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**Time-and-Materials Contracts**

New governmentwide and Defense Department rules on the use of time-and-materials and labor-hour contracts in acquiring services went into effect Feb. 12, 2007, after several years of confusion and controversy in the area. This analysis provides a review of the issues underlying the rules and a detailed discussion of their key features. It concludes with a summary table that provides a quick reference tool for those applying the new standards.

## From Engine Overhauls to Information Technology Consulting: A Service Contractor's Guide to the New Federal Acquisition Regulations Applicable to Time-and-Materials and Labor-Hour Contracts

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Effective February 12, 2007, contractors that provide services to the Federal Government under ''time-and-materials'' (''T&M'') or ''labor-hour'' (''LH'') contracts (referenced collectively herein as ''T&M contracts'') will face a new set of rules that will significantly impact the way they manage such contracts. These new rules—which take the form of three separate sets of revisions to the Federal Acquisition Regulation (''FAR'') and Defense FAR Supplement (''DFARS''), including six new or revised contract clauses—prescribe a complex framework in which different sets of terms and conditions apply to T&M contracts depending on whether the required services are commercial or noncommercial, whether the contract is the result of adequate price competition, and whether the purchaser is a Department of Defense (''DoD'') or non-DoD agency. Contractors that are unaware of how the rules apply to different circumstances will find their ability to manage these contracts and their business case for performing the work significantly affected. Once understood, however, the rules do provide a reasonable framework and go far in resolving nearly three years of uncertainty regarding the proper interpretation of the prior T&M payments clause.

This article provides an overview and analysis of the new rules with the intention of guiding service contrac-

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tors through the intricacies of the new regulatory framework.

## I. *Background*

T&M contracts permit the Government to acquire services on the basis of direct labor hours at specified fixed hourly rates. In addition to actual employee wages, the fixed hourly rates include contractor overhead, general and administrative expenses, and profit. Materials provided in conjunction with the labor hours typically have been provided to the Government at the prime contractor's cost. Unlike a firm-fixed-price contract under which the contractor provides the required services or supplies at a fixed price, the Government's ultimate price for a T&M contract will depend largely on the number of labor hours provided by the contractor in performing the services. Moreover, in contrast to cost-reimbursement types of contracts, the labor costs charged to the Government are not limited to the contractor's actual incurred costs.

Because the Government views T&M contracts as providing less incentive for efficient performance than firm-fixed-price contracts, the FAR provides that T&M contracts should be used only when the scope of work or duration of performance is not defined sufficiently to allow a reasonable basis for contractors to price the work on a firm-fixed-price basis. [1] Although the Government has used T&M contracts since the 1990s to acquire services under the General Services Administration's (''GSA's'') commercial item-based Multiple Award Schedule program, it was not until the Services Acquisition Reform Act of 2003 (''SARA'') became law that Congress explicitly authorized Government agencies to acquire commercial services on a T&M basis using the FAR Part 12 streamlined commercial acquisition procedures.

Shortly after SARA became law, however, significant confusion arose over whether prime contractors could include profit in the labor rates they charged for subcontract labor. In audit guidance dated April 9, 2004, the Defense Contract Audit Agency (''DCAA'') interpreted the standard T&M payment clause, FAR 52.232-7 (Payment Under Time and Materials and Labor Hour Contracts) as limiting the price that prime contractors may charge Government agencies for subcontract labor. [2] Specifically, DCAA interpreted the T&M payment clause as treating subcontract labor essentially as a pass-through cost, meaning that prime contractors could not include any profit or other added margin to the price charged to the Government for subcontract labor. DCAA's interpretation conflicted with the prevailing practice under which the parties applied the clause's limitation only to subcontracts for materials, not for labor. [3] DCAA's interpretation also would produce an inequitable result considering that prime contractors would not be compensated for their costs incurred in administering subcontract labor or for the risk prime contractors assumed for defective subcontractor performance. Nonetheless, DCAA's interpretation led to several significant contract disputes involving agencies that withheld large payments attributable to work performed by subcontractors.

**The rules provide a reasonable framework and go far in resolving nearly three years of uncertainty regarding the proper interpretation of the prior T&M payments clause.**

The rulemaking process itself started in September 2004 when the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (together, the ''Councils'') issued an Advanced Notice of Proposed Rulemaking (''ANPR'') to implement SARA. The ANPR's draft provisions that would have required prime contractors to treat subcontract labor as a pass-through cost generated significant controversy. [4] A year later the Councils issued separate proposed FAR rules: one rule covering T&M contracts for commercial services and another proposed rule covering T&M contracts for non-commercial services. [5] Both proposed rules adopted a default approach whereby subcontract labor hours would be treated as ''materials'' and charged to the Government at the prime contractor's cost.

The Councils' more than two year rulemaking process included substantial fact finding. The Councils conducted two public meetings and two public comment periods; they also reviewed analyses prepared by the Government Accountability Office (''GAO'') and materials presented to the Acquisition Advisory Committee tasked by SARA to recommend changes to acquisition statutes, regulations, and government-wide acquisition policies with a view toward ensuring effective and appropriate use of commercial practices and performance-based contracting. In addition to the subcontract labor issues, the Councils tackled many other issues inherent in T&M contracts, including the internal approval requirements for T&M contracts; payment for direct materials, incidental services, other direct costs, and indirect costs; the treatment of rebates, refunds, and discounts; subcontractor approval requirements; standard of performance; termination for default and termination for convenience issues; Government oversight; and the application of the Cost Accounting Standards.

