

Subcontractor Cost Allowability Problems

Written by Nick Sanders
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It's called "privity of contract" and what it means is that a contract cannot confer rights nor impose obligations on entities who are not a party to the contract. In the world of government contracting, the concept means that (with extremely rare and narrow exceptions) subcontractors may not directly pursue a protest or a claim against the government. Since they are not a party to the prime contract, they do not possess privity. Because subcontractors do not hold the contract with the government, they are not entitled to enforce any of its obligations. (See this brief [legal article](#) from the firm of Weitz Morgan, from whence we borrowed the prior two sentences.)

Because the government only has privity of contract with the prime contractor, it enforces requirements on the prime and (generally) relies on the prime to enforce the requirements on its subcontractors, who then enforce requirements on their subcontractors. As the Weitz Morgan article explains, "subcontracts are governed by common law and written agreements between the prime and sub." Thus, if there is a problem at any level in the prime's supply chain, it is the prime's problem as well. If there is an assertion of defective pricing by a subcontractor, it is the prime who must pay. If there is an assertion of somebody billing hours on a T&M contract when they did not meet the qualifications of that hourly billing rate, the remedy is enforced against the prime contractor. If there is an assertion (in a cost-reimbursement contract) that a lower-tier subcontractor invoiced for unallowable costs, then it is the prime contractor who must credit those costs and pay any assessed penalties and interest. The only recourse available to the prime is to require the subcontractor to pay it back. (This assumes that the subcontractor agrees with the government's assertions. If the subcontractor disagrees then it is likely that a dispute between the prime and sub is going to materialize.)

Because the prime is responsible for its billings to its government customer, it is fairly clear that the prime has to perform some due diligence on its subcontractor cost assertions. We discussed that responsibility in several articles, including [this one](#).

More recently, Senator Claire McCaskill (D-MO) had some choice words about how the DoD was managing certain Afghanistan contracts. On April 26, 2018, her office released a House Subcommittee on Governmental Affairs [report](#) on the subject. The report included some juicy quotes, such as —

The Legacy Program was executed by a contractor named Jorge Scientific Corporation, later known as Imperatis Corporation (Imperatis), which has since become insolvent. This company first attracted the attention of Senator McCaskill in 2012, when allegations arose of drug and

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alcohol abuse and other misconduct at its compound in Kabul. Last year, Ranking Member McCaskill learned that at the same time Imperatis personnel were reportedly getting drunk and high in Afghanistan, its subcontractor [New Century Consulting, or NCC] was billing taxpayers for Bentleys, Porsches, and other luxury cars under the contract.

The report stated that DCAA audited the contractors and “identified \$51 million in egregious costs under the Legacy Program contracts,” but there is a problem. Privity of contract may prevent the government from recapturing those questioned costs. As the report explained—

DCAA’s audit only investigated costs between 2008 and 2013, and was not completed until 2016—nearly three years after that period ended and almost eight years after the first costs were incurred. Its audit of the remainder of NCC’s costs will not be complete until later this year. DCAA’s audit backlog, a longstanding concern of Ranking Member McCaskill, has resulted in an audit inventory whose average age is 14 months. Prior to DCAA’s audit, Imperatis filed for bankruptcy, meaning that the government may never recover its claim submitted after DCAA completed its work.

DCAA’s audit report was obtained by Senator McCaskill, who reported that “DCAA examined NCC’s incurred costs between 2008 and 2013 and revealed that NCC improperly incurred costs over \$50 million, including exorbitant salaries, unallowable travel expenses, and Bentleys, Porsches and other ‘luxury’ cars that were used by NCC executives and their assistants.”

Because the prime contractor is now bankrupt, the government lacks the legal means to go after the subcontractor. In addition, late DCAA audit findings raise the issue of whether any government claim would be considered timely under the Contract Disputes Act’s Statute of Limitations. This is an unfortunate situation—and it’s one that Secretary of Defense Mattis promised to address.

This [article](#) by Jared Serbu at Federal News Radio includes video of McCaskill’s questioning of SECDEF Mattis, who told her that “it’s probable that federal officials will file criminal charges” as part of an ongoing investigation into the situation.

For its part, NCC posted [a letter](#) on its website in response to Sen. McCaskill’s comments that stated (in part) “A number of the points of concern made in your letter are factually inaccurate

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and incorrect, albeit this partly stems from the inaccuracies within the DCAA audit report itself.” The letter also stated that the company had made a lengthy and detailed reply to the draft DCAA audit report but to no avail. The company wrote: “Disappointingly, but in what we understand is common practice, the final version of the audit report was little changed from the draft, despite these detailed explanations.”

Meanwhile, Sen. McCaskill urged the DoD to use its suspension and debarment process to “at least temporarily prohibit the firm from receiving any new government work.”

Prime contractors should think about this situation. The risk assessment for subcontractor oversight should include some exploration of what happens if the first (or lower) tier subcontractor has audit findings. Certainly, the prime is going to want to understand those findings in some detail, because it is very likely going to be held responsible for them by its government customer.