BNA, INC.

FEDERAL CONTRACTS

BNA Employee-Owned Since 1947

REPORT



*Conflicts of Interest*

# DOD's Final Rule Regarding Organizational Conflicts Of Interest: Is it Better?

BY MARCIA G. MADSEN, DAVID F. DOWD, AND CAMERON S. HAMRICK

On December 29, 2010, the Department of Defense issued a final rule (the Final Rule) to amend the Defense Federal Acquisition Regulation Supplement (DFARS) to implement Section 207 of the Weapon Systems Acquisition Reform Act of 2009 (Pub. L. 111-23) (WSARA) (95 FCR 6, 1/11/11). *See* 75 Fed. Reg. 81908. Section 207 of WSARA addresses the treatment of organizational conflicts of interest (OCIs) in major defense acquisition programs (MDAPs). As stated in the Preamble, WSARA ''sets out situations that must be addressed and allows DOD to establish such limited exceptions as are necessary to ensure that DOD has continued access to advice on systems architecture and systems engineering matters from highly qualified contractors, while also ensuring that such advice comes from sources that are objective and unbiased.'' 75 Fed. Reg. at 81908.

These changes occur amidst an ongoing effort by the Federal Acquisition Regulatory Council to revise the Federal Acquisition Regulation coverage of OCIs, which is currently located in Subpart 9.5 of the FAR. The DFARS Final Rule follows a proposed rule (the Proposed Rule) that was issued on April 22, 2010. *See* 75 Fed. Reg. 20954. The Proposed Rule, among other things, extended beyond coverage of the MDAPs covered by WSARA and provided for a temporary replacement of OCI coverage in the current FAR with new and more extensive provisions in the proposed DFARS OCI provisions. The Final Rule is more limited in scope. Like Section 207 of WSARA, it focuses only on MDAPs.

Whereas the Proposed Rule had relocated OCI coverage from Part 209 to Part 203 of the DFARS, the Final Rule places the coverage back in Part 209. Some entities that commented on the Proposed Rule had raised the concern that grouping OCIs with the variety of improper conduct covered by Part 3 of the FAR (and Part 203 of the DFARS) – such as kickbacks – created the perception that OCIs are in the same category as such improper business practices. Some commenters expressed the view that coverage in Part 209 is inconsistent with the notion that mitigation is the preferred method of addressing OCI. *See* 75 Fed. Reg. at 81909. DOD disagreed. Among other things, DOD stated that Part 209 also covers conduct that is criminal in nature by way of its association with suspension and debarment. *Id.* at 81910. DOD also stated that the the scope of Part 203 has ''been evolving over time, an example being the recent FAR rule proposing inclusion of a new FAR subpart 3.11 to include policy addressing personal conflicts of interest by contractor employees performing acquisition functions closely associated with inherently governmental functions—see FAR Case 2008–025.'' *Id.* Nonetheless, the Preamble states that because ''the FAR proposed rule has not yet been published, and because the decision has been made to limit this rule to

*Ms. Madsen, Mr. Dowd, and Mr. Hamrick are partners at Mayer Brown LLP. Ms. Madsen chaired the Acquisition Advisory Panel.*

 ISSN 0014-9063

implementation of OCIs in MDAPs'' the Final Rule ''has been located primarily in subpart 209.5, until such time as the FAR coverage on OCIs may be relocated.'' *Id.*

In light of the concerns introduced by the expanded coverage of the Proposed Rule, particularly with regard to identification of OCIs and the lack of guidance on how to address them, the more limited reach of the Final Rule is somewhat reassuring. Furthermore, DOD has provided the comments received on the Proposed Rule to the team that is developing the new FAR coverage. *See* 75 Fed. Reg. at 81909. As a result, that group will have the benefit of a broad variety of comments well before issuance of a proposed FAR change, which can help to inform its thinking and be used to craft a better rule.

