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#### FEATURE COMMENT: Six Lessons Learned In Litigating A Defective Pricing Case: *Alloy Surfaces Co., Inc.*

In the past decade, defective pricing audits and claims have often stumbled short of trial and decision, as many cases settled and others faltered on the merits. The appeal of *Alloy Surfaces* represents the uncommon defective pricing claim to reach a published decision in recent times. *Alloy Surfaces Co., Inc.*, ASBCA 59625, 2020 WL 1896784 (April 9, 2020); 62 GC ¶ 122. In this case, the Army alleged that Alloy Surfaces did not disclose the latest reports of labor hours and material costs for producing infrared countermeasure flares used to protect helicopters from heat-seeking rounds. The Armed Services Board of Contract Appeals ultimately denied the Army's defective pricing claim on multiple grounds.

Due to the exceptional depth of the ASBCA's decision and the span of legal and factual issues (including 129 findings of fact), the *Alloy Surfaces* decision offers a buffet menu of lessons learned in litigating a case under the Truth in Negotiations Act (TINA). Some examples include the following:

1. Challenge the Five Points. Pushing the Government to prove each of its five points of proof pays off, as the ASBCA found the Army's defective pricing claim failed on multiple grounds in the *Alloy Surfaces* appeal.
2. Tell the Negotiation Story. The heart of a defective pricing case is the negotiation context—a context in *Alloy Surfaces* showing that negotiations hinged on the inefficiencies of ramping up production in new plants with new workers, not the dissimilar cost history in the old plant with seasoned employees.

3. Test the Cost Data Assertion. While Alloy Surfaces' management reports contained some factual data, the reported labor and material usage factors did not meet the test for cost or pricing data where the factors were derived from judgments that lacked verifiability, reliability and accuracy.
4. Question the Agency's Reliance. Despite the Army negotiation memorandum's bald assertion of reliance on cost or pricing data, other negotiation facts refuted this claim, including the Army's own independent estimate, focus on judgmental factors, and reliance on the TINA certificate (rather than the data itself).
5. Showcase Government Knowledge. While the Army did not see the latest labor and material usage factors, the Army's inside knowledge of the flare automation and production process resulted in an Army technical analysis with usage factors much lower than negotiated, thus undercutting reliance and causation.
6. Start Early. The outcome reflects the value of attacking the draft audit early, as many of the themes from Alloy Surfaces' 2011–12 rebuttals—unreliable cost data, widely fluctuating usage estimates, new plant inefficiencies, and the Army's independent technical analysis—ultimately won out in the ASBCA's decision.

**Challenge the Five Points**—For many decades, the Defense Contract Audit Agency's Contract Audit Manual (DCAM) has acknowledged that to show defective pricing, the audit must establish “five points” of proof: (1) the data qualifies as cost or pricing data; (2) such data were reasonably available prior to price agreement; (3) the data were not disclosed to, or known by, the Government; (4) the Government relied on this data during negotiations; and (5) this defective data caused an increase in the contract price. DCAM § 14-102(b). In the *Alloy Surfaces* decision, the ASBCA dealt with all of these issues, thus illustrating the importance of a broad-spectrum TINA defense.

*Building a Broad Defense:* Contesting multiple points of defective pricing makes the Government's job tougher in a TINA dispute. Even if the Government prevails on most of the five points, failure of proof on a single element suffices to defeat the TINA claim. See, e.g., *Chu Assocs., Inc.*, ASBCA 15004, 73-1 BCA ¶ 9,906 at 46,456–57 (finding proof of nondisclosure, but denying claim due to lack of reasonable availability of cost data). In the *Alloy Surfaces* case, the contracting officer issuing the final decision focused on whether the data at issue was “available or not,” thus exposing gaps in the Army's proof on other elements. Ultimately, the ASBCA held for Alloy Surfaces on four of the five points of defective pricing: (1) the Alloy Surfaces management reports did not qualify as cost or pricing data, (2) the latest management reports did not become available until after price agreement, (3) the Army did not rely on the data in these reports and (4) such data did not cause any increase in price.

