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FEATURE COMMENT: Recent Legislation On Award And Incentive Fees—Why Congress Thinks That 'Satisfactory' Performance Is Unacceptable And DOD Is Caught In The Middle

As the 109th Congress recessed on September 30 to campaign for the midterm elections, a flurry of last-minute legislation emerged from chambers. Among the legislation were two key Department of Defense acts: (1) the 2007 Department of Defense Appropriations Act (P.L. 109-289) (2007 Appropriations Act) and (2) the John Warner National Defense Authorization Act for Fiscal Year 2007 (P.L. 109-364) (2007 Authorization Act). Responding to criticism in the press and on Capitol Hill, both acts contained special legislation targeted at limiting award-fee overpayments to contractors performing substandard work. While the legislative goal—namely, limiting Government waste—is laudable, some of the new provisions may have unintended consequences. Congress should be aware that if it chooses to implement policies that undercut the direct and ancillary benefits that award and incentive fees offer to defense contractors, then it must be prepared for the consequences.

Historically, a defense contractor could count on getting what it bargained for, especially with regard to award or incentive fees on cost-plus-fee contracts. So long as the contractor meets certain minimum requirements—which are clearly spelled out in the contract and in the negotiated award fee agreement—then it will earn a certain amount of money from an available fee pool. But the new legislation threatens to undermine this tranquil status quo by forcing DOD to act in a way that is inconsistent with the national interest. Despite DOD resistance on the need to respect its contractors, honor its requirements and support the U.S. defense industrial base, the 109th Congress has sent a message loud and clear: Uncle Sam will no longer pay award fees for merely *satisfactory* performance. Rather, award fees will be reserved for circumstances in which the contractor truly deserves it and when the contract requirements are clearly exceeded. While this type of merit-based capitalism seems reasonable at first blush, it actually is two-faced: potentially allowing the Government to *underperform* on its contractual promises while requiring a defense contractor to *overperform* to earn an award fee.

When it comes to award fees, the 2007 legislation does much to appease the cries of the mob raging about "contractor waste." But only time will tell whether the legislation also has unintended consequences undermining basic principles of fairness, equity and accountability in DOD contracting practices.

Defense Contractors Are Entitled to Earn a Reasonable Profit—Defense contractors, like any person or company providing a valuable service, deserve to earn a profit. This has long been recognized in industry and Government alike, but many still bristle at the idea of "greedy defense contractors" bilking the American taxpayer for millions. One need look no further than Halliburton and the beating it has taken in the press for proof that many find the idea of defense contractors earning a reasonable profit distasteful. But profit is not "gravy" waiting to be sopped up by a "fat cat" contractor. Profit under a defense contract is a contractor's reasonable return on the investment of its assets in performing the contract—whether those assets are tools, equipment, or valuable engineers, scientists or other personnel.

Moreover, contractor profit addresses basic business concerns that are hardly distasteful or offensive. For example, risk is associated with performing a contract, and intuitively, if the contractor bears a larger portion of that risk, it should be entitled to a larger profit. Whether inflation risk, risk of nonperformance or security risk, a contractor

must be entitled to earn a reasonable profit to cover this risk and to offset costs associated with managing this risk. Further, there are unallowable costs, including many routine business operation costs that the Government simply will not pay. The Federal Acquisition Regulation limits the allowability of certain costs, including research and development, employee compensation, legal costs, entertainment expenses, alcohol, and insurance costs. While a contractor may incur some of these costs in the normal course of business (and be reimbursed a portion of these costs consistent with the regulations), many of these costs often are covered at the company's own expense.

The bottom line is that businesses (including defense contractors) need to make a profit. For many publicly traded companies—such as Lockheed Martin, Boeing or Northrop Grumman—shareholders require a reasonable return on investment to justify the company's business dealings with DOD. Given the choice between investing in a commercial venture that will yield a 10-percent profit, or a defense contract that will yield a 3-percent profit (if *any*), which option would the company choose? Which one *should* it choose? The recent criticism in the press and on Capitol Hill reminds defense contractors that Uncle Sam is a fickle customer.

Recent Events—The public outcry about waste and abuse in the federal procurement system is nothing new—it dates back to the time when bureaucracies, government and money first collided. Recently, DOD and industry have come under fire from numerous sources, all criticizing the use of award or incentive fees for merely "satisfactory" or substandard performance.

December 2005 GAO Report: In December 2005, the Government Accountability Office issued a report to the Senate Armed Services Committee observing that DOD practices of allowing contractors to re-earn award fees, along with paying for "acceptable, average, expected, good, or satisfactory" performance "undermine the effectiveness of fees as a motivational tool and marginalize their use in holding contractors accountable for acquisition outcomes. They also serve to waste taxpayer funds." See 47 GC ¶ 525. GAO's report is available at *www.gao.gov/new.items/d0666.pdf*.

