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Operating Leases for Real Property Between Organizations under Common Control: Restrictions in Allowable Costs

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Costs for the rental of real property (building and land) required to conduct a contractor's business activities are generally allowable under FAR 31.205-36, as long as such costs are comparable to commercial marketplace lease rates for similar facilities, due diligence has been exercised in acquiring reasonable lease terms and conditions, and the company has given adequate consideration of property rental options.

But where the government contractor rental arrangement is with a leasing entity where there is "common control" between the contractor and lessor, allowable real property rental costs are limited to the "normal cost of ownership" of that property. "Common control" exists when both the government contractor (lessee) and leasing entity (lessor) are controlled by the same person(s) or organization; one common example being a lease between two affiliates under the governance and/or ownership of the same parent organization or group of investors. Cost of ownership represents the amount which would be incurred had the government contractor owned the leased property. By inference, the allowable cost ceiling being equivalent to a commercial market lease value, less the mark-up/profit added to the cost of ownership incurred by the owning/leasing related party.

Many government contractors, after having conducted operations in rented office, factory, or warehousing space for many years, choose to invest in company owned facilities through the purchase or construction of structures to house their operations. Purchase or construction of facilities are often made after determining that facilities ownership is, in the long-term, less expensive and allows for expansion for projected business growth without the continued burden of moving every few years to different leased facilities. And, government contractor owners, investors, or senior officials other than owners sometimes elect to house the newly purchased/constructed building into a separate company (example, Limited Liability Corporation—LLC) and lease the property back to the government contractor at a commercial market value. Reasons for this decision vary, but obviously a primary motive is to make an additional profit on the owners'

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investment in the building, while also separating the control and disposition options of the property from that of the contractor.

Contractors who enter into leases for facilities with related party leasing companies are presented two challenges when considering rental amounts that the government will absorb. Determining if common control exists between the two entities, and if so, how to calculate the "normal cost of ownership".

Common Control

The FAR cost principle does not define common control, nor the factors that must be considered in determining if such control exists between contractor and leasing entity. Case decisions as well as DCAA guidance, however, identify certain components or indicators of common of control, the underlying principle being whether one party has the authority, ability, or ownership capacity to exercise control over the financial and operating policies or practices of the related party. DCAA calls attention to the FAS 57 definition of "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract or otherwise".

Court case decisions have affirmed that in determining if common control exists, one must examine the facts, rather than mere appearances, in establishing that "actual" control exists. DCAA, in its Contract Audit Manual, notes that examination of underlying facts behind decision making processes are paramount in determining control or the absence thereof; such facts may include stock ownership percentage; interlocking management or ownership; family member interests; shared facilities between contractor and leasing entity; use of same employees for duties of both entities; level at which management direction of operations takes place (e.g., venture capitalists control direction of company rather than company officers), and; most important within DCAA's guidance, the reasonableness of the lease terms between contractor and the leasing entity potentially under common control.

If lease terms (and rates) between related parties are not comparable to those typically negotiated in the commercial market place not involving a related party, whereby true arm's length bargaining can be demonstrated, auditors most often will, perhaps prematurely, conclude that control of one related party over the other exists. Indicators of common control within lease terms and conditions include negotiated square footage rate higher than other facilities available by non-related leasing entities; absence of standard lease duration, and; ability to terminate lease without penalty.

No longer is owners'/investors' percentage of ownership of both entities the most dominant factor in asserting common control. Common owners or officers of both entities who have less than controlling stock or financial ownership are not immune from exerting control over either related party. In "Richard D. Salvatierra" (EPA decision), the court found that the president of RII (government contractor), who held 40% ownership of the leasing entity (PLI), actually "exercised day to day control over the operations of PLI". In another decision, "Data Design Laboratories" (ASBCA), the board concluded that common control did not exist between a corporation and a leasing entity owned by several officers of the corporation; the board found that the corporation's venture capitalists, who held majority ownership of the corporation, and not the company's officers, actually controlled the leasing corporation. Thus, common control did not exist between the corporation (lessee) and the leasing partnership (lessor) owned by corporation senior officials. In other decisions, family relationships, such as husband having control of the contractor with the wife holding majority interest in the leasing company, were deemed evidence of common control, based on factual data demonstrating that both family members were assigned responsibilities for financial management over both companies.

