U.S. Department of Energy
Office of Inspector General
Office of Audit Services

Audit Report

The Department of Energy's Management of Contractor Fines, Penalties and Legal Costs

DOE/IG-0825 September 2009

Department of Energy
Washington, DC 20585

September 30, 2009

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Audit Report on "The Department of Energy's Management of Contractor Fines, Penalties and Legal Costs"

BACKGROUND

The Department of Energy reimburses its facility contractors for millions of dollars in settlement costs and for fees paid to outside law firms for legal research, litigation and consulting activities. Because of contract reform initiatives, the Department increased contractor financial responsibility for certain legal costs. For example, fines and penalties for violations of laws and regulations, which totaled almost $12 million over the five-year period of our review, were found to be unallowable and were not reimbursed by the Department. The Department specifically considers certain other costs to be unallowable, such as those for punitive damages or in cases where contractor management officials are found to have engaged in willful misconduct or have failed to exercise prudent business judgment. Legal costs may also be disallowed if they are not properly coordinated with Department officials.

A 1994 Office of Inspector General review, *Inspection of Administrative Management Procedures for Legal Services Acquired by Selected Management and Operating Contractors* (DOE/IG-0363), found weaknesses in the management of certain contractors' legal costs. The inspection concluded that sites did not have adequate written agreements with outside law firms and that one site was reimbursing costs that should not have been allowed. The Department has since strengthened its management of legal costs by adopting Legal Management Plans that outline Department requirements for hiring outside counsel and Engagement Letters that define and limit the types of costs that can be reimbursed when outside legal firms are used. The Department's contractors incur and are reimbursed for significant legal expenses each year. Thus, we initiated this audit to determine whether the Department's process for managing contractor fines, penalties and other legal costs was effective.

RESULTS OF AUDIT

Our audit testing revealed that the Department did not fully implement processes for managing the cost of legal services and settlements. We identified instances where payments were made for costs that, in certain cases, were potentially unallowable. Specifically, two of the four facility contractors we reviewed were permitted to claim almost $300,000 in legal costs directly associated with unallowable fines and penalties. We also identified other instances where facility contractors incurred questionable costs

paid to outside legal firms. For example, some contractors paid law firms for expenses that had not been reviewed and approved as required, including first class airfare, travel expenses where no receipts were provided, and other costs normally treated as unallowable.

The Department also allowed payment to contractors for a number of unauthorized settlements and for settlements that were made without a review of the facts and circumstances surrounding alleged contractor "managerial personnel" misconduct. The term "managerial personnel" generally describes a very limited group of specifically identified senior level contractor managers. The Department of Energy Acquisition Regulation and the Department's Legal Management Requirements at 10 CFR 719, permit the Department to review these cases for cost allowability. Such action was not taken in these cases. Several responsible officials, in discussing this issue, argued that, as an alternative, the government has the option of questioning costs based on the results of subsequent audits or reviews. We concluded, however, that controls designed to prevent or detect payments that may not be allowable on a real time basis are a more effective means of reducing or eliminating such payments.

We concluded that these activities occurred because of weaknesses in controls at certain contractor locations. In particular, Federal officials at some sites had not always considered applicable regulations that prohibit payment of certain costs that are directly associated with otherwise unallowable costs. Additionally, Department officials had not: (1) required facility contractors to enforce the terms and conditions of legal Engagement Letters; (2) fully considered the circumstances of legal actions before agreeing to settlements; and, (3) conducted reviews to identify instances of "defined" senior contractor management personnel misconduct or analyze recurring lawsuits and ensure corrective actions were being taken to prevent future lawsuits for systemic problems.

While this audit was initiated prior to enactment of the *American Recovery and Reinvestment Act of 2009,* it identifies yet another important risk factor that the Department should consider as it moves to satisfy its statutory responsibilities. With the large influx of funds at the contractor level, claims for similar settlements and outside legal costs are likely to increase substantially. Given the significance of these costs, and the potential for inappropriate reimbursement, we made a series of recommendations designed to improve the effectiveness of controls over fines, penalties and other legal costs.

MANAGEMENT REACTION

Management did not agree with the need to implement all corrective actions we proposed, but did agree that some actions were necessary and proposed alternative actions in each case. Management also did not completely concur with a number of the conclusions presented in the report. We believe, however, that management's suggested alternative actions are generally responsive to our recommendations. Management's comments and our responses to each of its concerns are summarized in the body of our report. The full text of those comments have been included as Appendix 3.

Attachment

cc: Deputy Secretary
Under Secretary for Nuclear Security
Under Secretary of Energy
Under Secretary for Science
Chief of Staff

REPORT ON THE DEPARTMENT OF ENERGY'S MANAGEMENT OF CONTRACTOR FINES, PENALTIES AND LEGAL COSTS

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Government Reimbursement of Questionable Costs

Our review identified a number of instances where the Department of Energy's (Department) reimbursements of its facility contractors were inappropriate. Specifically, we found that facility contractors were being reimbursed for legal costs that were potentially unallowable. Certain of these costs should not have been paid because they had a direct association with an unallowable cost while others were generally prohibited under existing legal agreements, absent specific authorization. In addition to these questionable outside legal costs, we found that the Department reimbursed contractors for settlements that were either not approved or had not been reviewed to determine whether allegations of contractor management misconduct has merit. Department regulations specify that contractors shall not be reimbursed if the cause of the action was due to contractor management personnel[1] willful misconduct or failure to exercise prudent business judgment.

