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Overlooked Obligations

In this second of three installments on Ethics and Compliance, Dentons attorneys highlight certain ways in which doing business with the federal government creates unique challenges that can sometimes be missed by federal sales teams accustomed to ordinary commercial transactions. Companies lacking a fundamental appreciation of the need for a robust contracts management structure as part of the compliance framework may easily lose sight of these requirements, and that risk increases exponentially at the subcontract level.

BNA INSIGHTS: Commercial Contractors Face Consequences From Commonly Overlooked Obligations

By Erin B. Sheppard

In the first installment of Dentons' three-part Ethics and Compliance *BNA Insights* series, Jeniffer De Jesus Roberts emphasized the critical importance of establishing an effective ethics and compliance program to ensure a contractor's compliance with a vast array of laws, regulations and contractual requirements.

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Federal government contractors who heed such advice are well-positioned to address the myriad compliance obstacles that may arise under government contracts. However, many government contractors fail to undertake a comprehensive and systemic analysis of such obligations prior to entering into the federal contracting market. Commercial item contractors, in particular, tend to see entry into the government market as a means of expanding their market share. What such contractors do not always see are the various strings attached to that decision. They also often overlook the ways federal contracting is operationally distinct from commercial contracting.

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contracting[1] under the Federal Acquisition Regulation (FAR) is a much less burdensome contracting method when compared with standard competitive procurements,[2] there are still many requirements that are easy to overlook.

Companies lacking a fundamental appreciation of the need for a robust contracts management structure as part of the compliance framework may easily lose sight of these requirements, and that risk increases exponentially at the subcontract level. This article aims to help prevent commercial contractors at both the prime and subcontract level from making that mistake by highlighting some of the most commonly overlooked ways government contracting differs from commercial contracting. Finally, this article concludes with some practical tips for how an effective contracts management function can bolster a contractor's compliance program.

Commercial Contracting Pitfalls

Although somewhat elementary, one of the primary ways federal government contracting varies from standard commercial contracting is the method by which the government competes for and enters into government contracts. Unlike a typical commercial transaction, in which the parties may negotiate or propose a host of conditions on the other side through a series of offers and counteroffers, contractors typically cannot employ such techniques when negotiating with the federal government.

When a federal agency issues a request for proposal (RFP) or request for quotation (RFQ) and a contractor submits its bid or proposal in response to that request, unless otherwise specified in the terms of the solicitation itself, the contractor is bound by the terms of the government's RFP or RFQ if the government accepts its proposal. Should a contractor wish to be exempted from a requirement contained therein, it must expressly state its intention to take such an exception, and the government, in awarding the contract, must specifically acknowledge and agree to the exception. Otherwise, the contractor is bound by the solicitation's terms.

Notwithstanding these one-sided bidding rules, many commercial contractors employ their standard commercial quote templates when bidding on government work. Such templates often include assumptions underlying their price proposal or the proposed scope of work and attempt to carve out specific aspects of the work at issue.

For example, if the solicitation requires the contractor to provide all material to be delivered or used in conjunction with an equipment installation project, a prospective offeror may include pricing notes stating certain materials are not included but will be available to the government only at an additional cost. The offeror, in effect, has changed the terms of the resulting contract. Likewise, some contractors include statements imposing affirmative obligations on the government, such as deadlines for deliverable review or the provision of adequate government technical support, which may not actually be provided for in the statement of work.

Similarly, contractors sometimes use the proposal process to state their assumption or interpretation of the statement of work itself, seeking to memorialize their interpretation of the requirements with the belief that the proposal as drafted will supersede the RFP and dictate the terms of any resulting contract. These same contractors are often perplexed when the contract is awarded without incorporating their proposal by reference into the contract award and, instead, simply include the original, RFP version of the statement of work. This could result in potentially negative contract performance.

The far safer approach under these circumstances is for a contractor to submit questions during the question-and-answer period under the solicitation to obtain the clarification necessary. A contractor who bids on a contract containing patent ambiguities without first seeking clarification of those ambiguities does so at its own risk.[3] As such, a contractor should strongly consider availing itself of the pre-award opportunities to obtain such clarification or file a pre-award bid protest to obtain the necessary clarity prior to award.