*Showing the Synergies:* Establishing one defense may open the door to other defenses. As an example in another case, the prime contractor did not rely on the subcontractor's actual labor hours due to the general unreliability of the data, resulting in the Government losing its TINA claim on two separate elements: (1) lack of reliance on the cost data, and (2) inability to show the information qualified as cost or pricing data. See *The Boeing Co.*, ASBCA 20875, 85-3 BCA ¶ 18,351 at 92,033. In *Alloy Surfaces*, one defense (unavailability of the final report prior to price agreement) then led to a second defense—i.e., the preliminary usage report hinged on judgments that did not qualify as cost or pricing data. Other similar synergies are discussed in more detail below (i.e., Government knowledge, cost or pricing data and reliance), reinforcing the importance of a multi-prong defense.

**Tell the Negotiation Story**—As the ASBCA has stated, the “circumstances surrounding the negotiations ... are, after all, at the heart of a defective pricing case.” *Rosemount, Inc.*, ASBCA 37520, 95-2 BCA ¶ 27,770 at 138,456; 37 GC ¶ 540. In *Alloy Surfaces*, this negotiation context proved to be pivotal in two respects.

*Showing Apples and Oranges:* At the heart of the *Alloy Surfaces* negotiation stood a defining fact: the new delivery order “required the largest production ramp-up for delivering M211 decoy flares” in the history of Alloy Surfaces. *Alloy Surfaces Co., Inc.*, 2020 WL 1970847, slip op. at 5. For this unprecedented production ramp-up, Alloy Surfaces explained during

negotiations that it must open new plants, qualify new equipment and hire hundreds of new employees. As a result, the rising efficiencies in the old plant with seasoned employees for prior orders would not predict the labor and material usage efficiencies for the new delivery order to be built in new plants by new employees with yet-to-be-qualified equipment:

Moreover, because the DO 13 data was from Plant 1, the data would not have shed any light on the inefficiencies associated with starting and ramping-up production at the two new manufacturing plants. ... Indeed, the fundamental problem with the government's position is that DO 13 data sheds no light on the actual effect of ramp-up inefficiency on manufacturing in Plants 2 and 3.

*Id.* at 29. Thus, the negotiation context explained why the Army accepted higher labor and material usage factors, even though it knew about lower usage factors for production in the old plant with experienced workers.

*Explaining the Why:* At first blush, labor and material usage factors calculated to the fourth decimal place might appear to be classic cost or pricing data on which the parties would routinely rely. In the *Alloy Surfaces* appeal, the negotiation context explained why the parties did not. First, as noted above, the switch in manufacturing plants and workforces resulted in the prior data not being relevant. Second, the parties had not previously used management reports with work-in-process (WIP) data—as opposed to *completed* work orders—during negotiations because the WIP reports depended on judgments on estimated usage (equivalent units) that lacked the “requisite degree of certainty” to qualify as cost or pricing data. *Id.* at 2, 26. Third, the Army conceded that Government representatives knew that Alloy Surfaces' practice was to generate WIP reports and that Alloy Surfaces did not view such reports as being cost or pricing data. For these reasons, the negotiation context made sense of the parties' conduct in not relying on the historical usage data at issue.

**Test the Cost Data Assertion**—The management reports with WIP data included not only the overall labor and material usage factors for each job, but only broke these factors down to the fourth decimal point for each major manufacturing step. Nonetheless, these management reports did not meet the test for cost or pricing data.

*Separating Judgment and Fact:* As a general rule, contractors must disclose intertwined judgments and

facts, such as the vendor cost analyses that included both prior cost history (facts) and judgments (prime contractor's estimate of future subcontract prices). See, e.g., *Grumman Aerospace Corp.*, ASBCA 27476, 86-3 BCA ¶ 19,091 at 96,494–95. In the *Alloy Surfaces* appeal, the ASBCA articulated a key additional distinction:

Unlike the reports in *Texas Instruments*, which included verifiable factual data alongside estimates, Alloy's job cost reports set forth usage factors that are *calculated* using estimates. ... WIP sheets, like the Internal Operating Controls (IOC) reports in *Aerojet*, are management tools based on an individual manager's judgment, not a cost accounting process relying on precision.

