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THE DEFENSE PRODUCTION ACT AND COVID-19: WHAT INDUSTRY NEEDS TO KNOW

To Our Clients and Friends:

On March 18, 2020, President Trump announced that he was invoking the Defense Production Act ("DPA") in order to allow the administration to marshal American industry to prioritize production of medical supplies and pharmaceuticals that are in short supply to fight the coronavirus pandemic. Notably, the President stated that he was invoking the DPA authority "just in case we need it," but did not say whether he planned to issue orders pursuant to that authority for the time being. The President's announcement on Wednesday followed public urging by Senate Democrats to invoke the authority granted by the DPA to address medical supply shortages.[1] The powers granted to the Government under the DPA are unique and broad. In this Client Alert, we summarize the requirements of the DPA and its implications for contractors performing under contracts issued pursuant to the Government's authority under this statute, or private industry companies that may be directed to prioritize production based on the same authority. Below, we address the scope of the DPA, contractors' rights and responsibilities under it, and special actions that the Government may direct industry and businesses to take in order to support the national interest.

Scope of the Defense Production Act

Enacted in 1950 in response to the start of the Korean War,[2] the DPA, 50 U.S.C. §§ 4501 *et seq.*, ensures that the domestic industrial base is mobilized and prepared to support the national defense both during national emergencies and peacetime. Since its enactment, the DPA has been reauthorized over 50 times, most recently in 2018.[3] The term "national defense" as defined in the DPA has been expanded over time, and currently includes:

> programs for military and energy production or construction, military or critical infrastructure assistance to any foreign nation, homeland security, stockpiling, space, and any directly related activity. Such term includes emergency preparedness activities conducted pursuant to title VI of The Robert T. Stafford Disaster Relief and Emergency Assistance Act [42 U.S.C. §§5195 et seq.] and critical infrastructure protection and restoration.[4]

The Stafford Act, in turn, states that "emergency preparedness":

> means all those activities and measures designed or undertaken to prepare for or minimize the effects of a hazard upon the civilian population, to deal with the immediate emergency conditions which would be created by the hazard, and to effectuate emergency repairs to, or the emergency restoration of, vital utilities and facilities destroyed or damaged by the hazard.[5]

Given the breadth of "national defense" activities, the DPA can apply to a wide variety of companies providing goods or services deemed essential to the national interest. The authorities granted by the DPA are generally afforded to the President, who has in turn delegated these authorities to department and agency heads by Executive Order.[6]

The DPA empowers the Government to ensure availability of essential items by: (1) requiring contractors to accept and perform high priority contracts, or be subject to civil or criminal penalties or an injunction requiring performance; (2) requiring contracts issued pursuant to the DPA (called "rated orders") deemed necessary to the national defense be prioritized over other contracts that are not essential to the national defense, subject to certain limited exceptions; (3) allocating the distribution of essential items;[7] (4) guaranteeing loans from contractors or their subcontractors performing contracts deemed necessary to the national defense; and (5) establishing special action plans to ensure the sufficiency of the defense industrial base during national emergencies.[8]

Contractor Rights and Responsibilities Under Rated Orders

The Department of Commerce, which is delegated authority through Executive Order 13603 to implement the DPA's priorities and allocations provisions for industrial resources, established a priority allocation system known as the Defense Priorities and Allocations System ("DPAS") to prioritize national defense-related contracts and orders throughout the U.S. supply chain in order to support military, energy, homeland security, emergency preparedness, and critical infrastructure requirements.[9] Commerce, in turn, has delegated authority to the Department of Defense, the Department of Energy, the Department of Homeland Security, and the General Services Administration to place priority ratings on contracts or orders necessary or appropriate to promote the national defense.[10]