Ultimately, on December 12, 2006, the Councils published three sets of regulations governing T&M contracts. Specifically, the Councils issued: (1) a final FAR rule that applies to commercial item acquisitions; (2) a final FAR rule that applies to noncommercial item acquisitions; and (3) an interim DFARS rule with request

[1] FAR 16.601(b).

[2] Robert DiMucci, DCAA Assistant Director Policy and Plan, Memorandum for Regional Directors, ''Audit Guidance on Review of Orders under GSA Schedule Contracts'' (Apr. 9, 2004) (''FAR 52.232-7(b)(4)(ii) specifically limits the reimbursement of costs in connection with subcontracts to amounts paid by the subcontractor. . .'').

[3] The issue gained the attention of members of Congress when Senator Carl Levin (DMich.), on July 19, 2005, proposed an amendment to the fiscal 2006 DoD Authorization bill that would have adopted an approach that was consistent with DCAA interpretation.

[4] ''Additional Commercial Contract Types,'' 69 Fed. Reg. 56,316 (Sept. 20, 2004).

[5] ''Payment Under Time-and-Materials and Labor-Hour Contracts,'' 70 Fed. Reg. 56,314 (Sept. 26, 2005); ''Additional Contract Types,'' 70 Fed. Reg. 56,318 (Sept. 26, 2005).

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for comments that applies to DoD noncommercial item acquisitions. [6] The new rules are effective for new contract actions on or after February 12, 2007. Importantly, GSA and many other agencies that administer long-term multiple award contracts have not yet publicly announced their plans for adding the new T&M clauses to existing service contracts.

## II. *Appropriate Use of T&M Contracts for Commercial Acquisitions*

### A. T&M Contracts Are Not Limited to Specific Categories of Services

The FAR commercial T&M rule implements Section 1432 of SARA, which expressly authorizes the use of T&M contracts for commercial service acquisitions under specified circumstances. [7] SARA restricts use of T&M contracts to two types of services: (a) ancillary commercial services procured to support a commercial item, and (b) any other category of commercial service designated by the Office of Federal Procurement Policy (''OFPP'') as being of a type that is commonly sold to the general public through T&M contracts. Accordingly, OFPP was tasked by Congress to identify the categories of services the Government could acquire under the FAR Part 12 commercial item acquisition procedures.

In response to this statutory mandate, OFPP conducted fact finding and ultimately decided to designate *all* categories of services (*i.e.*, any service) as being of a type that is commonly sold to the general public on a T&M basis. [8] In coming to this conclusion, OFPP considered: (i) a GAO survey indicating that T&M contracts are used in commercial practice across a wide range of industries, and (ii) presentations by members of industry to the Acquisition Advisory Panel. OFPP concluded that it is not the type of service that drives the commercial marketplace's use of T&M contracts, but instead whether the scope of work is defined well enough to allow for fixed-priced terms. Specifically, OFPP concluded that the commercial marketplace uses T&M contracts ''when requirements are not sufficiently well understood to complete a well-defined scope of work and when risk can be managed by maintaining surveillance of costs and contractor performance.'' [9] OFPP further concluded that use of T&M contracts may be in the Government's best interests when these conditions are present. The final commercial FAR rule reflects OFPP's designation by not limiting the acquisition of services on a T&M basis by service type and instead adopting an approach that focuses on the circumstances of the procurement.

### B. Determination and Findings Requirements

The FAR commercial rule creates three significant administrative requirements that must be satisfied before an agency may use a T&M contract. [10] First, the rule implements SARA's mandate that commercial T&M contracts be awarded using competitive procedures. Competitive procedures include those described in FAR 6.102, the setaside procedures described in FAR Subpart 19.5, and the simplified acquisition procedures described in FAR Part 13. [11] The Councils' commentary accompanying the final rule further clarifies that the requirement to use competitive procedures does not mean that conducting a full and open competition is required. [12]

Second, the rule provides that, prior to using a T&M contract, the contracting officer must execute a written determination and findings (''D&F'') explaining that no other contract type is suitable. [13] At a minimum the D&F must:

(1) describe the market research conducted,

(2) ''establish'' that it is not possible to accurately estimate the extent or duration of the work or to anticipate costs with any reasonable degree of certainty,

(3) ''establish'' that the requirement has been structured to best allow for the use of a fixed-price-type contract (including a fixed price with economic price adjustment contract) on future acquisitions, and

(4) describe actions planned to maximize the use of fixed-price-type contracts in the future.

The rule also addresses several nuances applicable to D&Fs for indefinite delivery (''ID'') contracts. When an ID contract is awarded with services priced on a T&M basis, the contracting officer shall, to the maximum extent practicable, also structure the contract to allow issuance of orders on a firm-fixed-price or fixed-price with economic price adjustment basis. [14] For these contracts, the rule requires the contracting officer to execute a D&F for each order placed on a T&M basis. [15] If an ID contract only allows for issuance of orders on a T&M basis, a D&F must be executed to support the basic contract and explain why an alternative firm-fixed-price or fixed-price with economic price adjustment pricing structure is not practicable. [16] The D&F must be approved one level above the contracting officer.

