



# Arrow COVID-19 Communication

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## COVID-19 UPDATE: The Defense Production Act Your Rights & Obligations

On March 18, President Donald J. Trump issued an executive order invoking the Defense Production Act (DPA). Here is how the DPA might affect your business.

### What Is It?

Congress originally enacted the DPA in 1950 to give the President the power to take actions he deemed necessary to ensure production of wartime materiel and to provide financing to suppliers. Over time, the DPA has been updated to reflect current federal agencies and modern times through Executive Orders, including those issued by Presidents Bill Clinton (EO 12919) and Barack Obama (EO 13603). As the DPA currently stands, it gives the President broad powers to:

- Require that civilian contractors give the government priority in completing certain contracts and task or delivery orders (50 U.S.C. § 4511(a)(1));
- Allocate materials, services, and facilities as he deems necessary to promote the national defense (50 U.S.C. § 4511(a)(2));
- Designate “scarce materials,” and declare hoarding of scarce materials illegal (50 U.S.C. § 4512);
- Authorize government agencies to guarantee loans supporting production capability necessary to “create, maintain, expedite, expand, protect, or restore production and deliveries or services essential to the national defense” (50 U.S.C. § 4351(a)(1)); and
- Authorize direct government loans to businesses for the “creation, maintenance, protection, or restoration of capacity, the development of technological processes, or the production of essential materials, including the exploration, development, and mining of strategic and critical metals and minerals” (50 U.S.C. §4532(a)).

### Limitations on the DPA

The DPA does place some limits on the President’s power to act without Congress. In particular, the President may not use his powers under the DPA to:

- Implement wage or price controls (50 U.S.C. § 4514(a));
- Allow an agency to require any private entity to assist in the production of chemical or biological warfare by agency action (though he may do so himself) (50 U.S.C. § 4514(b)); or
- Ration gas as between different classes of end-users (though a general gas rationing program appears to be OK) (50 U.S.C. § 4515).

### Priority in Contract Completion

Your biggest concern with the President’s invocation of the DPA is likely prioritization of government contracts. In particular, the President (or the agency delegate) can require a contractor deemed capable of performing a contract or order to accept the government’s contract “*in preference to other contracts or orders by any other person.*”

50 U.S.C. § 4511(a).

So, not only can the government require you to deliver its goods and services before anyone else, it can force you to accept a contract, then make you perform right away. The order does not have to follow particular formalities or come from a high-ranking official. *E. Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957, 994 (1976).

### **Protection from Customer Lawsuits**

Naturally, if you have to drop everything and fill the government's requirements before your other customers, the other customers are going to be irate. And they may even sue. Fortunately, the DPA provides a defense: "No person shall be held liable for damages or penalties for any act or failure to act resulting directly or indirectly from compliance with a rule, regulation, or order issued pursuant to this chapter[.]" 50 U.S.C. § 4557. Even if a court finds that the rule, regulation, or order was invalid, a contractor may still invoke § 4557's protection. *Id.* This statutory defense encodes the common law concepts of impossibility of performance and excusable delay, and it applies whether the contractor "resisted" the government order or the order was technically deficient under the DPA. *E. Air Lines, Inc.*, 532 F.2d at 994-98.

Note, however, § 4557 **does not** provide a mechanism for a supplier to seek indemnification from the government if the product or service fails or causes harm to third parties. *Hercules, Inc. v. United States*, 516 U.S. 417, 429-30 (1996). For this reason, we are recommending special contractual provisions.

### **Procurement Framework**

This Client Alert uses the procurement procedures of the Department of Health and Human Services (HHS) since it is the major agency player in the current crisis. HHS regulations for filling priority national needs under the DPA are found at Title 45, Part 101, Subpart A of the Code of Federal Regulations. Other federal agencies have similar frameworks meriting review if at issue.

### **Rated Orders**

A "rated order" is "a prime contract, a subcontract, or a purchase order in support of an approved program issued in accordance with" 45 C.F.R. Part 101. 45 C.F.R. § 101.20. HHS's regulations create three tiers of rated orders. In ascending order:

- The first tier, the "DO" rating, takes priority over all unrated—that is, nonpriority—contracts. 45 C.F.R. § 101.31(a)(2);
- The second tier, the "DX" rating, takes priority over all DO-rated contracts and nonpriority contracts. 45 C.F.R. § 101.31(a)(2).
- The final tier requires a "Directive" from HHS telling the contractor that the contract takes priority over all other orders. 45 C.F.R. § 101.31(a)(3).

For an order to be "rated," it must contain certain elements:

- the appropriate priority rating;
- the required delivery date;
- a signature (written or electronic) from a person authorized to sign rated orders certifying the rated order is authorized under Part 101 and the agency followed Part 101's requirements;
- statement substantially reading "This is a rated order certified for national defense use, and you are required to follow all the provisions of the Health Resources Priorities and Allocations System regulation at 45 C.F.R. part 101." If the order supports emergency preparedness and requires expedited action, it should also include a statement that "This rated order is placed for the purpose of emergency preparedness. It must be accepted or rejected within two (2) days after receipt of the order if: (A) The order is issued in response to a hazard that has occurred; or (B) If the order is issued to prepare for an imminent hazard, as specified in HRPAS § 101.33(e)."

