
Dear Sir or Madam:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced Federal Acquisition Regulation ("FAR") interim rule issued with a request for comments by the Civilian Agency Acquisition Council and the Defense Acquisition Council (the "Councils") on October 14, 2009. The Section consists of attorneys and associated professionals in private practice, industry, academia, and government service. The Section’s governing Council and substantive committees contain members representing these segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works. ¹

The Section is authorized to submit comments on acquisition regulations under special comment authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Honorable Thomas C. Wheeler, a member of the Council of the Section of Public Contracts Law, did not participate in the Sections’ consideration of or voting on these comments.

¹ The Honorable Thomas C. Wheeler, a member of the Council of the Section of Public Contracts Law, did not participate in the Sections’ consideration of or voting on these comments.
the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.2

I. BACKGROUND

Section 852 of the National Defense Authorization Act for Fiscal Year 2007 ("FY07 NDAA") required the Department of Defense ("DoD") to issue regulations to address excessive pass-through charges on DoD contracts and subcontracts. DoD published an interim rule on April 26, 2007 ("2007 Interim Rule").3 The 2007 Interim Rule required offerors and contractors to identify the percentage of work to be subcontracted, and, if the subcontracted costs are expected to exceed 70 percent of the total work, to provide additional information on indirect costs, profit, and the value being added by the contractor to the subcontracted work. Based on its review of public comments on the 2007 Interim Rule, DoD issued a second interim rule on May 13, 2008 ("2008 Interim Rule").4 The Section provided comments on both the 2007 and 2008 Interim Rules, which are attached.

On October 14, 2009, the combined Councils issued an Interim Rule ("FAR Interim Rule") amending the FAR to implement Section 866 of the National Defense Authorization Act for Fiscal Year 2009 as well as Section 852 of the FY07 NDAA. The FAR Interim Rule applies to all executive agencies, including DoD, and establishes regulations to minimize excessive pass-through charges. The Section respectfully submits these comments regarding the FAR Interim Rule to highlight what it believes to be important points for the Councils to consider prior to the release of a final rule.

II. COMMENTS

In its comments on the 2007 and 2008 DoD Interim Rules, the Section concurred that pass-through charges should not be excessive and commended DoD for its thorough review of the comments and the issues those interim rules raised. The Section also addressed the importance of guidance regarding the effective implementation of the rule and stated that this guidance should include, among other matters, direction that Contracting Officers consider in assessing contractor added value the lower contract risk when cost reimbursable contracts are subject to

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2 This comment letter is available in pdf format at http://www.abanet.org/contract/federal/regscomm/home.html under the topic "Subcontracting and Teaming."


full and open competition. In its notice accompanying the 2008 Interim Rule, however, DoD deferred this issue to a point "when necessary." 73 Fed. Reg. at 27471.

The FAR Interim Rule does not provide such guidance to Contracting Officers, nor does it require that the Councils or DoD issue such guidance in future Procedures Guidance and Instructions ("PGI") or other guidance or instructions. As discussed in more detail below, the Section notes that a January 2008 Government Accountability Office report ("GAO Report") made this same recommendation.⁵

In addition, the Section does not believe that the Councils have addressed the conflict between DoD policies that the Section identified in its comments on the 2007 and 2008 DoD Interim Rules. The Section also suggests that the Final Rule make the threshold for flowing down the clause in cost reimbursable subcontracts under contracts with executive agencies other than DoD the same as that for subcontracts under DoD contracts. Finally, the Section recommends that the Councils define the term "total cost of [the] work" as used in FAR 52.215-22 and 52.215-23.⁶

A. Guidance Should be Available to Contracting Officers, As Noted in the Section's Earlier Comments and in the GAO Report

In its comments on the 2007 and 2008 DoD Interim Rules, the Section recommended that DoD provide guidance to Contracting Officers so that they can effectively implement the goal of eliminating or reducing excessive pass-through charges. In the discussion of "Planning and Guidance" in the Notice accompanying the 2008 Interim Rule, DoD mentions the Section's statement that there is no substitute for adequate contract planning and administration on the part of the Government, and further relates the Section's concern that without adequate guidance, there is potential for mischief. The DoD response stated that "DoD will monitor implementation and will provide guidance when necessary." 73 Fed. Reg. at 27471. To ensure that the 2009 FAR Interim Rule is implemented in an effective manner and is not employed merely to reprice contracts, the Section repeats its recommendation that the Councils and DoD proactively address the creation of guidance to assist Contracting Officers with implementing the rule.


⁶ FAR 52.215-22 and 52.215-23 use the terms "total cost of work" and "total cost of the work."
GAO, at the request of congressional committees, conducted a study leading to the above-mentioned January 2008 report because one-third of DoD’s fiscal year 2006 spending on goods and services was for subcontracts. As a result, DoD auditors and Congress raised concerns about the potential for contractors to assess excessive pass-through charges. GAO reviewed and analyzed the FAR and DFARS, discussed the issues with DoD acquisition policy, audit and contracting officials, and interviewed private companies. As a result of this extensive review, GAO recommended that DoD issue guidance to implement this rule and noted that DoD concurred with the recommendation. Notably, the GAO Report states that:

While the rule aims to provide contracting officers with more information on contractor value added, it alone will not provide greater insight into DOD’s supply chain and costs – information that companies told us they use to mitigate excessive costs. In addition, while the rule is not yet final, contracting officials we spoke to indicated the need for guidance on how to effectively implement the rule since they were not clear what more they should be doing beyond applying tools in the FAR and DFARS. This would ensure that contracting officers, particularly newer and less experienced staff, consistently apply federal acquisition tools in conducting their assessments of contractor value added and take into account contract risk when determining the degree of assessment needed, documenting assessments, and involving DCAA and DCMA as appropriate.8

The Section believes that the GAO Report further supports the need for guidance at the time of implementing this requirement as a final rule, and recommends that the Councils provide such guidance in the final rule. The GAO Report provides information and suggestions relevant to the creation of guidance such as a description of unique circumstances that drive contracting arrangements that include greater risk of excessive pass-through charges, including the lessons learned on contracts awarded for Hurricane Katrina recovery efforts,9 which the Section noted in its earlier comments was one of the excessive pass-through

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8 Id. at 4 (emphasis added).
9 Id. at 14–17.
situations that gave rise to the statutory requirement for the DFARS rule\(^\text{10}\) and likely, the FAR Interim Rule.

Evaluation of a program’s cost and a contractor’s proposed management approach, including the subcontract plan, is a part of the Procurement Contracting Officer’s award determination. The Section believes that to the maximum practical extent – for those procurements that are not otherwise exempt under the FAR Interim Rule – any excessive proposed costs related to subcontract management can be evaluated in the context of competition or addressed in negotiations in a sole-source procurement. Indeed, the GAO Report stated that one of the key elements for Contracting Officers in assessing contractor value added is whether the contract is awarded on the basis of full and open competition and stated that “[w]hen adequate price competition exists generally no additional information is necessary to determine the reasonableness of price.”\(^\text{11}\) The GAO recommended, as the DoD finalizes its rule on preventing excessive pass-through charges and develops implementing guidance to ensure consistency in how contracting officials assess contractor value added, that DoD “[r]equire contracting officials to take risk into account when determining the degree of assessment needed.”\(^\text{12}\) GAO further elaborated that: “[r]isk factors to consider include whether (1) the contract is competed; (2) the contract type requires the government to pay a fixed price or costs incurred by the contractor; and (3) any unique circumstances exist, such as requirements that are urgent in nature.”\(^\text{13}\) The Section urges the Councils to consider these recommendations in formulating the final rule. In addition, the final rule should serve as a tool to ensure consistency to the extent practicable between contractors’ proposals, as evaluated by the Procurement Contracting Officer, and actual performance, monitored by the Administrative Contracting Officer, rather than to serve as a basis to disallow cost after incurrence.

With further regard to evaluation of negotiated procurements, the Procurement Contracting Officer should, in light of the FAR Interim Rule, pay special attention to those contract elements that would require multiple tiers of subcontractors and thus multiple layers of indirect cost and profit. For example, contracts that require the prime contractor to act as an integrator implicitly require that the prime contractor employ subcontractors to accomplish the scope of the

\(^{10}\) See Section Comments on 2007 Interim Rule at 5 n. 3.

\(^{11}\) GAO Report, Appendix II: Key Elements for Contracting Officers in Assessing Contractor Value Added, at 29.

\(^{12}\) Id.

\(^{13}\) Id. at 22.
contract. A more explicit example would be the requirement to satisfy a small business plan that could necessitate multiple subcontractors. Finally, the final rule should carefully consider the potential effects on those small businesses performing as prime contractors on contract set-asides given that small business prime contractors could experience significant adverse financial impacts as a result of disallowed pass-through costs under this rule. This is contrary to the protections typically afforded small businesses that perform federal contracts.

In all events, it would seem advisable that additional guidance be provided. Even in the short time between the FAR Interim Rule’s issuance on October 14, 2009, and the drafting of this comment, public contract lawyers have indicated that contractors have sought clarification of the rule’s requirements and how it will be implemented only to be told by Contracting Officers that they lack knowledge of this issue and are not prepared to discuss the rule other than to recite the FAR requirement.

B. The Interim Rule Does Not Reconcile Conflicts with Existing Policies

The Section’s comments on the 2007 and 2008 DoD Interim Rules noted that those rules could impact team assembly and formation decisions, conflicting with DoD policy that seeks both to ensure robust competition for subcontracts and to prevent bias on the part of prime contractors toward in-house sources. The Section notes that the FAR Interim Rule may conflict with the policy of the recently enacted Weapons Systems Acquisition Reform Act, which directs the Secretary of Defense:

\[ \text{14 Section 202 of the Weapons Systems Acquisitions Reform Act of 2009.} \]

\[ \text{15 FAR 52.215-23(d).} \]
subcontractors. The Section recommends that DoD reconcile its policies to avoid confusion.

In the discussion of "Impact on Business Strategy, Spares Contracting, and Indefinite-Delivery Indefinite-Quantity or Delivery Order Contracts" in the Notice accompanying the 2008 DoD Interim Rule, DoD mentioned the Section’s concern. DoD stated that the policies are not inconsistent, and that this:

rule is intended to protect the Government from those situations where there appeared to be an agreement with the contractor to perform the contract scope of work, including “managing” subcontractors, and then after award, the contractor subcontracts substantially all the effort without providing the required ‘added value.’"16

The Section believes that the 2008 DoD Interim Rule and the FAR Interim Rule go far beyond such situations. DoD’s 2008 statement connotes a situation where there is active misrepresentation of the prime contractor’s intent and perhaps its capabilities. The 2008 DoD Interim Rule, however, addressed much more than misrepresentation, and reached all situations where subcontracting can be used to create a strong team.

