

# ARNOLD & PORTER ADVISORY

## Defense Production Act Requirements

October 2001

In light of the September 11<sup>th</sup> tragedies and President Bush's declared "war against terrorism," the United States Government may request that a number of the firm's clients and friends accept "rated orders," or assist the United States in developing industrial preparedness programs. Indeed, under the **Defense Production Act**, the Government has broad discretion, particularly in times of national emergency, to direct contractors to accept and perform contracts that are essential to the national interest and to require contractors to prioritize that work over commercial contracts and other government contracts.

Because the powers granted to the Government are both unique and wide-ranging, we thought it would be helpful to summarize in question and answer format the general requirements of the Defense Production Act and its implications for the contractors who perform contracts issued pursuant to the Government's authority under that statute.

### 1. What is the Defense Production Act ("DPA")?

The DPA, 50 USC §2061, *et seq.*, was enacted in 1950 to grant the Government broad discretion to take steps to ensure that a mobilized domestic industrial base was in place both during national emergencies and peacetime. It empowers the Government to ensure the availability of an adequate inventory of essential items – including sources of energy, military hardware and information technology. Contracts issued pursuant to the DPA are known as "rated orders."

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## 2. To whom could the DPA apply?

The DPA could apply to a wide variety of companies that provide goods or services that are deemed essential to the national interest. In addition to the defense industry, the Government could require, for example, a particular inventory of certain kinds of vaccines from pharmaceutical companies, electricity from nuclear power companies, or even textiles from textile companies if such products were deemed necessary to protect the United States in the event of a crisis.

## 3. What are the Government's rights under the DPA?

The DPA grants the Government broad discretion to: (1) direct contractors to accept and perform high priority contracts or be subject to civil and criminal penalties or to an injunction requiring the contractor to perform; (2) require that contracts or rated orders which are deemed necessary to the national defense be given priority over the contractor's other contracts or orders that are not as essential to the national defense; (3) guarantee loans from financial institutions to contractors or subcontractors performing contracts deemed essential to the national defense or security; and (4) establish special plans of action for ensuring a sufficient defense-industrial base during times of national emergency.

## 4. What is the Defense Priorities and Allocations System and how does it operate?

In implementing the DPA, the Department of Commerce (and other federal agencies) has established a priority allocation system known as the Defense Priorities and Allocations System ("DPAS"). The DPAS includes two priority allocations for rated orders – DX orders and DO orders. DX is the highest priority rated order. All DX orders are of equal priority with each other and take priority over DO rated orders. Likewise, all DO rated orders are of equal priority with each other and take priority over non-rated orders.

## 5. What are a contractor's obligations when directed to accept a contract or rated order pursuant to the DPA?

Absent narrow exceptions described below, contractors must accept and perform contracts as directed under the DPA or face significant civil and criminal penalties, as well as the threat of an injunction. Contractors must offer a similar price and terms and conditions for rated orders as they would offer for comparable unrated orders. Contractors also must require their subcontractors and suppliers to grant similar priority to needed components throughout the acquisition chain.

6. When is a contractor required to reject a rated order?

As noted, the general rule is that contractors must accept and fill all rated orders received regardless of any other rated or unrated orders that it is already obligated to perform. However, unless directed otherwise, the contractor must reject a rated order if it is unable to fill the order by the date required by the customer. In such a circumstance, the contractor must notify the customer of the earliest date on which delivery can be made and offer to accept the order on the basis of that delivery date. Similarly, where acceptance of a DX rated order would conflict with the performance of a previously accepted DX rated order, or where acceptance of a DO rated order would conflict with performance of a DX rated order or with a previously accepted DO rated order, the contractor must reject the rated order by offering to accept the order as of the earliest practicable date on which delivery could be made. If the contractor receives two or more requests for rated orders of equal priority on the same day, the contractor must accept, on the basis of earlier delivery dates, only those orders that it can fill and must reject the others. In other words, if order A requires delivery on January 1 and order B requires delivery on January 15, the contractor must accept order A before accepting order B. However, the contractor must offer to accept the rejected order based on the earliest possible delivery date.

7. When is a contractor entitled to, although not required to, reject a rated order?

A contractor may (but is not required to) reject a rated order when: (1) the customer is unwilling or unable to meet regularly established terms of sale or payment; (2) the contractor is not a supplier of the product or service requested; (3) the order is for a product or service that the contractor has not sold for two years prior to the date of receipt of the rated order; (4) the customer placing the order, other than the U.S. Government, makes the item or performs the service being requested; and (5) if acceptance of the rated order would violate any other regulation issued pursuant to the DPA or related statutes. As noted above, a contractor may not reject a rated order on the basis that acceptance of the order would interfere with its obligations under a lower priority rated order or an unrated order.

8. What are the time requirements for accepting or rejecting a rated order?

A contractor must accept or reject a DO rated order within 15 working days after receipt of the request and must accept or reject a DX rated order within 10

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working days after receipt of the request. If the contractor rejects the order, it must give its reasons in writing and must offer to accept the rated order at the earliest practicable date.

9. What are the required elements of a rated order contract?

There are four required elements that must appear in each and every rated order contract: (1) the appropriate priority ranking; (2) a required delivery date or dates; (3) the signature of an authorized representative of the customer; and (4) a statement that reads in substance that "this is a rated order certified for national defense use, and you are required to follow all of the provisions of the DPAS regulation."

10. Does the DPA grant the Government any special powers in the event of a national emergency?

Yes. In the event of a national emergency, the President is authorized to establish special rules to ensure a rapid response from industry to meet the critical needs of the United States. For example, the President could restrict use of critical or scarce resources to only essential purposes, require industry to convert production or distribution of non-essential items to the production or distribution of critical or scarce defense or emergency preparedness items, and direct industrial activity to focus on scarce and critical items. The DPA authorizes the President, in times when conditions exist that "may pose a direct threat to the national defense," to consult with industry and business representatives and establish voluntary agreements, preparedness programs and plans of action to provide for the national defense and for the expansion of production capacity for essential resources.

11. What if the performance of a contract under the DPA requires a contractor to breach a commercial contract or another lower priority government contract?

Section 707 of the DPA excuses contractors from breach of contract or other claims involving a failure to perform other contracts because it was required to prioritize a DPA contract or rated order. However, section 707 of the DPA does not indemnify contractors against claims relating to products manufactured or services provided pursuant to the DPA.

12. What are the penalties for failing to accept (or properly reject) a rated order contract?

The DPA subjects contractors who willfully perform any act prohibited by the DPA, or who fail to perform any act required by the DPA, to penalties of up to \$10,000 and/or up to one year in prison.

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13. What if the performance of a rated order contract requires the contractor to abandon lower priority, but higher profit, work?

The DPA requires contractors to perform rated orders before completing lower priority work, even if the rated order is not as profitable as the lower priority work. Neither the DPA nor the standard rated order contract compensates contractors for compliance with its terms. However, in certain instances, contractors may request that the Government invoke Pub.L. 85-804 (50 USC §§ 1431-36), which grants extraordinary relief to contractors who provide goods and services that are essential to the national interest when needed to keep the contractor operational. Contractors who are forced to abandon profitable work in complying with the DPA may become eligible for extraordinary relief under Pub.L. 85-804 if the contractor's financial stability is jeopardized.

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We hope that you will find this brief summary helpful. We remain available to advise you regarding any specific applications of the Defense Production Act to your company's particular circumstances. For additional information or questions, please contact our Government Contracts partners listed below:

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