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# Legal Protections for Subcontractors on Federal Prime Contracts: In Brief

**name redacted**

Legislative Attorney

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## Summary

Payment and other protections for subcontractors on federal contracts are of perennial interest to Members and committees of Congress, in part, because many subcontractors are small businesses, and it is the “declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns.” Subcontractors on federal contracts do not have “privity of contract”—or a direct contractual relationship—with the federal government. As such, subcontractors would generally lack the payment and other protections that federal prime contractors enjoy. However, Congress has enacted several measures that give small business and other subcontractors certain protections. Key among these are the Miller Act, the 1988 amendments to the Prompt Payment Act, and Section 8(d) of the Small Business Act.

The **Miller Act of 1935**, as amended, authorizes subcontractors who furnished labor or materials used in carrying out federal construction projects valued in excess of \$150,000 to bring a civil action against prime contractors’ payment bonds to obtain payments due. Congress enacted the Miller Act to compensate for the difficulties that subcontractors would otherwise have in obtaining payment from federal construction contractors, given that they cannot place a mechanic’s lien on the work because the government has sovereign immunity. The doctrine of sovereign immunity protects the government from being sued without its consent, and the Contract Disputes Act waives the government’s sovereign immunity only as to suits involving contracts to which the government is a party, not subcontracts under these contracts. Relatedly, because there is no privity of contract between the government and the subcontractor, the subcontractor generally cannot sue to enforce the payment or other terms of the subcontract against the government.

The **1988 amendments to the Prompt Payment Act** provide an additional form of payment protection for subcontractors on federal construction contracts by requiring federal agencies to include in their contracts a clause obligating the prime contractor to pay the subcontractor for “satisfactory” performance within seven days of receiving payment from the government. Absent such a clause in the prime contract, the prime contractor would generally be free to agree to whatever payment terms it wishes with the subcontractor and would not necessarily pay the subcontractor as quickly. However, the federal government cannot be interpleaded as a party to any disputes between contractors and subcontractors over late payments or interest, and contractors’ obligations to pay subcontractors cannot be passed on to the federal government in any way, including by contract modifications or cost-reimbursement claims.

**Section 8(d) of the Small Business Act** provides yet another payment protection for subcontractors by requiring that prime contractors notify officials of the federal agency that awarded the contract (known as “contracting officers”) in writing whenever they pay a “reduced price” to a subcontractor for completed work, or whenever payment is more than 90 days past due. Section 8(d) also generally requires that prime contractors agree to plans for subcontracting certain percentages of the work to be performed under federal contracts to various types of small businesses. In addition, under Section 8(d), prime contractors must make “good faith efforts” to work with the subcontractors whom they “used” in preparing their bids or proposals, and provide agency contracting officers with a written explanation whenever they fail to do so. Without these subcontracting plans, or similar contract terms, prime contractors would generally be free to subcontract with whomever they wish for the completion of work under the contract and would not be required to deal with various categories of small businesses.

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This report provides an overview of the payment and other protections for subcontractors on certain federal prime contracts under the Miller Act, the 1988 amendments to the Prompt Payment Act, and the Small Business Act.<sup>1</sup> Congress enacted these statutes to give subcontractors rights and remedies they would not otherwise have because of legal doctrines relating to sovereign immunity, privity of contract, and freedom to contract.

Payment and other protections for subcontractors on federal contracts are of perennial interest to Members and committees of Congress, in part, because many subcontractors are small businesses,<sup>2</sup> and it is the “declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns.”<sup>3</sup>

## The Miller Act

A Depression-era enactment named after its sponsor, Representative John Elvis Miller of Arkansas, the Miller Act creates a federal remedy for subcontractors who “furnish[] labor or material in carrying out work provided for” in certain federal construction contracts.<sup>4</sup> Absent the Miller Act, such subcontractors would generally have to rely on breach of contract actions against the prime contractor under state law to recover payments due to them because of the operation of the legal doctrines of privity of contract and sovereign immunity. Although working pursuant to a subcontract under a federal contract, subcontractors generally cannot enforce the payment or other terms of the contract or subcontract against the federal government because there is no privity of contract, or direct contractual relationship, between the subcontractor and the government.<sup>5</sup> The subcontractor’s contract is with the prime contractor, as is the government’s contract; there is no contract between the subcontractor and the government. Additionally, because the government has sovereign immunity and cannot be sued without its consent,<sup>6</sup> the

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<sup>1</sup> The report does not discuss protections for subcontractors’ employees provided under other provisions of law. *See, e.g.*, 40 U.S.C. §3145(a) (requiring that employees of subcontractors on certain federal construction contracts be paid prevailing wages); Executive Order 13495, 74 *Federal Register* 6103 (February 4, 2009) (giving employees of subcontractors of the incumbent contractor the right of first refusal to non-management and non-supervisory positions when a new contractor takes over performance of the contract); 48 C.F.R. §22.802(a) (affirmative action requirements for subcontractors); 48 C.F.R. Subpart 22.14 (protections for subcontractor employees with disabilities); 48 C.F.R. §§3.907-1 to 3.907-7 (protections for subcontractor employees who are whistleblowers).

<sup>2</sup> *See, e.g., Are Government Purchasing Policies Failing Small Businesses? A Roundtable before the Committee on Small Business and Entrepreneurship*, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess., at 38 (June 19, 2002) (“A lot of prime contractors today ... start off as subcontractors.”).

<sup>3</sup> 15 U.S.C. §631(a).

<sup>4</sup> An Act Requiring Contracts for the Construction, Alteration, and Repair of Any Public Building or Public Work of the United States to be Accompanied by a Performance Bond Protecting the United States and an Additional Bond for the Protection of Persons Furnishing Material or Labor for the Construction, Alteration, or Repair of Said Public Buildings or Public Work, P.L. 74-321, 49 Stat. 793 (August 24, 1935) (codified, as amended, at 40 U.S.C. §§3131-3134).