Nevertheless, DoD’s response did not address the Section’s concern. The Section supports the Wynne Memorandum’s purpose,17 which is to foster competition through assembly of a strong team that can address and satisfy the required capabilities while avoiding the favoring of an affiliate over an unrelated entity. The Section remains concerned that the FAR Interim Rule, like the 2007 and 2008 DoD Interim Rules, exerts pressure to keep work in-house to address the reporting requirement, and believes that the Councils should be aware – and concerned – about this unintended impact. It seems inconceivable that the FAR Interim Rule would not have an impact on contractor team assembly and formation decisions. The Section restates that the FAR Interim Rule’s emphasis on limiting the amount of subcontracted work conflicts with the Wynne Memorandum’s emphasis on ensuring robust competition to ensure consideration of subcontracting to independent companies. As the Wynne Memorandum indicates, a key DoD goal is to facilitate the most effective combination of complementary skills to ensure that the prime contractor can provide best value and accomplish the task efficiently.

16 73 Fed. Reg. at 27470.

17 On July 12, 2004, Michael W. Wynne, then-Under Secretary of Defense, Acquisition, Technology and Logistics (acting), issued a memorandum for the secretaries of the military departments entitled Selection of Contractors for Subsystems and Components (“Wynne Memorandum”).
and effectively. If the amount of subcontracting is limited to an arbitrary share of the total work effort, this goal will be seriously jeopardized.

Additionally, the FAR Interim Rule may be interpreted and applied so as to conflict with the requirements of the Cost Accounting Standards ("CAS"). CAS requires that all indirect costs be fully absorbed and allocated to final cost objectives, and defines certain mandatory rules for the measurement, assignment, and allocation of those costs. The FAR Interim Rule provides a basis for Contracting Officers to disallow costs if the contractor fails to demonstrate "added value," which is defined in FAR 52.215-23(a) as "subcontract management functions that the Contracting Officer determines are a benefit to the Government." Under the FAR Interim Rule, the Contracting Officer is responsible for determining the value that certain allocable indirect costs actually add to the contract. Nevertheless, General and Administrative ("G&A") costs are by their very nature residual and do not permit the assignment of a clear beneficial or causal relationship between the cost incurred and a benefit to any particular final cost objective. As a result, there is a potential that the G&A applied to all tiers of subcontracts could be deemed to be "excessive" and therefore unallowable, even if it is incurred in accordance with the contractor's approved disclosed cost accounting practices. If a contractor incurs cost in accordance with CAS and its disclosed practices, the only question should be the allowability and reasonableness of the cost, both of which can be dealt with prior to award and incurrence of those costs.

To the extent a Contracting Officer believes that an adjustment to the amount of indirect cost applied to final cost objectives is appropriate because certain contracts receive more or less benefit from residual expenses than would be indicated by the contractor's standard allocation practices, those should be addressed through special allocations, such as those at CAS 410-50(j) and CAS 418-50(f), not through the disallowance of costs.

The Section believes that a distinction should be made with regard to G&A applied to contracts versus applied profit. This will serve to protect the contractor's recovery of allowable G&A if incurred in accordance with CAS and the contractor's disclosed practices, while focusing the Government's attention to the negotiated item of profit. Application of indirect cost, including G&A, is not only governed, but required by the CAS and FAR. Although public law and regulation determine the manner in which a contractor may apply those costs, they provide no methodology or guideline for the calculation and application of profit beyond justifying its existence. As a result, guidance should be issued to Contracting Officers to evaluate applied profit more stringently rather than to determine
unallowable those actual costs that have been incurred and allocated in accordance with applicable and approved guidelines.

C. **A Consistent Threshold Should be Established Across All Executive Agencies for the Flowdown of the Clause to Subcontracts**

The Section acknowledges and supports the Councils’ adoption of a minimum threshold for the mandatory flowdown of the requirement to subcontractors under DoD contracts. The Section believes that the threshold to obtain cost or pricing data in FAR 15.403-3 is appropriate. The summary of comments accompanying the 2008 DoD Interim Rule demonstrates the value of reasonable parameters with regard to the number of subcontractors to whom this requirement flows down. The Section suggests that the Councils should also apply this same threshold to subcontracts under contracts with executive agencies other than DoD. There should be a consistent minimum threshold among all executive agencies for subjecting subcontracts to the pass-through charges requirements.

Given that the clause requires Contracting Officers to make determinations with regard to subcontracts as well as the prime contract, the potential burden for satisfying this requirement with respect to subcontracts of a value above the simplified acquisition threshold but below the threshold for requiring cost or pricing data will be considerable. Although many such relatively low value subcontracts may be awarded on a competitive basis or fit the definition of commercial items, many will not. The risk to the Government is minimal with respect to such lower tier subcontracts. If the Councils use the threshold in FAR 15.403-4, the rule will exclude a significant number of subcontracts from this burdensome requirement, but still cover the vast majority of the total value of subcontracts and apply a consistent minimum threshold across all executive agencies.