*Alloy Surfaces* at 24. In other words, each Alloy Surfaces' usage factor for WIP units included an integral judgment about quantities ("equivalent units") that could not be separated from the report's factual data any more than hot water could be separated from cold water. Thus, the *Alloy Surfaces* decision illustrates the importance of challenging defective pricing claims where the data at issue depends, whether in whole or part, on making judgments.

*Assessing Reliability*: Shedding light on another murky area of TINA definitions, the ASBCA addressed the reliability or accuracy needed for cost or pricing data:

Although the estimates in the job cost reports may become more accurate as the end of a production run approaches, it is impossible to point to a time along the continuum where the estimates become accurate enough to possess the requisite degree of certainty for providing certified cost and pricing data to the government.

*Id.* at 23–24. In reaching this holding, the ASBCA cited the "significant volatility [of the data] showing variances of between 33 and 500 percent" in a given month, the "unreliability of the WIP data," and inability to verify the data until the end of the production run. *Id.* at 15, 24. While TINA precedent in this area is sparse, the holding fits squarely within the definition requiring cost or pricing data to be "verifiable" facts that "can be reasonably expected to contribute to the soundness of estimates of future costs." Federal Acquisition Regulation 2.101.

**Question the Agency's Reliance**—The unreliability of the WIP data in the management reports not only negated the cost or pricing data element of the Army's claim, but also drove the parties to rely on

judgments about future inefficiencies in ramping up production, rather than historical labor and material cost data resulting from the dissimilar history in the existing plant with an experienced workforce. While the agency starts with a presumption of reliance in a defective pricing claim, the *Alloy Surfaces* case lays out a roadmap illustrating multiple routes for contesting the agency's conclusory assertion of reliance in the CO's price negotiation memorandum (PNM).

*Performing an Independent Government Analysis*: An independent Government analysis represents a classic form of price analysis. FAR 15.404-1(b)(2)(v). For the Alloy Surfaces negotiation, the Army prepared an independent technical analysis of labor and material usage factors. *Alloy Surfaces* at 10. As the ASBCA held, the Army's independent analysis rebutted the presumption of reliance. *Id.* at 27.

*Relying on Judgments*: The Army's PNM expressly questioned Alloy Surfaces' proposed usage factors based on data showing greater efficiency in the existing plant with its seasoned workforce. Despite challenging the proposed usage factors, the PNM "acknowledged some inefficiency could occur due to additional production rate ramp-up." *Id.* at 27–28. In effect, the PNM admitted the Army's reliance on judgments about future inefficiencies, rather than history of past efficiencies gained in dissimilar circumstances.

*Failing to Provide Specifics*: When the presumption of reliance is rebutted, the agency still bears the burden of explaining how it would have used the undisclosed cost data:

In order to prove reliance, the Army must provide specific information about *how* it would have used the DO 13 data in negotiations. The Army cannot rely on speculation about how it would have used the data or how having the data would have affected negotiations.

*Id.* at 28. Given the negotiation context of predicted inefficiencies in the unprecedented production ramp-up, the Army could not demonstrate such "specifics."

*Relying on the Certificate*: In a defective pricing case, the agency must ultimately prove reliance on the cost or pricing data itself, not merely the TINA certificate. During trial, the Army CO admitted that she relied on the Certificate of Current Cost or Pricing Data "on the assumption that [she] would be able to recover any defective pricing cost later." *Alloy Surfaces* at 30. This admission undercuts the Army's proof of reliance on the cost or pricing data at issue.



