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E-ALERT | Government Contracts

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THE GOVERNMENT CONTRACTS UPDATE

DOD ISSUES FINAL INTERIM RULE RESTRICTING COST-TYPE CONTRACTS (79 FED. REG. 4631)

On January 29, the Department of Defense ("DOD") issued a final interim rule amending the Defense Federal Acquisition Regulation Supplement ("DFARS") to prohibit DOD from entering into cost-type contracts for the production of major defense acquisition programs (*i.e.*, over $300 million for R&D, testing, and evaluation, or over $1.8 billion for total procurement). The prohibition takes effect on October 1, 2014. The final interim rule tracks the previously reported requirement of the National Defense Authorization Act ("NDAA") for FY 2013. Notably, this interim rule coincides with the settlement of a 23-year-long litigation surrounding the A-12 *Avenger II* program, which was terminated for default once it became clear that contractors had severely underestimated the cost of the program in their fixed-price bid.

A major defense acquisition program may be excepted from the cost-type contracting prohibition only if the Under Secretary of Defense for Acquisition, Technology, and Logistics ("USD AT&L") provides a written certification that favors a cost-type acquisition. Relatedly, in July, the current USD AT&L, Frank Kendall, stated that "fixed priced contracts are not a 'magic bullet' to controlling cost . . . [and] we need to consider and select the most appropriate contract type given the maturity, system type and business strategy for each system."

PRESIDENT SIGNS EXECUTIVE ORDER ON CONTRACTOR MINIMUM WAGE HIKE

On February 12, President Obama signed an Executive Order to raise the minimum wage for federal services contracts to $10.10/hour, and to establish the minimum wage for tipped workers at $4.90/hour. The Executive Order applies to contracts awarded under solicitations issued on or after January 1, 2015. Starting January 1, 2016, the Secretary of Labor is required to increase the minimum wage each year by the annual percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers. Further, the Secretary of Labor is required to annually raise the minimum hourly wage for tipped workers by the lesser of $0.95/hour or the amount necessary to make the hourly wage for these workers equivalent to 70 percent of the minimum wage for all other workers.

The order applies to (1) procurement contracts for services or construction; (2) contracts subject to the Services Contracts Act; (3) contracts or contract-like instruments for concessions; and (4) contracts or contract-like instruments with the Federal Government relating to services provided to Federal employees or the general public and if wages of workers under such instruments is governed by the Fair Labor Standards Act, the Service Contract Act, or the Davis-Bacon Act. The Secretary of Labor is tasked with issuing regulations implementing the order by October 1, 2014, including specifying exclusions from the requirements where applicable. The FAR Council will in turn issue regulations in the Federal Acquisition Regulation ("FAR"), including a contract clause for inclusion in applicable contracts and subcontracts thereunder.

It is unclear how many federal contract workers will be affected by the increased minimum wage. Although the White House "fact sheet" accompanying the Order indicates the new wage requirement will impact "hundreds of thousands" of workers, the rates specified in Service Contract Act and Davis-Bacon Act wage determinations already exceed $10.10/hour in many jurisdictions. What is clear, however, is that this new wage requirement, with annual automatic increases, will cause additional compliance burden for some contractors. The implementing regulations that are to be issued by the Secretary of Labor and the FAR Council later this year should provide some much needed detail.

NEW SERVICE CONTRACT REPORTING REQUIREMENT (78 FED. REG. 80369)

On January 30, 2014, a new rule went into effect requiring contractors providing services (including construction services) to civilian executive agencies to submit information in support of agency-level inventories for service contracts. The rule implements section 743(a) of Division C of the Consolidated Appropriations Act 2010 (Pub. L. 111-117), which requires executive agencies covered by the Federal Activities Inventory Reform Act (except the DoD) to submit to the Office of Management and Budget annually an inventory of activities performed by service contractors. The goal of this new requirement is to give the government visibility into the number of contractor personnel supporting agency activities and federal spending on service contracts, and to evaluate the balance between services performed by federal employees versus contractors. In particular, new FAR Subpart 4.17 requires service contractors to report by October 31 of each year the contract number or order number (as applicable) for each service contract they perform; the total dollar amount invoiced for services performed during the previous Government fiscal year under the contract; the number of contractor direct labor hours expended on the services performed during the previous Government fiscal year under the contract; and data reported by first tier subcontractors with qualifying subcontracts. As contractors have not been required to provide such information to the government in the past, this new requirement may be burdensome, particularly to contractors with fixed-price contracts that do not typically require detailed reporting of labor hours.

