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GOVERNMENT CONTRACTS ISSUE UPDATE

Spring 2010

The Government's New Road for Analyzing In-Sourcing and Inherently Governmental Functions: Paved With the Best Intentions, but the Destination Remains Unclear

By Philip J. Davis, Richard B. O'Keeffe, Jr. and Thomas J. Warren*

In the past decade, the Government's use of contractors has increased exponentially. In the Department of Defense (DoD) alone, the percentage of private contractors making up the Pentagon's workforce has increased from 21% to 39%. As the Government's use of service contractors has blossomed, Congress has grown increasingly uneasy with what is perceived as an "overreliance" on service contractors to execute agencies' missions; in particular, they have expressed alarm at the prospect that private contractors may be performing "inherently governmental functions." As a result, Congress and the President have mandated that agencies take a closer look at the use of support contractors generally to determine whether the contracted tasks are more properly performed by Government employees. However, there is a growing concern from the contracting community that agencies may overreach in the rush to fulfill Congress' and the President's "in-sourcing" mandates.

This article will outline (1) the recent statutes, regulations and policies related to the in-sourcing initiative; (2) the recent Office of Federal Procurement Policy's (OFPP) proposed policy letter; and (3) the options available to challenge an agency's decision to in-source work.

Recent In-Sourcing Statutes, Regulations and Policies

In recent years, Congress has passed several statutes with provisions designed to shift the Government's focus from out-sourcing to in-sourcing, with DoD being the primary focus of initial in-sourcing efforts. Section 324 of the National Defense Authorization Act (NDAA) for FY 2008, Pub. L. No. 110-181, required DoD to establish procedures to ensure that it considers in-sourcing functions currently performed by contractors. *See* 10 U.S.C. § 2463. In April of 2008, DoD implemented procedures requiring DoD Components to meet certain requirements when making in-sourcing decisions. One important requirement is that a DoD Component must perform a cost analysis to account for the "full cost of manpower" to determine whether in-sourcing would result in the Government being the low-cost provider of the targeted services.

Additional DoD guidance followed in 2009 and 2010. On May 28, 2009, the Deputy Secretary of Defense, William J. Lynn, issued a memorandum (the Lynn Memo) titled "In-sourcing Contracted Services—Implementation Guidance." The Lynn Memo directed DoD Components to "review all contractual services for possible in-sourcing," and it set a deadline for the DoD Components to submit individualized in-sourcing plans. As we detailed in a previous article on June 29, 2009, the centerpiece of the Lynn Memo is a "decision tree," by which DoD Components are to evaluate contracted services and, if necessary, determine whether certain functions can be performed by DoD civilian employees more cost effectively than a contractor. On January 29, 2010, DoD further clarified this "cost analysis"

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requirement in Directive-Type Memorandum (DTM) 09-007, which elaborated on the requirement that DoD Components must estimate and compare the full costs of civilian and military manpower versus contract support when making in-sourcing decisions.

As the Obama administration has made in-sourcing a focus of its cost-conscious acquisition reform policy, Congress has acted to apply the in-sourcing rules beyond DoD. In March 2009, Congress enacted Section 736 of the Omnibus Appropriations Act of 2009, Pub. L. No. 111-8, which requires civilian agencies to devise and implement guidelines for in-sourcing new and existing contracted-out functions. Accordingly, on July 29, 2009, the Office of Management and Budget (OMB) issued a Memorandum titled "Managing the Multi-Sector Workforce," and instructed each agency to consider the use of federal employees "to perform new functions and functions that are performed by contractors and could be performed by Federal employees." Similar to the guidance provided by DoD, OMB directed that this analysis should "include a cost analysis that addresses the full costs of performance and provides 'like comparisons' of relevant costs to determine the most cost-effective source of support."

