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Analysis

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Iraq Reconstruction: Legal Issues In Subcontracting

The U.S. Government's efforts to rebuild Iraq have produced approximately 1,500 prime contracts to date, and those prime contracts are expected to generate 15,000 subcontracts within the next 12 months. Together, these contracts will consume only half of the approximately $20 billion that the U.S. has appropriated for Iraq reconstruction. This level of activity, described by some as a "gold rush" for the private sector, has attracted businesses beyond traditional U.S. Government contractors. Not all companies, however, will be able to compete in this market. The subcontracting environment is fluid and complex, and the barriers to market entry are not always obvious. Furthermore, neither the U.S. Government nor its prime contractors are fully utilizing the legal tools available to streamline the process and to foster widespread participation.

This article presents a range of issues important to companies contemplating involvement in the Iraq reconstruction process as subcontractors. The first two sections introduce Iraq's needs and the subcontracting environment. The third section describes legal impediments to widespread subcontractor participation. The fourth section analyzes why commercial-item subcontracting—a streamlined acquisition process open to commercial companies—should be used more widely in the context of Iraq reconstruction. The article concludes with a discussion of compliance risks for subcontractors, followed by recommendations for additional reading.

Iraq's Reconstruction Needs—According to the Joint Iraq Needs Assessment issued by the United Nations and the World Bank in October 2003, Iraq's immediate needs include:

• Infrastructure and Transportation—rebuilding the systems for water supply, sanitation, solid waste, highways, roads, bridges, railways, airports and civil aviation, ports and inland waterways, and public, freight, and commercial transport;

• Communications—expanding the switching and local access networks, upgrading the postal system, and acquiring hardware and software to operate those systems;

• Education—providing basic training for teachers, acquiring materials and equipment, rehabilitating schools, and developing new curricula and educational priorities;

• Health—implementing public health programs, rehabilitating essential infrastructure and health services, developing a national health plan, and acquiring medical equipment and supplies;

• Electricity—rehabilitating and constructing power generation and transmission systems throughout the country;

• Housing—developing a new system of land management, training laborers and management, constructing units, and developing a 15-year program for upgrading existing units;

• Agriculture, Water Resources, and Food Security—rehabilitating and expanding critical infrastructure, assessing water resources and needs, and developing food security controls; and

• Finance and Private Sector—rewriting applicable laws, modernizing offices and technology, and reforming accounting and banking standards to ensure congruence with internationally-applicable standards.

With cost estimates as high as $100 billion, the reconstruction of Iraq is the largest nation-building program since the Marshall Plan helped rebuild Europe following World War II.

The Subcontracting Environment—This effort is being undertaken in the most fluid of environments. While the Iraqi government is transitioning and the support role of Western powers is shifting, the reconstruction contracting activities are in full swing. Companies that wish to provide goods and services for this program need a basic understanding of the environment in which they will compete.

Since April 2003, the Coalition Provisional Authority (CPA) has served as the temporary government of Iraq, managing the policy and rebuilding activities in the country. The CPA's Program Management Office (PMO), commissioned in November 2003, is responsible for overseeing and directing the reconstruction program's activities, projects, and financial management. Agencies of the U.S. Government—including the Department of Defense, the U.S. Army Corps of Engineers, and the U.S. Agency for International Development—award and administer prime contracts funded by U.S. appropriations.

This organizational structure will change on June 30, 2004. The CPA will cease to exist and will transfer all governmental authority to a fully-sovereign

Iraqi Interim Government. At the same time, the PMO will shift from the CPA to the new U.S. Embassy in Baghdad. The functional aspects of the program will remain, however, as the PMO and the U.S. agencies continue their respective roles.

Funding levels for U.S. Government contracts are expected to continue or even increase over the coming months. Of the Iraq-related funds appropriated by Congress to date, approximately $20 billion is for reconstruction activities performed by contractors. At least $12.6 billion is to be spent on projects in the oil, public works and water, security and justice, transportation and communications, buildings, education, and health sectors. Another $5.8 billion is to be spent on non-construction items such as democracy-building, computers, uniforms, and school supplies.

