ACQUISITION AND TECHNOLOGY

OFFICE OF THE UNDER SECRETARY OF DEFENSE

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MEMORANDUM FOR DIRECTORS OF SMALL AND DISADVANTAGED BUSINESS UTILIZATION
DIRECTORS OF DEFENSE AGENCIES
DEPUTY FOR ACQUISITION AND BUSINESS MANAGEMENT, ASN(RD&A)
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE (CONTRACTING), SAF/AQC
DEPUTY ASSISTANT SECRETARY OF THE ARMY (PROCUREMENT), ASA(ALT)
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY
EXECUTIVE DIRECTOR FOR PROCUREMENT MANAGEMENT (DLSC/DLA)

SUBJECT: Subcontract Payments and Elimination of the Paid Cost Rule

The Department of Defense (DoD) has made a number of significant policy changes in recent years in the way it conducts business with its contractors. This memorandum addresses the impact that one of those changes, i.e., the removal of the so-called "paid cost rule" from payments provisions, will have on payments made to subcontractors, including many small businesses.

Federal Acquisition Circular (FAC) 97-16, issued March 27, 2000, eliminated the paid cost rule from contract payments provisions used in contracts with large businesses. Previously, large businesses were required to have actually paid their subcontractors before including those payments in their Government billings. In contrast, small businesses need only have incurred those costs to include them in their billings, provided they paid their vendors in the ordinary course of business. The elimination of the paid cost rule from the Progress Payments (FAR 52.232-16), Allowable Cost and Payments (FAR 52.216-7), and Payments Under Time and Materials and Labor Hour Contracts (FAR 52.232-7) provisions means that there will be consistent treatment of all incurred subcontract costs, without regard to whether the cost is incurred by a large or a small business.

To remove any possibility that this change could have a negative impact on subcontractors, the government put several safeguards in place to provide further assurances that payments

to subcontractors will not be delayed. Payments provisions now require that both large and small business prime contractors pay incurred subcontract amounts (1) in accordance with the terms of a subcontract or invoice, and (2) ordinarily before submittal of the next payment request sent to the government. This means the subcontractor will in most cases be paid no later than thirty days after the prime contractor submits a payment request to the government that includes amounts the prime has certified it will pay to its subcontractors. Thus, the new rules reinforce the longstanding requirement that prime contractors make timely payments in accordance with the payment terms of their subcontracts. Elimination of the paid cost rule from contracts with large business prime contractors has in no way relieved prime contractors of this responsibility.

The attached summary provides an overview of current DoD policies and procedures that address allegations of prime contractor nonpayment of subcontractors. We hope it will serve as a useful reference for contracting officers and small business specialists, and assist the small business community in dealings with prime contractors and the DoD.

Robert Neal
Director, Small and
Disadvantaged Business
Utilization

Deidre A. Lee
Director, Defense
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Attachment:
As stated

PRIME CONTRACTOR NONPAYMENT OF SUBCONTRACTORS

Department of Defense (DoD) interests are adversely affected if a prime contractor fails to pay amounts properly owed to its subcontractors. Failure to make payments:

- may impair the prime contractor's ability to perform DoD contracts;
- may be indicative of larger financial difficulties which could lead to a default, or result in the loss of government payments, and
- may irreparably damage subcontractors critical to the defense industrial base.

The Federal Acquisition Regulation Supplement (FAR) 32.112 addresses actions that contracting officers must take when a subcontractor alleges nonpayment. It should be read in conjunction with the payment clauses included in contracts and other pertinent provisions of the Federal Acquisition Regulation and Defense FAR Supplement, many of which are discussed below.

To facilitate any contracting officer review of a complaint of nonpayment, subcontractors must first be aware of the prime contract number and/or the office responsible for administration of the prime contract. Subcontractors are advised to request their prime contractors to provide them with this information as soon as possible after the subcontract is awarded, before any problems arise. Should the prime contractor resist providing this information, and if the subcontractor is also a prime contractor, it may request the assistance of the contracting office responsible for administration of its own prime contracts in the identification of contract administration responsibilities. Subcontractors, especially those with no government contracts, may also request the aid of any representative of DoD's Office of Small and Disadvantaged Business Utilization to help them identify points of contact within the Defense Contract Management Agency (DCMA) who can help identify the contracting office responsible for providing contract administration services to a particular prime contractor.

POLICIES THAT ADDRESS NONPAYMENT:

1. Preaward Surveys

Contracting officers are required by FAR Subpart 9.1 to make an affirmative determination of contractor responsibility prior to the award of a contract, and DoD has established an extensive capability for performing pre-award surveys and determining responsibility. These determinations address matters such as the adequacy of financial resources, business ethics and integrity, and relations with vendors, trade creditors, and bankers. The responsibility for using this tool to protect the Government's interests rests upon the contracting officer making an award.

In addition, when a contracting officer finds that a contractor failed to pay subcontractors properly due amounts, the cognizant preaward survey monitor should be alerted to ensure the matter is considered in future contract award decisions.

2. Contracting Officer Responsibilities

From time to time, subcontractor/supplier complaints of nonpayment by prime contractors may occur, particularly when businesses involved in relatively large contracts begin to experience cash flow problems. However, the failure to pay may also be due to a prime/subcontractor dispute over the work accomplished, a government delay in payment to the prime contractor which resulted in a delay in payment to the subcontractor, or an oversight.

Contracting officers must respond immediately to subcontractor complaints of nonpayment (FAR 32.112). When contracts are administered by an administrative contracting officer (ACO), the ACO is primarily responsible for receiving subcontractor nonpayment complaints, determining the validity of the complaint, consulting with the procurement contracting officer (PCO), and deciding how best to deal with the situation. When contract administration responsibility is retained by the PCO, such as on construction contracts, the PCO is responsible for dealing with the complaint.