D. **The FAR Interim Rule Should be Clarified to Define the Terms “Total Cost of Work”**

The FAR Interim Rule prescribes the use of a new provision, FAR 52.215-22 Limitations on Pass-Through Charges-Identification of Subcontract Effort, and a new clause, FAR 52.215-23 Limitations on Pass-Through Charges. Neither the provision nor the clause defines the terms “total cost of the work” and “total cost of work,” as these terms are used in the provision and the clause. The Section recommends that the provision and the clause be amended to include definitions of these terms.
Paragraph (c) of FAR 52.215-22 requires prime contractors to identify in their proposals the total cost of the work to be performed by the prime contractor, and the total cost of the work to be performed by each subcontractor, under the contract, task order, or delivery order. It further provides that if the prime contractor proposes to subcontract more than 70 percent of total cost of the work to be performed under the contract, task order, or delivery order, the prime contractor shall identify in its proposal the amount of its indirect costs and profit/fee applicable to the work to be performed by the subcontractor(s), and a description of the added value provided by the prime contractor as related to the work to be performed by the subcontractor(s). An identical reporting requirement applies to any of the prime contractor’s subcontractors (“higher-tier subcontractors”) that intend to subcontract to lower-tier subcontractor(s) more than 70 percent of the total cost of work to be performed under a higher-tier subcontract.

The Section recommends that FAR 52.215-22 be amended to provide that, for purposes of determining whether the 70 percent subcontracting threshold is reached, the “total cost of [the] work” to be performed by the prime contractor or a higher-tier subcontractor shall include the prime contractor’s or higher-tier subcontractor’s direct and indirect costs of the work, excluding applicable profit or fee, to be performed under the contract or higher-tier subcontract, as the case may be, and the “total cost of the work” to be performed by each subcontractor to the prime contractor or to a higher-tier subcontractor shall include its direct and indirect costs, including applicable profit or fee, of the work to be performed under its subcontract.

Similarly, the Section recommends that FAR 52.215-23 be amended to provide that, for purposes of determining whether a prime contractor, or higher-tier subcontractor, changes the amount of subcontract effort after award such that it exceeds 70 percent of the total cost of work to be performed under the contract or higher-tier subcontract, the “total cost of [the] work” to be performed by the prime contractor or a higher-tier subcontractor under the contract or higher-tier subcontract shall include the contractor’s or higher-tier subcontractor’s direct and indirect costs of the work, excluding applicable profit or fee, to be performed under the contract or higher-tier subcontract, as the case may be, and the “total cost of [the] work” to be performed by each subcontractor to the prime contractor or to a higher-tier subcontractor shall include its direct and indirect costs, including applicable profit or fee, of the work to be performed under its subcontract.

III. CONCLUSION

The Section supports the goal of the FAR Interim Rule on excessive pass-through charges, but remains concerned that without additional guidance, issues
will arise in the implementation of the final rule. Also, the Section recommends that DoD reconcile the FAR Interim Rule with the policies reflected in the Wynne Memorandum and also adopt as a minimum threshold for all subcontracts the minimum threshold tied to the cost or pricing threshold proposed for subcontracts under DoD contracts. The Section further recommends that the Councils clarify the term “total cost of [the] work.”

The Section appreciates the opportunity to provide these comments and is available to provide additional information and assistance as the Councils may require.

Sincerely,

Karen L. Manos
Chair, Section of Public Contract Law

Attachments A and B – Prior Section Comment Letters

cmp: Donald G. Featherstun
Carol N. Park Conroy
Mark D. Colley
David G. Ehrhart
Allan J. Joseph
John S. Pachter
Michael M. Mutek
Patricia A. Meagher
Council Members, Section of Public Contract Law
Chair(s) and Vice Chair(s) of the Strategic Alliances, Teaming & Subcontracting Committee
Kara M. Sacilotto
VIA FACSIMILE AND E-MAIL

Defense Acquisition Regulations System
Attn: Ms. Sandra Morris
OUSS (AT&L) DPAP (CPF)
IMD 3D139
3062 Defense Pentagon
Washington, D.C. 20301-3062


Dear Ms. Morris:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced Defense Federal Acquisition Supplement (DFARS) interim rule issued with a request for comments by the Defense Acquisition Regulations System on May 13, 2008. The Section consists of attorneys and associated professionals in private practice, industry, academia, and government service. The Section’s governing Council and substantive committees contain members representing these segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.¹

¹ Jeri Kaylene Somers, James A. Hughes, Jr., and Sharon Larkin, Council Members of the Section of Public Contract Law, and Mary Ellen Coster Williams, the Section of Public Contract Law’s representative to the ABA House of Delegates, did not participate in the Section’s consideration of these comments and abstained from voting to approve and send this letter.
The Section is authorized to submit comments on acquisition regulations under special comment authority granted by the Association's Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.²

BACKGROUND

The Department of Defense (DoD) reported and published an Interim Rule amending the DFARS in order to implement Section 852 of the National Defense Authorization Act for Fiscal Year 2007. Pursuant to Section 852, DoD is required to issue regulations that address excessive pass-through charges on DoD contracts and subcontracts to ensure that such charges are not excessive in relation to the cost of the work being performed.

The DoD published that interim rule on April 26, 2007, 72 Fed. Reg. 20758 (Apr. 26, 2007) ("2007 Interim Rule"), and included a solicitation provision and a contract clause requiring offerors and contractors to identify the percentage of work that will be subcontracted. If the subcontracted costs are expected to exceed 70 percent of the total work, additional information is to be provided on indirect costs, profit, and the value being added to the subcontracted work. The DoD received comments from fourteen sources, including comments from the Section, which are attached.³ As a result of its review of the comments, DoD issued a second interim rule on May 13, 2008. 73 Fed. Reg. 27464 (May 13, 2008) ("2008 Interim Rule"). The Section respectfully submits these additional comments to highlight what it believes to be important points for DoD to consider prior to the release of a final rule.

