



A New Era for Department of Energy Contractors and Subcontractors

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On June 19, 1991, the Department of Energy issued a final rule that fundamentally alters the longstanding Government/contractor relationship with its Management and Operating (M&O) contractor has existed for over 45 years and introduces a host of new uncertainties into the relationship. The rule also affects some DOE cost-type support contractors and includes new protections for fixed price subcontractors of M&O and cost-type support contractors.¹

Background

The DOE M&O contractor relationship originated in the War Department's Manhattan Engineer District (MED) project to develop the atomic bomb. Following World War II, Congress enacted the Atomic Energy Act of 1946, which transferred the MED nuclear production and R&D facilities to the Atomic Energy Commission (AEC), and authorized AEC to contract or continue in effect the MED contracts for these facilities. The legislative history of the AEC Act refers to these contracts as "management contracts."²

From that beginning, there evolved a long-term, novel cost-type contractual relationship with independent companies, nonprofit organizations, and universities to manage and operate the Government-owned facilities as well as with other cost-type contractors (e.g., architect-engineer and construction), most of whom received a "management allowance." The AEC protected these contractors against virtually all major financial risk, including loss of or damage to government property, third party claims, and fines and penalties, by treating such costs as allowable and paying them under the contract.³ The relationship was characterized by AEC as that "between industrial companies and their branch offices."⁴ In short, both the Congress and the AEC recognized that the Government did not have the expertise or resources and skills to manage and operate its nuclear production research facilities.

In 1974, the Congress abolished the AEC and transferred its authority and the Government-owned facilities to the Energy Research and Development Administration; and in 1979 transferred them to DOE. However, the basic "management contract" concept remained in effect until the recent DOE policy and contract changes.

This article outlines DOE's changes and assesses their impact and likely result. The changes are an appropriate reaction to political pressure, are replete with ambiguities, will cause confusion, delays in performance, increased costs, disputes, a heightened adversarial relationship between DOE and affected contractors, and will expose affected contractors and subcontractors to new and uncertain financial risks.

The New DOE Concept

DOE's new policy and contract clauses—applicable to what it classifies as profit-making contractors—impose significant limitations on allowability of so-called avoidable costs, which are: fines and penalties, direct

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bonds and insurance, loss of or damage to Government property, and litigation expenses and judgments. DOE stated rationale is that management and operation of its facilities will be enhanced by holding some profit-making M&O contractors responsible for these costs in the same manner as a company or organization conducting its own business. Conceptually, the increased financial risks would be offset by a larger fee if the contractor performs well. However, the rule also contains a new award fee system that could require forfeiture of up to 50 percent of the basic fee for marginal or unsatisfactory performance. To offset some of the risks, DOE puts a cap on the new award fee for unallowable costs, *i.e.*, with some exceptions, they will not exceed the contractor's fee earned in a particular award fee evaluation period.

DOE acknowledges that its M&O contractors occupy an "unusual" position because they "lack control over funding, authorization, and . . . hiring and control of their employees." Moreover, "they operate in a heavily regulated environment." Nothing in the new rule waives DOE control over these areas, over the work to be performed, or over subcontracting by its M&O contractors. Nevertheless, DOE has imposed additional financial risks on those contractors it classifies as profit-making. The comments on the rule do not indicate what has changed in the relationship between DOE and its M&O contractors that warrants the assumption of these new liabilities by the M&Os, *i.e.*, what the contractors are doing differently today that has created the need for the new rule.

DOE's Revised Acquisition Regulation

Nonprofit and Profit-Making M&O Contractors and Subcontractors

The new rule contains important exclusions from coverage for "nonprofit" M&Os, small businesses, and certain subcontractors. DOE defines a nonprofit M&O contractor as "one which receives no fee and is considered nonprofit under the laws where it is incorporated."⁸ This definition is not limited, however, to entities that are nonprofit in the accepted traditional sense. Under the rule, a contracting officer (CO) is authorized to treat a contractor "whose particular corporate organizations or circumstances . . . warrants such consideration" and the contractor is a nonprofit organization as defined in 35 U.S.C. 201(i).⁹ All other M&O contractors are considered profit-making.⁸

Interestingly, DOE appears to have classified a majority of its M&O contractors as nonprofit even though some do not meet its nonprofit definition. In comments on the rule, DOE states it will treat as nonprofit the present M&O contractors for Sandia National Laboratories (Sandia Corp., a wholly owned subsidiary of AT&T), Bettis Atomic Power Laboratories (Westinghouse), and Knowles Power Laboratory (General Electric).⁹ DOE also lists 20 major R&D facilities operated by universities and other not-for-profit organizations treated as "nonprofit," even though they are paid a fee or "management allowance." Westinghouse is treated as nonprofit for one of its M&O contracts and profit-making for its other M&O contracts.

