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Government Contracts Quarterly Update

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The Government Contracts Quarterly Update *is published by BakerHostetler's Government Contracts Practice Group to inform our clients and friends of the latest developments in federal government contracting.*

Proposed Rule Focuses on Audit of Business Systems, May Expedite and Streamline Process

On July 15, the Department of Defense ("DOD") released a proposed rule, 79 Fed. Reg. 41172, that will allow contractors that are subject to the requirement for audit of key business systems (more than $50 million annually of contracts requiring cost or pricing data) to self-certify that their key business systems are adequate and to elect to use DOD-approved third-party auditors to periodically validate those same systems. The comment period ends on September 15, 2014.

The Defense Contract Audit Agency ("DCAA") is tasked with examining accounting and billing, estimating, material management, and accounting systems, while the Defense Contract Management Agency ("DCMA") reviews purchasing, government property and management, and earned value management systems. Collectively, these systems comprise the key business systems that give rise to the generation of cost or pricing data that covered contractors are required to deliver in support of their offers. The proposed rule would leave the DCMA review process largely unchanged (DCMA is not as inundated with other audit work as is DCAA).

The proposed rule could be a net positive for contractors (and for DCAA, whose auditors are years behind in their review of incurred cost submissions). The proposed rule, if adopted, should ease the audit load that would otherwise be imposed on DCAA and thereby expedite the process and time frame for conducting business systems audits, thus giving contractors greater control over how and when those reviews are completed.

There is a dark side, however, to the proposed rule: contractors who opt to self-certify and rely upon outside audit firms will be required to provide to those auditors (and therefore, to the government) their internal audit work papers and related materials generated in connection with the self-certifications. In contrast, production of those same papers would not be required of contractors in a DCAA review. The accompanying requirement for delivery of records could give rise to creation of new or different work papers by personnel who operate outside the accounting and finance functions as a way of walling off those routine but nonetheless sensitive functions from the business systems review (operating much like an ombudsman). In other words, even with additional requirements for record transparency, contractors and their advisors will likely evolve the finance and accounting functions to avoid having to produce pure accounting and finance records, while still complying with the requirement for delivery of records that substantiate the adequacy of business systems.

D.C. Circuit Extends Attorney-Client Privilege to Internal Compliance Investigations

In recent years, numerous trial courts have ruled that communications between counsel and corporate executives or other personnel are protected by privilege only if the "primary purpose" of the exchange was to request or furnish legal advice, thereby potentially exposing to discovery communications in connection with the investigation of regulatory and compliance matters. *See, e.g.*, *United States v. ISS Marine Servs., Inc.*, 905 F. Supp. 2d 121, 128 (D.D.C. 2012) (but for the request for legal advice, the exchange with counsel could not qualify for privilege). Recognizing that companies often undertake actions for multiple overlapping reasons, the D.C. Circuit rejected the "but for" test, concluding that the attorney-client privilege applies "[s]o long as obtaining or providing legal advice was one of the significant purposes of the internal investigation." *In re Kellogg Brown & Root, Inc.*, – F.3d –, 2014 WL 2895939, at *4 (D.C. Cir. 2014). In other words, the request for legal advice need not be the primary purpose of the communication.

The KBR decision is especially important to government contractors because the original controversy arose in connection with a government contract. In KBR, a former employee advanced numerous allegations of improper conduct by KBR. KBR conducted an internal investigation, overseen by in-house attorneys, into many of the alleged improprieties. The investigation was commenced in fulfillment of the company's Code of Business Conduct, which was, in turn, promulgated to comply with Department of Defense contracting regulations requiring internal control systems. See 48 C.F.R. §§ 203.7000–203.7001(a). Before the lower court, the *qui tam* relator endeavored to compel production of investigative materials and files prepared by counsel and communicated to management. The district court found that KBR was obligated to conduct an investigation regardless of its need for legal advice, and therefore, the subject communications could not qualify for the privilege. In reversing the lower court, the D.C. Circuit eliminated what it viewed as a "false dichotomy," thereby restoring the safe haven that has always been provided under the attorney-client privilege. This holding allows businesses to plan and execute internal investigations without the risk of exposing to discovery all of their investigative communications with counsel, thereby preserving the need for and provision of candor between client and counsel.

Executive Order 13665 Allows Agencies to Terminate Contracts If Contractors Retaliate Against Employees Who Disclose Compensation

On April 8, President Obama signed Executive Order 13665, aimed at combating employer policies restricting or prohibiting employees from being able to discuss compensation with colleagues, thereby curtailing the practice of preventing employees from discussing compensation data (such as co-workers talking about their respective wage rates). The Executive Order, effective on April 8, 2014, allows agencies to terminate contracts where the contractor discriminates against or penalizes employees who discuss among themselves their compensation data.

