Government Contracts Client Alert

What Contractors Should Know About The FY 2013 National Defense Authorization Act

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On January 2, 2013, President Obama signed into law the National Defense Authorization Act for FY 2013 (NDAA or the Act). The legislation is a mixed bag for government contractors. On the positive side, efforts to reduce the contractor compensation cap and increase access to internal audits were favorably modified from earlier versions of the bill. Contractors also welcomed a more balanced approach to costs associated with counterfeit parts, as well as extensions to procedural rules, such as continued simplified acquisition for commercial item contracts until 2015 and the ability to protest defense agency task and delivery orders valued over $10 million, which was extended indefinitely.

Despite these favorable outcomes, the NDAA preserves controversial proposals, like the compensation cap, for further study and consideration. It also creates new contractor obligations with respect to reporting cybersecurity intrusions, detecting and preventing human trafficking, and expanding FAPIIS disclosures to include trafficking violations as well as parent, subsidiary and successor information. The NDAA likewise broadens government oversight of contracting activity through measures that strengthen whistleblower protections, increase limitations on cost-type production and pass-through contracts, and impose heightened transparency. Finally, it includes two small business provisions that are significant to all contractors. The impact of these measures varies; in some cases, we anticipate little real change to current practice, while for others, contractors may well expend significant costs to meet new requirements. Below, we examine these key provisions.

Contractor Compensation (Section 864):

Although contractors can be thankful that the compensation cap was not lowered, the question is for how long, as the NDAA includes a mandate to study the idea for future consideration. By May, 2013, the Comptroller General will be submitting a report to Congress on the effects of reducing the allowable costs of compensation to either the President's ($400,000) or Vice President's ($230,700) salary. Depending on the outcome of that report, Congress may well reassert the initiative to reduce allowable costs of contractor compensation, with the backing of the current administration.

Access To Internal Audits (Section 832):

The prior Senate version of the NDAA would have required contractors to provide their internal audit reports to the Defense Contract Audit Agency (DCAA) as a condition to approval of the contractor's business system. Language in the final bill makes no such dramatic change. Clearly a

product of compromise, Congress seems to take a strangely neutral, or perhaps conflicted, position on DCAA access to audit reports.

The NDAA requires the DCAA to issue new guidance to ensure it documents requests for internal audit reports, including the DCAA's determination that access is required, the request itself, and the contractors' responses. This documentation will be reviewed in a year by the Comptroller General. The DCAA also must adopt "appropriate safeguards" to ensure it uses contractor internal audits only for evaluating and testing contractor's internal controls and business systems. These provisions recognize the potential for an improper rationale for requesting internal audit reports and clarify that contractors may sometimes refuse DCAA requests. At the same time, the DCAA will be documenting how often internal audits are requested and refused, causing some concern that a number of refusals, even if well justified, may trigger undue focus by the DCAA. Although the law does not clearly prohibit the DCAA from considering a contractor's denial of internal audit reports as a factor in its assessment of internal controls, emphasis is placed on permissible uses of "internal audit reports provided," lending support for the notion that a contractor's refusal to provide an internal audit report should not negatively influence the DCAA's business systems analysis.

The NDAA further states that the DCAA's determinations that a contractor "has a sound system of internal controls shall provide the basis for increased reliance on contractor business systems or a reduced level of testing with regard to specific audits, as appropriate." Internal audit reports provided by a contractor may be considered in determining whether a contractor has a sound system of internal controls. But those reports "shall not be the sole basis" for such a determination. Although this language seems generally favorable for contractors, it is difficult to discern whether it is the substance of the internal audit reports or simply the act of performing the internal audits, or both, that will be weighed in the DCAA's analysis of a contractor's commitment to strong internal controls.

