



FEDERAL CONTRACTS



REPORT

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Ethics

The Department of Justice's Call for Integrity: Will Federal Contractors Answer?

By ANGELA B. STYLES

I. Background

In November 2007, the Federal Acquisition Regulation ("FAR") Council issued two rules, one final and one proposed, decisively targeted at contractor integrity.¹ After years of increased reports of contractor fraud and a targeted focus on federal contracting by the Department of Justice ("DoJ"), the FAR Council and DoJ sent a strong message to federal contractors. While the final rule makes mild and largely unobjectionable changes to ethics and compliance requirements for fed-

¹ Final Rule on Contractor Code of Business Ethics and Conduct, 72 Fed. Reg. 65873 (Nov. 23, 2007); Proposed Rule on Contractor Compliance Program and Integrity Reporting, 72 Fed. Reg. 64019 (Nov. 14, 2007).

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eral contractors, the proposed rule would make sweeping and highly controversial changes to contractor disclosure and cooperation rules.

The message is clear: if federal contractors cannot self-regulate, significantly reduce fraud, increase disclosures, and improve the government's perception of cooperation, then the fundamental relationship between the federal government and its contractors will change. The nature of the relationship may not change precisely as proposed in the rule, but it is clear the federal government has reached its tolerance level for fraud and is not willing to continue under the status quo. The FAR Council and DoJ have placed the ball in the federal contractors' court to demonstrate they are not deserving of these draconian measures.

II. Proposed Rule — Contractor Integrity Reporting

A. Proposed Requirements

On November 14, 2007, acting upon a May 23, 2007, request from the DoJ Criminal Division, the FAR Council issued a proposed rule to effectuate sweeping changes to contractor disclosure and cooperation rules. As part of the National Procurement Fraud Initiative started in October 2006 by the Deputy Attorney General, the DoJ Criminal Division proposed specific policy

and regulatory changes to the FAR to “effectively reduce the exposure of federal contracts to fraud and corruption.”² As explained by DoJ:

[T]he 1980s witnessed significant innovations in the federal procurement system. Many of those reforms, including corporate compliance programs and corporate self-governance, were adopted with industry cooperation, and were later incorporated into evolving regulatory schemes in other business sectors and industries. In fact, the United States Sentencing Guidelines’ treatment of corporations, adopted in 1991, borrowed heavily from reforms that were first instituted for government contractors in 1986. However, since that time, our government’s expectations of its contractors have not kept pace with reforms in self-governance in industries such as banking, securities and healthcare.³

The DoJ Criminal Division also expressed extreme dissatisfaction with the response by federal contractors to the invitation of the Department of Defense (“DoD”) to “report or voluntarily disclose suspected instances of fraud.” In calendar year 2006, the DoD Voluntary Disclosure Program had 5 disclosures. In CY07, the Program had 2 disclosures.⁴ This seemingly low level of voluntary disclosures, when compared to the DoJ’s apparent increased contractor fraud case load, seemed incongruous to the DoJ on its face and appears to have prompted the unprecedented request by the DoJ to the FAR Council to add a new section entitled “Contractor Integrity Reporting” to the FAR.

While the FAR Council did not entirely adopt DoJ’s suggestions in substance or form, the proposed rule would add three significant integrity-related provisions to the FAR. They would address suspension or debarment, mandatory disclosure, and mandatory cooperation:

1. **Causes for Suspension and Debarment.** The causes for debarment or suspension at FAR 9.406-2 and FAR 9.407-2 would be modified to add the knowing failure by a contractor to timely disclose (1) “an overpayment on a Government contract” or (2) a “[v]iolation of Federal criminal law in connection with the award or performance of any Government contract or subcontract.” These changes would apply to all federal contractors.

2. **Mandatory Disclosure.** A new contract clause for contracts exceeding \$5 million would require contractors to notify the Office of the Inspector General (“IG”) when the contractor “has reasonable grounds to believe that a principal, employee, agency, or subcontractor of the [c]ontractor has committed a violation of Federal criminal law in connection with the award or performance of [the] contract or any subcontract thereunder.” The clause also requires that the contractor pro-

² Letter to the Honorable Paul Denett, Administrator, Office of Federal Procurement Policy from the Honorable Alice S. Fisher, Assistant Attorney General, Criminal Division, Department of Justice (May 23, 2007).

³ *Id.*

⁴ While www.fedspending.gov indicates that DoD contracts accounted for \$285 billion of the total \$413 billion in federal contract dollars spent in FY 2006, the DoD program is not the best or only basis for measurement of disclosures. Many disclosures, even in DoD, occur outside the formal voluntary disclosure program. Contractors routinely disclose to the agency office of the IG or to the contracting officer. These matters are resolved without formal referral to DoJ.

vide a copy of any such notification to the contracting officer.

3. **Mandatory Cooperation.** Finally, for businesses other than small businesses, the new contract clause for contracts exceeding \$5 million would require “[f]ull cooperation with any Government agencies responsible for audit, investigation, or corrective action.”

