



Cost Allowability and Pricing Issues Impacting the Supply Chain

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Agenda

- Cost Issues: When Do the FAR Cost Principles Apply to the Supply Chain?
 - Key Cost Principles Applicable To Supply Chain
- Pricing issues: TINA Application and Compliance
- Business System Rule Applications to Suppliers/Subcontractors
- Increased Prime Contractor Oversight of Subcontractors
- Recent Developments/Look to the Future

When Are The Cost Principles Implicated By The Supply Chain?

- Cost Type Prime Contract: Inclusion Of FAR 52.216-7 In Prime Contract
 - If Not, Christian Doctrine?
- Subcontract/Supplier Agreement:
 - Far 52.216-7 Is Not A Mandatory Flow-down
 - Clause Must Be Negotiated
 - Ramifications For Both Parties If Not Flowed Down
- Cost Prime Contract And Cost Supplier/Subcontract:
 - If Subcontract/Supply Agreement Is A Cost-type Agreement And FAR 52.216-7 Is Not Flowed Down, Then Prime Is Potentially Exposed
 - Subcontractor/Supplier Might Be In Noncompliance With All Cost Principles, But Prime Has No Legal Recourse
 - Christian Doctrine Has No Application To Subcontractor/Supplier
 - If Clause Is Flowed Down, Increased Prime Responsibility To Ensure Supplier/Subcontractor Complies With Cost Principles

When Are The Cost Principles Implicated By The Supply Chain?

- Allowability of Prime Expenses Paid to Supplier/Subcontractor Presuming Cost Principle is Flowed Down
 - Cost Subcontracts
 - FAR 31.204(b)(1)—Costs incurred as reimbursements or payments to a subcontractor are allowable to the extent they are for costs incurred by the subcontractor that are “consistent” with Subpart 31.2
 - Cost-reimbursement
 - Fixed-price incentive
 - Price-redeterminable
 - FAR 31.204(b)(1) applies to any tier above the first FFP or FP subcontract with EPA provisions

When Are The Cost Principles Implicated By The Supply Chain?

- Cost Type Prime Subcontract and Fixed Price Supply Agreement/Subcontract
 - Impact: Cost Principles Affect Pricing
 - FAR 31.204(c) states that costs incurred as payments under FFP subcontracts or FFP subcontracts with EPA provision for which subcontract cost analysis was performed are allowable “*if the price was negotiated in accordance with 31.102.*”
 - FAR 31.102 provides:

The applicable subparts of part 31 shall be used in the pricing of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs. However, application of cost principles to fixed-price contracts and subcontracts shall not be construed as a requirement to negotiate agreements on individual elements of cost in arriving at agreement on the total price. The final price accepted by the parties reflects agreement only on the total price. Further, notwithstanding the mandatory use of cost principles, the objective will continue to be to negotiate prices that are fair and reasonable, cost and other factors considered.

Cost Principles And The Supply Chain

- Prime Concerns:
 - Exposure Due To Subcontractor/Supplier Non-compliance with Cost Principles
 - Responsibility for Supplier/Subcontractor Non-compliance With Cost Principles
 - False Claims Act Liability?
 - TINA Liability?
 - Claims/REAS
- Supplier Concerns:
 - Compliance adds cost
 - Exposure to FCA liability?
 - Exposure to TINA?
 - Claims/REAs
- Indemnification Issues—Privity Lacking Between Government and Subs/Suppliers

Key Cost Principles With Direct Impact on Subcontracts/Supply Agreements

- Material Costs
- Rental Costs
- Termination Costs
- Travel Costs
- IR&D/B&P Costs

Key Cost Principles Application: Material Costs

- Material Costs—FAR 31.205-26
 - (a) Material costs include the costs of such items as raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and in-transit insurance. In computing material costs, the contractor shall consider reasonable overruns, spoilage, or defective work (unless otherwise provided in any contract provision relating to inspecting and correcting defective work).
 - (b) The contractor shall—
 - (1) Adjust the costs of material for income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap, salvage, and material returned to vendors; and
 - (2) Credit such income and other credits either directly to the cost of the material or allocate such income and other credits as a credit to indirect costs. When the contractor can demonstrate that failure to take cash discounts was reasonable, the contractor does not need to credit lost discounts.

