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THE NEW EU DEFENCE PACKAGE

The European market for defence and security products is worth more than €90 billion (US\$117 billion). But less than 15 percent of that value is awarded through public tenders. Around 85 percent of the defence spending of national governments within the European Union goes to domestic suppliers.

In January, in an effort to open the European defence equipment market to greater international competition, the European Parliament voted to approve the EU Directive on Defence and Sensitive Security Procurement. This measure forms a part of the “European Defence Package” published by the European Commission.

When transposed into national law, the new rules promise to provide suppliers with improved market access by extending the use of the existing EU public procurement procedures to a broad range of defence and security programs. Significantly for U.S. companies previously shut out of domestic markets by national preference, the measure will, for the first time, introduce a procedure for bid protests for defence contracts.



Peter A. Teare
Partner – London
Europe/Middle East Corporate

Background

Within the European Union, there is currently no body of government contract regulation for defence procurement analogous to the U.S. Federal Acquisition Regulations. The founding treaty of the European Union expressly excludes

defence procurement from the scope of Community law. Article 296 of the EU Treaty expressly reserves to each EU member state the right to “take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material.” Article 296 is relied upon widely by national governments to avoid the use of the tendering rules of the EU-wide public procurement code for contracts involving a wide range of defence and security items—from boots to bullets.

The differing export control regimes in each member state also restrict the cross-border movement of defence and security items across national borders, further inhibiting international competition. While European law permits the free movement of dual-use items within the EU, the national export control rules governing defence articles remain inconsistent and cumbersome, requiring manufacturers with plants in different countries to deal with multiple licensing regimes for the movement of their products and components, as well as technology transfers. The European Commission estimates that the direct administrative cost of intra-community transfers of defence articles is €413 million (US\$ 538 million).

The European Commission’s response to these obstacles to greater competition is the European Defence Package, which has three elements: the Directive on Defence and Sensitive Security Procurement, a separate Directive on Intra-Community Transfers, and Commission Communication regarding the proper interpretation of the national security exemption in Article 296.

Directive on Defence and Sensitive Security Procurement

Current EU public procurement rules require that, with limited exceptions, qualifying contracts be awarded through a public tender process or other competitive procedure open to domestic and international suppliers. In most cases, the proposed contract award must first be advertised by the contracting authority inviting expressions of interest. The authority is then required to adopt one of four different types of tender procedures that include both an open tender process and, for some categories of contract, a “negotiated procedure.” The negotiated procedure allows the contracting authority to select one or more prospective suppliers, and to establish the contractual terms through direct negotiation. Currently, the negotiated procedure may only be used in limited circumstances; for instance, where the product or service is only available from a small number of sources or single source.

The Directive on Defence and Sensitive Security Procurement will extend features of the current EU-wide public procurement code to certain types of defence and security contracts. It recognizes that, given their complexity and sensitivity, conventional open tender procedures are not an appropriate method for the award of contracts for defence and security items. Instead, the Directive will permit contracting authorities to use the negotiated procedure as the contract award process, without having to provide justification.

The Directive will govern all contracts for the supply of military equipment, certain sensitive security equipment, works and services for specifically military purposes, and sensitive works and sensitive services that have a value of €412,000 (US\$536,000) for supply and service contracts, and €5,150,000 (US\$6.7 million) for works contracts. In the non-military security field (including homeland security), the Directive will apply to public contracts meeting these value thresholds possessing characteristics similar to defence contracts, such as procurements related to the protection of borders, police activities and crisis management operations.

The Directive covers both defence and security contracts, but its application for contracts involving intelligence will be limited. It will not apply to contracts involving sensitive information that, if revealed, would threaten essential security interests, or that support intelligence gathering activities.

The National Security Exemption

The new Directive does not remove the right of national governments under Article 296 to exclude a particular contract from the mandatory procurement procedures on grounds of national security. It will, however, limit use of the exemption to cases where the authority can show that the tender processes contained in the procurement Directive are not sufficient to safeguard essential security interests.

In an attempt to clarify the scope of the exemption, as a part of the European Defence Package, the European Commission has published an Interpretative Communication providing its interpretation of Article 296. This guidance document provides that application of Article 296 to defence procurement is subject to the following conditions: (1) the exemption must be necessary for the protection of member states’ essential security interests, (2) only the protection of essential security interests justifies an exemption, and other interests such

as economic and industrial interests, are by themselves not sufficient, and (3) the security interests at stake must be “essential,” which implies that the exemption is only available for defence procurement contracts that are of highest importance for member state’s military capabilities.

It will be for the contracting authority to make an assessment of whether the Article 296 exemption is available on a case-by-case basis. The European Commission, however, may ask a member state to furnish evidence for the justification of the use of the exemption for a particular contract. It can also challenge that use in the European Court of Justice if it considers that a member state is making improper use of Article 296. It will then be for the contracting authority to prove that the use of the exemption is necessary for the protection of its essential security interests.

Directive on Intra-EU Transfers of Defense Products

The European Defence Package includes a further Directive designed to simplify the current national licensing systems for cross-border transfers of military equipment, and technology transfers within the European Union. The new measure will permit suppliers established in one member state to move products and technology across borders within the Community under a single licensing scheme. The Directive will introduce a system of “general” and “global” licences in place of individual export licences.

A general licence issued by that national authority will permit all businesses in that member state that meet specific licence conditions to transfer defence items and technology without individual prior authorization. General licences will be available, for instance, for shipments made to a member of the armed forces of that member state, and for parts required for maintenance and repair to an existing customer.