The new reporting requirement will be phased in over three years and will apply only to contracts over certain specified thresholds based on type of contract and dollar amount. Specifically, Contractors will be required to report on all cost-reimbursement, time-and-materials, and labor-hour contracts and orders above the simplified acquisition threshold. For new fixed-price contracts, contractors will be required to report on contracts with an estimated total value at or above:

- $2.5 million in FY 2014;
- $1 million FY 2015; and
- $500,000 in FY 2016 and thereafter.

These thresholds also apply to the first-tier subcontractors that are primarily providing services. Existing indefinite-delivery contracts will be bilaterally modified within six months of the effective date of the final rule if sufficient time and value remain on the base contract (*i.e.*, the contract has a performance period that extends beyond October 1, 2013 and has $2.5 million or more remaining to be obligated to the contract). The FAR council has also determined that the rule should apply to contracts for the acquisition of commercial items.

If a contractor fails to comply with this reporting requirement, the contracting officer is required to document the failure in the contractor's performance evaluation, which could impact award fees and provide protest grounds for competitors in future procurements.

HOUSE HOMELAND SECURITY COMMITTEE UNANIMOUSLY PASSES CYBERSECURITY BILL

On February 5, the House Homeland Security Committee unanimously passed the National Cybersecurity and Critical Infrastructure Act of 2013. The bill, which we reported on when it was first introduced, would, among other things, significantly increase the scope of the Support Anti-Terrorism by Fostering Effective Technologies Act of 2002 ("SAFETY Act") by expanding liability protections to approved cybersecurity technologies in the event of a qualifying cyber incident. Whether a cyber incident qualifies for liability protection is determined by the Secretary of the Department of Homeland Security ("DHS"). Since its introduction, the bill has raised many questions, including what types of cybersecurity technologies would be eligible for liability protection and what magnitude of cyber incident would merit coverage. However, despite several proposed amendments to clarify these provisions, there has been little change to the provision as proposed.

Previously proposed amendments illustrate some of the unanswered questions surrounding the SAFETY Act-related provisions of this bill. During review by the House Homeland Security Cybersecurity Subcommittee, Representative Mike Rogers (R-AL) expressed concern that smaller entities would not receive the SAFETY Act's protections. To that end, he offered an amendment to strike the requirement that the incident "severely" affect the United States population, infrastructure, or national morale to qualify for liability protection. Rep. Rogers withdrew the amendment when the subcommittee promised to revisit the issue as the bill moves forward. Similarly, Rep. Eric Swalwell (D-CA) proposed an amendment during full committee markup that would promote transparency by requiring the DHS Secretary to explain via *Federal Register* notice the reasons for any determination that a cyber incident qualified for SAFETY Act coverage. Rep. Swalwell was concerned that the SAFETY Act protection may be too great, and would lead to companies becoming complacent with cybersecurity protections. He withdrew the amendment when Rep. Michael MCcaul promised to include language emphasizing the need for transparency in a report accompanying the bill.

This bill is one of the more contractor-friendly cybersecurity initiatives to come from the Federal government in the last few months. Most cybersecurity developments have imposed additional obligations on contractors, but this bill, if passed, will allow private companies to apply for liability protection in the case of a qualifying cyber incident.