Directly Associated Outside Legal Costs

The Department reimbursed facility contractors for costs that were questionable because of their direct association with other unallowable costs. The costs of fines and penalties are, with certain limited exceptions, unallowable according to the Federal Acquisition Regulation (FAR) Part 31.205-15. Over the period of our review, one contractor was assessed six environmental fines and/or penalties totaling over $780,000. Because fines and penalties are unallowable under the FAR and the terms and conditions of the contract, the contractor did not seek reimbursement for those costs. The contractor did, however, seek and obtain reimbursement of $120,000 for outside legal costs that were directly associated with two of the fines and penalties even though provisions in FAR 31.205-47(b) specifically prohibit such reimbursements. The FAR requires that "Costs[2] incurred in connection with any proceeding brought by a Federal, State, local or foreign government for violation of, or a failure to comply with, law or regulation by the contractor . . . are unallowable if the result is

[1] A contractor's managerial personnel is defined in Department of Energy Acquisition Regulation 970.5245-1 as directors, officers, and managers that have supervision or direction of substantially all the business or operations of the contractor, either on the whole or all the activities at a major facility or operation.

[2] According to FAR 31.205-47(a), "Costs" include, but are not limited to, administrative and clerical expenses; the costs of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist it; costs of employees, officers, and directors; and any similar costs incurred before, during, and after commencement of a judicial or administrative proceeding which bears a direct relationship to the proceeding.

. . . imposition of a monetary penalty." According to contractor attorneys, additional and unspecified costs for in-house support and processing were also reimbursed. Based on our review of the FAR requirement, we also consider these costs to be questionable.

Similarly, another contractor was reimbursed by the Department for over $170,000 for the same type of outside legal fees directly associated with some of the unallowable fines and penalties it incurred for environmental violations. By contrast, two other contractors in our review were implementing the "directly associated" requirements in compliance with the FAR and did not seek Departmental reimbursement for their costs associated with individual fines and penalties. We believe the practice of disallowing outside legal and contractor internal costs associated with fines and penalties as demonstrated by the latter two contractors is consistent with applicable FAR terms.

Outside Legal Costs

The Department also permitted certain facility contractors to incur costs for outside legal firms that should not have been paid based on the terms of the Engagement Letters between the contractors and outside legal firms. When facility contractors obtain outside legal services, they use Engagement Letters to define the types of costs that are allowed or specifically prohibited. Engagement Letters are required by 10 Code of Federal Regulations (CFR) Part 719.20 for retained legal counsel expected to provide $25,000 or more in legal services for a particular matter. We reviewed a number of litigation and consulting cases at four contractors, many containing invoices for several years of outside legal counsel support for an individual case. We selected a small judgmental sample of these invoices and noted numerous examples where certain facility contractors reimbursed consultants and outside law firms for specifically prohibited costs despite contrary provisions in their Engagement Letters.

For example, consultants and outside legal firms were required to follow the Federal Travel Regulation, which does not permit reimbursement for first class travel and includes maximum per diem amounts for hotels, meals, and incidentals unless these expenses have been justified and specifically approved. There are also additional cost limitations set forth in 10 CFR 719 that include, for example, limitations for the cost of photocopying

and reduced billing rates for time spent traveling. However, facility contractors paid outside law firms and consultants for many expenses that were not permitted in their Engagement Letters. Examples of these costs included:

- One contractor reimbursed three round trip first class air tickets for consultants totaling about $4,800;
- Another contractor paid almost $100 in excess of the per diem hotel allowance for one overnight trip taken by an outside attorney;
- One contractor reimbursed a consulting firm more than $6,800 in travel expenses with no receipts at all; and,
- A third contractor paid attorneys their full billing rates for time spent traveling. In one case alone, an attorney billed full rates for 14 separate driving trips. While we could not determine the exact amount of time spent traveling versus conducting case work, by our estimates these 14 trips included at least $950 in overcharges. The same contractor reimbursed another attorney more than $2,000 in similar overcharges for several trips.

While we were unable to select a statistical sample of invoices because of record keeping methods and complexities related to outside legal counsel invoicing, it is likely, based on the internal control problems we identified in invoices we randomly selected for review, that the same or similar errors are distributed throughout the population of reimbursed legal costs. All of the questioned costs we identified were reimbursed by the Department.

Settlement Costs

The Department also permitted two facility contractors to incur costs for cases that were settled without a determination of the appropriateness of the expenditures. Nine of these cases were settled absent a documented review by the Department to ensure that each settlement was appropriate. While another five were approved, Department officials authorized the payments without conducting a required post settlement review to ensure that the actions surrounding the settlement did not stem from misconduct on the part of the facility contractor.

