ACF Administration for Children and Families	**U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES** **Administration on Children, Youth and Families**	
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INFORMATION MEMORANDUM

To: State, Tribal, and Territorial Agencies Administering or Supervising the Administration of the Foster Care, Adoption Assistance, and Guardianship Assistance programs under Title IV-E of the Social Security Act, Indian Tribes, Tribal Organizations, and Tribal Consortia (Tribes); State and Tribal Information Executives; and Other Interested Parties

Subject: Contractual terms and conditions and their potential impact on Information Technology (IT) equipment and services procurements by States and Tribes

Related References: 45 CFR Part 95.13

Purpose: This document describes contract terms and conditions and their potential impact on a State's or Tribe's (Agency) procurement activities. In addition, this document identifies Federal contract provisions required in all procurement documents funded through one or more of the programs identified in the Advance Planning Document (APD) regulations at 45 CFR Part 95 Subpart F.

Background: When an Agency chooses to procure vendor resources to develop or maintain a human service application, 45 CFR 95.613 requires that the Agency conduct a competitive procurement. The terms and conditions included in the acquisition document (e.g., request for proposal, request for quote, or invitation to bid) set forth the rules, restrictions, provisions, and requirements under which a successful contract is executed. Some terms and conditions may have unexpected consequences that could limit competition, provide an advantage to a prospective vendor, or increase project risks and costs. This document discusses some of the terms and conditions that Agencies have added to their contracts and discusses the unexpected or unintended consequences of these terms and conditions.

Consideration: On October 28, 2010, this agency published new rules governing the APD process (45 CFR Part 95 Subpart F). One of the major changes in the revised rules

is a shift in focus from Federal to State procurement rules. Under the APD regulations at 45 CFR 95.613, the Federal agencies will now defer to State procurement rules if:

- The State procurement rules are applied consistently for procurements not reimbursed with Federal funds; and

- This Office determines that the State's procurement process will not substantially impact project cost or project risk.

The Department retains its oversight authority, including requiring an Agency to comply with the competition provision of Section 92.36 (c) if it determines that the Agency's procurement process is an impediment to competition that could substantially increase project cost or risk of failure. If the Administration for Children and Families (ACF) determines that project costs may be affected or that project risk has increased due to an Agency's procurement regulations, increased project oversight may be imposed in the form of heightened Federal monitoring and/or a requirement for independent verification and validation activities.

Certain terms and conditions may increase project cost or risk. Examples include unlimited liability, prescriptive staffing considerations, excessive withholding of contractor payments, imbalanced warranty requirements, and excessive performance bond requirements. Such terms and conditions are intended to protect the sponsoring agency but may actually limit competition, increase costs, or increase vendor or Agency risk. Restrictive terms and conditions concern ACF because limitations on competition may restrict the buyers' purchase options, limit technology innovations and could potentially affect both price and performance.

Free and open competition can provide the Agency with additional proposals and may reduce the final cost of the contract. The introduction of overly restrictive terms and conditions into procurement documents may limit the array of potential solutions if vendors simply do not bid. Additionally, vendors who perceive a disproportionate level of risk in the project may raise their bid price to cover the assumed risk.

The following sections discuss specific topics that State and Tribal Agencies should consider when drafting solicitation documents to procure vendor services.

Contract Terms

Contract terms should specify the order of precedence between the request for proposal (RFP), the vendor's response, the contract, and any deliverables or products, such as the requirements traceability matrix or the general system design document. Dispute resolution procedures should be clearly stated in the procurement documents.

Unlimited Liability

Some Agencies include contract clauses that impose unlimited liability on vendors in areas related to contract performance. Under an unlimited liability clause, all performance risk is assigned to the vendor, and there is no monetary constraint for unacceptable contractual performance. There are several reasons why the use of unlimited liability clauses, related to contract performance, are undesirable.

- Unlimited liability is perceived by the vendor as a risk that is evaluated and assigned a cost, then added to the vendor's proposal as increased cost.

- Eligible vendors may not respond to a solicitation if they are unwilling or unable to assume the financial risk, leading to a no bid or limited bid situation, which has the potential to increase contract price and may limit the Agency's technical options.

If a contract includes a liability clause, the Children's Bureau (CB) recommends that Agencies limit the vendor's liability to direct damages according to industry standards or an amount not to exceed 1.5 times the total contract cost. Agencies should also include a separate clause that will hold a vendor responsible for the costs to re-procure services in the event that the contract is not signed at the end of negotiations, or is terminated for cause. These limitations should protect the State or Tribe against vendor non-performance without significantly increasing project cost or limiting vendor competition.