COMMENTS

In its comments on the 2007 Interim Rule, the Section noted that it agrees pass-through charges should not be excessive. The Section has examined the extensive discussion of the comments submitted by fourteen sources on the 2007 Interim Rule and commends DoD for its thorough review of the comments and the

² This comment letter is available in pdf format at http://www.abanet.org/contract/federal/regscomm/home.html under the topic “Subcontracting and Teaming.”

³ The Section's previous comment letter, dated June 25, 2007, also is available in pdf format at http://www.abanet.org/contract/federal/regscomm/home.html under the topic “Subcontracting and Teaming.”
issues raised by that interim rule. In its comments on the 2007 Interim Rule, the
Section addressed the importance of guidance regarding the effective
implementation of the rule. In its notice accompanying the 2008 Interim Rule,
however, DoD has deferred this issue to a point “when necessary.” As discussed in
more detail below, the Section calls to DoD’s attention the January 2008
Government Accountability Office (GAO) report that makes the same
recommendation. In addition, the Section does not believe that the DoD has
addressed the conflict between DoD policies that the Section identified in its
comments on the 2007 Interim Rule. The Section also suggests that the Final Rule
include a threshold for flowing down the clause in subcontracts.

A. Guidance Should be Available to Contracting Officers, As Noted in the
Section’s Earlier Comment and in a More Recent GAO Report

In its comments on the 2007 Interim Rule, the Section recommended that
DoD provide guidance to contracting officers so that they can effectively
implement the goal of eliminating or reducing excessive pass-through charges,
which is an important goal. In the discussion of “Planning and Guidance” in the
notice accompanying the 2008 Interim Rule, DoD mentions the Section’s statement
that there is no substitute for adequate contract planning and administration on the
part of the Government, and further relates the Section’s concern that without
adequate guidance, there is potential for mischief. The DoD response states that
“DoD will monitor implementation and will provide guidance when necessary.” 73
Fed. Reg. at 27471. To ensure that the 2008 Interim Rule is implemented in an
effective manner and is not employed merely to reprice contracts, the Section
repeats its recommendation that DoD proactively address the creation of guidance
to assist contracting officers.

Since the Section submitted its comments on the 2007 Interim Rule, GAO,
at the request of congressional committees, conducted a study because one-third of
DoD’s fiscal year 2006 spending on goods and services was for subcontracts. As a
result, DoD auditors and Congress raised concerns about the potential for excessive
pass-through charges by contractors. GAO reviewed and analyzed the Federal
Acquisition Regulation, the DFARS, discussed the issues with DoD acquisition
policy, audit and contracting officials, and interviewed private companies. As a
result of this extensive review, GAO recommended that DoD issue guidance to

4 GAO, Defense Contracting: Contract Risk a Key Factor in Assessing Excessive Pass-Through
Charges, GAO-08-269 (Jan. 25, 2008).

5 Id.
implement this rule and noted that DoD concurred with the recommendation. Notably, the GAO report states that:

While the rule aims to provide contracting officers with more information on contractor value added, it alone will not provide greater insight into DOD's supply chain and costs — information that companies told us they use to mitigate excessive costs. In addition, while the rule is not yet final, contracting officials we spoke to indicated the need for guidance on how to effectively implement the rule since they were not clear what more they should be doing beyond applying tools in the FAR and DFARS. This would ensure that contracting officers, particularly newer and less experienced staff, consistently apply federal acquisition tools in conducting their assessments of contractor value added and take into account contract risk when determining the degree of assessment needed, documenting assessments, and involving DCAA and DCMA as appropriate.6

The Section believes that the GAO report further supports the need for guidance at the time of implementing this requirement as a final rule, and recommends that DoD reconsider its intent to provide guidance “when necessary.” The GAO report provides information and suggestions relevant to the creation of guidance such as a description of unique circumstances that drive contracting arrangements that include greater risk of excessive pass-through charges, including the lessons learned on contracts awarded for Hurricane Katrina recovery efforts,7 which, the Section noted in its earlier comment, was one of the excessive pass-through situations that gave rise to the statutory requirement for this DFARS rule.8

Evaluation of a program’s cost and a contractor’s proposed management approach, including the subcontract plan, is a part of the procurement contracting officer’s award determination. The Section believes that to the maximum practical extent — for those procurements that are not otherwise exempt under the 2008 Interim Rule — any excessive proposed costs related to subcontract management can be evaluated in the context of competition or addressed in negotiations in a sole source procurement. The Section further believes that the new rule should serve as

6 Id. at 4.

7 Id. at 14–17.

8 See Section Comments on 2007 Interim Rule at 5 n. 3.
a tool to ensure consistency to the extent practicable between contractors’ proposals, as evaluated by the procurement contracting officer, and actual performance, monitored by the contracting officer, rather than to serve as a basis to disallow cost after incurrence.

With further regard to evaluation of negotiated procurements, the procurement contracting officer should, in light of the 2008 Interim Rule, pay special attention to those contract elements that would require multiple tiers of subcontractors and thus, multiple layers of indirect cost and profit. For example, contracts that require the prime contractor to act as an integrator implicitly require that the prime contractor employ subcontractors to accomplish the scope of the contract. A more explicit example would be the requirement to satisfy a small business plan that could necessitate multiple subcontractors. Finally, the final rule should carefully consider the potential effects to those small businesses performing as prime contractors on contract set-asides given that small business prime contractors could experience significant adverse financial impacts as a result of disallowed pass-through costs under this rule. This would be contrary to the protections typically afforded small business federal contractors.

