

**FOOD SERVICE MANAGEMENT CONTRACTS:  
ARE CONTRACTORS OVERCHARGING  
THE GOVERNMENT?**

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**HEARING**

BEFORE THE

AD HOC SUBCOMMITTEE ON CONTRACTING  
OVERSIGHT

OF THE

COMMITTEE ON  
HOMELAND SECURITY AND  
GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE

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**FOOD SERVICE MANAGEMENT CONTRACTS:  
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WEDNESDAY, OCTOBER 5, 2011

U.S. SENATE,  
AD HOC SUBCOMMITTEE ON CONTRACTING OVERSIGHT,  
OF THE COMMITTEE ON HOMELAND SECURITY  
AND GOVERNMENTAL AFFAIRS,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 2 p.m., in Room SD-342, Dirksen Senate Office Building, Hon. Claire McCaskill, Chairman of the Subcommittee, presiding.

Present: Senator McCaskill.

**OPENING STATEMENT OF SENATOR MCCASKILL**

Senator MCCASKILL. I want to welcome everyone to this hearing today. I have an opening statement that I will give.

I have to say, before I begin this opening statement, though, that I am not shocked that this is not a full room. As I began to prepare for this hearing today, I began to understand the nature of the problem. This is really complicated and hard, and it is precisely when something is complicated and hard that bad things happen. Today, we seek clear direction and transparency because that usually translates into better accountability. And I think the lack of accountability in this particular area can be traced directly to the complexity of this issue.

So I am really glad that we have the three of you here today. This is going to be one of those hearings that I talk about a lot in this Subcommittee. That is, this subject matter is, as you can tell by the room, not the sexiest in Washington. We are not going to have breaking news online about this hearing today. But this is important work. This really brings "getting into the weeds" new meaning.

The irony is, everyone is running around this building giving political statements about how we have to bring down the spending of the Federal Government. Well, here we have a line item in the Federal Government that is north of billions and billions and billions of dollars, and yet it is not going to garner the attention as some other sexy headline that I am sure others are covering as we speak over in the main building.

So let me give the formal opening statement that has been prepared and then we will get to your testimony and questions. Unfortunately, and Senator Portman asked me to convey to you that he

cannot be here today even though he thinks this is a terrific subject for this Subcommittee to go at. I think he would have liked to have been here to discuss even the complexities of this, but he could not, and so he asked me to convey that to you and I am happy to do so. He and I are working well together on this Subcommittee.

Today's hearing focuses on how the government buys food. Every day, the government provides meals to our soldiers at home and overseas, veterans, government employees, and to our children through the National School Lunch Program (NSLP). Every year, billions of taxpayer dollars are paid to the food service contractors who supply the food for dining facilities on military ships, bases, and on the battlefield, as well as at government buildings, hospitals, and schools.

When food service contractors buy food for the government they get rebates from the manufacturers, suppliers, and vendors. In their simplest form, rebates often are based on volume purchases that contractors make from food manufacturers and distributors. For example, a contractor may order cases of cereal from a food manufacturer, for which it will receive a rebate in the form of a discounted price or a cash payment from the manufacturer.

In cost reimbursable contracts, the contractor will then submit invoices for its food purchases to the contracting agency. The problem is that the invoice price may not include the rebates received from the manufacturer or the distributor. So the agency then pays the full amount of the invoice and the contractor pockets the difference. When contractors buy food with the taxpayers' money, they should not be able to keep the change.

Recently, reports of fraud and other abuses on food service contracts have snowballed. Last July, the New York Attorney General's Office announced a \$20 million settlement with Sodexo, one of the largest food service management contractors in the world, regarding allegations that the company failed to pass along rebates that it received through its contracts with the New York public schools participating in the National School Lunch Program.

In September 2010, the Department of Justice (DOJ) announced a \$30 million settlement with U.S. Food Service, another major contractor, based on allegations that it had overcharged the government by inflating food prices on contracts with the Defense Department (DOD) and the Veterans Administration (VA).

The Department of Justice also has a major case pending against Public Warehousing Company (PWC), now known as Agility, based in part on allegations that Public Warehousing Company submitted false information, manipulated prices, and overcharged the government for food and related services under its contract to supply fruit to the military in Iraq.

This June, the Department of Agriculture's (USDA) Inspector General (IG) announced that it would be conducting its third audit of food service management contracts in the last decade. Both of its previous audits, conducted in 2002 and 2005, found serious problems with companies overcharging schools by withholding rebates.

The message that these reports and investigations send is clear. We are not doing enough to make sure that the government is not getting cheated. With increased scrutiny of rebate withholding, contractors have turned to new practices in order to avoid passing re-

bates on to the government or to pad their own profits. One such method is to simply call the rebate another name, such as “marketing incentives” or “vendor consideration.”

What is more, it seems obvious that the problem is even more widespread. For example, some companies have said that their accounting practices prevent them from accounting for the rebates owed to individual clients. Even if the company is giving the government the rebates that may be attributable for the individual contract, there is no way for the government to recoup the overall rebates that may be attributable to discounts based on purchases made by an entire Federal agency or the Federal Government overall.

We are here today to learn from some of the Nation’s experts on this issue on how contractors can manipulate their prices and invoices. We will discuss barriers to effective oversight of these contracts, including the complexity of the contractors’ relationships with their vendors and suppliers and the ambiguities in the Federal regulations relating to rebates. We will also discuss whether the practices that they have seen are exceptions or part of a pattern of fraud in these types of contracts across the Federal Government.

In this time of belt-tightening, we need to be more careful than ever to ensure that taxpayer dollars are not being wasted—particularly because every dollar that is lost through rebate schemes is a dollar that we cannot use to feed our soldiers and the children who need nutrition.

I thank the witnesses for being here today and I look forward to their testimony.

Senator MCCASKILL. And now let me introduce the witnesses and we will begin the testimony.

It is the custom of this Subcommittee to swear in all witnesses that appear before us, so before I do your introductions, if you do not mind, I would ask you to stand.

Do you swear that the testimony you will give before this Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. FONG. I do.

Mr. CARROLL. I do.

Mr. TIEFER. I do.

Senator MCCASKILL. Thank you all.

Phyllis Fong was sworn in as the Inspector General of the U.S. Department of Agriculture on December 2, 2002. Prior to her appointment at USDA, Ms. Fong served as the Inspector General of the U.S. Small Business Administration (SBA) from 1999 until 2002. Among many other positions of distinction, Ms. Fong also served as the Assistant General Counsel for the Legal Services Corporation and an attorney with the U.S. Commission on Civil Rights. Ms. Fong is also currently serving as Chair of the Council of Inspectors General on Integrity and Efficiency.

John Carroll is an Assistant Attorney General in the Criminal Division of the New York’s Attorney General, where he is leading an investigation of billing and marketing practices among food service companies. He is also the Deputy Chief of the recently formed Taxpayer Protection Bureau. Mr. Carroll specializes in civil

and criminal investigations involving allegations of public corruption as well as complex corporate investigations.

Charles Tiefer is currently a professor at the Baltimore School of Law, where he teaches government contracting and legislative process. Professor Tiefer also recently served as a Commissioner on the Commission for Wartime Contracting in Iraq and Afghanistan, a commission that is very near and dear to my heart, and did excellent work.

By the way, I should tell you, Professor Tiefer, that yesterday, Jim Webb and I hosted here at the Capitol one of the investigators for the Truman Committee. She was one of the first women ever hired in Congress to be an investigator for a congressional Committee and she was in charge of investigating on the Truman Committee the civilian manpower issues. She was a 1943 graduate of Vassar—and came to work for the Committee for several years. So Senator Webb and I had a chance to visit with her. She is anxious to see the report of the Commission, and asked us to send her one. She lives in Virginia and is a fascinating woman, and if you are interested, I would be glad to give you her contact information, because she told some great stories about the Truman Committee and the work it did and it was terrific.

Professor Tiefer has also served in both Chambers of Congress as Legal Counsel and investigated controversies related to Bosnia as well as the Iran Contra Affair.

We would ask that your testimony be around 5 minutes, but take as long as you would like, and we will begin with you, Inspector General Fong.

**TESTIMONY OF PHYLLIS K. FONG,<sup>1</sup> INSPECTOR GENERAL, U.S.  
DEPARTMENT OF AGRICULTURE**

Ms. FONG. Thank you, Madam Chairman, for the opportunity to testify today about the work that our office has done to help improve the Food and Nutrition Service's (FNS) oversight of the School Lunch and Breakfast Programs and the relationships with food service management companies (FSMC).

You have my full statement for the Record, so let me just highlight the key points.

In fiscal year (FY) 2010, approximately 43 million children participated in the School Lunch and Breakfast Programs, which together served an estimated 7.2 billion meals in 14,000 school districts around the country involving \$12.5 billion in Federal funds. Generally, as you note, the food service management companies who contract to provide these meals are required to pass discounts, rebates, and credits for USDA-donated commodities back to the local school food authorities (SFA), and those savings can then be used to benefit the students and the local school meal programs.

Over the last 10 years, we have issued several reports identifying problems in this program. As you note, in 2002, we audited eight food service management companies contracting with 65 local authorities in seven States and we found that five of those eight companies improperly retained \$6 million in cost savings that should have been passed on to the local food authorities.

<sup>1</sup>The prepared statement of Ms. Fong appears in the appendix on page 23.

The management companies, who had fixed-rate contracts, received \$5.8 million in USDA-donated food, but they did not credit this amount to their local food authorities' accounts. This happened because the FNS requirements on these programs were not clear and because some companies revised their contracts to allow themselves to retain savings that should have gone to the local food authorities.

The remaining \$280,000 involved companies with cost reimbursable contracts, and in those situations, the bid solicitations would require that rebates and credits be passed along to the food authorities. In those situations, the companies that won the bids either modified their contracts or they ignored the contract requirements.

So in 2005, we did another audit to take a closer look. We looked at one management company that had cost reimbursable contracts in 22 States and we found that the company violated its contracts with 106 food authorities in eight States by not crediting them with discounts, rebates, and other cost savings of about \$1.3 million.

Together, when you look at the recommendations that our audits made, we recommended that FNS needed to develop specific contract terms for State agencies and local authorities to use when contracting with food service management companies. We felt that the terms should ensure that SFAs benefit from the value of the food donated by USDA and also that the SFAs benefit from any discounts or rebates that companies received. We also recommended that FNS amend its regulations to require that these contract terms be included in specific contracts, to require that State agencies approve contracts before the local districts sign them, and to require State agencies to have the local districts enforce the contract provisions. In response to our recommendations, FNS revised its regulations in 2007, and in 2009 issued updated guidance to the State agencies and local authorities.

The issue of food service management companies improperly retaining savings, however, continues to be a concern, and due to express concerns that we have received from Congress and others, we have decided to initiate a new audit to assess the effectiveness of these corrective actions that FNS has implemented and to assess the effectiveness of State agency action. We will also be looking to see if the food service management companies with cost reimbursable contracts are passing along the discounts and savings as they should be.

So, in conclusion, we are committed to working with USDA to strengthen this program. We welcome the opportunity to answer your questions and appreciate the opportunity to be here today. Thank you.

Senator McCASKILL. Thank you, Ms. Fong. Mr. Carroll.

**TESTIMONY OF JOHN F. CARROLL,<sup>1</sup> ASSISTANT ATTORNEY  
GENERAL, OFFICE OF THE ATTORNEY GENERAL OF THE  
STATE OF NEW YORK**

Mr. CARROLL. Madam Chairman, please accept the greetings and the thanks of Attorney General Eric Schneiderman for taking testimony on this important topic, what are known as in the industry sometimes as off-invoice rebates. And indeed, Senator McCaskill, you raised the issue of transparency and the Attorney General believes that is exactly the problem with this practice, because it is inherently opaque.

I am an Assistant Attorney General and the Deputy Chief of General Schneiderman's Taxpayer Protection Bureau. Our focus, like that of this Subcommittee, is to investigate and prosecute allegations of fraud and waste in government contracting.

The United States and local governments provide millions of Americans with meals every day, and as a general proposition, individuals who are receiving meals from the government are among the most vulnerable. The meals provided by the government include through the National School Lunch Program, meals in health care facilities, and meals for soldiers in the field.

The meals are often provided through government contractors known in this industry as the food service management companies. Typically, such companies assume complete operational responsibility for delivering meals in a facility, whether in a Marine mess hall or a local elementary school. One task delegated to food service companies which contract with schools and others to provide this service is the daily task of ordering food to make meals for children, hospital patients, and soldiers. Food is bought either directly from food manufacturers or through distributors. These food vendors pay food service management companies millions of dollars to buy food from them. These payments are called rebates or, tellingly, off-invoice rebates.

The Attorney General's investigation has identified several problems with the system which, in other contexts, has been labeled as an unlawful kickback. First, the most obvious problem. Many food service contracts, as, Senator, you pointed out, are some version of cost-plus arrangements, but rebates are most often off-invoice. So, in other words, government customers who should be getting credit for rebates have no way to actually account for the numbers because the entire rebating process takes place behind the scenes, and so they have no way to police their contracts.

But there is a second, almost more important and definitely more insidious issue, which is that the rebates create a conflict of interest, and our investigation has seen the conflict of interest play out in such a way that very often food service companies will make food choices driven by the chase for rebates, which for some companies can amount to hundreds of millions of dollars in income, rather than issues of quality or other preferences. So, for example, food service companies are more likely to enter into rebating agreements with large agribusiness and may thereby forego entering into business arrangements with local farmers, which would serve

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<sup>1</sup>The prepared statement of Mr. Carroll appears in the appendix on page 30.

to thwart the National School Lunch Program's efforts to create farm-to-school efforts.

So, in conclusion, I am happy to take questions, and once again, the Attorney General expresses his gratitude for your interest.

Senator McCASKILL. Thank you very much, Mr. Carroll. Mr. Tiefer.

**TESTIMONY OF CHARLES TIEFER,<sup>1</sup> PROFESSOR OF LAW, UNIVERSITY OF BALTIMORE SCHOOL OF LAW, AND FORMER COMMISSIONER, COMMISSION ON WARTIME CONTRACTING IN IRAQ AND AFGHANISTAN**

Mr. TIEFER. Senator McCaskill and Subcommittee, thank you for the opportunity to testify today. I am a Professor of Law, as you noted, at the University of Baltimore Law School and the author of a case book on Federal Government contracting. For 3 years, I was Commissioner on the Commission on Wartime Contracting in Iraq and Afghanistan. Senator McCaskill, you understated what you did for that Commission. You were one of the two cosponsors. You created it. You nurtured it. You inspired it. And, not least, you never let us forget the spirit of Senator Truman and the Truman Committee during World War II. That was a very high standard you asked us to measure up to.