Our focus on unlimited liability clauses is primarily on project processes and areas of shared Agency and vendor responsibility. This concern does not apply to contract clauses addressing criminal or civil misconduct, and other direct actions resulting in actual damage or harm by a vendor or its employees. We encourage agencies to differentiate their use of liability clauses for tasks with shared vendor-Agency project responsibilities and for damages that are the result of vendor fraud, neglect or criminal acts.

Additional Federal guidance on contract terms that can be used to encourage contractor performance is available in our Action Transmittal ACF-AT-92-05, dated January 16, 1992. This Action Transmittal is on our web page at: http://www.acf.hhs.gov/ programs/cb/ systems/sacwis/at9205.htm.

Staffing and Vendor Considerations

Some Agencies include restrictive staffing requirements or vendor qualifications that significantly reduce the number of firms qualified to bid. Examples include the following:

- A restriction that a vendor's workplace be located in a specified geographical area (such as a specific distance from an Agency office, or within a certain city or county) may limit competition and reduce the number of potential bidders if it favors long-

established vendors located near that office, or requires other vendors to establish secondary sites.

- Requirements for an excessive number of key staff may also limit competition. We recommend that procurements limit the number of required key staff (e.g., project manager, development manager, test lead and other project component leadership), and that the Agency should not require all key staff to be available for the entire term of the contract.

- A requirement that a corporation submitting a proposal have a specific number or level of project experiences may also limit competition. Rather than requiring the corporation to have extensive experience implementing a specific type of system, we recommend that the vendor demonstrate that it has experience in human service information technology projects similar in complexity and scope to the proposed project.

- To address concerns about explicit corporate experience, procurements should require a balance of demonstrated corporate capability and performance and vendor staff experience with the program or type of system (e.g., State Automated Child Welfare Information System, Child Support) being developed. A blend of proven and established project management practices, corporate stability, and staff experience can contribute to a vendor's readiness to perform.

Withholding and Prescribed Payment Terms

Prescribed payment terms should link contract payments to the value of the deliverables completed. We recommend that payment terms recognize that the vendor is incurring costs throughout the project and provide for reasonable payments throughout the period of performance, linking periodic payments to a reasonable percentage of the value of work completed. For example, if 40 percent of the work is completed, the cumulative payment to the contractor should be near 40 percent of the total value of the contract.

Many Agencies will withhold a percentage of all payments until the contractor has successfully completed its responsibilities under the contract. We recommend that the agency limit this holdback to less than 10 percent of the total value of the contract. If the Agency withholds an excessive amount, the contractor must self-finance the ongoing cost of the project, which may increase their project costs.

Warranties

Warranty provisions can be a useful tool for increasing the likelihood that the delivered product performs as expected, but may contribute to increased bidder costs or result in vendor-agency disputes. Agencies should carefully review standard warranty clauses to affirm that they are relevant to an information technology project. Warranty clauses that are beyond the scope of a project may serve to increase costs without adding a commensurate level of Agency protection.

Warranties should be clearly worded and time specific. Agencies sometimes include open-ended warranty periods that place no boundary on a vendor's obligation to remedy defects. An overly lengthy or stringent warranty clause may result in higher vendor prices. Similarly, vaguely worded warranties in which the warranty expectations and responsibilities are not clearly established may create confusion for both the purchaser and seller. For example, if warranty language is not specific, the vendor may argue that it is responsible only to support the product as delivered and not after the Agency has begun its own enhancements or customization.

The warranty language should provide a clear mechanism for identifying and prioritizing defects under the warranty and provide a specific process for resolving disputes that may arise. The warranty provisions should outline procedures that will be followed to determine the priority of a defect, and establish timeframes for resolution.

We additionally recommend that the warranty language for the performance of warranty compliance activity should reference positions rather than specific project staff by name. Finally, the Agency should be careful not to void legitimate warranty clauses through inaction, underperformance of Agency technology resources, or the premature introduction of code changes prior to vendor hand over.

Third Party Software Warranty Provisions:

Agencies sometimes require broad warranties that cover all of the components in the system. Since many large multi-function applications often include the use of third-party software, warranty language may apply to these commercial applications. This may become problematic if the vendor does not have control over the third-party product or is prohibited from making code changes. While warranty language may recognize that vendors are unable to modify or revise third-party software or support an "orphan" product if its manufacturer discontinues support for a product, it is reasonable to expect that the vendor is ultimately responsible for the performance and reliability of all its selected system components.

Negotiations over standard warranty clauses should find a reasonable balance between protecting an Agency's interests without subjecting the contractor to unachievable expectations for the maintenance or modification of third party software.