GAO recommended that DOD "improve its use of fees by specifically tying them to acquisition outcomes in all new award- and incentive-fee contracts, maximizing contractors' motivation to perform, and collecting data to evaluate the effectiveness of the fees." GAO was particularly critical of DOD for paying award or incentive fees even though total program costs or schedules slipped past the baseline. "Rather than focusing on acquisition outcomes, such as delivering a fielded capability within established cost and schedule baseline, DOD often places emphasis on such things as responsiveness of contractor management to feedback from DOD officials, quality of contractor proposals, or timeliness of contract data requirements."

DOD largely agreed with GAO's recommendations, but also took the position that it is both fair and reasonable to pay a portion of the award fee for "satisfactory" performance. On March 29, Deputy Undersecretary of Defense (Acquisition and Technology) James Finley issued a memorandum encouraging DOD to structure its new award-fee contracts "in ways that will focus the government's and contractor's efforts on meeting or exceeding cost, schedule and performance requirements," while linking a contractor's ability to earn an award fee with "achieving desired program outcomes." The memo is available at *www.acq.osd.mil/dpap/policy/policyvault/2006-0334-DPAP.pdf*.

Implementing the GAO recommendations, Finley stated that "award fees must be commensurate with contractor performance over a range from satisfactory to excellent performance. Clearly, satisfactory performance should earn considerably less than excellent performance, otherwise the motivation to achieve excellence is negated." While recognizing that "some" fee may be appropriate for merely satisfactory work, he stated that unsatisfactory performance is not entitled to any award fee. He also emphasized that "roll over" of award fees "should be the exception rather than the rule." Even in the exceptional circumstances in which an award fee is "rolled over," the contractor should only be able to earn a fraction of the rolled over fee.

Testimony before the SASC: Following the Finley memo and the GAO report, Undersecretary of Defense (Acquisition, Technology & Logistics) Kenneth J. Krieg testified April 5 before the SASC. See 48 GC ¶ 131. He stated that DOD "largely concurred with the GAO recommendations" and that the department was conducting a review to implement them.

Explaining some of the tensions in the procurement industry, Krieg explained that there are two basic issues relating to fee and contractor profit that

must be considered to place the debate on incentive fees in the proper context. First, to give DOD access to the best resources and technologies, the department must ensure that its contractors make a "reasonable return on DOD contracts." Second, award fees often are used on contracts in which numerous variables affect contract performance, and award fees help mitigate some of those variables. Still, he stated that the March 29 memo addressed some core issues and that DOD was moving forward while also reducing the tension on award fee payments for "satisfactory" work. Nonetheless, he warned against tying award fees to undefined terms: If the Government does not define "satisfactory," then tying the fee to a word "is not a good idea." Krieg's written testimony is available at *armed-services.senate.gov/statemnt/2006/April/Krieg%2004-05-06.pdf*.

Krieg's testimony was followed by testimony from U.S. Comptroller General David Walker, who stated that continuing to award *some* fee for satisfactory performance simply was "indicative of DOD's resistance to change." Critical of DOD's unwillingness to raise the proverbial bar, Walker re-emphasized the conclusions in the December 2005 GAO report and recommended immediate and effective implementation. Walker's testimony is available at *www.gao.gov/new.items/d06409t.pdf*.

Despite GAO criticism of DOD policy—and at the risk of stating the obvious—if the contract allows for an award fee for "acceptable, average, expected, good, or satisfactory" performance, then the contractor is *entitled* to such payments (provided its performance matches the label defined in the contract). If the negotiated award fee plan in *future* contracts excludes "acceptable, average, expected, good, or satisfactory" performance, then the Government would be justified in withholding award fees for "merely satisfactory" performance. However, as Krieg noted, award fees serve two purposes beyond merely recognizing exemplary performance: first, to provide the contractor with a reasonable profit and, second, to help share the risk on contract performance. If Congress chooses to implement a policy preventing contractors from achieving a return on their investment and undercutting the two ancillary benefits of award fees, then Congress must be prepared for the consequences.

The 2007 Legislation—Congress has acted, acknowledging—although largely ignoring—the counsel of Krieg. Both the 2007 Appropriations Act and the 2007 Authorization Act contain provisions prohibiting award-fee payments for unacceptable contract performance. While the legislation leaves open the issue of whether an award fee is appropriate for satisfactory performance, the rhetoric and finger-pointing on this issue no doubt will continue to create confusion within DOD as to "how good is good enough" to earn a contractually guaranteed award fee.

