

March 2005

Government Contracts Fraud and Audit Alert

**Stephen D. Knight
Smith, Pachter, McWhorter & Allen**

The last three months have brought significant developments in government contracts fraud enforcement and audit issues.

The government is renewing its efforts to probe government contractors for fraud, using new tactics and advancing novel theories of liability. On February 18, 2005, federal prosecutors in the Eastern District of Virginia announced that they have established The Procurement Fraud Working Group, which will include investigators from the Federal Bureau of Investigation, the Department of Defense, Homeland Security, the State Department, the Department of Transportation, and the National Reconnaissance Office. The Group will use, among other tools, data-mining software to search for suspicious transactions including multiple billings, and to review the flow of funds. Investigators will also become “embedded” with procurement officials to detect fraud early in the contracting process. *See* “Initiative to Probe Contractors for Fraud,” *The Washington Post*, E1 (February 19, 2005).

Contractors are well advised to redouble their compliance efforts, especially relating to the interface between employees and government personnel. Fraud investigators will seek to scrutinize company statements and submissions. Contractors should pay particular attention to proposal submissions and negotiations relating to any pricing action. This change in government investigation tactics will magnify contractors’ risks of doing business and increase the time necessary to negotiate and administer contracts.

In an unprecedented move, the Department of Justice (“DOJ”) recently filed an unsealed amended complaint in Texas, alleging that a contractor’s failure to disclose estimates violated the Truth in Negotiations Act (“TINA”) and constituted fraud. *United States ex rel. Woodless v. SAIC*, Civil Action No. SA-02-CA-028 WWJ (W.D. Tex.). Also, in a December 20, 2004, “False Claims Act Alert,” the Air Force Office of Fraud Remedies agreed that estimates, risk reserves, quantitative risk analyses, internal analyses of inefficiencies and unanticipated schedule delays, are cost or pricing data that must be disclosed current, complete and accurate as of the date of price agreement. TINA case law, however, has for decades made clear that the definition of “cost or pricing data” distinguishes fact and judgment, and acknowledges that estimates are judgments, not fact. DOJ and the Air Force will now focus on estimates and “negotiated profit” in firm fixed price contracts. The government can now be expected to allege fraud if the contractor negotiates a particular profit level but anticipates making more profit due to undisclosed estimates of future events. Contractors should review their proposal processes and

statements made internally by, *e.g.*, the business development and marketing functions relating to anticipated profit. Internal management approval letters often carry marketing assessments of anticipated profit levels that may or may not be the same as profit levels discussed with government negotiators. Contractors should expect the government to argue that failure to disclose internal approval letters is potentially fraudulent.

In another fraud action, DOJ supported a *qui tam* relator's position on appeal that a contractor fraudulently induced the Army Corps of Engineers to award a contract by submitting an intentionally undervalued bid, with the intention of obtaining increases in the contract price after award. *United States ex rel. Bettis v. Odebrecht Contractors of California, Inc.*, (D.C. Cir. Jan. 11, 2005), *aff'g* 297 F. Supp. 2d 272 (D.D.C. 2004). This is yet another example of the government demonstrating a renewed aggressiveness in tactics and liability theories to charge contractors with fraud.

Finally, DCAA has issued numerous audit guidance memoranda, including one that pointedly requires DCAA auditors to discuss company efforts to comply with the Sarbanes-Oxley Act. Notwithstanding DCAA's position, contractors are not required to coordinate with DCAA on Sarbanes-Oxley compliance, and should carefully assess the risks inherent in agreeing to do so.

For further information on these subjects, contact Steve Knight, 703 847 6284, sknight@smithpachter.com