

# Client Alert

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## Government Contracting Scrutiny: A Commission's Report and FERA Significantly Increase the Potential Exposure of Government Contractors to Enforcement Action

The United States Congress, emboldened by a popular mandate to end alleged government contract fraud, has yet again increased its scrutiny of the industry. In 2008, it established the Commission on Wartime Contracting in Iraq and Afghanistan in response to growing concern over perceived waste, fraud, and abuse in government contracting.<sup>1</sup> The Commission was charged with not only assessing contractor misconduct but also recommending ways to end and prevent contract abuse.

On June 10, 2009, the Commission released its Interim Report on contingency contracting and the Commission's Co-Chairs testified on the Hill regarding the Commission's findings. At the hearing, the Commission outlined the increasingly utilized enforcement tools at the Inspector Generals' and other auditors' disposal.<sup>2</sup> These enforcement mechanisms are significantly strengthened by the Fraud Enforcement and Recovery Act (FERA), enacted on May 20, 2009. FERA alters the scope of potential liability for illegitimate government contracting practices. The combination of this new legislation with the surge in use of powerful enforcement tools—including subpoena power, referral mechanisms and

interagency information sharing—increases the risk of potential enforcement actions against contractors.

### Commission on Wartime Contracting Interim Report

In its Report, the Commission outlines the major problems surrounding government contracting fraud, waste and abuse, as well as its short- and long-term plans to remedy these problems. This *Alert* focuses on three functional issues raised in the Report and discusses corresponding examples of increased government scrutiny concerning these issues. First, the Report discusses management and accountability issues, specifically as it relates to subcontractor oversight.<sup>3</sup> Second, the Report outlines the current reconstruction effort and how the government can best coordinate with allied nations and supervise multinational corporations.<sup>4</sup> Finally, the Report considers logistical concerns—understaffing, subject matter expertise, inadequate oversight—surrounding government audits and the fraud referral system.<sup>5</sup>

### Management and Accountability— Subcontractor Oversight and Compliance

During the June 10th hearing before

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Congress, Commission Co-Chairs Michael Thibault and Christopher Shays testified to the inconsistent monitoring by prime contractors of their subcontractors' performance.<sup>6</sup> Subcontractor services comprise approximately 70 percent of contingency contracts costs, making them a prime target for increased scrutiny.<sup>7</sup>

In March 2009, the Special Inspector General for Iraq Reconstruction (SIGIR) reported to the Commission continuing instances of foreign subcontracting firms engaging in kickbacks and other illegal schemes.<sup>8</sup> The Report notes that due to the government lacking privity of contract with these subcontracting groups, it relies on, and increasingly expects, prime contractors to provide the necessary oversight. In order to better enforce this oversight, the Commission recommends more frequent Defense Contract Audit Agency (DCAA) investigations, as well as requiring contractors to update their billing and business management systems significantly.<sup>9</sup> In the coming months, the Commission will also recommend further changes in law, regulation and contract requirements to ensure subcontractor compliance.<sup>10</sup>

### **Reconstruction—International Coordination and Increased Convictions**

Upon review of contract performance in Iraq and Afghanistan, the Commission strongly recommends that the US government create "an acknowledged central point where its own vast expenditures and operations in support of wartime reconstruction, stabilization, and development can be best coordinated in cooperation with other governments and national entities."<sup>11</sup> Heightened cooperation within US agencies and their international partners have already led to increased convictions of foreign nationals both abroad and domestically.<sup>12</sup>

This increased scrutiny and the proposed "central node" to coordinate government oversight will have differing effects in the two theaters. In Iraq, where the US is drawing

down operations, the Commission recommends increased auditing to uncover unnecessary or redundant projects. In Afghanistan, where coalition forces are planning a new surge, the Commission calls for greater oversight of fast-acting Command Emergency Response Programs (CERP) projects and more accountability for security and democratization programs.<sup>13</sup>