Global transfer licences will permit companies to make multiple transfers of defence articles to a named consignee or category of consignees; specifically, transfers to armed forces of others EU member states, transfers to companies of components in the context of industrial cooperation, transfers of products necessary for cooperative programs between participating member states. A global licence will be granted for a period of three years.

The transfer Directive should improve security of supply and reduce the administrative burden and uncertainty of routine exports within the European Union. A greater compliance burden will, however, be placed on the contractor in terms of ensuring continued compliance with the applicable licence conditions.

Bid Protests

In contrast to the position in the United States, challenges by aggrieved bidders of defence contract awards are very rare in Europe. This is, in part, because of the nature of the relationship between national defence ministries and their favored suppliers, the reluctance of contractors to sue their largest customer, and the absence of a judicial review procedure tailored to the defence sector. The procurement Directive introduces a potentially important change—both for domestic contractors and prospective suppliers from other countries.

Contracts awarded under the new Directive’s procedures will be subject to the review procedures established by the EU Remedies Directive (which came

into force in 2008). This measure requires the awarding authority to wait for a specified number of days following contract award before signing the contract. This “standstill period” gives rejected bidders the opportunity to commence a review procedure in the national courts of that authority.

The Directive also requires member states to establish clear and effective procedures to enable an aggrieved bidder to seek redress in cases where contracts have been unfairly awarded. Local courts are empowered to set aside contracts where the mandated tender procedures have not been followed, and to require retendering.

The procurement Directive provides for specific procedures for the safeguard of sensitive and classified information.

Offsets

Many EU-governments require offsets as a condition of granting contracts in the defence industry to non-domestic suppliers. Offsets can take various forms, but often involve a condition that subcontracts of a specific value be awarded to domestic companies. Indirect offsets can require suppliers to procure the placement of contracts for unrelated (non-military) goods with domestic suppliers.

Offsets, by their very nature, are discriminatory and are inconsistent with the open market principles enshrined in the EU Treaty. In the context of large defence contracts, they are often a political necessity for a government wishing to place an order with a non-domestic supplier.

The procurement Directive is neutral with regard to offsets. Instead of regulating them in the context of the procurement Directive, the European Commission has decided to leave it up to the individual member states to decide whether a particular offset requirement complies with competition rules and the EU Treaty.

Impact

It remains to be seen whether the European Defence Package will succeed in breaking down the long-standing and cosy relationships between national governments and their favored domestic suppliers that currently characterize the European defence market. The success of the new measures in achieving greater transparency and greater competition is going to depend upon the willingness of both the European Commission and individual bidders to challenge the continued reliance by contracting authorities on the Article 296 national security exemption.

In the future, a bidder excluded from a contract opportunity limited to domestic suppliers on grounds of national security will have a clear legal basis for challenging that decision and any subsequent contract award. The contracting authority can be put to the burden of proving that the use of the negotiated procedures mandated by the procurement Directive are not sufficient to safeguard essential security interests.

But perhaps the most significant impact of the package will be the imposition of the European Commission’s oversight over national defence procurement decisions. A defence minister’s discretion regarding procurement awards will now become subject to continual review and possible challenge from Brussels. The threat of such intervention may be sufficient incentive to open more large procurements to international competition.

WORKING THINGS OUT BY APRIL 15: DEALING WITH THE GOVERNMENT'S CRACKDOWN ON CONTRACTOR TAX DELINQUENCY

April 15 has some new implications that may affect your status as a responsible government contractor, and may influence your ability to obtain and maintain a federal contract. A new rule, which took effect May 22, 2008, cites tax delinquencies as grounds for declaring contract bidders non-responsible, and for debarment and suspension from federal procurement. Prior to the implementation of this rule, contractors were not required to disclose tax debts. Furthermore, contracting officers did not consider tax debts in making contracting decisions. However, since the issuance of the new rule, contractors could be in jeopardy of losing the opportunity to receive contract awards based on tax delinquency.



Lorraine M. Campos
Partner – Washington, D.C.
Global Regulatory Enforcement

The new rule, issued by the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (“Councils”), now requires contractors to disclose federal tax information. Under an amendment to the Federal Acquisition Regulations (“FAR”), entitled “Certification Regarding Responsibility Matter,” a contractor must disclose certain tax delinquencies when certifying its responsibility. Although an affirmation of tax delinquency does not necessarily equate to a lack of contractor responsibility, tax liability now is one of many

factors to be evaluated by the contracting officer when determining responsibility and awarding a contract. In addition, tax delinquency may be considered by a suspension and debarment official (SDO) in multiple aspects of suspension and debarment proceedings.

The origins of the new rule stem from the response to the Senate Permanent Subcommittee on Investigations’ (“PSI”) request for information on noncompliance with tax law and reports by the Government Accountability Office (“GAO”) on federal contractor abuse of the federal tax system. The GAO’s reports showed that thousands of federal contractors had substantial amounts of unpaid federal taxes. In an effort to better estimate and curb contractors’ unpaid taxes, the FAR was amended to add language addressing the nonpayment of taxes.

The new language applies not only to the offeror, but also to principals of the contractors. The FAR defines the term “principal” to include officers, directors, owners, partners, and persons having primary management or supervisory responsibilities within a business entity.^{*} The Councils have held that this definition should be interpreted broadly, including compliance officers or other persons in positions of responsibility. Thus, a plant manager or head of a business division would be considered a principal for purposes of this requirement, and their tax information would be subject to the certification requirement.