The contracting officer should immediately inform the prime contractor of a subcontractor complaint of nonpayment, determine the legitimacy of the complaint, and encourage the contractor to make timely payment. If timely payment is not made, the contracting officer should examine the payment clauses included in the contract to determine if payments may be reduced or suspended. The contracting officer should also determine if any certifications made by the contractor were inaccurate in any material respect.

3. Nonpayment Resulting From Disputes Between a Prime Contractor and Subcontractor

If it is determined that the reason for nonpayment is a prime/ subcontractor dispute over the work accomplished, the contracting officer shall not become involved in the dispute because DoD does not have privity of contract with the subcontractor. However, the contracting officer should ensure that DoD payments are made in accordance with payment provisions included in the prime contract.

- If the prime contract provides for progress payments (on a fixed-price type contract) or payment of cost vouchers (on cost reimbursement or time-and-materials contracts), the contracting officer should ensure that the prime contractor has not included the cost of supplies and services purchased directly for the contract in progress payment requests or cost vouchers unless actual payment either has been made, or will soon be made, to the subcontractor. The prime contractor's payment requests or cost vouchers may include only amounts that the prime contractor certifies it has a contractual obligation to pay the subcontractors, and only those amounts it will be paying the subcontractors prior to submitting its next payment request to the government. In most cases, this means the subcontractor payments will occur within thirty days of the prime contractor receiving the government payment.

- For a construction contract, the prime contractor is required to certify that its payment request does not include any amounts which it intends to withhold or retain from a subcontractor in accordance with the

terms and conditions of the subcontract (see FAR 52.232-5(c)(3)). Additionally, the prime contractor is required to provide a written notice of any subcontractor payment withholding, including the reason for the withholding and the remedial actions to be taken by the subcontractor in order to receive payment (see FAR 52.232-27(g)), and the prime contractor may not request payment from DoD of amounts withheld until the contractor certifies to the contracting officer that the subcontractor is entitled to payment of previously withheld amounts (see FAR 52.232-27(h)).

4. Nonpayment of a Subcontractor for Other Reasons

If it is determined that a subcontractor was not paid for other reasons, the responsible contracting officer should encourage the prime contractor to make timely payment; if timely payment is not made, the contracting officer should inform the prime contractor that:

- Progress payments based on cost (see FAR 52.232-16(c)(4)) or performance-based payments (see FAR 52.232-32(e)(3)) may be reduced or suspended because the contractor is delinquent in payment of the costs of performing the contract in the ordinary course of business or

- Cost reimbursements may be reduced because the contractor is delinquent in paying the costs of contract performance in the ordinary course of business (see FAR 52.216-7(b)(ii)).

When payment bonds have been required for a contract, such as a construction contract, the contracting officer is not authorized to withhold payments during contract performance because subcontractors have not been paid. Instead, the contracting officer should advise subcontractors who allege nonpayment to contact the surety on the bond and should also notify the surety of the nonpayment allegations (see FAR 28.106-6 and 28.106-7).

5. False Certifications

Certain types of payment requests require the prime contractor to certify that subcontractors are being paid in a timely manner. If the contracting officer finds that this type of certification is inaccurate in any material respect because a subcontractor has not been paid, the contracting officer should consult with legal counsel on whether a false certification has been made and determine if the matter should be referred to (i) the local agency fraud investigation activity, or (ii) the debarring official in accordance with DFARS 209.406-3. For example,

- When a contractor prepares a SF 1443, Contractor's Request for Progress Payment, the contractor must certify on the form that "...all the costs of contract performance (except as herewith reported in writing) have been paid to the extent shown herein, or where not shown as paid have been paid or will be paid currently, by the contractor, when due, in the ordinary course of business..."

- When a contractor submits a request for a progress payment on construction contract, the contractor certifies that "...payments to subcontractors have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by this certification..." and that the request for payment "...does not include any amounts which the prime contractor intends to withhold or retain from a subcontractor or supplier in accordance with the terms and conditions of the subcontract" (see FAR 52.232-5(c)).

6. Special Techniques

When contract performance is jeopardized due to subcontractor payment problems, the contracting officer should consider if additional actions need to be taken to protect the Government's interests. The following techniques have been used by contracting officers to deal with the ramifications of payment problems; in some cases,

no direct Government action is involved other than encouraging the contractor to enter into an arrangement:

- Escrow Accounts. The prime contractor may agree to establish an escrow account at a federally insured financial institution that would make direct disbursements of contract funds to subcontractors and prevent the use of those funds for other purposes. Government contract payments are made to the escrow agent who pays subcontractors in the amounts specified by the prime contractor. The terms of an escrow account agreement can vary widely, but the Government's involvement is usually limited to acceptance of an assignment of claims to the financial institution, or to a change of payment address to direct the Government's checks to the escrow account.

- Letters of Credit. A letter of credit is a document issued by a financial institution authorizing the bearer to draw a specified amount of money from the issuing financial institution. Letters of credit can be used to assure payment to subcontractors who deliver in accordance with subcontract requirements. *The Government is not a party to the arrangement.*

- Contract Restructuring. Occasionally the Government will be able to restructure a contract delivery schedule to mitigate peak demands on contractor cash flow, thereby facilitating continued contract performance. Such restructurings require that the Government receive consideration.

- Proof of Payment. In some cases, it may be desirable to require a contractor to provide proof that subcontractors have been paid prior to payment by DoD.

- Unusual Financing. If the contractor has a short-term cash flow problem on an otherwise profitable, well-managed contract, additional contract financing may be desirable. Additional financing should be considered only as a last resort, and the requirements in FAR Part 32 apply.