The OFPP Proposed Policy Letter—"Work Reserved for Performance by Federal Government Employees"

On March 31, 2010, the OFPP issued a proposed policy letter (OFPP Letter) to clarify when work must be reserved for federal employees. The OFPP Letter makes the following policy proposals:

- The various definitions of "inherently governmental function" would be replaced by a single, government-wide definition—one previously used in the Federal Activities Inventory Reform Act (FAIR Act) of 1998, Pub. L. No. 105-270. Section 5 of the FAIR Act defines an inherently governmental function as "a function that is so intimately related to the public interest as to require performance by Federal Government employees."
- The OFPP Letter retains and endorses the list of examples of inherently governmental functions currently in FAR 7.503(c), such as commanding military forces, determining foreign policy and awarding or administering contracts.
- For all other functions not specifically identified as inherently governmental, the OFPP Letter proposes that agencies use two tests when determining whether a function is, in fact, inherently governmental.
  - The first—the "nature of the function" test—would ask agencies to consider whether the direct exercise of sovereign power is involved in the task; such functions are inherently governmental and should be performed exclusively by Government personnel. Examples of these functions are an ambassador representing the United States, a police officer making an arrest and a judge sentencing a person convicted of a crime.
  - The second test—the "exercise of discretion" test—would ask agencies to evaluate whether a contractor's exercise of discretion associated with the function would have the effect of committing the Government to a course of action, effectively preempting the Government's decision-making authority.
- The OFPP Letter also identifies criteria for determining when positions dedicated to performing "critical" functions must or should be reserved for federal employee performance. The OFPP Letter defines a critical function as one that is "necessary to the agency being able to effectively perform and maintain control of its mission and operations." Functions that would not risk causing mission failure if performed by contractors are not critical.

Interested parties from both the public and private sectors are invited to provide comments, which will be considered in the formulation of the final policy letter. All comments should be submitted via the federal regulatory portal http://www.regulations.gov, faxed to 202.395.5105 or mailed by June 1, 2010. *See* 75 Fed. Reg. 20397 (Apr. 19, 2010) (Correction to submission address). After public comments are considered and the policy letter is finalized, the FAR will be amended accordingly.

While the OFPP Letter proposes much needed guidance on inherently governmental functions, many questions remain. Will agencies take a measured approach when implementing these tests and performing cost analyses, or will they move beyond inherently governmental and "critical" functions into other areas in which contractors are currently providing excellent, cost-effective support? For a contractor facing the uncertainty involved with the

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in-sourcing process, perhaps the most important question is: In the event that an agency decides to cancel a solicitation or take your work in-house, what can be done?

Legal Challenges to Agency In-Sourcing Decisions

There may be several potential options available to contractors who wish to challenge an agency's in-sourcing decision. In addition to a protest directly with the agency, there are three fora where a contractor may potentially challenge the agency's decision to in-source work: (1) the Government Accountability Office (GAO); (2) the Court of Federal Claims; and (3) the Federal District Courts.

GAO is an attractive forum because a timely protest will require the Government to stay performance of the work pending GAO's resolution of the protest. Although GAO recently declined to hear a protest challenging an agency's decision to cancel a solicitation and perform the work in-house, the decision was founded on a narrow ground and does not preclude challenges on other bases. *See Aleut Facilities Support Services, LLC*, B-401925, Oct. 13, 2009, 2009 CPD ¶ 202. In *Aleut*, GAO held that the protestor failed to state a valid basis of protest based on 10 U.S.C. § 2463 because that statute, relied on by the protestor, does not require a cost comparison between the agency and outside contractors. However, a similar statute—apparently not cited to or considered by GAO—provides that the DoD "*shall* consider . . . the advantages of converting from one form of personnel (military, civilian, or *private contract*) to another for the performance of a specified job" and provide a "complete justification for converting from one form of personnel to another." 10 U.S.C. § 129a. (emphasis added). The Lynn Memo notes that the justification necessarily requires a "cost analysis to be conducted to determine whether DoD civilian employees or the Private Sector would be the most cost effective provider." As of the date this article was published, a protest at GAO under 10 U.S.C. § 129a remains an option.

At least one judge on the Court of Federal Claims has held that the court has jurisdiction to hear an incumbent contractor's challenge to an agency's decision to take the contractor's work in-house. *See LABAT-Anderson, Inc. v. United States*, 65 Fed.Cl. 570 (2005) (noting that the plaintiff alleged that the agency violated 10 U.S.C. § 2463 by failing to perform a cost comparison). In addition, a recent decision by the Federal Circuit supports the argument that the court has jurisdiction over challenges to agency in-sourcing moves. In *Distributed Solutions, Inc. v. United States*, 539 F.3d 1340, 1345 (Fed.Cir.2008), the Federal Circuit held that Tucker Act jurisdiction over "procurements or proposed procurements" "extends to all stages of the process of acquiring property or services, beginning with the process for *determining a need* for property or services and ending with contract completion and closeout." (Emphasis added).