<sup>5</sup> *See, e.g., Williams v. Fenix & Scisson*, 608 F.2d 1205 (9<sup>th</sup> Cir. 1979) (finding that the defendant owed no contractual duty to the plaintiff because the defendant’s contract was with the plaintiff’s employer, not the plaintiff). Under narrow circumstances, persons who are not parties to a contract but are “third party beneficiaries” to it are entitled to enforce the contract’s terms. However, this is generally only the case when the purpose of the contract is to confer a gift on the third party, or when the purpose of one party to the contract is to discharge an actual, supposed, or asserted duty to the third party. *See, e.g., Young Ref. v. Pennzoil*, 46 S.W.3d 380 (Tex. App. 2001). Subcontractors under federal prime contracts would generally not qualify as third-party beneficiaries entitled to enforce the terms of the prime contract on either of these grounds.

<sup>6</sup> The Contract Disputes Act (CDA) waives the government’s sovereign immunity concerning claims arising under or relating to its contracts, but not for claims arising under or relating to subcontracts under its contracts. *See* 41 U.S.C. §§7101-7109.

subcontractor cannot place a mechanic's lien on the improved property, as it potentially could with a private construction project.<sup>7</sup>

The Miller Act requires that, before any contract of more than \$150,000 is awarded for the construction, alteration, or repair of a "public building or public work of the Federal government," the contractor furnish two bonds to the government.<sup>8</sup> The first of these is a performance or completion bond, which would compensate the government for any defects in the contractor's performance under the contract. The second is a payment bond, which would assure that certain persons who supply labor or materials used in carrying out the work provided for in the contract receive payment. Both bonds become legally binding upon award of the contract,<sup>9</sup> and their "penal amounts," or the maximum amounts of the surety's obligation, must generally be 100% of the original contract price plus 100% of any price increases.<sup>10</sup>

The act further authorizes "[e]very person that ... furnished labor or material" in carrying out work provided for in the contract who was not paid in full within 90 days of completing performance to bring a civil action on the payment bond for the amount due.<sup>11</sup> However, "[e]very person," as used here, has been construed to include only first- and second-tier subcontractors.<sup>12</sup> Lower-tier subcontractors are excluded,<sup>13</sup> as are "materialmen" or other parties who supply materials or labor without a contract.<sup>14</sup> These exclusions are partly based on policy considerations and partly based on the definition of "subcontractor." Prime contractors would have greater difficulties in protecting themselves from liability to remote tiers of subcontractors or materialmen than they would in protecting themselves from liability to first- or second-tier subcontractors.<sup>15</sup> Materialmen are excluded because the usage of "subcontractor" in the building

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<sup>7</sup> See, e.g., *F.D. Rich Co. v. United States for Use of Indust. Lumber Co.*, 417 U.S. 116, 122 (1974) ("Ordinarily, a supplier of labor or materials on a private construction project can secure a mechanic's lien against the improved property under state law. But a lien cannot attach to Government property, ... so suppliers on Government projects are deprived of their usual security interest. The Miller Act was intended to provide an alternative remedy to protect the rights of these suppliers.").

<sup>8</sup> A bond is a promise by a surety, or third party, to pay any debts of the contractor or make good any default by or failure of the contractor to satisfy a contractual obligation. See *Taylor Constr. Inc. v. ABT Serv. Corp., Inc.*, 163 F.3d 1119 (9<sup>th</sup> Cir. 1998).

<sup>9</sup> 40 U.S.C. §3131(b).

<sup>10</sup> 48 C.F.R. §28.102-2(b)(2)(i)-(ii) ("Unless the contracting officer makes a written determination supported by specific findings that a payment bond in this amount is impractical, the amount of the payment bond must equal (A) 100 percent of the original contract price; and (B) [i]f the contract price increases, an additional amount equal to 100 percent of the increase. The amount of the payment bond must be no less than the amount of the performance bond.").

<sup>11</sup> 40 U.S.C. §3133(b)(1).

<sup>12</sup> 40 U.S.C. §3133(b)(2) (authorizing suits by "person[s] having a direct contractual relationship with a subcontractor but no contractual relationship, express or implied, with the contractor furnishing the payment bond").

<sup>13</sup> See, e.g., *J.W. Bateson Co., Inc. v. United States ex rel. Board of Tr. of the Nat'l Automatic Sprinkler Indus. Pension Fund*, 434 U.S. 586 (1978) (only persons who contract with the prime contractor or a contractor in privity of contract with the prime contractor may recover under the Miller Act; subcontractors at or below the "third-tier" are not protected); *United States for the Use and Benefit of Global Bldg. Supply v. WNH Ltd. P'ship*, 995 F.2d 515 (4<sup>th</sup> Cir. 1993) (same).

<sup>14</sup> See, e.g., *Clifford F. MacEvoy Co. v. United States*, 322 U.S. 102, 108-09 (1944) (finding that "those who merely sold materials to materialmen, who in turn sold them to the prime contractor," are not entitled to recover on Miller Act payment bonds).

<sup>15</sup> *Id.* at 110 (internal citations omitted) ("The relatively few subcontractors who perform part of the original contract represent in a sense the prime contractor and are well known to him. It is easy for the prime contractor to secure himself against loss by requiring the subcontractors to give security by bond, or otherwise, for the payment of those who contract directly with the subcontractors. But this method of protection is generally inadequate to cope with remote and undeterminable liabilities incurred by an ordinary materialman, who may be a manufacturer, a wholesaler (continued...)

trades includes only “one who performs for or takes from the prime contractor a specific part of the labor or material requirements of the original contract.”<sup>16</sup> The term “thus exclude[s] ordinary laborers and materialmen.”<sup>17</sup>

