False Claims Act—Be Wary of Red Flags When Quantifying a Claim

Sam Hadley
CPA/CFF, CFE, CGFM, CCA, CCP
Audit Partner
Cotton & Company LLP
Alexandria, Virginia

Presented at the 2019 Mid-Winter Program
January 30-February 1, 2019
Millennium Biltmore Hotel, Los Angeles, CA

©2019 American Bar Association
**Sam Hadley** is an Audit Partner at Cotton & Company LLP, a certified public accounting partnership located in Alexandria, Virginia. Ms. Hadley is a Certified Public Accountant (CPA), Certified in Financial Forensics (CFF), Certified Fraud Examiner (CFE), Certified Government Financial Manager (CGFM), Certified Construction Auditor (CCA), and Construction Control Professional (CCP). Ms. Hadley has testified as an expert witness in various courts and tribunals. Her testimony includes opinions on damages from alleged owner and contractor delay, amounts owed for termination and equitable adjustment claims, and opinions regarding procurement and construction controls. In particular, Ms. Hadley has testified in False Claims Act cases, including supporting allegations of potential fraud, assisting in fraud counterclaims, and calculating qui tam damages.

Ms. Hadley was assisted by **Katherine Anderson**, CFE, a Supervisory Senior Auditor at Cotton & Company.
Table of Contents

I. Overview ................................................................................................................................................ 1

II. Red Flags to Consider When Quantifying a Claim
    A. Guesstimates vs Estimates .............................................................................................................. 5
    B. The Joint Venture Shell Game ........................................................................................................ 6
    C. Hiding Your ‘Unallowables’ ........................................................................................................... 8
    D. Undefined Terms ............................................................................................................................ 10
    E. Projected or Future Costs .............................................................................................................. 11
    F. Claiming Unaffected Fixed Costs ................................................................................................. 13
    G. Indirect Costs that Don’t Pass the “But-For” Test ..................................................................... 13
    H. Use of Standard or Commercial Rates ....................................................................................... 14

III. Conclusion .......................................................................................................................................... 15
I. Overview

Claims are an important yet challenging component of the government contracting environment. A false or improperly prepared claim carries the threat of civil and criminal penalties. Given the current inviting landscape of federal and state false claims acts litigation, it is paramount that the contractor properly understand its obligations, as well as when and how to discharge its liabilities for federally funded projects. States have enacted versions of false claims act legislation that mirror the federal False Claims Act (FCA)\(^1\) and rely on federal precedent as guidance in interpreting the state statutes. Similar to the federal FCA, various state FCA legislation carries hefty penalties for contractors that are found guilty of submitting a false claim. Identifying false claims can be difficult, and it is often even more difficult to articulate the cause(s) and the effects/impacts to the government for those claims. This paper explores red flags identified from a Certified Public Accountant and Certified Fraud Examiner (“CPA/CPE”) experiences with the FCA. CPAs and CFEs cannot express an opinion regarding fraud. They can, however, identify fraud indicators and assess the impact of those actions to the ultimate claimed or recovered amount. The red flags discussed below may not have been ultimately identified as fraudulent claims, but they were considered fraud indicators in past FCA cases. Some notable and recent cases are used to highlight the red flags discussed here:

- *Daewoo Engineering and Construction Co., Ltd. v. United States*, 557 F.3d. 1332 (Fed. Cir. 2009). The CPA/CFE evaluated delay and inefficiency claims related to construction of a 53-mile asphalt roadway in the Republic of Palau, with an estimated cost exceeding $100 million. Daewoo Engineering and Construction Co., Ltd. (“Daewoo”) presented a $64 million claim, including a measured-mile methodology and projected damages for future work. The CPA/CFE prepared two expert reports and provided deposition and
trial testimony during a 13-week trial before the U.S. Court of Federal Claims. The CPA/CFE identified significant unallowable costs related to inconsistent and incorrect use of equipment rates, the inclusion of scrapped equipment in disruption claim calculations, the inclusion of duplicate equipment in both disruption and inefficiency claim calculations, errors and logical flaws in the measured-mile methodology, and use of markup rates that resulted in duplicate recovery of direct and indirect project costs. Based on the significant fraud indicators identified in the CPA/CFE’s reports, the U.S. Department of Justice ("DOJ") filed fraud counterclaims against Daewoo. The Court of Federal Claims denied Daewoo’s claim and ordered it to pay $51 million in damages and penalties related to the federal Contract Disputes Act (CDA)\(^2\), the FCA, and the Forfeiture of Fraudulent Claims Act (FFCA). Subsequent to the U.S. Supreme Court’s denial of Daewoo’s request for a review of its appeal petition, Daewoo paid the U.S. Government $51 million. Currently, Daewoo and individual employees and representatives remain on the U.S. Government Excluded Parties List System.

- **Morse Diesel International, Inc. v. United States**, 79 Fed. Cl. 116 (2007). The federal General Services Administration awarded Morse Diesel International, Inc., d/b/a AMEC Construction Management, Inc. (“Morse Diesel”) federal construction contracts related to the Thomas F. Eagleton Federal Courthouse in St. Louis, Missouri; the U.S. Customs House in San Francisco, California; and the Federal Courthouse in Sacramento, California. Morse Diesel issued a claim for more than $460,000 related to the St. Louis contract. The CPA/CFE assisted DOJ in evaluating the claim, including providing discovery assistance and deposition testimony. The U.S. Government asserted nine counterclaims against Morse Diesel under the Anti-Kickback Act of 1986 (“AKA”)\(^3\), the
FCA, the CDA, and the FFCA, as well as common law claims for false bond reimbursements. The Court granted summary judgment and held Morse Diesel liable for violations of the AKA and the FCA, awarding the U.S. Government approximately $7.3 million. The CPA/CFE subsequently provided assistance and deposition testimony in the U.S. Government’s efforts to recover its re-procurement costs.

- **United States ex rel. Harold Salomon v. Derish M. Wolff & Salvatore J. Pepe**, Crim. No. 11-719 AET (D. NJ. 2013). The U.S. Agency for International Development (“USAID”) contracted with the Louis Berger Group (“LBG”) to support numerous reconstruction efforts, including efforts in Afghanistan and Iraq. Mr. Derish Wolff, former Chief Executive Officer of LBG, closely managed LBG’s accounting and billing practices, including overseeing LBG’s development and negotiation of its indirect cost rates applicable to reimbursable federal projects. Subsequent to resolving false claims issues with LBG, DOJ filed criminal charges against Mr. Wolff for the alleged artificial inflation of LBG’s indirect cost rates applicable to these projects. DOJ retained the CPA/CFE to provide analysis and expert opinions regarding the nature, timing, and extent of accounting adjustments and methodologies that significantly impacted the resulting indirect rates applied to those projects. The defendant ultimately plead guilty, and was sentenced to a year of home confinement and fined $4.5 million.

- **Non-Profit International Relief Organization.** The USAID Office of Inspector General initiated an investigation based on allegations made by a qui tam relator, who asserted that a non-profit relief organization was inappropriately applying its negotiated indirect cost rate to one of its federal programs, resulting in an overbilling to the agency. The CPA/CFE is currently performing an audit of the contractor’s negotiated indirect cost
rate and additional reviews of the application of the entity’s rates to federal programs to assess any potential impacts to the government.

- **State Highway Contractor.** A state Department of Transportation alleged that a contractor made false claims in change orders and requests for equitable adjustments (REAs) submitted for project overruns and delays. The CPA/CFE evaluated the contractor claims and identified significant duplication of those claimed costs to amounts recovered through previous change orders and costs for activities under the original contracted scope of work. The CPA/CFE ultimately performed a complete project review to identify the duplicate recoveries between all change orders, REAs and the original contract award.

