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Government Contracts

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Federal Contractors Face Uncertainty as Multi-State Coalition Challenges Executive Order 14398's Anti-DEI Contracting Provisions

OVERVIEW

Federal contractors: take notice. A significant lawsuit recently filed in the U.S. District Court for the District of Maryland challenges Executive Order ("EO") No. 14398, "Addressing DEI Discrimination by Federal Contractors," which President Trump issued on March 26, 2026. *State of Maryland v. Hegseth*, Case No. 1:26-cv-02322, was filed on June 10, 2026, by a coalition of 19 state attorneys general and the District of Columbia under the Administrative Procedure Act ("APA"). This case presents administrative law challenges that could reshape the compliance landscape for every entity that does business with the federal government, whether directly or indirectly.

THE EO AND ITS REQUIREMENTS

As we have previously covered, EO No. 14398 declares that diversity, equity, and inclusion ("DEI") activities are "unethical and often illegal" and directs all federal agencies to include new contract terms in their contracts, subcontracts, and "contract-like instruments" barring contractors from engaging in "racially discriminatory DEI activities." The order defines that term as "disparate treatment based on race or ethnicity in the recruitment, employment (*e.g.*, hiring, promotions), contracting (*e.g.*, vendor agreements), program participation, or allocation or deployment of an entity's resources."

Section 3 of the order directs federal agencies to insert a comprehensive clause into federal contracts that requires contractors to: (1) refrain from engaging in racially discriminatory DEI activities; (2) furnish all information and reports, including access to books, records, and accounts, as requested by the Contracting Officer to enable compliance reviews; (3) flow the clause down to subcontractors at every tier including to commercial item subcontracts; (4) report any subcontractor's known or "reasonably knowable" conduct that "may violate" the clause; (5) inform the contracting agency if a subcontractor sues the contractor regarding the validity of the clause; and (6) recognize that compliance with the clause is "material to the Government's payment decisions" for purposes of the False Claims Act ("FCA").

The order threatens severe consequences for violations, including contract termination, suspension or debarment, and lawsuits under the FCA.

FAR COUNCIL IMPLEMENTATION

On April 17, 2026, the Federal Acquisition Regulatory ("FAR") Council issued a memorandum directing agencies to implement the EO by incorporating the new contract terms into all new contracts starting April 24, 2026. For existing contracts, the FAR Council directed that "contracting officers must make every effort to bilaterally modify existing contracts by July 24, 2026." The FAR Council further specified that if a contractor refuses to agree to a bilateral modification, the Contracting Officer should consider whether the contract "no longer meets the agency's needs and should therefore be terminated for convenience."

Notably, the FAR Council acknowledged that it had not yet conducted notice-and-comment rulemaking or completed amendments to the FAR, stating only that it "intends to conduct rulemaking pursuant to the notice and comment process set forth at 41 U.S.C. 1707." The FAR Council has estimated that as many as 640,000 contracts and subcontracts, including more than 160,000 contracts with more than 34,000 unique vendors, would be subject to the new requirements.

THE MULTI-STATE CHALLENGE (*MARYLAND V. HEGSETH*)

The 20-state coalition (led by Maryland and comprised of California, Illinois, Colorado, Connecticut, the District of Columbia, Hawai'i, Maine, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, New Mexico, Oregon, Rhode Island, Vermont, Virginia, Washington, and Wisconsin) advances exclusively administrative law claims under the APA, contending that the agencies' implementing actions are both unlawful and arbitrary and capricious.[1]

Count I: Agency Action in Violation of Law, in Excess of Authority, or Without Observance of Procedure Required by Law. Revise the regulation to align with the statutory definition of social disadvantage in 15 U.S.C. § 637(a)(5) and 15 U.S.C. § 631(f)(1)(B). 15 U.S.C. § 637(a)(5) defines "socially disadvantaged individuals" as "those who have been subjected to racial or ethnic prejudice or cultural bias because of their identity as a member of a group without regard to their individual qualities." This is very similar to the definition of "socially disadvantaged individuals" found in 13 C.F.R. § 124.103(a).