Key Cost Principles Application

Material Costs 31.205-26 (*cont'd*)

- (c) Reasonable adjustments arising from differences between periodic physical inventories and book inventories may be included in arriving at costs; provided such adjustments relate to the period of contract performance.
- (d) When materials are purchased specifically for and are identifiable solely with performance under a contract, the actual purchase cost of those materials should be charged to the contract. If material is issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable.
- (e) Allowance for all materials, supplies and services that are sold or transferred between any divisions, subdivisions, subsidiaries, or affiliates of the contractor under a common control shall be on the basis of cost incurred in accordance with this subpart. However, allowance may be at price when—
 - (1) It is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary or affiliate of the contractor under a common control; and
 - (2) The item being transferred qualifies for an exception under 15.403-1(b) and the contracting officer has not determined the price to be unreasonable.

Key Cost Principles Application *(cont'd)*

- (f) When a commercial item under paragraph (e) of this subsection is transferred at a price based on a catalog or market price, the contractor—
 - (1) Should adjust the price to reflect the quantities being acquired; and
 - (2) May adjust the price to reflect the actual cost of any modifications necessary because of contract requirements.

Material Cost Principle: Practical Considerations

- Dangers of FAR 31.205-26
- “Common Control” Issues: Due diligence when an affiliated company is part of the supply chain
 - Internal controls adequate?
- What relationship triggers “common control”?
 - Court/Board decisions are based on specific situational facts; exposure may be uncertain
 - Seek advance agreement/Be transparent
- Materials broadly defined (Services included?)
- Credits Issues—Can be a trap
- Exceptions:
 - Established practice of transferring at price
 - Applicability Confirmed in Recent Case: *A-T Solutions, Inc.*, ASBCA No. 59338 (Feb. 8, 2017).
 - Commercial Item
 - Evolving Definition—DOD Efforts to Narrow v. Legislative Efforts to Expand Use (e.g., NDAA 2016)

Key Cost Principles Application—Rental Costs

- Rental Costs: FAR 31.205-36
 - (2) Rental costs under a sale and leaseback arrangement only up to the amount the contractor would be allowed if the contractor retained title, computed based on the net book value of the asset on the date the contractor becomes a lessee of the property adjusted for any gain or loss recognized in accordance with 31.205-16(b).
 - (3) Charges in the nature of rent for property between any divisions, subsidiaries, or organization under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to part 31), provided that no part of such costs shall duplicate any other allowed cost. Rental cost of personal property leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees shall be allowed in accordance with subparagraph (b)(1) above.

Rental Cost Allowability: Practical Considerations

- Triggers same “common control” issues as 31.205-26:
- Perform due diligence when affiliated renters are involved
- Exemptions may be available
 - e.g., established practice with “unaffiliated lessees”
- Common control issues depend upon specific facts

Key Cost Principles Application-- Terminations Costs

- FAR 31.205-42, Termination Costs
- Note: Termination Clause is not a mandatory flow-down
- 31.205-42(h) Subcontractor claims. Subcontractor claims, including the allocable portion of the claims common to the contract and to other work of the contractor, are generally allowable. An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors; provided, that the amount allocated is reasonably proportionate to the relative benefits received and is otherwise consistent with 31.201-4 and 31.203(d). The indirect expense so allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.

Termination Costs: Practical Notes

- Risk again is failure to flow down
- Doubly impactful here because, in addition to the fact that FAR 52.216-7 is not a mandatory flow-down, the termination clause at 52.249-6 is not a mandatory flow-down.