The new provisions do not apply to small businesses (SB) and small disadvantaged businesses (SDB), or to a nonprofit subcontractor of a profit-making M&O contractor.¹⁰ Moreover, they do not appear to apply to a profit-making subcontractor of a nonprofit M&O contractor. In comments regarding fines and penalties incurred by a subcontractor, DOE states that such fines and penalties are allowable if the subcontractor is nonprofit.¹¹ Nothing in the rule requires an M&O classified as a nonprofit contractor to absorb the new unallowable costs or include them in its subcontracts.

DOE's statement accompanying the new regulation says that it *does not* apply to environmental restoration contractors who are *not* M&O contractors,¹² but *does* apply to environmental restoration subcontractors of M&O contractors. Presumably, the subcontractor exclusions for SB and SDB apply.

[As used below, "nonprofit M&O contractor" means one exempt from, and "profit-making M&O contractor" means one subject to, the new unallowable costs and liabilities.]

Fines and Penalties

The new DOE rule and the contract clause for profit-making M&O contractors make fines and penalties unallowable for "an area of responsibility *clearly placed* on the contractor and/or the subcontractor."¹³ (Emphasis added.) However, the rule does not contain any guidance concerning the meaning of "clearly placed." If DOE shared in the decision for the action or inaction that resulted in the fine or penalty, presumably the responsibility would not be "clearly placed" on the contractor. Therefore, contractors (and subcontractors) that

previously accepted oral instructions from DOE will cease to do so. The contractor will want a record of DOE involvement in the decision. Therefore, a conservative contractor obviously would insist that all direction from the CO be written—a process guaranteed to cause contention and delays. It should be noted that the definition of “fine or penalty” encompasses both those imposed in a civil enforcement action and those resulting from a criminal conviction.

Also problematic is the fact that the rule and the contract clause for nonprofit M&Os are inconsistent. The rule states that it is DOE policy to reimburse nonprofit M&O contractors for fines and penalties that are the result of willful misconduct or bad faith, the contract clause for nonprofit M&O contractors is considerably narrower in scope providing only that fines and penalties are allowable costs when incurred in compliance with the scope of work, specific terms and conditions, or advance written instructions from the CO.¹⁴ The limitation of the clause to fines and penalties incurred in specific compliance with the contract scope of work or terms and conditions or advance written instructions from the CO guarantees that contractors will not exercise judgment in questionable areas without explicit instruction from the contract or the CO. Unfortunately, the language of the clause implies that DOE will view fines and penalties that are incurred in circumstances other than those permitted in the clause as constituting bad faith or willful misconduct. Both the clause for profit-making M&Os and the clause for nonprofit M&Os provide that Price-Anderson Act fines and penalties and related litigation costs are unallowable except as covered by (yet to be promulgated) DOE regulations.¹⁵

DEAR 970.3102-21(b)(3) enumerates the factors that a CO “shall” consider in reviewing a contractor’s request for payment of fines and penalties. It also states that the criminal fines and penalties will be paid only in “extraordinary circumstances” and that the final decision will be made by the DOE Procurement Executive in the concurrence of the DOE General Counsel.

DOE’s new policy statement and contract clause for profit-making M&O contractors are clearly intended to make most fines and penalties unallowable costs. The unanswered question is when fines and penalties will be considered within an area of responsibility “clearly placed” on the contractor or a subcontractor.

DOE states there is an exception to unallowability in a situation where the contractor is required to perform a task which results in a possible violation of law. But DOE also states that “the Contracting Officer has no legal contractual basis for authorizing contractors to violate public laws and regulations.”¹⁶ Thus, any such requirement, authorization, or approval would now seem to be void *ab initio*, the contractor’s compliance with any contractual obligation, and the resulting fine or penalty unallowable. This result appears to occur despite the fact that the CO and the contractor might both be acting in good faith.

Direct Costs

DOE has added a contract clause for profit-making M&O contractors making unallowable those direct costs that are avoidable, *i.e.*, incurred as the result of negligence or misconduct by the contractor’s—or a subcontractor’s—personnel.¹⁷ Examples of costs included in the clause are additional expenses for R&D and production, third party claims, and litigation expenses.¹⁸

It is not clear at what point the decision whether an avoidable cost is unallowable will be made. If it is possible in the first instance to tell whether negligence has resulted in the cost, the contractor (or subcontractor) may have already been reimbursed for it. Tracking these unallowable costs apparently will require the contractor to maintain separate records which allocate salary and wages, as well as other expenditures, to those which are unallowable as avoidable cost and pay that part of salary, wages and other expenditures from its own funds rather than DOE funds made available to pay allowable costs.¹⁹ Apart from the need for new management controls, increased overhead and delays in performance this can cause, the contractor may be subject to liability under the False Claims Act and False Statements Act and debarment for mistakes in allocating such costs to the contract and paying them from DOE funds.