Within one year of completing performance, first- and second-tier subcontractors seeking payment on a Miller Act bond must file suit in the name of the United States in the federal district court for the area where the subcontractor provided labor or services under the contract.<sup>18</sup> They must also provide the prime contractor with notice served in the same manner as a summons, or by any other means that provides written, third-party verification of delivery to the contractor at its place of business or primary residence.<sup>19</sup> Failure to provide proper notice may bar recovery from either the prime contractor or the surety.<sup>20</sup> Assuming proper notice, the amount a subcontractor may recover if it prevails in the litigation is generally based on the contract amount for the goods or services or, if no amount is specified in the contract, the amount that a person in the subcontractor’s position at the time and place the services were rendered would have spent completing those services.<sup>21</sup> However, after performance is completed, subcontractors may waive in writing their right to bring a civil action, in which case no recovery may be made on the bond.<sup>22</sup>

Contractors that fail to obtain performance bonds as required under the Miller Act are in breach of their contract with the government and could potentially be terminated for default by the government. However, the subcontractor cannot recover from the government for the prime contractor’s failure to obtain a bond,<sup>23</sup> or its failure to obtain a sufficient bond.<sup>24</sup>

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(...continued)

or a retailer. Many such materialmen are usually involved in large projects; they deal in turn with innumerable sub-materialmen and laborers. To impose unlimited liability under the payment bond to those sub-materialmen and laborers is to create a precarious and perilous risk on the prime contractor and his surety.”)

<sup>16</sup> *Id.* at 109.

<sup>17</sup> *Id.*

<sup>18</sup> 40 U.S.C. §3133(b)(3)(B) (filing in the name of the United States and in the district court for the area where the subcontractor provided the labor or services); 40 U.S.C. §3133(b)(4) (“An action brought under this subsection must be brought no later than one year after the day on which the last of the labor was performed or material was supplied by the person bringing the action.”). *See also* United States for Use and Benefit of Harvey Gulf Int’l Marine Inc. v. Maryland Cas. Co., 573 F.2d 245 (5<sup>th</sup> Cir. 1978) (noting that the venue provision is intended to benefit the defendant and is strictly construed); United States for Use and Benefit of Statham Instruments, Inc. v. Western Cas. & Sur. Co., 359 F.2d 521 (6<sup>th</sup> Cir. 1966) (suit within one year a condition precedent of the right to bring suit).

<sup>19</sup> 40 U.S.C. §3133(b)(2)(A)-(B). Notice to the surety is generally not required. *See* Cont’l Cas. Co. v. United States for Use and Benefit of Robertson Lumber Co., 305 F.2d 794 (8<sup>th</sup> Cir. 1962).

<sup>20</sup> *See, e.g.*, United States for Use of John D. Ahern Co., Inc. v. J.F. White Contracting Co., 649 F.2d 29 (1<sup>st</sup> Cir. 1981) (notice a condition precedent to the existence of a right of action on the bond); Nat’l Union Indem. Co. v. R.O. Davis, Inc., 393 F.2d 897 (5<sup>th</sup> Cir. 1968) (recovery may be precluded when proper notice is not given).

<sup>21</sup> *See, e.g.*, W.F. Magann Corp. v. Diamond Mfg. Co., Inc., 775 F.2d 1202 (4<sup>th</sup> Cir. 1985) (awarding the subcontractor damages in quantum meruit); United States v. Algernon Blair, Inc., 479 F.2d 638 (4<sup>th</sup> Cir. 1973) (same).

<sup>22</sup> 40 U.S.C. §3133(c)(1)-(3).

<sup>23</sup> *See, e.g.*, Arvanis v. Noslo Eng’g Consultants, Inc., 738 F.2d 1287, 1289-90 (7<sup>th</sup> Cir. 1984) (“Appellants argue that the Miller Act requires the government to insist that its contractors furnish Miller Act payment bonds. This is incorrect. The statute requires only that contractors obtain performance and payment bonds. The statute places no affirmative obligation on the government, and says absolutely nothing about what happens when the contractor fails to furnish the bond.”).

<sup>24</sup> *See, e.g.*, Automatic Sprinkler Corp. of Am. v. Darla Envtl. Specialists Inc., 53 F.3d 181, 182 (7<sup>th</sup> Cir. 1995) (denying recovery from the government when the bonds were found to be insufficient because the prime contractor had failed to properly qualify the bond securities); United States for Use and Benefit of Gulf States Enters., Inc. v. R.R. Tway, Inc., 938 F.2d 583 (5<sup>th</sup> Cir. 1991) (remedies can only be obtained from parties having a direct contractual (continued...))

## The Prompt Payment Act

Enacted in response to agencies' widely reported delays in paying their bills,<sup>25</sup> the Prompt Payment Act of 1982, as amended, generally requires federal agencies to pay interest on any payments they fail to make by the date(s) specified in the contract, or within 30 days of receipt of a "proper invoice," if no date is specified in the contract.<sup>26</sup> This act originally applied only to payments made by the government to prime contractors, although it encompassed payments under all types of contracts (e.g., manufacturing, construction, service). However, the Prompt Payment Act was amended in 1988 to extend certain payment protections to *subcontractors* on federal *construction* contracts,<sup>27</sup> in part, because agencies' continued practice of paying late created particular difficulties for subcontractors on construction projects.<sup>28</sup> At the time when these amendments were adopted, subcontractors reportedly performed 80% of the work on construction projects, and subcontractors on construction contracts generally do not get paid until the prime contractor has been paid.<sup>29</sup> Without the 1988 amendments, or similar contract terms, prime contractors would generally be free to agree to whatever payment terms they wish with their subcontractors and would not necessarily pay their subcontractors as quickly.

The 1988 amendments require that every construction contract awarded by a federal agency contain clauses obligating the prime contractor to (1) pay the subcontractor for "satisfactory performance" under the subcontract within seven days of receiving payment from the agency<sup>30</sup> and (2) pay interest on any amounts that are not paid within the proper time frame.<sup>31</sup> The contract must also obligate the prime contractor to include similar payment and interest penalty terms in

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relationship with the subcontractor). Although the United States must be named as a party to the suit, it has no actual financial interest involved. *See* United States ex rel. Haycock v. Hughes Aircraft Co., 98 F.3d 1100 (9<sup>th</sup> Cir. 1996).