According to the Deputy Assistant Secretary of the Army for Policy and Procurement, the 1,500 prime contracts awarded so far are valued at nearly $10 billion. This leaves significant funds for more prime contracts. Additionally, much of the contracting focus will shift to the 15,000 subcontracts expected to be awarded within the next year. As a result, prime contractors are experiencing overwhelming subcontractor interest. For instance, over 13,000 companies have registered on Bechtel Corp.'s vendor website alone.

All U.S.-funded Iraq reconstruction contracts are governed by the U.S. procurement system. The three statutory foundations for federal procurement policies and procedures are: (1) the Armed Services Procurement Act of 1947, 10 USCA §§ 2301-2314; (2) the Federal Property and Administrative Services Act of 1949, 40 USCA §§ 471-514 and 41 USCA §§ 251-260; and (3) the Competition in Contracting Act (CICA), codified in various sections of Titles 10, 31, 40, and 41 of the U.S. Code. The Federal Acquisition Regulation (FAR), codified at Title 48 of the Code of Federal Regulations, implements the referenced statutes and contains the uniform policies, procedures, and contract clauses for acquisitions by all federal agencies. There are also agency-specific supplements to the FAR.

Prime contractor obligations are often applicable to subcontracts through "flow down" clauses, but many subcontractors are unaware of the obligations with which they must comply. This situation is especially prevalent in the context of Iraq reconstruction, which is attracting a significant number of companies unfamiliar with the U.S. procurement system. The result has been frequent misunderstandings and misapplications of the subcontracting rules. Some companies are even bidding on subcontracts without understanding whether they qualify to compete.

Legal Impediments to Widespread Subcontractor Participation—The U.S. procurement system mandates competition. Nevertheless, companies wishing to compete for Iraq subcontracts are encountering legal and practical barriers to participation in this market. The obstacles most commonly encountered include the following.

First, the CICA requires federal agencies to seek and obtain "full and open competition" wherever possible in the prime contract award process, unless one of the authorized exceptions applies. This statutory requirement, however, does not apply to the selection of subcontractors by prime contractors. At the subcontractor level, a negotiated prime contract must contain the standard "Competition in Subcontracting" clause at FAR 52.244-5, which requires prime contractors to select subcontractors (including suppliers) on a competitive basis to the maximum practical extent consistent with the objectives and requirements of the prime contract. If this clause is not included in a particular prime contract, the prime contractor has leeway in limiting subcontractor competition.

Second, a perceived limitation has arisen from DOD's well-publicized decision to restrict prime contract competition to companies from "eligible countries," i.e., the United States, Iraq, "coalition partner" countries, force contributing nations, and Canada. This restriction has frustrated the participation of companies from countries that opposed the war (e.g., France, Russia, and Germany). Recognize, however, that this limitation applies only to *prime* contracts awarded by DOD. It does not apply to any DOD subcontracts or to USAID prime contracts or subcontracts. See *Determination and Findings*, Deputy Secretary of Defense, Dec. 5, 2003, available at *http://www. rebuilding-iraq.net/pdf/D_F.pdf*.

Third, domestic preference requirements can serve as an obstruction to would-be subcontractors in Iraq. Since the Buy American Act, 41 USCA §§ 10a through 10d, does not apply to procurements of "products or services for use outside the United States," it will have limited applicability to subcontracts in Iraq. However, certain "Little Buy American Act" preferences may be included in the Iraq solicitations, thus restricting the origin of certain goods (e.g., Defense Federal Acquisition Regulation Supplement (DFARS) 252.225-7012 (food and certain fibers and fabrics),

and DFARS 252.225-7016 (ball and roller bearings)).

Fourth, the Trade Agreements Act of 1979 (TAA) and the North American Free Trade Agreements Act of 1993 (NAFTA), when applicable, restrict the acquisition of end products that are not from the U.S., a designated country, a Caribbean Basin country, or a NAFTA country. See 19 USCA § 2501 *et seq.*, 19 USCA § 3301 note, and FAR Subpart 25.4. For example, under the TAA's "rule of origin," an item is considered to have originated in a "designated country" only if certain criteria are met. See 19 USCA § 2518(4)(b), and FAR § 25.001. Therefore, a company may be excluded from a subcontract competition if its end products or construction materials do not originate from one of the "designated countries" listed in FAR 25.003.