Key Cost Principles Application—Travel Costs

■ Travel Costs—FAR 31.205-46

- (a) *Costs for transportation, lodging, meals, and incidental expenses.* (1) Costs incurred by contractor personnel on official company business are allowable, subject to the limitations contained in this subsection. Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof, provided the method used results in a reasonable charge. Costs for lodging, meals, and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge.
- (2) Except as provided in paragraph (a)(3) of this section, costs incurred for lodging, meals, and incidental expenses (as defined in the regulations cited in (a)(2) (i) through (iii) of this paragraph) shall be considered to be reasonable and allowable only to the extent that they do not exceed on a daily basis the maximum per diem rates in effect at the time of travel as set forth in the—
 - (i) Federal Travel Regulation, prescribed by the General Services Administration, for travel in the contiguous United States, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 922-002-00000-2;

Key Cost Principles Application *(cont'd)*

- (ii) Joint Travel Regulations, Volume 2, DoD Civilian Personnel, Appendix A, prescribed by the Department of Defense, for travel in Alaska, Hawaii, and outlying areas of the United States, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 908-010-00000-1; or
- (iii) Standardized Regulations (Government Civilians, Foreign Areas), section 925, *Maximum Travel Per Diem Allowances of Foreign Areas*, prescribed by the Department of State, for travel in areas not covered in (a)(2) (i) and (ii) of this paragraph, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 744-088-00000-0.

Key Cost Principles Application—Travel Costs

- Summary of Other Key Components of Travel Costs Principle:
 - Allowability Of Actual Costs—in Certain Limited Instances
 - Entirety Of JTRs/FTRs Are Not Incorporated—Only the Rates, Definitions Of Lodging/MIE and Special or Unusual Situation Guidance.
 - Partial Travel Days
 - Airfare Costs In Excess Of The Lowest Priced Airfare Available To The Contractor During Normal Business Hours Are Unallowable
 - Exceptions
 - Contractor-owned Or Leased Automobiles
 - Private Use?
 - Trip Purpose Documentation
 - Travel Rebates—PWC False Claims Settlement In 2005

Travel Costs: Practice Notes

- Prime Cannot Evade Responsibility for Compliance By Supplier/Subcontractor Simply Because The Clause Is Not Flowed Down
- When Clause Is Flowed Down, It May Create Oversight And Management Problems Because Of The Nature Of Travel Costs—i.e., numerous transactions, details and rules
- DCAA Maintains A Major Focus On Travel Costs
- “Contractor Personnel” Application
 - Some indications that DCAA/DCMA looking at expanding the scope of coverage—e.g., that consultants are contractor personnel and subject to the regulation

Key Cost Principles Application—B&P, IR&D Costs

- IR&D Costs/B&P Costs—FAR 31.205-18
 - IR&D and B&P do “not include the costs of effort sponsored by a grant or required in the performance of a contract”
 - *ATK Thiokol, Inc. v. United States*, 598 Fed. Cir. 1329 (2010) clarified the definition: Specifically required by the contract
- Costs For IR&D And B&P Are Allowable As Indirect Expenses On Contracts To The Extent That Those Costs Are Allocable And Reasonable.

Independent Research and Development (IR&D) Costs

- New Proposed IR&D Rule, DFARS Case 2016-D017
 - 48 CFR 215, 48 CFR 252 ; Dkt. ID - DARS-2016-0004.
- Proposed rule would amend the DFARS to require DoD Contracting Officers to adjust offerors' proposed prices and estimated costs upward when their proposals rely on the results of their IR&D efforts.
- *ATK Thiokol, Inc. v. United States*, 598 F.3d 1329, 1335 (2010): R&D implicitly necessary to carry out a contract could be charged as indirect IR&D costs.
- If the proposed rule means research and development that is “specifically required by the contract,” then by definition, such costs cannot be treated as IR&D. FAR 31.205-18 excludes those costs from the definition of IR&D costs.

Independent Research and Development (IR&D) Costs

- New DFARS 231.205-18, Independent research and development and bid and proposal costs.
- New Rule: 81 Fed. Reg. 780008 (Nov. 4, 2016) (DFARS Case 2016-D002).
- To be allowable, IR&D projects must be reported to the Defense Technical Information Center (DTIC) using the DTIC's online input form and instructions.
- Annual updates required.
- Must engage in a technical interchange with a technical or operational DoD government employee before incurring the IR&D costs.
- DoD Instruction 3204.01, "DoD Policy for Oversight of Independent Research and Development (IR&D)." explains the technical interchange process.