<sup>25</sup> *See* H.Rept. 97-461, 97<sup>th</sup> Cong., 2<sup>nd</sup> sess. 108 (1982). *See also* David M. F. Lambert & Nancy B. Wilson, *The Prompt Payment Act: Requiring Government Agencies to Pay Their Bills on Time*, 42 *Nat'l Pub. Acct.* 1 (January/February 1997) (referencing a 1978 study by the Government Accountability Office which found that government agencies paid up to 30% of their bills after their due dates).

<sup>26</sup> P.L. 97-177, 96 Stat. 85 (May 21, 1982) (codified, as amended, at 31 U.S.C. §§3901-3907). Among other things, a proper invoice contains (1) the name of the contractor, the invoice date, and the contract number; (2) a description of the goods rendered and the shipping and payment terms; (3) other substantiating documentation or information required under the contract; and (4) the name, title, telephone number, and complete mailing address of the person to whom payment should be sent. 31 U.S.C. §3901(a); 48 C.F.R. §32.905(b)(1)(i)-(x). The interest rate to be used is that determined by the Secretary of the Treasury twice a year under the Contract Disputes Act. *See* 31 U.S.C. §3902(a).

<sup>27</sup> Prompt Payment Act Amendments of 1988, P.L. 100-496, §9, 102 Stat. 3460-63 (October 17, 1988) (codified at 31 U.S.C. §3905(b)(1)-(2)).

<sup>28</sup> *See* Gov't Accountability Office, *Prompt Payment Act: Agencies Have Not Fully Achieved Available Benefits*, AFMD-86-69, August 28, 1986, *available at* <http://archive.gao.gov/f0502/131181.pdf> (reporting that federal agencies still paid 24% of their bills late despite enactment of the Prompt Payment Act).

<sup>29</sup> *See, e.g.*, H.Rept. 100-784, at 26 (percentage of work on federal construction contracts performed by subcontractors); S.Rept. 100-78, at 23 (same). *See also* 48 C.F.R. §28.106-7(a) ("During contract performance, agencies shall not withhold payments due contractors or assignees because subcontractors or suppliers have not been paid.").

<sup>30</sup> 31 U.S.C. §3905(b)(1). A subcontractor's work is generally seen to be satisfactory if the "property and services received conform to the requirements of the contract." *See* New York Guardian Mortg. Corp. v. United States, 916 F.2d 1558, 1560 (Fed. Cir. 1990) (relying on the definition of "satisfactory performance" in Office of Management and Budget (OMB) Circular A-125). OMB Circular A-125 instructed agencies on implementing the Prompt Payment Act. It was rescinded after regulations implementing the act were promulgated.

<sup>31</sup> 31 U.S.C. §3905(b)(2). The interest is to be computed for the period beginning on the day after the required payment was due and ending on the date on which payment is made. The interest rate is that determined by the Secretary of the Treasury. *See supra* note 26.



its subcontracts, as well as require its subcontractors to impose these terms on *their* subcontractors.<sup>32</sup> This latter provision, requiring subcontractors to impose the terms on their subcontractors, ensures that the payment and interest penalty requirements “flow down” to all tiers of subcontractors. The prime contractors would have obligations to any first-tier subcontractors, who would have obligations to second-tier subcontractors, who would have obligations to third-tier subcontractors, etc.

The 1988 amendments do, however, allow contractors and higher-tier subcontractors to negotiate terms permitting them to retain or withhold payment from subcontractors or lower-tier subcontractors without incurring interest penalties.<sup>33</sup> “Retainage” is generally said to occur when a contractor holds back a specified percentage (often 10%) of each progress payment otherwise due under a construction contract as a routine matter, or because of the subcontractor’s failure to perform.<sup>34</sup> Retainage can be seen as a type of withholding.<sup>35</sup> However, the term “withholding” can also be used more broadly to describe the nonpayment of contract amounts because of debts of the contractor outside of the contract.<sup>36</sup> Contractors withholding funds under a contract subject to the Prompt Payment Act must generally provide both the procuring agency and the subcontractor with written notification of withholding, and the amount withheld cannot exceed the amount specified in this notice.<sup>37</sup> Contracting parties often agree to retainage and withholding in order to encourage timely completion of the contract and ensure full understanding between the parties regarding the terms of completion.

Because the payment and interest clauses of the contract apply only to the parties, the federal government’s obligations run only to the prime contractor.<sup>38</sup> Prime contractors have the duty to pay subcontractors, and subcontractors have the duty to pay lower-tier subcontractors. The federal

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<sup>32</sup> 31 U.S.C. §3905(c).

<sup>33</sup> 31 U.S.C. §3905(d)(1)-(3) (“The clauses required by subsections (b) and (c) of this section shall not be construed to impair the right of a prime contractor or a subcontractor at any tier to negotiate, and to include in their subcontract, provisions which—(1) permit the prime contractor or a subcontractor to retain (without cause) a specified percentage of each progress payment otherwise due to a subcontractor for satisfactory performance under the subcontract . . . ; (2) permit the contractor or subcontractor to make a determination that part or all of the subcontractor’s request for payment may be withheld in accordance with the subcontract agreement.”). Although not expressly mentioned in statute, defendants in Miller Act suits may similarly plead that they “set off” payments for retainage or withholding. *See* United States for Use and Benefit of Kashulines v. Thermo Contracting Corp., 437 F. Supp. 195 (D.N.J. 1976).

<sup>34</sup> 31 U.S.C. §3905(d)(1); PCL Constr. Servs., Inc. v. United States, 2008 WL 4725463 (Fed. Cl., October 16, 2008); Am. Airlines, Inc. v. Austin, 778 F. Supp. 72 (D.D.C. 1991).