Performance Bonds

Performance bonds are purchased by the vendor to offer a level of protection to the Agency if the contractor fails to meet its responsibilities. The costs of bonds have risen significantly in recent years, and vendors are likely to pass these costs on to the sponsoring Agency. Small companies may not qualify for bonding or may find costly bond premiums a disproportionate burden.

Therefore, we do not recommend the use of performance bonds because they can significantly increase the cost of the procurement without providing a commensurate level of assurance that the vendor will be successful. Instead, CB suggests that Agencies

use other methods described in Action Transmittal ACF-AT-92-05 to encourage contract performance.

One widely used alternative method for providing the vendor with incentive to comply with contractual requirements for timely performance and high quality work is withholding a small percentage of a scheduled payment, such as five to ten percent until project completion.

Requirements for Intellectual Property Rights

Intellectual property (IP) generally refers to protected concepts which the owner protects through patents, copyrights, trademarks, or as trade secrets. While work products and software developed with Federal financial participation are subject to the ownership provisions outlined in Departmental regulations at 45 CFR 95.617, independently developed company IP, such as project management tools brought to the engagement, are generally not subject to these ownership rules.

This Office recognizes that vendor owned IP is a valuable asset that must be protected. IP that becomes publicly available can be exploited by competitors.

Even with the acceptance of the ownership provisions defined at 45 CFR 95.617, private companies may be reluctant to enter into contracts that transfer to States or Tribes ownership of other IP assets such as project management tools or work approaches, if contract terms inhibit or eliminate their ability to competitively use these IP assets in future engagements. Contract language that threatens vendor control of IP assets may lead companies to decline to bid on work. Again, it is important to note that this discussion regarding IP assets is not referring to the work products or tools developed under the contract or integral to the operation of the resulting system and covered by the CFR Part 95 ownership rules.

We recommend that Agencies assess contractual language regarding intellectual property ownership and control to determine if it fairly balances Agency and vendor interests, and encourages innovation without undue risk to vendor IP assets.

Additional Issues Affecting Commercial-Off-the-Shelf Third-Party Software

Implementation vendors frequently do not custom build or own all of the components proposed or delivered in an application. It is becoming increasingly common that commercial-off-the-shelf (COTS) applications from third-party vendors (e.g., word processors, search or workflow engines, or business intelligence tools) are used within a human services application. Issues related to this relationship extend beyond warranty provisions.

Some Agencies have structured contracts so that financial and liability risks assumed by the prime contractor are conveyed to third-party vendors providing COTS products.

These risks, which may be judged acceptable by the prime contractor, may not be perceived as acceptable to COTS vendors receiving a comparatively small per-unit profit.

Agencies have also sought to apply ownership or licensing requirements to COTS products provided by third-party vendors. This arrangement is often unacceptable to COTS vendors. Such requirements, while seeming to lower risk to the sponsoring Agency, can thus limit possible technology solutions.

Although custom-built applications are subject to the Federal ownership and licensing provisions of 45 CFR 95.617(a) and (b), "Proprietary operating/vendor software packages which are provided at established catalog or market prices and sold or leased to the general public shall not be subject to [these provisions]."[1] Therefore, the Federal government does not impose ownership or licensing requirements on COTS vendors beyond those commonly practiced in the market. We encourage States and Tribes to follow this practice.

Non-negotiable Terms and Conditions

In an effort to treat all prospective bidders equally and fairly, some Agencies have clauses in procurement documents stating that the terms and conditions may not be negotiated. We recommend that States and Tribes use caution when considering such a requirement in their procurements. If bidders are concerned about elements of an Agency's terms and conditions and the procurement precludes negotiations, the vendor may be less likely to bid or could increase costs to cover a perceived risk.

Some terms and conditions cannot be met by every vendor. For example, the bidder is to provide publicly disclosed financial statements for the past three years. However, the documentation needed would not be available from a vendor that is not a publicly traded company. In this example, if the vendor is not able to negotiate an acceptable alternative to this requirement, the vendor would be precluded from bidding. Further, if an Agency subsequently adjusts terms as part of final contract negotiations, other vendors may seek to appeal this departure from the stated procurement process.

Agencies are encouraged to consider reasonable bidder requests to negotiate terms and conditions where the Agency determines that its interests or needs can be preserved and the bidder has presented a justifiable business case for the change. We recommend that Agencies require all bidders to submit a business case for any proposed modifications to terms and conditions prior to the close of the procurement process. The Agency's acceptance of proposed changes or alternatives can be communicated to all prospective bidders prior to the bid submission date, and may encourage additional bids.