In a comment on the new rule, DOE states an M&O contractor is liable for avoidable costs incurred by a subcontractor only if the M&O contractor is *responsible*, in whole or part, for the subcontractor’s actions which resulted in such costs.²⁰ To the extent this statement actually modifies the above contract clause it leaves unclear what is meant by “responsible.” Presumably, DOE will determine whether the contractor’s negligence contributed to the cost. This possibility creates the potential for significant disputes between the contractor and its various subcontractors.

Loss of or Damage to Government Property

DEAR 970.5204-21(j) is a new subsection to the contract clause for Government property that makes a profit-making M&O contractor liable for direct costs and expenses to repair or replace Government property damaged as the result of contractor or subcontractor negligence or willful misconduct. The subsection applies to costs resulting from circumstances *clearly* within the contractor's or subcontractor's "sole and exclusive control" where exercise of reasonable care would have avoided the loss or damage. In addition, direct costs and expenses resulting from such damage to Government property caused *in part* by third parties (e.g., another DOE contractor) other than DOE are unallowable.

DOE's comments in response to a question concerning this provision in the Interim Rule state that the contractor will not be held liable for damage caused by a third party unless there is negligence on the part of the M&O contractor or subcontractor.²¹ Where the M&O contractor has liability, DOE states that allocation of financial responsibility should be determined by the parties.

This subsection also makes the M&O contractor liable for loss of or damage to Government property due to theft, embezzlement, unauthorized use, or *ultra vires* activity by contractor or subcontractor personnel. However, another contract clause states that this subsection does not apply to loss or damage caused by a SB, SDB, or nonprofit subcontractor.²²

This new avoidable unallowable cost provision exposes a profit-making M&O contractor to significant financial risks. There is little policy guidance regarding the intent or meaning of the phrase "clearly within . . . sole and exclusive control."²³ In addition, that limitation on liability apparently is not included in the contract language holding the M&O contractor liable for theft, embezzlement, etc.

While the new subsection does not refer to loss or damage caused by another M&O contractor, it may be implied that such contractor may be considered a "third party" within the meaning of the clause. If the other M&O contractor is classified as nonprofit, its DOE contract does not impose the new liability and a profit-making M&O contractor cannot pass on any part of its financial responsibility to the other M&O contractor.

This subsection does not expressly exclude loss or damage to Government property caused by a "nuclear incident." However, the "nuclear incident" indemnity clause included in DOE M&O contracts protects the contractor from liability for such loss or damage and states that that clause is not limited by any other clause in the contract.²⁴

Insurance

DEAR 970.5204-13(e)(36)(i) adds a provision to profit-making M&O contracts which makes unallowable the cost of insurance to cover otherwise unallowable avoidable costs except when required by the CO. The DOE policy statement in DEAR 950.7011(c)(2) provides that the contractor *may* be reimbursed for insurance against non-nuclear risk above the contractor's liability cap as approved by the CO. (See *Ceiling on Certain Liabilities, infra.*)

The DOE rule contains no policy guidance on when a CO may require or approve otherwise unallowable insurance costs. In its comments in response to a question concerning the insurance clause in the proposed rule, DOE states that it would be inconsistent for DOE to disallow a cost and reimburse a contractor for the cost of insuring against the disallowed cost. DOE states that the premiums for insurance against unallowable costs "are properly a portion of the contractor's overhead, to be offset against his profits in the same manner as most commercial manufacturers are required to do."²⁵ With respect to non-M&O contractors (ERMCs and others), the rule states that while it is DOE policy to require insurance against non-nuclear risks (e.g., hazardous waste), there may be circumstances where a "contractual indemnity" may be necessary to protect a contractor against uninsurable non-nuclear risks. This provision strongly suggests that where pollution insurance is not available, DOE will consider indemnification.²⁶

Because third party claims resulting from negligence of a profit-making M&O contractor's employee (e.g., automobile accident) are not allowable, the contractor apparently will no longer be covered under DOE's separate insurance agreements for the cost of such claims. It is our understanding that the contractor can submit an automobile accident claim to DOE's insurance contractor who will handle the claim if it determines the employee was not negligent. If DOE's insurance contractor takes on the claim but a court decides the employee was

negligent, presumably the insurance contractor will not pay the judgment because it is unallowable. result in more disputes between the M&O contractor and DOE.

