



Government Contracts Advisory

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DOD Issues New Interim Rule Amending Regulations Governing “Excessive” Subcontract Pass-Through Charges

On May 13, the Defense Department (DoD) issued an interim rule amending a prior interim rule, which last April had prescribed new regulations at Defense Acquisition Regulation Supplement (DFARS) §§ 215.408, 231.203, 252.215-7003 and -7004 directed at what the government characterized as “excessive” subcontractor charges. This revised interim rule requests comments by July 14, 2008. Designed to implement Section 852 of the National Defense Authorization Act for Fiscal Year 2007, both the initial and amended interim rule—which include solicitation provisions and contract clauses—target DoD concerns that it has been paying “excessive pass-through charges” on a range of prime contracts and lower-tier subcontracts. Government prime contractors and subcontractors alike must become conversant in the additional requirements set forth by this amended rule and prepare for its impact on current business practices.

The previous interim rule drew wide-ranging criticism from industry, including serious questions about the lack of clarity. While the authors responded to certain of these concerns, they were largely unmoved by these critics. Thus, the amended rule retains the basic structure of the original rule in that it requires both notice and justification from contractors and subcontractors where a substantial amount of a contract’s costs (over 70%) will be subcontracted. The amended rule still obligates contractors/subcontractors first to identify the percentage of cost that will be subcontracted and, if the percentage exceeds 70 percent of the total cost of the work to be performed, the rule requires that contractors/subcontractors then provide information to support the value added by them in order to justify their indirect costs and profit. The rule applies to contracts, task and delivery orders and covers priced options. In addition, it incorporates mandatory flow-down clauses applicable to subcontractors at every tier. The rule does exclude application to firm-fixed price subcontracts, task or delivery orders based on adequate price competition, and commercial item acquisitions.

The amended rule also sets forth the following additional provisions:

- Adds an alternate contract clause (“Alternate I”) for the contracting officer (CO) to use when he/she makes a decision—prior to contract award—that excessive pass-through charges do not exist.
- Adds definition of “added value” to clarify that “contract management” functions are included as the type of contractor effort that represents added value.
- Requires that the contractor notify the CO if it decides after contract award to subcontract more than 70 percent of the total cost and to verify that the contractor will add value consistent with rule’s definition.
- Establishes a minimum coverage threshold tied to the Federal Acquisition Regulation (FAR) cost or pricing data submission threshold (currently \$650,000).
- Defines “subcontract” and “subcontractor” to be consistent with the FAR definitions.

In comments issued with the new interim rule in response to concerns that the government’s reliance on 70 percent was arbitrary and unsupported by the rule’s statutory authority, the rule’s authors insist that the 70 percent threshold is merely a “reporting mechanism” enabling the parties to address the potential for excessive pass-through charges before award or to address it should the level of subcontracting exceed 70 percent following award. Consistent with that intention, the revised rule incorporates a new

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“Alternate I” clause (stating that the CO has determined that there will be no excessive pass-through charges) for use by COs once they make the determination—at the time of award—that excessive pass-throughs do not exist.

The ultimate impact of the rule, of course, will depend upon the government’s execution in practice and the levels of depth and degree of detailed information it will require contractors and subcontractors to provide in order adequately to demonstrate the requisite “added value.” Notably, the revised rule incorporates the new post-award requirement that, where a contractor subsequently decides to subcontract more than 70 percent of an already awarded contract, the contractor must notify the CO in writing and verify that it will add value or benefit to the government. The rule writers maintain that this provision is necessary to protect the government where a contractor initially agrees to a certain work scope and, then after award, proceeds to subcontract all or substantially all of the effort without providing the required value-added management functions expected by the government. The rule makes it clear that post-award audit rights apply to address this situation. The rule’s authors also state in comments published with the amended interim rule that the CO “will rely” on this written notice supporting added value. Moreover, this post-award notification and justification rule applies equally to fixed price prime contracts and subcontracts. The revised rule also retains a recovery mechanism which entitles the government to a price reduction for fixed price contracts in the amount of excessive pass-through charges included in the contract price and, for other than fixed price contracts, the excessive pass-through charges are made unallowable in accordance with FAR Subpart 31.2 and DFARS Subpart 231.2.

As do other elements of this rule, the post-award notice and justification requirements create uncertainty and raise potentially serious risks for contractors/subcontractors. What will be the result where the CO later determines that the contractor’s added value described in its post-award submission was inadequate? Will a price reduction or cost disallowance be the limit of Government remedies, and, if so, in what amounts? Could this reliance result in a termination for default? False claims action? Suspension/debarment? Penalties or fines? What will be the impact on a prime contractor of a subcontractor which fails to provide notice and support concerning its flow-through of work to a lower-tier subcontractor? Under the recovery provision, how will the government measure the amount of flow-through indirect costs and profit it will not pay? Will the government disallow the entire amount of indirect costs or profit or will it apportion? What additional information will the Government request per its audit rights, including the right to audit subcontractor records necessary to determine whether the subcontractor proposed, billed or claimed excessive pass-through charges?

For now, we encourage contractors/subcontractors to monitor closely the 70% “total cost” thresholds before and after contract award and to prepare themselves to provide specific documentation of the value-added benefits they provide, tailored to the factors described in the interim rule—*i.e.*, subcontract management functions to include processing of orders or parts or services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, managing financial aspects of a contract including progress payment requests by subcontractors, coordinating deliveries, and performing quality assurance functions. We further encourage contractors/subcontractors to work closely with their COs at the proposal stage to obtain the “Alternate I” statement that their flow-throughs provide added value to the government.

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