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E-ALERT | Government Contracts

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THE GOVERNMENT CONTRACTS UPDATE

PRESIDENT OBAMA SIGNS EXECUTIVE ORDER BANNING DISCRIMINATION BASED ON SEXUAL ORIENTATION OR GENDER IDENTITY

On July 21, 2014, President Obama signed an Executive Order making it illegal for federal contractors to discriminate on the basis of sexual orientation and gender identity. The new order amends existing Executive Order 11246, first signed by President Lyndon Johnson in 1965, to add sexual orientation and gender identity to the list of protected categories covering federal contractors. The order applies to prime contractors and subcontractors holding federal contracts worth $10,000 or more annually. Although it preserves an existing exemption for the hiring of clergy and other religious personnel, it does not include a broader exemption for religiously affiliated contractors.

According to White House statistics, the vast majority of large contractors already prohibit discrimination based on sexual orientation, but fewer firms have policies covering gender identity. Such policies may be less common at small and mid-sized contractors, many of which will now find themselves subject to the new rule in light of the relatively low dollar threshold. Even contractors that already prohibit discrimination based on sexual orientation and gender identity will be well-advised to monitor closely rulemaking developments related to the new order. The Department of Labor's Office of Federal Contract Compliance Programs ("OFCCP") is charged with developing regulations to implement the order within 90 days of its issuance. Among key issues to watch is whether – and to what extent -- the expanded nondiscrimination coverage triggers additional affirmative action obligations.

DOD PROPOSES NEW BUSINESS SYSTEMS RULE

On July 15, 2014, the Department of Defense ("DOD") issued a proposed rule setting forth a new framework for audits of contractor accounting systems, estimating systems, and material management and accounting systems. The proposed rule seeks to relieve some of the burden from the Defense Contract Management Agency and Defense Contract Audit Agency, which have been laboring under audit backlogs. The proposed rule would require contractors to annually review these three business systems and self-report any identified deficiencies, and also would call for certain audit responsibilities to be outsourced to third-party Certified Public Accountants.

Although efforts to reduce the audit backlog are a positive development for companies doing business with the government, contractors should be aware of aspects of the proposed rule that may introduce new costs and complications. For example, contractors would be responsible both for covering the costs of third-party audits and for reporting to DOD any material deficiencies that are discovered. Additionally, although the government would not be conducting the initial audit, DOD could still perform its own review of the contractor's third-party audit, and contracting officers would retain significant discretion in determining the depth of review, documents to be requested, and penalties, if any, to be imposed.

The proposed rule would not apply to small businesses, nor would it impact the existing framework for the review and audit of contractors' purchasing, property management, and earned value management systems. Still, it appears poised to have a significant impact on the defense contracting community, even if its precise effects will not be known until its implementation. Our recent E-Alert provides a detailed summary of the proposed rule and its implications for government contractors.

CONGRESS PROPOSES NEW RESTRICTIONS ON CONTRACTING (AND SUBCONTRACTING) WITH INVERTED CORPORATIONS

Existing laws and regulations already prohibit inverted domestic corporations ("IDCs") -- U.S. companies that have reincorporated abroad -- from receiving appropriated funds under prime government contracts.[1] However, lawmakers in Washington have now proposed a bill that, for the first time, would broaden the existing prohibition and extend it to many federal subcontracts as well.

On July 29, 2014, Sens. Richard Durbin (D - IL) and Carl Levin (D - MI), along with Reps. Rosa DeLauro (D - CT) and Lloyd Doggett (D - TX), announced the No Federal Contracts for Corporate Deserters Act ("NFCCDA"), a bill that, if adopted, would represent a significant expansion of the existing contracting prohibition in two ways. First, the NFCCDA would expand the definition of an IDC. Under current law, 6 U.S.C. § 395(b), a company that reincorporates abroad will not be considered an IDC unless 80 percent of the shares of the new foreign company are held by former shareholders of the domestic company. The NFCCDA proposes to lower this continuity-of-ownership threshold to 50 percent. Second, the NFCCDA requires any federal contract exceeding $10 million to contain a provision prohibiting the prime contractor from "awarding a first-tier subcontract with a value greater than 10 percent of the total value of the prime contract" to an IDC. Given the continuing uncertainty surrounding the scope of government subcontractor relationships under various federal programs such as TRICARE and Federal Employees Health Benefit Plan, the impact of this provision, if adopted, could be significant.

The NFCCDA is not the only proposal currently pending to prevent IDCs from securing government contracts. Identical amendments designed specifically to prohibit the award of federal contracts to IDCs domiciled in Bermuda or the Cayman Islands have been added to four different House appropriations bills.[2] And the Senate version of the FY15 Defense spending bill contains a similar provision that would prevent inverted corporations from receiving funds appropriated under that bill.[3] This flurry of activity demonstrates Congress's increasing concern with the recent trend of companies reincorporating abroad for tax purposes. Contractors considering a similar move should understand not only that there already are significant restrictions associated with such a relocation, but that further restrictions are likely as the issue continues to receive the attention of policymakers in Congress and the Executive Branch.

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[1] *See* Consolidated Appropriations Act of 2014 (H.R. 3547), § 733; *see also* FAR 9.108-2.

[2] The amendments were added to the Fiscal Year 2014 Financial Services and General Government Appropriations Act, the Fiscal Year 2015 Transportation-Housing and Urban Development Appropriations bill, the Fiscal Year 2015 Energy and Water Appropriations bill, and Fiscal Year 2015 Department of Defense Appropriations bill.