For the Defense Department operations in the war zone, the government purchases the necessary food by its prime vendor contract managed by the Defense Logistics Agency (DLA). In recent years, massive criminal and civil fraud charges have been brought against the food services contractor Public Warehousing Company, renamed Agility. The scale of these schemes is breathtaking. Public Warehouse Contracting earned \$8.5 billion in revenue from its Iraq food supply contracts, and press accounts have discussed that a settlement of the charges would be on the order between \$500 million, \$600 million, lawyers said \$750 million. Trial has not yet occurred, so I will use the word "alleged," as you did, for purposes of the criminal case, but that does not prevent DLA or GAO or this Subcommittee from taking advantage of what is set forth in the indictment to make the necessary repairs in the program so that this does not recur.

In brief, and the pattern is very similar to what my fellow witnesses described, the contract is supposed to charge the government a delivered price, which is what the suppliers are supposed to charge, plus the fee charged by PWC, or the prime vendor. And we are talking about, even though this is a wartime supply program, United States food. It is easy to parse the indictment and see that the bulk of what is being talked about is food that—meat, chicken, desserts—are produced in the United States, supplied in the United States, from U.S. suppliers. And PWC was forbidden to keep rebates or discounts from suppliers. Its pricing intended that this be passed along to the U.S. Government. But instead, it used its marketing muscle to obtain and to keep such discounts, and what made it a fraud case, a criminal fraud case, was covering this up by false statements.

<sup>1</sup>The prepared statement of Mr. Tiefer appears in the appendix on page 45.

I am going to take one of the indictment's examples in a little detail. In 2005, I am quoting from the indictment—"U.S. manufacturer S.L. engaged in discussions with defendant PWC." This was about discounts. I might say parenthetically, the indictment refers to these suppliers with initials, but the press and blogs have attributed the initials to well-known food suppliers like Sara Lee.

"Through the discussions between defendant PWC and S.L. about discounts, PWC insisted that the discount be called an early payment discount, even though S.L. did not want to use that term and suggested any discount offer to PWC be called what it was, a marketing allowance, a rebate. Defendant PWC insisted the allowance be labeled an early payment discount. Ultimately, S.L. agreed to use the label."

I could tick off the other U.S. suppliers mentioned in the indictment. My statement covers these.

To me, the allegations in the indictment show—just as Mr. Carroll pointed out—that there were conflicts of interest here. I would point out that this amounts to corruption, that the prime contractor who is engaging in kickbacks makes false reports to the government in words, in numbers, and even creates an entire false stream of reporting. It corrodes the whole system of supply for the government and it develops a whole network of suppliers who may, to some extent, be witting in this and are willing to comply with the crookedness, to cooperate in it.

I have some suggestions for what can be done about this. I think certifications by the prime vendor and declarations of what they receive would box them in. It would make it extremely easy to prosecute them or have False Claims Act cases qui tam brought against them. There is also an extensive study, an internal study by DLA which is extremely embarrassed that this happened on its watch. It could be helped to remember the reforms that it knows it needs to do.

Thank you, Senator.

Senator MCCASKILL. Thank you very much.

I have a lot of specific questions, and I promise you I will not ask all of them, but this is an interesting concept, that someone buys a lot of volume from what essentially is a broker, a type of middleman, and the middleman service they are providing is going to go out and locate the various foods that this program needs. But the volume that is necessary is dictated by the size of the customer—the fact that it is the Federal Government, the military or School Lunch Program or whatever. Are they engaging in getting this kind of extra padding when they are dealing with potential folks that are not the government? Is this like the common practice in this industry, that you get an extra padding on the contract because you are buying more than one case of Cheerios?

Mr. CARROLL. May I?

Senator MCCASKILL. Sure.

Mr. CARROLL. The agreements can run with food distributors, between food distributors and food service companies, so, for example, not to—just to use the name, just an example, a Cisco or U.S. Foods would be examples of distributors, and rebates can run between the distributors, like Cisco or U.S. Foods, and the Sodexos of the world. Or it can run between a chicken wholesaler, a large

national chicken wholesaler and the food service company. And the agreements are not limited to particular customers, the ones that the Attorney General's Office has reviewed. They run—so, in other words, the agreement could be 25 cents rebate on every case of chicken delivered to Sodexo, and so they—

Senator MCCASKILL. So it does not matter who is buying it?

Mr. CARROLL. Exactly.

Senator MCCASKILL. And is that the excuse they use?

Mr. CARROLL. That is one excuse, that the agreements actually have to do with volume across all business lines. So, for example, it could be business for the Senate mess hall or it could be business for a company, and what the food service companies will say is, well, we buy for so many different entities, that is why we are entitled to these discounts. But the excuse kind of starts to fall apart if you consider that the buying power of the United States, based on that, the United States would certainly also be entitled to those discounts.

Senator MCCASKILL. Right. So let me start with you, Ms. Fong. What recommendations are still outstanding on your audits that were done in 2002 and 2005? I mean, how many findings do you have with recommendations that they have not yet implemented?

Ms. FONG. We went back to our audit records in preparation for this hearing, and currently, FNS has addressed all of our recommendations and has said to us that they have implemented all the corrective actions that are necessary. And by redoing their regulations that they issued in 2007, they believe that they have addressed the specific recommendations we made. Now, one of the purposes of our new audit is to actually go out and see whether their actions have been effective in dealing with the problems that we had seen earlier in the decade.

Senator MCCASKILL. They certainly clarified it in 2007.

Ms. FONG. Yes.

Senator MCCASKILL. I mean, no one can say that is ambiguous at this point.

Ms. FONG. That is right.

Senator MCCASKILL. Mr. Carroll, for the investigations that you have done on the rebate withholding, can you give some estimate on the amount of dollars we are talking about in terms of what percentage of the overall contract price could you attribute to these withheld rebates?

Mr. CARROLL. Generally, the rebate amounts that the food service companies receive on particular products—so it could be anything from a jar of a particular spice or it could be, as I said, a case of chicken—run between 5 and 50 percent of the price that is charged to the customer. So, generally, they fall on average—in the National School Lunch Program, for example, it could be around 10 to 15 percent of the price. But there is a lot of variability because, obviously, you are buying very different foods to serve in a school program as opposed to a corporate dining room.

Senator MCCASKILL. When they are asked for the excuse for keeping the rebates when they are aware that it is in violation of the contracts, do any of you have any—can you articulate what their excuse is, even though it appears fairly clear the contracts are

obviously trying to make sure those rebates are passed on to the taxpayers, what is the excuse? Is the excuse the accounting issue?

Mr. CARROLL. One issue certainly is the accounting, especially for a large multinational corporation. But, the response there is the system is kind of designed to be complicated. So, in other words, they enter into agreements—

Senator MCCASKILL. Right.

Mr. CARROLL [continuing]. To buy things nationwide and that involves millions of dollars of payments, and then in order to get down to how many cases of Cheerios went to this school and how much rebates is that school entitled to, it is a complicated exercise, but that is the way the system, in the view of the investigation, is intentionally designed. In fact, one target I reviewed some accounting records for entered into an agreement with its offshore parent in order to further obscure rebate flow of where the revenues were going.

Senator MCCASKILL. And that could be this no value added addition of some company that is there just to be an excuse for a place to park the rebate?

Mr. CARROLL. That is right, and actually, the case that we settled yesterday involved a relatively smaller regional player and about \$800,000 in rebates, but we settled the claim for \$1.6 million based on the False Claims Act damages. They entered into what they called marketing agreements, as you mentioned, Senator, and we reviewed the marketing agreements and the so-called work product that they supposedly delivered in exchange for marketing services, and in the view of the investigation, at least, the so-called marketing services were illusory.

Senator MCCASKILL. So they called it marketing services, created a company and ran it through there in order to add some legitimacy to parking it.

Mr. CARROLL. They created a special department and—exactly, Senator, to disguise the—because if it was called “rebates,” obviously, it would have had to have been returned. But if it is called something else—

Senator MCCASKILL. Professor Tiefer, did the Public Warehousing Company case—are there rebates involved in all of the charges involving them? Is this all similar to what you indicated about S.L. and PWC, renaming the rebate an early payment bonus?

Mr. TIEFER. It comes down to a rebate. There were a variety of ways that they sort of squeezed a rebate out of the stream as it went past them. Another way which is more complicated is that out of their fee, the fee they get from the government, which is supposed to be all the things they do, including some processing and packaging and consolidating, they can do it themselves or they can pay a consolidator. That is supposed to come out of their fee. But instead, they found ways to throw—have the suppliers pay for that, add it to what the supplier was charging, and so the government—which is not supposed to pay for that, it is supposed to be a reduction in what they are making—ends up not being a reduction in what they are making. So it is a roundabout rebate.

Senator MCCASKILL. Right. Was the contract flawed in the PWC case? Was there a flaw in the way the contract was drafted? I

mean, if you could go back and look at the way—I mean, in so many of the wartime contracts, I do not need to tell you, we said to people, tell us what we need, write the contract, and tell us what we need to pay. It was all on the side of the contractor to do way too much of the scoping and the actual purview of the contract. Were the underlying contracts in the PWC case actually flawed?

Mr. TIEFER. They certainly need improvement. I will say this, because when I and a staff team, we talked to DLA, went to their center in Philadelphia and delved into it, they said, we are not set up to deal with a fraudulent prime vendor. Our assumption is we are dealing with people who are honest. And so there is a limit to how well you can—they were saying, you can deal with outright fraud, people who make false statements, who lie about what they are doing.

With that aside, yes, the contract is designed as a fixed-price contract which has the least visibility for the Federal Government. But because of the way that the charges get added together from two different streams, it is not as a practical matter fixed price.

Senator MCCASKILL. Right.

Mr. TIEFER. The supplier price can go up and down. Things can be hidden in it. Things can be subtracted from it. You can move the back door from it. So it is drafted without protecting the government.

Senator MCCASKILL. So it is called a fixed-price contract, but really, it is anything but.

Mr. TIEFER. I agree. Yes. That is the problem.

Senator MCCASKILL. I mean, and so the irony is that they are going to tout this fixed-price contract, oh, it is not cost plus, it is not cost plus, it is fixed price, but in reality, it is fixed price just masquerading when it is really cost plus.

Mr. TIEFER. Yes, and therein lies a big problem in changing things. As Mr. Carroll said, the industry out there will say that the industry practice is to do things by fixed price and we should not impose on them any contract but a fixed price. They will fight against visibility of their suppliers on behalf of the U.S. Government.

Senator MCCASKILL. Yes. Well, we are a big customer. We ought to have more leverage. You would think that we could bring these guys to their knees if we were tough negotiators, but I do not think we have been very tough negotiators, obviously, in light of the problems that we are hearing about on all of these contracts.

What kind of contract should we look to? If we were going to redo—let us just assume we could wipe the slate clean and we were actually going to exert the power that the Federal Government has, and we were going to say, this is the way we are going to contract to buy food. What input can the three of you give me as to how we would design that model?

Ms. FONG. In the School Lunch Program, as you mentioned, the complexity of the relationships between the parties is what really comes into play here. One of the issues that the Department faces is how can it regulate those kinds of contracts between a third party and a local school district, and I think where FNS has ended up, after consultations with OMB, is that the only way to really reach that is to mandate contract clauses that USDA can enforce

against the local school districts, not necessarily against the food management company. And so this is going to be a really interesting review that we do to see if those contract provisions are going to do the trick. Basically, those provisions would require the food service management companies to pass on all rebates and to specifically and transparently identify the rebates. A very interesting provision, and I think if it works, it will be a good model.

Senator MCCASKILL. Well, and we will be anxious to see, because, obviously, they are trying.

Ms. FONG. Right.

Senator MCCASKILL. So if it has worked, then that is the time that we need to migrate it over to Department of Defense and to other places in the Federal Government, because everybody is buying food.

Is this issue that they cannot account for the rebates—obviously, they are keeping track of this stuff internally, right? They are making up companies to park it. This sounds like an unladylike term that Harry Truman would use that has to do with farm animals and bulls. I have a hard time imagining, with the complexity of the accounting that has to be embraced by this kind of contract model, if this is the norm in the food service industry, that they could not easily pull the thread and tell us how much the rebates are that they are getting for these individual contracts within the Federal Government.

Mr. CARROLL. I can tell you, Senator, that is absolutely correct. In fact, a lot of decisions are made—for example, employees, food service company employees are evaluated on the basis of manager of school or manager of Marine base, how much of your purchases are compliant, and compliant means on a list of products that generate rebates. So the companies have very sophisticated systems to keep track of and collect rebates from vendors.

Senator MCCASKILL. So they are actually encouraging their folks to utilize those contracts that are most rebate-heavy internally and they are keeping track of it for purposes of judging how well their employees are doing at maximizing their profit?

Mr. CARROLL. Absolutely, Senator, and—

Senator MCCASKILL. Are they giving bonuses based on this? Do you know?

Mr. CARROLL. Well, the personnel evaluations that the Attorney General's Office reviewed showed that was a component in the form evaluating—

Senator MCCASKILL. That makes sense.

Mr. CARROLL [continuing]. So among other factors, I think, that it is fair to say that played a role in whether employees received bonuses or not. And we also did see e-mail traffic, for example, where one locale manager—because the way the business works is you take an employee of the food service company and they are installed in the school or on the base and—or in the hospital and they often wear the school's uniform, the facility's uniform, and there is e-mail traffic where, for example, one food service company employee was writing to headquarters saying, "I found a great source for locally grown tomatoes," and the response came back, "Don't do that. That is not where the best rebates are."

So to pick up on another issue that Professor Tiefer brought out, which is the game that seems to be being played is it is changing the name of the revenue flow. So, for example, in our most recent subpoena, the length of the definition of the word "rebate" is, I think, 250 words, because the name will change and then, for example, in the National School Lunch Program, it calls for rebates to be returned, but it does not necessarily say that contingent compensation has to be returned.

Senator MCCASKILL. Or marketing incentives.