SBA AMENDS POLICY DIRECTIVES FOR RESEARCH AND TECHNOLOGY TRANSFER PROGRAMS, BUT POSTPONES MAJOR CHANGES (78 FED. REG. 53375)

Each year, agencies with research and development budgets exceeding $100 million are required to allocate 2.8% of the budget to Small Business Innovation Research ("SBIR") programs, and agencies with extramural research and development budgets exceeding $1 billion are required to reserve 0.3% of the budget for Small Business Technology Transfer ("STTR") awards. As required by the NDAA for FY 2012, the Small Business Administration (the "SBA") published final SBIR and STTR Program Policy Directives on August 6, 2012 (available here, and here), which made significant changes to eligibility requirements; the award process; program administration; and fraud, waste and abuse programs. Following public comments, on January 8, 2014, the SBA amended both directives (amendments available here, and here).

The highlights from the SBA's January 8 amendments are:

- *Clarifications on how supplemental Phase II awards are counted*. The SBA's directive now states that Phase 2.5 or Phase IIb awards are counted as part of the initial Phase II award. Accordingly,

all supplementary Phase II awards, including options and enhancements, are subject to the SBA limit of $1.5 million.

- *Clarifications on agency calculations of rate benchmarks for Phase I eligibility and other success rates*. Agencies are required to establish benchmarks for the success of Phase I awardees in receiving Phase II and Phase III awards. Agencies were previously required to track these benchmarks over situation-specific time periods (*i.e.*, on a yearly basis from the date of a business' application for an award), but these have now been normalized (with agencies tracking benchmarks for all businesses every year starting June 1).
- *No changes to fraud, waste, and abuse programs*. Although several commenters indicated that these programs were too stringent and would discourage small businesses from participating in SBIR and STTR programs, the SBA indicated it would not make changes to fraud, waste, and abuse programs. These programs require agencies to (1) establish methods for reporting fraud, waste, and abuse; (2) designate a SBIR/STTR liaison for the Office of the Inspector General and the agency's suspension and debarment office; (3) publish successful prosecutions of fraud, waste, and abuse on the agency website; and (4) create systems to enforce the programs and to establish fraud-detection indicators.

The SBA's amended directives do not address significant comments relating to the allocation of data rights and whether agencies have obligations to give preference to SBIR/STTR awardees for follow-on Phase III work. The SBA indicated it would address these comments in the next revision of the Program Policy Directives.

GAO Developing New Online Protest Docketing System, Authorized to Charge Filing Fee

The Consolidated Appropriations Act of 2014 requires the U.S. Government Accountability Office ("GAO") to create an electronic filing system that would replace the current, primarily email-based process for filing and accessing protest-related communications. Congress also authorized the GAO to charge a filing fee to support the system's establishment and operation. It has been reported that the filing fee would be approximately $250.

Along with basic questions about the amount of the fee (and who is responsible to pay it in the case of a sustained protest or corrective action by the agency), several questions remain that might impact bid protest strategy. For example, the GAO has yet to disclose how the electronic system will operate, including how information subject to protective orders will be handled, and whether third-parties may have access to some information on the system.

VA Seeking Bids for Workgroup Coordinators for Modernizing Health IT System

As we previously reported, the Department of Veterans Affairs ("the VA") is pursuing electronic health record ("EHR") modernization after the DOD announced that it will not participate in creating a new $4 billion joint system with VA. On January 27, the VA issued a sources sought notice to replace its aging health IT system, known as the Veterans Health Information Systems and Technology Architecture ("VistA"). The program is intended to leverage previous development work on the system and to replace "VistA Web and other EHR viewers with a single viewer that supports the VA/DOD interoperability efforts." According to the notice, the VA is seeking workgroup coordinators to ensure its system is compatible with DOD's system.

CHINA OPPOSES SCALED-BACK CYBERSECURITY RESTRICTIONS IN SPENDING BILL

As we previously reported, the Consolidated Appropriations Act of 2014 scaled-back a cybersecurity provision designed to curtail a publicly perceived surge in Chinese-backed hacking of U.S. businesses by prohibiting four agencies (the Commerce and Justice Departments, NASA, and the National Science Foundation) from purchasing IT products produced, manufactured, or assembled by Chinese entities. However, the omnibus bill retained language prohibiting these four agencies from purchasing "high-impact or moderate-impact" information systems from "entities identified by the United States Government as posing a cyber threat." Soon after the bill was signed into law, the Chinese Ministry of Commerce (MOFCOM) stated that it "firmly opposes" the bill, and it urged the U.S. to "correct the erroneous practice[s]" mandated by the law. Mounting pressure from China may lead to further changes in the law.

