

## Defective Pricing Making a Comeback

Written by Nick Sanders

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Readers may already know that DCAA has reemphasized performance of audits intended to detect instances of “defective pricing.” Formerly known by the innocuous description “post-award audits,” they are [now called](#) “Truth in Negotiations audits,” because the Truth-in-Negotiations Act (TINA) was [renamed](#) the “Truthful Cost or Pricing Data Act” about six years ago. Regardless of what you call them, these audits (assignment 42000) are coming back; and for some contractors they are coming back big-time.

Simply put, “defective pricing” means a contract price that was negotiated on the basis of cost or pricing data that was not accurate, complete, or current as of the date of the price agreement, even though the contractor certified that its cost or pricing data was accurate, complete, and current as of the date of price agreement. Sounds simple, but it’s really not simple at all. There are myriad nuances and exceptions that have to be addressed in a “defective pricing” situation. Even though FAR 2.101 defines “cost or pricing data” and “certified cost or pricing data,” and even though FAR 15.407-1 discusses the situation in detail, and even though there are several solicitation and contract clauses that also discuss the situation in great detail, it’s a complicated matter that really should be addressed by people who know a lot about it, rather than your generic government contract compliance representative.

We came across a [recent case](#) at the ASBCA that illustrates some of the nuances involved in “defective pricing” matters and we thought we should discuss it here, if only to (a) provide a refresher on defective pricing, or (b) to illustrate why it’s not for the uninitiated. Of course, all we can do is summarize the case; if you want all the details, you need to read it carefully.

In 2004, Alloy Surfaces Company was awarded an ID/IQ contract for the production of M211 infrared countermeasure decoy flares. In 2006, the Army customer requested a proposal for a large number of additional flares (essentially tripling the required output), which was awarded as Delivery Order #14 (DO 14). DO 14 was negotiated and awarded in August, 2006. Previous Delivery Orders—including DO 13—had been Produced in Alloy’s “Plant 1.” However, in its proposal, Alloy was clear that it wouldn’t be producing DO 14 flares in Plant 1; instead, Alloy stated that it would add substantial amounts of equipment, including expanding Plant 2, starting production at Plant 3, and hiring 234 new employees.

DO 13 flares, produced in Plant 1, were manufactured using new and more efficient means. The manufacturing process for DO 13 included the use of auto-loaders, the one-step bake, and the auto epoxy processes. When combined, these processes produced efficiencies in labor usage

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and material usage. The Army was aware of these production improvements. Indeed, the Army “reviewed and approved each step of the automated production process” used in Plant 1.

Obviously, the pricing of DO 14 production was challenging, because DO 14 involved production from two new plants that had never produced flares before, using new equipment, by new employees who would have various levels of training and experience. Also obviously, the Plant 1 production efficiencies would be carried over into Plant 2 and Plant 3 production; but was the actual DO 13 cost experience in Plant 1 a good indication as to the expected production cost of DO 14 in Plants 2 and 3? Alloy thought not. In Alloy’s view, “the ramp-up associated with DO 14 would require Alloy to obtain permitting and expand M211 operations to two new plants; pass first article testing; qualify and install new equipment; and hire and train new employees.” Those variables were different from DO 13, and therefore made DO 13 an unsuitable basis for use in pricing DO 14.

Alloy provided historical data to the Army technical evaluators and negotiators; however, there was disagreement as to whether the data provided was representative of the newer, more efficient production methods Alloy was using on DO 13. Alloy also proposed a negative 10 percent “learning curve” for direct labor, because of the new equipment and new employees. Importantly, Alloy did not submit Work-in-Process cost reports for DO 13 production to the Army. Alloy had never provided WIP cost data to the Army in the past. Data was only provided after the flares had been inspected and accepted (via DD250). The DO 14 negotiation was no exception. Even though Alloy had WIP reports (in particular, the dispute was focus on month-end September 2006 WIP reports), and even though the Army requested WIP reports, Alloy declined to provide them, as it had previously declined to provide them during negotiations of earlier Delivery Orders.

After about six weeks of negotiations, the parties agreed on a price and DO 14 was awarded. Alloy’s Certificate of Current Cost or Pricing Data stated that it certified its cost or pricing data was accurate, complete, and current as of September 25, 2006.

In 2011 (five years after the events just recounted) DCAA performed a defective pricing audit, noticed that DO 13 WIP reports had not been provided, and issued an audit report in February, 2012 alleging defective pricing. The cognizant contracting officer issued a Contracting Officer Final Decision (COFD) in July, 2014, demanding repayment of \$15.9 million. (Interestingly, the COFD was based on a position other than the one in DCAA’s audit report. The DCAA report used a weighted average of prior DO cost experience but the COFD used only DO 13 cost experience. DCAA later concurred with the contracting officer’s audit approach.) Alloy appealed that COFD to the ASBCA.

As Judge Woodrow, writing for the Board, noted:

The government has the burden of proof in a defective pricing claim. As a general matter, this entails proving three elements by a preponderance of the evidence. First, the government must establish that the information at issue is ‘cost or pricing data’ within the meaning of TINA. Second, the government must show that the cost or pricing data was either not disclosed or not meaningfully disclosed to a proper government representative. Third, it must demonstrate detrimental reliance on the defective data.

As we noted above, the disputed centered on DO 13 WIP cost reports. The government argued that those WIP cost reports were “cost or pricing data” because they contained factual cost information; however, Alloy argued that considerable judgement went into those WIP reports and they were never final before the end of production. For example, Alloy’s production control department made manual allocations of certain batch costs to units of production, and that allocation was largely judgmental in nature. Because they were judgmental (at that point) rather than factual, they were not cost or pricing data. The Board agreed with Alloy, likening the WIP sheets to Internal Operating Controls (IOC) reports in another defective pricing case involving Aerojet Ordnance Tennessee, writing—

WIP sheets, like the Internal Operating Controls (IOC) reports in *Aerojet*, are management tools based on an individual manager’s judgment, not a cost accounting process relying on precision. In *Aerojet*, we concluded that, although the data in IOC reports may be accurate for management purposes and may even be close to accounting reports, the IOC reports do not possess the requisite degree of certainty necessary for providing certified cost and data to the government. By the same token, Alloy’s WIP sheets are management tools and do not possess the requisite degree of certainty necessary for providing certified cost and data to the government.

Further, the Board found that the DO 13 WIP sheets in question had not been finalized until after the parties reached price agreement (despite the dates on the WIP sheets). In addition, the Board found that there was no evidence that, even if the Army had the DO 13 WIP sheets, it would have changed its negotiation strategy and/or negotiated a different price.

Judge Woodward wrote:

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... because the DO 13 data was from Plant 1, the data would not have shed any light on the inefficiencies associated with starting and ramping-up production at the two new manufacturing plants. Although the Army could quantify the projected efficiency resulting from the increased use of automation, it was forced to speculate about the effect of ramping-up production at two new plants. Indeed, the fundamental problem with the government's position is that the DO 13 data sheds no light on the actual effect of ramp-up inefficiency on manufacturing in Plants 2 and 3.

Thus, because the Army could not prove reliance on the missing DO 13 WIP reports, and because those WIP reports had not been finalized and made available to Alloy management prior to the conclusion of price negotiations, and because those DO 13 WIP reports contained significant amounts of judgment prior to the end of the production run, the Board found that no defective pricing had taken place.

This ASBCA case illustrates some of the complexities involved in defective pricing matters. As we said at the beginning of this article, when you are faced with an allegation of defective pricing, you really want knowledgeable and experienced people on your side. In this multi-million-dollar matter, Alloy was ably represented by the law firm of Crowell & Moring.