Commercial contractors should proceed with extreme caution when relying on such techniques to impose obligations on the government or to change the solicitation's terms. Using the examples above, unless the government expressly incorporates the contractor's assumptions — which is exceedingly rare — the contractor is still on the hook to provide the additional equipment under the statement of work or to perform the work without the support requested or timely deliverable review demanded.

When a contractor bids on a federal contract, it is not choosing from a menu of options. Nor is it able to impose additional conditions on the government. To the contrary, a contractor can bid the work as proposed, take exceptions when permitted under the terms of the solicitation, or not bid at all. Although some contracts involve negotiations, the counteroffer process is much different and not nearly as simple in federal contracting as it may be in the commercial space, making it far more difficult to impose such conditions or additional terms on the government.

Flow-Down Compliance

Another area rife with a host of compliance pitfalls is compliance with contractor flow-down requirements. From a prime contractor perspective, the process of reviewing, analyzing and understanding the prime contract obligations that must be included in subcontracts with suppliers and first-tier subcontractors is a critical element of ensuring prime contract compliance. In addition to assessing which subcontract terms must be flowed down by law and regulation,[4] a prime contractor should also review its prime contracts to determine

[1] *See* FAR Part 12.

[2] *See* FAR Part 15.

[3] *See, e.g., Triax Pac., Inc. v. West,* 130 F.3d 1469 (Fed. Cir. 1997) (ambiguous contract term will not be construed against the drafter where bidding party had an obligation to seek clarification of an ambiguity of which it should have been aware); *Nielsen-Dillingham Builders, J.V. v. United States,* 43 Fed. Cl. 5 (1999).

[4] For solicitations containing only FAR 52.212-5, the list of required flow-downs is included at FAR 52.212-5(e)(1). However, flowing down those clauses alone may not be sufficient to ensure compliance with the prime's obligations.

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which clauses should be included in its subcontracts to ensure contract compliance.

For example, if a subcontractor will be handling information subject to certain prime contract security requirements, then the prime contractor should be certain to include those requirements in the subcontract. Similarly, if the subcontractor will be responsible for a specific section of the prime contract statement of work, then the subcontract should include the same performance or other requirements as the prime contract for that particular segment of work. Likewise, because federal contracts have termination for convenience provisions, as well as a range of other government-led rights, ensuring that first- and lower-tier subcontractors are on the hook for the same requirements is an essential element of contractual compliance that commercial contractors may not always think to include.

At the subcontractor level, the perils are even greater. Fundamentally, not all subcontractors may be aware that their goods or services are intended for a federal government customer. As such, a subcontractor may not be looking for these additional requirements when reviewing purchase orders. Second, many prime contractors take the easy approach of flowing down all FAR clauses in their prime contract to their subcontractors. Indeed, this is often the easiest approach for prime contractors. A federal subcontractor, therefore, must be prepared to understand whether the requirements being included are, in fact, required to be included in the subcontract.

As explained above, many prime contractors will also include certain ''advisable'' provisions necessary to ensure prime contract compliance. An effective federal compliance and contracts management program should build in a process for closely reviewing such flow-down obligations prior to executing a subcontract in which the federal government is the ultimate customer.

As we explained previously, many of these flow-down clauses include affirmative obligations on government contractors that can be easily overlooked. Using FAR 52.212-5(e)(1) as an example, a contractor who signs on to a contract including that clause will be required to have or create the following:

- a Contractor Code of Business Ethics and Conduct as required under FAR 52.203-13;
- an Equal Opportunity Employment Policy consistent with FAR 52.222-26, Equal Opportunity; and
- an Anti-Human Trafficking Compliance Plan consistent with FAR 52.222-50, Combating Trafficking in Persons.

Each of these requirements and clauses carries a host of compliance obligations such that contractors at the first- or second-tier subcontract level should take care to review and familiarize themselves with such requirements prior to executing the subcontracts at issue if possible. Here are a few key examples of how three short lines of text carry substantial affirmative programmatic compliance obligations.

The Perils of Incorporation by Reference

At the federal first-tier subcontractor level, the issues highlighted above are exacerbated because subcontracts are a degree further removed from the federal government. As a result, subcontractors do not always fully appreciate the requirements that their potentially more savvy prime contractor may be flowing down to them. Often, the subcontract may include an appendix of federal terms and conditions, either as an appendix to the applicable purchase order, or, in some instances, incorporated by reference and not even expressly incorporated in the subcontract agreement itself.