B. The Interim Rule Does Not Reconcile Conflicts with Existing Policies

In its comments on the 2007 Interim Rule, the Section noted that the 2007 Interim Rule could impact team assembly and formation decisions, and that it conflicts with DoD policy that seeks both to ensure robust competition for subcontracts and absence of bias on the part of prime contractors toward in-house sources. The Section recommended that DoD reconcile its policies to avoid confusion.

In the discussion of “Impact on Business Strategy, Spares Contracting, and Indefinite-Delivery Indefinite-Quantity or Delivery Order Contracts” in the notice accompanying the 2008 Interim Rule, DoD mentions the Section’s concern. DoD states that the policies are not inconsistent, and that this “rule is intended to protect the Government from those situations where there appeared to be an agreement with the contractor to perform the contract scope of work, including ‘managing’ subcontractors, and then after award, the contractor subcontracts substantially all the effort without providing the required ‘added value.’” 73 Fed. Reg. at 27470. The Section believes that the 2008 Interim Rule goes far beyond such situations. DoD’s statement connotes a situation where there is active misrepresentation of the prime contractor’s intent and perhaps its capabilities. The 2008 Interim Rule, however, addresses much more than misrepresentation, and reaches all situations where subcontracting can be used to create a strong team.
Nevertheless, DoD’s response does not address the Section’s concern. The Section supports the Wynne Memorandum’s purpose, which is to foster competition through assembly of a strong team that can address and satisfy the required capabilities while avoiding the favoring of an affiliate over an unrelated entity. The Section remains concerned that the 2008 Interim Rule exerts pressure to keep work in-house to address the reporting requirement, and believes that DoD should be aware—and concerned—about this. It seems inconceivable that the 2008 Interim Rule would not have an impact on contractor team assembly and formation decisions. The Section restates that the 2008 Interim Rule’s emphasis on limiting the amount of subcontracted work conflicts with the Wynne Memorandum’s emphasis on ensuring robust competition to ensure consideration of subcontracting to independent companies. As the Wynne Memorandum indicates, a key DoD goal is to facilitate the most effective combination of complementary skills to ensure that the prime contractor can provide best value and accomplish the task efficiently and effectively. If the amount of subcontracting is limited to an arbitrary share of the total work effort, this goal will be seriously jeopardized.

Additionally, the 2008 Interim Rule may be interpreted and applied so as to conflict with the requirements of the Cost Accounting Standards (CAS). CAS requires that all indirect costs be fully absorbed and allocated to final cost objectives, and defines certain mandatory rules for the measurement, assignment, and allocation of those costs. The 2008 Interim Rule provides a basis for contracting officers to disallow costs if the contractor fails to demonstrate “added value,” which is defined in DFARS 252.215-7004(a) as “... subcontract management functions that the Contracting Officer determines are a benefit to the Government.” Under the 2008 Interim Rule, the contracting officer is responsible for determining the value certain allocable indirect costs actually add to the contract. Nevertheless, General and Administrative (G&A) costs are by their very nature residual and do not permit the assignment of a clear beneficial or causal relationship between the cost incurred and a benefit to any particular final cost objective. As a result, there is a potential that the G&A applied to all tiers of subcontracts could be deemed to be “excessive” and therefore unallowable, even if it is incurred in accordance with the contractor’s approved disclosed cost accounting practices. If a contractor incurs cost in accordance with CAS and its disclosed practices, the only question should be the allowability and reasonableness of the cost, both of which can be dealt with prior to award and incurrence of those costs.

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9 On July 12, 2004, Michael W. Wynne, then-Under Secretary of Defense, Acquisition, Technology and Logistics (acting), issued a memorandum for the secretaries of the military departments entitled Selection of Contractors for Subsystems and Components (“Wynne Memorandum”).
To the extent a contracting officer believes that an adjustment to the amount of indirect cost applied to final cost objectives is appropriate because certain contracts receive more or less benefit from residual expenses than would be indicated by the contractor’s standard allocation practices, those should be addressed through special allocations, such as those at 48 C.F.R. 9904.410-50(j) and 9904.418-50(f), not through the disallowance of costs.

The Section believes that a distinction should be made with regard to G&A applied to contracts versus applied profit. This will serve to protect the contractor’s recovery of allowable G&A if incurred in accordance with CAS and the contractor’s disclosed practices, while focusing the Government’s attention to the negotiated item of profit. Application of indirect cost, including G&A, is not only governed, but required by the CAS and FAR. While public law and regulation determine the manner in which a contractor may apply those costs, they provide no methodology or guideline for the calculation and application of profit beyond justifying its existence. As a result, guidance should be issued to contracting officers to evaluate applied profit more stringently rather than to determine unallowable those actual costs that have been incurred and allocated in accordance with applicable guidelines.

C. A Threshold Should be Stated for Subcontracts That Must Flow Down the Clause

The summary of comments accompanying the 2008 Interim Rule demonstrates the value of reasonable parameters with regard to the number of subcontractors to whom this requirement flows down. The Section suggests that it is reasonable that subcontracts that are minimal in value or less than one to two percent of the total cost of the contract should be exempt.