<sup>35</sup> *See, e.g.*, Ralph C. Nash, Jr., Steve L. Schooner, Karen R. O’Brien-DeBakey, and Vernon J. Edwards, THE GOVERNMENT CONTRACTS REFERENCE BOOK: A COMPREHENSIVE GUIDE TO THE LANGUAGE OF PROCUREMENT 609 (3d ed. 2007) (defining “withholding,” in part, as “[t]he nonpayment of contract amounts by the contracting officer because the contractor failed to carry out some obligation under the contract”).

<sup>36</sup> *See, e.g.*, Imperial Excavating & Paving, LLC v. Rizzetto Constr. Mgmt., Inc., 935 A.2d 557 (Pa. Super. Ct. 2007) (contractor withholding \$262,330 in payments from a subcontractor under one contract because of problems with work under another contract that were not discovered until after payment on that contract had been made).

<sup>37</sup> 31 U.S.C. §3905(e)(1). A proper written notice must generally include the amount to be withheld; the specific causes for withholding under the terms of the subcontract; and the remedial actions to be taken by the subcontractor in order to receive payment of the amounts withheld. 31 U.S.C. §3905(g)(1)-(3). When withholding, the contractor must also (1) deduct the amount withheld from the progress payment otherwise due to the subcontractor; (2) pay the subcontractor “as soon as practicable” after correction of the deficiency; (3) notify the government of the amount of the reduction; and (4) pay interest on the withheld amount from the eighth day after receipt of such funds from the government. 31 U.S.C. §3905(e)(1)-(6).

<sup>38</sup> *See, e.g.*, 31 U.S.C. §3905(k) (“A contractor’s obligation to pay an interest penalty to a subcontractor pursuant to the clauses included in a subcontract under subsection (b) or (c) of this section may not be construed to be an obligation of the United States for such interest penalty.”).



government cannot be interpleaded as a party to any disputes between contractors and subcontractors over late payments or interest,<sup>39</sup> and contractors' obligations to pay subcontractors also cannot be passed on to the federal government in any way, including by contract modifications or cost-reimbursement claims.<sup>40</sup>

## **Obama Administration Payment Policies**

In 2011-2012, the Obama Administration issued guidance that supplements the requirements of the Prompt Payment Act as to the payment of small business contractors and subcontractors. Initially, this guidance called for agencies to pay small business *contractors* within 15 days of receipt of a proper invoice.<sup>41</sup> However, subsequent guidance sought to address payment of small business *subcontractors* by calling for agencies to “accelerate payments to all prime contractors, in order to allow them to provide prompt payments to small business subcontractors.”<sup>42</sup>

Subsequently, in November 2013, the Administration amended the Federal Acquisition Regulation (FAR) to implement the accelerated payment policy as to small business *subcontractors*.<sup>43</sup> As amended, the FAR requires that agencies' prime contracts include terms that obligate the contractor,

[u]pon receipt of accelerated payments from the Government, [to] make accelerated payments to its small business subcontractors under this contract, to the maximum extent practicable and prior to when such payment is otherwise required under the applicable contract or subcontract, after receipt of a proper invoice and all other required documentation from the small business subcontractor.<sup>44</sup>

The FAR amendment also requires that agencies' contracts include terms which obligate prime contractors to incorporate similar language in their subcontracts with small businesses (including those for the acquisition of commercial items), thereby binding themselves to make accelerated payments to their subcontractors.<sup>45</sup> However, agencies are not required to pay interest on any payments that are not made within “accelerated” time frames, unlike with “late” payments under

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<sup>39</sup> 31 U.S.C. §3905(i) (“[A] dispute between a contractor and subcontractor relating to ... section (b) or (c) of this section does not constitute a dispute to which the United States is a party.”).

<sup>40</sup> 31 U.S.C. §3905(k).

<sup>41</sup> Exec. Office of the President, Office of Mgmt. & Budget, *Accelerating Payments to Small Businesses for Goods and Services*, September 14, 2011, *available at* <http://www.whitehouse.gov/sites/default/files/omb/memoranda/2011/m11-32.pdf>.

<sup>42</sup> Exec. Office of the President, Office of Mgmt. & Budget, *Providing Prompt Payment to Small Business Subcontractors*, July 11, 2012, *available at* <http://www.whitehouse.gov/sites/default/files/omb/memoranda/2012/m-12-16.pdf>. The policy as to “accelerated payment” of small business subcontractors was recently extended through December 31, 2016. *See* Exec. Office of the President, Office of Mgmt. & Budget, *Extension of Policy to Provide Accelerated Payment to Small Business Subcontractors*, July 10, 2014, *available at* <http://www.whitehouse.gov/sites/default/files/omb/memoranda/2014/m-14-10.pdf>. Also in July 2014, the Department of Defense (DOD) announced that it would re-instate, effective August 1, 2014, the practice of providing accelerated payments to prime contractors, so that they may make accelerated payments to small business subcontractors. *See* Dep't of Defense, *Providing Accelerated Payment to Small Business Subcontractors*, 79 *Federal Register* 42506 (July 22, 2014). DOD had previously suspended this policy in February 2013 in response to sequestration under the Budget Control Act of 2011 (P.L. 112-25).

<sup>43</sup> Dep't of Defense, Gen. Servs. Admin. & Nat'l Aeronautics & Space Admin., *Federal Acquisition Regulation: Accelerated Payment to Small Business Subcontractors: Final Rule*, 78 *Federal Register* 70477 (November 25, 2013).

<sup>44</sup> *Id.* at 70479 (codified at 48 C.F.R. §52.232-40(a)).

<sup>45</sup> *Id.* (codified at 48 C.F.R. §52.232-40(c)).

the Prompt Payment Act.<sup>46</sup> In addition, because they lack privity of contract with the government, small business subcontractors generally cannot hold agencies accountable if the prime contractor fails to incorporate the requisite clauses in its subcontracts, or fails to make accelerated payments pursuant to such clauses.<sup>47</sup>

The FAR has not been similarly amended to address “accelerated” payments to small business *contractors*, although the general policy of accelerating payments to such entities remains in effect.<sup>48</sup>

## The Small Business Act

Section 8(d) of the Small Business Act provides several different protections to subcontractors that qualify as “small businesses” pursuant to the act,<sup>49</sup> by generally requiring prime contractors to (1) agree to subcontract certain percentages of the work to be performed under federal contracts to various types of small businesses; (2) make “good faith efforts” to work with the subcontractors whom they “used” in preparing their bids or proposals; and (3) notify the contracting officer of the federal agency that awarded the contract in writing if payment to a subcontractor is late or reduced.