### **Logistics—Increased Oversight and More Frequent Auditing**

Finally, both the Report and June 10th hearing focused on logistics concerns surrounding the multi-billion dollar United States Army's Logistics Civil Augmentation Program (LOGCAP) contracts. In its Report, the Commission notes that LOGCAP III suffered from a lack of competition, weak oversight and flawed performance.<sup>14</sup> These problems have led government auditors to question billions of dollars in contractor billings and payments. The Commission also found "troubling" the corresponding lack of government supervision under LOGCAP III.<sup>15</sup> Both the Commission and Committee members called for change, with Congressman Tierney warning yet again that the current status of "more spending coupled with less oversight is a recipe for disaster."<sup>16</sup>

The Report also cites various agency heads who have committed to increased oversight of contingency contracts. Director Williams of the Defense Contract Management Association (DCMA) promised to increase the number of oversight positions beyond the 100 additional personnel already hired in 2008.<sup>17</sup> Additionally, Director Stephenson of the DCAA touted her Agency's subpoena authority, which gives the DCAA access to contractor accounting books and records.<sup>18</sup> This information can be used to assist the DCAA in their comprehensive audit throughout the life of the contract and to determine the contractor's final payment. Just last year, the DCAA performed more than 30,000 audits covering \$501 billion in proposed or claimed contractor costs.<sup>19</sup> During

their investigations, they questioned \$17.9 billion in billed costs and found \$7 billion in unsupported costs.<sup>20</sup> In addition to their robust investigatory powers, the agency works in unison with the Joint Contracting Command, US Army Corps of Engineers, DCMA, USAID and the State Department to ensure timely and comprehensive audits.<sup>21</sup>

The Commission also advocates increased use of the fraud referral system, where DCAA refers its findings to an Inspector General for legal sanctions against a contractor.<sup>22</sup> There are two types of forms used in the fraud referral system. Form 1, *Notice of Contract Costs Suspended and/or Disapproved*, suspends or disapproves costs if a contractor does not voluntarily remove costs from billing. This Form is mainly used to contest the reasonableness of subcontractor pricing. During LOGCAP III, the DCAA issued more than 100 Form 1s, suspending a total of \$553 million in payments.<sup>23</sup> The second major form is DCAA Form 2000 *Suspected Irregularity Referral*, which is used to report suspicions of fraud, corruption or other unlawful activity affecting government contracts to the appropriate investigative organization.<sup>24</sup> In the past five years, the DCAA has made 32 in-theater related Suspected Irregularity Referrals.<sup>25</sup> More than half of these referrals addressed irregular conduct by subcontractors.<sup>26</sup> These referrals can damage a contractor's reputation and finances for even seemingly minor infractions such as labor mischarging, where a contractor's employees work 10 hour days but charge the government for 12 hour days.<sup>27</sup>

Escalating government auditing has already had a substantial impact on contractor business practice. During the Commission's May 4th hearing, one of the largest government contractors stated that the increased governmental scrutiny and oversight has become taxing. It has a team of dedicated individuals whose sole function is to track and respond to thousands of information requests each year, hold

monthly status meetings with the DCAA and DCMA, and satisfy individual auditor queries.<sup>28</sup> In fact, the difficulty of legitimately disputing claims with the federal government will only increase as a result of FERA, which expands the potential exposure of companies accused of FCA violations.

## Fraud Enforcement and Recovery Act of 2009

FERA's substantial revisions to the Federal False Claims Act (FCA), 31 U.S.C. §§ 3729-3333, create a host of potential additional liabilities for government contractors. The FCA continues to have the same significant penalties for failing to abide by these stringent reforms, including fines of \$5,000 to \$10,000 plus three times the amount of damages sustained by the government due to the violation.<sup>29</sup> Three specific changes in the law present the most likely problem areas for government contractors.

First, FERA expands a contractor's liability where it has "knowingly conceal[ed]" or "knowingly and improperly avoid[ed] or decreas[ed] an obligation to pay or transmit money or property to the government."<sup>30</sup> This "reverse false claims" liability provision specifically includes overpayment by the government. Furthermore, such reverse false claims can be prosecuted with or without the use of a false record or statement. A contractor should now thoroughly review its receivables to ensure that it will not, in the future, knowingly and improperly retain such payments.