The National Labor Relations Act ("NLRA") grants employees the right to discuss the terms and conditions of their employment for the purpose of collective bargaining, and prohibits employers from interfering with that right. 29 U.S.C. §§ 157-58. The NLRA does not, however, prescribe serious penalties for employer violations; the National Labor Relations Board ("NLRB"), which has jurisdiction over employment disputes arising under the Act, may order injunctive and equitable relief—including back pay and reinstatement for wrongfully terminated employees—but may not issue punishments such as fines for employer violations. 29 U.S.C. § 160(c).

Given that somewhat incomplete framework, employers routinely restrict employees from discussing compensation with one another.

With limited exceptions, the Executive Order applies to all government contractor employees, not just the nonsupervisory employees covered by the NLRA. Although the Order is technically in effect, the Department of Labor must propose implementing regulations by September 15, 2014. Employers should take the time now to review and revise their policies and procedures to comply with the Order's prohibitions and participate in the public comment process once DOL releases the new rules.

Proposed DOD Rule Expands Contractors' Risk of Personal Conflicts of Interest

Currently, the FAR includes some coverage to require contractors to identify personal conflicts of interest ("PCI") in connection with contractor personnel who work on "acquisition function[s] closely associated with inherently governmental functions," such as developing the work specifications to be included in a solicitation. FAR 3.1101. Contractors are required to maintain procedures to identify potential PCIs, including requiring internal employee disclosure of financial interests and managing work assignments to ensure that covered employees are only assigned to conflict-free projects.

On April 2, the FAR council proposed a new rule expanding the scope of the PCI rules. 79 Fed. Reg. 18503. The proposed rule does not materially change the existing rules, but it does expand the definition of "covered employee" to include those folks performing any work that is *closely associated* with inherently governmental functions, such as law enforcement activities, intelligence operations, or internal policy development, FAR 7.503(c), and those working on service contracts, FAR 37.104. The expanded coverage scope is not limited to just the acquisition functions. The new rule does not apply to commercial items or to contracts valued below the simplified acquisition threshold ($150,000). Even so, the FAR council estimates the new rule could affect over 28,000 contract actions (e.g., actions resulting in a contract, including actions for additional supplies or services outside the existing contract scope) annually, requiring many contractors to now implement PCI procedures for the first time.

The public comment period ended on June 2. Numerous business groups (i.e., the U.S. Chamber of Commerce, Aerospace Industries Association, and Professional Services Council) commented in opposition to the new requirements.

DOD's Restrictions on Counterfeit Parts Rule Is Limited to Electronic Parts, but More Changes Are Expected

On May 6, DOD issued the final version of its counterfeit parts rule, 79 Fed. Reg. 26,092. *See Baker's* July 2013 Quarterly Update. Responding to concerns of ambiguity and overbreadth, the Final Rule is limited strictly to counterfeit *electronic* parts and adds an intent requirement that the part be "knowingly mismarked, misidentified, or otherwise misrepresented" as a precondition for finding contractor liability.

The Final Rule, also effective May 6, 2014, covers all prime contractors subject to the Cost Accounting Standards, requiring them to implement as part of their purchasing system policies that are designed to prevent the introduction of counterfeit parts into the supply chain. Among other things, this requires imposition of flow-down clauses to ensure that lower tier subcontractors also take preventative measures against incorporation of counterfeit electronic parts into their

supply chains. Covered contractors whose purchasing systems are found to be deficient face the possibility of having payments withheld.

Even though DOD agreed to narrow the scope of its final rule, contractors must remain vigilant. The FAR council released a proposed rule on June 10, 2014 that will (if implemented as final) expand civilian contractor responsibilities to include proactive measures to protect against the incorporation of counterfeit and nonconforming items. 79 Fed. Reg. 33164. But, unlike DOD's final rule, the proposed FAR rule will apply to any item supplied by any contractor that is subject to FAR. The comment period closes on August 11.

DOD's New FOCI Rules Present New Challenges to Contractors with Foreign Connections

On April 9, DOD issued an interim final rule formally implementing National Industrial Security Program ("NISP") regulations for companies subject to foreign ownership, control, or influence ("FOCI"), 79 Fed. Reg. 19467, *codified at* 32 C.F.R. Part 117. The rule replaces the informal agency guidance that was available through individual DOD staff contacts and high-level provisions in the NISP Operating Manual ("NISPOM").

