Oh, this is a *good one*. We love it when some of our assertions and opinions end up being supported, after the fact, by legal decisions.

A couple of caveats first. One: we are neither lawyers nor attorneys, neither barristers nor solicitors; we have no legal training whatsoever and we are not offering legal advice in this article. If you want legal advice, pay for it. Don't get it from this blog. Second: we are going to discuss a recent Armed Services Board of Contract Appeals (ASBCA) decision. Because we are not any kind of legal practitioners, we might be misinterpreting it. If you want a higher-confidence legal interpretation, see our first point. Also, because it's an ASBCA decision, it is subject to appeal. The points we are about to discuss could be reversed by a higher court. Thus, while we think this is an important decision that reinforces and supports some of the assertions and opinions we've previously published on this blog site, keep in mind that it all might change months (or even years) from now.

Okay, then. On to the recent ASBCA **decision** in the matter of the appeal of Lockheed Martin Integrated Systems, Inc., ASBCA Nos, 59508 and 59509, decided 20 December 2016.

Bottom-line up-front: Lockheed successfully had the government's demand for $116.8 million dismissed, for "failure to state a claim upon which relief can be granted." As we will discuss, it was kind of like getting off on a technicality. The government's reliance on the DCAA's audit findings and audit positions fatally impaired its case. Had DCAA and the contracting officer done a better job of articulating their position(s), the result might well have been different.

This appeal concerned two LMIS contracts "CR2" and "S3". (It was actually two appeals but they were consolidated. In fact, there seem to be three other appeals that were consolidated, for a total of five appeals, but those other three were "suspended pending the Board's decision on the motions to dismiss" with respect to the two appeals at issue here.) The CR2 contract was a multiple-award ID/IQ contract that "contemplated the issuance of time-and-materials task orders and included on-site and off-site fully loaded labor rates for each Lockheed Martin segment and for each non-Lockheed Martin subcontractor." It incorporated the T&M payment clause (52.232-07, 2002). The S3 contract was also a multiple-award ID/IQ contract that contained "time-and-material, cost, and firm-fixed-priced contract line item numbers (CLINs)" and provided for "fully loaded labor rates for each category of service." The S3 also incorporated a T&M payment clause but it was the 2005 version of 52.232-7. Although the clause dates were different, Judge O'Sullivan, writing for the Board, found that "in relevant part" the two clauses were identical.

The Defense Contract Audit Agency (DCAA) started auditing LMIS' 2007 proposal to establish final billing rates (popularly but incorrectly called an "incurred cost submission") in January 2014. The proposal was submitted for audit in August, 2008—meaning that DCAA waited nearly five and a half years to start the audit. (Note: the Contract Disputes Act gives the parties no more than six years after "claim accrual" to assert a claim; this was cutting it very close.) DCAA issued the audit report at the heart of this dispute a scant four and a half months after starting it—a startlingly quick turn-around time, given DCAA's well-publicized statistics that indicate an average incurred cost audit takes the audit agency about three years to complete. How they completed their work in such record time is simple: they only audited part of the proposal—the *least important part*. The auditors only examined the LMIS' claimed direct costs on its "flexibly priced" contracts. In other words, they looked at direct costs and issued a report in advance of opining on the allowability of claimed indirect costs, even though *the entire freakin' purpose* of the annual proposal is to establish final billing rates, and the allowability of direct contract costs has absolutely no impact on the calculation of the indirect cost rates. But there you go. DCAA performed its (partial) work in record time and issued an audit report finding literally more than a hundred million dollars in "questioned" and "unresolved" costs related to LMIS' subcontractor costs on the CR2 and S3 contracts.

Here's the quoted DCAA audit finding:

We questioned $103,272,918 of claimed direct costs attributable to subcontracts and considered $173,623,920 of additional subcontract costs to be unresolved. The questioned amounts represent costs claimed at the subcontractor level that were questioned within assist audit reports received or as a result of the prime contractor's noncompliance with FAR 42.202, Assignment of Contract Administration, Paragraph (e), Subsection (2). These costs represent amounts incurred by the subcontractors and claimed by LMIS in its FY 2007 incurred cost submission.

Let's break that down, as Judge O'Sullivan did:

-

$102.5 million of CR2 subcontractor costs claimed by LMIS in its final billing rate proposal, consisting of $18.55 million of costs questioned in 29 individual assist audits (audits performed by other DCAA branches) on LMIS CR2 subcontractors plus $83.751 million of claimed subcontractor costs because LMIS failed to comply with the (alleged) requirements of FAR

42.202(e)(2), in that LMIS failed to obtain and or retain sufficient information to permit DCAA to perform meaningful audits of those subcontractors. (DCAA specifically identified subcontractor personnel resumes and timesheets as two pieces of information that LMIS failed to obtain and/or retain.) More on this latter point to follow ….