These D&F requirements extend far beyond what is required by statute and are more burdensome administratively than those applicable to noncommercial T&M

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[6] ''Payments Under Time-and-Materials and Labor-Hour Contracts,'' 71 Fed. Reg. 74,656 (Dec. 12, 2006); ''Additional Contract Types,'' 71 Fed. Reg. 74,667 (Dec. 12, 2006); ''Labor Reimbursement on DoD Non-Commercial Time-and-Materials and Labor Hour Contracts,'' 71 Fed. Reg. 74,469 (Dec. 12, 2006).

[7] National Defense Authorization Act for Fiscal Year 2004, Pub. L. No. 108-136, § 1432, 117 Stat. 1392, 1672 (2003). SARA amended Section 8002(d) of the Federal Acquisition Streamlining Act (''FASA'') to authorize commercial T&M contracts.

[8] *Id.* § 1432(5).

[9] 71 Fed. Reg. 74,668.

[10] The commercial rule utilizes the existing definition of commercial item in FAR Part 2 with one exception—it deleted the second sentence from paragraph (6) of that definition: ''This does not include services that are sold based on hourly rates without an established catalog or market price for a specific service performed or a specific outcome to be achieved.'' 71 Fed. Reg. 74,676.

[11] *See* FAR 12.207(b).

[12] 71 Fed. Reg. 74,670.

[13] FAR 12.207(b)(1)(ii)(A).

[14] FAR 12.207(c)(2).

[15] FAR 12.207(c)(2). The rule does not require a D&F for orders placed on a firmfixedprice or fixed-price with economic price adjustment basis. For existing ID contracts, the rule likely will require the D&F for all new tasks orders issued after the effective date.

[16] FAR 12.207(c)(3).

contracts. [17] The FAR noncommercial rule merely retains the pre-existing FAR Part 16 requirement that the contracting officer execute a D&F that no other contract type is suitable. [18] The Councils justified holding commercial T&M contracts to a higher standard based upon the Government's stated preference for fixed-price acquisitions of commercial items. [19]

Third, the FAR commercial rule adds an approval requirement applicable to both commercial and noncommercial acquisitions. Specifically, the rule requires approval by the head of the contracting activity (''HCA'') for any T&M contract that has a base period plus option periods exceeding three years. [20] The Councils stated that this requirement constitutes an additional control to ensure that both commercial and noncommercial T&M contracts are used only when ''no other contract type is suitable'' and to avoid protracted use of T&M contracts that should be unnecessary once the parties have a basis for firmer pricing. [21] The HCA approval requirement will likely discourage some contracting officers from using T&M contracts and decrease the number of long-term T&M contracts.

## III. *Treatment of Subcontract and Affiliate Labor*

As indicated above, the appropriate treatment of labor supplied by subcontractors under T&M contracts has been the subject of intense debate over the past several years. The trouble arose due to the lack of specificity in the standard T&M payments clause and because FAR 16.601, Time-and-Materials Contracts, did not address subcontract costs. (In addition, the FAR did not adequately address the treatment of other direct costs and indirect costs other than material handling.) The Councils have clarified Government policy and crafted a far more workable framework to govern payment of prime contractors for labor hours provided by subcontractor personnel. For *all* T&M contracts, subcontracts that meet the contract's labor category qualifications are reimbursed at a fixed hourly labor rate that may include prime contractor profit and overhead in addition to the price paid to the subcontractor providing the labor.

### A. FAR Commercial T&M Rule

For commercial T&M contracts, the final rule permits prime contractors to request payment for subcontract labor (including third party subcontractors and interdivisional transfers) at the hourly rates prescribed in the contract for those employees that satisfy the contract's applicable labor category qualification requirements. [22] *These hourly rates may be a single set of labor rates that do not distinguish between work performed by prime contractor or subcontractor employees*. [23] A new FAR solicitation clause, FAR 52.216-31, requires the prime contract to identify the categories to which the hourly rates apply, including (i) the offeror, (ii) its subcontractors, and/or (iii) divisions, subsidiaries, or affiliates of the prime contractor. Another new contract clause, FAR 52.2124 (Alt. I), provides other terms and conditions for commercial T&M contracts, including the payment provisions. That clause provides that services that do not correspond with a labor category in the prime contract generally are considered to be ''incidental services'' and are reimbursed as ''materials' under a different set of rules, as further addressed below. [24]

The FAR Councils explicitly rejected the approach presented in their prior proposed rule that would have limited Government payment for subcontract labor to the prime contractor's cost, unless the subcontractor was pre-approved by the contracting officer. After consideration of public comments, the Councils characterized this prior approach as ''problematic and contrary to standard commercial practice.'' [25] In addition, the Councils concluded that treating subcontract labor as a pass-through item charged to the Government at the prime contractor's cost would discourage prime contractors from subcontracting work, which in turn would negatively impact the Government's objective of expanding small business opportunities. [26] The Councils also concluded that the proposed rule would have imposed government-unique cost accounting requirements on interdivisional transfers. [27]

### B. FAR Noncommercial T&M Rule

The final FAR rule applicable to noncommercial T&M contracts abandons the provision in the proposed rule that would have allowed reimbursement for subcontract labor at the hourly rates only if the subcontractor was listed in the contract. It introduces two new FAR solicitation clauses concerning the listing of hourly labor rates, and prescribes the use of one or the other depending on whether the contracting officer expects the price to be based on adequate competition. (The rule directs the contracting officer to the regulations implementing the Truth in Negotiations Act for determining what constitutes adequate price competition.) [28] These clauses include pricing provisions applicable to civilian agency acquisitions. The new DFARS interim rule prescribes an alternate clause to apply to DoD acquisitions when adequate price competition is expected.