At the same time, the treatment of OCIs for MDAPs in the Final Rule still leaves some gaps that may prove problematic in application. In addition, the Final Rule eliminates an express preference for mitigation as a means of resolving OCIs. This retreat – and what it might signal with regard to the anticipated FAR rule – poses a concern for industry.

**Background.** WSARA, which was enacted in May 2009, directed a number of significant changes in defense acquisition. Section 207 of WSARA directed DOD to revise the DFARS to ''provide uniform guidance and tighten existing requirements'' for OCIs ''by contractors in major defense acquisition programs.'' 123 Stat. 1728.

The Acquisition Advisory Panel (AAP), which was chartered under Section 1423 of the Services Acquisition Reform Act of 2003 in the National Defense Authorization Act for Fiscal Year 2004, recommended in its January 2007 Report that the FAR Council address OCIs. The AAP commented that over the last two decades changes in the procurement landscape had led to an increasing need to protect against OCIs and that the regulatory framework was out of date. Specifically, the AAP observed that the growth of services, industry consolidation, and the use of multiple award indefinite quantity contracts had increased the likelihood of OCIs and the corresponding need to address them. The AAP recommended that the FAR Council review existing rules and regulations and, to the extent necessary, create uniform government-wide policy and clauses dealing with OCIs. As the Final Rule notes, the FAR Council still is in the process of revising the FAR coverage on OCIs. *See* 75 Fed. Reg. at 81908.

The Proposed Rule reflected a significant change in approach to the regulatory coverage of OCIs. It proposed to charge Contracting Officers with gathering and considering a broad range of information. Offerors for government contracts (and, to some degree, contractors) covered by the DFARS, in turn, would be required to disclose information relevant to OCIs. Indeed, the Proposed Rule, if implemented, would have created a new set of challenges for COs and contractors in addressing OCIs. As further discussed below, the DOD (at least for now) has held back on such a change by removing it from the Final Rule. It remains to be seen whether this approach – which was the subject of considerable comment on the Proposed Rule – returns through the anticipated changes to the FAR's treatment of OCIs.

**Summary Of The Final Rule.** The Final Rule largely tracks the requirements set forth in WSARA Section 207 with regard to tightening the OCI rules that apply to MDAPs. Key aspects of the Final Rule are summarized below.

Like the Proposed Rule, the Final Rule requires the CO to ''consider'' the:

> ownership of business units performing systems engineering and technical assistance, professional services, or management support services to a major defense acquisition program or a pre-major defense acquisition program by a contractor who simultaneously owns a business unit competing (or potentially competing) to perform as: (1) The prime contractor for the same major defense acquisition program; or (2) The supplier of a major subsystem or component for the same major defense acquisition program.

New DFARS 203.1270-5(a). In a change from the Proposed Rule, the Final Rule adds the phrase ''potentially competing'' to the mix.

The Final Rule also requires the CO to consider the ''proposed award of a major subsystem by a prime contractor to business units or other affiliates of the same parent corporate entity,'' particularly the award of subcontracts for software integration or the development of a proprietary software system architecture. *See* New DFARS 203.1270-5(b), (c).

The treatment of mitigation is a key concern in the Final Rule. The Proposed Rule expressed a policy preference for mitigation of OCIs rather than other techniques for addressing OCIs. *See* Proposed DFARS 203.1203(c). The Final Rule does not include that express preference. Neither the Proposed Rule nor the Final Rule offered guidance to COs or contractors regarding potential mitigation approaches that might be used for resolving OCIs.

Characterization of such matters as OCIs can have significant effects on contractor make/buy decisions. The lack of guidance in the Final Rule regarding when an OCI would arise and how it should or might be mitigated is highly problematic. Although this approach may increase CO flexibility to address such a situation, it arguably does so at the expense of certainty for contractors and valuable guidance for COs.