What is clear is that Congress has assumed that submission of at least some internal audit reports to the DCAA is appropriate. In light of the lack of clear, recent legal precedent on the scope of the DCAA's audit authority, many contractors have already been keeping to the middle ground on this issue, refusing blanket access to their internal audit reports but cooperating with limited, reasonable, and well-supported requests for specific internal audit reports. The DCAA will soon be formulating its own views on access to internal audit reports. And a contractor pushed past the limits of its patience by audit demands may resist such demands on the basis of the 1988 Newport News decision denying the DCAA access to internal audit reports in connection with cost type audits. Meanwhile, a middle-of-the-road approach may continue to work best. As highlighted in our recent alert, contractors should continue to take steps sufficient to protect as privileged the reports of any investigations undertaken under attorney direction and should continue to limit access to other internal audit reports, if warranted.

Counterfeit Parts (Section 833):

The NDAA provides limited relief for contractors from the costs associated with the Government's recent efforts to cleanse the supply chain of counterfeit electronic parts. Section 833 of the Act provides that the cost of counterfeit electronic parts, and of rework and corrective action necessitated by such parts, may be allowable if: (1) the contractor has "an operational system to detect and avoid counterfeit parts and suspect counterfeit parts that has been reviewed and approved" by the Department of Defense (DoD); (2) the parts were "provided" as "Government property" (which term includes both Government-furnished and contractor-acquired property); and (3) the contractor notifies the Government of the counterfeit or suspect counterfeit parts in a "timely" manner.

The new provision provides some much-needed balance between contractors' and the Government's responsibilities. But contractors must lay the

appropriate ground work to take advantage of this relief. They must develop and adopt an appropriate operational system and get it approved by the Government. The system also has to work well enough to enable the contractor to provide "timely" notice, already explained in the statute to be written notice provided within 60 days of the time the contractor "becomes aware of, or has reason to suspect" that a purchased or Government-furnished item or part contains counterfeit or suspected counterfeit electronic parts.

Limitations of Cost-Type Contracts (Section 811):

The NDAA in Section 811 creates a new statutory limitation on the use of cost-type contracts for production of major defense acquisition programs. The provision is not likely to stir up much controversy because it applies only to production phases of a program ("Milestone C" in terms of DoD Instruction 5000.02), rather than the development or earlier phases of a program where cost-type contracts have historically been viewed as more appropriate (cf. Sec 8118 of the 1988 DoD Appropriations Act, for example, which generally required the award of a cost-type contract for development). New Section 811 of the NDAA will have little practical effect, since very few true production contracts are awarded on a cost-type basis. This is so because production normally entails that a fixed and final design of the system has already been achieved, and the costs of production can thus be estimated with reasonable accuracy. The greater question, unresolved by this new provision, is whether fixed price contracts can ever be appropriate for high-risk and uncertain weapon system development efforts. DoD's "Better Buying Power" guidance now advises government buyers to employ the "appropriate contract type" rather than using a fixed-price solution as preferred.

Pass-Through Contracts (Section 802):

With Section 802, the NDAA creates yet another "pass-through" regulation in the making. Since 2009, the FAR has contained two clauses addressing "pass-through" charges on subcontractors. FAR 52.215-22 requires contractors to identify subcontracts it intends to award for more than 70% of a contract's total cost and to describe the contractor's markups on those subcontracts with an explanation of the contractor's added value. If, upon reviewing this, the contracting officer concludes (usually with the assistance of the DCAA) that the markups comprise an "excessive pass-through" charge as defined under FAR 52.215-23, the contracting officer can declare the costs unallowable or recoup them, depending on the contract type. Among other things, this has created accounting difficulties for contractors that pool and allocate subcontract administration costs.