The Department also did not object to the payment by one contractor for the costs of nine settlements that Department Counsel had not approved to be settled. The 10 CFR 719

requires the establishment of a Legal Management Plan that, among other things, can be used to establish dollar thresholds for settlements that should be reviewed by the Department. Although 10 CFR 719 established this requirement in 2001, the contractor and Department had not yet finalized the Legal Management Plan for the contractor in question at the time of our review. These nine settlements were internal personnel cases that totaled over $460,000, however, the settlements were not submitted to Department Counsel for review. The exclusion from review denied the Department the opportunity to consider the matters that gave rise to the settlements to determine whether the settlements were a prudent expenditure of public funds. One of these cases alone was settled for $180,000. Subsequent to our review, the contractor and the Department finalized a Legal Management Plan requiring that all settlements be reviewed and approved by the Department, regardless of dollar value.

In response to our preliminary draft report, officials at the location referred to above advised that those cases were severance allowances or other internal human resources matters. However, these cases were specifically designated as legal costs by the contractor. For example, in one case, a contractor attorney explicitly wrote that the action was a settlement agreement and not a layoff. Also documented were the facts that the contractor did not follow their traditional layoff process, the amount of the settlement was more than the contractor would have calculated for a layoff, and in return the contractor had secured a signed release from any possible suit. Another case specifically designated the payment as a legal settlement.

Two contractors also incurred costs for and settled five cases that were not reviewed for allowability. According to Department of Energy Acquisition Regulation (DEAR) 970.5228-1(h), contractors shall not be reimbursed if the cause of action was due to contractor managerial willful misconduct, lack of good faith, or failure to exercise prudent business judgment. According to 10 CFR 719, Appendix, Section 5.1, underlying causes for incurrence of costs such as those described in the DEAR or other findings of liability, fault, or avoidability are a separate consideration and may be determinative of the allowability of the legal costs. We discovered several cases where field office officials should have reviewed the facts of the case to determine whether costs should have been disallowed based on the above factors.

For example, one facility contractor incurred costs for a settlement and associated legal costs of well over $1 million without a fully documented review by the Department of the terms and circumstances of the case. In this particular case, fraud and breach of contract on the part of a defined contractor management official were alleged. The case was settled at the direction of the court, and, despite Departmental coordination on many aspects of the case, an allowability determination was not documented by officials at the field location. At another site, the contractor expended funds for potentially unallowable costs of defending itself against allegations of management retaliation that named defined contractor management personnel. The contractor at this location had a series of legal cases in our sample that alleged management retaliation for certain actions, such as making protected disclosures. Four of these cases were settled without a separate analysis by field officials to determine the causes of the separate but similar cases and whether there was management misconduct.

To illustrate the importance of reviewing the circumstances surrounding various types of settlements, we noted that the Department did review the factual basis for a recent wrongful termination case and found that approximately 90 percent of the multi-million settlement was punitive in nature and therefore unallowable. This approach protected the Government's rights because the settlement was based on a jury decision that found that the contractor acted in a fraudulent, willful and reckless manner, making the majority of costs unallowable because they were punitive in nature. In the interest of protecting taxpayer funds, Government field office officials should examine the factual basis behind all prior settlements made by contractors to determine whether their costs are allowable.

Implementation of of Regulations

Excessive and potentially unallowable costs were incurred by the Department because of cost control weaknesses at certain sites. The Department incurred legal costs directly associated with fines and penalties because neither field site office officials nor facility contractor personnel considered applicable acquisition standards that prohibit such expenses. Other potentially unallowable costs were paid because neither the facility contractors nor Department reviewers enforced the terms of Engagement Letters and identified and removed non-conforming charges from outside legal contractor invoices prior to payment. Facility contractors also paid questionable

settlements because the Department had not established required Legal Management Plans to, among other things, establish settlement authority amounts. Additionally, certain Federal field site officials, in some instances, were not conducting reviews of cases to make a determination, as required in DEAR 970.5228-1(h) and 10 CFR 719, Appendix, Section 5.1, whether contractor management acted with potentially questionable business judgment or was displaying a pattern of impropriety that might require corrective actions to prevent them from recurring.

Payment of Directly Associated Costs

The Department contractors paid potentially unallowable, directly associated costs at two of the four sites we visited because the Contracting Officers were not fully considering provisions in the FAR applicable to directly associated legal costs. One of the Contracting Officers believed that these types of costs for outside legal fees were allowable based on general provisions in FAR 31.205-47. However, while the FAR states that outside legal costs are generally allowable, it also specifies at FAR 31.205-47(b) that such costs are unallowable if in connection with any violation of a law or regulation, i.e. a fine or penalty, that results in a monetary penalty. As a matter of clarification, Department headquarters officials pointed out that associated costs may be allowable to the extent the proceeding is resolved by consent or compromise by the Government, but this was not the case with the fines and penalties discussed earlier.

We solicited an opinion from the Department's Office of the General Counsel on this topic. The response was an evaluation of the FAR 31.205-47 provisions, including a conclusion that costs related to imposition of a monetary penalty should be disallowed. Additionally, outside legal costs associated with fines and penalties were disallowed at the two other locations we visited. At these other locations, the Department went one step further and also disallowed all of the contractor's internal costs associated with the fines and penalties – including (in-house) Counsel costs.