The DPAS includes two priority allocations for rated orders. DX is the highest priority rated order, and all DX orders are of equal priority with each other and take priority over DO rated orders or non-rated orders. DO rated orders are of equal priority with each other, and take priority over non-rated orders. Every rated order contract must reflect: (1) the appropriate priority ranking; (2) required delivery date(s); (3) the signature of an authorized customer representative; and (4) a statement reflecting the substance that "this is a rated order certified for national defense use, and you are required to follow the provisions of the DPAS regulation." Contractors must accept or reject a DX or DO rated order within 10 working days or 15 working days after receipt of the request, respectively.[11]

With limited exception, contractors must accept and perform contracts as directed under the DPA.[12] Contractors must offer a similar price and terms and conditions for rated orders as they would offer for comparable non-rated orders,[13] and must flow down to their subcontractors and suppliers the requirement to grant similar priority to necessary components throughout the acquisition supply chain[14]. Failure to adhere to these requirements could result in civil or criminal liability, or an injunction requiring specific performance.[15]

There are exceptions where a contractor *may*, and in some cases *must*, nonetheless reject a rated order. A contractor *must* reject a rated order if it is unable to fill the order by the requested delivery date. If a

contractor is required to reject a rated order, the contractor must notify the customer of the earliest date on which delivery can be made, and offer to accept the order based on that delivery date. A contractor is also required to reject a DX rated order where acceptance would conflict with performance of any previously accepted DX rated order, and to reject a DO rated order that would conflict with performance of any previously accepted DO or DX rated order. In each instance, the contractor must offer to accept the conflicting order as of the earliest practicable date on which delivery could be made.[16] Where a contractor receives two or more requests for rated orders of equal priority on the same day, the contractor must accept, on the basis of the earliest delivery dates, only those orders it can fill and must reject the others.[17]

A contractor *may* reject a rated order under the following five circumstances: (1) the customer is unwilling or unable to meet regularly established terms of sale or payment; (2) the order is for an item not supplied or for a service not performed; (3) the order is for an item produced, acquired, or provided only for the supplier's own use for which no orders have been filled for two years prior to the date of receipt of the rated order; (4) the person placing the rated order, other than the U.S. Government, makes the item or performs the service being ordered (e.g., if a contractor in receipt of a rated order is placing a rated order with a subcontractor); or (5) acceptance of a rated order or performance against a rated order would violate any other regulation, official action, or order of the DPAS.[18] Any rejection of an order, whether mandatory or permissive, must provide the reason for rejection in writing.[19]

Performance of DPA contracts and rated orders can have significant impacts on the non-priority work – unrated Government contracts or private industry commitments – that contractors may be required to back-burner in the interest of the national defense. Neither the DPA nor the standard DPAS rated order contract provision compensates contractors for potential lost profits associated with abandoning lower priority, but higher profit, work during fulfillment of priority contracts and orders. However, in circumstances where the contractor's financial stability becomes jeopardized as a result of complying with the DPA, contractors may request that the Government invoke its authority to grant extraordinary relief to contractors providing goods and services essential to the national interest when needed to keep the contractor operational.[20] And although the DPA excuses contractors and businesses from breach of contract (whether government or commercial) or other claims involving failure to perform other contracts because it was required to prioritize a rated order or DPA contract, the protection does *not* indemnify against claims relating to products manufactured or services provided under a DPA contract.[21]

Industry Rapid Response, Voluntary Agreements & Special Action Plans

In the event of a national emergency, including the current novel coronavirus pandemic, the President is authorized to establish special rules to ensure a rapid response from domestic industry to meet the critical needs of the country. For example, the President could direct industry to focus on production of scarce or critical materials.[22] In the context of the current novel coronavirus pandemic, non-medical product manufacturers may be asked or required to shift production to medical supplies. Former FDA Commissioner Robert Califf is urging U.S. manufacturers, regardless of industry, to do so,[23] and the UK Prime Minister has requested that non-medical manufacturers shift production to the manufacturing of ventilators.[24] French conglomerate LVMH, the company behind Louis Vuitton and other luxury