DoD’s response to these comments indicates that it agrees that a minimum threshold is required and that it has established a threshold tied to the cost or pricing data threshold. This establishes a threshold at the prime contract level. DoD did not, however, include a threshold for subcontracts in paragraph (f) of DFARS 252.215-7004. As a result, prime and higher tier subcontractors through each tier of the supply chain will be required to include the clause in every subcontract, regardless of value, except for those that meet the four exclusions currently identified in the clause. Given that the clause requires contracting officers to make determinations with regard to subcontracts as well as the prime contract, the potential burden for satisfying this requirement with respect to low value subcontracts will be considerable. While many low value subcontracts may be awarded on a competitive basis or fit the definition of commercial items, many will not. The risk to the Government is minimal with respect to lower tier
subcontracts. If DoD uses the threshold in FAR 15.403-4, it will exclude a significant number of subcontracts from this burdensome requirement, but still cover the vast majority of the total value of subcontracts.

CONCLUSION

The Section supports the goal of the 2008 Interim Rule on excessive pass-through charges, but remains concerned that without additional guidance, issues will arise in the implementation of the final rule. Also, the Section recommends that DoD reconcile the 2008 Interim Rule with the policies reflected in the Wynne Memorandum and that it address a threshold for subcontracts.

The Section appreciates the opportunity to provide these comments and is available to provide additional information and assistance as the Councils may require.

Sincerely,

[Signature]

Patricia A. Meagher
Chair, Section of Public Contract Law

cc: Michael W. Mutek
Karen L. Manos
Donald G. Featherstun
Carol N. Park-Conroy
John S. Pachter
Michael A. Hordell
Robert L. Schaefer
Council Members, Section of Public Contract Law
Chair(s) and Vice Chair(s) of the Strategic Alliances, Teaming and Subcontracting Committee
Chair(s) and Vice Chair(s) of the Accounting, Cost and Pricing Committee
Scott M. McCaleb
Kara M. Sacilotto
June 25, 2007

VIATA ELECTRONIC MAIL AND FIRST CLASS MAIL

Defense Acquisitions Regulations System
Attn: Mr. John McPherson
OUSD (AT&L) DPDP (CPF) IMD 3C132
3062 Defense Pentagon
Washington, DC 20301-3402


On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced DFARS case. The Section of Public Contract Law consists of attorneys and associated professionals in private practice, industry and Government service. The Section’s governing Council and substantive committees have members representing these three segments, to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the

1 Jeri Kaylene Somers, a Council member of the Section of Public Contract Law, did not participate in the Section’s consideration of these comments and abstained from the voting to approve and send this letter.
Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association. 2

Introduction

On April 26, 2007, the Department of Defense ("DoD") published in the Federal Register an interim rule, 72 Fed. Reg. 20758, amending the Defense Acquisition Regulation Supplement ("DFARS") with respect to pass-through charges on DoD contracts and subcontracts ("Interim Rule"). The Interim Rule implements Section 852 of the National Defense Authorization Act for Fiscal Year 2007 (Pub. L. No. 109-364), which requires the DoD to prescribe regulations to ensure that pass-through charges on contracts or subcontracts that are entered into for or on behalf of the DoD are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor.

The Section agrees that pass-through charges should not be excessive. Furthermore, the Section commends the DoD for its recognition of the effect of market forces indicated by the exclusion of certain contracts and subcontracts from the requirements of this Interim Rule. Nevertheless, the Section notes that inconsistent policies exist at DoD with regard to subcontracting. Therefore, the Section recommends that DoD reconcile its policies to avoid confusion. In addition, the Section believes that express guidance should be provided to contracting officers so that they can effectively implement the goal of eliminating or reducing excessive pass-through charges. This guidance should recognize that one value a contractor or subcontractor provides is competency in identifying, forming, and managing contractual arrangements with best-in-class companies. In these arrangements, the prime contractor or higher tier subcontractor can bring considerable integration talents to the program. Without recognition of this value, the Interim Rule could result in arbitrary "make" decisions rather than reasoned "buy" decisions that provide best value, and the Interim Rule could be used merely as a tool to reprice contracts.

Current Policies Conflict

On July 12, 2004, Michael W. Wynne, then-Under Secretary of Defense, Acquisition, Technology and Logistics (acting), issued a memorandum for the secretaries of the military departments entitled Selection of Contractors for Subsystems and Components ("Wynne Memorandum" or "Memorandum"). The

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2 This letter is available in pdf format at http://www.abanet.org/contract/regscomm/home.html under the topic "Subcontracting and Teaming."
purpose of the Wynne Memorandum is to foster competition for major program subsystems and components. To achieve this purpose, the Memorandum mandates action by the Government during the acquisition planning process and by industry when assembling a team to deliver the required capabilities.

The Wynne Memorandum notes that defense acquisition benefits from the assembly of a strong team at both the prime and subcontractor levels. Furthermore, the Memorandum points out that because of defense consolidation, large defense contractors more often than not must choose between an affiliate and an unrelated company for major program subsystems or components. The potential for bias favoring the affiliate is a stated reason in the Wynne Memorandum for the Government to seek greater insight into the prime contractor's team-selection process.

On October 27, 2004, the Section submitted comments to the DoD on the Wynne Memorandum. These comments stated that the Section understands and fully supports the Government's efforts to foster robust competition at both the prime contract and subcontract levels. In fact, the first principle in the Principles of Competition in Public Procurements adopted by the American Bar Association urges that public acquisitions use full and open competition to the maximum extent practicable. The Section also strongly supports upholding the integrity of the acquisition process. With these principles in mind, the Section suggested that DoD recognize that the Wynne Memorandum does not distinguish between competitive and sole source situations, and suggested that a revision to the Memorandum or implementing guidance may be helpful to address the fact that, in competitive situations, the marketplace exerts an incentive to assemble the most competitive team possible, along with legal and regulatory restraints against anticompetitive behavior. As discussed in the Section comments, the marketplace tends to punish wrong decisions. The Section also noted that the Government has sought to avoid unnecessary involvement in team assembly decisions and has relied on the marketplace.