Reimbursement of Other Potentially Unallowable Costs

Questionable costs were also paid because Department and contractor invoice reviews were not sufficient to ensure that all potentially unallowable costs were discovered and omitted

from payment in accordance with Engagement Letters. The Department is responsible for reviewing invoices for outside legal services submitted to the Department for reimbursement by a facilities contractor. These reviews include all invoices unless Streamlined Litigation Management procedures have been approved, in which case they are done annually on a sample of invoices. The implementation of Streamlined Litigation Management procedures at two locations had resulted in reduced Federal review because not all invoices are included and, in one case, the review had not been conducted in several years. Facility contractors must review outside legal counsel invoices, which were required to be submitted monthly according to the terms and conditions of engagement letters for the cases we reviewed.

At three of the four locations we visited, despite the availability of Engagement Letters to identify the terms and conditions of the outside attorney's work, and detailed checklists to identify prohibited costs, Department and facility contractor officials did not identify many costs that, based on our review, should have been disallowed. Under procedures established by the Department's Office of the General Counsel, both facility management contractor Legal Counsel and Department Counsel must separately review invoices from outside legal firms. At one location, we found that contractor Counsel was approving outside legal costs that would normally be unallowable without justification or explanation for the charges, even after an administrative review of the invoice identified the unallowable cost for non-payment.

Even in cases where either the Department or the facility contractors identified and disallowed certain costs such as copy expenses that exceed prescribed limits, law firms would continue to invoice higher rates month after month afterwards. In some cases, our review identified that costs were reimbursed by contractors because reviewers failed to identify and disallow the costs. Outside legal firms are required to include certifications with every invoice stating that "under penalty of law" the bill is truthful and accurate, and services and charges comply with the terms of engagement. However, we did not find any cases where penalties were invoked against outside law firms for continuously submitting invoices that did not meet these conditions.

Also, while one of the locations was approved to conduct its oversight using Streamlined Litigation Management procedures, the required annual review had been performed

only once since 2001. Specifically, the site Counsel's Office performed a review of litigation files for Fiscal Year (FY) 2004 during April and May, 2005. This review noted many nonconforming charges including, for example, billings for multiple attorneys attending a single meeting, and a law firm billing for meals when they were not in travel status. Both of these types of costs are not permitted under Department regulations without specific justification or advance written approval from Department Counsel. However, the report was never finalized, so it does not appear that any corrective actions were taken. Prior to this, a review had not been conducted since April 2001 because there was a two-year delay in filling the vacant Counsel position at the site. While the site office Counsel attempted to schedule a review in FY 2007, the review never occurred.

Approval of Settlements

One contractor was permitted to incur unapproved settlements because the site office had not yet finalized the contractor's Legal Management Plan. The purpose of such plans is to define, among other things, the interaction between the Department and the contractor, the contractor's corporate legal approach, and a description of the legal matters that may necessitate handling by retained legal counsel. While 10 CFR 719 required that such a plan be developed in 2001, the plan for the particular contractor we reviewed had not been finalized and approved by the time we began our review in 2008. As evidenced by various memoranda, the lack of a finalized plan resulted in a number of instances where the contractor and Department field office Counsels were in disagreement with legal approaches and other legal issues. For example, the draft Plan set forth the requirements for when the contractor must obtain Department field office approval to settle contractor litigation and claims. Since this Plan was not finally approved, however, several settlements were approved by the contractor without the knowledge of the Site Office Counsel or the Contracting Officer. Subsequent to completion of our audit field work we learned that the Plan had been agreed to and had been finalized.

Even now that a Legal Management Plan is in place that, based on our reading, requires that all settlements be reviewed, contractor counsel asserts that certain personnel related settlements are excluded from the Plan's requirements. As

indicated earlier, the contractor reimbursed nine settlements without Department approval. However, the contractor contends that the settlements were limited to personnel matters. As we noted earlier, these settlements were claimed as legal costs and specifically designated as settlements in the applicable case files. Since these settlements aggregated in the hundreds-of-thousands of dollars, we believe clarification of how to handle these matters should be a component of the Legal Management Plan.

The Department also allowed payment to two contractors for the cases that were settled but not reviewed for allowability because it did not conduct and document analyses of whether liabilities were caused by "defined" contractor managerial personnel's willful misconduct, lack of good faith, or failure to exercise prudent business judgment. While such a determination would not be warranted in most cases, we did find certain cases such as those described earlier that alleged fraud, breach of contract, and retaliation against employees that made protected disclosures by facility contractor "defined" management personnel.

Funds Better Spent

As a result of not fully monitoring costs and finalizing legal management plans, the Department is using funds to pay for legal costs that could be better spent on activities benefiting the Department's mission. In total, the four facility contractors we reviewed spent more than $105 million in settlements and outside legal costs during the five-year period of our review. While a majority of these costs were allowable under the Department's regulations, our audit work shows that the total amount could be reduced through disallowance of certain costs associated with fines and penalties. This amount could also be reduced through more diligent cost reviews and consideration of the types and similarities of legal cases at the Department's facility contractors.

RECOMMENDATIONS

To address the weaknesses associated with the payment of unallowable costs and the review and approval of settlements, we recommend that:

1. The Senior Procurement Executive, National Nuclear Security Administration (NNSA):

    a. Issue guidance to ensure that site offices follow provisions of the FAR with respect to disallowing costs directly associated with

otherwise unallowable costs, including costs for facility contractor staff time and efforts; and,

b. Direct Contracting Officers at two locations to review the directly associated costs identified in our audit and make allowability determinations, and recover unallowable costs as appropriate.