Now, however, the contracting officer's authority will be broadened to give the government the ability to contract directly with a prime's proposed subcontractor. Specifically, when a prime proposes to have a subcontractor perform more than 70% of the work, Section 802 will require contracting officers to consider the availability of alternative contract vehicles and the feasibility of contracting directly with the subcontractor. The contracting officer will also have to justify why the contracting approach taken is in the best interests of the government. Whether and how an agency will be able to implement an alternative approach or directly contract with the subcontractor during an acquisition is a question left unanswered by Section 802. The evaluation process already is arduous and time consuming, with a great deal of effort expended on acquisition planning and evaluation criteria. Changing these midstream seems impossibly difficult. Moreover, if the agency decides to contract directly (or differently) with a subcontractor, that will entirely disrupt the proposal of the prime offeror. Industry is likely to ask how such a scenario will be handled by the offeror and evaluated by the agency. The bid protest ramifications seem abundant. Whatever salutary purpose that might be served by such a regulation may well be overwhelmed by the impracticality of implementing it. Industry should focus on the proposed draft regulations.

Expansion of Whistleblower Protections (Sections 827 and 828):

The NDAA significantly strengthens whistleblower protections for employees of contractors, subcontractors, and grantees of executive agencies other than elements of the intelligence community.

Previously, 10 U.S.C. § 2409 had prohibited DoD contractors from discharging, demoting, or otherwise discriminating against employees as a reprisal for reporting wrongdoing in connection with a contract to government officials. Section 4705 of Title 41, U.S.C., extended similar protections to employees of contractors for other executive agencies.

Section 827 of the NDAA amends the whistleblower protections currently available to employees of non-intelligence community DoD contractors by:

Extending whistleblower protections to employees of DoD subcontractors as well as contractors;

Expanding the entities to which a protected disclosure can be made to include a court or grand jury and a management official or other employee of the contractor or subcontractor who has the responsibility to investigate, discover, or address misconduct; and

Explicitly providing for attorneys fees and costs where the government files a court action to enforce the whistleblower protections.

Section 828 institutes a pilot whistleblower protection program for employees of contractors, subcontractors, and grantees of executive agencies other than the DoD and the intelligence community that essentially tracks the whistleblower protections available to employees of DoD contractors and subcontractors. The new section also directs the Comptroller General of the United States to complete a study of the implementation of the pilot program within four years. The prior whistleblower provision applicable to employees of contractors of non-intelligence community and non-DoD executive agencies will be suspended during that four-year period.

In the wake of these new provisions, companies that do business with the government must be even more careful when contemplating employment actions with respect to whistleblowers. The whistleblower protections now cover employees not only of contractors, but of subcontractors and grantees, and not only of the DoD, but of other executive agencies as well. Furthermore, an employee's report to a broad group of other employees, possibly including managers, supervisors, auditors, attorneys, and ethics officers, can trigger whistleblower protections, so a company must ensure that it responds appropriately to such reports and refrains from taking any action that could be construed as a reprisal against an employee who makes them. Meanwhile, the government's ability to seek attorneys fees and costs where it files a court action to enforce the whistleblower protections may make companies less interested than ever in challenging an administrative determination that it has engaged in prohibited reprisals.

Expansion of Federal Awardee Performance and Integrity System (FAPIIS) (Section 852):

Since 2010, the Government has operated the Federal Awardee Performance and Integrity System (FAPIIS) as a one-stop resource for information regarding the business ethics and quality of prospective contractors competing for Federal contracts. The information the Government enters into FAPIIS is broad and includes determinations regarding non-responsibility, defective pricing, default, suspension/debarment, and certain criminal, civil, and administrative proceedings. Offerors are required to assist the Government in updating these data by reporting the results of certain criminal, civil and administrative judgments. More about FAPIIS can be found in our alert on the topic.