Mr. CARROLL. Or marketing incentives or whatever the specific word is, so—

Senator MCCASKILL. Or you get a bigger bonus at Christmas if you buy more of this stuff.

Mr. CARROLL. Exactly, Senator. So the focus kind of as we have evolved and started asking smarter questions is, tell us about the revenue flow that is going in what seems to be the wrong direction. In other words, if I am buying cases of chicken, why is the chicken distributor sending me a check? So whatever you call it, you have to tell me what is that flow, how much cash is that.

Senator MCCASKILL. So on accounting, they can keep track of it if it is going to be their money. They just cannot keep track of it if it is going to be our money.

Mr. CARROLL. That is correct, Senator.

Senator MCCASKILL. And you brought up a point about the local tomatoes. One of the things we are struggling with in this country is how we hold on to independent producers of food in this country. We obviously have—my State, for example, we used to have 27,000 feeder pig operations in Missouri. It was the largest feeder pig operations in the country in my State. Now, I think we are down to about 7,000 or fewer, and that is all because they have been bought by or are doing contracts solely with the big guys.

So as I have gotten to know and understand the issue of independent producers versus the mega large multinational food corporations, it is with a sense of urgency that I realize we have to hold on to the ability of independent food producers to get a product to market.

Clearly, this system is not working in their favor, because they cannot afford—an independent producer cannot afford to pay a quarter on every box of tomatoes, whereas the big guys that are dealing with huge, huge volume can. So, I mean, the example you gave in that e-mail is a perfect example of how local independent farmers are being denied a market in their local schools because they cannot compete with the Ciscos of the world in terms of the rebate culture. Is that in any way an inaccurate summary of the problem?

Mr. CARROLL. I think that is absolutely right, Senator. You could have a situation where a grower has—or there could be a farm two blocks away from the school that is growing potatoes, but the food service company is not going to enter into rebate agreements with every little farmer and every little farmer does not have the wherewithal to engage in that kind of transaction.

So, for example, we saw one e-mail string where the local school manager was saying, we want to buy local apples. It is good for the business, it is the right thing to do, et cetera, but we do not have

a mechanism to collect rebates. Can we forego the rebate issue? And then, interestingly, what happens is the cost of the apples to buy them locally goes up so that the producers can pay the rebate.

Senator MCCASKILL. So what they do is they force a price increase on the local market so that they can take a piece of it?

Mr. CARROLL. I have seen an example, at least one specific example, of that.

Senator MCCASKILL. If Kirkwood High School said, there is a great nursery that has been in Missouri for years and years and has amazing peaches and amazing apples. If they said, we want to go out and buy from Eckert's or from these other nurseries, we want to go buy these, can they not do that? Can they just go directly and buy local products, or is it because they are tied to the contracts with these big mega in between companies? Do you guys know?

Mr. CARROLL. They are allowed to purchase locally and there are rules that permit—this is more a USDA issue than my area of expertise. They are certainly allowed to buy locally, but as I said, it is a choice for the food service company whether they buy locally. And just to give the full story, in fairness, what the food service companies will say is, well, it is much easier for us to police food safety issues, uniformity, make sure we are getting what we think we are paying for if it is all coming from one giant facility as opposed to if we buy locally from a thousand local farms, so that—

Senator MCCASKILL. Well, that may be true, but it seems to me that would have a lot more credibility if we took the rebate issue off the table.

Mr. CARROLL. I would agree, Senator.

Senator MCCASKILL. I mean, if, in fact, they were not getting the extra plus-up by going to the big guys, then we really would, pardon the expression, have an apples-to-apples comparison.

Mr. CARROLL. Very fair.

Senator MCCASKILL. Yes. OK. Yes.

Mr. TIEFER. If I can come in on that—

Senator MCCASKILL. Yes.

Mr. TIEFER. Although theoretically it is possible in the prime vendor program for the troops in Iraq and Afghanistan to buy from a particularly good supplier for whatever reason they think that is a good supplier, the actual situation is that there are contractors at both ends of the transaction. The dining facilities in Afghanistan are run by—it used to be KBR.

Senator MCCASKILL. Right.

Mr. TIEFER. Now it is DynCorps and Fluor.

Senator MCCASKILL. Right.

Mr. TIEFER. They may very well have a subcontractor who does the actual running of the dining facility and they just sort of coordinate at a higher level. So their subcontractor talks to PWC or the other food service, U.S. Food Service, Supreme Food Service, or wherever it is. At no point does the desire of U.S. Government people to do the right thing even come into the conversation.

Senator MCCASKILL. Right, because by the time it gets to where the rubber meets the road, it is two or three degrees removed.

Mr. TIEFER. Exactly, and it is quite probable that each of the two corporations at both ends of the transaction are pursuing their interests rather than anything else.

Senator MCCASKILL. Right. When you were referring to the indictment in your testimony and you talked about S.L., and whether it is Sara Lee or whether it is not. If you think about the environment in this country as it related to contracting in Iraq compared to the attitude in this country around contracting in World War II, I think my predecessor, Senator Truman, would have an awfully hard time getting his arms around how big this problem has become. I think in another year, another time, that company would have said, we refuse to change the name on this because it appears that maybe you are changing the name on it in order to profit more at the expense of men and women who are fighting for our country in a foreign land. I just do not think that would have been put up with then.

But now, because everyone is so removed from it and it has gotten so complex, they folded under the pressure from PWC and did that. I think all of the companies that are allowing themselves to be manipulated in order to plus-up these contractors should be ashamed of themselves, particularly in the context of Iraq and Afghanistan. I think it is really inexcusable.

Why do you think, Professor Tiefer, that we see so often that the government keeps doing business with these contractors? I mean, it is my understanding, correct me if I am wrong, that the government continued to do business with PWC as they had a lot of evidence in front of them about this fraud. Is that correct, or am I incorrect in those facts?

Mr. TIEFER. You are, unfortunately, quite correct. PWC not only had the giant Iraq food service product, it also was one of KBR's major subcontractors on some stuff for the logistics contract. So, yes, we had multiple flows of renewing contracts going out to them.

Senator MCCASKILL. And are we still doing business with them?

Mr. TIEFER. That is a good question.

Senator MCCASKILL. We will find out.

Mr. TIEFER. Let me say, when the indictment came down, this was one of the ones where at least—this has not happened in all cases—they were suspended and debarred from obtaining new contracts. So there certainly was a period of time they could not obtain new contracts, and I cannot tell you whether that period came to an end or not.

Senator MCCASKILL. OK. And that is extraordinary, because I cannot tell you how many times in this Subcommittee we have talked about the failure to suspend and debar.

We have talked about the fact that we believe the guidance is pretty clear now, Ms. Fong, about FNS. I am aware there is at least one legal case that is casting doubt on FNS's ability to regulate contracts through the School Lunch Program. Should we be concerned now that the regulations that are currently written are not enough to hold these contractors in check as this case is working its way through the court?

Ms. FONG. Right. If you are referring to the decision from Pennsylvania in 2009, we took a look at that and the rebates that were the subject of that case were rebates that had been paid between

1992 and 2002, which was under the prior regulatory framework—

Senator MCCASKILL. I see.

Ms. FONG [continuing]. Before FNS had the authority in place. Our sense is that with the current regulatory framework, there should be a way to go after these kinds of situations. But we are very happy to work with your staff to flesh out that issue a little more.

Senator MCCASKILL. OK.

Professor Tiefer, in your view, do the requirements outlined in Part 31 of the Federal Acquisition Regulations (FAR) apply to contracts executed under Part 12?

Mr. TIEFER. They do. I looked into this especially for this hearing. These are commercial contracts. That is why we asked whether Part 31 about payments applies to the Part, I think it is 12 that is for commercial, and there was a holding by the GAO. Extraordinarily, it was by PWC itself that protested to the GAO that said, we are a commercial company. This is a commercial contract. Requirements should not apply to us. That is getting in the way of the commercial way that rebates freely flow around. And the GAO stomped on that. It is part of a continuing stream of rulings that GAO gives about when—what concessions you have to make to commercial contracts and when you keep government safeguards, and this is one of the government safeguards that GAO wanted to keep.

Someone mentioned to me, though, that the GAO ruling is not the end, you can go to the Court of Federal Claims, and that issue is pending in the Court of Federal Claims, so there is still some ambiguity.

Senator MCCASKILL. Since there have been protests with GAO and we think those have been resolved appropriately, what, if anything, are things specifically that you all can bring to our attention today that you think we need to further investigate in this very murky area of rebates or marketing incentives, or extra juice for the or middleman, whatever you want to call it? What other investigations do you think we can be doing from this Subcommittee, or what legislative fixes could we do that would clarify contracting law as it relates to the ability of the Federal Government to enjoy the discounts they get because of the amount of volume they are purchasing?

Mr. TIEFER. If I can put one answer to that, I completely agree with Inspector General Fong earlier who said that identifying rebates, clearer clauses in the contracts to identify all manner of rebates, is necessary, and I thought that was a very healthy suggestion.

I would add that there need to be audit clauses, that we need to get the auditors in on this situation. Let me say, if someone says to me, why, that is ridiculous, of course, the auditor is already in on this, it is a fixed-price contract.

Senator MCCASKILL. Right.

Mr. TIEFER. There are very limited capacities for auditors to go in. If you try to put auditors in now, it is quite possible that the industry will challenge this and will say, look, the audit clause speaks of cost reimbursement contracts, time and materials con-

tracts, but it does not say fixed-price contracts, so the audit clause does not apply. And that applies in spades to the problem of looking at the suppliers, which is often necessary. Unless you have a flow-down clause in the main contract that says that the auditors can look at the suppliers, a Federal auditor shows up, says, who are you, which government are you with—

Senator MCCASKILL. Right.

Mr. TIEFER [continuing]. We never heard of you. The United States? Are you somewhere around here?

Senator MCCASKILL. Right. So that would be something that we could actually require. And, by the way, I know this is possible to do because in Medicare Part D, they actually specified that the government was not allowed to negotiate for volume discounts. If I can remember back to legislative construction in law school, which I am trying to live every day—I think that would mean that there is an assumption that the government can always negotiate for volume discounts unless they are prohibited from doing so by law, like they are in Medicare D. So it seems to me that this is something that we need to underline and put an exclamation point on.

Anything else from anyone about what we can be doing? Auditing clauses and identifying the rebates in the contracts. Are there other things that you think we need to be doing?

Mr. CARROLL. Well, if there was a mechanism, and I have no expertise whatsoever in legislative drafting, but if there was a mechanism to move the rebates up so that they appear on invoices.

Senator MCCASKILL. Transparency.

Mr. CARROLL. Transparency—

Senator MCCASKILL. On the invoice.

Mr. CARROLL. Right. And then it is hard to see how anybody could have any objection to regulating this, if the question is, we just want to know what is going on and then we are negotiating on fair territory.

And one other thing I wanted to pick up on what Professor Tiefer raised, and I think you also raised, Senator, is this issue of why are companies paying this. In some conversations with vendors, the sense is if we do not pay them, we do not get access to the markets, and food service companies like the large ones have enormous markets. So we may not like paying them, but we are going to get shut out if we do not. So I would think that you would have some constituency there. It would not be a completely one-sided battle. I think that there are a lot of entities who would like to eliminate this practice.

Senator MCCASKILL. So the vendors would probably be on our side?

Mr. CARROLL. I suspect.

Senator MCCASKILL. Yes. I bet you that is correct. And I know the local independent producers would be.

Mr. CARROLL. Absolutely, Senator.

Senator MCCASKILL. Right.

Ms. FONG. One issue that we would like to put on the table, as you mentioned, is suspension and debarment as a remedy. We have been trying to give some thought to that, as to whether suspension or debarment would be appropriate or available with respect to food service management companies. And the sense that we have

is that the Federal Acquisition Regulation, would not allow a procurement debarment for an FSMC because the FSMC is not a contractor with the Federal Government and so that is a big issue.

Then the other question is, is there any way—because the food—

Senator MCCASKILL. But we could fix that legislatively. We could say, if the flow of dollars are Federal dollars, then any agents that are hired to run programs that are funded through Federal dollars must be subject to Federal laws of suspension and debarment for failure to perform under the contract. I would think we could do that.

Ms. FONG. I think that would be worth exploring.

Senator MCCASKILL. We do an awful lot with putting handcuffs on everyone about what they can do and not do if it is Federal money. I cannot imagine that we could not do that. It seems like, to me, that is much more logical than a lot of the handcuffs we have out there right now. So, OK, that is a good suggestion.

Anything else? Inspector General Fong. Mr. Carroll. Professor Tiefer.

Mr. TIEFER. You talked about what investigations could be done. Now, you have a lot on your plate, Senator. You look at a whole wide array, and I do not know if I want to bog you down on this one, but I would think a survey of some of the contractors here, whether it is the suppliers or the main vendors—Mr. Carroll noted the wide range of discounts involved, the percentages involved, and it would be interesting to get some sense. They have to answer under oath if they are surveyed.

Senator MCCASKILL. That is exactly right.

Mr. TIEFER. Yes.

Senator MCCASKILL. I will tell you that the Subcommittee intends to submit document requests at the close of this hearing to agencies, to Federal agencies and companies with food service management contracts. We are going to try to get an accounting of the retention of rebates by the contractors and an understanding of the policies that are in place at the agencies that contract for food service management. We want to address through these document requests the potential issues in domestic contracting, such as that seen in the New York Schools contracts and the problems discussed by DLA. The investigation should also hopefully shed some light on service contracts in contingency operations, as demonstrated by the Agility case and the support for further oversight and transparency.

I cannot go into details, but I got second-and third-hand that there was actually a conversation that was had in Afghanistan not too long ago about a potential contract and someone mentioned that might not be a good idea because of the quote-unquote team, and my name was used. But my name should not be used because I think they were referring to the team of people who work on this Subcommittee who feel very strongly about really shedding the light on contracting abuses in the Federal Government and the amount of money that is being wasted as a result of those abuses.

And I want to take this hearing to congratulate the field of government auditors on the arrests that were made yesterday, the Inspector Generals that worked on that case involving the Army

Corps of Engineers, an Alaska Native Corporation, and the blatant and brazen fraud that was going on between government contracting officials and this company involving massive kickbacks and massive over-billings to the Army Corps of Engineers. That case came about because of people like you, and I know what you would do if you had the opportunity right now. You would point to your staff and the great work they do, because there are thousands of government auditors out there that deserve the respect and, frankly, the funding of this government because they are really doing the heavy lifting in this regard. So congratulations to all the government auditors involved in that case and the many others that do not get the attention they deserve.