A company is considered to be under FOCI when a foreign interest has "the power . . . to direct or decide matters affecting the management or operations of the company in a manner that may result in unauthorized access to classified information or may adversely affect the performance of classified contracts." 32 C.F.R § 117.56(b)(1); *see also* 79 Fed. Reg. 19472. Although various arrangements may constitute FOCI, including contractual arrangements, the NISP has heretofore been concerned primarily with ownership arrangements and the attendant right to control corporate actions. The new rule allows DSS to find FOCI when the foreign holder of an ownership or voting interest of greater than five percent cannot be adequately identified. 32 CFR § 117.56(b)(3)(v). This provision may create significant complications for complex investment vehicles such as hedge funds, which often do not readily disclose their underlying investors.

The new rule also clarifies the relationship between the review of foreign acquisitions conducted by the Committee on Foreign Investment in the United States ("CFIUS") and the NISP procedures. 32 C.F.R. § 117.56(b)(14); *see also* 79 Fed. Reg. 19473. Although the two procedures remain separate, the rule explains that CFIUS and DSS will coordinate their reviews and share information, increasing the importance of a coordinated regulatory strategy for companies submitting investments from or acquisitions by foreign interests for government review.

Would-Be Service Contractors Face Exposure of up to $10,000 Penalty per Day under HHS Contracts

On May 12, the U.S. Department of Health and Human Services ("HHS") published notice of a proposed rule to amend the civil monetary penalty ("CMP") rules of the Office of Inspector General ("OIG"). As part of an overhaul of 42 C.F.R. Part 1003, the OIG proposed several updates to codify changes made by the Patient Protection and Affordable Care Act ("PPACA"). The proposed rule would (if implemented) expand the range of conduct subject to CMPs, assessments, and exclusions to include:

- Failing to grant OIG timely access to records upon reasonable request;
- Ordering or prescribing treatments likely to be financed by federal programs from which one is excluded;
- Making or causing to be made any false statement, omission, or misrepresentation in a bid, contract, or application;
- Failing to report and return known overpayments; and
- Making or using false records and statements to support a fraudulent claim.

The proposed rule would also clarify the methodology used for calculating penalties and assessments for utilization of excluded employees, among other things. Of significant potential concern is the proposed application of a default assessment of $10,000/day as a penalty for failing to return overpayments within 60 days of their identification.

The commenting period closed on July 11.

GAO Decides That Small Business Joint Venture Proposals Do Not Require SBA Pre-Approval

On May 29, the GAO ruled that joint venture agreements do not require approval from the Small Business Administration ("SBA") before submitting a proposal for solicitations issued pursuant to the SBA's 8(a) set-aside program. *See BGI-Fiore JV, LLC*, B-409520 (May 29, 2014). NASA conceded during the protest that the SBA's regulations do not require pre-proposal certification, *see* 13 C.F.R § 124.513, but it nonetheless argued that the FAR permits agencies to impose more stringent standards than those required by the SBA. FAR 52.219-18. NASA, hoping to avoid evaluation of proposals that might later be deemed ineligible for selection, rejected all proposals submitted by joint ventures that did not possess SBA approval at the time of their proposal submission. The GAO disagreed with NASA's views, noting that the SBA's regulations only require a joint venture agreement to be approved prior to the awarding of the contract.

Of course the GAO's decision makes complete sense from a savings perspective. Why should SBA be required to consider all joint ventures before bids are submitted when it really need consider and approve only the one joint venture that is selected for award?

Baker Team Secures Arbitration Award for Wrongful Termination of Subcontract

On July 9, a panel of three arbitrators issued an arbitration decision awarding Baker's client, a small business under subcontract to furnish nursing personnel at the Tripler Army Medical Center ("TAMC"), approximately $2 million for the prime contractor's wrongful termination of the subcontract 18 months before the agreed-upon expiration date. The award capped a 15-month arbitration proceeding that culminated in a 10-day hearing.