TINA: Pricing Issues

■ TINA Application to Suppliers/Subcontractors

- TINA Is A Disclosure Requirement, Aimed At Putting The Government On Equal Footing With The Contractor When It Negotiates A Contract. See 10 U.S.C. § 2306a and 41 U.S.C. § 3501, *et seq.* Implemented in Regulations at FAR subpart 15.4
- Generally:
 - TINA Requires Contractors To Submit Accurate, Complete, And Current Certified Cost Or Pricing Data When Negotiating Contracts With The Government.
 - It Also Provides The Government With A Price Reduction Remedy If A Contractor Fails To Comply And Includes Provisions For Interest And Penalties.
- FAR 15.404-3 Subcontract pricing considerations:
 - (a) The contracting officer is responsible for the determination of price reasonableness for the prime contract, including subcontracting costs. The contracting officer should consider whether a contractor or subcontractor has an approved purchasing system, has performed cost or price analysis of proposed subcontractor prices, or has negotiated the subcontract prices before negotiation of the prime contract, in determining the reasonableness of the prime contract price. This does not relieve the contracting officer from the responsibility to analyze the contractor's submission, including subcontractor's cost or pricing data.

TINA

- As provided in FAR 15.403-1(b), contractors may obtain exceptions from submitting certified cost or pricing data when:
 - (1) the price is based on adequate price competition,
 - (2) the price is based on prices set by law or regulation,
 - (3) the item meets the definition of a commercial item,
 - (4) when a waiver has been granted, or
 - (5) a commercial contract is modified and meets the requirements of 15.403-1(c)(3).

TINA Fundamentals

- Basics (10 U.S.C. §2306a; 41 U.S.C. § 254b):
 - Contractors Must Submit Cost Or Pricing Data Before The Date Of Price Agreement For “Covered” Negotiated Contracts
 - 750k Threshold (includes changes/modification “adjustments”)
 - Subcontracts: If Over Threshold & Prime/Higher Tier Subs Covered (41 U.S.C. § 3502(a)(3))
 - Sweep for data obtained between initial submission and date of agreement on price
 - The Contractor Or Subcontractor Must Certify That, To The Best Of Its Knowledge And Belief, The Data Are Current, Accurate, And Complete
 - As of Date of Agreement on Price; or
 - Another Date Agreed Upon By the Parties As Close “as is practicable” to Date of Agreement on Price

TINA

- Thorny Subcontractor Issues
 - Prime Essentially “Strictly Liable”; No “Privity” Between Govt- Sub
 - Prime Responsible For 2nd Tier Subcontractor Despite Lack of Knowledge. *See McDonnell Aircraft Co.*, ASBCA No. 44504, 03-1 BCA 32154
- Two Dates Scenario:
 - Prime agrees on price prior to agreement subcontract price—Cost Contract
 - Liable for defective subcontractor data as of prime agreement
 - Liable for defective subcontractor data as of subcontractor agreement on price
- Subcontractor liability?: Language of flow down/Indemnity
 - *Importance of Language Confirmed in Recent Decision: BAE Systems Land & Armaments LP v. Ibis Tek LLC*, 0:14-cv-03111-SRN-TNL, D.Min. (July 7, 2016).

TINA

Date of Agreement on Price

- “Shake hands” date - All significant facts existing as of the date of agreement on price -- the “shake hands” date -- are cost or pricing data.
- After the “shake hands” date - Facts coming into existence after the “shake hands” date are not cost or pricing data.
- “Another date agreed upon” - Parties may agree to an effective certification date other than “shake hands” date. The alternate date must be as close as practicable to the “shake hands” date. FAR 15.403(b)(2)

TINA: Practical Notes

- Negotiation of Indemnification
 - Include Key Terms for Protection (See e.g., *BAE Systems Land & Armaments LP v. Ibis Tek LLC*, 0:14-cv-03111-SRN-TNL, D.Min. (July 7, 2016)).
- Prime Must Be Diligent and Proactive