The FAR now requires a contractor to certify whether it has been convicted of or had a civil judgment rendered against it for tax evasion. In addition, the FAR requires a contractor to certify whether or not it or any of its principals have been notified of any delinquent federal taxes in an amount that exceeds \$3,000 for which the liability remains unsatisfied.

Under the new rule, the contractor must also certify whether or not, within the three-year period preceding the offer, it or any of its principals have been notified of any delinquent federal taxes exceeding \$3,000 and remaining unsatisfied. According to revised FAR 52.209-5, delinquency only occurs when two criteria are met. First, tax liability must be finally determined. Tax liability is considered “final” only when no pending administrative or judicial challenges exist, and when all judicial appeals have been exhausted. Second, the taxpayer must be delinquent in making payment. A contractor is delinquent in making payments when it fails to pay tax liability in full when it is due and required.

The new rule provides multiple examples describing when a contractor does not need to certify that it is a delinquent taxpayer. One example states that a contractor is not delinquent if it is in full compliance with an installment tax payment agreement with the Internal Revenue Service. Another example specifies that a taxpayer who receives statutory notice of a deficiency and seeks tax court review has not encountered final tax liability. Thus, the contractor needs to understand the status of its tax liability to properly determine whether it must affirm tax delinquency in compliance with the provisions of the new rule.

Although the presence of a tax delinquency does not expressly prevent contractors from obtaining federal contracts, a federal contractor may be adversely affected by its tax liability status. Contractors, who may have previously had competitive advantages in costs compared with tax compliant contractors, now need to find new ways to create a competitive advantage against competitors.

The attorneys at Reed Smith can assist contractors with tax and contractor responsibility issues, and can provide additional guidance on other procurement matters.



Leslie A. Peterson
Associate – Washington, D.C.
Global Regulatory Enforcement

* As of Dec. 12, 2008, the term “principal” is also defined at FAR 2.101, and applies to multiple FAR parts

LEGISLATIVE WATCH: UPDATE ON PENDING PROPOSED AMENDMENTS TO THE FALSE CLAIMS ACT

Two proposed amendments to the False Claims Act, 31 U.S.C. §§ 3729, *et seq.* (“FCA”) currently pending in the House (H.R. 4854) and the Senate (S. 2041) are known as the The False Claims Act Correction Act of 2007. The proposed revisions are significant and, if passed, will effect the most substantial changes to FCA/*qui tam* litigation in more than 20 years. Both bills have been passed by their respective Judiciary Committees and are awaiting a floor vote. It is expected that The Obama Administration will support passage of these amendments.

The major proposed changes to the FCA under these bills include:

Expanding The Presentment Requirement

Currently, false claims must be presented directly to the United States and not just to an entity that receives federal funds. Both H.R. 4854 and S. 2041 would revise the FCA, however, to impose liability on any person who presents “a false



Jason P. Matechak
Partner – Washington, D.C.
Global Regulatory Enforcement

or fraudulent claim for government money or property,” or also uses a “false statement or record to get” the claim paid. The Senate bill defines “government money or property” to include money or property that the United States has “provided or will reimburse to a contractor, grantee, agent or other recipient to be spent or used on the government’s behalf or to advance government programs, or money or property belonging to any ‘administrative beneficiary.’” If this broad definition were accepted, the current FCA requirement—that the government itself have approved or denied payment based on a

false claim presented directly to it—would be eliminated. This proposed change could materially increase the number of FCA claims filed by broadening the reach of the FCA to include a wide range of disputes between private parties in which the government’s involvement is only nominal or tangential. The proposed revisions would also be at odds with recent court decisions that have confirmed that false claims must be presented directly to the United States, and not merely to an entity that receives federal funds. *See, e.g., U.S. ex. rel. DRC v. Custer Battles*, 376 F. Supp. 2d 628 (E.D. Va. 2006); *U.S. ex. rel. Totten v. Bombardier Corp.*, 286 F. 3d 542 (D.C. Cir. 2004).

Eliminating The Public Disclosure/Original Source Defense

Under the current FCA, courts do not have jurisdiction over *qui tam* actions that are based on information publicly known, unless the person bringing the *qui tam* action is an original source of the information. 31 U.S.C. 3730(e)(4)(A). Accordingly, defendants often seek dismissal if a *qui tam* relator’s case is based only upon information gleaned from public sources, or when the relator is not an original source of the information disclosed to the government. H.R. 4854 proposes to change this provision by allowing only the government—not the defendant—from raising public disclosure as a ground for dismissal. Another reason *qui tam* actions may increase if the proposed amendments are adopted is that the revisions seek to allow such actions to be brought even when there is already a government investigation in progress. Under the proposed

amendments, *qui tam* actions would be subject to dismissal only if “all essential elements” of the allegations are “based exclusively on the public disclosure” (defined as information “on the public records” or “disseminated broadly to the general public”). The concern arising from this revision is that relators could profit from *qui tam* actions without any personal, first-hand knowledge of the alleged wrongdoing, if the relators are able to establish that any one element of their FCA claim is based upon information that was not “disseminated broadly to the general public,” even in cases where a government investigation is in progress.

Qui Tam Actions By Federal Employees

The revisions also propose to amend the FCA to permit federal employees to bring *qui tam* actions, even if the suit is based upon information uncovered in the course of the employees’ official duties, so long as the employee previously presented the allegations to the respective inspector general or to the attorney general, before initiating the *qui tam* action. Once a *qui tam* action is filed, the proposed revisions would only afford the government 60 days to seek dismissal of the action filed by a federal employee.