Fifth, depending upon the type of subcontract used, a subcontractor may be required to have an accounting system that complies with the Cost Accounting Standards (CAS), 50 USCA App. § 2168, and the FAR Part 31 cost principles, and that will support the submission of "cost and pricing data" under the Truth In Negotiations Act (TINA), 10 USCA § 2306a. See FAR 52.230-2, Subpart 31.2, and Subpart 15.4, respectively. In the context of Iraq, where contractors from around the world are hoping to win subcontracts, the lack of a compliant cost-accounting system may be the most significant practical barrier to participation.

Thus, companies wishing to compete for subcontracts in Iraq may face a number of obstacles under the U.S. procurement rules. For many, the challenge will be to gain a sufficient understanding of the rules to avoid being excluded from competition.

Subcontracting for Commercial Items—One of the PMO's stated objectives is to utilize "the most efficient and effective method[s]" of accomplishing the goals of the reconstruction program, while "at the same time maximizing realistic competition." See *Statement of Objectives for Coalition Provisional Authority Program Management Office and Sector Program Management Offices*, Jan. 6, 2004. While the PMO and U.S. Government agencies are working diligently to rebuild Iraq, this objective has been hampered by the substantial underutilization of a streamlined procurement system available under U.S. procurement law since 1994: "commercial-item" contracting.

Over a decade ago, DOD determined that it was paying a premium of 30% to 100% for products that were regularly available in the commercial marketplace. See Acquisition Law Advisory Panel, *Streamlining Defense Acquisition Laws: Report of the Acquisition Law Advisory Panel to the United States Congress*, at 8-13 (Jan. 1993). The additional cost was directly related to the Government's standard acquisition approach, which effectively excluded many commercial companies from competing unless they were willing to comply with the complex set of federal procurement laws and regulations. Congress responded by enacting two statutes that reformed the acquisition process where the Government is acquiring a "commercial item." See Clinger-Cohen Act of 1996, P.L. 104-106, 110 Stat. 186, 642 (Feb. 10, 1996) (Clinger-Cohen); and Federal Acquisition Streamlining Act of 1994, P.L. 103-355, 108 Stat. 3243 (Oct. 13, 1994) (FASA).

FAR 2.101 contains a detailed definition of "commercial item," which includes (a) items, other than real property, that are of a *type* customarily used by the general public and that have been sold, leased, or licensed to the general public or offered for sale, lease, or license to the general public; and (b) services of a type offered and sold in substantial quantities in the commercial marketplace, based on established catalog or market prices for specific tasks performed under standard commercial terms and conditions.

The procedures governing "commercial-item contracting" are found primarily in FAR Part 12. When applicable, FAR Part 12 mandates the use of simplified acquisition procedures and abridged solicitation provisions and contract clauses (versus those used in non-commercial item contracting). It also makes inapplicable many laws and regulations, thereby (1) eliminating the obstacles many commercial companies may face, and (2) streamlining the source selection and contract administration activities. For example, a company that has been awarded a commercial-item prime contract or subcontract is *not* obligated to comply with the CAS, the FAR Part 31 cost principles, or the TINA requirement to submit "cost or pricing data" with regard to that subcontract.

FASA, Clinger-Cohen, and the FAR all mandate a preference for the acquisition of commercial-items under FAR Part 12, rather than the more time-consuming and costly process for non-commercial item acquisitions under FAR Part 15. Federal agencies are *required* to acquire commercial items or non-developmental items when they are available to meet agency needs. See FAR 12.101(b). Such agencies should also develop their requirements so as to meet this goal, where appropriate. See FAR 10.001(a)(3). Perhaps more im-

portantly, agencies are to require prime contractors and subcontractors at all tiers to incorporate, to the maximum extent practicable, commercial items as components of items supplied to the agency. See 10 USCA § 2377, 41 USCA § 264b, and FAR 11.002(a) and 12.101.

Prime contractors can and should utilize this streamlined approach in awarding subcontracts, even where the prime contract was awarded under FAR Part 15 procedures for contracting by negotiation. Most of the significant prime contracts in Iraq are not commercial-item contracts, but *every* Government prime contract for supplies or services—including those awarded under the FAR Part 15 process—should contain the "Subcontracts For Commercial-Items" clause found at FAR 52.244-6. This clause is to be flowed down to subcontracts at all levels, as well. See FAR 52.244-6(d). In short, all contractors and subcontractors are *obliged* to purchase commercial items using the FAR Part 12 procedures *to the maximum extent practicable*.