-

$14.495 million of S3 subcontractor costs claimed by LMIS, consisting of $978,026 in questioned costs stemming from LMIS failure to comply with the alleged requirements of FAR 42.202(e)(2) and $13.5 million in “unresolved costs” that, apparently equated to questioned costs for some unstated reason.

Naturally, LMIS rebutted the audit findings. In its rebuttal, it noted that a single contractor was responsible for $13.9 million of the questioned costs but, because DCAA provided no details regarding exactly what costs were being questioned, LMIS could not comment on the appropriateness of the originally claimed or the auditor-questioned costs. With respect to differences between amounts claimed by LMIS in its annual proposal and amounts claimed by the subcontractors in their individual final billing rate proposals, LMIS also could not comment. As it noted, DCAA had refused to share any of the details because those details were considered by the subcontractors to be proprietary. With respect to differing amounts, LMIS commented:

Without insight into the values used in making this assessment, it is impossible to comment on the nature or validity of these values. DCAA also did not opine on what the differences may be; however, they also acknowledged that fiscal year timing could be a factor since the auditors did not have direct access to the submissions and relied solely on the values shown in the summary assist reports conducted by other DCAA offices. Based on the available facts, it is unreasonable to conclude that these costs are in any way inappropriate and unallowable.

DCAA tied much of its questioned costs to a position that LMIS failed to comply with a term of its contract, this falling afoul of the requirements of FAR 31.201-2(a)(4). The term that DCAA alleged LMIS failed to comply with was FAR 42.202(e)(2). As DCAA wrote—

Since the prime contractor did not properly manage its subcontracts in accordance with the FAR, we questioned the cost accordingly. The contractor failed to maintain necessary

documents to substantiate they reviewed (i) resumes to assure for compliance with contract terms, and (ii) timesheets to assure the number of hours invoiced were supported.

Further, the contractor did not provide any records demonstrating that they attempted to cause the subcontractor to prepare an adequate submission or any requests to the Government for assistance if the subcontractor refused. A literal interpretation of FAR 42.202 requires the prime contractor to act on behalf of the Government and serve as both the Contracting Officer (CO) and the Contracting Administrative Office (CAO) for each subcontract that it awards under a Government flexibly priced contract. This includes the requirement for the prime contractor to audit their subcontracts or request audit assistance from the cognizant DCAA office when the subcontractor denies the prime contractor access to their records based on the confidentiality of propriety [sic] data. Since the Government did not have contract privy [sic] with the subcontractors, the Government could not force or compel the subcontractors to comply with the requirements set forth in their contract with the prime. …

Further, our audit evaluation determined that the prime contractor did not have proof of submissions or proof of requests for audit for any of the subcontractors we determined did not submit incurred cost submissions. Without an incurred cost submission from the subcontractor, the prime and DCAA are unable to audit their costs claimed. If the costs are not audited, we are unable to determine if the costs are allowable, reasonable, and allocable in accordance with FAR 31 … Since it is the prime contractor's responsibility to manage their subcontractors, we determined they are not properly managing subcontractors.

We could summarize DCAA's audit position thusly: The auditors came in against the CDA Statute of Limitation time pressure. The auditors performed a half-assed job for which they, their Supervisory Auditors, and all levels of DCAA Management should be deeply embarrassed to have approved as a GAGAS-compliant audit report. They couldn't do their actual auditing job as (DCAA's unique interpretation of) GAGAS required them to, and so they took out their frustrations on the contractor. They cooked up a cockamamie theory that, somehow, every prime government contractor in America must require all subcontractors to submit annual proposals to establish final billing rates and then audit those proposals, or ask the Government to audit them. Notably, this was a *legal conclusion made by an auditor regarding a regulatory interpretation* not found in any DCAA audit program nor found within the DCAA Contract Audit Manual. Implied but not stated in DCAA's manufactured theory of contractor management is that the subcontractors must obtain annual proposals from their lower-tier subcontractors, and so on and so forth,
ad infinitum
. It's a clearly ridiculous theory and we wonder if LMIS had trouble writing their rebuttal as diplomatically as they did. LMIS wrote—

By the very nature of the incurred cost submissions, they often are developed at a business unit or segment level to substantiate indirect rates. As a result, that is not something we request from our subs due to the broad and proprietary nature of the data. Rather, we flow down the requirements to all applicable subcontracts and advise them of their responsibility to submit to DCAA all applicable schedules for compliance. Our management and due diligence over our subcontractors is related to their cost and performance relative to a specific program, as detailed in the procedures we previously provided. …

DCAA has not cited any FAR provisions, contract clauses, precedent or case law that counters this position to provide the basis for why they have determined this to be insufficient or a basis to question 100% of the subcontractor costs.