Count II: Arbitrary and Capricious Agency Action. The states further assert that the EO's definitional terms are fatally unclear and fail to provide sufficient guidance either to contractors or federal contracting officers regarding what particular activities are prohibited. They note that neither the EO nor the agencies' implementing actions explained how the new requirements differ from existing civil rights laws or from prior contract requirements under EO No. 11246, which President Trump rescinded on January 21, 2026. The states argue that the agencies failed to account for the reliance interests of longtime federal contractors who had tailored their operations around EO No. 11246 for 60 years, and that the agencies failed to consider reasonably obvious alternatives such as retaining the prior regime or adopting requirements that clearly track existing civil rights laws.

The states seek a preliminary and permanent injunction, a declaratory judgment, and vacatur of the challenged agency actions.

IMPLICATIONS FOR FEDERAL CONTRACTORS

Immediate Compliance Uncertainty. The July 24, 2026, deadline for bilateral modification of existing contracts remains in effect absent judicial intervention. Contractors face an immediate dilemma: agree to terms whose scope and meaning are disputed and may be enjoined, or risk termination of valuable contracts.

1. As we have previously covered, on April 20, 2026, the National Association of Diversity Officers in Higher Education, the American Association of University Professors, the National Association of Minority Contractors, and other plaintiffs filed a complaint for declaratory, preliminary, and permanent injunctive relief in the U.S. District Court for the District of Maryland, challenging the EO as unconstitutional. *Nat'l Ass'n of Diversity Officers in Higher Educ. v. Trump*, No. 8:26-cv-01532 (D. Md. filed Apr. 20, 2026). The plaintiffs specifically allege that the EO violates the First Amendment's protections of free speech and free association by penalizing constitutionally protected expression on topics related to race and ethnicity, including by "threatening... suspension of contracts, debarment from contracting, and liability under the False Claims Act." The complaint further alleges that the EO's definition of "racially discriminatory DEI activities" is "both overbroad and imprecise" and reaches "a vast swath of contractor and subcontractor expression and activities... even if those activities are justified, legal, and constitutionally protected."

Scope of Restricted Activity Remains Unclear. As the plaintiff states emphasize, neither the EO nor the FAR Implementation explains what "racially discriminatory DEI activities" actually prohibits, if anything, beyond what existing civil rights laws already require. Contractors cannot readily determine whether activities long understood to be lawful, such as recruitment activity aimed at enhancing the number of minority applicants, anti-discrimination trainings, or organizational resource allocation to address disparate outcomes would violate the new clause.

Subcontractor Reporting Obligations. The requirement that contractors report subcontractors' conduct that "may violate" the clause could be read to suggest a requirement to monitor subcontractors, which is especially onerous given the lack of clarity in the underlying prohibition.

FCA Exposure. The states argue that the provision requiring contractors to acknowledge that their compliance with the clause is "material to the Government's payment decisions" for FCA purposes is legally infirm because materiality under the FCA cannot be established by contract alone.

Impact on State and Local Government Contractors. The plaintiff states collectively manage hundreds of contracts worth billions of dollars annually with the federal government. If the courts grant relief, the plaintiff state agencies and their subcontractors may be shielded from compliance obligations, at least temporarily. However, contractors in states that are not party to the litigation may not benefit from any state-specific injunction.

RECOMMENDED ACTIONS

Federal contractors should consider the following steps in light of this evolving situation.

- Contractors should conduct a thorough inventory of existing federal contracts and subcontracts to identify those that may be subject to modification demands.
- Contractors should evaluate their current DEI-related programs, trainings, recruitment practices, and resource allocation decisions against the EO's definitions to identify potential areas of perceived risk and document how those activities comply with existing civil rights laws.
- Contractors should monitor both pending cases for any preliminary injunction or stay that could alter compliance timelines before the July 24, 2026, deadline.
- Contractors should carefully evaluate any bilateral modification requests from contracting officers and consult with legal counsel before signing, particularly given the disputed legality of the underlying requirements.

We will continue to monitor these cases and provide updates as developments warrant. For more information or assistance, please contact Christina Manfredi McKinley or Dominique L. Casimir.

Christina Manfredi McKinley
412.932.2733 | christina.mckinley@blankrome.com

Dominique L. Casimir
202.420.2232 | dominique.casimir@blankrome.com

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