The Act provides that the new regulations shall ''ensure that [DOD] receives advice on systems architecture and systems engineering matters with respect to major defense acquisition programs from federally funded research and development centers or other sources independent of the prime contractor.'' Section 207(b)(2). The Act also provides that DOD may establish limited exceptions to (i) this requirement and (ii) the requirement that systems engineering and technical assistance (SETA) contracts for a program prohibit the contractor or any affiliate from participating as a prime contractor or major subcontractor in the development or construction of a weapon system under the program. Neither the Proposed Rule nor the Final Rule included an exception to the former requirement.

In regard to SETA contracts, the Proposed Rule provided that the prohibition on a contractor from participating as a contactor or major subcontractor in the development or construction of a weapon system for which it has a SETA contract would not apply if (i) the performance is ''design and development work in accordance with FAR 9.505-2(a)(3), FAR 9.505-2(b)(3), or preparation of work statements in accordance with FAR 9.505-2(b)(1)(ii) or (ii) the contractor ''is highly qualified with domain experience and expertise and the organizational conflict of interest will be adequately re-

  FCR ISSN 0014-9063

solved in accordance with 203.1205-3.'' Proposed DFARS 203.1270-6(b).

The Proposed Rule defined the term ''systems engineering'' in the same way as the current FAR. *Compare* Proposed DFARS 203.1270-1 *with* FAR 9.505-1(b). The Proposed Rule defined the term ''technical assistance'' in the same way as ''technical direction'' in the FAR. *Compare* Proposed DFARS 203.1270-1 *with* FAR 9.505-1(b). The Final Rule elaborates on these definitions by giving greater context for what constitutes ''systems engineering'' and ''technical assistance.'' *See* New DFARS 209.571-1. The Final Rule then introduces what the Preamble terms a ''unified'' definition of ''systems engineering and technical assistance.'' *See* 75 Fed. Reg. 81910. The Preamble states that a unified definition was provided because ''systems engineering and technical assistance'' is the statutory term and is the recognized term for a particular type of contract.'' *Id.* Under the unified definition, the Final Rule lists a non-exhaustive list of a variety of activities, such as performing technology assessments, determining specifications, and evaluating test data, among others, which are not further defined. *See* New DFARS 209.571-1. The Preamble states that further definition of the elements is ''not required.'' 75 Fed. Reg. at 81910. The FAR definitions used in the Proposed Rule can be vague in application. Although it elaborates on these definitions with context and employs a unified definition for SETA, the Final Rule perpetuates the vagueness by listing a variety of services that are common in other types of contracts.

Finally, Section 207 permitted DOD to establish ''limited exceptions'' to the prohibition on a contractor serving as a SETA contractor on an MDAP and later participating as a contractor or major subcontractor for the development or production of that program. Section 207 called for such exceptions ''as may be necessary'' to ensure DOD has ''continued access to systems architecture and systems engineering matters from highly qualified contractors with domain experience and expertise, while ensuring that such advice comes from sources that are objective and unbiased.''

The Final Rule provides that the prohibition on a contractor from participating as a contactor or major subcontractor in the development or production of a weapon system for which it has a SETA contract does not apply if the head of the contracting activity determines that: (1) an exception is ''necessary because DOD needs the domain experience and expertise of the highly qualified, apparently successful offeror;'' and (2) based on the ''agreed-to resolution strategy, the apparently successful offeror will be able to provide objective and unbiased advice, as required by 209.571-3(a), without a limitation on future participation in development and production.'' The requirement for a determination by the head of the contracting activity is a change from the Proposed Rule. The Final Rule (like the Proposed Rule) does not explain what such a plan should include or explain how a plan could mitigate an impaired objectivity or biased ground rule OCI.

The Final Rule also makes clear that SETA work does not include: (a) ''[d]esign and development work in accordance with FAR 9.505-2(a)(3) or FAR 9.505-2(b)(3)'' or the ''[p]reparation of work statements by contractors, acting as industry representatives, under the supervision and control of Government representatives, in accordance with FAR 9.505-2(b)(1)(ii).'' New DFARS 209.571-1.