- **State Highway Contractor.** A state Department of Transportation is currently exploring potential false claims related to a contractor’s compliance with Occupational Safety and Health Administration and other safety regulations. The CPA/CFE reviewed records that the contractor submitted to the state Department of Transportation and federal agencies regarding its safety performance and identified discrepancies between those required compliance reports and the contractor’s internal records.
II. Red Flags to Consider When Quantifying a Claim

Below are some common red flags that contractors should avoid when preparing claims. Incorrect treatment of these costs and issues may result in undesirable outcomes for the contractor.

A. Guesstimates vs Estimates

We have seen that significant adjustments to contractors’ claimed costs in an effort to revise an original rough estimate to a more refined estimate may result in the inclusion of additional claim elements which have not been provided to the contracting officer. The Daewoo decision provides insight to the court’s dissatisfaction with re-pricing claims directly before and during trial.

There is nothing wrong with using estimates in a claim; even a contractor that is using proper accounting treatments to identify and segregate damages, change work, or other expenditures incurred outside the original scope of work often needs to rely on estimates when accumulating actual damages. However, the contractor must calculate these estimates properly using supported concepts and skilled personnel, and the estimates must be verifiable by outside parties such as a contracting officer, auditor, or potentially an arbitrator or judge. Most properly prepared and well-supported estimates are based on historical information using exact amounts; nothing says “Auditor—LOOK HERE” like a claim element in rounded millions, a delay expressed in months, hourly labor rates with no pennies, or even re-work hours expressed in thousands. Even if the rounded figure represents a good estimate, the use of rounding serves as a red flag that invites additional scrutiny from auditors to ensure that the contractor used sufficiently precise data in preparing the estimate.
In the years following enactment of the CDA, contractors received additional guidelines regarding the certification of claims, including the need to establish a sum certain. The lack of a sum certain also represents a red flag for auditors. Unfortunately, too many contractors focus on demonstrating their entitlement to the cost elements and do not fully support the specific dollar amounts claimed (i.e., the quantum aspect of their claim). This can be a costly mistake, as failure to support the quantum aspect of a claim will have the same result as a failure to prove merit. It is also important to recognize that the government does not have to prove intent to invoke its options under the FCA.\(^4\) As a result, an expert report that provides even a few examples or anecdotes of unsupported cost elements can have devastating results for the claimant.

\textit{B. The Joint Venture Shell Game}

Forming a joint venture for a particular construction project may have many legal and performance benefits; however, joint ventures also increase the complexity of claims in many ways. In particular, joint ventures must be able to support their claims using actual cost data; the claim may not simply consist of amounts that the individual joint venture partners allocated or charged to the joint venture. The U.S. Federal Acquisition Regulation (FAR) § 31.201-3 (2013) defines “cost reasonableness” as a cost that a prudent business person would incur in an arm’s-length transaction. Payments among related parties, such as a joint venture and one of its partners, therefore may not be considered reasonable under the FAR without further scrutiny. Specific examples include:

- **Management Labor.** Joint venture agreements typically identify employees that each joint venture partner will dedicate to the project. These employees continue to be employed by the joint venture partner, and the joint venture pays the partner an hourly or
monthly rate for the employee’s labor, as stipulated in the joint venture agreement. This arrangement is often advantageous for both the joint venture and the joint venture partner with respect to insurance and other employee benefits. The joint venture reports all employee labor rates paid as project costs; however, contractors must review these labor rates to determine whether they include recovery of indirect costs or profit for the joint venture partner. If so, the contractor will need to deduct these amounts from the rates when preparing a claim.

- **Equipment.** Joint ventures often use equipment that one partner owns and either loans or rents to the joint venture. The joint venture records rental payments as equipment costs; however, as with management labor, the contractor must review the equipment rental rates to ensure that the amounts represent the actual costs of the joint venture partner and do not include any recovery of indirect costs or profit before including those amounts in a claim.

