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Government Contract Reforms To Watch In 2012

By **Dietrich Knauth**

Law360, New York (January 01, 2012, 12:00 AM ET) -- Already grappling with the federal government's budget crunch, government contractors must prepare themselves for more regulatory and legislative oversight in 2012, as lawmakers' efforts to control spending continue to put contractor payments in the spotlight.

The failure of the the congressional deficit-reduction supercommittee to come together on a deficit deal has many in the defense industry bracing for sequestration, a procedure that will trigger $1.2 trillion in across-the-board, automatic spending cuts, half of which will fall on the U.S. Department of Defense.

Those cuts are set to take effect in 2013, setting the stage for a legislative showdown between some members of Congress who want to undo the automatic cuts, and the Obama administration, which has vowed to veto any legislation aimed at defusing the sequestration process. Either way, attorneys say, any cuts will fall on top of $450 billion in cuts already identified by the Pentagon, putting many contracts on the chopping block.

“Whatever happens, it's not going to be good,” said John W. Chierichella, a partner in Sheppard Mullin Richter & Hampton LLP's government contracts and regulated industries practice group. “The government is obviously going to look at programs it can sacrifice, and contractors are going to suffer when those programs are sacrificed.”

In addition to looming spending cuts and increased infighting over dwindling federal dollars, contractors in 2012 will have to prepare for the implementation of several rules designed to enhance contract competition and prevent the government from overpaying for goods or services. That includes a rule allowing the Defense Contract Audit Agency to withhold payments to contractors with deficient business systems and a potential overhaul of personal and organization conflict of interest rules.

And while the Obama administration is unlikely to introduce many new regulations in an election year, experts say members of Congress are likely to propose new, contract-focused legislation — such as support for small business contractors or efforts to increase spending transparency — to win support among their constituents.

Congress to Boost Small Business Contracting

In 2012, election year sentiments among federal lawmakers could lead to new legislation aimed at helping small businesses, as well as a push for legislative fixes to long-standing problems in small business contracting, experts said.

“In an election year, everybody seems to start rallying round small businesses,” said Robert A. Burton, a government contracts partner at Venable LLP. “2012 provides an opportunity to address some of the challenges that face small business contractors.”

In 2011, the small business lobby succeeded in pushing the repeal of a rule that would have automatically withheld 3 percent of all payments to contractors, for tax reasons. Small business advocates are expected to try to build on that success by asking Congress to create a smoother transition for successful contractors who outgrow their small business status, according to Burton, who served as deputy administrator of the Office of Federal Procurement Policy from 2001 to 2008.

Under current rules, small businesses that outgrow size standards set by the U.S. Small Business Administration are reclassified “overnight” and are suddenly forced to compete with Fortune 500 companies for contracts. Those companies may make a strategic decision to limit their growth, rather than deal with the fallout of losing their privileged status, according to Burton.

“There's something wrong with our system when you've got businesses that don't want to grow,” he said.

The Obama administration has aimed to give 23 percent of all federal contract dollars to small businesses, and preferential treatment of small businesses could lead to stepped-up oversight. Congress has shown concern about whether contract set-asides are actually going to small businesses, after a string of scandals including the October 2010 suspension of GTSI Inc., which allegedly set up businesses as fronts to gain lucrative no-bid contracts designed to help corporations owned by native Alaskans.

In the wake of the GTSI scandal, Sen. Claire McCaskill, D-Mo., pledged to fight small business contracting fraud and she successfully pushed a March amendment to the 2010 National Defense Authorization Act that ended one problematic exemption. Under previous rules, contracting officers could give sole-source contracts to Alaska Native-owned companies without the justification-and-approval statement typically used for contracts that fulfill other small business goals — even when the amount of the contract was $20 million or more.

McCaskill's amendment won't be the last word on the subject, and the continuing congressional attention to the issue means more legislation and oversight are likely, Chierichella said. Besides legislation, the increased attention will lead to more litigation as corporate rivals, whistleblowers and government officials sue companies suspected of improperly taking small business money, Chierichella said.

“There's always a lag between the time the issue surfaces and the time when the government and private individuals react to it,” Chierichella said. “You have to get hurt first. And when you get hurt, that's when you lash out at someone.”

Small businesses could also benefit from the 2012 implementation of a rule proposed in October by the SBA, which would require prime contractors to report certain small business subcontractor payments. The rule is intended to ensure that contractors follow up on proposals to use small business subcontractors and prevent them from failing to use the proposed subcontractor, paying them less than promised or paying them late.

Putting the reporting burden on prime contractors helps small businesses avoid getting into fights they don't think they can win, according to Shlomo Katz, counsel in Brown Rudnick LLP's government contracts practice.

“Small businesses are always in a very weak position when they're in a subcontract and they think they're being treated unfairly,” Katz said. “It's not practical for them to sue over relatively small amounts of money.”

Contractors Brace for DCAA Withholdings

On the regulatory side, contractors should be prepared in 2012 for increased scrutiny as a result of rules like the Defense Contract Audit Agency's business deficiency withholding rule.

The DCAA's 2012 implementation of an interim rule published in May by the DOD will allow the government to withhold contractor payments if the agency finds a “significant deficiency” in the contractor's business systems, such as accounting systems, estimating systems, purchasing systems, earned value management systems, material management and accounting systems, and property-management systems.

The rule allows a contracting officer to withhold up to 10 percent of contract payments for significant deficiencies in a contractor’s business systems, or up to 5 percent for significant deficiencies in a single business system, amounts that Chierichella characterized as “punitive.”

