



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.