Finally, a recent case demonstrates that Federal District Courts may be an appropriate forum to challenge an agency's decision to in-source work previously performed by contractors. In *Rohmann Services, Inc. v. Dep't. of Defense*, an incumbent small-business contractor performing a contract for audiovisual services at Edwards Air Force Base, CA, brought suit in the Western District of Texas (No. 10-CV-0061) under the Administrative Procedures Act seeking to enjoin the Air Force from in-sourcing its contract. The plaintiff argued that the in-sourcing decision—and the faulty cost analysis the Air Force used in support of this decision—was arbitrary and capricious. The Air Force subsequently decided to withdraw its in-sourcing decision and extend the contractor's contract term, thus rendering the action moot.

In anticipation of the possibility that work may be in-sourced, the wisest policy is to maintain detailed cost records so that you can demonstrate to the agency that your performance of the contract is more cost effective than if they brought the work in-house. In the event that the Government decides to take your work in-house or cancel a solicitation to perform the work itself, early consultation with counsel is critical. DoD and OMB will likely have more to say on this subject, and Wiley Rein will continue to keep you updated on any significant statutory or regulatory changes.

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House Armed Services Committee Continues Acquisition Reform Efforts

By Tracye Winfrey Howard

Following a year-long review of the defense acquisition system, the House Armed Services Committee's Panel on Defense Acquisition Reform on March 23, 2010, issued its final report and recommendations. The Committee established the Panel in March 2009 in response to a belief among Committee members that the defense acquisition system "was not responsive enough to today's mission needs, not rigorous enough in protecting taxpayers, and not disciplined enough in the acquisition of weapons systems for tomorrow's wars." The report reflects information gathered and conclusions drawn from the Panel's 16 hearings and briefings, as well as comments from the DoD and other stakeholders on the public interim report. Committee members, including Chairman Ike Skelton and Ranking Member Howard McKeon, on April 14, 2010, introduced H.R. 5013, the Implementing Management for Performance and Related Reforms to Obtain Value In Every (IMPROVE) Acquisition Act of 2010, to implement many of the Panel's recommendations. The Committee intends to incorporate H.R. 5013 into the House version of the National Defense Authorization Act for Fiscal Year 2011.

In general, the Panel found that the defense acquisition system continues to focus primarily on the acquisition of weapons systems, even though the majority of DoD contracting dollars is now devoted to acquiring services. In sharp contrast to weapons acquisitions, the military departments acquire most services without DoD management or oversight, resulting in what the Panel described as an ad hoc requirements process lacking any Department-wide strategy. The Panel also concluded that the defense acquisition system is "particularly poorly designed" for information technology (IT) acquisitions, causing defense IT systems to be two to three generations out of date before they are even delivered. Nor did DoD's traditional strength of acquiring cutting-edge weapons systems escape scrutiny. The Panel believes that the current system leads to development contracts that last far too long, resulting in decreased competition, cost overruns, numerous additional requirements, industry consolidation, few realistic opportunities for small and mid-sized companies, and most important, a failure to meet Warfighter needs in a timely manner.

The Panel made several recommendations aimed at expanding the industrial base and ensuring that DoD is "getting the most" from contractors. The Panel first noted that the current system of providing public notice of solicitations—simply posting the information to FedBizOpps—should be replaced by a more proactive effort to notify firms in relevant industrial classifications, particularly small businesses, about potential contracts. Another suggestion for expanding the industrial base was repeal of the requirement to withhold 3% of all contract payments in anticipation of taxes owed, which is currently scheduled to take effect in 2012. The Panel felt that the withholding might discourage tax-compliant commercial firms from entering the government contracts field and that DoD resources would be better spent on identifying and targeting serious tax delinquencies. To that end, although H.R. 5013 would require contractors to certify in their bids and proposals whether they have a "seriously delinquent tax debt" of more than $3,000, the proposed legislation does not include a repeal of the 3% withholding requirement.

The Panel heard testimony that some federal contractors have gained an unfair competitive advantage by providing low pay and benefits to their employees and violating employment laws.