#### 1. *When Adequate Price Competition Is Expected*

When adequate price competition is expected, all labor hours that satisfy the labor category qualifications delineated in the prime contract must be paid at the hourly rates specified in the prime contract. [29] The Councils adopted the same approach they took for the commercial rule, reasoning that ''*[c]ompetition for commercial items is the same as competition for noncommercial items and the approach should be the same for both FAR cases*.'' [30]

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[17] FAR 12.207(b)(2).
[18] FAR 16.601(d)(1).
[19] 71 Fed. Reg, 74,670.
[20] FAR 16.601(d)(1)(ii).
[21] 71 Fed. Reg. 74,669.
[22] FAR 52.212-4(i)(1)(i). The rule indicates that the hourly labor rates will not vary for overtime work, unless the contract schedule provides otherwise. *Id.*(i)(1)(i)(E). If the contractor does provide overtime work with the contracting officer's approval, the parties will negotiate the overtime rates.
[23] *Id.*(e)(ii).
[24] FAR 52.212-4(e)(iii)(B).
[25] 71 Fed. Reg. 74, 669.
[26] 71 Fed. Reg. 74, 672.
[27] *Id.*
[28] FAR 16.601(c)(2)(ii) (citing FAR 15.403-1(c)(1)).
[29] FAR 52.216-29(b); *see* 71 Fed. Reg. 74662 (''Upon further consideration, the Councils believe it is appropriate to reimburse subcontracts on competitively awarded T&M contracts at the schedule labor rates without listing the subcontracts.'').
[30] 71 Fed. Reg. 74,658.

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To this end, the rule prescribes a new FAR clause, FAR 52.216-29, which requires the offeror to specify whether each set of hourly rates applies to labor performed by the offeror, subcontractors, and/or affilates/ interdivisional transfers. The FAR clause instructs offerors to establish the hourly rates using any of the following methodologies:

> (1) separate set of rates for each labor category to be performed by the offeror, each subcontractor, and/or the offeror's divisions, subsidiaries, and affiliates;
>
> (2) blended rates for each labor category to be performed by the offeror, subcontractor, and/or the offferor's divisions, subsidiaries, and affiliates; or
>
> (3) any combination of separate and blended rates for each labor category. [31]

These rates include wages, overhead, general and administrative expenses, and profit. [32] The term ''blended rate'' indicates that the rate applies to multiple entities and does not necessarily mean that the rates must be reflective of a weighted calculation. [33]

The rule provides agencies with discretion to develop ''procedures'' that authorize the contracting officer to make one of the three methodologies listed above mandatory and/or to require identification of all subcontractors included in a blended labor rate. [34] As explained below, DoD already has exercised this discretion through issuance of the interim DFARS T&M rule applicable to noncommercial item acquisitions.

#### 2. *When Adequate Price Competition Is Not Expected*

When adequate price competition is not expected, the rule prescribes a different FAR clause, FAR 52.216-30. Unlike FAR 52.216-29 and the rules applicable to commercial services, this clause requires the offeror to *list separate sets of hourly rates for each subcontractor* and each division, subsidiary, or affiliate of the prime contractor under common control. [35] The Councils stated that they adopted a different rule because ''for noncommercial T&M contracts awarded without adequate price competition, competitive pressures are substantially diminished and the Government must take a much more cautious approach with respect to labor provided by subcontractors.'' [36] The prime contractor may still include its profit (in addition to wages, overhead, and general and administrative expenses) as part of the separate hourly labor rates. [37] The separate rates, however, will provide the contracting officer with additional pricing information, along with any cost or pricing information required to be submitted under the Truth in Negotiations Act, [38] to analyze in the context of a price reasonableness determination and for use in final price negotiations.

Another distinction for noncompetitive contracts is that the hourly rates for services transferred between divisions, subsidiaries, or affiliates of the offeror may include profit for the prime contractor, but *not* for the transferring organization. [39] However, an exception to this rule provides that ''[t]he fixed hourly rates for services that meet the definition of commercial item at [FAR] 2.101 that are transferred between divisions, subsidiaries, or affiliates of the offeror . . . may be the established catalog or market rate when . . . [i]t is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the offeror or any division, subsidiary or affiliate of the offeror.'' [40] The exception is consistent with other aspects of the rules that permit a contractor to charge the established catalog or market rate when a service or item is commercial.

### C. DFARS Interim T&M Rule

The DFARS rule, which was issued on the same date as the final FAR rules, provides a different approach from the FAR when adequate price competition is expected by *requiring offerors to specify fixed hourly labor rates for each subcontractor and for interdivisional transfers and affiliates*. [41] The rule prescribes its own contract clause, DFARS 252.216-7002(c), which provides a substitute paragraph (c) for FAR 52.216-29. Unlike the corresponding FAR provision, *offerors are not permitted to use a blended rate approach*. DoD justified its more restrictive approach based on the following three considerations: (1) the relatively large dollar value of many noncommercial DoD T&M contracts; (2) the significant oversight and legislative initiatives recently focused on DoD; and (3) the ''preponderance'' of noncommercial T&M contractors and subcontractors who already possess the necessary mechanisms to establish separate fixed hourly rates for each performing entity (*e.g.*, the prime contractor, subcontractor, or affiliate) without a significant administrative burden. [42] The DFARS rule applies only to the requirement to list separate hourly labor rates for subcontractors; nothing in the interim rule precludes the prime contractor from adding its profit to the labor rates designated for each subcontractor.