[3] Like the NFCCDA, the Senate bill would expand the definition of an inverted company by lowering the continuity-of-ownership threshold to 50 percent. *See* Section 8122(d).

HRSA PUBLISHES INTERPRETIVE RULE ADDRESSING TREATMENT OF ORPHAN DRUGS IN 340B DRUG DISCOUNT PROGRAM

On July 23, 2014, the Health Resources and Services Administration ("HRSA") published in the Federal Register an interpretive rule setting forth the agency's view that drug manufacturers are required to provide discounts to certain 340B entities on orphan drugs[4] when used for non-orphan indications. As we previously reported, the U.S. District Court for the District of Columbia permanently enjoined HRSA from implementing regulations that required pharmaceutical manufacturers to offer orphan drugs to covered hospitals at reduced prices if the drugs were used to treat non-orphan conditions. The Court did not, however, invalidate HRSA's interpretation of the statute; it vacated the regulation on the grounds that HRSA lacked the authority to engage in such rulemaking. On July 16, 2014, HRSA announced that it would stand by its interpretation of the statute and publish an interpretive rule. Last week's Federal Register publication is the result of this effort.

INTELLIGENCE AUTHORIZATION ACT DIRECTS INTELLIGENCE COMMUNITY TO PROMULGATE CYBERSECURITY RAPID REPORTING REQUIREMENTS

On July 7, 2014, President Obama signed the 2014 Intelligence Authorization Act ("IAA") into law, starting a 90-day clock for the Director of National Intelligence ("DNI") to promulgate regulations addressing the requirement that "cleared intelligence contractors" report any "successful penetration" of their networks and information systems. Pursuant to Section 325 of the IAA, DNI's forthcoming regulations will require cleared intelligence contractors to report the following information to a designated element of the Intelligence Community ("IC") following a penetration of the contractor's covered network or information system:

- A description of the technique or method used in such penetration;
- A sample of the malicious software, if discovered and isolated by the contractor, involved in such penetration; and
- A summary of information created by or for an element of the IC that has been potentially compromised.

The regulations are expected to specify how quickly the cleared intelligence contractors will need to report this information; DOD has already imposed a 72-hour reporting requirement in similar regulations.

In addition to setting forth rapid reporting requirements, the new regulations will implement the IAA's requirement that intelligence community contractors allow IC personnel access to their equipment or information in the event of a "successful penetration" of a covered network so that the IC personnel can conduct a forensic analysis of the breach. Section 325 of the IAA requires that any new regulations provide for the "reasonable protection of trade secrets, commercial or financial information" and prohibit the dissemination of information obtained by a forensic analysis without the consent of the contractor. It does not, however, address whether the IC can use information obtained during the forensic analysis for other purposes, such as responsibility or past performance determinations. For more detailed information concerning rapid reporting requirements under the IAA, please see our recent blog post addressing this topic.

[4] Orphan drugs are drugs that treat rare diseases or conditions. They are so-named because efforts to research, invest in, and produce them might be abandoned if not for the incentives Congress provides pharmaceutical manufacturers. While orphan drugs can only be designated as such to treat rare diseases or conditions, they also are often used to treat non-rare diseases or conditions.

HHS TO IMPLEMENT NEW ACQUISITION INITIATIVE

The department of Health and Human Services ("HHS") recently announced a new initiative to encourage innovative and efficient ways to procure information technology. The program, referred to as the HHS Buyers Club, aims to facilitate a more streamlined and agile process for the procurement of IT services. Although HHS has not released details of the program, officials have hinted at what it might entail. For example, rather than requiring offerors to draft lengthy written submissions reciting how they will meet specific RFP requirements, the Buyers Club program envisions a process in which offerors submit "short concept proposals," followed by actual prototypes, so that contracting officers can develop a more concrete sense of each offerors capabilities. In this way, the program would shift away from telling contractors exactly what to do and focus instead on the outcomes the agency wants to achieve. The success of the Buyers Club initiative, and its impact on government contractors, remains to be seen. But given the scheduling and budget problems plaguing many federal IT procurements, contractors should anticipate that agencies will continue to explore alternative approaches to managing their IT procurements.

CASE DIGEST

Government Liable for Breach of Contract Following Statutorily-Required Termination (*Cardiosom LLC v. United States*, No. 08-533C (June 30, 2014))

The Court of Federal Claims recently ruled that a contractor could seek damages following a termination of its contract by an act of Congress. In March 2008, the Centers for Medicare & Medicaid Services ("CMS") awarded a contract to Cardiosom LLC to supply durable medical equipment to Medicare recipients. In July 2008, Congress passed legislation amending the Medicare statute and directing HHS to cancel certain contracts, including Cardiosom's. Cardiosom filed a breach of contract action seeking damages for both out-of-pocket expenses incurred in preparing to perform the CMS contract and lost profits. The government responded that language in Cardiosom's contract, under the heading "Compliance with Laws and Regulations," and stating that the contract was "subject to any changes in the Medicare statute or regulations that affect the Medicare program," precluded the recovery of any damages arising from the contract's termination. The government argued that this provision effectively shifted the risk of a legislative termination of the contract - such as the July 2008 amendment to the Medicare statute - to Cardiosom.

The Court rejected the government's defense, concluding that "[w]hen read in context of the contract, [the provision] was simply compliance language; it did not shift the risk of regulatory change to Cardiosom." The Court entered summary judgment for Cardiosom on the question of the government's liability, and directed the parties to file additional briefing as to damages.

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