Statute Of Limitations

Both the House and Senate versions of the bill provide for a 10-year statute of limitations in all FCA suits that would not begin to run until the *qui tam* case is unsealed. The current statute of limitations is six years, or three years from the date of discovery of the false claims, up to a maximum 10-year period. The concern with the proposed extension of the limitations period is that *qui tam* cases often remain sealed for years, and defendants might first learn of the action long after employee memories have faded, documents have been destroyed and/or witnesses are no longer available. This extension could also require that contractors retain documents for many more years than legally required in the event that *qui tam* actions are filed at some time in the future.



Lawrence S. Sher
Partner – Washington, D.C.
Global Regulatory Enforcement

We will continue to monitor and report to our clients regarding the status of these proposed amendments to the FCA. In the meantime, the likelihood of increased future *qui tam* actions—along with the requirements of the new Mandatory Disclosure Rule—all call for a new look at your company’s ethical codes of conduct, and internal compliance policies and procedures to protect against False Claims liability.

RECOVERING CONTRACTOR-SPONSORED RESEARCH AND DEVELOPMENT COSTS AFTER THE RECENT U.S. COURT OF FEDERAL CLAIMS *TEKNOLEDGE CORPORATION* DECISION

Despite decades of legal precedent to the contrary, the recent U.S. Court of Federal Claims *Teknowledge Corporation* decision imposes additional hurdles for federal government contractors seeking to recover research and development costs incurred in connection with commercial work. See *Teknowledge Corp. v. U.S.*, No. 06-310C (Fed. Cl. filed January 7, 2009) ("*Teknowledge Corporation*"). A contractor pursuing research and development that may generate both commercial and federal government sales should recognize not only the



Stephanie E. Giese
Associate – Washington, D.C.
Global Regulatory Enforcement

benefits, but also the risks associated with seeking reimbursement of those research and development costs under federal government contracts.

Contractors benefit because the federal government will reimburse an equitable share of those costs without imposing most of the Federal Acquisition Regulation ("FAR") provisions applicable to the award and performance of a federal government research and development contract. In addition, the government generally encourages contractors to pursue contractor-

sponsored research and development, including Independent Research and Development ("IR&D"), to (1) increase the pool of technology to meet government needs; (2) foster greater competition through the availability of alternative technologies; and (3) generally promote technological advances that could not be achieved by government-sponsored efforts alone. See Report of Armed Services Investigating Subcommittee, Committee on Armed Services, House of Representatives, 91st Cong., 2d Sess., on *Review of Independent Research and Development Program Management*, at 13. However, contractors run the risk that these costs will ultimately be disallowed because of conflicting legal precedent set by the courts and the administrative boards of contract appeals regarding the recovery of research and development costs. As discussed below, the recent Court of Federal Claims decision in *Teknowledge Corporation* only appears to add to the controversy.

Compliance With Accounting Standards In The *Teknowledge Corporation* Decision

In general, a contractor may recover a portion of its contractor-sponsored research and development costs as an indirect cost under a government contract if the contractor complies with the FAR allocability and allowability provisions; the generally accepted accounting principles, such as the Financial Accounting Standards ("FAS"); and the contractor's established accounting practices. In *Teknowledge Corporation*, the Defense Contract Management Agency ("DCMA") successfully argued that software development costs incurred by the contractor's commercial business segment were neither allocable to government contracts, nor allowable because any potential benefit to a government contract from the software development was too speculative.

Accounting for Software Development Costs under FAS No. 86 and the Contractor's Established Accounting Practices. Here, FAS No. 86 is the relevant generally accepted accounting principle. FAS No. 86 governs accounting for the costs of developing and producing computer software that will be sold, leased or otherwise marketed. FAS No. 86 requires the contractor to distinguish research and development costs and production costs. Under FAS No. 86, research and development costs incurred before technological feasibility has been established should be expensed. Production costs incurred after technological feasibility has been established must be capitalized. Further, FAS No. 86 requires amortization to begin when the software product is available for general release to customers.

Consistent with FAS No. 86, the contractor in *Teknowledge Corporation* treated the software development as production costs because the technological feasibility of the software had been established. In addition, consistent with its established accounting practices and as required for a production cost under FAS No. 86, the contractor capitalized its software development costs and began charging the amortized costs to its overhead pool, rather than expensing the entire cost of the development.

Allocability of Costs to Government Contracts Under the FAR. The allocability of these amortized software development costs to government contracts is at issue in *Teknowledge Corporation*. The FAR determines whether the costs are allocable to government contracts. The contractor allocated a portion of those amortized software development costs incurred by its commercial division to its government contracts through its overhead pool. DCMA relied on the FAR provision discussed below to convince the Court of Federal Claims that these costs were not allocable to government contracts.



James P. Gallatin, Jr.
Partner – Washington, D.C.
Global Regulatory Enforcement

The FAR provision applicable to determining whether a cost is allocable to a federal government contract states:

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the *basis of relative benefits received* or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

- (a) Is incurred specifically for the contract;
- (b) *Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or*
- (c) *Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.*

48 C.F.R. § 31.201-4 (*emphasis added*).

A contractor's cost must satisfy one of the three prongs to be allocable. Prong (a) refers to the allocability of direct costs. Prongs (b) and (c) refer to the allocability of indirect costs, including the cost of contractor-sponsored research and development and IR&D. In *Teknowledge Corporation*, the government and the contractor agreed the software development costs were not required in the performance of any contracts, and, as such, were indirect costs that implicated prongs (b) and (c) of the allocability provision.

