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special government contracts update

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In this issue:

DoD Amends Interim DFARS Provisions that Prohibit Payment of "Excessive Pass-Through Charges" on Subcontracts

Background: In April 2007, we informed you of an interim rule that implemented Section 852 of the FY 2007 National Defense Authorization Act. The interim rule prohibited the payment of excessive pass-through charges on certain subcontracts under prime contracts and higher-tier subcontracts that were entered into for, or on behalf of, the Department of Defense (DoD). The rule was motivated by congressional concerns that government contractors were applying charges to subcontracts while adding little or no value to the overall contract effort. See April 2007 Government Contracts Update at www.venable.com/publications.cfm?action=view§ion=newsletters&publication_id=1672 for details.

We identified some serious concerns regarding this interim rule and the impact it would have on DoD prime contractors or subcontractors that subcontract a significant part of their overall work under a federal contract. For example, even though prime contractors and higher-tier subcontractors might have little difficulty showing that they are adding more than "negligible" value consistent with the rule, the regulation imbues contracting officers with significant discretion to determine whether pass-through charges are "excessive." Furthermore, the interim rule provided the government with access to the contractor's records for up to three years after final payment under the contract or subcontract, so such issues might not arise until long after the government has accepted the contractor's original proposal for the work. Recently, in response to industry comments, the DoD has amended this interim rule to address some of these and other concerns.

Summary of Significant Changes to the Interim Rule: The revised interim rule amends DFARS Parts 215 (Negotiated Contracts), 231 (Cost Principles) and 252 (Solicitation and Contract Clauses) to establish definitions and rules relating to charges that prime and higher-tier subcontractors apply to their subcontracts. The effective date of the revised interim rule is May 13, 2008. See 73 Fed. Reg. 27,464, May 13, 2008.

- While the revised interim rule does not alter the requirement that a contractor report when more than 70% of the total cost of work is to be subcontracted, the revised interim rule clarified when such reporting was required. In addition, the DoD responded to comments regarding this issue by repeatedly stating that this was merely a reporting threshold; the contracting officer will make the ultimate determination as to whether there are excessive pass-through charges.
- The revised interim rule also includes an Alternate I for paragraph (b) of the basic clause. The alternate provision is intended to be used when the contractor has demonstrated, prior to award, "that its functions provide added value to the contracting effort and there are no excessive pass through charges." Under this scenario, the contracting officer will make his or her decision at the time of award and will not re-address this determination during contract performance unless the contractor does not, in fact, perform the disclosed value-added functions.
- The revised interim rule also adds a minimum threshold. The rules only apply when the total value exceeds "the threshold for obtaining cost or pricing data in accordance with FAR 15.403-4" ($650,000).
- The revised interim rule also added or revised the following definitions of key terms:
  - "*Added value* means that the Contractor performs subcontract management functions that the Contracting Officer determines are a benefit to the Government (e.g., processing orders of parts or services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, performing quality assurance functions)."
  - "*No or negligible value* means the Contractor or subcontractor cannot demonstrate to the Contracting Officer that its effort added value to the contract or subcontract in accomplishing the work performed under the contract (including task or delivery orders)."
- Any comments concerning the revised interim rule that contractors may want the DoD to consider in implementing the final rule must be submitted on or before July 14, 2008 by mail to: Defense Acquisition Regulations System, Attn: Ms. Sandra Morris, OUSD (AT&L) DPAP (CPF), IMD 3D139,

3062 Defense Pentagon, Washington, DC 20301-3062; by fax to 703-602-7887; or by the Federal eRulemaking Portal at www.regulations.gov.

Discussion: As discussed in our earlier Government Contracts Update, the interim rule imposes substantial new requirements upon government prime contractors and subcontractors whenever they contemplate subcontracting out a significant amount of work. Although the revised interim rule addresses some concerns shared by government contractors, other concerns were not addressed and remain valid. Given that the rule still provides that the government shall have access to the contractor's records for up to three years after final payment under the contract or subcontract, issues may not arise until long after the government has accepted the contractor's original proposal for the work or the work has been completed. In addition, it remains to be seen if the revised interim rule will spawn False Claims Act actions based on inaccurate reporting or a failure to report at all.

For further information please contact Terry Elling, Patrick Doherty or any other attorneys of the Venable's Government Contracts Practice Group.