Second, FERA overrules *Allison Engine*, making subcontractors on government projects potentially liable for FCA violations even if their claim was only given to the prime contractor.<sup>31</sup> Previously, FCA liability was limited to fraudulent statements that were designed "to get" false claims paid or approved "by the Government."<sup>32</sup> Now, the FCA penalizes fraudulent requests for funds by a contractor if the money or property requested "is to be spent or used on the Government's behalf or

to advance a Government program or interest."<sup>33</sup> Thus, a false "claim" has been defined to include requests for payment or property that are made either to the federal government or to a contractor, grantee, or other recipient of federal funds.<sup>34</sup> Subcontractors, subgrantees and vendors are now explicitly covered by the Act.

Moreover, this provision, along with the Federal Acquisition Regulations' Mandatory Disclosure Rule, which came into effect on December 12, 2008, increases a prime contractor's potential exposure for reverse false claims by its subcontractors.<sup>35</sup> The Mandatory Disclosure Rule requires a government contractor's timely disclosure of "credible evidence" that a principal, employee, agency or subcontractor has (a) committed a violation of certain federal criminal statutes, (b) has been significantly overpaid or (c) has violated the False Claims Act.<sup>36</sup> Pursuant to the new Mandatory Disclosure Rules, where there is credible evidence of a subcontractor's potential FCA violation or significant overpayment, a prime contractor on a procurement matter must disclose that conduct to the government.

Finally, FERA expands the ability of the government to issue costly Civil Investigative Demands (CIDs), which are official governmental requests for documents and testimony during an FCA investigation. Prior to FERA, the Attorney General had to approve the issuance of a CID personally; now, the Attorney General is authorized to appoint any designee to approve a CID.<sup>37</sup> This pre-intervention discovery will be shared with any federal administrative or state investigative agency for the purposes of advancing or pursuing an FCA matter. Additionally, the wealth of information gleaned from that CID may now also be shared with any "qui tam relator," such as a disgruntled employee whistleblower, "as part of any false claims act investigation."<sup>38</sup> While pre-FERA the government may have been barred by the statute of limitations from adding additional claims as a result of evidence obtained during discovery, now it can add claims to whistleblower

lawsuits, by providing that these additional claims are considered filed as of the date of the initial *qui tam* lawsuit.<sup>39</sup>

## Best Practices

As government scrutiny and capabilities continue to increase, government contractors and subcontractors should act prudently and proactively to avoid future liability.

- Contractors should be ever aware of the vastly expanded scope for potential FCA liability. See Latham & Watkins Client Alert 877 dated June 8, 2009.
- Government contractors and subcontractors should have in place effective compliance policies that demonstrate the company's vigilant efforts to avoid wrong doing.
- A prime contractor's increased exposure for material overpayments made by the government to the prime suggests that the prime should have sufficient internal controls in place to determine whether there is sufficient evidence of such material overpayment. To assist in making this determination, the prime should develop reliable internal procedures to detect, process and investigate potential violations.
- Relatedly, a subcontractor's increased exposure to the government for material overpayments made to the subcontractor by the prime contractor where the money is to "advance a Government program or interest," suggests that sufficient internal controls should be in place to determine whether there is sufficient evidence of such material overpayment.

This new climate of increased contractor scrutiny and expanding investigative tools has given the government significant power to prosecute procurement fraud. Government contractors should be prepared for an increase in investigations and litigation, as the government attempts to scrutinize fraud, waste and abuse in these challenging economic times.