## IV. *Materials, Other Direct Costs, and Indirect Costs*

As noted above, the prior rules also failed to clearly address the treatment of materials. Under the new rules, ''materials'' now include direct materials, subcontracts for supplies and incidental services (services for which no labor category is specified), other direct costs, and indirect costs. Except as provided otherwise below, materials that meet the definition of a ''commercial item'' under FAR 2.201 are reimbursed at the estab-

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[31] FAR 52.216-29(c).

[32] FAR 52.216-29(b).

[33] *See* 71 Fed. Reg. 74,658 (''The Councils adopted the philosophy on treatment of subcontractor labor that was developed under FAR Case 2003-027 [Commercial T&M Rule] and applied it to noncommercial T&M contracts awarded on the basis of adequate price competition. That is, FAR case 2003-0027 requires *no special treatment of labor provided by subcontractors.*'') (emphasis added); *id.* (the contract ''may use blended rates that apply to any labor meeting the qualifications of the contract, regardless of whether provided by the contractor or a subcontractor.'').

[34] FAR 16.601(e)(1).

[35] FAR 52.216-30(b).

[36] 71 Fed. Reg. 74,658.

[37] FAR 52.216-30(b).

[38] 10 U.S.C. § 2306a; *see also* FAR 15-506-2; FAR 52.215-10; FAR 52.215-12; FAR 52.215-20.

[39] FAR 16.601(c)(2)(iii).

[40] FAR 16.601(c)(2)(iv).

[41] DFARS 252.216-7002(c).

[42] 71 Fed. Reg. 74,470. The interim DFARS rule included a request for public comments. The comment period ended on February 12, 2007.

lished catalog or market price for all T&M contracts. Materials that do not meet that definition are reimbursed at actual cost. As a practical matter, when materials constitute a major part of an acquisition, an agency may prefer to acquire them through a separate contract action or under a non-T&M contract line item.

## A. FAR Commercial T&M Rule

For contractor-furnished direct materials and ''incidental services'' (services for which there is no labor category specified in the contract), the treatment depends on whether the material or incidental service qualifies as a commercial item. If the material furnished by the contractor constitutes a ''commercial item'' under FAR 2.201, the price to be paid for the material is the contractor's established catalog or market price, adjusted to reflect the quantities being acquired and any modifications necessary because of contract requirements. [43] A potentially significant point is that the final rule does not retain the language of the proposed rule that explicitly tied the ability to charge the contractor's catalog or market price to only those situations where the contractor furnishes its ''own'' materials. The final rule strikes the word ''own'' so that it may be read to include third party materials for which the prime contractor acts as a reseller and has an established catalog or market price. If the direct materials or incidental services furnished by the prime contractor do not constitute a commercial item, the price to be paid is the cost to the prime contractor—*i.e.*, it does not include profit or G&A. [44] Although reimbursed at ''actual cost'' to the contractor, direct materials and incidental services under the commercial T&M rule are *not* subject to the FAR Part 31 cost principles.

For ''other direct costs'' (''ODCs''), such as travel and computer usage charges, agencies may reimburse contractors based on actual cost, but only for the types of ODCs that are designated in the contract. [45] In other words, the ODCs must be identified up front and included in the executed contract. For example, in order to authorize payment of ODCs for travel, the contracting officer must list travel in the contract clause.

For indirect costs not already included in the fixed hourly labor rates (*e.g.*, material handling costs), agencies may reimburse contractors at a fixed amount allocated on a pro-rata basis set by the contract payment schedule. [46] Contractors bear the risk of the indirect costs exceeding the fixed amount negotiated and specified in the contract.

For ID contracts, the contracting officer has discretion to establish at the contract level or the order level the types of ODCs that will be reimbursed at actual costs and the applicable fixed amounts for indirect costs. [47] Also, the contracting officer has discretion to modify the clause so that ODCs and indirect costs will not be reimbursed. [48] If the contracting officer intends to restrict reimbursement for ODCs, the contracting officer will insert ''None'' in the contract clause.

[43] FAR 52.212-4 (Alt. I) (i)(1)(ii)(A).
[44] FAR 52.212-4 (Alt. I) (i)(1)(ii)(B).
[45] FAR 52.212-4 (Alt. I) (i)(1)(ii)(D)(1).
[46] FAR 52.212-4 (Alt. I) (i)(1)(ii)(D)(2).
[47] FAR 52.212-4 (Alt. I) (i)(1)(ii)(D)(1) & (2).
[48] *Id.*

## B. FAR Noncommercial T&M Rule

For contractor-furnished direct materials and incidental services, a revised FAR clause 52.232-7, Payments under Time-and-Materials and Labor-Hour Contracts, provides that if the contractor furnishes its *own* materials that meet the definition of ''commercial item'' under FAR 2.201, the price to be paid for the material shall not exceed the contractor's established catalog or market price, adjusted to reflect the quantities being acquired and any modifications necessary because of contract requirements. [49] Unlike the corresponding commercial rule, the noncommercial rule expressly limits pricing in this manner to situations where the furnished materials are the contractor's ''own'' materials. Otherwise, materials will be paid at cost pursuant to the cost principals in FAR Part 31 and the Allowable Cost and Payment clause, FAR 52.216-7, which must be inserted in all noncommercial T&M contracts. [50] FAR 52.232-7 now expressly indicates that the Government does not pay profit or fee on materials except for the commercial item exception. Contractors may recover such fees through the fixed hourly labor rates.