For a government contractor to prevail in asserting absence of common control between related parties, e.g., government contractor and leasing entity, the greater the distance and the higher the fences that individual owners, officers, investors, or relatives can build to alleviate "actual" control of one over the other related party, the better chances of claiming commercial rental rates under government contracts, thus bypassing the cost of ownership ceiling. Initiatives the government contractor should consider to eliminate the specter of common control include a negotiated lease agreement containing terms and rates that ordinarily re executed with non-related parties; removing the same personnel from both the responsibilities of lease terms development as well as the approval process; minimizing or completely avoiding delegating operational and

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financial responsibilities to family members who have an interest in either one or the other related party, or, more dramatically; removing common party investors from any responsibility for the financial or operations of the related party leasing company.

Notwithstanding implementation of policies to avert common control practices between related parties in a leasing arrangement, our experiences in supporting client assertions that common control does not exist, when facing DCAA audit challenges, have often been futile. Many auditors perceive that any relationship between owners and/or officers/managers having an interest in both parties, albeit limited management activities or minimal ownership, still constitutes common control, without further examining evidential data supporting, or not supporting, common control in the context of the ability to exert influence by one party over the other.

Cost of Ownership

If the government contractor concludes that common control exists between related parties in a leasing arrangement, the next step is to calculate the cost of ownership, e.g., actual (or estimate actual) costs that would normally be incurred by the contractor were the building and related facilities (e.g., parking lot, etc.) owned rather than leased. Common cost of ownership components may include building depreciation, capital renovations, property taxes, facilities insurance, maintenance & repairs, utilities, and property and facilities administration. In addition to normal costs of ownership that would be identifiable recorded expenses were the contractor to own the building, the cost of facilities capital (referred to as cost of money, a CAS 414 concept), an imputed (non-recorded) expense based on investment in capital equipment, including real property, is an allowable component in cost of ownership calculation—it is also a value that is frequently omitted by contractors with related party leases when establishing the total constructive cost of ownership for comparison to the rental amount.

Understand that the ultimate use of a cost of ownership calculation is to determine the extent of allowable lease costs by comparison of that ownership cost to the actual lease payments paid to the related party—should the cost of ownership be less than the lease payments, the difference would be classified as unallowable. Should the cost of ownership be more than the lease payments, the allowable cost would be limited to the actual lease payments costs.

One important concept is frequently overlooked in establishing an equitable ownership cost calculations: the cost of ownership calculation should only include expenses (or costs for services) that are symmetrical to the services/types of costs covered in the leasing entity's established fixed rental value, often based on a fixed amount per square footage. All other rented property related costs that are directly incurred by and paid for by the contractor (lessee), including costs originating with the lessor but billed directly to the contractor, would not be included within the contractor's cost of ownership calculation. These costs will flow through the contractor's (lessee) general ledger and passed on to the government within the contractor's bid and billed indirect rates, and obviously those costs should not be a component of the lease payments.. The primary concern of the government in calculating cost of ownership is to reduce any fixed lease costs to an actual ownership level, taking into consideration only those costs and services which were intended to be reimbursed to the lessor in a fixed value arrangement.

An example of the above: the leasing entity charges government contractor fixed amount $10,000 per month, or $120,000 per year. The fixed rent value includes building depreciation, general repairs, taxes and insurance for the building, and property management fees. Other costs that either originate within the leasing entity (then billed to the contractor) or are incurred directly by the government contractor, pertinent to leased property, are ultimately recorded as expenses within the government contractor's (lessee) general ledger. For purposes of determining the cost of ownership, the government contractor will only include amounts for depreciation, general repairs, taxes and insurance and property management fees. Other costs already recorded by the contractor within its general ledger, which are allocated to the government through its rates, are omitted from the cost of ownership column.

