

“Pass-Through Claims” Against Federal and State Governments – Lessons for Prime Contractors, Subcontractors, Material Suppliers and Sureties

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"Pass-through claims" are particularly important in government contracting. The rules regarding pass-through claims vary between federal, state and local government jurisdictions. Prime contractors, subcontractors, material suppliers and sureties should understand the differences and distinctions regarding "pass-through claims" in different jurisdictions in order to preserve and assert their rights should a pass-through claim arise, as is often the case.

What are pass-through claims?

A pass-through claim is a claim by a party who has suffered damages (typically a subcontractor), against a responsible party with whom it has no contract (typically a governmental entity, *i.e.*, the Owner/Government), presented by an intervening party (typically the prime contractor) who has a contractual relationship with both. In this example, the claim from the subcontractor “passes-through” the prime contractor to the Owner/Government.

Generally, absent "privity of contract," a subcontractor may not make a claim against or sue the Government directly. "Privity of contract" simply means that parties are in a direct contractual relationship. For example, on a typical government project, the prime contractor is in privity of contract with the Government and at the same time its subcontractors; however, the subcontractors are *not* in privity of contract with the Government (because the subcontractors do not have a contract with the Government but only with the prime contractor). Absent legal authority to the contrary, pass-through claims are not allowed due to subcontractors' lack of privity of contract with the Government. However, a body of law has developed in the federal contracting arena, and many states, allowing pass-through claims against the Government if certain requirements are met.

The Severin Doctrine and Liquidating Agreements

In the federal contracting arena, the so-called *Severin* doctrine, which developed from the case *Severin v. United States*, 99 Ct. Cl. 435 (1943), provides for pass-through claims against the Federal Government. In the *Severin* case, the court held a subcontractor could not recover against the Government in a representative lawsuit if the prime contractor was not also liable to the subcontractor on the same claim. This means that the prime contractor must be obligated to pay the subcontractor regardless of whether the subcontractor claim is ultimately paid by the Government.

However, Over the past several decades, federal court decisions have modified the *Severin* doctrine to limit the potential harsh effects from its strict application. For example, the *Severin* doctrine does not bar a legal action against the Government if the prime contractor and subcontractor enter into a liquidating agreement. A "liquidating agreement" is an agreement

between the prime contractor and subcontractor which typically provides that the subcontractor will release all claims it may have against the prime contractor in exchange for the prime contractor's promise to pursue the subcontractor's claims against the Government. *When properly drafted*, liquidating agreements are enforceable. Liquidating agreements do not violate the *Severin* doctrine unless they completely and expressly release the prime contractor from liability to its subcontractor.

Federal Pass-Through Claim Examples

In *J.L. Simmons v. United States*, 304 F.2d 886 (Ct. Cl. 1962), the Court defined the basic requirements of a liquidating agreement. The court held that where a prime contractor agreed to reimburse its subcontractor for damages suffered at the hands of the Government, but only as and when the prime received payment for the subcontractor from the Government, the prime may maintain its action against the United States on behalf of the subcontractor. The *J.L. Simmons* court further held, under the specific facts of that case, that a "waiver of lien and release" did not negate an action by the prime contractor on behalf of its subcontractors where the subcontracts did not expressly negate the prime's liability, even though the waivers provided that if the prime was unsuccessful in prosecuting the subcontractor claims the prime's liability would be extinguished.

As it now stands, the *Severin* doctrine has evolved to the point that contractors can now pass-through a subcontractor's claim for unabsorbed home office overhead costs incurred due to government-caused delay, despite the fact the overall project is not delayed. In the recent case of *E.R. Mitchell Construction Co. v. Danzig*, 175 F.3d 1369 (Fed. Cir. 1999), a federal court rejected the Government's argument that the timely completion of the prime contract bars an otherwise satisfactory pass-through delay claim of a subcontractor where the Government caused the subcontractor's delay.

Pass-Through Claims on Non-federal Government Projects

On non-federal government projects, a prime contractor's right to sponsor a pass-through claim against the Government is not as certain or uniform as in the federal arena. The emerging trend among the states permits pass-through claims against the Government, similar to the federal contracting arena. However, some important exceptions exist, creating a potential minefield for unknowing contractors, material suppliers and sureties.

Interstate Contracting Case (Texas)

In the recent case of *Interstate Contracting Corp. v. City of Dallas*, 135 S.W.3d 605 (Tex. 2004), the Texas Supreme Court held that Texas recognizes pass-through claims. The Court further held that, similar to the *Severin* doctrine, in order to assert a pass-through claim, the prime contractor must remain liable to the subcontractor for damages sustained by the subcontractor.

In *Interstate Contracting*, the prime contractor, Interstate Contracting Corp. ("ICC"), contracted with the City of Dallas to construct levees around a water treatment plant, in addition to the excavation of two areas to create storm water detention lakes.

The material excavated for the lakes was to be used to construct the levees. ICC entered into two subcontracts with Mine Services, Inc. ("MSI") for the levee construction and excavation. Shortly after work began, MSI discovered the excavated materials were unsuitable for the levee construction due to a high clay content. Consequently, MSI was forced to manufacture suitable fill material by mixing sand with the clay. ICC informed the City of MSI's increased work and submitted a claim which the City denied. ICC then filed suit on behalf of MSI against the City. Prior to the lawsuit, ICC and MSI entered into a liquidating agreement.

Other States' Laws regarding Pass-Through Claims

In reaching its decision recognizing pass-through claims in Texas, the *Interstate Contracting* Court reviewed the law regarding pass-through claims in federal courts and other states. The Court concluded that the federal government (through the *Severin* doctrine) and 18 of the 19 states that have considered pass-through claims allow them. The 18 states the *Interstate Contracting* Court found treat pass-through claims favorably include the following: Alaska; California; Florida; Georgia; Kansas; Louisiana; Maryland; Massachusetts; Michigan; Minnesota; Missouri; Nevada; New Jersey; New York; North Carolina; Oregon; Rhode Island and Virginia (regarding claims against the Virginia Department of Transportation ("VDOT") only).

Of the 19 states that have considered pass-through claims, the only state the *Interstate Contracting* Court found that explicitly rejects pass-through claims is Connecticut. In addition, although Virginia allows pass-through claims against VDOT, pass-through claims are not permitted against other Virginia governmental entities, *i.e.*, they are not allowed against Virginia counties, cities and other non-VDOT state agencies pursuant to the Virginia Public Procurement Act. The law regarding pass-through claims in the remaining 30 states is unsettled and subject to change, though the emerging national trend appears to clearly favor pass-through claims.

In addition to the potential minefield created by selected states that do not recognize or have not yet ruled on pass-through claims, contractors, material suppliers and sureties must be aware of the time and procedural requirements for bringing pass-through claims. The failure to follow a state's time and/or procedural requirements is typically fatal to a pass-through claim (prior to the claim ever being considered on the merits).

Summary

Pass-through claims are an important aspect of government contracting at the federal, state and local level. The *Severin* doctrine, which is applicable in federal contracting and some states, allows for subcontractor pass-through claims. However, some states do not allow pass-through

claims; while courts in other states have not yet ruled on the issue. In addition, there are often time and procedural requirements — unique to each jurisdiction — which must be satisfied in order to bring a pass-through claim.

In summary, contractors, material suppliers and sureties are well advised to become familiar with the law in whatever jurisdictions they transact business in order to understand, preserve and assert their rights regarding pass-through claims.