Three months after receipt of the DCAA audit report (and exactly *one day* before the CDA Statute of Limitations would come into play regarding submission of the proposal), the contracting officer issued a couple of Contracting Officer Final Decisions (COFDs), essentially slapping a cover letter on DCAA's audit reports. The CO accepted DCAA's position and rationale at face value. There was no evidence that the CO had weighed LMIS' rebuttal, which was characterized as being "extensive." Further, as Judge O'Sullivan noted, no rationale was provided in the COFD "for claiming entitlement to costs that the audit categorized as unresolved." In other words, the "independent business judgment" that DCMA likes to think its contracting officers bring to the table was evidently missing in this case. (We note that independence in adjudicating disputes between government and contractor is a required element of the CO's decision-making process, according to the Supreme Court of the United States. We have written about this situation
here
.)

LMIS appealed the COFDs, as any sane person would expect them to. You can hire quite a few attorneys when there is $100 million at stake. LMIS' legal fees likely will be unallowable. That's money that could have gone into LMIS' IR&D programs to develop innovative technology for the warfighter, or that could have gone into hiring more subcontractor project management staff. Instead, it went to external attorneys. *Sad.* (We note that LMIS was very ably represented by the skilled government contracts attorneys at Dentons. We mean them no disrespect.)

And make no mistake, the whole notion that FAR 42.202(e)(2) means something as broad and

far-reaching as DCAA and the DCMA contracting officer asserted is just nonsense. In fact, we wrote about the overreach in interpretation of that FAR sentence in **this article** . We wrote at the time—

We think this whole thing has gotten out of hand. A minor reminder to Contracting Officers that primes are responsible for managing their subcontractors (duh) has evolved into another way to question the adequacy of a contractor's purchasing system, or to question incurred costs. Clearly, that's not what the FAR drafters intended, but that seems to be where we are.

Judge O'Sullivan seemed to agree with our opinion, at least as the government presented it in this case. We are going to quote from her Decision extensively, because it is so important to understanding a prime's duty to manage its subcontractors and we expect our readers may need to use some of her language in their own rebuttals to similar DCAA audit findings. She wrote—

The [Government's] complaint offers no legal theory for its claim of disallowance nor does it provide any allegations of fact. It states conclusorily that there were questioned costs and some variances that entitle the government to disallow subcontract costs. Our pleading standard requires factual assertions beyond bare conclusory assertions to entitlement. The audit report, which was incorporated into the complaint, states that some assist audits questioned costs but does not explain on what grounds. It also states there were differences between amounts in LMIS's proposal and costs under subcontracts but provides no facts regarding these differences. More importantly, the COFD does not cite a single actual fact, only the audit report's unsupported conclusions. Neither the complaint nor the COFD contain sufficient factual (or legal) allegations, accepted as true, to state a claim to relief that is plausible on its face. …

Notably, nowhere in either complaint or COFD does the government cite to a contract term giving rise to a contractual obligation or duty. As the government conceded in its briefs, FAR 42.202 is not a term of the contract. … Even though the government has conceded that FAR 42.202 is not a term of the contract, we find it to be relevant to this inquiry because the audit report, the COFDs, and the complaints (in other words, 100 percent of the documents that articulate the government's claim in both appeals), all rely on FAR 42.202 in describing the duty that LMIS allegedly breached. …

The subcontracts clause does not impose any express responsibility on the prime contractor to

manage subcontracts after they are awarded. Nor do FAR Parts 42 and/or 44 impose any specific responsibilities on LMIS to manage its subcontractors, foremost because they were not incorporated by reference in either the S3 or the CR2 contract. But even if they had been, by their plain terms they do not impose the duties that DCAA, the CO, and the government in this appeal allege were breached. For instance, the alleged duty to maintain documents to substantiate that the contractor reviewed resumes to assure compliance with contract terms and timesheets to assure the number of hours invoiced were supported exists, but not as described by the government. The duty stems not from FAR 42.202(e) or any implied contract duty, but from FAR 52.232-7, the Payments under Time-and-Materials and Labor-Hour Contracts Clause … [but] there is no allegation in these appeals that LMIS did not comply with the requirements of FAR 52.232-7 which, we observe, *does not require the contractor to maintain these kinds of substantiating records until DCAA is finished conducting incurred cost audits seven or so years after the costs were first billed and paid.*
…

The other duty alleged by DCAA and the government generally in these appeals to have been breached by LMIS is a duty to cause its subcontractors to submit incurred cost submissions directly to LMIS for audit, and request audits from DCAA if the subcontractors refuse. This duty is not to be found in any express term of the contract; nor is it to be found in FAR Parts 42 or 44. … the Board's reading of FAR Part 42 reveals no requirement (literal or implied) that a prime contractor act as both CO and CAO with respect to its subcontracts. Moreover, as we noted … the enumerated responsibilities of the CO and CAO in FAR Part 42 do not involve receipt or review of incurred cost submissions. That duty is reserved to DCAA or other cognizant audit agency by FAR 42.201. …