brands, announced this week that it is converting its cosmetics factories to produce hand sanitizer.[25] The DPA authorizes the President to create, maintain, protect, expand, or restore domestic industrial base capabilities essential to the national defense through a variety of mechanisms, such as purchasing or making purchase commitments of industrial resources or critical technology items, and making subsidy payments for domestically produced materials.[26] The Act also authorizes the President to issue loan guarantees and direct loans to reduce current or projected shortfalls for essential materials necessary for national defense purposes.[27] Although the Government has not used the DPA loan authorities in more than 30 years, the Government has used purchases and purchase commitments with relative frequency.[28] For example, the Department of Defense used DPA authorized funding for a portfolio of 32 projects as of the end of 2018, including to address key industrial base shortfalls in the production of metal castings for critical rotorcraft applications and trusted advanced photomasks for microelectronics.[29]

The DPA also authorizes the President, upon a determination that a "condition exists which may pose a direct threat to the national defense or its preparedness programs," to consult with industry and business representatives and establish voluntary agreements, preparedness programs, and plans of action to provide for the national defense and expand production capacity of essential resources.[30] Although voluntary agreements or plans of action between competing private industry entities could be subject to legal ramifications under the antitrust statutes or by contract, the DPA affords such parties a special legal defense if their actions under such a voluntary agreement or plan would otherwise violate antitrust or contract laws – but they do not grant blanket immunity.[31] It remains to be seen to what extent the Administration will invoke these provisions of the DPA.

For example, Section 708 of the DPA creates a defense to any civil or criminal action brought under federal antitrust laws or any similar law of any state.[32] The requirements to invoke the defense are stringent, and its coverage is narrow. Only actions taken in the course of developing or carrying out agreements or plans of action initiated by the President or by individuals to whom he has delegated his power to initiate such agreements are within the scope of the defense.[33] Moreover, the party invoking the defense must prove that it complied with all statutory and regulatory requirements of Section 708 and acted in accordance with the terms of the voluntary agreement or plan of action at issue. The defense further requires that, except for actions taken to develop a voluntary agreement or plan of action, the defendant must prove that the action taken was specified in, or within the scope of, an approved voluntary agreement initiated by the President or a plan of action adopted under such an agreement, and that the President or his designee authorized and actively supervised the agreement or plan of action.

It remains to be seen to what extent the Administration will invoke these provisions of the DPA. Absent express Presidential or governmental approval of collaborative agreements to respond to orders issued under the DPA, companies responding to such orders should exercise caution and seek advice about any business practice in advance to minimize risk.

Impact on Foreign Corporate Mergers, Acquisitions, or Takeovers

Critically, the U.S. Committee on Foreign Investment in the United States ("CFIUS") also operates pursuant to the DPA. CFIUS is an inter-agency committee authorized to review the national security

implications of investments made by foreign companies and persons in U.S. businesses and to block transactions or impose measures to mitigate any threats to U.S. national security. National security and supply chain issues—including with respect to DPAS priority contracts—are considered by CFIUS in the course of a review. On February 13, 2020, final regulations were implemented to expand the scope of inbound foreign investment subject to CFIUS review to include the unique risks posed by foreign investments in U.S. businesses involved in critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens. Supply chain risks associated with the coronavirus crisis are likely to shift the immediate focus of the Committee with respect to foreign investments in U.S. businesses involved in key sectors.

Current Government contractors, as well as companies in a position to assist with the production of essential materials necessary for the national defense in light of the current novel coronavirus national emergency, should be aware of the Government's authorities and industry's responsibilities under the DPA.

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[1] *See, e.g.*, https://www.nytimes.com/2020/03/17/us/politics/trump-coronavirus-plan.html.

[2] Congressional Research Service, The Defense Production Act of 1950: History, Authorities, and Considerations for Congress, updated March 2, 2020, *available at* https://fas.org/sgp/crs/natsec/R43767.pdf (last accessed March 18, 2020).

[3] Sec. 791 of P.L. 115-232.