For ODCs and indirect costs, the contractor may include such allocable costs to the extent they are comprised only of costs that are clearly excluded from the hourly rate and allocated in accordance with the contractor's written or established accounting practices. Indirect costs may not be applied to subcontract labor that is paid at the hourly rates. [51]

## C. Rebates, Refunds and Discounts

The commercial T&M rule eliminated a proposed provision that would have required commercial contractors to give the Government credit for any rebates, refunds, or discounts that ''accrued'' to the contractor. [52] The Councils concluded that the proposed rule would have inappropriately imposed Government-unique accounting requirements on commercial T&M contracts. [53] Instead, the final commercial rule requires contractors to reduce the costs of material for any rebates, refunds, or discounts ''that are *identifiable to the contract*.'' [54] Although not entirely clear, it appears that the rule is intended to relieve contractors of any obligation to track and account for rebates, refunds, and discounts that pertain to what may be considered global considerations—such as rebates based on annual volume of purchases—as opposed to individual contract actions.

The noncommercial rule, however, retains the language that ''[t]he Contractor shall give credit to the Government for cash and trade discounts, rebates, scrap, commissions, and other amounts *that have accrued* to the benefit of the Contractor . . . .'' [55] The rule provides no further guidance on how contractors must account for rebates that are based on global considerations and may arise only after the fact, including, for example, when overall purchase volume thresholds entitling rebates are satisfied. As an example of the poten-

[49] FAR 52.232-7(b)(1)(D). The rule provides the contracting officer with discretion to negotiate the price to be paid for materials that meet the ''commercial item'' definition.
[50] FAR 16.307(a)(1).
[51] FAR 52.232-7(b)(5).
[52] 70 Fed. Reg. 56,336.
[53] 71 Fed. Reg. 74,673.
[54] FAR 52.2124 (Alt. I) (i)(1)(ii)(C)(2).
[55] Revised FAR 52.2327(b)(6)(ii).

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tial havoc this provision could cause, in 2005 four large, multinational consulting firms each paid millions of dollars to the federal government to settle allegations that they failed to disclose travel expense rebates they received from airlines, car rental firms, hotels, and travel service providers. [56]

## V. *Consent to Subcontractors*

The commercial FAR rule eliminates the proposed requirement that prime contractors obtain the contracting officer's consent for each proposed subcontractor. The FAR Councils changed course and concluded that the proposed rule's consent requirement was unduly burdensome and counterproductive, especially considering that the Government can only use T&M contracts when it cannot develop a fully defined statement of work at the outset and that the consent requirement would cause delays by requiring potentially protracted negotiations, fostering disputes, and adding stress to an already over-taxed acquisition workforce. The FAR Councils rejected the earlier FAR proposed approach as ''unduly restrictive and inappropriate,'' and stated that ''[i]f a contracting officer failed to provide a timely consent or disagreed with the subcontract award, the Government could wrongly affect contract performance and potentially impact a company's commercial reputation.'' [57]

The noncommercial FAR rule maintains the standard consent and notification requirements for noncommercial T&M contracts in contract clause FAR 52.244-2, which is prescribed by FAR 44.204. Under FAR 52.244-2, if the contractor does not have an approved purchasing system, it must obtain consent to subcontractors. [58] Even if the contractor does have an approved purchasing system, the contracting officer may require the contractor to obtain consent before placing certain designated subcontracts. [59] If the contractor enters into any subcontract that requires consent under FAR 52.244-2 but does not obtain such consent, the Government is not required to reimburse the contractor for any costs incurred under the subcontract prior to the date the contractor obtains the required consent. [60]

## VI. *Best Efforts, Total Cost, and Ceiling Price*

The FAR commercial rule requires that contractors use their best efforts to perform the work within the designated ceiling price. It also provides the Government the right to inspect and test all materials furnished and services performed under the contract at all places and all times (including during performance) before acceptance, ''to the extent practicable.'' [61] Further, the Government is entitled to inspect the contactor's and any subcontractor's plant or plants, and the contractor and any subcontractors are required to furnish ''all reasonable'' facilities and assistance for safe and convenient inspection.[62] Unless the contract specifies otherwise, the Government will accept or reject services and materials at the place of delivery as promptly as practical after delivery.[63] The Government is presumed to accept services and materials 60 days after delivery. At any time during contract performance, but not later than six months (or such other time as may be specified in the contract) after acceptance of the services or materials last delivered under the T&M contract, the Government may require reperformance of nonconforming work up to the ceiling price. [64] *Payment for reperformance will be at the contractor's labor rates, but less profit, which the rule presumes to be 10 percent of the rate unless the parties specify a different amount in the contract.*

The Government ''at any time'' may require the contractor to remedy, at the contractor's own expense, any failure by the contractor to comply with the contract requirements, if the failure is due to (1) fraud, lack of good faith, or willful misconduct by the contractor's managerial personnel, or (2) conduct of a contractor employee selected or retained after the managerial personnel had reasonable grounds to believe that the employee is habitually careless or unqualified. [65] In addition, the Government is not obligated to pay any amounts beyond the ceiling price and the contractor is not required to perform any work if it would exceed the ceiling price in doing so. The rule requires the contractor to notify the contracting officer when it has notice that hourly rate payments and material costs will exceed 85 percent of the ceiling price in the next 30 days. [66]

The payment clause prescribed by the noncommercial T&M rule (FAR 52.232-7) does not change the best efforts standard of performance, total cost notification requirements, and mandatory ceiling price provisions included in the previous version of FAR 52.232-7.