2. The Senior Procurement Executives for both the Department and the NNSA direct Contracting Officers to ensure, in conjunction with field site Counsels as deemed appropriate, the following actions are taken:

   a. Define amounts for and review high-value outside law firm invoices from April 1, 2003, through March 31, 2008, identify and make allowability decisions on costs that are not in accordance with Engagement Letters, and recover unallowable costs from facility contractors as appropriate;

   b. Require facility contractors to either terminate the agreement or impose available remedies in cases where outside law firms continue to bill for the same unallowable fees that do not adhere to the terms and conditions of legal agreements; and,

   c. Review the reasons for incurrence of fines and/or penalties for certain legal cases, such as instances where there is an indication of a "defined" contractor management personnel failure to exercise prudent business judgment, and document an allowability determination before agreeing to reimburse such costs.

3. The Department's Office of the General Counsel (OGC) and the NNSA OGC:

   a. Work with field sites to ensure that all locations have appropriate Legal Management Plans in place; and,

   b. Determine the need to revise regulations to require that Legal Management Plans define the

types of settlements that would require the contractor to obtain the Department's approval.

MANAGEMENT REACTION

We received comments from the Associate Administrator for Management and Administration, NNSA, including technical comments from the NNSA Office of the General Counsel. Also, we received comments from the Department's Director, Office of Procurement and Assistance Management (OPAM) including technical comments from the Department's Office of the General Counsel (OGC).

Each of the responding elements expressed some level of concurrence with the need to implement actions in the recommendations, but suggested alternate actions in many cases. Additionally, each responding element questioned the applicability of some of the cited regulations, such as allowability determinations in cases of potential management misconduct and the imposition of financial penalties for outside legal firms that submit invoices with unallowable costs.

NNSA concurred with recommendation 1 and provided corrective actions as well as expected implementation dates. For recommendations 2 and 3, NNSA either provided alternate actions or advised that actions were already in place to address the recommendations. For recommendation 2a., NNSA stated that most Site Offices conduct a 100 percent review, but suggested that the Contracting Officer at each site conduct a review of high value invoices to ascertain whether further reviews are warranted. For recommendation 2b., NNSA suggested that the Department does not have authority to require facilities contractors to impose penalties on outside legal firms, but did suggest that consideration be given to terminating engagements with firms that continue to bill for unallowable expenses, and advised that a new Performance Evaluation Plan objective will be put in place to evaluate contractors' abilities to successfully manage litigation. For recommendation 2c., NNSA contends that it currently reviews the reasons for incurrence of certain legal cases as a matter of course. For recommendation 3, NNSA advises that all Site Offices currently have Legal Management Plans in place.

OPAM offered alternatives to recommendation 2. For recommendation 2a., OPAM suggested that the OGC review the procedures at each site to ensure they are properly implemented and conduct a more in depth review where they are not. For recommendation 2b., OPAM suggested the OGC

should ensure each contractor consider terminating a law firm's service and consider not employing the firm in the future for those that continue to bill for unallowable costs. For recommendation 2c., OPAM suggested that, rather than requiring the Contracting Officer to make a determination separate from the OGC, the recommendation should state that the OGC ensure it takes extra care in reviewing the underlying facts leading to the lawsuit when it sees a pattern of cases involving the same issue.

The OGC made several comments on recommendations 2 and 3. For recommendation 2a., OGC stated that a review of every outside invoice from 2003 to 2008 would be extremely resource intensive and may cost more than any return it might provide. Also, OGC states that Department counsels already review all invoices prior to payment. Further, OGC attempts to put the facts of the review into perspective by stating that the report identified approximately $300,000 in potentially unallowable costs out of about $105 million in settlements and outside legal costs, which equates to 0.3 percent of the amount approved for reimbursement.

For recommendation 2b., OGC's comments echo those of NNSA and OPAM with regard to considering termination of a legal firm and possible refusal to re-hire the firm in the future. For recommendation 2c., OGC advises that there is not a requirement for a Contracting Officer to make a separate determination of cost allowability, and points out that the designation of Department counsel as a Contracting Officer Representative is meant to provide coordination and a better understanding of cost issues. Additionally, OGC points out that Department counsel reviews the circumstances of each case prior to approving outside counsel costs for reimbursement, and in some instances, has resulted in a Departmental decision to not approve all or part of the outside legal costs. Finally with regard to this recommendation, OGC refers to the 48 CFR 952.231-71 clause which states that the willful misconduct, lack of good faith, etc. must have been committed by one of the managerial personnel listed in the facilities contract.

For recommendation 3, OGC agrees that it should ensure Legal Management Plans are in place at all locations, but states that the provisions of 10 CFR 719 do not require the plans have a

specific citation on settlement authority, although such a citation could exist and it would be a good idea to encourage inclusion of such authority.

AUDITORS COMMENTS

Management's comments and alternatively proposed actions, in most cases, are largely responsive to our recommendations and should, when fully implemented, result in improvements to the Department's management of outside legal costs. As appropriate, we made revisions to our report and recommendations in response to management comments.

Recommendation 2 is not meant to suggest that Contracting Officers bear the full burden of managing outside legal costs or that they should be required to conduct independent evaluations and analyses. We agree it is logical that the Department's Counsel be heavily involved in these actions, and have added clarifying language to the recommendation. However, only the Contracting Officers have the ultimate authority to direct facilities contractors to take actions or disallow certain costs.