We will continue down this road. If I could ask that you all continue to be cooperative with the staff on this investigation, we are going to keep going down this road because I think there is real money here. I think there are significant dollars that we can save in the purchase of food by the Federal Government if we pull this thread all the way to its logical conclusion and clean this area up once and for all and provide that transparency. It will allow everyone to figure out what they are paying for and whether they are getting the best deal.

And please convey to your boss, Mr. Carroll, that we appreciated his cooperation with allowing you to come here today. I have taken that train back and forth and it is easier sometimes than the shuttle. I do not know which you took, but I am glad you came here today to help us with this, and we will continue to call on you for the expertise you have developed in the cases you have worked on.

I thank all of you for what you have provided here today and we will continue to be in contact with you as we continue down this path to try to clean this up once and for all. Thank you all very much for today.

[Whereupon, at 3:03 p.m., the Subcommittee was adjourned.]



# A P P E N D I X

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## FOOD SERVICE MANAGEMENT CONTRACTS: ARE CONTRACTORS OVERCHARGING THE GOVERNMENT?

Senate Homeland Security and Governmental Affairs Ad Hoc Subcommittee on  
Contracting Oversight

October 5, 2011

Chairman Claire McCaskill

### Opening Statement

Today's hearing focuses on how the government buys food. Every day, the government provides meals to our soldiers at home and overseas, veterans, government employees, and to our children through the National School Lunch Program. Every year, billions of taxpayer dollars are paid to the food service contractors who supply the food for dining facilities on military bases, ships and on the battle field, as well as at government buildings, hospitals, and schools.

When food service contractors buy food for the government they get rebates from manufactures, suppliers, and vendors. In their simplest form, rebates often are based on volume purchases that contractors make from food manufacturers and distributors. For example, a contractor may order several cases of cereal from a food manufacturer, for which it will receive a rebate in the form of a discounted price or a cash payment from the manufacturer. In cost-reimbursable contracts, the contractor will then submit invoices for its food purchases to the contracting agency. The problem is that the invoice price may not include the rebates received from the manufacturer or distributor, so that the agency then pays the full amount of the invoice and the contractor pockets the difference. When contractors buy food with the taxpayers' money, they shouldn't get to keep the change.

Recently, reports of fraud and other abuses on food service contracts have snowballed. Last July, the New York Attorney General's Office announced a \$20 million settlement with Sodexo, one of the largest food service management contractors in the world, regarding allegations that the company failed to pass along rebates it had received through its contracts with the New York public schools participating in the national school lunch program.

In September 2010, the Department of Justice announced a \$30 million settlement with U.S. Foodservice, another major contractor, based on allegations that it had overcharged the government by inflating food prices on contracts with the Defense Department and the Veterans Administration.

The Department of Justice also has a major case pending against Public Warehousing Company, now known as Agility, based in part on allegations that PWC submitted false information, manipulated prices, and overcharged the government for food and related services under its contract to supply food to the military in Iraq.

This June, the Department of Agriculture's Inspector General announced that it would be conducting its third audit of food service management contracts in the last decade. Both of its previous audits, conducted in 2002 and 2005, found serious problems with companies overcharging schools by withholding rebates.

The message that these reports and investigations send is clear: we're not doing enough to ensure that the government isn't getting cheated.

With increased scrutiny of rebate withholding, contractors have turned to new practices in order to avoid passing rebates on to the government or to pad their profits. One such method is to simply call the rebate another name, such as “marketing incentives” or “vendor consideration.”

What’s more, it seems obvious that the problem is even more widespread. For example, some companies have said that their accounting practices prevent them from accounting for the rebates owed to individual clients. And even if the company is giving the government the rebates that may be attributable for the individual contract, there is no way for the government to recoup the overall rebates that may be attributable to discounts based on purchases made by an entire federal agency or the federal government overall.

We’re here today to learn from some of the nation’s experts on this issue how contractors can manipulate their prices and invoices. We will discuss barriers to effective oversight of these contracts, including the complexity of the contractors’ relationships with their vendors and suppliers and the ambiguities in federal regulations relating to rebates. We will also discuss whether the practices that they have seen are exceptions or part of a pattern of fraud on these types of contracts across the federal government.

In this time of belt-tightening, we need to be more careful than ever to ensure that taxpayer dollars aren’t being wasted – particularly because every dollar that is lost through rebate schemes is a dollar we cannot use to feed our soldiers and children.

I thank the witnesses for being here today and I look forward to their testimony.

UNITED STATES DEPARTMENT OF AGRICULTURE  
OFFICE OF INSPECTOR GENERAL

STATEMENT OF THE HONORABLE PHYLLIS K. FONG  
INSPECTOR GENERAL

Before the  
Subcommittee on Contracting Oversight  
Senate Homeland Security and Governmental Affairs Committee

October 5, 2011



Good afternoon, Chairman McCaskill, Ranking Member Portman, and Members of the Subcommittee. Thank you for the opportunity to testify about the Office of Inspector General's (OIG) work to help improve the Food and Nutrition Service's (FNS) oversight of State agencies and local school food authorities (SFAs) that contract with food service management companies to provide meals for the National School Lunch Program (NSLP) and the School Breakfast Program.<sup>1</sup> As both our audit and investigative work demonstrate, USDA and its agencies must remain vigilant in their oversight of companies that provide food to the public under the auspices of Federal programs.

I will begin my testimony with a brief summary of OIG's mission and the work we do. Then, I will outline how FNS administers NSLP before discussing our completed and planned work in support of enhancing FNS' oversight of food service management companies.

#### **OIG's Mission**

OIG's mission is to promote the economy, efficiency, and effectiveness of USDA programs and operations by performing audits and investigations to reduce fraud, waste, and abuse. The Inspector General (IG) Act of 1978 established a dual reporting responsibility, whereby IGs report both to the head of their respective agencies and to Congress.<sup>2</sup> This unique reporting relationship protects OIGs' independence and objectivity as we conduct our oversight responsibilities.

USDA OIG conducts audits designed to ascertain if a program is functioning as intended, if program payments are reaching those they are intended to reach, and if funds are achieving their

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<sup>1</sup> For simplicity and for the purposes of this statement, references to "NSLP" will generally include the School Breakfast Program.

<sup>2</sup> 5 U.S.C. app. 3, §§ 1-13.

intended purpose. When we find problems with the programs we assess, we make recommendations we believe will help the agency better fulfill its mission. We do not have programmatic or operating authority over agencies or programs; instead, agencies are responsible for implementing our recommended corrective actions. We also conduct investigations of individuals and entities that are suspected of abusing USDA programs—these investigations can result in fines and imprisonment for those convicted of wrongdoing in addition to agency disciplinary actions for USDA employees found to have engaged in misconduct.

#### **NSLP Overview**

FNS uses a multi-layered approach to reimburse States that provide meals to children under NSLP. Typically, FNS enters into written agreements with State agencies, such as education departments, to administer NSLP. These agencies, in turn, enter into agreements with SFAs to deliver the program at the local level, such as at schools within a district. SFAs can either manage the program themselves—buying and serving food—or they can contract with food service management companies to provide meals. Federal funds flow from FNS to State agencies, which reimburse SFAs based on the number of meals claimed. OIG does not provide day-to-day oversight of FNS, State agency, SFA, or food service management company interactions or administration of NSLP. Instead, to ensure program compliance, each NSLP administrative level maintains oversight of the next.

In general, USDA regulations require food service management companies to pass savings and applicable credits along to the SFAs with which they contract. These contracts can either be fixed-rate or cost-reimbursable. In a fixed-rate contract, a management company charges a flat rate for the meals served and must credit the SFA for the full value of any food USDA has

donated.<sup>3</sup> In a cost-reimbursable contract, a management company purchases and serves food for an SFA and must submit invoices for payment; in this case, the company must pass along any purchase discounts and rebates it receives.<sup>4</sup> Regardless of the type of contract, an SFA's share of Federal funds is based on the number of meals claimed.

In fiscal year 2010, approximately 43 million children participated in NSLP and the School Breakfast Program, which together served an estimated 7.2 billion meals in 14,000 school districts, with disbursements totaling approximately \$12.5 billion in Federal funds.

#### **Related OIG Audits**

In 2002, OIG completed an audit of 8 food service management companies contracting with 65 SFAs in 7 States.<sup>5</sup> We determined that over half of the companies (5 of 8) improperly retained \$6 million in cost savings that should have been passed on to the SFAs with which they contracted. Management companies with fixed-rate contracts received a total of \$5.8 million in USDA-donated food but did not credit this amount to their SFAs. This occurred both because FNS requirements for companies crediting SFAs with the value of donated food were not clear, and because some companies revised their contracts to retain savings that should have accrued to the SFAs with which they contracted. The remaining \$280,000 involved management companies with cost-reimbursable contracts. Although the bid solicitations for the food service work (i.e., requests for proposal) required that rebates, credits, and discounts be passed along to

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<sup>3</sup> 7 C.F.R. § 210.16(a)(6).

<sup>4</sup> 7 C.F.R. § 210.21(f)(1)(i).

<sup>5</sup> The States were Illinois, Michigan, Missouri, New Jersey, New Mexico, South Carolina, and Washington. We selected six of the States because they had either the highest number of food service management company contracts, or the highest percentage of SFAs using such companies. We reviewed the seventh State (Illinois) as part of a joint effort between our audit and investigation groups. *Food and Nutrition Service National School Lunch Program, Food Service Management Companies* (27601-0027-CH, April 2002).

the SFAs, the companies that won the bids either modified their contracts to amend or eliminate the requirement, or they ignored it.

In 2005, we followed up with an audit of one of the management companies that had cost-reimbursable contracts with 298 SFAs in 22 States.<sup>6</sup> We found the company had violated its contracts with 106 of the SFAs in 8 States by not crediting them with varying amounts of discounts, rebates, and other cost savings it had received, totaling \$1.3 million.<sup>7</sup> The eight State agencies did not enforce the contracts and company officials claimed that keeping these savings allowed them to lower overall prices. However, when we compared its prices to another food service management company's (which had also bid for the contracts), we found that it charged significantly more for 29 of 35 identical items we reviewed. Even though the company kept its cost savings, it still charged SFAs more for food than the other company would have.

Overall, our 2002 and 2005 audits recommended that FNS should establish specific contract terms for State agencies and SFAs to use when contracting with food service management companies. The terms would ensure that SFAs benefited from the value of food donated by USDA (in fixed-rate contracts) and any discounts or rebates that companies received (in cost-reimbursable contracts). We also recommended that FNS amend its regulations and guidance to require these specific contract terms, that State agencies approve contracts prior to their SFAs signing them, and that State agencies require SFAs to enforce contract provisions. In 2007, FNS

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<sup>6</sup> The States were Arizona, California, Connecticut, Florida, Idaho, Kansas, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Washington, and Wisconsin. We selected them because the company's contracts with SFAs in these States provided for discounts and other savings to accrue to the company. *Food and Nutrition Service National School Lunch Program Cost-Reimbursable Contracts with a Food Service Management Company* (27601-15-KC, December 2005).

<sup>7</sup> The States were Arizona, Connecticut, Michigan, Minnesota, Missouri, Rhode Island, South Carolina, and Washington.

revised its regulations accordingly and, in 2009, FNS issued updated guidance to State agencies and SFAs.

However, the issue of food service management companies improperly retaining savings that should be passed on to SFAs continues to be a concern. In July 2010, after an investigation by the State of New York's Attorney General, a company agreed to a \$20 million settlement to resolve a lawsuit after it fraudulently retained discounts and rebates. The settlement prompted a Member of the United States House of Representatives to request of the Secretary of Agriculture that an audit be conducted to determine if this practice was happening in other school districts nationwide.

Accordingly, OIG is initiating an audit this month (October 2011) to assess the effectiveness of corrective actions implemented by FNS and State agencies in response to our previous recommendations. We will also determine if food service management companies with cost-reimbursable contracts are passing discounts and savings along to SFAs. We plan to examine a sample of SFAs' cost-reimbursable contracts with food service management companies nationwide for fiscal years 2010 and 2011.

#### **Related OIG Investigations**

OIG investigations have demonstrated that the issue of food service management companies' business practices extends beyond the practice of keeping savings owed to SFAs. For example, in 2003, one of our investigations showed that a food service management company in Greenwich, Connecticut, overcharged school districts and other customers over \$8 million for costs it never incurred. The company admitted that it had inflated invoices and made false claims to the Government. In December 2008, in the U.S. District Court for the Southern

District of New York, the company agreed to pay over \$3.5 million to the Government and to reimburse the school district nearly \$8.5 million.

Other types of food companies, such as suppliers, have also been subject to our investigations for conspiring to sell or transport food illegally. For example, our investigations helped disclose that the owner and employees of a food company in Houston, Texas, forged export certificates to send food past its expiration date to Middle Eastern companies, including some that supplied U.S. troops.<sup>8</sup> The owner was charged with conspiracy to defraud the Government through false claims. In November 2010, the company and its owner entered into a settlement agreement with the U.S. Attorney's Office for \$15 million. In December 2010, the Federal Court for the Southern District of Texas sentenced the company's owner to serve 2 years in jail and to pay a \$100,000 fine. In April 2010, a former purchasing agent for the company was sentenced to serve 3 years' probation and to pay, with the owner, over \$2 million in restitution.

### **Conclusion**

In summary, OIG's audit and investigative work has sought to enhance FNS oversight of food companies participating in NSLP, and to help ensure that Federal funds intended to provide nutritious meals are used for that purpose. OIG is committed to strengthening USDA and its agencies' controls over such companies in order to better safeguard both Federal funds and NSLP objectives.

This concludes my testimony. Thank you again for inviting me to testify before the Subcommittee, and I would be pleased to address any questions you may have.

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<sup>8</sup> International health certificates for exported food and plant products originating from the United States are issued by USDA's Animal and Plant Health Inspection Service (APHIS) and must be completed by accredited veterinarians. The export certificates help APHIS facilitate safe trade; monitor the movement of risk material; protect against the introduction of pests and disease; regulate the import and export of plant and animal products; and provide exporters with an understanding of import countries' requirements.