Litigation and Claims

The new litigation and claims clause to be included in profit-making M&O contracts makes significant changes with regard to litigation and claims by and against the contractor.²⁷ While DOE may retain control over litigation and claims if it so chooses (subject to the Major Fraud Act)²⁸, the contractor is exposed to paying expenses and judgments from its own funds and filing a claim for reimbursement under the Contract Disputes Act. This almost certainly will entail lengthy delays and additional out-of-pocket expenses, and in so doing exacerbate the adversarial nature of the relationship between the contractor and DOE.

The new clause states that DOE *may* reimburse the costs of litigation and judgment against the contractor notwithstanding the new unallowable avoidable costs discussed above. This is an illusory commitment because DOE does not constitute a legal obligation to do so.

Determining Avoidable Costs

The clause governing the determination of avoidable costs provides that unallowable avoidable costs are incurred: (i) when the work is *clearly* within the "sole and exclusive control" of the contractor or subcontractor; or (ii) the increased costs or expenses result from actions or inactions of the contractor or subcontractor; and DOE is not responsible in any way.²⁹ The clause applies the "sole and exclusive control" limitation to avoidable costs, including theft, embezzlement, etc. of Government property. While this clarification of the contract at DEAR 970.5204-21(j) (government property) would seem to modify the contractor's potential financial liability, the ultimate effect both for that clause and other clauses is uncertain because nothing in the rule debarment provides policy guidance as to what "clearly" and "sole and exclusive control" mean.³⁰ In addition, the new rule and penalties clause for profit-making M&O contractors³¹ appears to change the standard by stating that it is unallowable for an "area of responsibility clearly placed on the contractor" rather than a matter within the contractor's "sole and exclusive control." Moreover, determining whether DOE was "in any way" responsible for apportioning that responsibility likely will create a whole new series of disputes.

M&O Contractor Fees

Also of interest is the treatment of fee schedules. The rule makes changes in the fee schedules for M&O contractors depending on the type of facility involved.³² It ostensibly authorizes higher fees for activities deemed to involve more risks—technical, management, and financial—as incentives to achieve higher levels of performance, and to offset the effect of the new unallowable cost provisions.

While the new fee schedules are perhaps valid in theory, there are real questions as to whether they will result in higher fees and net income. The increases in unallowable costs likely will reduce the base for DOE's calculation of the maximum fee. Because a fee is not a net profit, the additional unallowable costs a profit-making contractor must absorb may result in significantly lower profit than the contractor made under the fee schedule.

Ceiling on Certain Unallowable Costs

DEAR 970.5204-55 is the new clause which provides that a profit-making contractor's financial liability for certain avoidable costs are *capped* at the amount of basic and award fee earned during the periods when the costs or liabilities were incurred or determined. The following are expressly excluded from the liability cap: (i) criminal fines and penalties and (ii) insurance covering unallowable costs. In addition, costs incurred under the Major Fraud Act of 1988 and Price-Anderson Act fines and penalties are excluded from the ceiling, except as provided in DOE regulations. DOE also has included a catch-all exclusion for "any other unallowable costs." Subject to these exceptions, DOE states it will treat as *allowable* otherwise "avoidable" costs in excess of the liability cap (*i.e.*, DOE will reimburse the contractor for all amounts in excess of the cap). This means that avoidable costs in excess of the cap are allowable and will be paid, while the same costs up to the cap are unallowable. Characterization of a given cost at a given point in time may prove difficult and confusing.

The M&O contractor (and subcontractors) is required to provide guarantees (letter of credit) to assure DOE that it has sufficient resources to satisfy its liability for avoidable costs, or agree to let DOE retain a percentage

award fee sufficient to protect the Government's interest. While the contractor has legal rights to claim allowability of avoidable costs exceeding the liability cap, recovery of these costs could easily involve expensive and protracted litigation with DOE.

Importantly, the ceiling on the M&O contractor's liability is not an indemnity.³⁴ The standard contract clause for DOE M&O contractors limits the Government's obligation for payment of allowable costs to the amount of funds obligated. For allowable costs above that amount, DOE's contractual commitment is subject to the availability of funds DOE can legally use for that purpose.³⁵ In addition, DOE's obligation is subject to the release executed after completion or termination of the contract. These restrictions on reimbursement can severely limit an M&O contractor's legal right to claim and recover avoidable costs in excess of the ceiling, particularly where the event giving rise to the costs was not known at the time the contract was completed and a release executed. Such restrictions are significant for long-term environmental liabilities to third parties that may not materialize until 20-30 years after contract close-out. Unless DOE provides an exception to the release for such liabilities, it may well chill the use of innovative technological approaches to remediation of hazardous and mixed wastes.³⁶ At the same time, however, an exception would be of little value without assurance of funding.