## VII. *Government Oversight*

Under the commercial FAR rule, the Government has access to records to verify labor hours and material costs. Specifically, contractors must provide the contracting officer access to records that verify that employees whose time was billed to the contract meet the contract labor category qualifications. [67] In addition, for labor hours when timecards are required, the contractor must provide access to the ''original timecards'' (which may be paper-based or electronic), the timekeeping procedures, records that show distribution of labor between jobs and contracts, and interview employees whose labor hours were billed to the contract. Accordingly, prime contractors will want to flow down the substantiation requirements to subcontractors that are providing direct labor on the contract. Although conceding that ''such access may not be a standard commercial practice,'' [68] the Councils retained this provision permitting the contracting officer to interview

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[56] *See Four Multinational Consulting Firms Settle, Pay Millions to U.S. in Travel Overbilling Case,* BNA Federal Contracts Report, Vol. 85, No. 1 (Jan. 10, 2006).

[57] 71 Fed. Reg. 74,672.

[58] FAR 52.244-2.

[59] FAR 52.244-2(e).

[60] The prior rules did not specifically address the Government's remedy if a contractor failed to adhere to the subcontract consent requirements.

[61] FAR 52.212-4 (Alt. I) (a)(1).

[62] FAR 52.212-4 (Alt. I) (a)(1) & (2).

[63] FAR 52.212-4 (Alt. I) (a)(3).

[64] FAR 52.212-4 (Alt. I) (a)(4). This provision is a departure from the ANPR, which would have required the contractor to repair or replace rejected supplies or reperform rejected services at no cost to the Government.

[65] FAR 52.212-4 (Alt. I) (a)(6).

[66] FAR 52.212-4 (Alt. I) (i)(2).

[67] FAR 52.212-4 (Alt. I) (i)(4).

[68] 71 Fed. Reg. 74,674.

contractor and subcontractor employees to verify labor hours. [69] For materials and subcontract costs, the contractor must also provide access to invoices and subcontract agreements substantiating cost and any documents to support payment of the invoices.

The noncommercial T&M rule provides somewhat more stringent Government oversight provisions. The Government has the right to audit noncommercial T&M contracts under the Audit clause, FAR 52.215-2, to verify costs and, if applicable, determine whether defective pricing occurred in proposal submission. Further, the Government has broad rights to verify the accuracy of vouchers under the new clauses, FAR 52.216-7 and 52.232-7(f). In addition, the contracting officer may issue a unilateral contract modification requiring the contractor to withhold billings up to the lesser of 5 percent of the contract value or $50,000 if he or she deems the withholding necessary to protect the Government's interest. [70]

## VIII. *Applicability of Cost Accounting Standards*

In the commentary accompanying the commercial rule, the Councils stated that the question of whether the Cost Accounting Standards (''CAS'') apply to commercial T&M contracts is one for the CAS Board. [71] The Councils elected not to address the issue in the FAR rule, even though the Federal Acquisition Reform Act of 1996 provides a statutory exemption from CAS for ''contracts or subcontracts for the acquisition of commercial items.'' [72] The CAS Board on January 4, 2006 issued a proposed rule that would have exempted commercial T&M contracts from CAS, but has not issued a final rule. [73]

## IX. *Conclusion*

The final FAR and interim DFARS T&M rules prescribe terms and conditions that clarify many outstanding issues associated with T&M contracts, while striking a balance between contractor and Government rights and responsibilities. Although this article provides an overview and analysis of many aspects of these rules, they do contain many nuances in the six new or revised FAR and DFARS clauses and elsewhere in the regulations that are not addressed in this article and that may prove significant depending on the particular circumstances faced by individual contractors. In addition to being necessary for successfully managing T&M contracts, a solid understanding of the new rules is critical for ensuring that the contractor's business case for performing the work is well grounded.

[69] FAR 52.212-4 (Alt. I) (i)(4)(ii)(D).
[70] FAR 52.232-7(a)(7).
[71] 71 Fed. Reg. 74,675.
[72] FARA, Pub. L. No. 104-106, § 4205 (codified at 41 U.S.C. § 422(f)(2)(B)).
[73] CAS Board, Proposed Rule, ''T&M Contracts For Commercial Items,'' 71 Fed. Reg. 313 (Jan. 4, 2006).

## APPENDIX

### Comparison of Regulations Applicable to Time-and-Materials and Labor-Hour Contracts

| Issue | Rule/Acquisition Type | | | |
|---|---|---|---|---|
| | FAR Commercial Rule | FAR Noncommercial Rule/Adequate Price Competition | FAR Noncommercial Rule/Without Adequate Price Competition | DFARS Noncommercial Rule/Adequate Price Competition |
| **Competition Requirements** | No sole source awards; must be awarded using competitive procedures of FAR 6.102, set-aside procedures under FAR 19.5, or the streamlined procedures of FAR Part 13. | Can be awarded using any of the procedures authorized by the FAR, including sole-source procedures. | | |