**Analysis of Key Differences From The Proposed Rule.** The Final Rule differs from the Proposed Rule in several key respects, among others:

- The Final Rule removes the proposed changes that would have provided general regulatory coverage on OCIs to replace (on a temporary basis, pending FAR changes) the coverage in the current FAR Subpart 9.5. *See* 75 Fed. Reg. at 81909.
- The Final Rule removes the stated preference for mitigation as the ''preferred method'' for resolving OCIs in the Proposed Rule in favor of a general statement of policy that COs should seek to resolve OCIs in a manner that will promote competition and preserve DOD access to the expertise and experience of qualified contractors. *See* 75 Fed. Reg. at 81909, 81914.
- The Final Rule changes the definition of ''major subcontractor.''

These differences are discussed in detail below.

**Scope of Coverage.** The Proposed Rule was not limited in application to major defense acquisition programs. Instead, it proposed to extend beyond major defense acquisition programs and to introduce – pending completion of the revisions to the current FAR regarding OCIs – a new approach to be used by defense agencies in lieu of the current FAR Subpart 9.5. In the process, the Proposed Rule would promulgate – for the first time – standard OCI clauses for use by defense agencies and require extensive disclosures by prospective contractors regarding OCI matters.

As acknowledged in the Preamble to the Final Rule, some questions had been raised in comments on the Proposed Rule whether DOD had authority to impose such coverage. *See* 75 Fed. Reg. at 81909. The Preamble asserts that DOD has the requisite authority, but ''coordinating and reconciling the many comments received on the proposed general coverage with the team developing FAR coverage would delay the finalization of this rulemaking and could create unnecessary confusion.'' 75 Fed. Reg. at 81909. Accordingly, DOD elected to proceed only with ''MDAP and SETA OCI coverage as required by section 207'' of WSARA. *Id.* DOD provided the comments received on the broader coverage to the team that is working on the revisions to the FAR coverage on OCIs. *See id.*

**Mitigation.** The Proposed Rule expressed a policy preference for mitigation of OCIs rather than other techniques for addressing OCIs. *See* Proposed DFARS 203.1203(c). The Proposed Rule expressly stated that mitigation is the preferred approach. *See* Proposed DFARS 203.1205-1(c)(1). The Proposed Rule provided that if the CO (after consultation with counsel) determined that the otherwise successful offeror is ''unable to mitigate'' an OCI, the CO – ''taking into account both the instant contract and longer term Government needs'' – shall ''use another approach to resolve the [OCI], select another offeror, or request a waiver.'' *See* Proposed DFARS 203.1205-1(c)(2). The Proposed Rule did not address a preference among these alternative approaches.

The Final Rule retreats from the Proposed Rule's stated preference for mitigation, eliminating the stated preference. In its stead, the Final Rule provides that COs:

> generally should seek to resolve organizational conflicts of interest in a manner that will promote competition and preserve DOD access to the expertise and experience of qualified contractors. Accordingly, contracting officers should,

> to the extent feasible, employ organizational conflict of interest resolution strategies that do not unnecessarily restrict the pool of potential offerors in current or future acquisitions. Further, contracting activities shall not impose across-the-board restrictions or limitations on the use of particular resolution methods, except as may be required under 209.571–7 or as may be appropriate in particular acquisitions.

New DFARS 209.571-3(b). In the Preamble, DOD expressed the concern that establishing a formal preference for mitigation might ''have the unintended effect of encouraging contracting officers to make OCI resolution decisions without considering all appropriate facts and information.'' 75 Fed. Reg. at 81911. As a result, DOD removed the preference to ''make it clear that decisions about how best to resolve OCIs arising in particular procurements remain a matter within the 'common sense, good judgment, and sound discretion'' of DOD COs. *Id.* The Preamble to the Final Rule explains that DOD replaced the rule's explicit mitigation preference with a more general statement of DOD policy interests in this area. *Id.* According to DOD, the rule now provides that it is DOD policy:

> to promote competition and, to the extent possible, preserve DOD access to the expertise and experience of highly-qualified contractors. To this end, the rule now emphasizes the importance of employing OCI resolution strategies that do not unnecessarily restrict the pool of potential offerors and do not impose per se restrictions on the use of particular resolution methods, except as may be required under part 209.571–7.

