

Defense Authorization Act provides inflationary relief for government contractors

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Everyone is feeling the bite of inflation. While the impact of rising prices of consumer staples like gas, milk, and household goods on the bottom line of American households is fairly clear, the repercussions for government contractors are a little more difficult to ascertain.

Government contracting is a unique business where — especially on firm-fixed-price (FFP) contracts — increased costs can be difficult to pass on to the end customer due to the underlying structure of government procurement. For example, when bids are prepared it is difficult for a business to predict and price in 9% inflation because doing so would likely result in a losing bid as the government is cost conscious and competition between contractors can be fierce.

The economic instability of the current contracting marketplace could inhibit the recruiting and retention of quality talent and drive government contractors, especially small businesses, out of the market, leading to gaps in national security capabilities, decreased competition, and an overall deterioration of the defense industrial base. Many believe help is on the way as this year's National Defense Authorization Act (NDAA) contains a provision giving the Secretary of Defense authority to modify contracts to ameliorate the worst effects of inflation, but it is far from a panacea for the industry's problems. The provision's implementing guidance will be key to determine whether it is a life raft or hollow promise.

Prior government actions

Since inflation has ratcheted up over the last year, the federal government has slowly made changes, adjusting its position in an attempt to ease the inflationary impact on contractors.

First, in mid-March, the General Services Administration (GSA) released an acquisition policy memorandum (<https://bit.ly/3FYfJe2>) detailing how government contractors performing on FFP contracts can secure relief. The memorandum lifted a cap on the number of Economic Price Adjustments (EPA) a company could request and encouraged contractors to ask the government for EPAs. Contracting Officers (CO) were deputized with broader authority to award EPAs to companies, and reviews are now done on a contract-to-contract basis.

In late May, the Department of Defense (DOD) followed suit (<https://bit.ly/3W6kVCj>), but instead of providing avenues of relief to those performing on FFP contracts, DOD argued it did

not have the authority to do so. The memo, written to assist COs with navigating procurement in the current economic landscape, made clear the department would not accommodate Requests for Equitable Adjustment (REAs). It stated that FFP contracts place "the risk of cost increases, including those due to inflation" on the contractor; however, it did suggest that EPA clauses may be appropriate in order to "equitably balance" risks.

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Then, in mid-September, the DOD released new guidance (<https://bit.ly/3j8KAvA>) sympathizing with contractors performing on FFP contracts, advising COs to help fight rising costs by making accommodations by "mutual agreement" and outlining a potential avenue to relief through Public Law 85-504. The mechanism would allow the president to amend contracts, "but only to the extent necessary to avoid such impairment to the contractor's productive ability." The updated guidance was a small, yet positive step toward addressing the burden inflation has placed on contractors performing FFP contracts.

Section 822 of the National Defense Authorization Act

Inflation has posed a daunting problem for the DOD contracting community as many FFP contracts awarded over the last two years are more expensive to perform than was anticipated at the time bids were prepared. That has tangible impacts not only on U.S. national security capabilities, but on the broader economy with small businesses particularly vulnerable. Unfortunately, previous DOD guidance was not sufficient to effectively address the problems. While the DOD seemed ready to offer a helping hand, DOD claimed it could only go so far given existing legal authority.

Section 822 of the NDAA is the latest attempt to provide relief to DOD government contractors facing inflationary pressures. The provision would amend Public Law 85-804 to temporarily provide the Secretary of Defense with the necessary authority to modify FFP contracts and provide contractors with relief. The provision allows prime contractors to request a contract modification when “due solely to economic inflation, the cost to a prime contractor of performing such eligible contract is greater than the price of such eligible contract.” Additionally, the government is prohibited from asking for any consideration in return for the modification.

Section 822 would provide relief to both prime contractors and subcontractors. Prime contractors are authorized to seek relief for themselves as well as those costs borne by subcontractors. A subcontractor need not rely on the prime contractor, however. If a prime contractor fails to seek authorized relief, a subcontractor could seek relief directly from the DOD.

Section 822 seems like a major win for a hurting industry, but the devil is in the details. First, the provision incorporated in this year’s NDAA contains more restrictive language than an earlier version of Section 822.

The new authority, set to expire on Dec. 31, 2023, is discretionary — not mandatory. The proposed legislation’s language provides the DOD with a fair amount of discretion when determining whether a contractor should be granted relief and fails to delineate guidelines or criteria for such a decision.

Section 822 also increases the monetary thresholds in Public Law 85-804, widening the applicability of the provision. Under Public Law 85-804, the threshold for approval for any adjustments was \$50,000 and congressional notification was required for adjustments over \$25 million. Section 822 proposes to raise those thresholds to \$500,000 and \$150 million respectively.

Will it make a difference?

Ostensibly, Section 822 seems like a major win for a hurting industry, but the devil is in the details. First, the provision incorporated in this year’s NDAA contains more restrictive language than an earlier version of Section 822. For example, it requires costs

to be “due solely to economic inflation.” This will likely be difficult for contractors to prove as higher costs are not only attributed to inflation, but wage growth as a result of a tight labor market, supply chain issues, etc. Thus, it will be difficult for contractors to segment those costs and meet the standard required in the provision.

Provision 822 also leaves a fair amount of discretion to the agency to determine whether aid should be awarded without outlining criteria contractors must meet. Assuming the bill — which recently passed in the Senate — is signed into law by the president, the executive branch will be charged with promulgating guidance on implementing the provision. The guidelines will be critical in providing clarity on how much relief DOD contractors will be entitled to receive, as well as what contractors have to provide in the forms of cost or pricing data to support their request.

The guidelines should outline the eligibility requirements for the contractual modifications defining “inflation” broadly to encompass all costs borne from factors out of the contractor’s control including wage growth and supply chain problems resulting from COVID-19 shutdowns and the Ukraine war. The guidelines should also provide objective and concrete guardrails for the COs to follow when reviewing modification requests. Discretion allows COs to pick winners and losers, even if done so unknowingly. An objective and definitive framework will help eliminate biases and ensure relief gets to all who need it.

Also, the guidance should outline the application process and the steps that must be taken for prime and subcontractors to receive relief. Normally, more technically savvy firms will easily parse regulations, apply, and be awarded relief, yet small businesses who do not possess the same internal knowledge and ability may find it difficult to navigate complex and ambiguous processes. A user-friendly and clearly delineated application process, including the level and type of cost or pricing data required, will provide a more level playing field for obtaining relief.

Section 822 is a welcome development for the DOD contracting community and for U.S. national security more broadly, but its potential effectiveness is not yet certain. With a rapidly developing technological race with China and conflict in Europe, a great deal of pressure has been placed on the government contracting community to rapidly innovate and keep pace with the military needs of the U.S. and its allies, but inflation has created an obstacle in realizing defense objectives.

Now is the time to ensure our industrial base is healthy and a ready partner for the decades to come. A Section 822 outfitted with the correct enabling guidelines can go a long way in protecting our national security interests and broader economy.

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