While the Panel sought ways to increase competition and expand the universe of companies performing DoD contracts, it also made recommendations to heighten oversight of those contractors. Although it does not provide details, the report states that the Panel heard testimony that some federal contractors have gained an unfair competitive advantage by providing low pay and benefits to their employees and violating employment laws. The Panel recommended that DoD review and respond appropriately to an upcoming GAO report on the issue, as well as a recent GAO report on fraud and abuse in the Small Disadvantaged Veteran-Owned Business program. The Panel also expressed concern about the independence and effectiveness of the Defense Contract Audit Agency (DCAA). It recommended that DoD consider shifting responsibility for

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certification of contractor business systems outside DCAA or to independent teams within DCAA to avoid any conflict between DCAA's responsibilities for certifying the adequacy of contractor business systems and auditing the vouchers produced by those systems. To address this issue, H.R. 5013 would require that business system reviews be "performed by an audit team that does not engage in any other official activity (audit-related or otherwise) involving the contractor concerned."

The Panel concluded that DoD senior leadership needs a comprehensive ability to assess and manage acquisition performance to correct the problems the Panel identified in the report. An essential element of this performance assessment would be provided by expanded responsibilities for the Office of Performance Assessment and Root Cause Analysis (PARCA), which was formed only last year in response to the Weapon Systems Acquisition Reform Act, Pub. L. No. 111-23. The Panel envisions (and H.R. 5013 would require) that PARCA would audit acquisition performance DoD-wide, develop measurable goals for each program executive office, and reform or shift acquisition responsibilities from low performers—significant responsibilities for an office that has barely begun to perform its existing role. The Panel also proposed to enhance management of acquisition performance by establishing clear lines of authority for setting acquisition requirements, including reforming the Joint Requirements Oversight Council process to meaningfully consider cost assessments and input from combatant commanders, and revising benchmarks for obligation and expenditure appropriated funds during the acquisition cycle. H.R. 5013 focuses even more on financial management by establishing incentives for DoD components that produce auditable financial statements by September 30, 2017, and corrective measures for components that are unable to meet that deadline.

To appropriately align defense acquisition policy with DoD's acquisition priorities, the Panel stated that DoD should review DoD Instruction 5000.02 and other acquisition guidance to ensure they are appropriately applied to services and IT acquisitions and develop guidance for communicating mission needs with industry outside the context of specific procurements. This latter recommendation seeks to provide industry with sufficient information so that private sector investments in capacity, infrastructure and technology development correspond to DoD's future requirements. H.R. 5013 also addresses the current system's lack of emphasis on services acquisitions by proposing a revision to the Federal Acquisition Regulation to provide "appropriate references" to services contracting throughout.

Through Section 804 of the National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84, Congress already directed DoD to implement an alternative process for IT acquisitions. The report recommends that DoD consider including specific elements in that alternative process such as establishing clear performance metrics, developing alternative milestone decision points that are more in line with commercial IT development, revising contracting mechanisms and incentive structures, and focusing on an open architecture approach that would permit more modular "plug and play" hardware and software.

Continuing the recent Congressional focus on enhancing the number and skills of the acquisition workforce, the Panel recommended improvements to management, hiring and training of the acquisition workforce, particularly in the area of cost estimating. The Panel also encouraged DoD to establish clear, attractive acquisition career paths for both civilian and military personnel. To address these issues, H.R. 5013 would authorize a demonstration project for personnel management policies related to the DoD acquisition workforce.

Wiley Rein will continue to monitor these and other legislative developments that relate to government contracts issues. ■

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Recent D.C. Federal Court FOIA Decisions Favor Contractors

By Kara M. Sacilotto

On March 9, 2010, we issued an Alert on a recent decision by the United States District Court for the District of Columbia that held that the Army properly withheld from public release unit pricing for a government contract awardee, finding the information exempt under Exemption 4 of the Freedom of Information Act (FOIA), 5 U.S.C. § 522, which protects from disclosure confidential commercial or financial information. *See* "District Court for the District of Columbia Dismisses FOIA Action Seeking Contractor Unit Prices Citing Potential Substantial Harm to Competitive Position." On March 23, 2009, the United States Court of Appeals for the D.C. Circuit continued the trend of contractor-friendly FOIA decisions in *United Techs. Corp. v. Department of Defense*, No. 08-5435 2010 WL 1030053 (D.C. Cir. Mar. 23, 2009), a "reverse FOIA" action seeking to prevent disclosure of Defense Contract Management Agency (DCMA) evaluations of quality control processes used by Sikorsky Aircraft Corp. (Sikorsky) and the Pratt and Whitney Division (Pratt) of United Technologies.