DOE Cost-type Support Contractors

DOE's new rule on unallowable costs and liabilities applies to profit-making cost-type support contractors.³⁷ Nonprofit and SB/SDB support contractors are completely exempt. Existing support contractors are covered if they modify their contracts to conform to the new provisions.

Subcontractors

As noted above, several of the new clauses for profit-making contractors hold the contractor liable for costs resulting from subcontractor negligence and actions or inactions. However, a subcontractor who is a SB/SDB or who meets the DOE definition of nonprofit is expressly excluded from the new avoidable cost provisions, and such costs resulting from actions or inactions by the subcontractor are allowable costs to the M&O contractor. A profit-making subcontractor to a nonprofit M&O or support contractor also will be treated as nonprofit and accordingly will be exempt from the new avoidable unallowable cost rule, *i.e.*, will be treated as though the new rule did not exist.³⁸

While the exclusions provide an incentive for the profit-making M&O contractor to subcontract to exempt firms, since the contractor is thereby excused from their avoidable costs, they may at the same time inhibit the likelihood of assuring that subcontracts are awarded to responsible and experienced subcontractors with the greatest expertise and financial resources.

The DOE contract clause establishing a liability cap for certain avoidable costs applies to subcontractors—whether cost-type or fixed price—of profit-making M&O contractors. The cap is the amount of fee or profit earned during the period when the events occurred. Where the amount of profit cannot be reasonably determined by the M&O contractor, the amount shall be deemed to be 15% of the subcontract price prorated to the period involved. If the amount of subcontractor fee or profit is not sufficient to pay the avoidable costs, the excess amount of those costs will be treated as allowable costs to the profit-making M&O contractor, unless the latter is partly responsible. In such an event, it appears that the M&O contractor is obligated to pay the subcontractor's excess costs up to the M&O contractor's ceiling on liability for avoidable costs without reimbursement from DOE. This provision will no doubt engender disputes between M&O contractors and their subcontractors. It also raises a question as to whether the subcontractors subject to this rule should have access to the DOE Board of Contract Appeals, rather than having to resort to a forum unfamiliar with the rule and its complexities.

The M&O contractor must obtain financial guarantees from its subcontractors, but is prohibited from requiring a subcontractor to provide financial guarantees for payment of avoidable costs in excess of the fee or profit earned during the period involved.³⁹ DEAR 970.5204-55(b)(3) requires profit-making M&O contractors to include language in their subcontracts to implement this provision of DOE's rule. The requirement is mandatory for subcontracts at "any tier or level."

The unprecedented feature of this provision of DOE's rule is that it makes reimbursable some avoidable costs incurred by a fixed-price subcontractor. This provision of the DOE rule may encourage more responsible companies to compete for fixed-price subcontracts where they are exposed to substantial financial risks, but it is not limited to those situations. Extending it to all subcontractors at any tier arguably contradicts the basic

concept of fixed-price contracting and increases the financial risks of affected M&O contracts and any contracts to which the rule is applied.⁴⁰

The 15% of price ceiling applies only if the M&O contractor cannot "reasonably" determine the subcontractor's profit. Obviously, it will be in the interest of the M&O contractor to utilize the ceiling which reduces potential financial responsibility the most; and the subcontractor can be expected to contest the contractor's determinations. What's more, the M&O's cost of resolving the dispute may be unallowable because if its determination is overruled.

The DOE contract clause also prescribes in detail how a subcontractor's financial obligation for avoidable costs will be made where the events or actions cover more than one M&O contractor fee evaluation period or can be allocated to a particular evaluation period, or where the determination is made after the contract is completed or the subcontractor replaced. Whether the M&O contractor or the subcontractor will be adversely affected depends on how the formula is applied and by whom.

DEAR 970.5204-55(b)(1) does not expressly exclude subcontractors otherwise exempt from the restriction on allowability of such costs. While it may be inferred that this subsection is intended to apply only to subcontractors who are subject to the avoidable cost limitations, the contract clause is not precise and can be interpreted otherwise, particularly in view of the fact that the exemption exists only in DOE comments on rule and is contained in the rule itself.⁴¹ Because nonprofit M&O contractors are not covered by the rule, this subsection likely does not protect any of their fixed-price subcontractors against avoidable costs. This should concern potential subcontractors because most M&O contractors are nonprofit, and thus are not subject to the new rule. These subcontractors receive no benefits from the new rule, unlike the subcontractors to profit-making M&O contractors who now benefit from a cap on their liabilities under fixed-price contracts.