## Subcontracting Plans

Amendments made to Section 8(d) of the Small Business Act in 1978 established the “Small Business Subcontracting Program,” a program designed to benefit certain prospective subcontractors on federal prime contracts.<sup>50</sup> The requirements of this program vary depending upon the anticipated value of the contract. Contracts valued at over \$150,000 and performed within the United States must generally include two clauses pertaining to subcontracting with small businesses.<sup>51</sup> The first of these clauses articulates federal policies regarding subcontracting with small businesses and timely payment of subcontractors:

It is the policy of the United States that small business concerns, small business concerns owned and controlled by veterans, small business concerns owned and controlled by service-disabled veterans, qualified [Historically Underutilized Business Zone] HUBZone small business concerns, small business concerns owned and controlled by

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<sup>46</sup> *Id.* (codified at 48 C.F.R. §52.232-40(b)). (“The acceleration of payments under this clause does not provide any new rights under the Prompt Payment Act.”).

<sup>47</sup> See *supra* note 5 and accompanying text (generally discussing privity of contract).

<sup>48</sup> The Department of Defense FAR supplement has, however, been amended to address accelerated payment of contractors. See Dep’t of Defense, Defense Federal Acquisition Regulation Supplement: Accelerate Small Business Payments: Final Rule, 76 *Federal Register* 71468 (codified at 48 C.F.R. §232. 903) (“DoD policy is to assist small business concerns by paying them as quickly as possible after invoices and all proper documentation, including acceptance, are received and before normal payment due dates established in the contract.”).

<sup>49</sup> For purposes of the Small Business Act, a *small business* is one that is “independently owned and operated;” is “not dominant in its field of operation;” and meets any definitions or standards established by the Small Business Administration. 15 U.S.C. §632(a)(1)-(2)(A). These standards focus primarily upon the size of the business, as measured by the number of employees, its annual average gross income, and the size of other businesses within the same industry. See 13 C.F.R. §§121.101-121.108. For example, recreational vehicle dealers are small if their annual receipts (averaged over three years) are less than \$32.5 million, while line-haul railroads are small if they have fewer than 1,500 employees. 13 C.F.R. §121.201.

<sup>50</sup> An Act to Amend the Small Business Act and the Small Business Investment Act of 1958, P.L. 95-507, §211, 92 Stat. 1767-70 (October 24, 1978).

<sup>51</sup> 15 U.S.C. §637(d)(2)-(3).

socially and economically disadvantaged individuals, and small business concerns owned and controlled by women shall have the maximum practicable opportunity to participate in the performance of contracts let by any Federal agency, including contracts and subcontracts for subsystems, assemblies, components, and related services for major systems. It is further the policy of the United States that its prime contractors establish procedures to ensure the timely payment of amounts due pursuant to the terms of their subcontracts with small business concerns, small business concerns owned and controlled by veterans, small business concerns owned and controlled by service-disabled veterans, qualified HUBZone small business concerns, small business concerns owned and controlled by socially and economically disadvantaged individuals, and small business concerns owned and controlled by women.<sup>52</sup>

The second of these clauses embodies the contractor's agreement to carry out the aforementioned policy "to the fullest extent consistent with the efficient performance of this contract," as well as cooperate in any studies necessary to determine the extent of its compliance.<sup>53</sup>

Contracts in excess of \$700,000 (\$1.5 million for construction contracts) that offer subcontracting possibilities generally must also incorporate a subcontracting plan that includes the following:

- "[s]eparate percentage goals" for subcontracting with small businesses, veteran-owned small businesses, service-disabled veteran-owned small businesses, HUBZone small businesses, small disadvantaged businesses, and women-owned small businesses;
- a statement of the total dollars planned to be subcontracted and the total dollars planned to be subcontracted to small businesses;
- a description of the principal types of supplies and services to be subcontracted; and
- assurances that the contractor will (1) include terms relating to the government's policy of promoting contracting with small businesses in all subcontracts that offer subcontracting opportunities and (2) require all subcontractors receiving subcontracts valued in excess of \$700,000 (\$1.5 million for construction) that are not themselves small businesses to adopt their own subcontracting plans.<sup>54</sup>

Contractors on these "larger" contracts are also required by Small Business Administration (SBA) regulations to provide pre-award written notification to unsuccessful small business offerors on all subcontracts valued at over \$150,000 for which a small business concern received a preference.<sup>55</sup> This notification must include the name and location of the apparently successful

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<sup>52</sup> 15 U.S.C. §637(d)(3)(A). Regulations promulgated under the authority of this act, however, qualify the "maximum practicable opportunity to participate in contract performance" by adding "consistent with its efficient performance." 48 C.F.R. §19.702. The "timely payment" provided for here refers to the payment terms of the subcontract, not the requirements of the Prompt Payment Act. *Id.*

<sup>53</sup> 15 U.S.C. §637(d)(3)(B).

<sup>54</sup> 48 C.F.R. §19.704(a)(1)-(11). Prospective contractors that are not themselves small businesses are generally required to submit a proposed subcontracting plan as part of their bid or offer, and agencies may not find a contractor affirmatively "responsible" for purposes of the award of a federal contract unless it agrees to a plan that is also acceptable to the agency. *See* 48 C.F.R. §19.705-4(b)-(c). As an alternative to the plans described here, contractors may establish "master plans" that contain similar elements and are valid for three years, or "commercial plans," which apply to the entire production of commercial items sold by the entire company or a portion of it, in the case of contractors furnishing commercial items. 48 C.F.R. §19.704(b) & (d).

