When **we wrote** about the UTC/Pratt & Whitney litigation that addressed (among other issues) the definition of "cost" for the purpose of CAS compliance and government contract cost accounting, we thought we were writing about relatively ancient history. After all, the Federal Circuit decision we vivisected was issued in 2003-more than a decade ago. Many folks had forgotten all about it.

So why was the final settlement between Pratt & Whitney and the U.S. Government the subject of a May, 2014, Department of Defense Inspector General Hotline Investigation Report?

But before we answer that question, remember that we are on record as asserting that contract-related litigation is on the rise, that apparently the DCMA has forgotten the FAR 33.204 statement that "The Government's policy is to try to resolve all contractual issues in controversy by mutual agreement at the contracting officer's level;" and as a result, the lawyers are very busy indeed. See, for example, **this two-part article** from August, 2012, in which we opined-

COs don't resolve complex issues any more. They don't negotiate DCAA audit findings (such as cost disallowances or CAS noncompliances). They don't look to 'split the baby' because getting an assured half a loaf now is no longer better than litigating for an entire loaf (plus interest), even when the probability of getting that entire loaf in a judicial award approaches zero.

Well, according to that **recent DOD IG report** , DCMA shouldn't really ever try to settle complex issues unless that settlement adheres to strict FAR and CAS rules. Any negotiated settlement that contemplates accepting less than the full amounts allegedly due the Government will be second-guessed and criticized. And that criticism may come from an unlikely source.

Let's start with a chronology of events, courtesy of Appendix B of the DOD IG report.

The issue began in 1991, when "DCAA reported that Pratt had not complied with CAS 410, 418, and 420 when accounting for the cost of material obtained through the use of collaboration agreements." In December, 1996, DCMA agreed with the DCAA assertion and issued a $260 Million demand for payment associated with the CAS noncompliances. In July, 2001, Pratt appealed to the ASBCA. As we know from the prior blog article on the case, the ASBCA found in Pratt's favor. The Government appealed to the Federal Circuit and, in January, 2003, Judge Dyk (writing for the Court) vacated the ASBCA decision and remanded the case back to the ASBCA to determine damages.

And that's where we lost interest; honestly, we thought it was routine from there. But apparently we were wrong. One of the items we missed was Footnote 19 in the Appellate decision. It stated:

To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts.

That innocuous footnote turned out to be important in the later chronology of events, which continued to unfold as follows:

In November, 2003, "DCMA issued an updated demand to Pratt in the amount of $754.7 Million," based on DCAA's "Rough Order of Magnitude" calculation "produced as a nonaudit service." (Readers may recall we have discussed DCAA's issuance of ROMs **before** .)

Throughout 2004, DCMA leadership and Pratt discussed the matter and attempted to resolve it through negotiation. In December, 2004, Pratt offered to pay $125 Million and DCMA countered with a settlement offer of $605 Million. Pratt rejected the DCMA counteroffer.

Discussions continued and in March, 2005, "DCAA Northeastern Regional Director e-mailed the DCAA Director a briefing sheet that identified a range of settlement positions calculated by DCAA as a nonaudit service." In particular, DCAA asserted that "$200 million was a reasonable recovery considering Pratt's explanation that some portion of the revenue shares represented payments for items other than parts."

In April, 2005, Pratt upped its offer to $175 Million. Internal DCAA briefings stated that "$334 million is a reasonable estimate of the cost impact (based on estimate of cost to Pratt to manufacture)" and "$234 million is a reasonable settlement, recognizing certain litigative risks associated with this issue." However, the DCMA Senior Trial Attorney disagreed with that assessment, asserting that a recovery between $417 and $814 million was expected if the litigation proceeded to conclusion; settlement was expected to be at $420 Million with a minimum of $375 million.

By June, 2005, the Government team "had splintered" with each part of the team expecting a different recovery value. But while the various parties had their own notions of how much the Government had been damaged, the DCMA Divisional Administrative Contracting Officer (DACO) still had to hammer out a prospective agreement on how the CAS noncompliances would be resolved and how Pratt would be permitted to do its cost accounting. The DACO proposed letting Pratt use an estimate of the cost of manufacturing its parts in-house in lieu of obtaining the parts (at cost) from the suppliers, in order to calculate its indirect cost allocation bases. The Senior Trial Attorney stated that proposed go-forward methodology could not be supported by him.

Negotiations continued through 2006. Importantly, while discussions continued, personnel were transferred and promoted. Notably, an employee of Sikorsky Aircraft (another UTC subsidiary) became a member of the DCMA leadership team at Pratt & Whitney. DCMA decided to continue settlement discussions without the participation of the DCMA Senior Trial Attorney.

In April, 2006, the parties were close (Pratt offered $270M and the Government wanted $291M). Finally, the Government accepted Pratt's offer of $283 Million on April 29, 2006, which settled the matter for the CAS noncompliances between 1984 and 2004, and established that Pratt could use a collaboration part cost estimate for its indirect cost calculations, which was termed by DOD IG "a noncompliant practice." Regardless of whether the cost accounting practice was compliant with CAS, the parties agreed that Pratt could use it.

At that point, things seemed to be (finally) wrapped-up.

Then somebody called the DOD IG Hotline and made two allegations:

1.