The protection afforded subcontractors and DOE's contract commitment to reimburse affected M&O contractors also are laden with loopholes. In the first place, the commitment is not equivalent to an indemnity. As discussed above, DOE's contractual requirement to reimburse an M&O contractor for allowable costs above the amount contractually obligated is subject to the availability of funds. Whether or not DOE will have, or be able to obtain, the necessary funds for a subcontractor or M&O contractor claim for reimbursement of costs years after the M&O contract has expired is highly uncertain. Obviously, the M&O contractor can be expected to attempt to include language in its subcontracts qualifying its obligation to reimburse subcontractors.

Overall, DOE's complex, required, diversified and confusing treatment of subcontractors can be expected to result in delays in performance of work, confusion, protests, and litigation by profit-making M&O contractors and their subcontractors.

Major Fraud Act Unallowable Costs

The Major Fraud Act of 1988 (the Act), P.L. 100-700, established limitations on the allowability of costs incurred by *all* DOE M&O and cost-type support contractors. Section 8 of the Act amended the Federal Property and Administrative Services Act (FPASA), 41 U.S.C. 251 *et seq.*, to make unallowable those costs incurred as the result of a proceeding brought by the United States, or a State government relating to a violation of, or to comply with, *any* Federal or State law or regulation if the proceeding results in a criminal conviction, or a civil or administrative proceeding the contractor is held liable, debarred, suspended, or its contract rescinded or terminated for default.⁴² However, in a state proceeding the costs incurred may be reimbursed pursuant to regulations proscribed by the head of the contracting agency, if they are the result of a specified contract condition or written instructions of the contracting agency.

The FAR incorporates the Act's limitation and also makes unallowable costs incurred in a proceeding commenced by a local or foreign government.⁴³

DOE has not issued regulations implementing the Act and, in addition, its new rule and contract clause provide no guidance as to whether and when DOE will waive the Act's and the FAR's restrictions. Litigation and Claims contract clause for profit-making contractors refers to 41 U.S.C. 256 as a restraint on DOE's authority to direct the contractor to defend against a claim, accept a settlement made by the contractor, or negotiate a settlement of a judgment against the contractor.⁴⁴ The Ceiling on Financial Risk contract clause excludes the Act's unallowable costs from the ceiling except as provided in (yet to be issued) DOE regulations.

How the Act and the FAR will be interpreted and applied by DOE, its board of contract appeals, and the courts creates major uncertainties and will have significant financial consequences for DOE M&O and cost-type support contractors (and their subcontractors)—whether classified as nonprofit or profit-making.

Conclusion

While DOE asserts that its new rule will enhance management and operation of its facilities, the exclusions of some commercial entities, as well as for universities and other nonprofit organizations, SB/SDBs, and subcontractors, defy a rational explanation.

The circumstances under which the new unallowable cost provisions for profit-making M&O contractors will be applied are far from clear. Moreover, the rule does not define or provide specific policy guidance as to the meaning of "clearly," or "sole and exclusive" control or "responsibility" of the M&O contractor. There are also significant differences between the language of the new contract clauses and DOE's statements regarding the clauses. In addition, the rule does not clarify DOE's policy or address its legal authority regarding the Major Fraud Act and Price-Anderson Act fines and penalties.

Although DOE's rule excludes some M&O subcontractors from and protects others against the new avoidable costs, there are good reasons to be skeptical about when it will be applied and how much protection it really provides.

The uncertainties of the new DOE rule and potential financial risks of affected M&O and cost-type support contractors can result in a defensive posture which adversely affects the conduct of their work, interactions with DOE, and relations with subcontractors.

The rule also can result in less competition by responsible companies for M&O contracts and subcontracts.

The AEC "management contract" concept was not perfect, but it recognized that these unique facilities are managed for and on behalf of the Government. The new rule appears to have the intent of "pinning" on the contractor responsibility for decades of policies which are, by today's environmental and health and safety standards, outmoded. If DOE really expects contractors to continue to participate at these facilities, it will have to clarify this rule and add provisions that absolve or indemnify current contractors from past actions.

Footnotes

¹ 56 Fed. Reg. 28099-28110 (June 19, 1991). An interim final rule was published in the 56 Fed. Reg. 5064-5088 (Feb. 7, 1991). The final rule adopts the interim final rule with "minor" changes. The new rule amends 48 CFR Parts 915, 917, 950 and 970. It applies to contracts entered into after March 9, 1991; and to existing contracts if modified to include the revised contract provisions.

² S.Rep.No. 1211, 79th Cong., 2d Sess. 15 (1946).

³ For an in-depth review, see Hiestand and Florsheim, *The AEC Management Contract Concept*, 29 *Fed. B.J.* 67 (1969).

⁴ *AEC Ninth Semi-annual Report* 57 (1951).

⁵ 56 Fed. Reg. 5066.