[4] 50 U.S.C. § 4552(14).

[5] 42 U.S.C. § 5195(a)(3).

[6] Executive Order 13603, *National Defense Resource Preparedness* (2012).

[7] Although the DPA allows the President to allocate the distribution of materials, services, and facilities, no allocation action has been taken pursuant to the DPA since the end of the Cold War. Congressional Research Service, *supra*, n.2 (citing Department of Homeland Security, The Defense Production Act Committee Report to Congress, Calendar Year 2017 Report to Congress, June 18, 2019, p. 11).

[8] 50 U.S.C. §§ 4501 et seq.

[9] .https://www.bis.doc.gov/index.php/other-areas/strategic-industries-and-economic-security-sies/defense-priorities-a-allocations-system-program-dpas; *see also generally* DPAS Regulations, 15 C.F.R. Part 700.

[10] *Id.*

[11] 15 C.F.R. § 700.13(d).

[12] 15 C.F.R. § 700.13(a).

[13] *Id.*

[14] 15 C.F.R. § 700.15.

[15] 15 C.F.R. § 700.74.

[16] 15 C.F.R. § 700.14(c).

[17] 15 C.F.R. § 700.13(b).

[18] 15 C.F.R. § 700.13(c).

[19] 15 C.F.R. § 700.13(d).

[20] 50 U.S.C. §§ 1431-36

[21] 50 U.S.C. § 4557.

[22] *See* 50 U.S.C. § 4517

[23] *See* Twitter, Robert M. Califf, @califf001, Mar. 16, 2020, "The Defense Production Act gives FEMA the power to immediately rev up the production and distribution system for PPE. This should be done now" *available at* https://twitter.com/califf001/status/1239684030980751360. *See also* https://medtech.pharmaintelligence.informa.com/MT126396/Former-FDA-Chief-Urges-Manufacturers-To-Shift-Gears-In-Coronavirus-Efforts.

[24] *See* BBC News, "Coronavirus: PM urges industry to help make NHS ventilators," Mar. 16, 2020, *available at* https://medtech.pharmaintelligence.informa.com/MT126396/Former-FDA-Chief-Urges-Manufacturers-To-Shift-Gears-In-Coronavirus-Efforts.

[25] CBSNews, "LVMH, which owns luxury brands like Louis Vuitton and Christian Dior, will use perfume production lines to make hand sanitizer," Mar. 16, 2020, *available at* https://www.cbsnews.com/news/lvmh-hand-sanitizer-french-luxury-brands-perfume-production-lines-france-louis-vuitton-company/.

[26] 50 U.S.C. §4533.

[27] 50 U.S.C. §4531(a)(1).

[28] *See* Department of Homeland Security, The Defense Production Act Committee: Report to Congress, Calendar Year 2010 Report, August 2011, p. 10; Department of Defense, Annual Industrial Capabilities, Fiscal Year 2017 Report to Congress, March 2018, p. 33, at

https://www.businessdefense.gov/Portals/51/Documents/Resources/2017%20AIC%20RTC%2005-17-2018%20-%20Public%20Release.pdf?ver=2018-05-17-224631-340.

[29] Department of Defense, Annual Industrial Capabilities, Fiscal Year 2018 Report to Congress, May 2019, p. 8, available at https://www.businessdefense.gov/Portals/51/Documents/Resources/2018%20AIC%20RTC%2005-23-2019%20-%20Public%20Release.pdf?ver=2019-06-07-111121-457.

[30] 50 U.S.C. § 4558(c)(1).

[31] 50 U.S.C. §4558.

[32] 50 U.S.C. § 4558(j).

[33] For an example of a voluntary agreement initiated and approved under Section 708 of the Defense Production Act, see generally Renewal of the Voluntary Tanker Agreement Program, 84 Fed. Reg. 58824, 58825 (Nov. 1, 2019).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm's ***Coronavirus (COVID-19) Response Team****.*

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