Even where the terms and conditions are included, many of the FAR flow-down obligations are included as clauses ''incorporated by reference,'' meaning that the full text of the clauses themselves are not actually written into the contract. This is the same method that the federal government uses in its own standard contracts, but it is sometimes a foreign concept to less sophisticated contractors or new market entrants accustomed to commercial contracting.

The practical reality of this approach is that it can be easy for an unsophisticated salesperson focused on closing a deal to gloss over a lengthy list of FAR clauses that impose affirmative and substantial obligations on the contractor. Many a company has signed up to FAR requirements without even attempting to review the full clauses. Contractors who take that approach do so at great risk. Many nontraditional government contractors, and particularly subcontractors, fail to appreciate the depth and breadth of the FAR clauses incorporated by reference. At best, the contractor seeks legal advice regarding the clause's substance; at worst, the contractor ignores them entirely.

Operational and Financial Hurdles

There are also a host of operational areas where it is easy for a new government contractor to trip up when it comes to contract management and compliance. Perhaps one of the greatest examples of substantive areas where it is easy to make mistakes is in the area of segregation of costs. Contractors who pursue only commercial item contracts will be less likely to encounter the additional layer of contract compliance difficulties posed by cost-type contracts.

However, contractors who bid on large government-wide acquisition vehicles with cost-type elements often take on obligations to segregate costs that they may not realize. Likewise, a contractor who encounters changes or who seeks requests for equitable adjustments under those contracts may find itself unable to track the costs associated with those changes with the degree of certainty required to pursue a certified claim for those amounts.

Without digging too deeply into the substance of each of these requirements, the following general accounting principles from the Defense Contract Audit Agency's Contract Audit Manual[5] help illustrate the areas in which many novice contractors fall short:

- *Segregate direct costs from indirect costs.* Indirect costs are those costs that are not directly attributed to a specific project, product or contract. Indirect costs include items such as overhead expenses, fringe benefits, and general and administrative (G&A) expenses. In contrast, a direct cost

[5] DCAA Contract Audit Manual (CAM) DCAAM 7640.1.

can be specifically identified with a single contract (or a single cost objective).

- *Accumulate and segregate direct costs by contract and by line item.* Direct and indirect costs should be further segregated and tracked at the contract level.
- *Employ a logical and consistent method for the allocation of indirect costs.* Contractors must group indirect costs in logical categories and then employ a consistent allocation methodology for that category of costs.
- *Accumulate costs under general ledger control.* Ideally, contractors should perform a monthly, contract-by-contract reconciliation of direct and indirect costs.
- *Use a timekeeping system that tracks cost objective and allocates time logically and consistently*.
- *Segregate unallowable costs.* Contractors performing cost-type contracts or who have cost-type contract line item numbers should familiarize themselves with the FAR 31.205-6 categories of unallowable expenses to ensure that they properly segregate allowable and unallowable costs in their accounting systems. The concept of unallowable costs is somewhat foreign to commercial companies, and this is a critical area for education in the company's contracts management structure.

As each of the above principles demonstrate, the cost requirements are detailed, specific and tedious. Compliance with these requirements requires a contractor to have detailed financial systems and a great deal of care on behalf of the company. This is yet another example of the type of obligation that a government contractor may unknowingly undertake when focused on closing the deal and highlight the importance of making an informed entrance into the federal contracting space.

Sales-Driven Focus vs. A Culture of Compliance

One of the factors guaranteed to exacerbate some of the compliance traps highlighted above is a sales-driven business culture. As we emphasized in part one of this series, an effective ethics program must go beyond looking ''good on paper'' and instead establish and promote a ''culture of compliance'' throughout the company. Although the two cultures certainly can coexist, the incentives between the two are not clearly aligned. A contractor considering entry into the federal market or a contractor already in who may not fully appreciate the accompanying obligations should consider carefully the following illustration.