In preparing forecasted or actual year-end cost of ownership values, contractors will require the recorded or budgeted costs and supporting information from the related party lessor, e.g., the entity that owns and leases the facilities. Should the costs of ownership calculations be audited, government auditors may request the lessor's general ledger/transaction activity, as well as supporting accounting data such as depreciation

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source records, invoices for property taxes & insurance, and actual cost information supporting any management fees or other costs which were intended to be paid for as part of the lease terms and conditions.

Government contractors with related party leases where common control exists should calculate costs of ownership at least once a year. Additionally, cost of ownership calculations should not only entail adjustments for final year end indirect rates (requirements of an incurred cost proposal), but also must be estimated in preparing provisional indirect billing rate or forward pricing bid rates. Failure to calculate adjustments, especially for final year-end rates, will render those excess costs as expressly unallowable and present a likely imposition of penalties on those costs.

ASBCA Shreds Government TINA Defective Pricing Allegations

By Darryl L. Walker, CPA, CFE, CGFM, Director at Redstone Government Consulting, Inc.

The Armed Services Board of Contract Appeals (ASBCA, Case No. 56547) dismissed the government's defective pricing claim that Lockheed Martin's (LM) non-disclosure of certain cost and pricing data caused an increase in a negotiated contract price. At issue, the Truth-in-Negotiations Act (TINA) and implementing FAR 15.407 regulations, which could have required a contract downward price adjustment. The court's decision hinged entirely on one key principle for establishing defective pricing, which is that the government must establish that there was an increase in negotiated price as a direct result of defective pricing. The court rejected all government recommended price adjustments (RPA) presented during the course of the litigation because government evidence did not support that the non-disclosure of certain cost data, a Raytheon "Bridge" subcontract with Lockheed, contributed to an alleged overstatement of the Lockheed prime contract price.

The government's defective pricing claim arose from a Raytheon Systems Company subcontract proposal for its new Modular Mission Computer (MMC) 5000 systems, a component of the Lockheed retrofit kits for changes to hardware and software to the F-16 aircraft, under a Common Configuration Implementation Program (CCIP). The Raytheon MMC 5000 series was the successor to the earlier MMC 3000 series provided under a separate purchase order (PO) with Lockheed (and a separate prime contract), identified as the 4XT PO. Because the 4XT PO was soon to expire, Lockheed required a subcontracting/PO vehicle to cover short-term needs for the MMC 3000 series soon to go out of production as well as a "handful of MMC 5000 systems"; to fulfill those short-term needs, Raytheon submitted a proposal from which to negotiate a "Bridge Purchase Order". (The court noted that the Bridge PO was not intended to cover components for production of the MMC 5000 systems under the subsequent contract). During the same time frame, the Air Force and Lockheed negotiated a production CCIP contract for a newly configured retrofit kit which included the Raytheon MMC 5000 systems.

In September 2002, the Air Force, supported by a DCAA post-award (defective pricing) audit report, asserted that Lockheed defectively priced the CCIP production by failing to disclose lower prices for MMC components under the short-term Bridge PO, and that PO information reflecting those lower prices was available prior to final price agreement for the CCIP award. The audit report calculated an RPA of $14.6 million, and in May 2007, the contracting officer sustained the audit questioned amount and Lockheed/Raytheon subsequently appealed.