OCTOBER 5, 2011 TESTIMONY BY ASSISTANT ATTORNEY  
GENERAL JOHN F. CARROLL, STATE OF NEW YORK, BEFORE THE  
UNITED STATES SENATE, COMMITTEE ON HOMELAND SECURITY  
AND GOVERNMENT AFFAIRS, SUBCOMMITTEE ON CONTRACTING  
OVERSIGHT.

Chairman McCaskill, Senator Portman, distinguished Senators, New York Attorney General Eric T. Schneiderman extends his greetings and gratitude to the Committee for taking testimony on a topic of importance to the People of the State of New York, and indeed, the United States.

My Name is John Carroll, and I am an Assistant Attorney General in New York. I am the Deputy Chief of General Schneiderman's Taxpayer Protection Bureau, which investigates and prosecutes allegations of fraud and waste harming the state and local governments in New York. One of our primary tools is the New York's False Claims Act, which is modeled after the federal law of the same name.

Many American children only get one nutritious meal per day - that one nutritious meal is the one that they receive at school because of the National School Lunch Program. We all can theorize about why, in the richest most fertile country in the world this is so, but a fact it is.

For some children, the only daily evidence they have to believe that there are individuals in the greater world who care for them is the meal they receive via the National School Lunch Program. I am not a religious person, but I believe the NSLP exemplifies the scripture's direction that we should not love merely in word or talk, but rather in deed.

I was asked to tell you about Attorney General Schneiderman's ongoing investigation of the food service industry, and New York's \$20 million settlement with Sodexo, a multinational food service company with numerous government contracts in the United States. So I will tell you about the investigation, and the law it was brought under, the False Claims Act.

Food wholesalers make certain payments to food service companies which buy food and other materials on behalf of school clients. These payments are called many things, including rebates and tellingly, off-invoice rebates.

Rebating, by any reasonable view, is an intentionally opaque practice. It is a practice intended to obscure the actual costs incurred by food service companies, and also to obscure the relationship between food service companies and food distributors and vendors. Having said that, in an unguarded moment, I think every market participant would say that they would like to see rebating removed from the business, if it could only be done completely and effectively.

Now I have mentioned Sodexo, and of course Sodexo is the company that is at the center of the July 2010 settlement with the New York Attorney General's Office. Sodexo fully cooperated with my investigation in myriad ways. I think they worked hard to respond to my concerns, both during

the investigation, and as part of our agreement to resolve the investigation. Nothing here should be construed as criticism of Sodexo in particular, or any other market participants. Rather I hope that my remarks will be seen as my observations of an industry-wide practice - rebating, or as I said it was also known, off-invoice rebating. This practice is engaged in by most if not all members of this industry in all of its different segments, including the food service companies, the distributors like SYSCO and US Foods, and food vendors including General Mills, Tyson, and Coca Cola.

It is only fair to Sodexo to say that other members of this industry are cooperating in my ongoing investigation. Yesterday, I settled claims against a regional food service company on similar rebate-related claims for \$1.6 million. We are continuing to investigate other industry players as well. You may also be interested in learning that officials from numerous other states have been in contact with the Office of the New York Attorney General about this investigation, especially given the extraordinary financial pressure all of the States are under right now, and the increased concerns regarding child nutrition.

So my remarks are certainly not intended as a critique of any specific member of this industry. At the end of the day, my lasting impression of all of the participants in this business is that most all are trying to do the right thing in an extremely competitive and difficult business.

As I said, I will be speaking about three topics: rebates, the settlement New York reached with Sodexo last July concerning rebate payments; and the basis for that lawsuit, a law called the False Claims Act. Sodexo is one of the largest food service companies in the world and like most of the

food service companies, it enters into volume purchasing arrangements with manufacturers, suppliers and distributors in connection with their many different clients and customers. By entering into such arrangements, food service management companies can typically purchase products on better terms than those terms which are available to any single customer.

Volume discount arrangements with food providers also generally contain a mechanism whereby food service companies receive rebate payments for their purchases on behalf of government clients. So for example, when Sodexo or any other food service company buys food on behalf of a school from a food vendor like a General Mills or a Tyson Chicken, food service companies have pre-existing agreements with the food vendors whereby vendors pay what is called the off-invoice rebate.

Why "off-invoice" rebates? Because the invoice accompanying the goods delivered to the school or other government agency does not show the rebate discount amount, unlike the receipt from when one goes to the grocery store or any other typical purchase. The rebate transaction takes place "behind-the-scenes."

My research suggests that rebates were not a significant revenue source or economic factor prior to 2000. However, from 2002 onward, earnings from rebates have become an increasingly important revenue source for food service companies. Rebates are now an important element to the food service business model. This fact, in my opinion, is not readily apparent in their publically available financial statements. The large food service companies earn hundreds of millions of dollars in rebates across all business lines.

The significance of rebate earnings to the food service business is magnified by an important economic factor: the cost of earning a rebate dollar is relatively low, as compared to the cost of earning dollars in food service in general, which is a highly labor and materials intensive business. This may explain why food service companies have such a voracious appetite for rebate revenues.

Food service companies defend off-invoice rebates by saying that rebates are beneficial because rebates (1) increase the profit margin on an account, making it supposedly cheaper for the government, and (2) rebating provides other benefits, among which they say that these volume purchasing arrangements help to ensure quality, safety, uniformity and availability, which in turn, in the K-12 market, also helps them meet health, wellness and nutrition standards at the local, state and federal levels.

It would appear that all of these benefits purported to be obtained through rebating, could just as easily be obtained through up-front price discounts but in a transparent manner which would help customers like the United States and New York to protect themselves from conflicts of interest.

On the micro level, based on my review of contracts between food sellers and food service companies, the amounts of rebates varies widely depending on the type of product. Some products trigger rebate payments of less than 5% and other products earn rebates of more than 50% of purchase cost for individual items purchased. Looking at the accounts of specific schools and school districts in New York State, the total rebate earnings on particular K-12 School food accounts seems to fall between ten

and fifteen percent of the cost of the food purchased for the school during the year.

USDA rules, and New York's rules, which are likely the same in all states, say that the school must retain supervisory control over the food service. In my opinion, and based on my personal observation, this is not in fact what happens. But you should know that historically, most school officials had little or no information about these rebate payments to food service companies or that they were retained by the food service companies. When a food service company manages the food service at a particular client school or other government facility, the food service company generally takes over the kitchen, buying all of the food, preparing it and serving it. Government facilities and schools with limited resources and knowledge have a difficult time keeping up as it is, and they see the purpose of hiring a food service as a way to increase the ability of officials to apply time and resources elsewhere.

As one school official told me, he does not, and cannot stand on the loading dock at dawn to observe that the right milk is unloaded, and that he is being charged correctly. This is a task he pays for the food service to do. This a task that he trusts the food service to do appropriately.

One of the ways food service companies seek to maximize rebate earnings, is to restrict the number of sources local site managers, the food service employee working in the school, can use to buy foods. Food service companies endeavor to create lists of the companies which site managers buy from, and site managers are evaluated based on compliance, that is, the degree they adhere to purchasing from the company's list of vendors.

I do not think it will surprise you to know that by and large, all vendors on food service company's list of approved vendors pay rebates, and the vendors which do not pay rebates rarely appear on the lists of approved vendors. Food service company site managers - the food service company employee managing a particular location - are strongly discouraged from making purchases from non rebate paying vendors. My investigation determined that some food service employees are evaluated and compensated based in part on the amount of "compliant" purchases such employees make for a particular account-that is, from vendors which pay rebates.

I believe that this places local and smaller scale food producers, including local farmers and others, at a disadvantage. Such food producers are less likely to have the profit margins or wherewithal to enter into rebate agreements with food service companies, and even when they can give rebates, food service companies prefer to enter into one-stop-shopping arrangements with large national vendors since such agreements are easier to police across all business segments. Food service companies prefer to collect rebates from ten food vendors - not 100.

In other words, to the extent some food item, for example chicken, can be purchased from one source, instead of from myriad local sources, this is more desirable for the food service company which will thereby maximize a rebate payment. I say this, knowing of course, that buying from fewer sources may have other desirable consequences, for example, it also helps the food service company to control the quality of the delivered product.

The government may and does have other interests though, including the value of business cultivation of smaller, regional, or local food producers,

which may yield lower energy costs, higher employment rates, and a less vulnerable food supply based on decentralization.

In fact in one instance I observed that a local produce wholesaler increase the prices it charged to the school district for fresh produce, including locally grown produce, so that it could pay the food service company a rebate. In that same market I also observed that the local site manager found it difficult to meet buy local requirements and still comply with the food service company requirement that the vendor pay rebates.

So for example, the local site manager wanted to try to buy apples from a local grower directly, but felt pressure not to do so, because the local apple grower could not pay rebates on par with what the food service company expected based on expectations from larger food vendors.

Contracts between food service companies and government entities, including schools, fall broadly into two categories: management fee contracts, and fixed cost contracts. In fixed cost contracts, the food service company agrees to deliver school meals at a fixed cost per meal, whatever the actual cost might be to deliver the meal. Where food service companies have fixed cost arrangements with their school clients, one might say that rebates are irrelevant in such contracts.

However, I have observed food service business proposals to schools and other clients, the RFP responses, where the food service represents the costs of providing the food service, and in my opinion, bidders do not clearly state whether the cost representation in an rfp response reflects the rebate the food service is receiving for the goods used to put food on the table.

So, in other words, food service companies will submit a proposal to serve a school meal for \$3.00, stating in the proposal that the cost to the food service company for material to produce the meal will be \$2.50, but not disclose that the actual cost for the food service company to produce the meal after taking into account rebates, might be 10 to 15 percent lower, that is, closer to \$2.15.

In my view, in addition to the school having incomplete information from which to decide if the food service company is earning an appropriate fee, there is a more serious problem with this incomplete disclosure of food cost.

It also means that children, and the soldiers serving the United States, will receive .35 cents in a meal less worth of nutritional value than we might believe we are paying for, a significant number in a meal which costs less than \$3.00.

And generally, as in this context, I believe that rebates have the tendency to muddy the waters as to the true nutritional value which is being delivered to children. While not universally true, the higher the value of the foods going into the meal, for example fresh vs. processed in some way, the more likely it is that the meal recipient is receiving good nutrition.

So, in my opinion, to the extent that it is difficult to determine or there is obscurity as to the true value of the food going into the final meal, the more difficult it will be to be certain that school children or our soldiers in the field are getting a healthy meal that they will actually want to eat.

The second type of contract between food service companies and schools is known as the management fee contract, also known as cost-plus contracts. Cost plus arrangements more clearly implicate rebates. Under a cost plus arrangement, food service companies agree to charge the school a management fee only and then bill the school, supposedly, for the actual cost of the food used to prepare the meals.

However, historically, food cost reports did not report discounts and rebates to the schools, and the food service companies routinely kept the rebates which were being paid by food sellers. In other words, the schools bought the food, and the food service companies kept the discount payments from the food sellers.

In fact, there was generally nothing unlawful about the practice of food service companies retaining rebates and discounts, prior to November 2007 because United States Department of Agriculture rules and regulations did not require that discounts and rebates be credited against the costs to be paid out of a school district's non-profit school food service account.

Rather, USDA rules and regulations provided participating school districts with the discretion to decide, as a matter of contract, whether the discounts and rebates received by food service management companies would be credited to the school district or retained by the food service management company as part of the financial terms and conditions of their cost reimbursable contract.

Until the fall of 2007, the USDA allowed school districts and food service management companies around the country to determine whether

and how to address the treatment of discounts and rebates in their contracts. While USDA encouraged school districts to require the return of all discounts, rebates and other applicable credits in their cost reimbursable contracts with food service management companies, it did not require school districts to do so. Instead, school districts were free to choose to allow food service management companies to retain some or all of any discounts or rebates as part of the financial terms and conditions of their agreements.

My investigation, however, has concluded, and I believe that the USDA also ultimately concluded, that the pre-2007 treatment of rebates rested on a faulty assumption-that the intentionally opaque rebating practice could be deciphered by government actors, even though there was no way school officials could independently determine what was going on behind the scenes between food vendors and food service companies.

This changed in October 2007, when USDA promulgated the Discounts and Rebates Final Rule which required cost reimbursable contracts between participating school districts and food service management companies to include provisions requiring all discounts, rebates and other applicable credits to be credited against the costs to be paid out of a school district's non-profit school food service account.

And that is the rule as it stands today all around the country: Food Service Companies are required to credit K-12 schools with cost reimburseable contracts for all rebates and discounts earned in connection with food purchases.

New York took a different approach, and I think it provides a useful starting point for remediation of this issue. New York, in this, like it does in many things, charted its own course. Since at least 2003, New York has required food service companies to return rebates to schools. In the State of New York, the solicitation and contracting process between schools participating in the National School Lunch Program and food service management companies is controlled by the New York State Education Department.

Each year, New York's Education Department issues a prototype solicitation and contract for new solicitations for food service management services. All school districts participating in the National School Lunch Program in the State of New York are required to use the prototype solicitation and contract issued by NYSED in order to procure the services of a food service management company. The prototype solicitation and contract contains the specific terms and conditions that govern any new solicitations and contracts between New York public school districts and food service management companies.

Since at least 2003, all contracts between food service companies and New York participants in the National School Lunch program have been required to contain a clause stating that, I quote,

The [food service management company] shall receive for its services a reasonable fixed fee. Any prompt payment discounts rebates obtained from local vendors or through national or regional purchasing arrangements will be retained by the [school district]. Allowable charges to the [school district] must be net of all credits, discounts, and rebates. The [school district] must not be charged by the [food service management company] for costs that have been reduced by credits, discounts and - rebates. The [school district] must benefit from all credits, discounts and rebates including those obtained by the [food service management company]. Monthly

operating statements must clearly show these amounts.

New York was a bit ahead of the rest of the country, and this is what has placed New York and the food service industry in a slightly different posture than the rest of the country on this issue.

Now, how did this matter come to the attention of the New York Attorney General? Through a law known as the False Claims Act. The federal False Claims Act was a law originally initiated by Abraham Lincoln during the Civil War. The False Claims Act gives the government a mechanism to sue its contractors for intentional contract breaches. But because the government is not especially good at protecting itself, what the law does is say, we the government have too much going on to really make sure everyone is abiding by all of the terms of the millions of agreements we make with businesses. So in those instances where we catch you violating an agreement, you will suffer serious consequences.