<sup>55</sup> 13 C.F.R. §125.3(c)(1)(viii).

offeror and its small business status, if any.<sup>56</sup> “Large” prime contractors are encouraged, but not required, to provide similar notice to offerors for subcontracts valued at less than \$150,000.<sup>57</sup>

The contracting officer has discretion in determining whether particular contracts require a subcontracting plan,<sup>58</sup> and the percentage goals for particular contracts need not correspond to the procuring activities’ goals for the percentage of contract and/or subcontract dollars awarded to various categories of small businesses.<sup>59</sup> However, any subcontracting plan that is required constitutes a material part of the contract,<sup>60</sup> potentially allowing the contractor to be terminated for default if it fails to substantially perform in accordance with the requirements of the plan.<sup>61</sup> Additionally, the contract must include a clause requiring the contractor to pay liquidated damages of an “amount equal to the actual dollar amount by which the contractor failed to achieve each subcontracting goal”<sup>62</sup> if the contractor fails to make a good faith effort to comply with the plan.<sup>63</sup> Agencies are also required to consider contractors’ performance vis-à-vis their

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<sup>56</sup> *Id.*

<sup>57</sup> 13 C.F.R. §125.3(c)(1)(ix)

<sup>58</sup> 48 C.F.R. §19.705-2. Neither the Small Business Act nor regulations promulgated under its authority define the scope of the contracting officer’s discretion here. However, contracting officers have historically been granted broad discretion to utilize the powers granted to them by Congress. *See, e.g., Precision Std., Inc. v. United States*, 228 F. App’x 980, 982 (Fed. Cir. 2007) (holding that contracting officers have broad discretion in responsibility determinations); *Night Vision Corp. v. United States*, 469 F.3d 1369, 1375 (Fed. Cir. 2006) (noting that contracting officers have broad discretion “to execute and amend contracts, administer contractual performance and decide contractual claims”); *E.W. Bliss Company v. United States*, 77 F.3d 445, 449 (Fed. Cir. 1996) (holding that contracting officers have broad discretion in their evaluation of bids when awarding contracts).

<sup>59</sup> *See, e.g., B.H. Aircraft Co., Inc., Comp. Gen. Dec. B-295399.2* (July 25, 2005) (denying a protest that alleged, in part, that the Defense Logistics Agency (DLA) improperly agreed to a small business subcontracting goal in a contracting plan that was lower than the overall DLA goal). There are government-wide and agency-specific goals for the percentage of federal contract and/or subcontract dollars awarded to various categories of small businesses. *See* 15 U.S.C. §644(g)(1)-(2). The government-wide goal is that 23% of all contract dollars be awarded to small businesses; 3% of all contract and subcontract dollars be awarded to service-disabled veteran-owned small businesses; 3% of all contract and subcontract dollars be awarded to HUBZone small businesses; 5% of all contract and subcontract dollars be awarded to small businesses owned and controlled by socially and economically disadvantaged individuals; and 5% of all contract and subcontract dollars be awarded to women-owned small businesses. 15 U.S.C. §644(g)(1). The agency-specific goals are generally the same as the government-wide ones. *See Small Business Goaling Report: Fiscal Year 2014, available at* [https://www.fpds.gov/downloads/top\\_requests/FPDSNG\\_SB\\_Goaling\\_FY\\_2014.pdf](https://www.fpds.gov/downloads/top_requests/FPDSNG_SB_Goaling_FY_2014.pdf). There are no government-wide goals for contracting and subcontracting with small businesses owned and controlled by veterans who do not have service-related disabilities, and only the Department of Veterans Affairs would appear to be required by statute to have agency-specific goals for contracting and subcontracting with such firms. *See* 38 U.S.C. §8172(a).

<sup>60</sup> 15 U.S.C. §637(d)(8); 48 C.F.R. §19.702(c).

<sup>61</sup> When the contractor’s performance is defective, the procuring agency may generally reject the defective supplies or services, reduce the contract price, or terminate the contract for default. *See generally* CRS Report R44202, *Selected Legal Mechanisms Whereby the Government Can Hold Contractors Accountable for Failure to Perform or Other Misconduct*, by (name redacted) and (name redacted) .

<sup>62</sup> 48 C.F.R. §19.705-7(b). *See also* 15 U.S.C. §637(d)(4)(F); 48 C.F.R. §19.702(c). Liquidated damages are damages whose amount was agreed upon, as compensation for specific breaches, by the parties at the time of the contract’s formation.

<sup>63</sup> Contractors often avoid having to pay such damages because the Federal Acquisition Regulation defines “[f]ailure to make a good faith effort” to mean a “willful or intentional failure to perform in accordance with the requirements of the subcontracting plan, or willful or intentional action to frustrate the plan.” 48 C.F.R. §19.701. Good faith can be shown even if the contractor does not achieve all the goals established in the contract provided that it either (1) exceeds one goal by an amount that is at least equal to any deficiency on another goal or (2) takes certain steps, such as breaking contract work-items into economically feasible units to facilitate small business participation or conducting market research to identify small business contractors and subcontractors. 13 C.F.R. §125.3(d)(3). Compliance is determined based on on-site reviews conducted 12 months after contract award and follow-up reviews conducted 6 to 8 months (continued...)

subcontracting plans when evaluating their past performance,<sup>64</sup> determining whether prospective contractors are responsible,<sup>65</sup> and making source selection decisions in certain negotiated procurements.<sup>66</sup>

If such percentage goals were not contained in the subcontracting plan, prime contractors would generally be free to subcontract with whomever they wish, and various categories of small businesses would not necessarily have this opportunity to obtain federal contract dollars. However, although subcontracting plans are intended to benefit small businesses, these businesses are not parties to the contract between the government and the contractor, and they generally cannot enforce its terms against the prime contractor.<sup>67</sup> Only the government may generally do so.