45 C.F.R. § 101.32.

**It is not a good idea to refuse a rated order if it does not comply with formalities, and even if informal, you receive protections under the DPA if you do not meet a deadline for a non-rated order. The DPA has significant teeth, with potential criminal penalties of a \$10,000.00 fine and up to a year in jail.**

50 U.S.C. § 4513.

### **Who Can Place a Rated Order?**

Obviously, HHS can place rated orders. HHS regulations also allow “persons”<sup>1</sup> to place rated orders under certain circumstances.

Persons **must** use rated orders to acquire:

- Items that will be physically incorporated into other items to fill rated orders, including material consumed in making the items;
- Containers or packing material needed to fill rated orders;
- Services other than contracts of employment needed to fill rated orders; and
- “MRO”<sup>2</sup> needed to produce the finished items or fill rated items.
- 45 C.F.R. § 101.37(a). Persons **may** use rated orders to replace inventoried items that it used to fill rated orders if:
  - They place the order within 90 days of when they used the inventory; and
  - They use a “DO” rating, not a “DX” rating.

45 C.F.R. § 101.37(b).

#### Example 1: MaskCo

MaskCo makes surgical masks. These are a high-priority item, and you receive a delivery order from HHS for 10,000 surgical masks with a DX rating. If MaskCo does not have any other DX-rated orders or “directive”-rated orders, outside of certain circumstances, it **must** fill that order ahead of any other orders.

#### Example 2: MaskCo

In the same scenario: MaskCo assembles masks from cloth and string purchased from its suppliers. If MaskCo does not have enough cloth and string in inventory to fulfill its contractual obligation, it must place DX-rated orders with its suppliers for sufficient material to fulfill the order for 10,000 surgical masks. However, if MaskCo uses its inventory to fulfill the order (or part of it), it **may** place DO-rated orders for replacement inventory, as long as it does so within 90 days of using its inventory.

### **Acceptance or Rejection of a Rated Order**

“Wait, I thought that I had to accept orders and contracts and orders under the DPA?” That is generally true. For most orders, acceptance is mandatory, and the contractor may not discriminate against the government order (by, say, charging a higher price than to other purchasers). 45 C.F.R. § 101.33(a). But there are some orders that a contractor **must** reject, and some it **can** reject.

#### **Orders You Must Reject**

There are four types of rated orders you **cannot** accept, “unless otherwise directed by HHS for a rated order involving all forms of health resources”<sup>3</sup>:

- A rated order specifying a date of delivery you can’t meet. You must, however, inform the person placing the order the earliest date you **can** fulfill the order. **You may not reject a rated order because it conflicts with a lower-rated or unrated order, including from your non-government customers.**
- DO-rated order that would conflict with a previously accepted DO- or DX-rated order. You must offer to accept based on the earliest delivery date you can meet without a conflict.
- DX-rated order that would conflict with any previously accepted DX-rated order. Again, you must offer to accept based on the earliest delivery date you can meet without a conflict.
- If you receive multiple rated orders of equal priority, and can’t fill them all, you must accept them in order of delivery date until you can no longer meet a delivery date. And, once again, you must offer to accept the contracts you can’t fill based on the earliest delivery date possible.

45 C.F.R. § 101.33(b).

#### Example 3: MaskCo

MaskCo has a capacity of 15,000 masks a month. On March 1, it receives a DO-rated order for 10,000 masks from HHS for delivery on April 1. MaskCo already has pending, non-rated and/or commercial orders for 12,000 masks on April 1. MaskCo **must** accept the HHS order.

MaskCo has a capacity of 15,000 masks a month. On March 1, it receives a DO-rated order for 10,000 masks from HHS for delivery on April 1. On March 2, it receives a DX-rated order for 15,000 masks. MaskCo must **accept** the DX-rated order, and inform the person placing the first order of the conflict and when it can deliver the first-ordered masks.

#### Example 4: StringCo

StringCo makes strings for surgical masks. It has never done business with MaskCo before. On March 1, it receives a DO-rated order from MaskCo for 10,000 strings deliverable on March 15. StringCo has 10,000 strings in inventory earmarked for delivery to Surg-O-Mask, a MaskCo competitor on a normal, unrated commercial contract. StringCo **must** accept the MaskCo order and deliver 10,000 strings by March 15, even if it cannot supply string to Surg-O-Mask.

#### Example 5: StringCo

StringCo has an inventory of 10,000 strings, and a production capacity of 5,000 strings per month. On March 1, StringCo receives a DO-rated order from MaskCo for 10,000 strings deliverable March 15. On March 2, StringCo receives a DO-rated order from Surg-O-Mask (a longtime and valuable customer) for 5,000 strings deliverable on March 14. StringCo must accept the MaskCo order and reject the Surg-O-Mask order but inform Surg-O-Mask that it can fill the order on April 1 if acceptable.