In addition to satisfying one of the three prongs, the U.S. Court of Appeals for the Federal Circuit has interpreted this FAR allocability provision to also require a showing that the government received some benefit from the cost incurred. See *Boeing North American, Inc. v. Roche*, 298 F.3d 1274, 1285 (Fed. Cir. 2002). Further, the Federal Circuit defined "benefit" as "the nexus required for accounting purposes between the cost and the contract to which it is allocated." *Id.* In *Teknowledge Corporation*, the Court of Federal Claims held that the contractor provided no factual evidence to support either prong of the allocability provision. Further, as discussed in detail below, the contractor was unsuccessful in proving the government received any benefit from the cost incurred.

U.S. Court of Federal Claims and the Armed Services Board of Contract Appeals Have Different Interpretations of the Federal Circuit's 'Benefit to a Government Contract' Requirement for Allocability

The Court of Federal Claims and the Armed Services Board of Contract Appeals have different interpretations of the Federal Circuit's requirement that a government contract receive a benefit from a cost incurred in order for the cost to be allocable. The Court of Federal Claims requires a showing of a general and specific benefit to a government contract. See *Teknowledge Corp. v. U.S.*; see also *KMS Fusion, Inc. v. U.S.*, 24 Cl. Ct. 582, 584, 589 (1991) ("KMS Fusion"). Further, the Court of Federal Claims seems to imply that for a specific benefit to be conferred, there must be evidence of actual benefit rather than merely a potential benefit to a government contract. *Id.* The Armed Services Board of Contract Appeals construes the "benefit" requirement more broadly, requiring some general benefit be shown. *Lockheed-Georgia Co.*, ASBCA No. 27660, 90-3 B.C.A. ¶ 22,957 (citing *Lockheed Aircraft Corp. v. U.S.*, 375 F.2d 786, 794-95 (Ct. Cl. 1967) ("Lockheed Aircraft")).

The U.S. Court of Federal Claims Continues to Impose the 'General and Specific Benefit' Hurdle to Recovering Research and Development Costs Incurred in Connection With Commercial Work

The Court of Federal Claims' decisions in *Teknowledge Corporation* and *KMS Fusion* provide insight into how a contractor may satisfy the general and specific benefit requirements for allocability. The *Teknowledge Corporation* decision identifies potential pitfalls to recovering research and development costs incurred in connection with commercial contracts at the Court of Federal Claims.

Teknowledge Corporation. In *Teknowledge Corporation*, the contractor argued unsuccessfully that the government received a benefit from the costs incurred to

develop its TekPortal software. The contractor stated the government received the general benefit of the contractor's continued viability, and the specific benefit of its commercial business absorbing indirect costs that would have otherwise been charged to the government. However, the contractor did not provide evidence that the software development contributed to its increase in commercial business. The contractor only offered evidence that it began developing the software for the financial services industry, and that it eventually unsuccessfully proposed the software in its response to three Government Requests for Proposals.

The Court of Federal Claims found that the software development did not provide the requisite general or specific benefit to a government contract. The court relied on the contractor's statement that it was not using the software in the performance of any of its contracts. Based on that statement, the court found that the increase in its commercial business could not be attributed to the software development. Therefore, the court held that the software could not provide the general benefit of improving the overall viability of the company, nor could the software development have provided the specific benefit of reducing indirect costs allocated to its government contracts. Further, the contractor did not assert any other general or specific benefit to the contractor's government contracts. Therefore, the court was left to conclude that "any benefit to the Government resulting from TekPortal development costs would be too remote and insubstantial to deem them allocable."

The court's reasoning seems to also imply that for a specific benefit to be conferred, there must be evidence of actual benefit rather than merely a potential benefit to a government contract. It was not enough for the contractor to show that the software (1) had been offered to government and commercial customers for sale; (2) had the potential to increase sales; and (3) had the potential benefit of reducing indirect costs charged to government contracts. The court concluded that the contractor needed to show actual benefit to a government contract or, in other words, that the reduction in indirect costs charged to government contracts had already occurred.

KMS Fusion, Inc. In contrast to its *Teknowledge Corporation* decision, the Court of Federal Claims held in its *KMS Fusion* decision that the costs incurred to employ a government affairs consultant provided both general and specific benefit to the government, and were allocable to the contractor's government contracts. The contractor hired the government affairs consultant to diversify its business in the federal government market. At time the consultant was hired, the contractor provided specialized technical expertise primarily in support of one Department of Energy ("DoE") contract. Although *KMS Fusion* does not address recovery of research and development costs in connection with commercial work, the arguments presented here to prove general and specific benefit to the government are useful to a contractor that intends to recover research and development costs as indirect costs under its government contracts.

(continued)

Recovering Contractor-Sponsored Research and Development Costs...—continued from page 7

The contractor successfully argued that the government received general and specific benefits as a result of the costs incurred for the consultant. The contractor stated that the DoE benefited in a general sense because the DoE could make better-informed procurement decisions based on the consultant's insights. Relying on sales data as support that the consultant was successful in generating new business, the contractor also stated that the costs incurred for the consultant provided a specific benefit to its DoE contract because the increase in contracts (1) resulted in a decrease in the indirect costs allocated to the DoE contract and (2) enabled the contractor to remain viable if the government reduced the funding under the current DoE contract. Here, the court relied on the sales to data to find a specific benefit in the form of an actual increase rather than a potential increase in awarded contracts and a corresponding decrease in indirect costs allocated to the DoE contract. Based on this showing of general and specific benefits to a government contract, the court held that the cost of the consultant was allocable to the contractor's government contracts.