Consider, for example, a motivated salesman working for a first-tier subcontractor in the federal information technology field. He has a target quota, a volume-based incentive and a strong motivation to put as much product into the hands of his federal prime contractors as possible. His performance metrics do not assess his adherence to or recognition of best-practice compliance procedures for screening second-tier suppliers when designing specific solutions in response to requests for proposal. Likewise, he is not evaluated on his appreciation of the lengthy list of flow-down conditions included in the purchase orders that he receives and executes on behalf of the company. Indeed, either step — subcontracting due diligence review or a flow-down analysis — is lengthy, burdensome and, in his mind, above his paygrade.

Playing it out, the consequences can be grave. Maybe by signing the purchase order's terms and conditions, the salesman signs the company up to a cost accounting obligation that the company cannot possibly comply with. Maybe he certifies the company's compliance with and possession of certain policies and procedures that the company does not actually have. Or perhaps he certifies the country of origin of certain products provided without any actual understanding of the meaning of that statement or whether the products comply with the requirement. Any of those certifications and representations could lead to breach of contract or even fraud.

Contrast that individual with an individual trained in the importance of subcontract compliance when working with the federal government. That individual will be more likely to realize the fundamental importance of and risks associated with signing such certifications without obtaining the company's informed opinion on the company's ability to comply with such requirements.

A company with a robust framework of federal contracting policies and procedures will have a process in place to ensure such compliance (or, at minimum, creation of a plan for such compliance where immediate compliance may not be possible) and will have procedures to ensure that the company does not sign on to any such contract or subcontract without first obtaining such a confirmation.

Practice Tips

Having reviewed the preceding litany of ways commercial item contractors can overlook or minimize the scope and breadth of their legal and regulatory obligations when signing on to government contracts, you may be asking yourself how contractors can protect themselves against these pitfalls.

As addressed in part above, we suggest the following key takeaways as the foundational principles for an effective contracts management program to complement your organization's ethics and compliance program. It is our hope that by illustrating some of the ways these things can go wrong, we can help you chart a course that will minimize the number of times the company veers off course.

Create a robust business capture process. Companies should strongly consider implementing a review process for potential federal contract work that includes a review of the solicitation from both a compliance standpoint (e.g., whether the contract imposes new systemic compliance obligations that the company may not be able to comply with, such as cost accounting principles) and also a review of the scope of work to ensure that the solicitation is clear and provides contractors with the ability to meaningfully bid on the proposed scope of work. For example, if the solicitation contains ambiguities or other shortcomings that raise operational concerns that could affect successful contract performance (e.g., the contract has unclear performance standards that could be interpreted in vastly dif-

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ferent ways), the contractor should seek to clarify those ambiguities prior to contract award.

Separate contract management from sales. A corollary to the above recommendation: By separating contracts management from the company's sales function, the company can align interests to ensure a greater appreciation of the obligations imposed on the company as a result of a particular transaction. This division of resources is helpful in the early stages of a shift from a sales-driven culture to a culture of compliance.

Require robust training for federal sales force. Even if they are removed from the contracts management function, federal sales representatives should still be required to understand and appreciate the critical ways the federal contracting negotiation process is different from the standard commercial negotiation process. Training the federal sales force on effective negotiation techniques and proper proposal writing can help curb some of the perilous activities highlighted above.

Build cross-checks into signature authority process. Even contractors that lack the manpower necessary to employ entirely separate sales and contracts management staffs can still build procedural cross-checks into the process that ensure sufficient review to protect the company's interest. For example, requiring corporate-level sign-off prior to proposal submission, to include a review of the prime contract terms and conditions and whether the company can comply with such requirements, is a critical component to ensuring that contractor sales teams do not get out ahead of the company's compliance program.

Similarly, requiring review or approval of subcontract terms and conditions prior to execution of a subcontract can help prevent against the inclusion of subcontract flow-down obligations without sufficient review by the company. Building in procedural review points at these key risk points can keep companies from being blindsided by obligations they did not realize they had committed to.

Maintain contract management role throughout contract performance. Although these tips are focused on the contract award stage, the need for effective contract management does not end there. A dedicated contracts management staff is crucial for ensuring ongoing contract compliance, such as maintenance of required records, adherence to deliverable deadlines and other similar obligations. Effective contracts management also equips the contractor to respond swiftly in the event that performance issues arise. Having a well-informed, qualified and trained contracts management function in place ensures the level of successful contract performance necessary to make the company's foray into the government market a viable, and hopefully profitable, investment.