- **Management Fees.** Joint venture agreements often include management fees paid to the individual joint venture partners; however, the agreements do not always define what this fee represents. In many cases, the fee is a fixed amount to cover management labor, equipment, administrative support, or the recovery of a capital investment or initial cash flow. As with the other costs discussed, contractors must review management fees to ensure that these amounts represent actual costs for value received by the joint venture. Further, contractors must carefully assess the value received to ensure that they use an appropriate method to recover those amounts in a claim.

- **Indirect Costs.** A Negotiated Indirect Cost Rate Agreement (“NICRA”) can be a valuable asset when recovering indirect costs in claims involving funding from federal or
state governments. However, claim preparers may not apply the NICRA for one joint venture partner to project costs claimed by the joint venture. An indirect cost rate is specific to the entity for which it was developed and is based on the entity’s actual indirect and direct costs. The NICRA for a joint venture partner would not have included any joint venture project costs as part of its calculation and therefore cannot be applied to those costs. The contractor must also be mindful of the specific indirect costs it is attempting to recover. If the joint venture partner already charged those indirect costs to the joint venture using the management fee, applying an indirect cost rate would result in a duplicate recovery.

- **Distributions.** The contractor must assess any payment from the joint venture to an individual partner to ensure that the payment does not represent a distribution of profits or a repayment of cash flow. Such distributions may not be included as a cost in a total cost claim, in a daily overhead rate or in any other indirect cost rate.

When reviewing joint venture claims, contractors often must obtain tax returns and financial statements to identify the true costs to the individual partners.

**C. Hiding Your ‘Unallowables’**

Although contractors typically perform construction projects (or major portions of construction projects) under fixed-price contracts, FAR cost principles still apply and proper accounting for those costs become increasingly important when preparing claims. It is important to remember that incurring costs that are unallowable per the FAR is a typical part of doing business; auditors are aware of the need to incur these costs, and seeing these costs in accounting reports is not a cause for concern. Contractors should simply identify any unallowable costs,
allocate (i.e., charge) these costs to the project in their accounting system, and exclude these costs from any claim elements.

Construction contractors working under fixed-price contracts are not required to report on their actual expenditures to support routine project billings or revenues. Auditors understand that contractors have limited need for project accounting that identifies and segregates allowable and unallowable project costs. However, contractors may not include unallowable costs in a construction claim or change order. Contractors must therefore be familiar enough with their unallowable costs to identify and exclude these costs when accumulating project costs for a claim element. Contractors are particularly likely to overlook unallowable costs when calculating and claiming delay costs. Contractors typically compute the daily overhead rate by accumulating indirect project costs during a portion of the project to determine a daily rate that they may apply to asserted days of owner-caused delays. As contractors rarely calculate daily rates in the normal course of business, they often do not have a process in place to review the project costs to ensure that they have excluded all unallowable costs from the calculation. To avoid additional auditor scrutiny, a contractor can show its total costs, then show the deduction for unallowable costs, resulting in a net cost amount. The contractor can then use this net cost amount to calculate its daily rate.

Contractors should also keep in mind that auditors will attempt to identify any unallowable costs. Unallowable costs not only include those costs that the FAR identifies as unallowable; they also include costs that violate the contractor’s reimbursement policy, such as certain travel, entertainment, and phone/truck usage policies. Other costs, such as performance bonuses and termination payments, must be in accordance with the contractor’s established, written policies to be considered allowable. Lastly, the FAR requires that contractors include all
credits, income, and rebates as a deduction to like project costs.\textsuperscript{5} This would include any
equipment salvage values, credits for returned rentals, and even internal credits applied to
projects for return of contractor-owned equipment, or changes in applied indirect cost rates. As
with unallowable costs, auditors expect to see credits in the accounting system, and claims must
include these credits as a deduction against claimed costs.

\textit{D. Undefined Terms}

When preparing a claim, contractors must clearly state the costs they are claiming. Additionally, the contractor is certifying that it has not previously recovered these costs through change orders or through values in the original contract. This can prove difficult when quantifying indirect costs that are attributable or allocable to the direct costs associated with the claim. Contractors should define terms such as markup, overhead, and indirect costs, as these terms are often defined differently by different organizations even within the same industries, and even within the same project and contract.