The new contract clause for mandatory disclosure and mandatory cooperation would not apply to contracts “for the acquisition of a commercial item awarded under FAR Part 12” or to “be performed entirely outside the United States.” Proposed Rule at FAR 3.1004.

B. Potential Issues

The proposed rule would change the federal contracting system from an ethics/compliance model based upon voluntary disclosure to a model based wholly on specified rules. The primary concern with any rules-based model is that the incentive is to find a way to justify your actions under the written rule, not simply to do what is in the best interest of the customer and the company. A rules-based model is also difficult to draft and administer fairly. Indeed, the primary issues with the Proposed Rule relate to the fact that the FAR Council and DoJ have attempted to draft a rules-based model for ethics. These concerns include:

- The proposed rule effectively amends the voluntary disclosure provisions of the False Claims Act. To avoid a per invoice penalty of \$5,500 to \$11,000 and treble damages, the False Claims Act provides a mechanism for contractors to reduce potential liability to double damages by voluntarily disclosing the violation. 31 U.S.C. § 3729. However, if the proposed rule makes all disclosures mandatory, the voluntary disclosure mechanism is effectively written out of the statute by the proposed rule. If a contractor is required to disclose, no disclosure from a contractor will be voluntary for purposes of the False Claims Act.

- The proposed rule eliminates the potential for reduced penalties for voluntary disclosures of violations of federal criminal law under the Federal Sentencing Guidelines. See U.S. Guidelines Manual, § 8C2.5(g). If contractor disclosure is mandatory under the proposed rule, contractors may no longer be able to participate in the sentencing regime established by Congress.

- Similar to the voluntary disclosure provisions of the False Claims Act and the Federal Sentencing Guidelines, the proposed mandatory disclosure provisions would eviscerate the potential for “timely and voluntary” disclosures under the Deputy Attorney General’s January 20, 2003, memorandum, “Principles of Federal Prosecution of Business Organizations.” Again, the voluntary nature of a disclosure, justifying leniency in prosecution, will be negated by the proposed mandatory disclosure provision.

- The new contract clause for mandatory disclosure and mandatory cooperation would apply to General Services Administration (“GSA”) Schedule contracts. The new contract clause only exempts contracts “for the acquisition of a commercial item awarded under FAR Part 12.” Because GSA Schedule contracts are executed under FAR Part 8, a broad category of commercial item contracts would be subject to the rule.

- The term “overpayment” is not defined and could include innocuous situations where a contract claim is in dispute. Contractors and the government make pay-

ment mistakes and have disputes about the proper allocation and accounting for costs.

■ The term “timely” is not defined and could be subject to widely varying interpretations. What constitutes a “timely” disclosure of an overpayment or violation of federal law could vary from days to years.

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■ The term “reasonable grounds” to believe that a principal, employee, agency, or subcontractor of the contractor has committed a violation of federal criminal law is difficult even for well-seasoned prosecutors and judges to interpret, but the proposed rule expects contractors to make this independent determination. Even though the DoJ May 2007 letter to OFPP noted that “it might be necessary to include guidance that defines terms such as ‘reasonable grounds,’ ” the proposed rule does not include a definition.

■ The lack of specificity regarding a “criminal violation” will be difficult to apply. If the rule is promulgated as written, contractors would be left on their own to determine what constitutes a violation of criminal law and what are “reasonable grounds” for deciding if a violation has occurred.

■ The reference to “subcontractor” within the mandatory disclosure requirements appears to imply that prime contractors would have an undefined requirement to police their subcontractors. Prime contractors cannot be expected to be the fraud police for subcontractors.

■ The rule is not clear whether it is prospective only. If the rule is promulgated as written, contractors could be required to disclose previous violations of law for which they now have “reasonable grounds” to believe occurred.

■ The meaning of “full cooperation” is undefined. The provision could be interpreted to (1) require the contractor to disclose attorney-client privileged information and/or (2) allow government auditors and contracting officers to demand extraordinary disclosures of information as part of contract administration. The breadth of this requirement could easily open government contractors to “fishing expeditions” by the government in normal contract administration situations.

Clearly, the rules-based approach created extreme difficulties in drafting and would create greater difficulties in implementation. To date, the FAR Council has received 12 comments through www.regulations.gov. Many comments are lengthy and express extraordinary concern over the potential for misuse and misinterpretation of a rules-based system.

III. Final Rule — Contractor Code of Business Ethics and Conduct

A. New Requirements

On November 23, 2007, the FAR Council published a final rule requiring certain federal contractors and encouraging others to adopt a written code of business ethics and conduct and to implement a program to ensure compliance with the code. The final rule adopts a new policy encouraging all contractors to “have a written code of business ethics and conduct” and to “promote compliance with such a code” by establishing a training program and an internal control system that:

- (1) Are suitable to the size of the company and extent of its involvement in Government contracting;
- (2) Facilitate timely discovery and disclosure of improper conduct in connection with Government contracts; and
- (3) Ensure corrective measures are promptly instituted and carried out.