Damages are trebled, and every false claim, basically every invoice the contractor submits to the government for payment for work that was intentionally or recklessly not performed in accordance with the contract, will be subject to a penalty.

The False Claims Act gives the government the right to sue for contract breaches, but on steroids, and it also does something else unusual: it allows private citizens to file lawsuits in the name of the government. These citizens are known as Relators.

So I am speaking about the False Claims Act for two reasons: The First is that as an investigator and enforcement attorney, I want as many people to know about the benefit of becoming a whistleblower, because whistleblowers are capable of being a fist-line of defense against government fraud.

The second reason I am speaking about the False Claims Act is that I want anyone doing business with the government who is considering whether to play a little fast and loose to know there is a very serious, and very expensive consequence to taking advantage of the government.

How was the Sodexo matter resolved? As I said, the total settlement was for \$20 million. A fair amount of horse trading went into that number, but the vast majority of the dollars paid did not have to do with Sodexo's K-12 business, it had to do with issues across a spectrum of New York government contracts, all of which had to do with rebating issues.

In addition to the monetary settlement Sodexo also voluntarily agreed to take a number of remedial steps. The first was a very complete independent examination of the systems whereby Sodexo tabulated the rebate dollars which it owed to K-12 schools. That independent examination undertaken at Sodexo's expense, that is, in addition to the \$20 million settlement figure, revealed that by and large, Sodexo did a reasonable job of keeping track of rebate dollars and making sure that dollars owed to New York schools went back to the schools. Sodexo also sent a disclosure letter to New York K-12 clients describing rebates and New York's requirements. And Sodexo also set up an 800 number for clients to call with questions concerning rebates.

The last thing I want to tell you is why I think rebates are fundamentally bad business. First, even though rebates now are required to go back to schools, the process of counting the rebates and allocating will inevitably be imperfect and the entire process is wasteful.

Second, in my opinion, rebates create an inherent conflict of interest. Decision makers are likely to make food choices based on maximizing rebate income rather than more important factors.

So, if anyone has any questions now or later I am happy to make myself available and to conclude, my wife Jean, my son Jackson and I all thank you for taking the time away from all of your own families to come to Washington for all of the important work of the Senate, and especially on behalf of the children of the United States.



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TESTIMONY BEFORE  
 THE SENATE SUBCOMMITTEE ON CONTRACTING OVERSIGHT

by Professor Charles Tiefer

THE PRIME VENDOR PROGRAM  
 FOR DoD PURCHASE OF FOODS  
 HAS SEVERE CONTRACTOR CHEATING  
 WHICH WARRANTS OVERSIGHT AND REFORM

Thank you for the opportunity to testify today on the subject of improper food service contracting with the United States government for our forces in Iraq and Afghanistan. I am Professor of Law at the University of Baltimore Law School since 1995, and the author of a casebook on federal government contracting.<sup>1</sup> In 2008-2011, I have been a Commissioner on the statutorily chartered, federal Commission on Wartime Contracting in Iraq and Afghanistan, which held twenty-five hearings on problems in government contracting. I note that the chair, Senator Claire McCaskill, was a key sponsor of the legislation creating the Commission. My Commission could never have performed its work of looking into waste, fraud, and abuse in contracting without her absolutely crucial support and leadership.

For the Defense Department operations in the war zone – including soldiers, civilians, and contracting personnel – the government purchases the necessary food to be served at dining facilities and the like by its “Prime Vendor” contracts, managed by the Defense Logistics Agency (DLA). In recent years, the prime vendor contracts have drawn attention because of massive criminal and civil fraud cases filed by the Justice

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<sup>1</sup> GOVERNMENT CONTRACT LAW: CASES AND MATERIALS (Carolina Academic Press 2d edition 2004)(co-authored with William A. Shook).

Department against the Prime Vendor for the Iraq foodservices contract, Public Warehousing Company (PWC) (which has renamed itself Agility).<sup>2</sup>

As the professor of government contracting law on the Commission, and one of its only two lawyers, issues like fraud in the foodservice contract attracted my special interest and attention. As Commissioner, I delved with our staff into these issues. The staff team on logistics, with which I worked closely, led by the highly able Steven Sternlieb, took a full-scale review trip to the Philadelphia office that handles the prime vendor food purchase program. I myself went to Ft. Belvoir for a full-day briefing by the top levels of Defense Logistics Agency, including talking to the head of DLA, Nancy Heimbaugh. DLA provided a length and very concrete in-house report by its Operational Evaluation Team on its current improvement efforts. I raised DLA-related questions at several Commission hearings.<sup>3</sup>

#### 1. Scale of the Improper Charging

At the heart of these cases is cheating of the government by PWC not passing along discounts from suppliers, and similar schemes involving manipulations of costs from suppliers. The scale of these improper discount schemes is breathtaking. PWC earned \$8.5 billion in revenue from the Iraq supply contracts. Press accounts in the Washington Post and the Atlanta Constitution-Journal say PWC discussed a settlement with the Justice Department of these cases for \$500 to \$600 million. Lawyers familiar with the negotiations said that a settlement agreement, if reached, would be \$750 million.

Parenthetically, that does not in the least take away from the great significance of the testimony today about the school meals. The Commission's job was review.<sup>4</sup> The NY testimony involves hands-on experience the Commission did not have, and I myself am learning a great deal from it. What I can say complements the school meals testimony, while fully recognizing its importance.

Trial has not yet occurred for the PWC fraud cases because of lengthy pretrial proceedings in the case, and so the best source of information about the case continues to be the Justice Department's detailed criminal indictment of PWC. The indictment's statements, and the prior investigation leading to it, have been used both by DLA and by the GAO to develop and uphold precautions for the program. So, while what I say about the indictment should be regarded as "alleged" and not proven for purposes of the criminal case itself, those statements are relevant, and, they can and should be used for considering both the need, and the methods, to prevent fraud in this context. Parenthetically, the fraud was first exposed by a whistleblower lawsuit by Kamal Mustafa al-Sultan— a qui tam lawsuit pursuant to the False Claims Act. The Justice Department found merit in the suit and announced the United States joined the civil suit at the same time it announced the indictment.

#### Basic Example

<sup>2</sup> The contracts covered Iraq, Kuwait, and two other countries, but the bulk of the food was for Iraq.

<sup>3</sup> DLA had other problems in this period, such as with fuel and with the foodservice contract in Afghanistan. So, my briefings and Commission hearing questions included a focus on those other problems.

<sup>4</sup> The Commission did not go into PWC's records, did not sue, did not have negotiation with the vendor, and did not implement remedies.

To understand the problem discussed in the Justice Department's indictment,<sup>5</sup> we focus on the series of contracts in 2002-2005 that went to Public Warehousing Company, later called Agility, for total payment of about \$8.5 billion. Suppliers – like producers of prepared foods – charged their supplier rates --“Delivered Price” -- which PWC passed along to the government, adding on its own “Distribution Fee.” The contract used the pricing formula: “Delivered Price” plus fixed “Distribution Fee” = Unit Price (per unit of product). For supplies bought in the United States, the Delivered Price consisted of the supplier's charge plus transport costs (unless the U.S. handled transportation) to the place in the United States, called the “place of performance,” where the government took over the food product to get it to Iraq.

A great deal of the food, ranging from meat and chicken products to desserts, is produced here in the United States. These are supplied (for the most part) by United States suppliers here in the United States. And, this United States food was delivered to, and received by, delivery points here in the United States. This is important because it means the problems were with the United States food supplying industry that supplies food to government buyers. The same type of United States suppliers who provide prepared food to schools here would provide prepared food to the distribution points in the Justice Department indictment. To me it seems quite obvious that the same types of vulnerabilities to fraud shown in the indictment are the vulnerabilities to fraud shown in the school meals case.<sup>6</sup>

For the Prime Vendor such as Agility, what was supposed to be the limit on how it could profit was the Distribution Fee. This was a firm fixed price. It was supposed to cover all expenses, profit, packaging, and transport to final delivery points. This was the only amount PWC was allowed to add to the suppliers' Delivered Price.

PWC was forbidden to keep rebates or discounts from suppliers, apart from narrowly defined, limited, genuine “prompt payment” discounts for PWC paying a supplier quickly. If Agility got rebates or discounts, it was supposed to pass them on to the government, such as by subtracting them from the Delivered Price. However, PWC was not doing such subtracting. It was allegedly using its marketing muscle to obtain and to keep such discounts, and covering this up by false statements.

Take one of the indictment's examples in some detail, before summarizing others. The indictment explains in paragraph 63a that in 2005 “ [U.S.] manufacturer S.L. engaged in discussions with defendant PWC . . . . S.L. proposed that any increase in any discount or allowance be tied to S.L.'s receipt of additional business, in particular, the purchase of pies from S.L.” To identify suppliers, the indictment only uses initials like

<sup>5</sup> Of course federal indictments are handed up by a federal grand jury. However, that grand jury receives evidence from a federal investigation headed by the Justice Department. For simplicity we speak of a “Justice Department indictment.”

<sup>6</sup> To be sure, there is also a foreign and Iraq aspect to the Public Warehousing indictment. (While prepared foods were produced in the United States, other food was not produced in the United States, such as, typically, fresh food and vegetables.) However, it appears from the indictment that we can readily distinguish the problems that were here in the United States and put aside the foreign and Iraq aspects.

The top entity involved in Public Warehousing is a Kuwaiti corporation. And one part of the fraud charges concerned a related Kuwaiti corporation. However, my testimony will not involve those aspects.

“S.L.,” but the press or blogs have attributed named well-known food suppliers, like Sara Lee.

The indictment continues, “Throughout the discussions between defendant PWC and S.L. about discounts, PWC insisted that the discount be called an ‘early payment discount,’ even though S.L. did not want to use that term and suggested that any discount offered to PWC be called what it was, a marketing allowance or rebate. Defendant PWC insisted that the allowance be labeled an ‘early payment discount,’ even though S.L. did not want to use that term and claimed that it could not be called a marketing allowance or rebate. Ultimately S.L. agreed to use the label that defendant PWC demanded.”

Here we see the pressure applied by the Government’s prime vendor to its suppliers, to take payments that should go to the Government and instead describe these in a false way as early payment discounts so the prime vendor could improperly pocket them and deceive the government about this. Note that the pattern resembles the garden-variety kickback in a government contract in some ways. As with a kickback, the subcontractor receives more business from the prime contractor, under pressure from the prime contractor to “kick” it “back” a payment that raises the government’s costs. I would call it a “kickback-like” payment.

Other examples

Now summarize a number of examples. The indictment explains in para. 35 and 36 that PWC turned down the bargains it was contractually required to get for the United States: “PWC failed to purchase less expansive product that it was instructed by [the Defense Department] to purchase because the vendor did not offer PWC a ‘prompt payment’ discount.” Specifically, an honest supplier (“G.S.”) with facilities in Conyers Georgia quoted a Delivered Price to defendant PWC of \$161 per pound. “G.S.” – there is a beef supplier in Conyers, Georgia named Golden State Foods – deserves credit for refusing to cooperate with PWC’s scheme, and PWC went elsewhere, to another supplier, R.P.Q.

So in the face of repeated government inquires why PWC was not buying ground beef from G.S., PWC falsely claimed that honest supplier had a significantly higher price. “PWC was buying from R.P.Q., in part, because R.P.Q. offered it a ‘prompt payment’ discount, and G.S. did not.” The aftermath: “From 2004 until 2007, defendant ignored the directive of [the government] to purchase ground beef from G.S. and often purchased it from R.P.Q., at an inflated Delivered Price, in part because R.P.Q. gave PWC a ‘prompt payment’ discount while G.S. did not.”

Here we see a stream of falsehoods to the government by the prime vendor. The normal oversight which the government repeatedly attempted, is frustrated by these contractor falsehoods. And, the concealed corruption punishes the honest supplier who will not cooperate in the scheme, while rewarding the supplier who treats rebates and discounts in a way that is consistent with PWC’s schemes.

In para. 44-50, the indictment describes a scheme, which, as simplified, allowed PWC to make the government pay bills that were supposed to be PWC’s. PWC engaged a “consolidator” at the delivery point in Front Royal, Virginia. PWC was supposed to pay for consolidation services out of the “Distribution Fee” paid to it by the government. Instead, the suppliers were charged these services and included the charge in the Delivered Price paid by the government, increasing PWC’s profit and increasing the United States’ costs.

In para 41-60, the indictment describes a similar scheme. As simplified, in one instance, “In October 2005, defendant PWC considered purchasing breakfast sandwiches from [U.S.] manufacturer P.F.” A blog has mentioned Perdue Farms as a supplier involved in the indictment transactions; Perdue Farms does make breakfast chicken sandwiches. “P.F. advised defendant PWC that the Delivered Price of the breakfast sandwiches was \$90.00 per case with an allowance of 8% or \$7.20 per case meaning that the actual case price was \$82.80 . . . . through [PWC’s designated] consolidator/distributor. . . .” And, “It was part of the agreement between defendant PWC and [its consolidator that the consolidator] would quote a Delivered Price, not of \$82.80 or even \$90.00 per case as offered by P.F. to PWC, but an inflated Delivered Price of \$93.60 . . . resulting in a fraudulently inflated price to the United States for the breakfast sandwiches, while eliminating the distribution fee that PWC would have to pay to [its consolidator]”

Sometimes the schemes affected the packing of the product. Para. 64-66 address this. These relate that “to increase the Distribution Fees paid to PWC by the United States for the same amount of product, PWC asked some vendors to decrease the amount of product in each case (generally referred to as pack size).” “PWC asked a sales representative for vendor Z.I., a company located in Rome, Georgia” – there is a meat processing company sometimes referred to as Zartec Inc. in Rome, Georgia – “to change to a smaller pack size for several products for which the Distribution Fee was calculated on a per case basis.”

“As a result of defendant PWC’s request, vendor Z.I. reduced the pack size on three products. Defendant PWC utilized the smaller pack size of these three products to invoice DSCP additional Distribution Fees totaling about \$1.4 million in excess of what those fees would have been without the artificial reduction in the pack sizes of the three products.” In other words, the PWC deal now altered the way the food was delivered.

Besides the scale of the problem with the Prime Vendor foodservice contract, and some of the mechanics, these parts of the indictment reveal something else. They show that a lot of the improper conduct took place here in the United States. These are domestic aspects, not foreign or war zone problems.