⁶ Dept. of Energy Acquisition Reg. [hereinafter DEAR], 48 C.F.R. 970.5204-18 (1991) (hereinafter all references to the new rule will be to the amended provisions of the DEAR).

⁷ *Id.*

⁸ *Id.*

⁹ 56 Fed. Reg. 5074-75. DOE's explanation for treating AT&T's Sandia subsidiary as nonprofit is that the facility is operated at no fee or profit, AT&T agreed to manage the facility at the request of President Truman, and for "over forty years... has made a significant contribution to DOE's mission at SNL." The Bettis and Knowles facilities are part of the Naval Nuclear Propulsion (NNP) Program and subject to Executive Order 12344, which requires the DOE Secretary to assign responsibility for supervision of these facilities and for procurement involving the NNP Program to the NNP Program Director. One can assume that the Director opposed subjecting the Bettis and Knowles M&O contractors to the new DOE rule.

¹⁰ DEAR 970.5204-13(e)(36)(ii).

¹¹ 56 Fed. Reg. 5066. The contract clause at DEAR 970.5204-13(e)(36) for profit-making M&O contractors states that the avoidable cost provisions of the rule are not applicable to profit-making subcontractors of nonprofit contractors.

¹² The draft RFP for the Environmental Restoration Management Contractor for the Feed Materials Production Center (July 26, 1991) does include the substance of the new rule, even though the ERMC is supposedly not considered an M&O by DOE.

¹³ DEAR 970.3102-21 and 970.5204-13(e)(12).

¹⁴ *Id.*

¹⁵ The Price Anderson Amendments Act of 1988, § 17, imposes civil penalties for violation of DOE nuclear safety rules, regulations, or orders by a DOE contractor or subcontractor who has a Price Anderson indemnity for a nuclear incident. DOE can waive or reduce the amount of the penalty. 42 U.S.C. § 2282a (1988). The statute excludes specified universities, corporations, and nonprofit organizations (and their subcontractors) for designated M&O contracts.

⁴⁸ 56 Fed. Reg. 5066. Although M&O contractors classified as nonprofit probably will continue to receive favorable treatment, most fines and penalties, they are exposed to significant financial risks under the Price Anderson Amendments Act and the Fraud Act of 1988. See *infra*, *Major Fraud Act Unallowable Costs*.

⁴⁹ DEAR 970.5204-13(e)(17)(iv). Among the factors to be considered by the CO in determining whether a cost is "avoidable" is the "completeness, efficiency and effectiveness" of the contractor's internal control systems and procedures, including training. DEAR 970.3102-22.

⁵⁰ *Id.* While not expressly referred to in this clause, other provisions of the new rule modify its application. See *infra*, *Subcontractors and Determining Avoidable Costs*.

⁵¹ DOE M&O contractors do not use their own funds to pay allowable costs. They use Government funds in special bank accounts established for this purpose. DEAR 970.3202.

⁵² 56 Fed. Reg. 5071.

⁵³ 56 Fed. Reg. 5073.

⁵⁴ See *infra*, *Subcontractors*.

⁵⁵ The new rule contains no definition or guidance. In a response to comments about the phrase, DOE referred to appropriate authorizations requested by a contractor but not provided as outside exclusive control. 56 Fed. Reg. 5071.

⁵⁶ DEAR 952.250-70.

⁵⁷ 56 Fed. Reg. 5067.

⁵⁸ DEAR 950.7011(c)(1).

⁵⁹ DEAR 970.5204-31.

⁶⁰ See *infra*, *Major Fraud Act Unallowable Costs*.

⁶¹ DEAR 970.5204-56.

⁶² See *supra*, *Loss of or Damage to Government Property*.

⁶³ 56 Fed. Reg. 5071.

⁶⁴ See *supra*, *Fines and Penalties*.

⁶⁵ DEAR 970.1509, 970.5204-16, and 970.5204-54.

⁶⁶ DOE has just approved use of P.L. 85-804 indemnification for the EG&G Rocky Flats contract. This indemnification is "consistent with the cap on liability provided under the new rule and means that funds will be available in future years for those costs reimbursable. It does not cover unallowable costs."

⁶⁷ DEAR 970.5204-15.

⁶⁸ The draft ERM RFP does include such an exception.

⁶⁹ DEAR 970.5204-14(e)(10)(15) and (34); 970.5204-21(j) and 970.5204-31. The DEAR does not define cost-type contractor. However, DEAR 970.5204-18 includes them as M&O contractors. Presumably they include contractors who provide site services; e.g., architect-engineering and construction.

⁷⁰ 56 Fed. Reg. 5074.

⁷¹ DEAR 970.5204-55(b)(1) and (2).