FAR 3.1002(a). For contracts expected to exceed \$5 million with a performance period of 120 days or more that are executed after December 24, 2007, the Final Rule requires that the contracting officer add a new contract clause mandating the contractor’s adoption of a written code of business ethics and conduct, an awareness program, and an internal control system. FAR 52.203-13; FAR 3.1004(a). If a contract will exceed \$5 million, only contracts “for the acquisition of a commercial item awarded under FAR Part 12” or to “be performed entirely outside the United States” will be exempted from the requirement to include this new contract clause.

The new contract clause, FAR 52.203-13, entitled “Contractor Code of Business Ethics and Conduct (Dec. 2007),” requires all contractors with a contract containing this clause to establish a written code of business ethics and conduct within 30 days after contract award.⁵ The Final Rule provides no guidance on the content of the code, except to require that “each employee engaged in performance of the contract” must be provided a copy and that the contractor “shall promote compliance with its code of business ethics and conduct.” FAR 52.203-13(b).

For businesses other than small businesses, the new contract clause requires the adoption of an internal control system and an ongoing business ethics and business conduct awareness program within 90 days after contract award.⁶ The contract clause requires that the contractor’s internal control system (1) facilitate “timely discovery of improper conduct in connection Government contracts”; and (2) ensure “corrective measures are promptly instituted and carried out.” The contract clause advises that the contractor’s internal control system “should” provide for:

- (A) Periodic reviews of company business practices, procedures, policies, and internal controls for com-

⁵ The contract clause at FAR 52.203-13(b) allows the contracting officer to extend the 30-day time period after contract award for the adoption of a written code of business ethics and conduct.

⁶ The contract clause at FAR 52.203-13(c) allows the contracting officer to extend the 90-day time frame after contract award for the adoption of an awareness program and an internal control system.

pliance with the Contractor's code of business ethics and conduct and the special requirements of Government contracting;

(B) An internal reporting mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports;

(C) Internal and/or external audits, as appropriate; and

(D) Disciplinary action for improper conduct.

FAR 52.203-13(c)(2)(ii). This new contract clause must be flowed down to subcontracts exceeding \$5 million with a performance period of 120 days, except when "the subcontract is for the acquisition of a commercial item" or "is performed entirely outside the United States."

Finally, the Final Rule adds a second contract clause, FAR 52.203-14, entitled "Display of Hotline Poster (Dec. 2007)," which requires the contractor during performance in the United States to "prominently display in common work areas within business segments performing work" under the contract all agency fraud hotline posters that are specifically identified in the contract clause. The clause also requires that the agency posters be displayed on any website maintained for employees. Importantly, the contract clause requires the contracting officer to identify in the contract clause any agency fraud hotline posters that must be displayed. The clause also eliminates the agency fraud hotline poster requirement if the contractor "has implemented a business ethics and conduct awareness program, including a reporting mechanism, such as a hotline poster." This new contract clause must be flowed down to subcontracts exceeding \$5 million with a performance period of 120 days, except when "the subcontract is for the acquisition of a commercial item" or "is performed entirely outside the United States."

B. Concerns with Final Rule

As compared to the Proposed Rule, the Final Rule is mild and the potential concerns are largely ones of implementation. The issues that have been raised by the Final Rule to date include the following:

- The new contract clauses, FAR 52.203-13 and 14, apply to GSA Schedule contracts. The new contract clauses only exempt contracts "for the acquisition of a commercial item awarded under FAR Part 12." Because GSA Schedule contracts are executed under FAR Part

8, a broad category of commercial item contracts is subject to the rule.

- The Final Rule contains no specific guidance on the requirements for a code of business ethics and conduct or a system of internal controls. While this flexibility will allow for the utilization of a wide variety of codes and systems, no contractor will know if its code or system is sufficient for the purpose of the contract.

- The Final Rule provides no guidance on whether the contracting officer can demand changes to the code. Presumably, some contracting officers will exercise greater discretion over codes and internal control systems than will others. Nothing in the rule will prevent disparate treatment by contracting officers and micro-management of contractor codes and internal control systems.

- The Final Rule does not provide guidance on payment for drafting or implementation of contractor codes. Presumably, because this is a contract requirement, the costs of drafting, changes, and implementation will be reasonable costs that are passed back to the federal government through firm and flexibly priced contracts.

IV. Conclusion

As contractors contemplate the potential effect of these rules, they should not be deterred by the fact that the official comment period has closed. Because the Proposed Rule would so significantly change the nature of the federal government's relationship with contractors, extensive thought and discussion will occur within the Executive Branch and with Congress over the next several months.

Contractors should look for and take advantage of non-traditional mechanisms for providing input into this decision-making process. Because the Proposed Rule was determined to be a "significant rule," the Office of Management and Budget's Office of Information and Regulatory Affairs ("OIRA") will be open to receiving contractor comments. Contractors and associations should also look to Congress and members of the FAR Council to express their concerns over the effects of the rules.

Perhaps most important, however, the Department of Justice will be waiting to see if the threat of significant regulation affects contractor activity. The future relationship between the federal government and its contractors could depend on DoJ's perception of whether contractors can self-regulate, reduce fraud, increase disclosures, and increase cooperation.