Furthermore, the problems involved mainstream food suppliers of substantial size, not tiny or exotic providers. I will not speculate as to whether or how witting they were, what and how much they knew or suspected, or whether their activity was extracted by intense pressure and threats, by incentives, or simply by PWC’s cunning. Although these factors matter greatly for some aspects, regardless of these, the problem is not an isolated problem coming out of some narrow context of providers of unique products.

These are mainstream products like ground meat and breakfast sandwiches. These are heartland U.S. locations like Rome, Georgia and Conyers, Georgia. And, the problem is not very different, in terms of the suppliers involved, as would be found in the school meals program. If some would prefer to whitewash or to minimize the problem by saying that it is not serious, or is just from a few rotten apples in an otherwise sound industry barrel, they have an uphill struggle to show this convincingly.

## II. Problems and needed reforms exposed by Kickback Abuses

What are some of the overall problems exposed, and corresponding needed reforms, exposed by the kickback-like abuses at PWC? Let us see how important is the

problem with these mislabeled rebates and discounts, and similar schemes. That the schemes worked for a number of years, over the life of an \$81.5 million set of government contracts – judging from the enormous settlement offers, on a huge scale – points up the huge scale.

The problem is not merely of waste, but of corruption. If the food vendor mistakenly, but honestly, buys from a more expensive supplier than necessary, that is mere waste. That is undesirable. But, it may not even be so problematic for the government as to spark a refusal to pay. Assuming proper procedures such as seek several quotes were followed, only in a rather striking case might auditors question the expenditure as unreasonable. More often, waste is deemed unfortunate and regrettable but part of an imperfect world, and its occurrence will be expected to be self-correcting and not to undermine the whole contracting enterprise.

However, the allegations in the indictment amount to something much worse: corruption. The prime contractor makes false reports, both in words and in numbers, and even created an entire false stream of reporting. Moreover, the prime contractor devotes its skills, and its planning and arranging, not to doing its job better, but to cheating the government better and to escaping detection. And, it made use of United States suppliers, including some very large ones, in the schemes.

Furthermore, the suppliers who have acted consistently with the schemes are put in an uncertain situation. However the schemes took place, even if suppliers were in the dark about some or most of what PWC was doing, these suppliers too have been brought by the schemes into a universe of false reporting to the government of their transactions. They have come into a changed foodservice business in which skill, planning, and arranging are not devoted to doing the job better, but to cheating the government and to escaping detection.

Who knows where the moral journey downward that starts in simply participating, even unwittingly, in a prime contractor's scheme, will end for the supplier and for others in the industry? Moreover, competition among suppliers for the prime vendor's business may have the effect of driving down the legal and moral level of activity. The instances just described include specific examples in which a virtuous contractor who firmly refused to mislabel discounts lost out to other contractors who were willing. This is how corruption in federal contracting works a general corrosion – the competition powerfully pressures all providers, prime and subs alike, downward to the lowest common denominator.

### III. Lack of visibility

The first problem and corresponding reform relate to the lack of visibility to the government of transactions with subcontractors/suppliers. This is not unique to foodservice contracting, but, it is clearly an acute one in this field.

The government has only a narrow window on subcontractors/suppliers: it may see their invoices in paying the vendor's price. It does not see the rest of what goes on with the subcontractors/suppliers that is involved in the fraud. The government does not see private discounting deals between PWC and the supplier, let alone their details, negotiations, impact, and implications. In most of these instances, the government has not even pinned down a prime vendor like PWC to certifying falsely that it is not

cheating the government by deals with the subcontractors, let alone pinned down the subcontractor about anything remotely bearing on the discounts and similar transactions.

Moreover, the government makes a kind of contract, with the prime vendor like PWC, that was apparently viewed by some in the past as entailing a lack of visibility of the subcontracting. This keeps the government completely in the dark about the basic costs of the contractor covered by its Distribution Fee, and all about the subcontractor/suppliers. The Distribution Fee to the contractor is deemed a fixed price or fixed rate per unit. Although the "Delivered Price" has a cost that changes from time to time, and there is a danger of rearranging of rebates, discounts, and other amounts between the "Delivered Price" and the "Distribution Fee," there has been a tendency in the past to note that this is not a cost-reimbursement contract so the prime vendor does not have to provide the kind of information and access on costs provided by a cost-reimbursement contractor.

The subcontractor/supplier, too, sells the product on a fixed rate basis, and does not have to provide the kind of information and access on costs provided by a cost-reimbursement subcontractor. Moreover, since PWC is not a cost-reimbursement contractor, it does not have a "purchasing system" which government auditors can check to see whether sound practices are being followed adequately.

It is not merely that PWC did not have to furnish regularly to the government the kind of records that would reveal the fraud. Rather, PWC does not even have to allow an auditor to have access to the records that would reveal the fraud. Auditors ordinarily have no basis to ask, for a contractor like PWC, to provide access to the contractor's books. And, the subcontractor/suppliers would certainly look askance if government auditors showed up on a routine basis to review their books, with no clause in their own subcontracts providing for this.

I am not going to try to precisely dictate the changes to be made, but simply say that there is a need to increase the visibility of subcontractors, and of the prime's dealings with subcontractors. This does not at all involve transforming the contract from to a cost-reimbursement one. Cost-based contracting has to do primarily with the distribution of the risk between the government and the contractor, not primarily with the records. There are two ways to increase the visibility without necessarily prescribing in any great detail the creation of records beyond those currently present.

First, the government may provide for increased access by government officials and auditors on a routine basis to foodservice corporate officers and employees, and, records, at both the prime vendor and supplier level. A possible way to arrange this flexibly would be to provide that they shall have such access as the prime vendor contracts or subcontracts specify. Then it would be left to DLA, in setting up prime vendor contracts and its subcontracts, to decide whether to include such authority. Auditors or other involved supervisory personnel would set up procedures to inquire, using this authority, on a schedule that would detect improper activity without unduly burdening the prime vendor and its suppliers.

It should not take a fraud investigation, for a criminal or civil fraud case like PWC's, to obtain such access. And, it should not take subpoenas. Agencies may have subpoena authority which they husband for the most extreme cases. By limiting the auditing to prime vendor contracts and their subcontracts, arguments against that

auditing should not be persuasive that would be made if this went beyond the particular troubled prime vendor context to sweep up large areas of government contract.

Second, both prime vendors and suppliers should declare all the discounts they have given or received, and all redistributions of costs (such as consolidation costs) between the supplier and prime vendors, and certify these are transparently described and that there are none except the declared ones. If there are very frequent or small-volume transactions, then rather than have the declaration and certification occur for each transaction, it could occur periodically (i.e., depending on the volume of activity, anywhere from every year down to some fraction of a year). DLA should advise contractors and suppliers to maintain systems for reporting discounts and redistributions of costs to the officials who perform the declaration and certification.

This would not require contractors to maintain cost-type books and accounting as to anything besides such discounts and cost redistributions. It would detect improper activity without unduly burdening vendors. An additional benefit of such certifications is that it would increase the effectiveness of whistleblower lawsuits and other False Claims Act suits. It was just such a lawsuit by Kamal Mustafa al-Sultan that exposed the PWC fraud.

Industry critics may oppose such measures by suggesting that there is something unprecedented about taking such measures about supplier rebates. On the contrary, there is a long, important history of the government vigorously pursuing such rebates and refunds. Richard C. Johnson & Alan M. Bule, *Taxes, Refunds, Credits, and Cash: Handling the Government's Share of Sales and Use Taxes Refunded Under Aerospace Corp. v. State Board of Equalization*, 28 Pub. Cont. L.J. 449 (1999); Ralph C. Nash & John Cibinic, *Credits: Giving It Back*, 9 Nash & Cibinic Rep. para 55 (Sept. 1992). Today this is recorded in the important "Allowable Cost and Payment" clause, 48 C.F.R. 52-216-7.

This is not just for cost-reimbursement contracts. 48 C.F.R. 16.307 about regulating, and 52-216-7 about the clause, regarding refunds and rebates, both apply to time-and-materials contracts, which, like the prime vendor contract, vary with the costs of suppliers of materials. The audit clauses also apply to such time-and-materials contracts.<sup>7</sup> 10 U.S.C. sec. 2313; 48 C.F.R. sec. 52.215-2. And, 48 C.F.R. 1552.232-73, entitled "Payments—fixed rate services contract," has specific subsection (g), entitled "Refunds," that "The Contractor agrees that any refunds, rebates or credits . . . that arise under the materials portion of this contract . . . shall be paid by the Contractor to the Government." It further requires that the contractor make "an assignment to the Government of such refunds, rebates, or credits . . ."

What these regulations, standard clauses, and their history mean, is that the government has long insisted that supplier rebates and discounts be passed to the government. The government has taken steps to insure, not merely for cost-reimbursement contracts, but also for time-and-material contracts, that rebates and discounts be passed to the government. Like prime vendor contracts, time-and-material contracts pass along the costs of materials to the government in a way that makes the vulnerable to practices like PWC's that keep the rebates and discounts from the government. When necessary, the government has backed this up with audit provisions.

<sup>7</sup> The discussion here is about noncommercial time-and-material contracts. Commercial ones are different.

In responding to the current scandal in foodservice refunds and discounts, we are merely doing what we have to, in order to protect the taxpayer and the fisc.

#### IV. Oversight Weakness

DLA has weakness of oversight. It simply does not focus on fraud. Its own internal OET team found the most striking example: DLA contracting personnel did not receive enough training on spotting indications of fraud. DLA personnel did not have enough training to spot the signs of fraud in the PWC Prime Vendor contract. There are manuals or chapters of fraud indicators which they could study. And, DLA's heads of Primary Level Field Activities conduct pre-award reviews – i.e., oversight reviews. However, these focus on issues like performance metrics and do not specifically focus on vulnerabilities that create opportunities for fraud. In retrospect, the primary vendor contract used for the Iraq award called out for such review.

Similarly, the internal OET review found that DLA did not have procedures to validate if the vendor was providing discounts to DLA. Moreover, DLA was not set up for meaningfully checking price reasonableness. DLA did not request subcontractor invoices on a general basis, only when introducing new products or for significant price changes.

This is just a sampling of the large number of aspects of weak oversight found by the OET review. To DLA's credit in general, and its Director Nancy Heimbaugh's credit in particular, DLA conducted such a no-holds-barred internal review, and, is seeking to implement its proposals. Since this is an agency with many critical demands, and new ones may supplant prior ones, it could use Congressional reinforcement of the need for reforms. Either the GAO or the DoD-IG could be tasked to check on whether the program has been reformed sufficiently.

#### Need to keep government standards above "commercial" practice

One great problem as the government seeks to get a hold on foodservice fraud is the constant pressure to pull government standards down to the level of "commercial" practice. Such pressure pulls the government away from the kind of strictness in the PWC prosecution and in tightened-up DLA administration. That is the kind of strictness that is the goal of the government as the steward of taxpayer funds. That is the kind of strictness for dealing with corruption before it undermines the foundations of the state.

Down at the commercial level, rebates and discounts are taken much less seriously. They are simply one of many kinds of issues that arise regarding who owes how much to whom in the course of fluid commercial transactions. These are not taken too seriously because that would interfere with the wheels of commerce. Whereas bribery of a government official is a felony, commercial bribery is commonly taken as a misdemeanor. The kind of bright lines precluding certain kinds of payments in the government contracting context are replaced by gray areas about payments among agents in the commercial context.

Similarly, at the government level, the need to preclude corruption or fraud leads to requirements of certifications, record-access and record-keeping. The avenues through which corruption can infect the work of the government must be blocked off, even if that requires more oversight and more records. Down at the commercial record, such requirements are given much less of a welcome. Industry groups will say that tolerant commercial standards should govern discount and rebate practices, in order to reduce administrative interference and red tape.

In this very context of foodservice contracting, there have been legal proceedings – protests about the way a procurement was being conducted – resolved by the Government Accountability Office (GAO). In 2009, before the indictment, DLA issued its request for proposals that would lead to award of the next Iraq prime vendor contract. It was a “commercial” contract, meaning that it should omit terms inconsistent with customary commercial practice. This is done to encourage vendors to compete who come from the general commercial world, and not only from an overly limited pool of government vendors. PWC protested that the clauses requiring discounts be passed on to the government should be eliminated. DLA had obtained a waiver allowing it to have those clauses, but, GAO may review such waivers for reasonableness.

This procedure was in line with an effort since the mid-1990s to obtain more competition by having more commercial practices. Individual companies and sometimes trade associations will seek to restrain efforts DLA has made in the past, or might make in the future, about the improper handling of discounts and similar schemes. My own view has been that taxpayer funds are too vulnerable to waste, fraud, and abuse, to allow the knocking-down of protections by invocation of the commercial practice argument. It is an argument best used against overly rigid specifications, such as “MIL-SPECs.” It is not an argument for leaving the government vulnerable to corruption, as in this matter.

GAO rejected PWC’s protest. It received government declarations about the problems, with information about the investigation then being conducted (that led soon thereafter to the indictment). GAO said: DLA “faced with possible overcharges to the government under PWC’s current contract, has adopted a series of pricing provisions intended to safeguard the government from excessive charges and to ensure pricing transparency and integrity. . . . PWC has not shown nor does the record otherwise indicate, that the agency’s objectives with these provisions could be accomplished by the use of commercial clauses.”

In 2011, foodservice bidders challenged, at GAO, a recent request for proposals that would lead to award of a prime vendor contract. Once again, DLA had obtained a waiver allowing it to have provisions on such subjects as rebates and discounts. GAO upheld DLA’s provisions. It stated, that DLA’s “waiver justified changes to these provisions on the grounds that the agency wanted to avoid excessive pass through charges from multiple sources along the supply chain, promote transparency in pricing, and insert integrity into commercial pricing practice.” GAO further added that DLA justified its waiver as “necessary to ensure that the delivered price charged to the government only includes the price of the product delivered to the initial entry point of the contractor’s distribution network . . . .”

GAO upheld the DLA clauses on rebates and discounts, saying: “we cannot find unreasonable the agency’s decisions – when faced with possible overcharges to the government – to adopt a series of pricing provisions intended to safeguard the government from excessive charges and to ensure pricing transparency and integrity.” GAO cited its 2009 ruling on PWC’s protest.