There was pressure from the highest levels of the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) to settle this litigation for an amount that-was agreeable to the contractor rather than an amount that was fair to the taxpayer.

1.

The litigation of Pratt's cost accounting for engine parts on commercial engine collaboration programs from 1984 through 2004 was settled for an amount about $500 million less than an amount consistent with Government procurement regulations, including the Cost Accounting Standards (CAS).

The DOD IG found no evidence to support the first allegation. There was no evidence of undue pressure to settle at an amount favorable to the contractor.

However, with respect to the second allegation, the DOD IG found that the cognizant DCMA Contract Management Office (CMO) had "failed to protect the Government's interest" when "determining a reasonable basis for the $283 million settlement amount." The DOD IG found that-

It was the trial attorney's litigation position that all the revenue share payments should be deemed the cost of collaboration parts unless shown to be otherwise by Pratt. The decision by DCMA management to reach a negotiated settlement instead of pursuing a court decision on the amount of damages owed by Pratt to the U.S. Government left the DACO and her team with data insufficient to support a negotiated settlement position that was consistent with FAR and CAS.

(Proving once again that one key purpose of an IG audit is to enter the battlefield after the fight and bayonet the wounded.)

The DOD IG report went on to discuss a fairly recent DCMA creation, the use of Boards of Review to review proposed Contracting Officers' negotiations. The DOD IG asserted that, if the Board of Review DCMA Instruction had been in place at the time of the settlement, then "the Board would have disagreed with the basis of the DACO's prenegotiation position." Regardless, the DOD IG noted that the current Boards of Review "would not have ensured that the DACO and her team had data sufficient to support a negotiated settlement position that was consistent with FAR and CAS." Accordingly, the DOD IG recommended establishing a new Review Board policy "that requires a management official oversee an evaluation determining the extent to which data obtained from the trial attorney supporting litigation is sufficient to support and justify a settlement negotiated consistent with the [FAR}."

The DCMA Director "partially concurred" with the above. One action taken was to update and reissue DCMA-GC Operating Instruction 2 ("Resolution of Intra-General Counsel Differences"). The Boards of Review Instruction 134 would also be revised to (among other things) ensure that a GS-1102-15 Supervisory Team Leader review and approve all Contracting Officers' litigation settlement actions. As for the rest of the DOD IG's recommendations, the DCMA Director found them to be no longer necessary, given the recent reorganization and creation of the CACO/DACO group at the DCMA Cost and Pricing Center.

The DOD IG report also had a third finding. It found that "DCAA assistance had negatively impacted the settlement amount." According to the DOD IG, DCAA's analysis that $234 Million would be a reasonable settlement amount "resulted in a substantial reduction in the settlement expectation anticipated by DCMA" and "inappropriately provided advance on litigative risk." The DCAA Director did not concur with that DOD IG finding.

At the end of a 23-year odyssey involving complex CAS and GAAP interpretations, a favorable ASBCA decision and an unfavorable Federal Circuit decision, we remain convinced that too many individuals within the U.S. Government want to ignore the official policy to engage in negotiation in lieu of litigation. We remain convinced that the authority given to Contracting Officers is being eroded, and that the Warrant (or Certificate of Appointment) held by Contracting Officers is worth less and less each day. As a result, we expect it will become harder and harder to resolve such issues, even when entitlement has been decided and

what's being negotiated is simply quantum.

Please notice, readers, the elephant in the room, the one issue not addressed by the DOD IG report: *the accuracy of the original $754.7 Million ROM created by DCAA* and initially used to establish the Government's estimate of damages. Somehow, between November, 2003, and April, 2005, that ROM estimate
was more than halved
and became $334 Million. What happened to that number over eighteen months? We will never know because the DOD IG chose not to evaluate the DCAA methodology used to determine the initial ROM value.

We remain convinced that using DCAA as a stalking horse, and having auditors calculate ROMs without implementing rigorous oversight designed to ensure the accuracy of the ROM values, is a bad idea. In this particular instance, it may have been an inaccurate ROM value that led to the protracted litigation, the difficult negotiations, and the subsequent DOD IG Hotline complaint. We hope DCAA auditors will think twice or three times before throwing out ROMs they know to be suspect; and we hope DCMA Contracting Officers will think twice before accepting DCAA ROMs at face value.

And we hope DCMA Boards of Review will take into consideration DCAA's methodology used to calculate ROMs before rejecting a Contracting Officer's use of independent business judgment to resolve complex disputes.

Oh, one final comment:

Remember that DCMA/Pratt settlement agreement? The one that permitted Pratt to use an estimate of collaborator part costs (based on what it would have cost the company to manufacture the parts in-house)? The one that was going to settle the dispute prospectively?

About that.

On September 22, 2011, DCAA reported that the ongoing Pratt cost accounting practice "may be resulting in an estimated cost impact of $15.2 million" with respect to one year (FY 2009). A week later, DCMA issued a "notice of potential noncompliance with CAS 418" to Pratt. Pratt's response pointed out that the issue was more than six years old (*hello Statute of Limitations!*) and, in any case, the cost impact was immaterial in amount. DCMA has taken no action since then … subjecting the individuals involved to yet another round of DOD IG criticism.

And so it goes ….