The Armed Services Board of Contract Appeals Is More Likely to Accept a Showing of Only "General Benefit" to a Government Contract

General Benefit Requirement. Unlike the Court of Federal Claims, the Armed Services Board of Contract Appeals ("ASBCA") is more likely to accept a showing of only general benefit to a federal government contract for purposes of allocability. In fact, the ASBCA has consistently held that IR&D costs incurred in connection with commercial work are allocable to federal government contracts without imposing the Court of Federal Claims' specific benefit requirement. See *Data-Design Labs.*, ASBCA No. 27535, 85-3 B.C.A. ¶18,400 ("*Data-Design Labs*"); see also *General Dynamics Corp., Elec. Boat Div.*, ASBCA No. 18503, 75-2 B.C.A. ¶ 11,521, recon. den. 76-1 B.C.A. ¶11,743 ("*General Dynamics*").

In *Data-Design Labs*, the ASBCA stated the test for allocability, citing its 1968 decision in *TRW Systems Group*:

as absolute necessity [for the cost in relation to the overall operation of the business] decreases, the contractor's burden to show some benefit to or other equitable relationship with Government contracts increases.

See *Data-Design Labs.*, ASBCA No. 27535, 85-3 B.C.A. ¶18,400 (citing *TRW Systems Group of TRW, Inc.*, ASBCA No. 11499, 68-2 B.C.A. ¶7117).

Here, the ASBCA also cited the U.S. Court of Claims' decision in *Lockheed Aircraft* where the court concluded that the requirement to show a benefit is implicit in the allocability provisions, and "that the benefit required is a general one." See *Data-Design Labs* (citing *Lockheed Martin Corp. v. U.S.*, 375 F.2d 786 (Ct. Cl. 1967)). Here, the Court of Claims found that California property tax levied based on the contractor's commercial inventory was necessary to the overall operation of the business and thus, provided a benefit to government contracts that was general in scope and sufficient to find the tax allocable to government contracts.

Data-Design Labs Decision. In its *Data-Design Labs* decision, the ASBCA held that only a benefit to a government contract of a general nature is required

when an IR&D project is conducted "to obtain new business to replace declining Government business." See *Data-Design Labs.*, ASBCA No. 27535, 85-3 B.C.A. ¶18,400 (citing *General Dynamics Corp., Elec. Boat Div.*, 75-2 B.C.A. ¶11,521). The contractor was developing an electronic ballast that would substantially reduce the energy consumed by fluorescent lamps. The contractor intended to market the product to government and commercial customers. The ASBCA held that IR&D costs were allocable because the government would have benefitted from the energy conservation and, more generally, from a reduction in indirect costs to government contracts had the commercial business developed.

General Dynamics Decision. In its *General Dynamics* decision, the ASBCA allowed the contractor to recover IR&D and Bid & Proposal ("B&P") costs incurred in seeking commercial business with a showing of general benefit to a government contract "because [the costs] were basic to appellant's viability as a commercial enterprise." See *General Dynamics Corp., Elec. Boat Div.*, ASBCA No. 18503, 75-2 B.C.A. 11,521. The ASBCA held that using IR&D and B&P to develop the arctic tanker and foreign attack submarines for a new class of commercial customers was necessary to the overall operation of its business, satisfying the third prong of the FAR allocability provision. Furthermore, the ASBCA found the contractor was ameliorating the effects of the decline in government business which, if successful, the ASBCA noted, would have benefited government contracts through (1) commercial contracts absorbing a greater portion of the contractor's indirect costs; (2) providing the government valuable engineering and construction data; and (3) providing the contractor's employees valuable training in the construction of submarines that was transferrable to its government contracts.

Contractors Should Proceed With Caution When Recovering Research and Development Costs Incurred in Connection With Commercial Work

Contractors conducting research and development or IR&D projects that have both commercial and government sales potential generally may recover the cost of these projects under federal government contracts. The contractor must comply with the FAR, generally accepted accounting principles, and its own established accounting practices. Finally, contractors should seek legal counsel in making a determination as to whether the costs incurred meet the FAR allocability provision as interpreted by the Court of Federal Claims and the Armed Services Board of Contract Appeals.

PRESIDENT OBAMA SIGNS NEW EXECUTIVE ORDER TIGHTENING EXECUTIVE BRANCH ETHICS RULES

On January 20, 2009, President Barack Obama signed an Executive Order titled, “Ethics Commitments by Executive Branch Personnel” (the “Executive Order”). Following up on his campaign commitments to reduce the influence of lobbyists in Executive Branch affairs, the new Executive Order places significant restrictions



Gregory S. Jacobs
Associate – Washington, D.C.
Global Regulatory Enforcement

on: (1) the ability of appointees to accept gifts from lobbyists and lobbying organizations; and (2) the ability of appointees to leave lobbying practice to work in the Executive Branch, and vice versa, through the “revolving door.” The centerpiece of the new restrictions is the Ethics Pledge, a seven-point commitment required of all executive agency appointees. The effect of these new restrictions could be to significantly limit the access that certain organizations and people have to Executive Branch personnel.