#### Example 6: StringCo

Same facts as Example 5, but the Surg-O-Mask order is DX-rated. StringCo must accept the Surg-O-Mask order (if it still has the 10,000 strings in inventory) and deliver Surg-O-Mask 5,000 strings by March 14. It must inform MaskCo that a higher-priority order superseded its order, inform MaskCo that it can fill 5,000 strings (plus as many as it can produce) by March 15, and deliver the remainder by April 1.

There are five types of rated orders you **may** reject, unless “otherwise directed by HHS for a rated order involving all forms of health resources”:

- If the person making the rated order is unwilling or unable to meet regularly established terms of sale or payment;
- If you do not supply the particular item or cannot perform the requested service;
- If you only produce, acquire, or provide the item or service for your own use, and have not filled any orders for that item or service for the last two years. If you have sold similar items or services, or some of the items or services, required, you must accept up to the quantity you’ve produced or provided over the last two years;
- If the person placing the rated order (unless it’s the government) makes the item or provides the services itself;
- If acceptance would violate any regulation, official action, or order from HHS.

45 C.F.R. § 101.33(c).

#### Example 7: Surg-O-Mask

Surg-O-Mask makes surgical masks, using cloth it makes for itself and sourcing the string from StringCo. On March 1, it receives a DX-rated order from MaskCo for enough cloth to make 10,000 surgical masks. Surg-O-Mask **may** refuse the order so long as it has not sold cloth to any other person in the last two years.

#### Example 8: LinenLtd

Though Surg-O-Mask makes its own cloth, it uses LinenLtd for surge capacity. On March 1, Surg-O-Mask places a DX-rated order for enough cloth to make 10,000 masks deliverable on March 15. LinenLtd **may** refuse the order because Surg-O-Mask makes cloth for its own use.

#### Example 9: CottonCo

Both Surg-O-Mask and LinenLtd source cotton from CottonCo. On March 1, CottonCo receives DO-rated orders for enough cotton to make fabric for 20,000 masks from both Surg-O-Mask and LinenLtd. CottonCo has a strict Net 30 payment policy for invoices. Surg-O-Mask will not agree to Net 30 payment, saying that HHS will not pay it for masks for 60 days. CottonCo **may** refuse Surg-O-Mask’s order because it is unwilling or unable to meet regularly established terms of sale or payment.

Example 10: BandanaInc

BandanaInc makes bandanas. With some minor retooling, it can make surgical masks. On March 15, it receives a rated order from HHS for 10,000 surgical masks deliverable on April 15. BandanaInc can retool in time to meet the order. BandanaInc **may** refuse the order, even though it could meet the government’s requirements, because it does not make surgical masks. Note, however, that if it receives a directive from HHS to retool and make the masks, it must comply.

**If a person places a rated order with your company, you must accept or reject within fifteen days, either electronically or in writing. If you reject the rated order, you must provide a reason why. 45 C.F.R. § 101.33(d). But, if the rated order is for “emergency preparedness,” you must accept or reject within two days. 45 C.F.R. § 101.33(e). Maynard Cooper expects most rated orders will be for emergency preparedness, since that term encompasses “[m]easures to be undertaken during a hazard.” 45 C.F.R. § 101.20. That applies to the current health crisis.**

Moving Forward

Again, the President has delegated authority to the Secretary of Health and Human Services to determine the proper allocation of national resources in fighting Coronavirus. In the next several days, HHS will be coming up with “approved programs” as necessary to promote the national defense. To do this, HHS will likely engage in some notice-and-comment rulemaking under the Administrative Procedures Act (APA).

The APA requires an agency to publish a proposed rule in the Federal Register and allow at least 30 days for interested persons to comment. 5 U.S.C. § 553(b). And procurement regulations issued under the DPA must go through a 60-day notice-and-comment period absent “compelling circumstances.” 41 U.S.C. § 1707(a); 50 U.S.C. § 4559(c). If “urgent and compelling circumstances” require immediate action—as is likely in the current crisis—an agency can waive the requirement for notice and comment before publishing a final rule. 41 U.S.C. § 1707(d). The new regulation can only issue on a temporary basis, and the agency must provide for a 30-day comment period after publication of the new rule.

41 U.S.C. § 1707(e).

Once HHS creates its new approved programs, you will begin to see rated orders. Though it is likely the government will first attempt to fulfill needs through its existing federal supply schedule holders, it is also likely that current FSS holders will be unable to fulfill the government’s needs. So even if you do no government work at all, if you produce (or have the capability to produce) goods or supply (or have the capability to supply) services that Secretary Azar determines are necessary, you may receive a rated order from the government. If you have any questions about compliance, Maynard Cooper stands ready to assist you.

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<sup>1</sup> “Person includes an individual, corporation, partnership, association, or any other organized group of persons, or legal successor or representative thereof, or any State or local government or agency thereof.” 45 C.F.R. § 101.20.

<sup>2</sup> Maintenance, repair, and operating supplies. 45 C.F.R. § 101.20.

<sup>3</sup> “Health resource means drugs, biological products, medical devices, materials, facilities, health supplies, services and equipment required to diagnose, mitigate or prevent the impairment of, improve, treat, cure, or restore the physical or mental health conditions of the population.” 45 C.F.R. § 101.20.