

DoD Issues Final Rule Addressing Exclusion of Contractors that Present Supply Chain Risk in National Security System Procurements

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Government Contracts

On October 30, 2015, the Department of Defense (“DoD” or the “Department”) issued a [Final Rule](#) amending the Defense Federal Acquisition Regulation Supplement (“DFARS”) and clarifying the scope of the DoD’s ability to evaluate and exclude contractors that represent “supply chain risks” in solicitations and contracts involving the development or delivery of IT products and services related to National Security Systems (“NSS”). The Final Rule clarifies that the DoD’s exclusion authority is limited to procurement of NSS, explains that decisions apply on a procurement-by-procurement basis, and removes the flow down requirement that was present in the Interim Rule. The Final Rule also encourages contracting officers to consider imposing a Government consent requirement for all subcontracts.

As we [discussed](#) when the DoD issued its Interim Rule, these amendments are significant because they provide the DoD with authority to exclude IT contractors from contract participation and permit the DoD to withhold consent to subcontract if the Department determines that a contractor or subcontractor presents a supply chain risk.

Background

The Final Rule implements Section 806 of the National Defense Authorization Act (“NDAA”) for Fiscal Year 2011, Pub. L. No. 111–383, as amended by the NDAA for Fiscal Year 2013, Pub. L. No. 112–239, entitled “Requirements for Information Relating to Supply Chain Risk” (“Section 806”). The final rule responds to Congress’ growing focus on risks in the DoD’s supply chain. The NDAA for Fiscal Year 2011 authorized the head of a defense agency to address supply chain risk in the acquisition of NSS. Two years later, the NDAA for Fiscal Year 2013 extended Section 806 to September 30, 2018, as well as required the DoD to assess the effectiveness of Section 806 and report the results to Congress. The DoD issued an [Interim Rule](#) in November 2013 implementing Section 806, which was followed by the DoD’s recent issuance of the Final Rule.

Section 806 Actions

Authorized officials (i.e., the Secretaries of Defense, Army, Navy, and Air Force¹) may exclude a source or withhold consent to contract to address a “supply chain risk” in procurements “for

¹ These individuals may not delegate their Section 806 authority below (1) the Under Secretary of Defense for Acquisition, Technology, and Logistics, for the DoD’s procurements, or (2) the senior acquisition executive in each military department.

information technology, whether acquired as a service or as a supply, that is a covered system, is a part of a covered system, or is in support of a covered system” (a “Section 806 Action”).

Definitions

The Final Rule defines the key terms as follows:

- *Information technology*: Information “technology includes” any equipment, or interconnected system(s) or subsystem(s) of equipment, that is used in the automatic acquisition, storage, analysis, evaluation, manipulation, management, movement, control, display, switching, interchange, transmission, or reception of data or information by the agency.
- *Covered System*: A “covered system” means a NSS as defined by 44 U.S.C. § 3542(b)(2)(A). Therefore, a “covered system” is any information system, including any telecommunications system, used or operated by an agency or by a contractor of an agency, or other organization on behalf of an agency:
 - The function, operation, or use of which—
 - Involves intelligence activities;
 - Involves cryptologic activities related to national security;
 - Involves command and control of military forces;
 - Involves equipment that is an integral part of a weapon or weapons system; or
 - Is critical to the direct fulfillment of military or intelligence missions, but does not include a system that is to be used for routine administrative and business applications, including payroll, finance, logistics, and personnel management applications; or
 - Is protected at all times by procedures established for information that have been specifically authorized under criteria established by an Executive order or an Act of Congress to be kept classified in the interest of national defense or foreign policy.
- *Supply Chain Risk*: “Supply chain risk” refers to the risk that an adversary may sabotage, maliciously introduce unwanted function, or otherwise subvert the design, integrity, manufacturing, production, distribution, installation, operation, or maintenance of a covered system so as to surveil, deny, disrupt, or otherwise degrade the function, use, or operation of such system.

Procedure

Using its Section 806 authority, the DoD may employ three different supply-chain risk management tools:

- Exclude a source prior to award that fails to meet qualification standards for the purpose of reducing supply chain risk in the acquisition of covered systems;
- Exclude a source prior to award that fails to achieve an acceptable rating with regard to an evaluation factor providing for the consideration of supply chain risk in the evaluation of proposals for the award of a contract or the issuance of a task or delivery order; or

- Withhold consent after award for a contractor to subcontract with a particular source or direct a contractor for a covered system to exclude a particular source from consideration for a subcontract under the contract.

When implementing these tools, the Final Rule permits the DoD to limit, in whole or in part, the disclosure of information that served as the basis for the Section 806 Action.

In order to implement one of these actions, the DoD must follow a three step process:

- *Recommendation:* Authorized officials must obtain a joint recommendation from the Under Secretary of Defense for Acquisition, Technology, and Logistics and the DoD Chief Information Officer, based on a risk assessment by the Under Secretary of Defense for Intelligence, that there is a significant supply chain risk to a covered system.
- *Determination:* Authorized officials must then make a written determination that the Section 806 Action is (1) necessary to protect national security by reducing a supply chain risk, (2) less intrusive measures to reduce the security risk are not reasonably available, and (3) if the official plans to limit disclosure of information, that the risk to national security from disclosure outweighs the risk of not disclosing such information.
- *Notification:* Authorized officials must provide written notice of a Section 806 Action to congressional defense and intelligence committees and to other DoD components or Federal agencies responsible for procurement that may carry the same or similar supply chain risks.