DOD INSTITUTES ANNUAL ETHICS TRAINING FOR ENTIRE ACQUISITION WORK FORCE

In a DOD-wide memorandum, USD AT&L, Frank Kendall, has required that all acquisition work force members complete annual values-based ethics training. This is a significant step by the Department of Defense, recognizing the importance of training in ethics, in addition to rules-based compliance. This brings DOD more in line with recognized programs maintained by many defense contractors. Undersecretary of Defense Kendall cited recent events and DOD's commitment to ethical obligations in instituting the new policy.

CASE DIGEST

Federal Circuit Affirms Decision to Deny KBR Costs (*Kellogg Brown & Root Services, Inc. v. United States*, No. 13-5030, Dkt. #51-2 (Fed. Cir. Feb. 3, 2014))

There have been several potentially significant appellate decisions relating to KBR's performance of cost-plus-award-fee food services contracts for the Army's Logistics Civil Augmentation Program ("LOGCAP") (as we have reported here, here, and here). Most recently, the Federal Circuit has upheld an award to KBR of $6.8 million out of $12.5 million in outstanding costs incurred while providing services during Operation Iraqi Freedom under the LOGCAP III contract.

The costs in question were largely incurred by KBR's subcontractor, ABC International Group ("ABC"), which had agreed to provide a prefabricated metal dining facility and to provide dining services for a camp population of 2,573 for under $900,000/month. Three months into performance, the Army decided the facility should be made of reinforced concrete, and it increased the estimated headcount to 6,200+ persons. Due to the Army's urgency, KBR elected not to request new bids; instead, it directed ABC to prepare a revised proposal. ABC's revised proposal included a new monthly cost of over $2.7 million/month, tripling the prior monthly cost. ABC attributed the increase to the "drastic increase in the cost of labor and a severe shortage of available staff who are willing to work in Iraq." Later, after the Army suspended payment for a portion of the increased costs, KBR filed suit.

Affirming the lower court's decision to limit recovery to $6.8 million (the portion of increased costs incurred largely due to the change in the dining facility design from metal to concrete), the Federal Circuit held that the excess costs were unreasonable because KBR should have questioned the three-fold increase in ABC's cost. In so finding, the Federal Circuit stated that it was not extending its prior decision in *KBR I*. In *KBR I* (discussed here), the Federal Circuit held that evidence of gross negligence or arbitrary conduct was not necessary to find costs in a cost-reimbursement contract as "unreasonable." KBR argued that extending *KBR I* and withholding costs incurred as a result of

negligent conduct would contravene the risk-shifting purpose of cost-reimbursement contracts. The Federal Circuit took no position on this issue, stating that it "need not . . draw [that] line today." Instead, the Court held that KBR was grossly negligent in failing to question ABC's proposal. The Federal Circuit rejected KBR's arguments that the Army's urgency and the pressure of a war zone precluded an "arms-length negotiation," and it appears to have reaffirmed *KBR I*, at least in its open questioning of contractors' business judgment in performing cost reimbursement contracts.

Court of Federal Claims Denies Successful Protestor Bid and Proposal Costs (Innovation Dev. Enters. of Am. v. United States, No. 11-217 C (Fed. Cl. Jan. 17, 2014))

This bid protest involved a sole-source bridge contract for the Air Force's Command Man-Day Allocation System ("CMAS"), awarded in May 2010. In a prior decision, the Court held that the sole-source award was improper for several reasons, including the Air Force's failure to post a synopsis of the proposed sole-source contract on the FedBizOpps website or conduct market research before the procurement. The protestor argued that it was entitled to the bid proposal and preparation ("B&P") costs that it had incurred before the Air Force announced that it would not solicit competitive proposals.