Legislative Updates

Bill Number	Sponsor	Legislation Description	Last Action	Status
H.R. 4394	Grayson	A bill to prohibit the awarding of contracts to contractors responsible for delayed openings of Veterans Affairs facilities	4/3/14	Referred to Committee
S. 2247	McCaskill	A bill to prohibit awarding contracts or grants above the simplified acquisition threshold unless the prospective awardee certifies that it has no seriously delinquent tax debts	4/10/14	Referred to Committee
S. 994	Warner	A bill to enable taxpayers and policymakers to track federal spending more effectively by simplifying reporting requirements for entities receiving federal funds	5/9/14	Signed by President
S. 2334	King	A bill to amend the Small Business Act and Title 38 of the U.S. Code to provide for a consolidated definition of a small business concern owned and controlled by veterans	5/15/14	Referred to Committee
S. 2391	Murphy	A bill to amend the Buy American Act and certain other laws to narrow exceptions to domestic sourcing requirements	5/22/14	Referred to Committee
H.R. 4729	Grayson	A bill to require debarment of persons convicted of fraudulent use of “Made in America” labels	5/22/14	Referred to Committee
S. 1681	Feinstein	A bill to authorize intelligence activities for fiscal year 2014 and to require improvements in intelligence community security clearance procedures, stronger contractor protection of classified information and rapid reporting of unauthorized breaches of that information	6/12/14	Passed by Senate
H.R. 4876	Carson	A bill to amend the Small Business Act to provide for contracting preferences and other benefits for emerging business enterprises	6/17/14	Referred to Committee
H.R. 4920	Tiberi	A bill to amend the Social Security Act to require state licensure and performance guarantees for entities submitting bids under the Medicare durable medical equipment, prosthetics, orthotics, and supplies (“DMEPOS”) competitive acquisition program	6/19/14	Referred to Committee

Regulatory Updates

Code Section	Agency	Regulation Description	Lastest Action	Effective Date
48 CFR Parts 1, 4, 12, 22, and 52	DOD, GSA, NASA	To amend the FAR to require the use of Commercial and Government Entity (“CAGE”) codes, including North Atlantic Treaty Organization codes (“NCAGE”) for foreign entities, for awards valued at greater than the micropurchase threshold	Final Rule	11/1/2014
48 CFR Parts 4, 42, and 52	DOD, GSA, NASA	To implement the Consolidated Appropriations Act, 2014, by amending the FAR to revise the clause on Recovery Act reporting procedures and repeal the reporting requirements of the American Recovery and Reinvestment Act of 2009	Final Rule	5/30/2014
48 CFR Parts 31 and 52	DOD, GSA, NASA	To implement a section of the National Defense Authorization Act of 2012 by amending the FAR to expand the application of the senior executive compensation benchmark to a broader group of contractor employees on contracts awarded by DOD, NASA, and the Coast Guard	Final Rule	5/30/2014
48 CFR Part 42	DOD, GSA,	To amend the FAR to implement statutory changes expediting the review and dissemination of past performance evaluations	Final Rule	7/1/2014

About BakerHostetler

BakerHostetler, one of the nation's largest law firms, represents clients around the globe. With offices coast to coast, our more than 800 lawyers litigate cases and resolve disputes that potentially threaten clients' competitiveness, navigate the laws and regulations that shape the global economy, and help clients develop and close deals that fuel their strategic growth. At BakerHostetler we distinguish ourselves through our commitment to the highest standard of client care. By emphasizing an approach to service delivery as exacting as our legal work, we are determined to surpass our clients' expectations.

BakerHostetler's Government Contracts Practice Group consists of more than a dozen attorneys with extensive experience in government contracts, including former government attorneys from the Justice Department, SEC, and USPTO. Working closely with the firm's other practice groups, including the Intellectual Property, Labor, International Trade, FDA, and White Collar groups, among others, the Government Contracts Practice Group represents clients on a wide variety of government contract matters and cases.

Why BakerHostetler's Government Contracts Practice Group?

- Seasoned, experienced team with a deep bench.
- Several attorneys with technical and engineering backgrounds.
- Former government attorneys.
- Outstanding client service and responsiveness.
- Competitive value-driven rates and fee arrangements.

Hilary S. Cairnie
Partner, Washington, D.C.
202.861.1668
hcairnie@bakerlaw.com

Hilary Cairnie is the head of the firm's Government Contracts Practice. He focuses on public contract law, encompassing virtually all aspects including contract formation, performance, administration, and enforcement controversies at the federal and state levels. With two engineering degrees and several years of experience working as an engineer for various companies, Mr. Cairnie uses his unique technical background to represent clients involved in aerospace, automotive, shipbuilding, transportation, construction, software, medical and healthcare, engineering, and research and development endeavors, among others.

Kelley P. Doran
Partner, Washington, D.C.
202.861.1661
kdoran@bakerlaw.com

Kelley Doran has focused on government contracts counseling, contract negotiation, and litigation for over fifteen years. Mr. Doran's practice includes representing a broad array of commercial item, defense, and homeland security contractors that sell products and services to the federal, state, and local governments. He has worked with product and service companies in numerous industries, including biodefense and life sciences, environmental remediation, homeland security, information technology, and nanotechnology.