Liquidated Damages

A liquidated damages clause within a contract sets an amount to be paid in the event that a specific contract term is not met, for example, through a vendor's failure to deliver at a

[1] 45 CFR 95.617(c)

specific date or to correct an error within a specific period. Liquidated damages clauses should be based on a reasonable estimate of the financial harm to the Agency and not simply a penalty. Federal acquisition regulations note that "the liquidated damages rate must be a reasonable forecast of just compensation for the harm that is caused by late delivery or untimely performance of the particular contract."

Typically, liquidated damages are expressed in a daily amount to be assessed against a contractor who fails to meet delivery dates or who misses milestone completion targets. Liquidated damages should be tied to events or milestones on a project's critical path, where it can be shown that delay or failure will affect timely or expected project completion.

It is important to note that liquidated damages must reflect an element of reasonableness; courts and appeals boards have rejected claims that are found to be in excess of the damages incurred by contract delay or breach and thus are considered to be an unenforceable penalty.

Dynamics within a project usually involve close collaboration and interaction between a vendor and the Agency's staff; in some instances the work of vendor staff is directed exclusively by the Agency. In these circumstances it can be difficult to ascribe fault solely to a vendor or to one entity and this risk should be recognized when defining liquidated damage clauses.

Finally, there are limited benefits to be gained by adding unreasonable and or unenforceable damage clauses. Often such clauses simply serve to increase the cost of the contract as the vendor attempts to mitigate the inherent risk of such provisions while not providing the additional protections the Agency was seeking.

Procurement Cycle

While not directly related to the general discussion about Terms and Conditions, Agencies are strongly encouraged to allow potential vendors at least 60 days to respond to large system procurements. An Agency may take a year or more to document business processes and system requirements, while expecting a vendor to review and understand the scope of the initiative, decide whether or not to prepare a bid, identify a team, and draft a proposal in an abbreviated time period. This approach may limit vendor responses to the procurement, increasing the cost of bids to mitigate perceived risks associated with the abbreviated assessment of the scope of work, or in the submission of incomplete or inadequate solutions. Finally, we recommend that sponsoring agencies should consider extending response time if they plan to release a procurement document during a holiday period.

Required Federal Provisions

States and Tribes conducting procurements supported by Federal funds should validate that the procurement documents include standard Federal provisions. Chief

considerations for system development projects include language concerning software and ownership rights and providing access to project records for periodic review. These key provisions include:

- Software and Ownership Rights: The contract should require compliance with regulations at 45 CFR 95.617, in which the Federal government reserves a royalty-free, nonexclusive, and irrevocable license to the software, modifications, and documentation produced with Federal funds.

- Access to Systems and Records: The contract should specify that the government will have access to the system in all aspects, including Agency staff, design developments, operation, and cost records of contractors and subcontractors for periodic reviews as described at 45 CFR 95.615.

Other Federal contracting language that may be relevant to the development of Agency procurement and contract documents include the following:

- Equal Employment Opportunity: This is based on Executive Order (EO) 11246 as amended by EO 11375 and supplemented by Department of Labor regulations at 41 CFR Part 60.

- Anti-Lobbying Act: This Act as codified at 31 U.S.C. 1352 prohibits recipients of Federal contracts, grants, and loans from using appropriated funds for lobbying the Executive or Legislative Branches of the Federal government in connection with a specific contract, grant, or loan.

- Americans with Disabilities Act: This Act in regulation at 28 CFR Part 35 prohibits discrimination on the basis of disability in all services, programs, and activities provided to the public by State and local governments, except public transportation services.

- Debarment, Suspension, and Other Responsibility: Based on EO 12549 and common rule at 2 CFR 376 requires certification that the recipient and its principals are not debarred, suspended, or otherwise ineligible under the terms of the rule.

The HHS Grants Policy Statement documents the general terms and conditions of HHS discretionary grant and cooperative agreements, and may provide a relevant model for Agencies developing procurement rules and terms and conditions. The Policy Statement may be found at: http://dhhs.gov/asfr/ogapa/grantinformation/hhsgps107.pdf.

Conclusion

We recommend that an Agency carefully consider the potential impact of the terms and conditions incorporated into its procurement documents. While terms and conditions are intended to protect the Agency's interest, establish a fair procurement process and describe how the contract will be executed, they may also have unexpected or unwanted

effects on the Agency procurement process. Restrictive terms and conditions may substantially reduce the number of vendors that bid on an Agency procurement, or may increase bidders' cost estimates. Careful consideration of terms and conditions in a procurement document may increase the likelihood of multiple competitive bids representing varied technology approaches. ACF supports free and open competition that encourages the submission of multiple innovative approaches at a competitive price.

INQUIRIES: Director, Division of State Systems, Children's Bureau, Administration for Children, Youth and Families, Administration for Children and Families.

/s/

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Commissioner
Administration on Children, Youth
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