Lobbyist and Lobbying Organization Gift Ban

In a provision that may impose significant restrictions on the interactions between certain organization and persons and Executive Branch appointees, the Ethics

Pledge includes a commitment to “not accept gifts from registered lobbyists or lobbying organizations” during service as an appointee. As used in the ethics pledge, “gift” has the same broad meaning as under the Office of Government Ethics (“OGE”) regulations, which includes all gratuities, favors, and hospitality. The Executive Order retains the OGE regulations’ exception to the definition of “gift” for refreshments that do not constitute a meal. Importantly, however, the Executive Order does not include the provision in the OGE regulations permitting an employee to accept gifts of not more than \$20 per occasion, provided that the total received from any one source does not exceed \$50 in a calendar year. With respect to lobbyists and lobbying organizations, Executive Branch appointees are not permitted to accept “gifts” of any value.

In another potentially far-reaching provision, the Executive Order includes “lobbying organization” in the lobbyist gift prohibition. A “lobbying organization” is defined under the Executive Order as an organization that files a registration under 2 U.S.C. § 1603(a). An organization is required to file under that section when it: (1) has lobbying expenses exceeding \$10,000 in a quarter; (2) employs a lobbyist that spends more than 20 percent of his or her time on lobbying activities; and (3) makes more than one lobbying contact per quarter. The

(continued)

TAIWAN ACCEDES TO THE WTO GOVERNMENT PROCUREMENT AGREEMENT

On December 9, 2008, the World Trade Organization (“WTO”) Committee on Government Procurement formally invited Taiwan (often referred to as “Chinese Taipei”) to join the plurilateral Government Procurement Agreement (“GPA”) after more than 13 years of negotiations. Adopted in 1981, the aim of the GPA is to ensure fairness of competition between domestic and multinational enterprises bidding on government procurement, tender and construction projects. The GPA implements regulations and procedures to encourage transparency, to reduce favoritism for domestic contractors, and to eliminate discrimination against foreign contractors. As a GPA member, Taiwan will open its market to foreign firms, and Taiwanese firms will have greater access to foreign markets, including the United States.



Jason P. Matechak
Partner – Washington, D.C.
Global Regulatory Enforcement

Opportunities for U.S. Procurement

Taiwan’s accession to the GPA is a major step in opening up U.S. procurement markets to products from Taiwan. Currently, only those products from the United States or certain “designated countries” are eligible for sale in the U.S. procurement marketplace under the U.S. Trade Agreements Act (“TAA”). Currently, Taiwan is not a designated country and, as such, its products are not eligible for sale under U.S. Government contracts. However, under U.S. law and regulation, the term “designated countries” includes WTO GPA member countries. With Taiwan’s accession to the WTO GPA, it is expected that the U.S. Federal Acquisition Regulations (“FAR”) will be modified to include Taiwan as an eligible product going forward. U.S. contractors and Taiwanese suppliers should be on the lookout for this important change.



Brett D. Gerson
Associate – Washington, D.C.
Global Regulatory Enforcement

Opportunities for Taiwanese Procurement

Reflecting the immediate impact of his country’s accession to the GPA, Taiwanese President Ma Ying-jeou reportedly called for foreign firms to bid on projects in Taiwan’s major “i-Taiwan” infrastructure initiative, which aims to generate \$121 billion worth of investment over the next eight years. President Ma pointed out that the investment environment for foreign firms has improved in Taiwan as a result of its recent accession to the GPA. The United States Trade Representative has welcomed Taiwan’s accession to the GPA, saying it would assure U.S. suppliers access to the Taiwanese market, worth approximately \$20 billion annually. While there will certainly be opportunities for U.S. and other GPA member companies to participate in the Taiwanese procurement market, U.S. companies seeking to take advantage of procurement opportunities in Taiwan must continue to comply with U.S. export controls.

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definition of “lobbying organization” is significant because it covers not only those organizations that primarily engage in lobbying activities, but also a number of organizations that exist for other purposes and engage in only limited lobbying.

Under this broad prohibition, many organizations that have traditionally enjoyed access to Executive Branch employees may find that certain channels are now closed. As an example, a charitable organization organized under Section 501(c)(3) of the Internal Revenue Code is permitted to engage in insubstantial lobbying activities. Many of these charitable organizations do lobby for limited purposes related to their organizational missions, and accordingly are registered under 2 U.S.C. § 1603(a). Under the Executive Order, these organizations are now considered “lobbying organizations” and, therefore, Executive Branch appointees may not accept “gifts” such as meals and hospitality from these groups. Early agency interpretations of this provision have been that Executive Branch employees may not even attend a reception held by a lobbying organization.

It is likely that over time, further guidance on the parameters of the ban, and the exceptions thereto, will add nuance to these rules. However, the current understanding among agency ethics counsel appears to be that the ban on gifts from lobbyists and lobbying organizations is absolute and should be met with strict compliance.

Revolving Door Restrictions

The other major aspects of the Executive Order are “revolving door” provisions that limit certain persons’ abilities to be appointed to Executive Branch posts, and limit Executive Branch appointees’ abilities to operate in the private sector once they leave government. These provisions supplement the current OGE revolving door restrictions, which limit the ability of Executive Branch employees as follows: (1) a permanent bar on representing an outside party before a federal agency, department, or court on matters in which the employee has participated personally and substantially; (2) a two-year bar on representing an outside party on a matter that was within the employee’s official responsibility; (3) a one-year “cooling off” period for a high-level official, during which he or she may not represent any outside party before his or her former agency; and (4) a one-year “cooling off” period for a very senior official, during which he or she may not make any communication or representation on behalf of any outside party to high-level Executive Branch officials, as well as to employees of his or her former agency.