**Endnotes**

- <sup>1</sup> Comm'n on Wartime Contracting in Iraq and Afghanistan, H. Comm. on Oversight and Gov't Reform, *At What Cost? Contingency Contracting in Iraq and Afghanistan—Interim Report iii (June 2009) (hereinafter "Interim Report")*, available at [http://www.wartimecontracting.gov/download/documents/reports/CWC\\_Interim\\_Report\\_At\\_What\\_Cost\\_06-10-09.pdf](http://www.wartimecontracting.gov/download/documents/reports/CWC_Interim_Report_At_What_Cost_06-10-09.pdf).
- <sup>2</sup> Comm'n on Wartime Contracting in Iraq and Afghanistan, H. Comm. on Oversight and Gov't Reform, *Commission on Wartime Contracting: Interim Findings and Path Forward* (June 10, 2009) (joint statement of Michael Thibault and Christopher Shays, Co-Chairs) (hereinafter "*Interim Findings and Path Forward*"), available at [http://www.wartimecontracting.gov/download/documents/hearings/20090610/Co-Chairs\\_hearing\\_statement\\_HOGR-NSFA\\_6-10-09\\_\(rev\).pdf](http://www.wartimecontracting.gov/download/documents/hearings/20090610/Co-Chairs_hearing_statement_HOGR-NSFA_6-10-09_(rev).pdf).
- <sup>3</sup> *Interim Report*, *supra* note i, at 34.
- <sup>4</sup> *Id.* at 83.
- <sup>5</sup> *Id.* at 44.
- <sup>6</sup> *Interim Findings and Path Forward*, *supra* note ii.
- <sup>7</sup> *Interim Report*, *supra* note i, at 34, 47.
- <sup>8</sup> *Id.* at 35.
- <sup>9</sup> *Id.* at 27.
- <sup>10</sup> *Id.* at 93.
- <sup>11</sup> *Id.* at 84.
- <sup>12</sup> *Id.* In April 2009, three foreign military officers were convicted of extortion and bribery in connection with a \$70 million US-funded reconstruction program in northern Iraq. *Id.* at 86. Even more recently, on June 11, 2009, a Korean businessman pled guilty after being indicted for his role in a bribery conspiracy involving a \$206 million US Armed Forces telecommunications contract. Press Release, FBI, *Korean Businessman Pleads Guilty in Bribery and Fraud Scheme Involving \$206 Million Contract* (June 11, 2009), <http://dallas.fbi.gov/dojpressrel/pressrel09/dl061109.htm>.
- <sup>13</sup> *Interim Report* at 90-91.
- <sup>14</sup> *Id.* at 45-48. One example cited by the Commission was the construction of a new dining facility simultaneously and next to the renovation of the preexisting dining hall at Camp Delta. The work on both projects was done by the same company. *Id.* at 52.
- <sup>15</sup> See generally, *Interim Findings and Path Forward*, *supra* note ii. At an earlier hearing, the Committee found troubling the inverse relationship between the precipitous rise of contract expenditures and significant drop in contract fraud investigations between 2000 and 2008. Comm'n on Wartime Contracting in Iraq and Afghanistan, H. Comm. on Oversight and Gov't Reform, LOGCAP: *Support-Contract Challenges in Iraq and Afghanistan* (May 4, 2009) (statement of Rep. John Tierney, D-Mass., Chairman, H. Subcomm. on Nat'l Security and Foreign Affairs) (hereinafter "LOGCAP—Tierney"), available at [http://www.wartimecontracting.gov/download/documents/hearings/20090504/Tierney\\_statement\\_5-4-09\\_LOGCAP\\_hearing.pdf](http://www.wartimecontracting.gov/download/documents/hearings/20090504/Tierney_statement_5-4-09_LOGCAP_hearing.pdf).
- <sup>16</sup> *Interim Findings and Path Forward*, *supra* note ii.
- <sup>17</sup> *Interim Report*, *supra* note i, at 30.
- <sup>18</sup> *Id.* at 32. The DCAA is the agency responsible for the negotiation, administration and settlement of contracts and subcontracts for the Department of Defense. This authority is somewhat limited and does not extend, for example, to the subpoena of management reviews. However on April 21, 2009, Senator McCaskill, in the first hearing of the Senate Homeland Security and Governmental Affairs' new *ad hoc* Subcommittee on Contracting Oversight, honed in on ways to expand IG subpoena power. An overwhelmingly supported change to this power included compelling contractor and subcontractor attendance at governmental interviews. In fact, 95 percent of the 56 IGs surveyed supported compelled interviews to develop a more robust investigative record to assist Justice Department prosecutors put on their case. *Federal Contract Reports*, vol. 91, no. 16 at 349 (Apr. 28, 2009); see also Brian D. Miller, *Five Ideas to Fight Fraud that IG's Should Be Interested In*, available at [http://oig.gsa.gov/otherdocs/Five\\_ideas\\_to\\_fight\\_fraud.pdf](http://oig.gsa.gov/otherdocs/Five_ideas_to_fight_fraud.pdf) (advocating expanding the IG subpoena power beyond documents to compelled interviews where the evidence developed from such interviews could be shared with the agency).
- <sup>19</sup> Commission on Wartime Contracting Hearing: LOGCAP: *Support-Contract Challenges in Iraq and Afghanistan*, Comm'n on Wartime Contracting in Iraq and Afghanistan (May 4, 2009) (statement of April Stephenson, Director, DCAA) (hereinafter "LOGCAP—Stephenson"), available at [http://www.wartimecontracting.gov/download/documents/hearings/20090504/Stephenson\\_DCAA\\_testimony\\_5-4-09.pdf](http://www.wartimecontracting.gov/download/documents/hearings/20090504/Stephenson_DCAA_testimony_5-4-09.pdf).
- <sup>20</sup> *Id.*
- <sup>21</sup> *Id.*
- <sup>22</sup> *Interim Findings and Path Forward*, *supra* note ii.
- <sup>23</sup> Elise Castelli, *Auditor: 'Unprecedented Fraud' in LOGCAP III*, *Federal Times*, May 11, 2009, <http://www.federaltimes.com/index.php?S=4080958>.
- <sup>24</sup> LOGCAP—Stephenson, *supra* note xix.
- <sup>25</sup> Castelli, *supra* note xxiii.
- <sup>26</sup> LOGCAP—Stephenson, *supra* note xix.
- <sup>27</sup> See DCAA Case No. 05-015; see also LOGCAP—Stephenson, *supra* note xix.

