prime accountable for the actions of its subcontractors. Accordingly, if the subcontractor commits "defective pricing" then the government's remedy is to assess the pricing impact at the Prime level, and leave it up to the Prime to recover the price adjustment through legal action against the subcontractor. That's called "privity of contract" and it basically means that the contract is between the Prime and the government, so the government has no means of reaching the subcontractor.

Now, privity of contract is not always in play. For example, many times the cost impact(s) of CAS noncompliances will be assessed against the subcontractor and not the Prime—particularly if the subcontractor is a large company. (We note legal precedents that say this should not be the case, but in our experience it is the case, regardless of legal opinions to the contrary.)

In this particular instance, it seems that the government went after the subcontractor (TMI) first, then came after the Prime (Lockheed Martin) separately. (We caution readers that our interpretation of the situation may be wrong; we have no inside information and have only the tidbits in published news stories to guide us in our analysis. So *caveat emptor*.)

The news story (link in first sentence, above) reported—

In March 2006, Todd B. Loftis, a former TMI president, was sentenced in federal court in Fort Worth, Texas, to 87 months in prison and ordered to pay $20 million in restitution after his December 2005 guilty plea in connection with his role in the scheme.

Loftis had waived an indictment and pleaded guilty to a one-count information charging conspiracy to defraud the government with false and fraudulent claims. He admitted that from 1998 through 2004, as president and chief operating officer at TMI, he, along with others, conspired to defraud the Defense Department and Lockheed Martin Aeronautics by obtaining payments from both through false and fraudulent billings. …

In order to cover up this activity, the government said, Loftis and others under his direction created false invoices using a computer scanner to remove actual pricing data and substitute fictitious data to give the appearance of legitimate pricing. Loftis was able to control the audit sample of invoices as well so as to limit the possibility that a fraudulently priced part would be found. After the audits, Loftis ordered the fraudulently created documents and computer files to be destroyed.

TMI and Loftis realized approximately $20 million in profits on these fraudulent sales to the government, prosecutors said.

The foregoing provides details regarding how TMI perpetrated its fraud, but it doesn't address LockMart's culpability. Where was the deliberate ignorance or reckless disregard?

The first thing we noticed in the story was the following sentences—

In 1998, TMI … obtained a sole-source integrated supply contract with Lockheed Martin Aeronautics to supply all of Lockheed's perishable tools for the manufacture of airplanes including the Defense Department's F-16, F-22 and other military needs in Fort Worth, San Diego and Marietta, Ga. Perishable tools are the drill bits, router bits and other small tools that are used in the manufacturing process.

We wonder why TMI was able to win the subcontract award. Now, perhaps TMI had some kind of proprietary technology that made its "drill bits, router bits and other small tools" the only ones that met LockMart's requirements. That kind of technology certainly would justify a sole-source subcontract award. But we are skeptical that would have been the case. In fact, we bet that more than one company in the USA offered such perishable tools, and would have been willing

to submit bids on the subcontract, had LockMart opened up the opportunity to competition.

The story reported that the government was "accusing the firm of contributing to the inflated amounts paid by the government by failing to adequately oversee TMI's charging practices and by mishandling information revealing these practices." Thus, according to the story, it was not so much a matter of inappropriately awarding the subcontract, as it was a matter of failing to ensure that TMI was submitting accurate invoices. We have reported on DCAA's concerns with similar matters **before** . In that article, we quoted DCAA Director Pat Fitzgerald as follows—

During our review of prime contractor billings and incurred cost audits, DCAA has identified situations where the prime contractor has not awarded its fixed-price subcontracts based on fair and reasonable prices leading to unreasonable or unallowable costs being paid by the Government. … in those cases where the subcontract is sole source, it is often difficult to obtain cost data to ascertain the reasonable costs without access to the subcontractor's books and records. DCAA access to subcontractor books and records is generally limited and dependent on the flow down by prime contractor to the subcontractor of the appropriate FAR clauses, and in instances of fixed price subcontracts, virtually nonexistent. … Since DCAA does not have access to the subcontractor's books and records, we were unable to determine through other processes the reasonableness of the prices being paid to the subcontractor and subsequently passed on to the Government for reimbursement. … The FAR audit access clause does not provide for Government access to the subcontractor's costs records when the subcontract is firm-fixed-price.

Because DCAA was not able to verify the "reasonableness" of the subcontractors' prices, they questioned the entire amount paid to the subcontractor as being "unreasonable."

Now, we are not saying that LockMart's situation with TMI is the same as the one that Mr. Fitzgerald reported to the Commission on Wartime Contracting back in July 2010, but we don't think it's too dissimilar either. In both cases, the Prime contractor was held responsible for proving adequate oversight of its subcontractors. That oversight responsibility was considered to encompass more than just technical performance; it was also considered to encompass monitoring the accuracy and appropriateness of the original negotiated prices as well as the accuracy and appropriateness of invoices.

Lockheed Martin settled and it's unclear why the company chose to do so. Clearly, there's more to the story than was reported in the media.

The lesson here, if one can be taken from such scanty information, is that Primes need to focus on subcontractor management. (Long-time readers may recall that this is a familiar theme on this blog.) More importantly, Primes need to perform sufficient due diligence to ensure the appropriateness of the initial subcontract award pricing, and to perform some limited audits/reviews of subcontractor invoices. In this particular case, we would start with trying to gain an understanding as to why a sole-source subcontract award was thought to be justified and how pricing reasonableness was established.