The new acts both contain language designed to limit the payment of award fees to undeserving defense contractors. Section 9016 of the 2007 Appropriations Act provides:

> PROHIBITION ON PAYMENT OF AWARD FEES TO DEFENSE CONTRACTORS IN CASES OF CONTRACT NON-PERFORMANCE. None of the funds appropriated or otherwise made available by this Act may be obligated or expended to provide award fees to any defense contractor for performance that does not meet the requirements of the contract.

Section 814 of the 2007 Authorization Act further requires DOD to issue guidance, including detailed implementation instructions, on the appropriate use of award and incentive fees in DOD acquisition programs. Section 814 requires that the new guidance shall:

(1) ensure that all new contracts using award fees link such fees to acquisition outcomes, which will be defined in terms of program cost, schedule and performance;
(2) establish standards for identifying the appropriate level of officials authorized to approve the use of award and incentive fees in new contracts;
(3) provide guidance on the circumstances in which contractor performance may be judged to be "excellent" or "superior" and the percentage of the available award fee which contractors should be paid for such performance;
(4) establish standards for determining the percentage of the available award fee, *if any*, which contractors should be paid for performance that is judged to be "acceptable," "average," "expected," "good," or "satisfactory;"
(5) ensure that no award fee is paid for contractor performance that is judged to be less than satisfactory or that does not meet the basic requirements of the contract;
(6) provide specific direction on the circumstances, *if any*, in which it may be appropriate to

roll over award fees that are not earned in one award-fee period to subsequent award-fee periods;

(7) ensure consistent use of guidelines and definitions relating to award and incentive fees across the military departments and defense agencies;

(8) ensure that DOD (a) collects relevant data on award and incentive fees paid to contractors and (b) has mechanisms in place to evaluate such data regularly;

(9) include performance measures to evaluate the effectiveness of award and incentive fees as a tool for improving contractor performance and achieving desired program outcomes;

(10) provide mechanisms for sharing proven incentive strategies for the acquisition of different types of products and services among contracting and program management officials; and

(11) identify a federally funded research and development center to review DOD award and incentive-fee mechanisms, and to evaluate independently all award and incentive fee performance evaluations.

There is nothing inherently objectionable about these requirements. In fact, most defense contractors probably would agree to them, provided the award-fee conditions are spelled out precisely in the contract and the risk is properly understood. But the problem comes in implementing these guidelines, and whether DOD contracting officers can objectively evaluate the difference between the benchmark identified in the contract, and the benchmark that Congress or GAO expected, *regardless* of contract requirements.

Conclusion—To paraphrase a question posed by Krieg: What does "satisfactory" mean, and how far above "satisfactory" must a contractor perform in order to earn fee? If satisfactory means satisfies expectations, then contractors must be careful to spell out *in the contract* what those expectations are, rather than rely on the arbitrary expectations of a CO. Notably, while the legislation allows payment of fees for satisfactory performance or roll over of unearned award fees, the 2007 Authorization Act also creates an opening for COs to deny awards for "merely average" work or to allow a contractor to re-earn previously lost award fees.

In Government contracting, "satisfactory" is not a bad word—especially if that term is intended to reflect the achievement of a basic contractual requirement. If the recent legislation is misused to force contractors to perform above and beyond the contractual requirements, the legislation enforces bad policy. Uncle Sam's integrity rests on treating its contractors fairly and in paying award fees for work that is "good enough" if that is what the Government originally promised in the contract. If Uncle Sam does not like the deal, he can always change it. But the recent 2007 legislation does not entitle the Government to more than it previously bargained for in its contracts. And for future contracts, the 2007 legislation should not entitle the Government to impose unreasonable burdens on a contractor, especially when such requirements exceed the levels spelled out in the contract.

Perhaps the real question is whether there is any future for award fees based on satisfactory performance. The political winds blowing from Capitol Hill and the saber-rattling from GAO indicate there is not. In the end, the rational voice of Undersecretary Krieg undoubtedly will be drowned out. The public and Congress may forget that a viable defense industrial base must make a profit, and they may ignore the fact that payment of award fees, even for satisfactory performance, advances a national interest. Instead, they may limit Uncle Sam to a small roster of defense contractors, all of whom are capable of delivering merely satisfactory results, and little else, with other companies turning to more profitable investment opportunities. Unfortunately for Congress, the law of unintended consequences is not amended so easily from year to year.

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This* FEATURE COMMENT *was written for* THE GOVERNMENT CONTRACTOR *by* David S. Gallacher*, an associate resident in the Washington, D.C. office of Sheppard Mullin Richter & Hampton LLP. His practice focuses on counseling and litigation related to Government contracts.

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