We reiterate here that the issue to be decided in these appeals is not whether a prime contractor has a generalized duty to manage its subcontracts. The issue is whether LMIS under the two contracts at issue in these appeals had the particular duties alleged by the government: to (1) retain documentation substantiating its 2007 invoices for subcontract direct labor hours; and (2) retain documentation showing it had caused its subcontractors to make incurred cost submissions and either audited those submissions or called on DCAA to audit those who refused to submit, so that the documentation could be reviewed by DCAA when it conducted its audit of FY 2007 incurred costs in 2014. …

In this case, we are presented with a claim *based on a legal theory, originated by an auditor*, that LMIS, as a prime contractor, had a contractual duty to retain for purposes of an incurred cost audit the same documentation that it used to substantiate its billings during the course of performance of the contract and, moreover, had a duty to initiate audits of its subcontractors' incurred costs and be able to prove during the course of an incurred cost audit that it did so. LMIS's ‘breach’ of these non-existent duties is the government's only basis for asserting that

the subcontract costs for which it has reimbursed LMIS are unallowable costs. … [The Government] has gone forward with a claim for over $100,000,000 that is based on nothing more than a
plainly invalid legal theory
.

[Emphasis added.]

Government's claim dismissed.

We realize this has been a long one but, before we move on, we need to discuss some other thoughts.

1.

Why did DCAA question more than $100 million of costs? Have they no shame? Well, if you think back a couple of years to 2013/2014/2015, you may recall that DCAA leadership was busy justifying its startling lack of productivity by touting the "quality" of its audits, as measured by questioned costs. The more costs questioned, the better the quality—at least, according to Fort Belvoir. We strongly suspect that the average DCAA auditor quickly got the message: management likes to see lots of questioned costs and never mind the evidentiary basis. Our explanation is speculative, of course. Still, it would explain why the Supervisory Auditor(s) and other DCAA management were happy to approve the audit report, even though it was largely based on a "plainly invalid legal theory." We had some first-hand experience with that type of situation at about the same time; but that's a story for another day.

1.

How can we reconcile our position that 42.202(e)(2) doesn't impose a broad and far-reaching duty on the prime contractor to act in the government's stead with respect to managing its subcontractors with our oft-stated position that the prime contractor is responsible for managing its subcontractors, and may be held liable for failing to take reasonable steps to assure subcontractor invoices are accurate and compliant? Easy. We are talking about *progra m risk management*
. The prime must manage risks in its supply chain. Some of those risks involve invoices and payments and compliance with accounting and other administrative requirements imposed by

the subcontract agreement, including flow-down clauses from the prime contract. As Vern Edwards recently posted in a public forum, a well-drafted subcontract will be based on *all* the requirements of the prime contract (not just the flow-down clauses); for every prime contract requirement imposed on the prime contractor that could be impacted by a subcontractor action or failure to act, there should be a subcontract term that imposes a duty to comply on the subcontractor. The responsibility to effectively manage subcontractors does not come from the FAR; it comes from the fact that the prime is responsible to its government customer for the outcome of the contract.

Further, we never asserted that the prime contractor has a duty to review a subcontractor's final billing rate proposal; that's just stupid. As Judge O'Sullivan noted, the only entity with that duty is DCAA or other government auditor. We never asserted that the prime has a duty to retain subcontractor invoice support documentation beyond the periods described in FAR Part 4. Of all the specific issues that DCAA raised, we never asserted that any of them were a part of the prime contractor's duty of compliance.

Instead, we strongly believe that the prime contractor has a duty of risk management to assure the contractual outcomes to which it committed when it signed its government contract. Yes, it needs to make sure that any T&M invoices or cost-type vouchers submitted by its subcontractors comply with subcontract terms; but that is not at all the same as reviewing (and retaining) subcontractor resumes. One might address that risk through appropriate certification language, among other approaches.

1.

Finally, let's note (as we did in the beginning) that LMIS got off on a technicality. It got off because the contracting officer slapped a cover page on the DCAA audit report without (apparently) thinking things through. Sure, there was a potentially looming CDA SoL deadline, but that should be no excuse for a shoddy COFD. As Judge O'Sullivan noted, had the government based its disallowance on a failure to comply with the requirements of the 52.232-7 T&M payment clause, it may have had a stronger case—perhaps strong enough to survive a motion to dismiss. But nobody, not the auditors or their supervisors, not the contracting officer, not the government attorneys—nobody thought to base their disallowance on an actual clause in the LMIS contracts. *Sad.*

Thanks for taking the time to read this article; we know it was a long one. We trust it was worth it.