With regard to recommendation 2a., we believe NNSA's suggestion to review high-dollar invoices and expand the review if it is deemed necessary is responsive and addresses the perception that the costs of a review of all invoices could outweigh its benefit. To that end, we revised the recommendation from the Draft report to include identification of high-value invoices for review. We do not believe that a review limited to procedures at each site would be fully beneficial because our audit demonstrated that existing procedures were not completely effective. For example, procedures existed to review outside costs, including detailed checklists, but some unallowable costs were still reimbursed. As another example, a procedure existed for one field site to conduct annual audits of outside costs, however, that review had been conducted one time since 2001.

For recommendation 2b., we agree that consideration of terminating an agreement with an outside firm for continuing to submit unallowable costs, and potentially refusing to hire the firm again, would be penalties that could improve the management of outside legal costs. However, we did not identify any instances where field sites were considering such penalties and believe some proactive actions are necessary to ensure these options are considered in the future. Specifically, there were no written records to indicate field sites were

considering these or any other penalties. For recommendation 2c., we are not asserting that a Contracting Officer be forced to make an allowability determination separate from Department Counsel, nor are we suggesting that there is requirement to make such a determination in every legal case. As discussed earlier, the Contracting Officer should "ensure" this action is taken. We agree with management's assertion that the Contracting Officer should be relying on the expertise of Department Counsel, and changed the wording of our recommendation to make this more clear. However, any actions to disallow costs as a result of Counsel's determination are ultimately the responsibility of the Contracting Officer.

Further, our report states that an allowability determination should have been made in five specific cases in which there was at least the appearance that defined contractor management acted with willful misconduct, lack of good faith, or failure to exercise prudent business judgment. We recognize this where we note that such a determination would not be warranted in most cases, however these five cases alleged fraud, breach of contract, and retaliation against employees that made protected disclosures by defined facility contractor management personnel. Each of these five cases alleged such actions against management personnel specifically named in the facilities management contract. Given these circumstances, we believe it is prudent for officials at the field site to exercise their option under 10 CFR 719, Appendix 5.1, to make such a determination. Also, although not specifically a requirement of the CFR, we believe it would be prudent to document such an analysis since these types of considerations were not transparent in the files we reviewed. Such an analysis was created for one of the cases we reviewed.

For recommendation 3, we agree with OGC that the CFR does not specifically require settlement authority to be included in a Legal Management Plan. During our exit conference, OGC management stated that the CFR had been in its current form for approximately eight years and that it may be time for a review and revision of this regulation in light of the findings in our report. We believe this is a positive step toward improving the management of contractor fines, penalties and legal costs. Accordingly, we modified our report to recommend that management determine the need to revise the regulation to add direction on the types of settlements that require Department review and approval.

Finally, we believe OGC did not give sufficient consideration to a number of facts set forth throughout the audit report in its assessment that the audit identified approximately $300,000 in potentially unallowable costs of about $105 million in settlements and outside legal costs, which equates to 0.3 percent. While we cited only specific examples, unless the control weaknesses identified in our report are corrected, it is likely that additional problems will recur.

Appendix 1

OBJECTIVE

To determine whether the Department of Energy (Department) has effective processes for managing contractor fines, penalties and other legal costs.

SCOPE

We conducted the audit from April 2008 to May 2009 at Department of Energy Headquarters in Washington, D.C., and four facility contractors. We did not disclose the identity of the contractors chosen because of our concerns related to confidentiality requirements for legal settlements and details of ongoing legal cases.

In addition, we collected information from all facility contractors in the Department to determine the total amount of fines and penalties, and outside legal costs. Our review included fines, penalties and legal costs, including settlements, incurred from April 1, 2003, through March 31, 2008.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed applicable Federal laws and regulations related to the management of contractor fines, penalties and other legal costs;
- Reviewed policies and procedures for administration of Engagement Letters, Legal Management Plans, and other requirements for outside legal costs at local field sites;
- Held discussions with Department and facility contractor officials regarding management of fines, penalties and other legal costs;
- Conducted a data request to obtain information on all fines and penalties, and outside legal costs at each of the Department's facility contractors; and,
- Selected a statistical sample of outside legal costs for sites visited, and examined a judgmental number of invoices from legal firms to identify whether costs were in accordance with Engagement Letters.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis

for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Accordingly, the audit included reviews of Department and regulatory policies, procedures, and performance measures related to the Department's facility contractor fines, penalties and other legal costs. We assessed performance measures in accordance with the *Government Performance and Results Act of 1993* and concluded that the Department had not established performance measures related to contractor fines, penalties and other legal costs. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. We did not conduct a full reliability assessment of computer-processed data. However, we deemed the data to be sufficiently reliable to achieve our audit objective.

The exit conference was held with management on September 10, 2009.