⁷² Of course, there may be a question as to whether fixed-price contracts are appropriate in cases involving, for example, environmental remediation, where the nature of the work is not precisely defined and the M&O contractor is relying on the expertise and experience of the subcontractor.

⁷³ The clause states that it applies to the "financial obligations of a subcontractor, at any tier or level. . . ."

⁷⁴ 41 U.S.C. § 256 (1988).

⁷⁵ FAR 31.205-47(b).

⁷⁶ See Atomic Energy Act of 1954, 42 U.S.C. § 2202 (1988), Pub. L. No. 85-804, and FPASA, Section 502(d)(13).

⁷⁷ DEAR 970.5204-31. The Litigation and Claims Contract clause for nonprofit contractors does not include these restrictions. It appears to be an oversight.

⁷⁸ DEAR 970.5204-23.

bonds and insurance, loss of or damage to Government property, and litigation expenses and judgments. DOE stated rationale is that management and operation of its facilities will be enhanced by holding some profit-making M&O contractors responsible for these costs in the same manner as a company or organization conducting its own business. Conceptually, the increased financial risks would be offset by a larger fee if the contractor performs well. However, the rule also contains a new award fee system that could require forfeiture of up to 50 percent of the basic fee for marginal or unsatisfactory performance. To offset some of the risks, DOE puts a cap on the new unallowable costs, *i.e.*, with some exceptions, they will not exceed the contractor's fee earned in a particular award fee evaluation period.

DOE acknowledges that its M&O contractors occupy an "unusual" position because they "lack control over funding, authorization, and . . . hiring and control of their employees." Moreover, "they operate in a heavily regulated environment." Nothing in the new rule waives DOE control over these areas, over the work to be performed, or over subcontracting by its M&O contractors. Nevertheless, DOE has imposed additional financial risks on those contractors it classifies as profit-making. The comments on the rule do not indicate what has changed in the relationship between DOE and its M&O contractors that warrants the assumption of these new liabilities by the M&Os, *i.e.*, what the contractors are doing differently today that has created the need for the new rule.

DOE's Revised Acquisition Regulation

Nonprofit and Profit-Making M&O Contractors and Subcontractors

The new rule contains important exclusions from coverage for "nonprofit" M&Os, small businesses, and certain subcontractors. DOE defines a nonprofit M&O contractor as "one which receives no fee and is considered nonprofit under the laws where it is incorporated."⁸ This definition is not limited, however, to entities that are nonprofit in the accepted traditional sense. Under the rule, a contracting officer (CO) is authorized to treat a contractor "whose particular corporate organizations or circumstances . . . warrants such consideration" and the contractor is a nonprofit organization as defined in 35 U.S.C. 201(i).⁹ All other M&O contractors are considered profit-making.⁸

Interestingly, DOE appears to have classified a majority of its M&O contractors as nonprofit even though some do not meet its nonprofit definition. In comments on the rule, DOE states it will treat as nonprofit the present M&O contractors for Sandia National Laboratories (Sandia Corp., a wholly owned subsidiary of AT&T), Bettis Atomic Power Laboratories (Westinghouse), and Knowles Power Laboratory (General Electric).⁹ DOE also lists 20 major R&D facilities operated by universities and other not-for-profit organizations treated as "nonprofit," even though they are paid a fee or "management allowance." Westinghouse is treated as nonprofit for one of its M&O contracts and profit-making for its other M&O contracts.

The new provisions do not apply to small businesses (SB) and small disadvantaged businesses (SDB), or to a nonprofit subcontractor of a profit-making M&O contractor.⁸ Moreover, they do not appear to apply to a profit-making subcontractor of a nonprofit M&O contractor. In comments regarding fines and penalties incurred by a subcontractor, DOE states that such fines and penalties are allowable if the subcontractor is nonprofit.¹¹ Nothing in the rule requires an M&O classified as a nonprofit contractor to absorb the new unallowable costs or include them in its subcontracts.

DOE's statement accompanying the new regulation says that it *does not* apply to environmental restoration contractors who are *not* M&O contractors,¹² but *does* apply to environmental restoration subcontractors of M&O contractors. Presumably, the subcontractor exclusions for SB and SDB apply.

[As used below, "nonprofit M&O contractor" means one exempt from, and "profit-making M&O contractor" means one subject to, the new unallowable costs and liabilities.]

Fines and Penalties

The new DOE rule and the contract clause for profit-making M&O contractors make fines and penalties unallowable for "an area of responsibility *clearly placed* on the contractor and/or the subcontractor."¹³ (Emphasis added.) However, the rule does not contain any guidance concerning the meaning of "clearly placed." If DOE shared in the decision for the action or inaction that resulted in the fine or penalty, presumably the responsibility would not be "clearly placed" on the contractor. Therefore, contractors (and subcontractors) that