The ASBCA supported by the facts and testimony presented by the contractor, dissected and shredded the government's rationale, logic, and theories supporting its original RPA (DCAA audit position), its pre-trial, and its two post-trial revised RPAs, stating that "All are deficient and logically or factually flawed". The core of this observation: the government used the Bridge purchase order cost data as the cost baseline to calculate original and revised RPAs (i.e., increase in contract price that resulted because the Bridge PO cost data were not disclosed), but failed to sufficiently adjust the Bridge purchase order cost data to mirror the CCIP MMC 5000 series configuration, adjust differences between the 5000 and 3000 series units components (over 80% of Bridge price was for MMC 3000 systems), take into consideration the differences in actual monthly delivery rates (AMDR), and recognize that the Bridge PO was not intended to cover components for production of MMC 5000 systems which were to be supplied under the CCIP contract.

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Adding to the expanding and embarrassing government unsupportable positions during the hearing was the court's acknowledgement that the government and auditor did not use the most current, detailed Bridge recurring cost baseline breakdown for the MMC 5000 systems in calculating the initial RPA. The court affirmed that the government's initial RPA calculation was not accurate since it did not factor in the latest recurring cost breakdown, and ultimately the government also acknowledged the error and revised its RPA. Had the government avoided this blunder to begin with, the government's original RPA (e.g. audit report and contracting officer final decision) would have been significantly less albeit still flawed for other critical reasons.

Even after conceding lapses in its calculations and admitting that initial RPAs were not accurate, the government pursued one final attempt to prove defective pricing via utilization of the Bridge PO data. The contention: because proposed prices for the CCIR contract declined from the first to the second performance period by 26.3%, "the Bridge PO second period price would also have been used to reduce the CCIP price for the second period"—meaning that the Bridge PO price baseline should be decremented by 26.3% for comparison to the second period CCIP contract price—hence the decrement approach increases the amount of damages to the government. Two problems are cited by the board with this notion: first, during the evaluation of proposed prices in the pre-award stage, all government parties agreed to an escalation factor approach in pricing the second period CCIP MMC 5000 unit price without question, and second, there is no Bridge PO second period thus leaving it to anyone's imagination what decrement factor would have been negotiated, were there a Bridge second purchasing period. It is interesting to note that the auditor, during testimony, discounted the decrement factor approach by affirming that "comparability between the Bridge price and the MRC prices required application of an escalation factor to the second period shipsets."

The ASBCA's conclusion focused on two critical deficiencies in the government's calculation methods, one being the lack of adjustment for "materially different delivery rates" for the Bridge and CCIP contracts, and the improper application of a decrement "when comparing hypothetical second period Bridge prices to CCIP prices". When correcting these errors, there is no downward price adjustment to the CCIP contract due to defective pricing.

The board castigated the government's RPA calculations, the lack of attention to details in crafting price adjustments and supporting multiple, whimsical damage theories. The board noted that the government failed to explain its assumptions underlying its calculations and "the computations and assumptions inherent in the theories are far from clear, obvious, and logical…". As to the four separate theories supporting the computation of multiple RPAs, the board stated without persuasive evidentiary support, the government offered a number of counter-intuitive, illogical reasons" for not considering comparable delivery rates in the government RPAs. Finally, with respect to the pre-trial and post-trial RPAs, the board castigated the government by stating that the RPAs "are not based on the facts. They are based on a selective out-of-context reading and/or unreasonable interpretation of the facts."

The board also addressed the availability of the Bridge PO pricing data at the time of prime CCIP contract price agreement, although this issue was not paramount to the court's final decision since the ASBCA had already determined that there was no increase in price to the government. The court confirmed that on the date of prime contract price agreement, "there was no agreement between Lockheed and Raytheon on the Bridge PO component prices necessary to calculate an imputed shipset price for the MMC 5000". This statement essentially questions whether the Bridge PO data, used by the government in asserting defective pricing, met the definition of "cost or pricing data" since that pricing information was not available in meaningful detail at the time of the CCIP final price agreement.

The board's harsh criticism of the DCAA's audit position and the contracting officer's and government litigation specialists' decision to carry forward a flawed defective pricing case, fraught with errors and highly subjective perspectives, and absent of factual support, should give pause to the government in taking future defective pricing assertions to trial. At the very least, contracting officers who do nothing more than rubber stamp a DCAA defective audit opinion without carefully evaluating the merits of the RPA calculations and the supporting facts behind a defective pricing assertion should determine if they want to risk having their professional reputations ripped to pieces.