“It's a highly unpopular regulation. In all candor, it puts too much power in the hands of the DCAA,” Chierichella said.

Contractors worry that the rule, which allows for broad discretion in determining what constitutes a significant deficiency, will be inconsistently applied. Katz said a client of his had already been labeled “deficient” by the DCAA because it had paid one subcontractor one day late, one time. The payment was late because the contractor was closed for a holiday and was made as soon as the office reopened, Katz said.

The fact that DCAA is understaffed adds extra concern for attorneys who represent contractors. While congressional discussions about DCAA staffing focus on late audits and the hampered ability to catch fraud, a poorly staffed auditor can also hurt legitimate contractors, attorneys noted.

“What nobody ever seems to realize is that overworked, underskilled work forces make mistakes in both directions,” Chierichella said.

Conflict of Interest Reforms Take Effect

Conflicts of interest will remain an active area of acquisition reform in 2012, attorneys said, as the Department of Defense implements a personal conflict of interest rule, and the government chooses between two competing frameworks for overhaul of its organizational conflict of interest rules.

The Department of Defense, the General Services Administration and NASA finalized a rule in November aimed at reducing the federal government's exposure to personal conflicts of interest that could arise from contractor involvement in government procurement functions. Because of the heavy involvement of contractors in government decision-making, the agencies extended personal conflict of interest rules — which previously applied only to government employees — to some contractors.

Contractors and subcontractors involved in procurement decisions are now required to report their employees' potential financial or personal interests that could conflict with their government duties, a significant new reporting requirement that could expand into nonacquisition functions in 2012, attorneys said.

“I think it very well could be expanded in 2012 to other functions beyond just the acquisition function,” Burton said. “I think everybody's watching how those rules on personal conflicts of interest will be implemented.”

The personal conflict of interest rule is separate from a still-pending overhaul of organizational conflict of interest rules, which can bar companies from competing for government contracts when their relationships with other companies threatens to bias a procurement.

The DOD and the Federal Acquisition Regulatory Council have proposed competing frameworks for reform, with the defense agency embracing case law developed in bid protests at the U.S. Government Accountability Office and the U.S. Court of Federal Claims, and the FAR Council proposing more flexible approach that prioritizes competitive fairness and protection of nonpublic information over safeguarding the government's interests.

GAO case law and the proposed DOD rule are unforgiving of potential OCIs, and the GAO has often used organizational conflicts of interest to disqualify contractors from a competition. The FAR council rule requires strict reporting of potential conflicts, but allows agencies and contracting officers to decide whether or not to go forward with a contractor despite the OCI risk.

The government could choose between the two competing methods, or split the difference and have the DOD follow a different set of rules than civilian agencies, attorneys said. Public comments have been “all over the map” on the FAR council's OCI rule, making it hard to predict what the government will do, according to Peter Eyre, counsel at Crowell & Moring LLP.

“I don't think there's a consensus in the industry, and that's one of the things making it so difficult for the government to figure out a way forward,” Eyre said.

The more flexible FAR rules would be a sea change in the way OCI rules have developed in GAO case law, which has been very harsh in striking down contracts tainted by perceived OCIs, Chierichella said. He said he expects to be dealing with two separate rules in 2012.

Cybersecurity, Data Management Gain Traction on the Hill

Contractors will also look for Congress to pass legislation in 2012 aimed at improving cybersecurity and data management, attorneys said, especially after a year when hackers and data breaches involving government contractors have repeatedly made the news.

Vanguard Defense Industries LLC, which manufactures helicopter drones, was the target of an attack by the activist hacking group AntiSec in August, and a gigabyte's worth of the personal emails from one of the company's executives were posted online. And in September, computer tapes containing personal information of 5 million beneficiaries of the U.S. military's Tricare health program were stolen from contractor Science Applications International Corp.

In the wake of hacker attacks on contractors, the government wants to make sure that contractors assume risk of that activity, and to ensure that it has financial and other remedies against contractors when data is breached, according to Rand Allen of Wiley Rein LLP. Although Congress is working on cybersecurity bills, Allen expects real change to be driven by individual agencies, through regulations and specific clauses in contracts that relate to handling of sensitive data.

“I think you're going to see more agencies coming up with their own solutions, putting in agency-specific clauses, so companies are going to have be much more attuned to that,” Allen said.

Besides looking at security, Congress has also proposed bills to improve the quality and transparency of its databases, according to Burton, including the Digital Accountability and Transparency Act and the Government Results Transparency Act.

Legislation focused on improving the accuracy and transparency of procurement-related data could have a big impact on government contracts, as procurement data is held in various federal databases that are often incomplete or inaccurate, Burton said.

“The procurement data systems just do not have accurate and credible data,” Burton said. “A lot of it is the government's inability, for whatever reason, to embrace technology as far as data management and data analytics.”

The DATA Act of 2011, sponsored by House Oversight Committee Chairman Darrell Issa, R-Calif., would create a new independent body, the Federal Accountability and Spending Transparency Board, to track all federal spending on a single website, and implement uniform, governmentwide data standards. The DATA Act would build upon previous transparency efforts like USASpending.gov and the Recovery Accountability and Transparency Board, which tracked spending from the 2009 stimulus bill.

Meanwhile, the GRTA would require federal agencies to publicly disclose how much they spend on individual programs, as well as data on how effective those programs are at contributing to agency goals. Under current law, agencies are required to track and publish overall performance results, and publicly list and explain their programs, but are not required to compile program-by-program performance and spending data.

--Editing by Jocelyn Allison and Lindsay Naylor.