*Id.* The elimination of the stated preference for mitigation is somewhat disconcerting. Although it has not been replaced with a preference for avoidance and there is a policy statement in the Final Rule that COs generally should seek to resolve OCIs in a manner that will promote competition and preserve DOD access to the expertise and experience of qualified contractors and not unnecessarily restrict the pool of offerors, this policy statement is weaker than the preference for mitigation. When viewed in light of the approach in the Proposed Rule, it may send a message to COs that mitigation is one among equally viable approaches to addressing OCIs. The new DFARS 209-571-4, however, addresses mitigation and refers to steps that a CO should take (such as pursuing award to another offeror) if the CO determines (after consultation with agency counsel) that the otherwise successful offeror is unable to ''effectively mitigate'' an OCI. This language suggests that the CO should look first to mitigation and proceed to alternative approaches only if mitigation will not work. Nonetheless, COs might view a subtle shift away from mitigation, which often can be the most difficult way (from an administrative perspective) for the CO to resolve an OCI.

The Proposed Rule offered little in the way of guidance to COs to assist in determining the circumstances under which mitigation should not be used. The same is true of the Final Rule. Because mitigation of OCIs may prove administratively challenging, the lack of guidance in the Final Rule may hamper the ability of COs to craft and implement acceptable approaches. The Preamble to the Final Rule states that a ''more detailed analysis of the methods and benefits of mitigation is outside the scope of the present rule and may be addressed in the FAR rule on OCIs.'' 75 Fed. Reg. at 81912.

**Major Subcontractor.** The Proposed Rule provided that a SETA contract for a major defense acquisition program must include a clause which prohibited a contractor and any affiliate of the contractor from participating as a contractor or ''major subcontractor'' in the ''development or construction'' of a weapon system under such program.

The Final Rule changes the term ''construction'' used in the Proposed Rule to the term ''production,'' which is more commonly used in regard to weapons programs. *Compare* Proposed DFARS 203.1270-6(a) *with* Final DFARS 252.209-7008(c). This change eliminates some ambiguity from the Proposed Rule.

The Final Rule also changes the definition of ''major subcontractor.'' The Proposed Rule defined the term as ''a subcontractor that is awarded subcontracts totaling more than 10 percent of the value of the contract under which the subcontracts are awarded.'' *See* Proposed DFARS 252.203-70WW. The definition in the Proposed Rule raised the prospect that contractors with relatively small subcontracts might be covered while other contractors (with very large subcontracts) would not be covered due to the very large size of the program at issue. As a result of the change, a subcontract less than the cost or pricing data threshold would not be considered a major subcontract while any subcontract equal to or exceeding $50 million would be considered a major subcontract. This change should ensure more equitable treatment (and greater predictability) in ascertaining coverage.

Although the reference to a major defense acquisition program mitigated this concern to a good degree, the Final Rule sets a minimum subcontract value as well as a size at which a subcontract would be considered ''major'' without regard to what percentage it represented of the prime contract. Specifically, the Final Rule defines ''major subcontractor'' as a subcontract that equals or exceeds (1) both the cost or pricing data threshold and 10 percent of the value of the contract under which the subcontracts are awarded and (2) $50 million. *See* Final DFARS 252.209-7009(a).

**Conclusion.** By reducing the scope of the coverage, the Final Rule ameliorates – at least temporarily – some of the significant concerns that the Proposed Rule would have introduced, particularly in regard to the burdens of identifying and analyzing OCIs as well, possibly, as reducing the discretion contracting officers enjoy under the FAR to exercise business judgment to address OCIs. Because the Final Rule defers these topics to be addressed by the anticipated FAR Subpart 9.5 rewrite, many of these concerns may resurface in the near term.

  FCR ISSN 0014-9063