The FY 2013 NDAA modifies FAPIIS in two respects. First, it adds "substantiated allegations" of human trafficking violations to the list of information that must be reported in FAPIIS. Second, it adds an additional, general requirement that "information in the database on [corporations] shall, to the extent practicable, include information on any parent, subsidiary, or successor entities to the corporation in a manner designed to give the acquisition officials using the database a comprehensive understanding of the performance and integrity of the corporation." This broad requirement is daunting for large corporations with numerous subsidiaries that may have small and seemingly irrelevant infractions when considering the government work

the larger corporate entity is seeking. It is not clear whether all parent and subsidiary entities at all levels will be included or if only direct affiliate reporting will be required. Industry should work with regulators to resolve this question favorably. Regardless of that outcome, we can anticipate that the inclusion of information for different affiliated firms in FAPIIS will increase the burden imposed on larger contractors as well as the chance that past performance and responsibility information of limited relevance will be considered in an evaluation of offerors for government contracts.

Personal Conflicts of Interest Rules (Section 829):

The NDAA adopts the Senate provision for DoD to assess, by mid-2013, whether personal conflicts of interest (PCI) rules should be expanded in terms of their scope of contractor employee coverage. Currently, PCI rules apply only to contractor employees performing acquisition functions that are closely associated with inherently governmental functions, such as supporting or advising the government with respect to planning acquisitions, developing statements of work, approving contractual requirements, or otherwise evaluating, awarding, or administering contracts. Specifically, the NDAA asks the Secretary of Defense to examine whether PCI rules should likewise apply to personal service contracts or contracts for staff augmentation services. If DoD determines extension of PCI rules is warranted, the legislation permits implementation of expanded regulations in the Defense Federal Acquisition Regulation Supplement (DFARS) without any further legislation or reporting requirement. Contractors providing personal service contracts or staff augmentation services can review our alert on existing personal conflicts of interest rules for a better understanding of potential new obligations. Contractors should also consider reaching out to DoD during its assessment phase in early 2013 to shape that development.

Contractor Reporting of Cybersecurity Intrusions and Network Penetrations (Section 941):

Over the past several years, cleared defense contractors have been sharing information about cybersecurity intrusions and network penetrations with the DoD (and more recently the Department of Homeland Security) through a series of increasingly more formal relationships and processes. This provision of the FY 2013 NDAA instructs the Secretary of Defense to establish "rapid reporting" procedures for cleared defense contractors to report network intrusions to a Department of Defense team of officials. The scope of the information that is to be provided by contractors affected by intrusions includes the description of the techniques or methods used (if known), a sample of the malicious code, and a description of the DoD information that may have been compromised or exfiltrated. In addition, the new procedures may allow for DoD to request more information, including access to the equipment and files that had been improperly accessed. The procedures should also include restrictions and limitations on sharing certain types of sensitive information such as trade secrets and the nature of the breach without contractor consent.

This Section of the NDAA formalizes what has been an evolving cybersecurity relationship with DoD and cleared defense contractors, and provides more structure to their cybersecurity information sharing environment. The new procedures will likely not be superseded by the President's pending Executive Order on cybersecurity, because existing law, procedures, and relationships with the private sector are likely going to be excluded from the scope of the new voluntary information sharing standards anticipated in the Executive Order.

Human Trafficking (Title XVII, Sections 1701-1708):

Congress enacted comprehensive anti-trafficking laws within the NDAA that are in many respects identical to the reforms found in a recent Executive Order (EO) and which we detailed in an alert. One key difference is that beyond amending the Trafficking Victims Protection Act (TVPA) of 2000 (22 U.S.C. 7104(g)), the NDAA also expands criminal violations and penalties for fraud in foreign labor contracting, at 18 U.S.C. 1351, by including attempted fraud and work outside the United States.

All contractors, but especially those operating overseas, will be held to new compliance measures, with new Federal Acquisition Regulations

anticipated as early as March 2013, pursuant to the EO, and followed six months later by those mandated by the NDAA. Specific "improved safeguards" target coercive labor practices that were not previously part of anti-trafficking regulations. All federal contractors (domestic and overseas), subcontractors at all tiers, and their employees are expressly prohibited from (1) using misleading or fraudulent recruitment practices; (2) charging recruitment fees to employees; (3) destroying or denying access to the employee's identity documents, such as passports or drivers' licenses; (4) failing to pay return transportation costs to a home country following employment; and (5) providing substandard housing pursuant to host country standards.