The first step in utilizing the commercial-item acquisition procedures, as in any procurement, is to identify the requirement. Once the requirement is known, the acquisition personnel should conduct market research to determine the availability and suitability of "commercial items" to meet that requirement. Contractors at all levels have the authority and responsibility for determining whether an item to be supplied by a subcontractor is a commercial item. See FAR 12.101(c). They are expected to exercise reasonable business judgment in making such determinations, as with any other subcontracting-related decision. If a commercial item or a modified commercial item will meet the identified requirement, the streamlined FAR Part 12 procedures should be used.

To preclude agencies from unnecessarily including too many Government contract clauses in commercial item contracts, the law and regulation state that "to the maximum extent practicable, *only* the contract clauses [mandated by law and executive order, or consistent with commercial practice] may be used in a contract . . . for the acquisition of commercial items . . .." See P.L. No. 103-355, § 8002(b)(3); and FAR 12.301(a). This same restriction should be adhered to by prime contractors. FAR 52.212-4 contains standard terms and conditions applicable to commercial-item acquisitions. While federal acquisition personnel may tailor the FAR's commercial item contract clauses to adapt to unique market conditions for each acquisition, they should do so only in a manner that is consistent with standard or customary commercial practices. See FAR 12.302.

The Iraq reconstruction presents an environment ripe for the use of FAR Part 12 commercial-item contracting, for all the same reasons it is the favored approach for other U.S. Government procurements. These include:

• *Faster.* The source selection process can be quicker, because the solicitation provisions, contractor's proposal, and contract are all shorter and simpler. This is especially important in Iraq, where contracts are often awarded within days of the solicitation release. Additionally, the lead time for commencing performance is usually lessened, because contractors are supplying goods and services they often have immediately available.

• *Less Expensive.* Commercial-item contracting maximizes competition by allowing all qualifying businesses to compete—not just those companies capable of proposing products or services meeting unique Government contract requirements and willing to create the administrative infrastructure needed to perform cost-type or flexibly-priced negotiated Government contracts. Increased competition ensures that the PMO is obtaining the best value for the U.S. taxpayer during the reconstruction process, and it maximizes the PMO's budget for other much-needed projects.

• *Known Quality and Reliability.* Commercial items are, by definition, already being sold or offered for sale in the market place, providing assurance that the Government is buying goods and services proven to meet their stated objectives. This should reassure contracting personnel wishing to avoid reprocurement where a product or service proves inadequate.

• *Reduced Administrative Burden.* Contracting personnel involved in Iraq reconstruction are facing enormous demands on their time. The simplified commercial-item solicitation provisions and contract clauses, as well as the reduced number of applicable laws, make contract administration simpler, more efficient, and less costly.

• *Standard Safeguards.* Commercial-item contracting maintains the primary safeguards of the more extensive contracting processes: full-and-open competition, transparency in the contract award, and the assurance of quality products or services at fair and reasonable prices.

Given the statutory preference for buying commercial items, as well as the benefits of the stream-

lined FAR Part 12 process, Government and contractor personnel should be utilizing commercial-item contracting to the extent practicable in the context of Iraq. Unfortunately, many acquisition professionals have been reluctant to utilize this approach, because they do not fully appreciate the benefits or understand the applicable standards and procedures. They often start the contract process with the premise that FAR Part 12 should not apply, and then resist attempts to move away from the more-burdensome FAR Part 15 procedures for contracting by negotiation. As a consequence, the contracting process is unnecessarily and improperly slowed down. And, in some cases, competition is limited to those few companies already able to perform negotiated, flexibly-priced, or cost-type contracts. This works to the detriment of the reconstruction effort and the U.S. taxpayer, and it should be unacceptable to the PMO and to agency procurement executives.

The PMO could correct this problem by issuing policy guidance to all contracting activities, for further distribution to prime contractors. Such guidance should make it clear that Government acquisition personnel and contractors at all levels are expected to utilize commercial-item contracting to the maximum extent practicable. It should also instruct federal agencies to ensure that their contracting officers and prime contractors are well-trained in the commercial-item contracting rules. The efforts of all Iraq-focused acquisition personnel—both Government and contractor—are crucial to achieving increased use of commercial acquisitions, but the input of PMO leadership is particularly essential.