\textit{i. Markup}

What is markup? Is it profit? Is it how the contractor recovers its home office overhead or general and administrative ("G&A") costs? Many organizations define the term differently—and by extension, so do many construction contracts. Contracts often establish maximum markup rates or require that contractors exclude certain costs from the applied rates; it is not uncommon for a contractor to be participating in multiple contracts that all have different markup requirements. Because contractors use markup rates when recovering indirect project costs, it is important to specify which costs the contractor is and is not recovering to ensure that claims do not include duplicative costs or costs that were not impacted by the nature of the claim.
ii. **Indirect Costs**

The FAR defines indirect costs as those costs applicable to more than one final cost objective. Contractors outside of the construction industry typically consider a contract to be the final cost objective; however, construction contractors often consider contract line item numbers or other distinct sub-elements of a project to be final cost objectives, rather than the project itself. When considering sub-elements of a project to be final cost objectives, costs such as field office overhead, daily overhead, or general conditions are treated as indirect costs that the contractor then allocates to direct project activities. In most construction projects, costs such as permits, security, fencing, administrative trailers, water, trash fees, supplies, and even small tools and consumables are considered to be indirect costs, especially for estimating and budgeting purposes. However, contractors must evaluate these costs separately from the company’s home office overhead, G&A, facilities and administrative (“F&A”), or other indirect costs that are applicable to this and other projects. Contractors should be clear when applying indirect cost rates to define what indirect costs it is recovering and to explain why the application of those rates does not duplicate other indirect cost recovery.

E. **Projected or Future Costs**

The opinion in the Daewoo case includes interesting conversation regarding the contractor’s ill-advised claim of future project costs. The contractor’s representative admitted that the claim for future project costs was meant as a warning to the government, in hopes of settling its claims for lesser, reasonable amounts. While typically REAs include only costs that have already been incurred, it is possible that claims or settlement proposals may include projected or future costs. As there is no documentation to support the reasonableness of the claimed amounts, extra care should be used when determining a reasonable projected cost.
Additionally, the contractor should maintain internal documentation to support why the projection was reasonable at the time of certification, in case those projected amounts never result in actual costs incurred.

F. Claiming Unaffected Fixed Costs

Ensuring claims do not include fixed direct project costs is relatively straightforward. However, claim preparers should carefully review the costs included in claimed daily overhead rates or other indirect rates to ensure that the rate does not include any fixed project costs. The daily overhead rate (and any other portion of the claim) may not include fixed costs that were part of the initial project bid or estimate, such as many costs recovered as “mobilization and demobilization,” certain computer and computer software purchases, and other costs that the contractor budgeted as a fixed cost (or an expense for an asset that had no future useful life) in the original bid. Contractors should also be careful not to automatically include fixed cost overruns in a claim for project delays or other owner-caused issues; instead, they should identify why fixed costs may have increased from the amount budgeted. Claims should not include increases due to pricing or rate changes (unless the pricing or rate change itself stems from an owner-caused issue).

For international construction projects, the contractor must consider many additional fixed costs. For equipment, the original intent behind the purchase of the item is important. If the contractor prepared the bid under the assumption that it would dispose of or scrap all of the equipment (or even machinery) at the end of the project because it was too expensive to move the items to the next job site, then useful life becomes irrelevant. This issue would dramatically reduce or even eliminate the contractor’s claim for standby equipment costs during a work stoppage, or for equipment usage during extended project durations. Even direct craft labor costs
might have been a fixed cost for certain project durations. For example, if the contractor used annual employment agreements to attract third-country nationals, there may be no increased costs due to project delays if the delay did not extend project performance beyond the end of the annual employment agreement. Conversely, smaller project delays may cause substantially higher-than-expected increased labor costs if the contractor was forced to extend employment agreements by a full year for smaller delays, or incur additional recruitment costs if employees chose not to stay on for the extended period. Claims must consider the employment laws for the country where the project is, and potentially the surrounding countries that supply labor, materials, fuel and other project needs.