<sup>28</sup> Comm'n on Wartime Contracting in Iraq and Afghanistan, H. Comm. on Oversight and Gov't Reform, *LOGCAP: Support-Contract Challenges in Iraq and Afghanistan* (May 4, 2009) (statement of record by KBR), available at [http://www.wartimecontracting.gov/download/documents/hearings/20090504/KBR\\_statement\\_for\\_record\\_5-4-09.pdf](http://www.wartimecontracting.gov/download/documents/hearings/20090504/KBR_statement_for_record_5-4-09.pdf).

<sup>29</sup> 31 U.S.C. § 3729(a)(1)(G).

<sup>30</sup> *Id.*

<sup>31</sup> *Allison Engine Co. v. United States ex rel. Sanders*, 128 S. Ct. 2123 (2008). FERA overrules the Court's holding in this case. See S. Rep. No. 111-010 (2009).

<sup>32</sup> Former 31 U.S.C. § 3729(a)(2) (amended by Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21).

<sup>33</sup> 31 U.S.C. § 3729(b)(2)(A)(ii).

<sup>34</sup> *Id.*

<sup>35</sup> Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67,064 (Nov. 12, 2008).

<sup>36</sup> *Id.*

<sup>37</sup> 31 U.S.C. § 3733(a)(1).

<sup>38</sup> *Id.* § 3733(a)(1)(D).

<sup>39</sup> *Id.* § 3731(c).

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If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

**Barry M. Sabin**  
+1.202.637.2263  
barry.sabin@lw.com  
Washington, D.C.

**Alice S. Fisher**  
+1.202.637.2232  
alice.fisher@lw.com  
Washington, D.C.

**Maria Arhancet Fehretdinov**  
+1.202.637.2119  
maria.fehretdinov@lw.com  
Washington, D.C.

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