The Court rejected the protestor's arguments. Although the Air Force's decision to make a sole source award *precluded* the protestor from submitting a proposal, the protestor could not recover B&P costs because such costs are only recoverable if a proposal is submitted The Court's ruling suggests that B&P costs would rarely, if ever, be available in successful sole source award protests. The ruling is consistent with GAO's view.

Separately, the Court held that, even if the protestor could recover B&P costs without submitting a proposal, the protestor's costs did not qualify as B&P costs. Appropriate B&P costs include "generating engineering and cost data, reviewing specifications and bid forms, drafting and printing a proposal, and delivering the proposal to a government agency." In contrast, here, the Court held the following costs were "general business planning" and "marketing" costs: costs incurred in making phone calls and visits to Air Force officials to discuss an anticipated CMAS competition; costs of gathering information about subcontractors; and time spent monitoring the FedBizOpps website for developments.

Court of Federal Claims Grants Temporary Injunctive Relief to Contractor in Protest of Navy's Suspension (Inchcape Shipping Services Holdings Ltd. v. United States, No. 13-953 C, Dkt. # 31 (Fed. Cl. January 2, 2014))

Here, a shipping company filed a bid protest in the U.S. Court of Federal Claims, seeking injunctive relief from its suspension by the Navy. The Navy had suspended the protestor in connection with alleged bribery relating to its overseas port services contracts. The Suspension and Debarment Official ("SDO") based the decision on an audit report that had been disclosed to the Navy one year before the suspension decision.

The protestor asserted jurisdiction under 28 U.S.C. § 1491(b), which allows an "interested party" to object to a solicitation or procurement award. The protester argued that its suspension would wrongfully exclude it from several pending procurements in which it had a "substantial chance" of an award, and thus sought a temporary injunction prohibiting the Navy from enforcing the suspension. Courts rarely consider bid protests of suspension decisions and the burden of obtaining temporary injunctive relief is high. Nevertheless, the Court granted the temporary injunction, holding that the Navy was unlikely to show success on the merits because it waited over a year to suspend the contractor and thus lacked an "immediate" need for the suspension, as required by Federal

Acquisition Regulation ("FAR") 9.407-1(b)(1). The Court also found that the contractor, which had six bids pending, would suffer irreparable harm from the suspension.

The Navy lifted the suspension a few weeks after the decision, rendering the case moot before the Court could reach a final decision.

GAO Sustains Protest Decision Illustrating Distinctions Between Agency "Clarifications" and "Discussions" (Kardex Remstar, LLC B-409030 (Comp. Gen. January 17, 2014))

In this case, a protestor challenged the VA's award for vertical storage units involving a reverse auction among Federal Supply Schedule ("FSS") vendors, alleging that the VA failed to hold fair and meaningful discussions. The protester, which had submitted the lowest bid, provided responses to several information requests from the VA before the VA rejected the protestor's bid for failing to meet a specification requirement (according to the specification, the storage units should have been self-contained, while the protestor's were not). In one such information request, the VA provided the protestor with spreadsheets containing specification requirements, and the agency identified some of the information that was missing from the protestor's bid. However, the VA did not identify the failure to meet the self-containment requirement, for which it ultimately rejected the bid, in any communication. The VA disputed that it was required to advise the protestor of this failure to meet a bid requirement. According to the VA, its information requests were merely "clarifications" subject to FAR 15.306(a)(2) (which allows "limited exchanges" to clarify aspects of proposals), not formal "discussions" subject to FAR 15.306(d) (which requires that discussions be meaningful, and enhance the offeror's proposal).

The GAO rejected the VA's arguments, holding instead that the VA's communications constituted "discussions" because (1) they "invited responses from [the protestor] that were necessary to determine the acceptability of the firm's quotation"; (2) they requested pricing discounts; and (3) they resulted in the protestor substantively supplementing its bid. The GAO concluded that the VA's discussions were "unfair" and that the VA should have informed the protestor of its failure to propose self-contained units.

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