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| Issue | Rule/Acquisition Type | | | |
|---|---|---|---|---|
| | **FAR Commercial Rule** | **FAR Noncommercial Rule/Adequate Price Competition** | **FAR Noncommercial Rule/Without Adequate Price Competition** | **DFARS Noncommercial Rule/Adequate Price Competition** |
| **D&F Prerequisite** | Prior to executing contract, CO must issue written D&F that no other contract type is suitable.<br><br>The written D&F must describe: (1) market research performed, (2) why it is not possible to accurately estimate the extent or duration of the work or to anticipate costs with reasonable degree of certainty, (3) how the requirement is structured to allow for use of FFP contract in future, and (4) the actions planned to maximize use of FFP in the future. | Prior to executing contract, CO must issue written D&F that no other contract type is suitable. Additional D&F requirements under the commercial rule (*e.g.*, to describe market research performed) do *not* apply. | | |
| **Payment for Qualifying Labor Hours** | Payment for all labor hours at the applicable hourly labor rates specified in the prime contract for employees that satisfy the prime contract labor category qualifications. Hourly labor rates may include wages, indirect costs, general and administrative expenses, and profit. There is *no* requirement to treat subcontract labor as a ''pass through'' cost item. | | | |
| **Hourly Rates** | Requires offeror to specify whether the listed hourly labor rates apply to labor performed by prime contractor, subcontractors, and/or each division, subsidiary, or affiliate of the prime. No requirement for separate rates. | Requires offeror to specify to which entities its hourly labor rates apply; offeror may establish rates using (1) separate rates for each entity, (2) blended rates reflecting all entities, or (3) a combination of specified and blended rates. | Requires offeror to specify separate hourly labor rates for the prime contractor, each subcontractor, and each division, subsidiary, or affiliate of the prime. | Requires offeror to specify separate hourly labor rates for the prime contractor, each subcontractor, and each division, subsidiary, or affiliate of the prime. |
| **Interdivisional Subcontract Services** | Treated same as subcontracts. | Treated same as subcontracts. | Labor rates may not include profit for the transferring organization, unless service is commercial item (in which case service provided at catalog or market price). | Treated same as subcontracts. |

| Issue | Rule/Acquisition Type | | | |
|---|---|---|---|---|
| | **FAR Commercial Rule** | **FAR Noncommercial Rule/Adequate Price Competition** | **FAR Noncommercial Rule/Without Adequate Price Competition** | **DFARS Noncommercial Rule/Adequate Price Competition** |
| **Direct Materials** | Commercial items reimbursed at contractor's established catalog or market price, adjusted to reflect quantities acquired and modifications necessary due to contract requirements; noncommercial items reimbursed at actual cost. | Contractor's ''own'' commercial items reimbursed at contractor's established catalog or market price, adjusted to reflect quantities acquired and modifications necessary due to contract requirements; noncommercial items reimbursed at cost pursuant to FAR cost principles and the Allowable Cost and Payment clause. | | |
| **Incidental Services** | Services that do not correspond with labor category in prime contract are incidental services and are reimbursed as ''materials.'' | | | |
| **Other Direct Costs (e.g., travel, computer usage, etc.)** | Reimbursed actual costs for type of ODCs designated in contract; however, contracting officer may limit recovery. | Reimbursed at actual cost provided ODCs comprised only of costs excluded from hourly labor rates and allocated in accordance with contractor's written or established accounting practices. | | |
| **Indirect Costs** | Reimbursed fixed amount, excluding costs included in hourly labor rates, allocated on prorata basis set by payment schedule; however, contracting officer may limit recovery. | Reimbursed at actual cost provided indirect costs comprised only of costs excluded from hourly labor rates and allocated in accordance with contractor's written or established accounting practices. Indirect costs are not applied to subcontracts that are paid at the hourly rates. | | |
| **Withholding** | No withholding provision | Contracting officer may withhold up to the lesser of 5% of the contract value or $50,000 if necessary to protect the Government's interests. | | |
| **Rebates, Refunds and Discounts** | Requires contractor to reduce material costs for any rebates, refunds, or discounts ''identifiable'' to the contract. | Requires contractor to credit Government for cash and trade discounts, rebates, scrap, commissions, and other amounts that have ''accrued'' to the benefit of the contractor. | | |
| **Consent to Subcontractors** | No consent requirement. | Standard consent rules under FAR 52.244-2 apply; Government not required to reimburse subcontract costs incurred prior to obtaining consent for subcontractors subject to consent requirement. | | |
| **Standard of Performance** | Contractor required to use ''best efforts'' to perform work within ceiling price; Government may require reperformance for nonconforming work up to ceiling price. | Contractor required to use ''best efforts'' to perform work. | | |
| **Re-Performance for Nonconforming Services** | Hourly rate less profit. Profit is assumed to be 10% unless otherwise prescribed in the contract. | Hourly rate less profit. | | |

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| Issue | Rule/Acquisition Type | | | |
|---|---|---|---|---|
| | **FAR Commercial Rule** | **FAR Noncommercial Rule/Adequate Price Competition** | **FAR Noncommercial Rule/Without Adequate Price Competition** | **DFARS Noncommercial Rule/Adequate Price Competition** |
| **Employee Interviews** | CO right to interview contractor and subcontractor employees in order to verify the labor hours claimed by the contractor. | CO right to examine ''records and other evidence'' to verify costs claimed by contractor. | | |
| **Government Access to Records** | Records to verify that (1) employees meet the specifications for labor categories billed; (2) employees worked hours billed; (3) and amounts paid for amounts reimbursed at actual costs. | Standards access to records clause, FAR 52.215-2, applies. | | |