These are GAO rulings. DLA’s clauses may be challenged before the Court of Federal Claims. Accordingly, the Subcommittee should remain vigilant as to the need to reinforce DLA’s position in defending the taxpayer against waste, fraud, and abuse in the prime vendor program. Moreover, further reforms are needed, and should not be impeded by “commercial practices” arguments.

**Post-Hearing Questions for the Record**

**Submitted to**

**The Honorable Phyllis K. Fong, Inspector General, U.S. Department of Agriculture**

**From Senator McCaskill**

**“FOOD SERVICE MANAGEMENT CONTRACTS: ARE CONTRACTORS  
OVERCHARGING THE GOVERNMENT?”**

**Wednesday, October 5, 2011, 2:00 P.M.**

**United States Senate, Subcommittee on Contracting Oversight,  
Committee on Homeland Security and Governmental Affairs**

**1. It is my understanding that you have announced a new audit on the issues of rebates in the school lunch program. Is this a result of the settlement in New York?**

**Response:** In part. In July 2010, Sodexo, a large food service management company (FSMC), settled with the Office of the Attorney General of the State of New York (OAG - NY) for improperly withholding rebates and credits from 21 school districts. U.S. Representative DeLauro, in a letter to the Secretary of Agriculture, requested that OIG conduct a review of contract school meal programs in other states to help identify and recover any federal funds that have been misappropriated through illegal procurement practices. Our current audit was initiated based on this request.

**2. What areas do you expect this audit to cover?**

**Response:** We will review school food authorities (SFAs) that signed cost-reimbursable contracts with FSMCs to ensure they were credited with all purchase discounts and rebates. We will also review fixed-rate-per-meal contracts to ensure the SFAs were credited with the full value of USDA-donated commodities. Additionally, we will assess the effectiveness of any controls implemented by the Food and Nutrition Service (FNS) and selected State agencies as a result of our previous audits.

**3. When will the audit be released?**

**Response:** According to our current plan, we expect it to be issued sometime in early summer 2012.

**4. Many food service management companies use their own in-house food distributors. Should this make us more or less cautious in our oversight of their rebate practices?**

**Response:** Although we have not completed a formal review of this practice, our sense is that it should make us more cautious and we may have some observations to offer after we complete our work. Tracing rebates/discounts may be difficult if an FSMC used an in-house food distributor and did not document those rebates/discounts on the invoices provided to the school. This is because transactions between such entities may not be at arms' length, thus necessitating additional work to determine if the prices charged by the in-house distributors are actually concealing some or all of the rebates being passed along to the FSMCs.

**5. I have also learned of a practice called "silo-ing," where the contractors buy food for all their clients and amass rebates based on the overall volume of purchases, but because all of the product is "silo-ed" together, the contractor can't allocate the rebates to individual clients.**

**Is this a credible commercial practice?**

**Response:** This is the first we have heard of the term "silo-ing," but it is a relatively common business practice for FSMCs to purchase items in large quantities and receive volume discounts. In our prior audit work, the FSMCs we visited had internal records that allocated the discounts and rebates among the SFAs with which they had contracted. In our current audit, however, we will be looking further into this practice to assess whether the collection of discounts/rebates for products used for all of an FSMC's clients (participating schools, hospitals, etc.) are being allocated properly back to the individual clients.

**6. In your opinion, what are some of the biggest challenges for schools to effectively manage and oversee these contracts?**

**Response:** One of the biggest challenges we have found is that school district officials have limited experience in identifying the value of discounts and rebates the FSMC received on their behalf.<sup>1</sup>

FNS' new rule and subsequent guidance, if followed, should assist school district officials in identifying the value of the FSMC discounts and rebates that they receive.

**7. In your testimony, you highlighted some of the ongoing litigation and settlements that have occurred in rebate cases.**

**Is this a sign that the government has an idea of what is going on and how to prevent it or is it a sign that this problem is much bigger than we realize?**

<sup>1</sup> In a prior audit, OIG stated that: "...SFAs were not always aware that they were entitled to be reimbursed for the value of commodities. SFAs were satisfied to have someone else take over their food service programs...One FSMC amended an SFA's contract to remove the terms that would have required the FSMC to credit the SFA for purchase discounts and rebates...FSMC was allowed to disregard the terms of the request for proposal under which the contracts were awarded." See 27601-24-Ch, *Food and Nutrition Service National School Lunch Program Food Service Management Companies – Midwest Region*, Sept. 2001.

**Response:** We do not know the full extent of the information that various government entities have on rebate cases, but we do believe that the recent litigation could indicate that the problems are more pervasive than first realized. These cases may prompt other States and school districts to initiate similar investigations that could uncover further non-compliance by FSMCs. We will be looking into underlying issues in our current audit.

**8. Dating as far back as 1969, the Food and Nutrition Service (FNS) has issued guidance and prototypes for use by school districts when entering into agreements with Food Service Management Corporations, and has continually addressed this issue in the four decades since. In 2007, FNS provided explicit instructions to local schools regarding appropriate contractual provisions to ensure savings are passed on by the contractor.**

**In your view, is there anything unclear about the guidance provided by FNS?**

**Response:** Our initial reading of FNS' recent guidance was that it was clear. After we complete our audit fieldwork and evaluate implementation of the guidance, we may be better positioned to provide a better assessment of the regulation.

**9. Are you aware of any training FNS has undertaken to educate contractors, state agencies, and/or local school authorities about the guidance?**

**Response:** Since we are just beginning our audit, we have not independently assessed the extent of the educational outreach FNS has conducted on the guidance. We did, however, ask FNS to provide information on the outreach they have undertaken. FNS advised as follows:

FNS has taken many steps since the release of the regulation in 2007, which includes the issuance of several policy memorandums in order to provide technical assistance and guidance to the SA and SFA. The most recent policy memo, issued on April 5, 2011, reaffirmed the requirement that SFAs must comply with Federal regulations affecting rebates, discounts and other applicable credits in all cost reimbursable contracts, including contracts with cost reimbursable provisions. FNS also developed a comprehensive guidance document on FSMCs for both the SA and the SFA.

Additionally, FNS has developed an online web training program that includes considerable discussion on the enforcement of contract provisions and the return of rebates, discounts and other applicable credits. The web-based procurement training is available online through The University of Mississippi's National Food Service Management Institute (NFSMI) at the following web address: <http://www.nfsmi.org>. The web-based training was originally created to provide a procurement training guide to help SAs administer the school meals programs. This training provides SAs with a better understanding of how best to perform responsibilities in the area of SFA procurements, and provides information on the Federal procurement process requirements, particularly the requirement for free and open competition. The overarching goal is to help the SAs, as well as the SFAs, understand the responsibilities for following regulations when providing nutritious meals to enrolled school children.

Last year the web-based training tool was opened up to Regional offices, SFAs and other interested parties. The web-based training is comprised of 3 topic areas which build upon

each other and move from more general procurement issues to more specific procurement issues such as FSMC contracts. Topic 1 and 2 are currently available; FNS is in the process of developing materials for Topic 3. Each topic provides close to 18 hours of course credit.

Lastly, FNS annually speaks at a minimum of 2 conferences to provide procurement training (i.e., School Nutrition Association, American Commodity Distribution Association). The audience at these conferences includes SAs, SFAs, ROs, FSMCs and other related industries.



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November 23, 2011

**Via Email and U.S. Mail**

The Honorable Claire McCaskill  
Senate Committee on Homeland Security & Governmental Affairs  
Ad Hoc Subcommittee on Contracting Oversight  
Hart Senate Office Building, Ste. 506  
Washington, D.C. 20510

Re: Post-Hearing Questions for the Record Submitted  
to Assistant Attorney General John F. Carroll, Jr.

Dear Senator McCaskill:

Please accept New York Attorney General Eric T. Schneiderman's greetings and thanks for your continued concern regarding the National School Lunch Program (NSLP) and off-invoice rebating. Below you will find answers to the subcommittee's Post-Hearing Questions forwarded to me on October 5, 2011.

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1. *What role do the suppliers and other companies who pay the rebates play in these schemes?*

A: (1) Suppliers, and distributors (collectively, vendors) enter into agreements with Food Service Management Companies (FSMCs) for vendors to pay FSMCs off-invoice rebates in situations where the vendors are aware that the products are destined for NSLP or government clients; (2) vendors are aware of United States Department of Agriculture (USDA) regulations and other government contracting regulations; (3) vendors appear to have an interest in a lack of transparency; and (4) to the extent rebates are re-characterized as anything other than what they are, vendors participate in this change in nomenclature.

The Honorable Claire McCaskill  
 November 23, 2011  
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2. *Many food service management companies use their own in-house food distributors. Should this make us more or less cautious in our oversight of their rebate practices?*

A: The practice lessens transparency. Though this would not necessarily be determinative of questionable rebate practices, FSMC business activities which increase the complexity of the "bean counting" of rebates, can undermine the Government's interest in receiving its full share of rebate payments. A recent investigation and prosecution by the U.S. Department of Justice discussed at the hearing provides strong reason to believe that interposing corporate entities in the stream from vendor to NSLP or other government purchaser will, at a minimum, increase opacity and, at worst, may constitute a fraudulent effort to conceal.

3. *Did you contact the Department of Justice about your investigation?*

A: The original Sodexo investigation was triggered by a *qui tam* action filed in the United States District Court for the District of Massachusetts by the firm of Phillips and Cohen, in which U.S. government entities were named as parties. As such, the United States and the U.S. Department of Justice (DOJ) were aware of the allegations from inception of the *qui tam* matter.

The Office of the New York Attorney General has publicly announced its rebate investigation and settlements, and those announcements have been covered in the media.

4. *Did the Department of Justice provide a reason as to why it chose not to intervene in the case?*

A: Consistent with DOJ policy, OAG was not formally informed of the DOJ's reasons for declining to intervene in the *qui tam* action.

5. *I have also learned of a practice called "silo-ing," where the contractors buy food for all their clients and amass rebates based on the overall volume of purchases, but because all of the product is "silo-ed" together, the contractor can't allocate the rebates to individual clients. Is this a credible commercial practice?*

A: Interposing silo-ing as the sole basis to avoid crediting rebates to clients is a questionable justification since the sum of rebates can be readily divided mathematically and *pro rata*.

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6. *In your opinion, what are some of the biggest challenges for schools to effectively manage and oversee these contracts?*

A: The single main challenge is the fact that rebates are paid directly to FSMCs by vendors without specific knowledge of clients. Correspondingly, our investigation has found that when clients ask their FSMCs about rebates, FSMCs do not clearly and consistently articulate amounts or bases for the rebate payments, making it exceedingly difficult for clients to police their own agreements.

7. *Dating as far back as 1969, the Food and Nutrition Service (FNS) has issued guidance and prototypes for use by school districts when entering into agreements with Food Service Management Corporations, and has continually addressed this issue in the 4 decades since. In 2007, FNS provided explicit instructions to local schools regarding appropriate contractual provisions to ensure savings are passed on by the contractor. In your view, is there anything unclear about the guidance provided by FNS?*

A: In my view, the rule is clear and is also consistent with Generally Accepted Accounting Principles which provide that cost representations must be net of discounts and rebates.

As noted in response to Question 6, the main obstacle to enforcement is the inherent lack of transparency to rebating.

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To close, Attorney General Schneiderman looks forward to continuing to support the sub-committee's efforts. Should you wish to contact our office further in connection with your investigation, please contact Randall Fox at 212-416-6199. Thank you once again for your time and attention to this important issue.

Respectfully submitted,



John F. Carroll  
Assistant Attorney General

**Post-Hearing Questions for the Record**

**Submitted to**

**Professor Charles Tiefer, Professor of Law, University of Baltimore School of Law and  
Former Commissioner, Commission on Wartime Contracting in Iraq and Afghanistan**

**From Senator McCaskill**

**“FOOD SERVICE MANAGEMENT CONTRACTS: ARE CONTRACTORS  
OVERCHARGING THE GOVERNMENT?”**

**Wednesday, October 5, 2011, 2:00 P.M.**

**United States Senate, Subcommittee on Contracting Oversight,  
Committee on Homeland Security and Governmental Affairs**

1. To your knowledge, is Defense Logistics Agency (DLA) making progress on correcting its mistakes with the prime vendor program? Does it have the tools to succeed?

DLA is making limited progress. DLA’s internal study, which I described in my testimony, represented a first step toward identifying what needed fixing. If it did a credible follow-up study, describing progress but also identifying what had not yet been fully fixed, that would represent further progress.

I had some suggestions in my prepared testimony for further tools to be given by Congress to DLA. These include increasing the visibility of subcontractors and their dealings with the prime vendor contractor; strengthening DLA’s weak oversight; keeping government standards about matters such as rebates and discounts above “commercial practice.” There are further details on these suggestions in my prepared testimony, and I stand ready to cooperate with the Committee if it wants to flesh any of them out for further consideration.

2. From the complaint filed in the Public Warehousing Company (PWC) fraud case, we know that U.S. companies were involved in the scheme. How should we view their role?

These U.S. companies are a combination of “understandable” and “bad.” Take these two combined aspects separately. The indictment indicates that their cooperation in PWC’s scheme was coerced from them, by PWC’s threat, and by their own fear, of losing business if they did not cooperate in the scheme for putting rebates belonging to the taxpayer into PWC’s pocket. That means they can claim they were, to some extent, extortion victims. On the other hand, the indictment indicates that not everyone went along, and that the companies that went along did so in part from the greedy motive of sharing in the lucrative flow of business. That was “bad” of them.

Beyond the question of how to view them in the past, is the question of how to view similar companies in the future. Unfortunately, the same mix of fear and greed that drew them into cooperating with PWC may draw them into cooperating with such schemes in the future. Action by DLA and Congress must change the visibility and transparency of these companies' transactions so that neither fear nor greed can persuade them to join in such schemes in the future.

3. Many food service management companies use their own in-house food distributors. Should this make us more or less cautious in our oversight of their rebate practices?

I do not know the industry well enough to answer this authoritatively. Perhaps the vertical integration of such companies means that they can have all-inclusive charges, reducing the possibility of shifting charges around or taking in mislabeled rebates with the help of other food distribution firms. On the other hand, perhaps the vertical integration destroys some of the visibility so that charges can be shifted around within the company to move them from inclusion in all-inclusive charges to the kind of charges that are separately billed. On balance, it is an aspect that is worrisome. If the top management of the company decides to overcharge the government, they can do so without the cooperation of any external firm. PWC showed us that it is far from impossible that the top management of a company may not be trustworthy.