Business System Applications to Subcontractors

- DFARS 252.242-7005
- Applicable to CAS-covered contracts
 - Subcontractor May or May Not Be Covered
 - FAR 16.301-2 May Nevertheless Apply to Cost Type Contract
 - Requires that “contractor’s accounting system is adequate for determining costs applicable to the contract or order”
- Imposes numerous system requirements, including internal controls procedures
- Specifically Allows Withholds

Business Systems Rule

- Requires existence of six approved systems and identifies criteria for each:
 - Accounting (includes internal controls and billing)
 - Purchasing
 - Estimating
 - Materials Management and Accounting
 - Property Management
 - Earned Value Management
- Flow down of clause is not mandated for 5 of 6 systems, but is “recommended” for Prime
- Note: flow-down of clause likely to trigger significant issues such as level of diligence by Prime
- No examples yet of prime-sub issues

Business Systems

- Government Property System Criteria (§ 252.245-7003(c) Include:
 - Flow down of Government property terms and conditions to subcontractors Proper Acquisition
 - Proper physical control
 - Receipt
 - Use
 - Audits/due diligence to ensure Government property systems are functioning
 - Disposition

Increased Prime Contractor Oversight of Subcontractors

Counterfeit Parts

- New Rule: 81 Fed. Reg. 59510 (August 30, 2016).
- Allowable costs if:
 - DOD-approved operational system to detect/avoid counterfeit electronic parts;
 - Inform Govt within 60 days of “becoming aware” of suspect part
 - Counterfeit part supplied by government-approved source.
- Costs include re-work or corrective action.
- On the heels of Final Rule adding DFARS 252.246-7008—which requires sources to be original manufacturers, authorized suppliers, suppliers that source parts exclusively from OEM or authorized supplier; contractor-approved suppliers.

Prime--Subcontractor Management

Lockheed Martin Int. Sys., Inc., ASBCA Nos. 59508, 59509 (Dec. 20, 2016).

- Issue: Prime Contractor 's “independent” responsibility to manage subcontractors
- Gov't sought >\$116 million for alleged failure to properly manage subs.
 - Asserted Contractual Duty to require Subs to Submit Incurred Cost Proposals and to Audit its Subs
 - Asserted Contractual Duty to retain documentation for invoices for sub direct labor from 2007
- Gov't relied solely on a legal theory originated by an auditor
- ASBCA dismissed motions for failure to state a claim:
 - COFD “does not cite a single fact, only the [DCAA] audit report's unsupported conclusions.”
 - Gov't claim “based on nothing more than a plainly invalid legal theory.”
 - Contract contained no clauses requiring duty to manage subs alleged by Gov't.

Disputes/Claim Sponsorship

- Pass-through Claims
 - Sponsorship Clause (FAR 44.203(c))
 - Good Faith
 - Severin Doctrine
 - After Examination, Prime May Decide Not to Sponsor or Refuse To Pay
- Prime v. Supplier/Subcontractor
 - Choice of Law Clause
 - Contract Defines Disputes Process

Peering Into the Future

- Continued Emphasis On Supply Chain Improvements
 - DFARS Final Rule allowing DOD to consider impact of supply chain risk as factor in certain procurements (80 Fed. Reg. 67,244 (Oct. 30, 2015))
 - GAO Includes DOD Supply Chain in its 2017 High Risk Report, noting such areas as ineffective inventory management (excess inventory) and numerous others
- DCAA Making Progress on ICP Audit Backlog
 - Likely Result of Added Bandwidth Will Be Increased Audits of Business Systems and Pre-Survey Award (TINA) Audits
- Continued Increased Focus on Supplier/Subcontractor Direct Costs in ICPs
 - DCAA ICP Prime Audits Increasingly Question Direct Subcontract Costs for That Year
 - Basis is Often Lack of Documentation
- DOJ Increasing Scrutiny on Prime Oversight of Subcontractor as FCA Violation
 - Examples:
 - Subcontractor Travel Costs
 - Subcontractor Performance Failures

Q & A

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