Section 806 Actions do not require the DoD to provide notice to or engage in dialogue with contractors. Indeed, the DoD declined to implement these potential contractor protections in the Final Rule, implicitly suggesting that such protections were unnecessary—because Section 806 exclusions would be made on a case-by-case basis—or impossible—because national security considerations limit the DoD’s ability to communicate with the contractor. Nevertheless, although Section 806 Actions may not result in blanket exclusions, the Final Rule’s approach could result in contractor exclusions from DoD procurements without advance notice or an opportunity to object. DoD attempted to address the de facto debarment concern that had been raised by commenters by clarifying that each Section 806 decision to exclude is done on a procurement-by-procurement basis. Of course, multiple exclusions without an opportunity to object or address with the Government would, in practice, represent the same type of concern.

In addition to the lack of notice and opportunity for dialog with the contractor, the Final Rule confirms that a decision to exclude a contractor or refuse consent to subcontract is not reviewable in a bid protest before the Government Accountability Office or in any Federal court. The DoD explained when issuing the Final Rule that Section 806 Actions could not be subject to independent review because the decisions often involve classified intelligence information.

Although Section 806 Actions lack certain procedural protections, the DoD’s authority under Section 806 expires on September 30, 2018. Further, the DoD is required to issue a report by January 1, 2017, that addresses the effectiveness of the Section 806 Actions and the frequency with which the DoD exercises its authority under this provision. This will provide some limited oversight of the DoD’s determinations.

Additional Provisions to Address Supply Chain Risk

In addition to Section 806 Actions, the Final Rule provides the DoD additional tools to manage supply chain risk.

Evaluation Factor

Pursuant to the Final Rule, a supply chain evaluation factor must be included in all solicitations “for information technology, whether acquired as a service or as a supply, that is a covered system, is a part of a covered system, or is in support of a covered system.” The DoD declined to issue guidance in the Final Rule regarding how supply chain risk will be used as an evaluation factor, explaining that evaluation factors should be specified at the acquisition level. However, the DoD indicated that it is issuing DFARS Procedures, Guidance, and Information (“PGI”) to assist the contracting community in developing and employing supply chain risk evaluation factors.

Ongoing Obligation to Minimize Supply Chain Risk

Under the Final Rule, contractors supporting procurements “for information technology, whether acquired as a service or as a supply, that is a covered system, is a part of a covered system, or is in support of a covered system” must also “mitigate supply chain risk.” This requirement replaces the seemingly more burdensome obligation in the Interim Rule that contractors must “maintain control” of their supply chains. That said, DoD declined to issue guidance in the Final Rule regarding the steps contractors should take to mitigate their supply chain risk. Instead, DoD indicated that it is working with the industry to promulgate best practice documentation.

Changes and Clarifications in the Final Rule

When issuing the Final Rule, the DoD made the following noteworthy changes to the Interim Rule:

- *Limiting the Scope of the Prescription:* The Interim Rule provided for the inclusion of the supply chain clauses in all solicitations and contracts for the procurement of IT. In the Final Rule, the DoD limited the scope of the prescription clause such that the supply chain clauses should be included only in solicitations and contracts for information technology that (1) is a covered system, (2) is part of a covered system, or (3) supports a covered system. As noted above, a “covered system” is an NSS system.
- *Clarifying the Scope of a Section 806 Action:* The DoD clarified that a Section 806 Action applies on a procurement-by-procurement basis. Therefore, although a contractor may be excluded for purposes of a particular source selection, the contractor will not be subject to a blanket exclusion and may compete under other solicitations. Although clarifying that Section 806 Actions cannot result in blanket exclusions is a positive development for contractors, this clarification does not address the notice and due process concerns that remain when a contractor is excluded from a particular procurement. Similarly, there is no limit on the number of times that the DoD can exercise this authority with regard to any particular contractor.
- *Removing the Flow Down Requirement:* The Final Rule does not require contractors to flow down DFARS 252.239-7018 (Supply Chain Risk). Commentators to the Interim Rule highlighted that allowing the DoD to exclude a subcontractor at any tier could result in delays and disruptions to the supply chain, as well as claims and disputes, because the loss of a lower tier contractor is likely to have a ripple effect on all higher-tier contractors. Although removing the Interim Rule’s requirement to flow down this clause appears to be a positive development for contractors, contractors are still responsible for mitigating supply chain risks.

Impact on Contractors

Given the significant consequences of a Section 806 Action, the Final Rule could have a considerable impact on contractors supporting the DoD in its acquisition of NSS. Contractors may be excluded from a procurement without (1) notice or an opportunity to be heard, (2) an impartial review of the DoD's decision, or (3) an opportunity to take corrective action. Further, it is important for contractors to consider including subcontractors in the initial proposal so that any increased use of the subcontractor consent clause will not impact their ability to use preferred teammates. In addition to facing a Section 806 Action, contractors must address a new supply chain risk evaluation factor and satisfy an ongoing obligation to "mitigate supply chain risk" without receiving guidance in the Final Rule regarding the manner in which the evaluation factor will be applied or the appropriate means of mitigating supply chain risk. As a result, contractors would be well advised to closely monitor the DoD's implementation of the Final Rule.

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