Appendix 2

PRIOR REPORTS

Office of Inspector General

- *Inspection of Administrative Management Procedures for Legal Services Acquired by Selected Management and Operating Contractors*, (DOE/IG-0363, December 1994). The inspection found that additional management attention was needed by the Department of Energy (Department) to improve the controls over the acquisition of outside legal services, including litigation, by Management and Operating (M&O) contractors. The inspection found that acquisitions of legal services by M&O contractors did not always go through approved procurement systems; that payments were being made to outside law firms without any written agreement to support the scope or nature of the services being provided; and that reviews of the costs for outside legal services were being reviewed without regard to the Federal and Department Acquisition Regulations cost principles, and without the benefit of any written agreement which outlined the basis for incurring costs. Several recommendations were made to improve the controls over acquisition of outside litigation services obtained by M&O contractors, and to improve the review of charges for these services.

U.S. Government Accountability Office

- *Department of Energy: Reimbursement of Contractor Litigation Costs,* (GAO-04-148R, November 2003). This study was performed in response to an information request to determine the extent to which the Department reimbursed its contractors' litigation costs and the processes for doing so. The Government Accountability Office (GAO) found that the Department reimbursed its contractors for $330.5 million in litigation costs from Fiscal Year 1998 through March 2003, including $259.4 million for litigation costs and $81.1 million for judgments and settlements. The GAO also determined that the criteria the Department used to reimburse contractors depended on the nature of the case, but that the Department paid all reasonable costs in most cases with several exceptions. Among others, this included instances of when the contractor's actions involved either willful misconduct, lack of good faith; or failure to exercise prudent business judgment by the contractor's managerial personnel.

- *Department of Energy: Contractor Litigation Costs* (GAO-02-418R, March 2002). This study was performed in response to an information request to determine what laws and regulations provide for the Department to reimburse its contractors for the litigation, settlement and judgment costs in cases brought against them, and provide information as to the number of cases and the costs that the Department reimbursed its contractors and that contractor's paid themselves. The report stated that the Federal and Department acquisition regulations provide for the Department to reimburse contractors reasonable costs. Such costs are not reimbursable if the liability is related to the contractor's willful misconduct, lack of good faith, or failure to exercise prudent business judgment.

- *Managing DOE: The Department of Energy is Making Efforts to Control Litigation Costs* (GAO/RCED-95-36, November 1994). GAO found that the Department had not kept centralized data on costs reimbursed to contractors for outside litigation, and lacked effective criteria spelling out what costs it would reimburse. As a result, the Department was being billed at higher rates than other federal agencies for legal fees, travel, word processing and photocopying and legal bills were being reimbursed with little or no Departmental oversight. The audit found that the Department had begun to strengthen its controls over legal costs. In particular, the Department issued specific cost guidelines and instituted procedures for periodically reporting all litigation costs. In addition, the Department was also establishing an audit function to enable it to conduct detailed reviews of the bills it receives for legal services, and consolidating cases involving multiple contractors and law firms to improve management and reduce costs.

Department of Energy
Washington, DC 20585

July 7, 2009

MEMORANDUM FOR RICKEY R. HASS
DEPUTY INSPECTOR GENERAL
FOR AUDIT SERVICES
OFFICE OF INSPECTOR GENERAL

FROM: EDWARD R. SIMPSON
DIRECTOR
OFFICE OF PROCUREMENT
AND ASSISTANCE MANAGEMENT

SUBJECT: Draft Audit Report on "The Department's Management of Contractor Fines, Penalties and Legal Costs"

This memorandum responds to your May 29, 2009, memorandum requesting comments on the subject draft report (IG-30 AO8PT054). We appreciate the opportunity to provide comments. Because the National Nuclear Security Administration (NNSA) is responding directly to you, our comments address only those parts of recommendations two and three not directed to NNSA.

Attached are extensive comments from the Office of General Counsel. They represent the Department's position, and we add the following comments only to emphasize the importance of considering what the Office of General Counsel suggests. Our remarks should be read in the context of the complete comments of the Office of General Counsel.

We share the underlying concern of the Office of General Counsel that your Draft Report does not reflect an accurate understanding of the role of the Contracting Officer in the matters you reviewed. We do agree, however, that where an Office of General Counsel review indicates a contractor submitted unallowable costs, an appropriate recommendation would be that the Senior Procurement Executive will ensure that Contracting Officers take prompt and effective action to determine allowability and recover from the contractor any amounts due the Government.

Regarding the Draft Report's recommendation 2.a., rather than requiring the Contracting Officer or anyone else to review all invoices for the stated period, the recommendation should be that the Office of General Counsel will review the procedures at each site to ensure they are properly implemented and conduct a more in depth review where they are not.

Regarding the Draft Report's recommendation 2.b., rather than requiring the contractor to attempt to impose penalties on a law firm that continues to bill for unallowable costs, the recommendation should be that the Office of General Counsel should ensure that each contractor, in addition to not paying a law firm for unallowable costs, consider terminating the law firm's services, if it would not unduly jeopardize the representation in that case, and also consider not employing the firm in future cases.

Regarding the Draft Report's recommendation 2.c., rather than requiring the Contracting Officer to make a determination separate from the Office of General Counsel's, the recommendation should be that the Office of General Counsel ensure that when it sees a pattern of cases involving the same issue, it takes extra care in reviewing the underlying facts leading to the lawsuit and take appropriate action.

If you have any questions, please contact Mr. Michael Righi of my staff at (202) 287-1337.