As discussed below, the Executive Order extends the reach of revolving door restrictions to persons entering government. The Executive Order also includes a broad ban on lobbying current Executive Branch appointees once a former appointee leaves the government.

Restrictions on Participating in Matters Directly and Substantially Related

The first type of revolving door restriction limits the ability of a private person to serve as an Executive Branch appointee and participate in any matters directly and substantially related to his or her former employer and clients, for a period of two years.

Restrictions on Lobbyists Entering Government and Appointees Leaving Government

Under the Executive Order, a lobbyist entering government may not, within two years following appointment, participate on the particular matter or area regarding which he or she lobbied, or seek employment with an Executive Branch agency that he or she lobbied. In addition, the post-employment ban on a former appointee communicating with employees at his or her former agency with the intent to influence official action is extended to two years. Finally, an appointee leaving government to lobby may not, for the duration of the administration, lobby any covered Executive Branch official or senior appointee. Clearly, the intent of these provisions is to reduce the influence of lobbyists, both inside and outside of government, on Executive Branch affairs.

Conclusion

It is important to note that all limitations contained in the Executive Order are subject to waiver provisions where it is in the public’s interest that a waiver be granted. Already, a former lobbyist for Raytheon Company has been granted a waiver in order to serve as Deputy Defense Secretary. In addition, the appointment of a former lobbyist for Goldman Sachs Group Inc. to a high-ranking position with the Department of Treasury has raised controversy regarding the administration’s commitment to enforce the Executive Order. How the administration goes about implementing and interpreting these potentially far-reaching restrictions over the months and years to come will play a large role in determining the ultimate influence of these rules on the role of lobbyists in interacting with the Executive Branch.

MANDATORY DISCLOSURE RULE COMPLIANCE CHECKLIST

On Feb. 10, 2009, attorneys from Reed Smith’s Global Regulatory and Enforcement Group presented a teleseminar titled “Mission Impossible? Follow the FAR Mandatory Disclosure Rule Without Harming Your Government Contracts Business.” As part of that teleseminar, we recommended that all government contractors assess current legal and compliance resources and undertake a self-investigation, including review of their codes of ethics and internal controls. The following checklist is intended to be a convenient reference to supplement the presentation and a guide to conduct a self-investigation.



Lorraine M. Campos
Partner – Washington, D.C.
Global Regulatory Enforcement

Code of Ethics

- Ensure that the company has a written code of ethics that is made available to each employee engaged in performance of government contracts. The code should provide clear directions regarding actions that employees may or may not take, including a duty to report any facts that could support violations of any ethical standards, government overpayments, etc.
- Establish regular ethics training, as well as procedures for testing employees’ comprehension
- Require employees to acknowledge, in writing, the code of ethics and receipt of ethics training
- Review company compliance programs to determine effectiveness, and to assess legal and compliance resources, strengths, and weaknesses
- Establish specific consequences employees will face for violating the code of ethics

- Establish procedures for documenting ethical breaches and adopting plans to prevent future breaches of the same type
- Ensure that FAR clauses are “flowed down” to subcontractors where required

Internal Controls

- Establish procedures to detect overpayments and report (via a hotline or the equivalent) any potential violations
- Establish procedures for conducting and documenting investigations of any ethical violations, overpayments, or similar issues that employees report
- Appoint a senior official to be responsible for coordination of internal investigations
- Ensure disciplinary action is taken for improper employee conduct
- Periodically audit and review business practices and internal controls

Mandatory Disclosures

- Identify, survey, and obtain certifications from principals regarding their knowledge of information that could trigger a duty to disclose
- Create a written protocol for reporting, reviewing, and vetting potential disclosures
- Establish procedures for documenting the rationales underlying decisions to make, or not to make, disclosures in particular cases
- Ensure the mandatory disclosure process is part of the government contract record retention policy and procedure



Steven D. Tibbets
Associate – Washington, D.C.
Global Regulatory Enforcement

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Leah March · Reed Smith LLP · 435 Sixth Avenue · Pittsburgh, PA 15219 · Phone: 412 288 5735 · Fax: 412 288 3063 · lmarch@reedsmith.com

Name

Company

Title

Address

City State Zip/Postal Code Country

Phone E-mail

CONTRIBUTORS TO THIS ISSUE

Lorraine M. Campos

Washington, D.C.

+1 202 414 9386

lcampos@reedsmith.com

James P. Gallatin, Jr.

Washington, D.C.

+1 202 414 9274

jgallatin@reedsmith.com

Brett D. Gerson

Washington, D.C.

+1 202 414 9440

bgerson@reedsmith.com

Stephanie E. Giese

Washington, D.C.

+1 202 414 9246

sgiese@reedsmith.com

Gregory S. Jacobs

Washington, D.C.

+1 202 414 9480

gjacobs@reedsmith.com

Jason P. Matechak

Washington, D.C.

+1 202 414 9224

jmatechak@reedsmith.com

Leslie A. Peterson

Washington, D.C.

+1 202 414 9263

lpeterson@reedsmith.com

Lawrence S. Sher

Washington, D.C.

+1 202 414 9209

lsher@reedsmith.com

Peter A. Teare

London

+44 (0)20 7556 6858

pteare@reedsmith.com

Steven D. Tibbets

Washington, D.C.

+1 202 414 9242

stibbets@reedsmith.com

*The editor of the Federal Forecaster is **Lorraine M. Campos**,
a partner in the Washington, D.C. office.*

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