## Good Faith Efforts to Work with Subcontractors “Used” in Bids or Proposals & Notification of Late or Reduced Payments

The 111<sup>th</sup> Congress expanded the payment and other protections for small business subcontractors under Section 8(d) of the Small Business Act when it enacted the Small Business Jobs Act (SBJA) of 2010.<sup>68</sup> Among other things, the SBJA amended Section 8(d) to require that prime contracts incorporating subcontracting plans also include terms obligating the contractor to:

make a good faith effort to acquire articles, equipment, supplies, services, or materials, or obtain the performance of construction work from the small business concerns used in preparing and submitting ... the bid or proposal, in the same amount and quality used in preparing and submitting the bid or proposal,

and provide the contracting officer with a written explanation whenever it fails to do so.<sup>69</sup> In addition, the SBJA amended Section 8(d) to require that prime contractors with subcontracting plans notify the contracting officer in writing if they pay a subcontractor a reduced price, or if payment is more than 90 days past due on a contract for which the federal agency has paid the

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(...continued)

after a compliance review. 13 C.F.R. §125.3(f)(1).

<sup>64</sup> 48 C.F.R. §42.1502(g).

<sup>65</sup> 48 C.F.R. §19.705-5(a)(1). Firms must generally be determined to be affirmatively responsible before receiving each federal contract. For more on responsibility determinations, see generally, CRS Report R40633, *Responsibility Determinations Under the Federal Acquisition Regulation: Legal Standards and Procedures*, by (name redacted).

<sup>66</sup> 48 C.F.R. §15.304(c)(3)-(5); 13 C.F.R. §125.3(g). While agencies generally have “broad discretion” in selecting evaluation factors, when issuing solicitations involving bundling that offer a significant opportunity for subcontracting, they must incorporate a factor to “evaluate past performance indicating the extent to which the offeror attained applicable goals for small business participation under contracts that required subcontracting plans.” 48 C.F.R. §15.304(c)(3)(ii).

<sup>67</sup> See, e.g., *Ralte v. Helen Keller Int’l, Inc.*, 1998 U.S. App. LEXIS 6573, at \*8 n.3 (noting that the plaintiff did not allege that she was a third-party beneficiary of the contract in whose subcontracting plan she was listed).

<sup>68</sup> P.L. 111-240, 124 Stat. 2504 (September 27, 2010).

<sup>69</sup> *Id.* at §1322, 124 Stat. 2540-41 (codified at 15 U.S.C. §637(d)(6)). The SBA regulations implementing these provisions of the SBJA specify that a prime contractor can be said to have “used” a small business in preparing its bid or proposal when: (1) the offeror references the small business as a subcontractor in the bid or proposal, or associated small business subcontracting plan; (2) the offeror has a subcontract or agreement in principle to subcontract with a small business to perform a portion of the specific contract; or (3) the small business drafted a portion of the bid or proposal, or the offeror used the small business’s pricing or cost information, or technical expertise, in preparing the bid or proposal, and there is written evidence of an intent or understanding that the small business would be awarded a subcontract for the related work if the offeror is awarded the contract. See Small Bus. Admin., Small Business Subcontracting: Final Rule, 79 *Federal Register* 42390, 42405 (July 16, 2013) (codified at 13 C.F.R. §125.3(c)(3)(i)-(iii)).

prime contractor.<sup>70</sup> Contracting officers are also required to consider any “unjustified failure” by a prime contractor to make full or timely payments to a subcontractor in evaluating the contractor’s performance,<sup>71</sup> and note any “history” of unjustified failures to make full or timely payment in the Federal Awardee Performance and Integrity Information System (FAPIIS).<sup>72</sup>

Regulations promulgated by SBA to implement these provisions of the SBJA further bar prime contractors from restricting subcontractors’ ability to “discuss[] any material pertaining to payment or utilization with the contracting officer,”<sup>73</sup> apparently with the intent of promoting reporting by subcontractors in the event that prime contractors fail to provide the requisite notices. However, the preface to these regulations also makes clear that SBA does not view the SBJA as requiring contracting officers to involve themselves in disputes regarding reduced or late payments, or regarding whether particular subcontractors were “used” in preparing bids or proposals.<sup>74</sup> Instead, SBA envisions contracting officers factoring contractors’ failure to work with small businesses “used” in their bids or offers, or unjustifiable late or reduced payments, into contractors’ performance evaluations.<sup>75</sup>

## Author Contact Information

(name redacted)  
Legislative Attorney  
[redacted]@crs.loc.gov7-....

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<sup>70</sup> P.L. 111-240, at §1334, 124 Stat. 2542-43 (codified at 15 U.S.C. §637(d)(12)(B)).

<sup>71</sup> Agencies are generally required to evaluate contractors’ performance on all contracts valued in excess of \$150,000 (\$35,000 for architect-engineer contracts, \$700,000 for construction contracts) when the contract is completed or on an interim basis, in the case of multi-year contracts. 48 C.F.R. §42.1502(b) (general requirement); 48 C.F.R. §42.1502(e) (construction contracts); 48 C.F.R. §42.1502(f) (architect-engineer contracts). For more on evaluations of contractors’ performance, see CRS Report R41562, *Evaluating the “Past Performance” of Federal Contractors: Legal Requirements and Issues*, by (name redacted).

<sup>72</sup> 15 U.S.C. §637(d)(12)(C). The act does not define what constitutes a history of “unjustified failure” to make full or timely payments. However, regulations promulgated under the authority of the act define this to mean three incidents within a 12-month period. <sup>79</sup> *Federal Register* at 42393 (codified at 13 C.F.R. §125.3(a)(3)).

<sup>73</sup> *78 Federal Register* at 42404 (codified at 13 C.F.R. §125.3(c)(1)(iii)).

<sup>74</sup> *Id.* at 42393 (expressing SBA’s view that the regulations will not result in contracting officers “becom[ing] the entry point for contract disputes between primes and subcontractors,” since contracting officers “cannot be a party” to such disputes).

<sup>75</sup> *Id.*



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