The FOIA request for Sikorsky information was filed by a New Haven, CT, television station and sought all of the Corrective Action Requests (CARs) DCMA had issued to Sikorsky (and Sikorsky's responses) in the past year relating to the Black Hawk helicopter. After initially concluding that the CARs were competitively sensitive information under FOIA Exemption 4, DCMA reversed its position and notified Sikorsky that it planned to release the CARs (but not the Sikorsky responses). Citing *Nat'l Parks & Conservation Ass'n v. Morton*, 498 F.2d 765 (D.C. Cir. 1974), which held that Exemption 4 applies if disclosure is likely to impair the Government's ability to obtain necessary information in the future or cause substantial competitive harm, Sikorsky argued that release of the CARs would cause competitive harm because the CARs contain proprietary information regarding Sikorsky's manufacturing procedures. DCMA rejected this argument, stating that Sikorsky's asserted harm really concerned "suffering embarrassment in the marketplace." DCMA also rejected Sikorsky's claim that release of the CARs would harm the Government's ability to obtain data in the future, reasoning that this was a concern for the agency, but not Sikorsky.

The FOIA request for Pratt information was also a media request. It concerned an audit of a Pratt engine facility and related CARs. Like Sikorsky, Pratt also opposed release based on FOIA Exemption 4 and supported its opposition with proffered redacted documents and multiple affidavits describing the potential competitive harm that would result from release of the audit documents. DCMA rejected Pratt's arguments, again determining that Pratt's real competitive concern was "embarrassment," not substantial competitive harm, and that DCMA's ability to obtain similar data in the future would not be significantly impaired by release of the audit documents.

Sikorsky and Pratt each filed separate "reverse FOIA" actions against DoD in D.C. district court, and in both cases, the district court granted summary judgment to DoD. Although the district court acknowledged that release of the audit documents would reveal safety measures and quality control practices, it, like DCMA, concluded that Sikorsky and Pratt's main concern was "embarrassment or negative publicity," not competitive harm.

> In short, Exemption 4 does not apply to "mere embarrassment in the marketplace or reputational injury."

On appeal to the D.C. Circuit, Sikorsky and Pratt reiterated their arguments that release of the documents would cause substantial competitive harm and impair the Government's ability to obtain data in the future. The contractors made two arguments regarding competitive harm. First, they alleged that competitors would use the documents to discredit Sikorsky and Pratt with future potential customers, particularly foreign customers who would be unfamiliar with DCMA's exacting oversight and, as a result, would be more likely to conclude that the audit findings reflected serious shortcomings with the quality of the contractors' products. Second, they argued that the documents contained sensitive proprietary information about their quality control and manufacturing processes, including strengths and weaknesses of those processes, that a competitor could use to revise and improve its own quality control and manufacturing systems.

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The D.C. Circuit agreed with the district court that the first identified harm—being discredited with potential customers—was not recognized under Exemption 4. The court concluded that "[c]alling customers' attention to unfavorable agency evaluations or unfavorable press does not amount to an 'affirmative use of proprietary information by competitors.'" Slip op. at 11. In short, Exemption 4 does not apply to "mere embarrassment in the marketplace or reputational injury . . . ." *Id*.

The D.C. Circuit reversed the district court on the second ground, however. Here, the court noted that Sikorsky and Pratt had presented concrete evidence that competitors could use the proprietary information in the audit documentation, even as DCMA had proposed redacting it, to revise and improve their own processes. In response, DCMA presented no countervailing evidence, relying solely on its unilateral redactions and conclusory statement that the remaining material was not competitively sensitive. The court stated that "where, as here, a contractor pinpoints by letter and affidavit technical information it believes that its competitors can use in their own operations, the agency must explain why substantial competitive harm is not likely to result if the information is disclosed." *Id*. at 13. Because DCMA had no responsive explanation, the court remanded the matter to DCMA to examine the data and "articulate a satisfactory explanation for its action . . ." *Id*.