G. Indirect Costs that Don’t Pass the “But-For” Test

When preparing a claim related to owner-caused project delays, a contractor would typically be entitled to recover additional project costs that it incurred due to the extended project duration. Contractors commonly recover these costs using a daily overhead rate. A daily overhead rate is a logical methodology for recovering costs such as extended equipment rentals, certain management labor, and other time-driven costs; however, when calculating the daily overhead rate, it is important to include only those costs that were impacted by the extended project duration. Other project costs that did not increase solely due to the change in project duration, such as tipping fees, small tools, safety awards, bonuses, and other costs that were included in project overhead pools, should not be included in the daily overhead rate.

Unfortunately, many contractors simply accumulate all project overhead costs incurred during a certain portion of the project (or the entire project) and use these costs to determine an effective daily overhead rate that they then apply to alleged owner-caused project delays. This method may be simple to calculate; however, it does not maintain the required cause-and-effect
relationship between the costs that the contractor incurred and the reason for which the contractor incurred those costs. Similarly, when claiming project costs that increased solely due to project size, such as additional accounting staff, additional fencing and security for a larger project area, contractors should accumulate these costs and allocate them to the claim using an appropriate allocation base, such as direct labor hours, direct project costs, or contract value. Using this "but-for" logic is an important tool when determining the cause of increased indirect project costs and identifying a method to calculate the impact of those costs to each of the various causes.

\[ H. \quad \text{Use of Standard or Commercial Rates} \]

Construction projects rely heavily on internal and published rates when estimating costs. However, boards of contract appeals and federal courts have established that actual cost data is preferable to unsupported rates and third-party published equipment rate schedules as sources for estimates. Even the Army Corps of Engineers’ Construction Equipment Ownership and Operating Rate Schedule recognizes that organizations should not use rates developed based on this schedule when certified cost and pricing data is required, or if actual cost data is available. As such, the manual incorporates a process for using any known actual cost data to adjust the published rates. Further, using published rates for certain items when developing a contract or contract change order does not automatically allow the contractor to use those same rates when preparing equitable adjustments and many contract changes. If contractors have actual rates and costs and choose not to use them in claim calculations, the contractors must be prepared to explain why those actual rates would not result in an equitable recovery.
Similarly, contractors should not depart from the use of generally accepted accounting principles ("GAAP") when developing equipment and labor rates and other costs for claims, change order pricing, or even in the development of an original contractor bid. Contractors must properly apply depreciation and amortization methods and other GAAP concepts. In addition, a contractor must follow its stated practices when preparing a claim. Contractors are not allowed to use accelerated depreciation methods, even though these methods may be acceptable for tax returns and other purposes. Further, contractors may not expense an item as a claim cost if they would typically capitalize and depreciate the item, essentially allocating the item to several projects or accounting periods, unless the contractor can reasonably claim that it purchased the item solely for the claimed project and that the item will not benefit other projects in the future.

III. Conclusion

The claims process is a vital element of equitable treatment under a contract; however, it is fraught with potential for undesirable outcomes. As a result, participants must have a heightened awareness of potentially problematic areas. The areas highlighted in this article are not intended to be an exhaustive list; however, they serve as an introduction to common red flags to assist contractors and owners in responsibly preparing, submitting, and evaluating claims.

4 The contractor is deemed to have known that a claim it submitted was false if it had actual knowledge of the falsity of the claim or if it acted in deliberate ignorance or reckless disregard of the truth or falsity of the claim. 31 U.S.C. § 3729 (2000).
5 FAR § 31.205 states, “The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund.”
6 FAR § 31.203, Indirect costs.

7 Daewoo, Order No. 02-1914C; Filed October 13, 2006; page 35.