Citing *Luzon Stevedoring Corp.*, ASBCA 14851, 71-1 BCA ¶ 8,745, the ASBCA held that “the defective pricing clause is not a vehicle for repricing a contract which is deemed unreasonably high-priced.” *Alloy Surfaces* at 30.

**Showcase Government Knowledge**—Government knowledge of the cost data at issue extinguishes a defective pricing claim. *The Boeing Co.*, ASBCA 32753, 90-1 BCA ¶ 22,426 at 112,642. In the *Alloy Surfaces* case, the Army did not have actual knowledge of the WIP data at issue. If the WIP usage data had qualified as cost or pricing data, the ASBCA still would have had the opportunity to address whether the Army met its burden of proving lack of disclosure or Government knowledge of such data. Given the facts, Government knowledge played a different role in the *Alloy Surfaces* decision.

The Army did have extensive knowledge of Alloy Surfaces’ production and automation processes, resulting in an independent technical analysis with labor and material usage values considerably lower than the parties negotiated. *Id.* at 10, 12. This Government knowledge negated the Army’s proof of the fifth point of defective pricing—i.e., that defective pricing caused an increased contract price:

The Army was aware of the effect of automation on labor and material usage factors, based on its oversight of the production prove-out of the automation machinery at Plant 1. (Findings 31, 67, 101). Indeed, this knowledge was the basis of the technical team’s questioning of the Job 1516 and 1528 prices (findings 68, 98). Having the DO 13 data, therefore merely would have reinforced the technical team’s conclusions about the effect of automation. The Army’s knowledge of the effect of automation *undermines the causal connection* between the allegedly undisclosed data and an overstated contract price.

*Id.* at 28 (emphasis added). As illustrated by this ASBCA holding, a sound TINA defense should always address Government knowledge, as it may be relevant not only to the third element of defective pricing (lack of disclosure or Government knowledge), but also to the fifth element (causation of an increased contract price).

**Start Early**—When DCAA issues its draft post-award audit report, a contractor has an opportunity to respond. After receiving DCAA’s draft audit in September 2011, Alloy Surfaces submitted initial and supplemental rebuttals in October 2011 and March

2012—both well before the final decision in July 2014. *Id.* at 20–21. These early written rebuttals reaped multiple benefits.

- **Marshalling Facts & Law.** The early rebuttals allowed Alloy Surfaces to gather critical facts and law that laid the foundation for the negotiation context critical to defective pricing disputes.
- **Defining the Issues.** Alloy Surfaces’ rebuttals defined the framework (including the five points of defective pricing) that guided the litigation strategy through the final decision, trial, and post-trial briefing.
- **Creating the Cross.** As the final decision did not address many of the issues defined in the Alloy Surfaces rebuttals, much of the hearing’s cross examination in 2017 centered on un rebutted facts and defenses established in 2011–12.

In summary, the ASBCA’s decision in *Alloy Surfaces* represents a rich addition to over six decades of TINA precedent, as it clarifies some nuances in cost or pricing data law, reinforces critical precedent in the areas of reliance and causation, and underscores the importance of a thorough understanding of the negotiation story. For any agency or contractor grappling with a defective pricing audit, the *Alloy Surfaces* decision serves as an essential primer on the governing law under TINA. On a practical level, this decision offers valuable guidance on TINA standards that, if heeded, may also spare the parties from the challenges of dealing with a defective pricing final decision and preparing for trial many years after the close of negotiations.



***This Feature Comment was written for THE GOVERNMENT CONTRACTOR by David Z. Bodenheimer, a partner at Nichols Liu LLP. David litigated the Alloy Surfaces appeal before the ASBCA with outstanding support from Michael Hubbard (CHG General Counsel), as well as David’s former colleague Jason Crawford. Chambers USA ranks David nationally and recognizes him as the “premier expert in the field of defective pricing” and “an exceptional cost and pricing attorney who is terrific with clients.” He authored the Defective Pricing Handbook, which has been described in the Nash & Cibinic Report as “the definitive text on TINA.”***