The court noted that Sikorsky and Pratt had presented concrete evidence that competitors could use the proprietary information in the audit documentation to revise and improve their own processes.

Notably, the court did not address the contractors' final ground for opposing release of the documents—that release would impair the Government's future ability to obtain information. Citing *McDonnell Douglas Corp. v. NASA*, 180 F.3d 303 (D.C. Cir. 1999) and other decisions, the court noted that "[p]recedent suggests that it may be inappropriate to apply this prong [of Exemption 4] in a reverse-FOIA case." *Id*. at 14. Because it had remanded the case to DoD on the substantial competitive harm issue, the court did not resolve the issue.

In addition to adding to the contractor-friendly body of FOIA law, *United Techs. Corp.* is instructive to contractors faced with an FOIA request for competitively sensitive information. First, the decision makes clear that claims of competitive harm that rest upon reputational damage, marketplace embarrassment, or fear of lost customers will not fare well. Second, to support their claims of competitive harm, contractors should be prepared to submit detailed affidavits or declarations that specifically identify how competitors could use the information to be released to their own competitive advantage or to improve their own competitive standing. Lastly, contractors should not rely unduly on the Exemption 4 prong related to harm to the Government, particularly in a reverse-FOIA action. ■

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"High Road" Procurement Policy Would Favor Contractors That Offer Better Levels of Pay, Health Care and Benefits

By John R. Prairie

The federal contracting community has been abuzz the past several months over the Obama administration's controversial, but still unannounced, "High Road" contracting policy that would require agencies to favor contractors that pay higher wages and benefits to their employees. Reminiscent of the so-called "blacklisting" rules issued by the Clinton administration nearly 10 years ago, the new plan has the potential to materially alter the way contractors are evaluated in federal procurements.

As first reported by *The New York Times* in late February, the "High Road" procurement policy would give an edge to contractors in federal procurements that offer higher levels of pay, health coverage, pensions and other benefits. Although the White House has yet to make any official announcements regarding the proposal, early reports indicate that the administration intends to use a central office to assign scores to prospective contractors based on how they treat their employees. This office would likely be located within the Department of Labor or the OMB, and would assess the wages and benefits paid to a contractor's entire workforce, not just the employees working on federal contracts. Agencies may also be required to create a new position for a labor standards evaluator. Modeled after the federal small and disadvantaged business officers, this individual would be responsible for reviewing offerors' wage and benefits practices, and may have the power to vary the assigned score.

Many have compared the "High Road" plan to the so-called "blacklisting" rules issued by the Clinton administration. In December 2000, the Federal Acquisition Regulation (FAR) was amended to require contracting officers to take into account a company's compliance with tax, labor and employment, environmental, antitrust and consumer protection laws when determining whether a contractor is "responsible" to perform a particular contract. 65 Fed. Reg. 80,256 (Dec. 20, 2000). A consortium of business groups, led by the U.S. Chamber of Commerce and represented by Wiley Rein LLP, challenged the rule in federal court. The rule was ultimately vacated by the Bush administration soon after taking office.

The new proposal has been met with sharp criticism by business groups and contractors. Some have suggested that the Obama administration intends to use the plan as a way to shape social policy and lift more families into the middle class. Others have argued that the plan favors organized labor, as it would likely provide an edge to companies that offer wage and benefits packages designed by labor unions. Many in the contracting community argue the policy would have a detrimental impact on small businesses, which do not provide rich benefits, and that it may increase overall contract costs as contractors pass these additional costs on to the Government. Several industry groups have also noted that the Government already has sufficient tools at its disposal to ensure that federal contractor employees are paid a fair wage, including the Service Contract Act, Davis-Bacon Act and Walsh-Healey Act, all of which require that federal contractors pay their employees certain minimum wages and benefits.

Many in the contracting community argue the policy would have a detrimental impact on small businesses.

Although the specific details of the plan are still being ironed out behind closed doors, the "High Road" procurement policy is something that should have all federal contractors' attention. Whether the policy is ultimately implemented as part of a responsibility determination or an additional evaluation factor, it appears likely that the wage and benefits packages they provide will soon be viewed by agencies as more than simply a recruitment and retention tool. Contractors would be wise to begin looking at how they stack up against their competitors in this area, as it could very well be the difference between winning and losing future contract awards. ■

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