The Section believes that the DoD should recognize that the Interim Rule may impact team assembly and formation decisions. In particular, the Memorandum's emphasis on the desirability of teaming with independent companies conflicts with the Interim Rule's emphasis on limiting the amount of work being subcontracted out. As the Wynne Memorandum indicates, a key DoD goal is to facilitate the most effective combination of complementary skills to

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3 The Section's comments on the Memorandum are available at http://www.abanet.org/contract/federal/regscomm/subk_003.pdf.
ensure that the prime contractor can provide best value and accomplish the task efficiently and effectively. If the amount of subcontracting is limited to an arbitrary share of the total work effort, this goal will be seriously jeopardized.

The Section further wishes to point out that the Federal Trade Commission ("FTC") and the Department of Justice ("DoJ") have noted that in order to compete in today's marketplace, companies that are competitors might need to collaborate as teammates. The FTC and DoJ have also found that such teams may be pro-competitive. "Nevertheless, a perception that antitrust laws are skeptical about agreements among actual or potential competitors may deter the development of procompetitive collaborations."  

In contrast to the emphasis in the Interim Rule on excessive pass-through charges on the amount of work subcontracted out, which could impact the use of subcontractors, the Memorandum provides a reason to look outward and add non-affiliated subcontractors. This is an inconsistency in policy and a mixed message on the subject of subcontracting. The Section recommends a reconciliation of these conflicting positions by noting (i) that the assembly of strong and capable teams remains the goal and that the Interim Rule does not seek to discourage the formation of strong teams and (ii) in order to avoid excessive pass-through charges, the DoD must be assured that the prime contractor or higher tier subcontractor is providing value commensurate with the pass-through charge.

**Guidance is Needed to Assist Contracting Officers**

As noted above, the Section believes that the objective of this Interim Rule is beneficial. To ensure that the Interim Rule is implemented in an effective manner, and not employed merely to reprice contracts, guidance is needed to assist contracting officers.

In Senate Report No. 109-254 for the National Defense Authorization Act for Fiscal Year 2007, the Senate Armed Services Committee recommended a provision that would require the Secretary of Defense to modify DoD regulations to prohibit excessive pass-through charges on contracts and subcontracts because a subcommittee "identified a potential problem with pass-through charges by contractors responsible for major defense acquisition programs."  

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2 Id. at 1.
subcommittee "[was] particularly concerned by the possibility that the Department could be paying unnecessary pass-through charges to lead-system integrators on major weapon systems for which the integrator provides no value added, but that are acquired as a part of a system-of-systems." DoD, however, is taking a procurement-wide approach; the Interim Rule does not focus on lead-system integrators. Unfortunately, the Interim Rule also does not address an important reality in today's market: a strong prime contractor must actively search, administer, and integrate the work of many subcontractors in order to provide to the DoD the best solution and best value to fulfill the DoD's needs. In such a situation, the prime contractor or higher-tier subcontractor should not be penalized for finding best-in-class support, and the DoD should avoid the implication that would drive contractors to decide to "make" rather than "buy" – the exact concern that gave rise to the Wynne Memorandum.

Another issue covered in Senate Report No. 109-254 is the press coverage of a Hurricane Katrina-related contracting problem, notably a situation where a company received a contract and passed work down to a subcontractor that then passed the work down further. In testimony before the Subcommittee on Readiness and Management Support of the Senate Armed Services Committee on April 5, 2006, the Comptroller General, when asked his view on pass-through charges, stated that "one of the things that we need more visibility over is: How many layers, how many players, how many margins are in here?" The Section notes that contingency contracting, whether in response to a natural disaster such as Hurricane Katrina or as a result of a contingency military operation, carries with it numerous contracting issues. These contracting issues, however, should not drive overall DoD policy with respect to subcontracting. The Interim Rule contains a fundamental and beneficial goal -- the avoidance of excessive pass-through charges -- but there is the potential for mischief in the Interim Rule's procedure, which provides for price reductions and disallowances. This Interim Rule is no substitute for adequate contract planning and administration on the part of the Government. Without adequate guidance, this potential for mischief could become an issue.

Conclusion

The Section supports the goal of the Interim Rule on excessive pass-through charges, but is concerned with the conflict between the Interim Rule and the Wynne Memorandum.

\[1Id.\]

\[2Id. at 364 (quoting Comptroller General testimony).\]
Memorandum. Recognizing the value in locating subcontractors that provide the Government with the best solution and the best value, the Section also believes that the DoD should create guidance to assist contracting officers in the implementation of the rule.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

Michael A. Hordell
Chair, Section of Public Contract Law

cc: Patricia A. Meagher
    Michael W. Mutek
    Karen L. Manos
    Carol N. Park Conroy
    Mary Ellen Coster Williams
    John S. Pachter
    Robert L. Schaefer
    Patricia H. Wittie
    Council Members, Section of Public Contract Law
    Strategic Alliances, Teaming and Subcontracting Committee, Chair(s) and Vice-Chair(s)
    Scott M. McCaleb