For contracts and subcontracts where the estimated value of supplies or services outside of the U.S. exceeds $500,000, contractors and subcontractors must certify prior to award and annually thereafter that they (1) have implemented and are in compliance with a plan to prevent and detect trafficking; (2) have implemented procedures to prevent, monitor, detect and terminate any subcontractor, employee, or agent engaged in any of the prohibited trafficking activities; and (3) that "to the best of their knowledge," neither the contractor nor any subcontractor or agent of the contractor or subcontractor is engaged in any of the prohibited activities. Such compliance plans must be tailored to suit the size, nature, and scope of the contract. The NDAA likewise follows the EO in enhancing reporting obligations for both contractors and the government, as well as mandating contractors fully cooperate with government investigators. Substantiated allegations of trafficking violations must now be included in FAPIIS.

All federal government contractors, not just those operating overseas, should review their hiring practices and compliance programs to ensure they meet the new requirements. For contractors and their subcontractors operating overseas, a detailed review of compliance programs will need to be conducted for each individual contract that exceeds $500,000 to assure appropriate tailoring of policies occurs and that the minimum requirements are included. Whether a contractor has in place an appropriate mitigation plan may be a mitigating factor in determining which remedies, ranging from employee removal to contract termination and debarment, should apply.

Prime contractors, who are charged with ensuring procedures are put in place to prevent subcontractors at any tier from engaging in trafficking in persons, should flow down relevant certifications and assign responsibility for appropriate monitoring of subcontractor conduct, as well as design and document procedures for detecting and reporting illicit activities. Prime contractors should also ensure they draft subcontract provisions that will protect their interests in the event a subcontractor is found to have engaged in prohibited trafficking or trafficking-related conduct. Because these substantial new compliance measures will take some time to develop and implement, contractors should waste no time in beginning this effort so as to not be caught unprepared upon issuance of new regulations.

Expansion of Small Business Mentor Protégé Program (Section 1641):

The NDAA allows but does not require SBA to create a "mentor-protégé" program for all small businesses modeled on the current 8(a) mentor protégé program. The 8(a) mentor protégé program teams disadvantaged firms in SBA's 8(a) program with large businesses, often in qualifying joint ventures. The small business protégé benefits from the business experience and capabilities and, in some instances, capital of the large business mentor while also gaining access to Government prime contracts that previously may have been outside of its capabilities. The benefits to the large business mentor include (1) access to, with the protégé, set aside contracts for which it would otherwise have been ineligible; (2) an exception from affiliation with its small business protégé based on the mentor protégé relationship; (3) ownership of up to 40% of the protégé; and (4) performance of up to 60% of the work and up to 60% of the profit for contracts performed by the joint venture. Expanding the mentor protégé program beyond the confines of 8(a) procurement will provide assistance

to numerous small businesses that do not qualify for the 8(a) program and will expand the opportunities for large businesses to participate in the program.

Increased Penalties For Small Businesses Violating Subcontracting Limitations (Section 1652):

The NDAA in Section 1652 increases the penalty on small businesses for violating the limitation on subcontracting. Unless the contract is issued to an 8(a) mentor protégé joint venture, small businesses must generally be responsible for more than 50% of the cost of services or manufacturing of supplies under a small business set aside contract. Previously, small businesses who violated this rule could be fined up to $500,000 for failing to abide by these requirements, as well as being subject to suspension, debarment and ineligibility for set asides. Under the NDAA, a new monetary penalty will be added to this list equaling "the amount expended, in excess of permitted levels, on subcontractors." This is consistent with the "presumed loss" doctrine created in the Small Business Jobs Act of 2010 and could result in penalties in the millions of dollars. The possibility of steep penalties will cause small business subcontractors to monitor subcontracting levels closely and may limit the opportunity for significant large business subcontracting work under set aside contracts.

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