Attachment

Department of Energy
National Nuclear Security Administration
Washington, DC 20585

June 29, 2009

MEMORANDUM FOR: Rickey R. Hass
Deputy Inspector General
for Audit Services

FROM: Michael C. Kane
Associate Administrator
for Management and Administration

SUBJECT: Comments to the IG's Draft Report on Fines and Penalties, Proj. No. A08PT054; IDRMS No. 2008-01170

The National Nuclear Security Administration (NNSA) appreciates the opportunity to review the Inspector General's (IG) draft report entitled *The Department's Management of Contractor Fines, Penalties and Legal Costs*. I understand that this review was initiated to determine whether the Department had an effective process for managing contractor fines, penalties and other legal costs.

NNSA agrees in general with the draft report; however, we believe that there are issues that may be worthy of review and clarification: inconsistency between the conclusions in this draft report and the manner in which M&O contracts function; mischaracterization of the Department's contractor legal management requirements and attempts to pose an affirmative duty for a Contracting Officer to perform a separate determination of allowability prior to any cost "reimbursement that there was no willful misconduct, lack of good faith, or failure to exercise prudent business judgment on the part of the contractor's senior managers"; the Government has the right to review the circumstances for allowability of such costs despite the failure of the contractor to get advance settlement approval or the existence of a Legal Management Plan; and contractors use of "Actual" travel costs. NNSA's Office of General Counsel technical comments will be provided separately, which further discusses the issues identified above.

With regards to the recommendations, below are the actions that are in place:

The Senior Procurement Executive, NNSA –

Recommendation 1a: issue guidance to ensure that Site Offices follow provisions of the FAR with respect to disallowing costs directly associated with otherwise unallowable costs, including costs for facility contractor staff time and efforts.

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Concur. NNSA agrees that the site offices are to follow the provisions of the FAR, and will highlight this area of concern to them. Actions will be completed by the end of September 2009.

Recommendation 1b: direct contracting officers at two locations to review the directly associated costs identified in our audit and make allowability determinations, and recover unallowable costs as appropriate.

Concur. NNSA will direct the Contracting Officers to review the costs identified, and to make a determination of allowability. Actions will be completed by the end of December 2009.

The Senior Procurement Executives for both the Department and NNSA direct Contracting Officers to ensure the follow actions are taken:

Recommendation 2a: review outside law firm invoices from April 1, 2003 through March 31, 2008, identify and make allowability decisions on costs that are not in accordance with Engagement Letters, and recover unallowable costs from facility contractors as appropriate.

Concur. The majority of the NNSA Site Offices have already conducted 100 percent reviews of their legal invoices. Sandia and Los Alamos have approval to use a streamlined approach whereby they review a sample of invoices. For example, Los Alamos reviewed approximately 40 percent of the invoices for the period of time covered by their audit. Y-12, Kansas City, and Livermore have been doing a 100 percent review from 2003 to present. Other NNSA Site Offices have been doing a 100 percent review for the past several years. We believe this sampling suffices; however, the Contracting Officer will conduct a review of high value ("high value" being defined by the NNSA Senior Procurement Executive), invoices will be done to ascertain whether further reviews are warranted. Action will be completed by the end of December 2009.

Recommendation 2b: require facility contractors to impose available penalties in cases where outside law firms continue to bill for the same unallowable fee that do not adhere to the terms and conditions of legal agreements.

The Department has no authority to require its M&O contractors to impose penalties on its outside legal firms when they bill for unallowable expenses. M&O contractors are expected to employ their best business practices in this regard, and may take whatever steps it feels appropriate if its outside counsel continue to bill for unallowable expenses, including terminating their engagement with a firm. NNSA will ensure its M&O contractors comply with the Department's Contractor Legal Management Requirements. Furthermore, NNSA will evaluate our contractors ability to successfully manage their litigation, through a new Performance Evaluation Plan objective. NNSA believes the action taken meets the intent of the recommendation and considers it closed.

Recommendation 2c: review the reasons for incurrence of certain legal cases, such as instances where there is an indication of a contractor's failure to exercise prudent business judgment, before agreeing to reimburse costs for legal settlements.

As a matter of course, NNSA does review the reasons for incurrence of certain legal cases before agreeing to reimburse costs for legal settlements. NNSA considers this recommendation closed.

Recommendation 3: The Department's Office of the General Counsel and NNSA's Office of the General Counsel work with field sites to ensure that all locations have appropriate Legal Management Plans in place and that they are comprehensive in defining the types of settlements that require Department review and approval.

NNSA agrees that Site Offices should have Legal Management Plans in place and, in fact, the Sites Offices do have these plans in place and are in compliance with 10 CFR 719. Sandia submitted a Legal Management Plan, incorporating 10 CFR Part 719, to the Sandia Site Office (SSO) on September 29, 2003 and agreed to operate in accordance with the Plan as if it had been approved. Through negotiations between SSO and Sandia, the Plan was substantially revised and improved, and was subsequently approved by SSO on July 23, 2008. All Site Offices' Legal Management Plans are subject to further revision and continuous improvement. NNSA considers this recommendation closed.

If you have any questions concerning this response, please contact Cathy Tullis, Acting Director, Policy and Internal Controls Management, 586-3857.

cc: Dave Jonas, General Counsel
David Boyd, Senior Procurement Executive
Karen Boardman, Director, Service Center

IG Report No. DOE/IG-0825

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