Compliance Risks for Subcontractors—Transactions relating to the expenditure of public funds require the highest degree of public trust and standards of conduct. Subcontractors must avoid improper business practices and have a satisfactory record of integrity and business ethics. While the vast majority of subcontractors approach their compliance obligations in good faith, auditors regularly discover mistakes by even the most scrupulous contractors. The large number of inexperienced companies competing for subcontracts governed by complex U.S. procurement rules, combined with over-extended contracting offices and heavily-staffed audit and investigation offices in Iraq have resulted in a contracting environment ripe for mistakes and problems.

For example, in addition to cost-accounting system requirements, a subcontractor may be required to keep detailed records of labor hours incurred in performing each contract. Time charging is particularly difficult in the wartime environment, where employees often do not work regular schedules. A subcontractor that cannot support its time record or substantiate its expenses runs the risk of having them disallowed by the prime contractor. Additionally, Government auditors are likely to scrutinize financial information and records submitted by contractors for compliance with applicable requirements.

Government investigators in Iraq are also finding a few instances of intentional misdeeds, resulting in civil or criminal cases against subcontractors. The Government has a wide range of tools available to combat fraud. The false statements statute makes it illegal for anyone "knowingly and willfully" to make a false statement or representation concerning a matter within the jurisdiction or agency of the United States. See 18 USCA § 1001. Similarly, the criminal and civil components of the False Claims Act, 18 USCA § 287 and 31 USCA § 3729, make it illegal for anyone to make or present any claim upon or against the U.S. that the person knows (or should have known if not for recklessness) is "false, fictitious, or fraudulent."

Corrupt behavior is another area of active investigation in the context of Iraq reconstruction contracting. The Anti-Kickback Act prohibits a subcontractor from giving anything of value to a prime contractor for the purpose of improperly inducing or rewarding favorable treatment in connection with the award of a prime contract or subcontract. See 41 USCA § 52. This type of improper business practice rarely occurs, but it is important to avoid because a violation may result in the imposition of a criminal penalty.

The U.S. Government will not "overlook" improper business conduct merely because it occurs in a wartime environment. Accordingly, the prudent subcontractor must take affirmative steps to avoid improper business practices, conduct itself as a responsible entity, and mitigate the compliance risks inherent in this atmosphere. These steps should include (1) training of employees in the conduct of Government contracting; (2) establishing and enforcing the company's written code of conduct; and (3) self-policing as a means of confirming management's commitment to abide by ethical and legal standards and to correct instances when conduct falls below these standards.

Conclusion and Recommended Reading—Businesses wishing to compete for subcontracts in Iraq face a complex set of U.S. procurement rules. This environment, combined with other factors such as security risks and high insurance costs, will discourage some from participating in the reconstruction process. The unfortunate result for the U.S. Government is limited competition. The PMO can help to overcome some of the obstacles to participation by promoting the use of commercial-item contracting to the maximum extent practicable.

Companies can also increase their opportunities to compete and win contracts by gaining a more detailed understanding of the contracting rules and the Iraq reconstruction effort. The following articles can help in that respect:

• A primer on U.S. procurement rules is *Federal Government Contract Overview* by Carl L. Vacketta, available at *http://profs.lp.findlaw.com/govt/index.html*.

• For further information on the application of the federal procurement laws and regulations to subcontractors, see Feldman, *Subcontractors in Federal Procurement: Roles, Rights & Responsibilities*, BRIEFING PAPERS NO. 03-3 (Feb. 2003).

• For more information on the legal and operational aspects of the contracting activities in Iraq and the impending transition, see Nichols, Feature Comment, "Iraq Reconstruction—Significant Contract and Legal Issues," 46 GC ¶ 39; and Nichols, Feature Comment, "Emerging Issues in Iraq Reconstruction Contracting—Audits, Investigations, and the Transition of Sovereignty," 46 GC ¶ 185.

• Finally, just because an entity is providing goods and services to a prime contractor in Iraq, it does not necessarily follow that the entity will be treated as a "subcontractor" and assume the burdens of that status. For an analysis on when a supplier is considered a "subcontractor" under Government contracts law, see Richard C. Johnson's excellent article *Identifying "Subcontractors" Under TINA and Access-To-Records Statutes: Filling an Annoying Gap in Government Contracts Jurisprudence*, 32 PUB. CONT. L.J. 739 (2003).

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