This particular defective pricing issue dates back to 2002 when DCAA was somewhat routinely performing defective pricing

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audits; in contrast, DCAA defective pricing audits are not currently high audit priority, with the exception of DCMA identified pricing actions that are deemed high risk (i.e. requested audits). The beating that DCAA and the government received in this court case should be one more reason why DCAA keeps defective pricing audits as a low priority. It should not go unnoticed that DCAA reported a RPA of $14.6 million, both DCAA and its customer incurred countless hours and costs in attempting to support flawed and illogical assertions and ultimately sustained nothing other than public embarrassment.

A Silver Lining to DCAA's Backlog in Performing Incurred Cost Audits

By: Guest Author: Jerry Gabig, Attorney, Wilmer & Lee

Almost four years ago, DCAA shifted resources away from audits necessary to close out contracts (incurred cost audits) in order to focus on other DCAA priorities. Notwithstanding a backlog of approximately $560 billion in contracts needing audits for incurred costs, in 2011, DCAA only issued 349 incurred cost audit reports with audited dollars in the amount of $19 billion.

From the contractor's perspective, the military adage of "hurry up and wait" best describes the situation concerning certified final indirect cost rate proposals. FAR § 42.705-1(b) requires contractors to submit certified final indirect cost rate proposals within six months of the expiration of each fiscal year. These hurried final indirect cost rate proposals then languish for years without any meaningful DCAA action.

The DCAA's extensive backlog is having an unexpected consequence which is benefiting contractors. As a matter of background, when it finally performs an audit, DCAA auditors zealously search for expressly unallowable costs in certified final indirect cost rate proposals. The benefit to the government by DCAA finding expressly unallowable costs includes both sparing the government from paying for the unallowable costs as well as a penalty of up to "two times the amount" being assessed against the contractor. See FAR § 42.709-1.

The unexpected good news for contractors is that the DCAA's prolonged delays in conducting incurred costs audits are allowing contractors to successfully assert the six year Statute of Limitations (FAR § 33.206) . The recent decision of the Armed Services Board of Contract Appeals in Raytheon Co., ASBCA Nos. 57576, 57679 (Dec. 17, 2012) makes clear that the six years is measured beginning with when the contractor provides the final indirect cost rate proposal to the government and ends on the date that the contracting officer issues a final decision.

In the Raytheon decision, the DCAA audit asserted that Raytheon's "failure to withdraw from its incurred cost submissions a proportionate share of its costs of bonuses, restricted stock and other incentive compensation costs paid to employees engaged in expressly unallowable activities was a violation of FAR 31.201-6(a)." The Contracting Officer's final decision of January 10, 2010 sought a penalty of $5,946,762.

The ASBCA held that Raytheon's CY 2003 proposal that was submitted to the government in June 2004 was beyond the six year Statute of Limitations. Hence, the government could not recover the penalty for the CY 2003 final indirect cost rate proposal. However, for the CY 2004 proposal, the ASBCA held "[a]s for the government's claim for penalties for CY 2004, Raytheon's final indirect cost rate proposal for CY 2004 was submitted to the government on 2 June 2005, within 6 years of the date of the government's claim letter of 10 January 2011." Accordingly, the government was able to recover the penalty for Raytheon's CY 2004 final indirect cost rate proposal.

In summary, DCAA's zeal to assert penalties for expressly unallowable indirect costs is being thwarted by DCAA's decision to place a low priority on assisting contracting officers in closing out performed contracts. If DCAA has procrastinated too long, savvy contractors can assert the six year Statute of Limitations to escape having to pay the penalty for expressly unallowable costs found by DCAA in certified indirect cost rate proposals.

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Instructors

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- Darryl Walker
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- Courtney Edmonson
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