

Proposed Regulation Imposes New Ethics Standards and Internal Control Procedures on Government Contractors

INTRODUCTION

The government's aggressive enforcement approach to government contracting fraud is now reaching directly into the internal policies and operations of contracting companies. On November 14, 2007, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council ("Councils") issued a proposed rule to amend the Federal Acquisition Regulation ("FAR") to establish new ethics standards and internal control procedures for government contractors.¹ 72 Fed. Reg. 64,019 (Nov. 14, 2007). Non-compliance with the rule, if adopted, could result in elimination from an award evaluation process, suspension, or debarment.

The proposed rule, issued at the request of the Department of Justice ("DOJ"), imposes three new regulatory requirements on government contractors. It requires all contractors to have a code of ethics and business conduct, and requires large contractors to establish and maintain specific internal controls to detect and prevent improper conduct in connection with the award of performance of government contracts or subcontracts. It also requires all contractors to notify the government without delay whenever they become aware of violations of federal criminal law with regard to contracts or subcontracts. Written comments on the proposed rule must be submitted to the FAR Secretariat on or before January 1, 2008.

CONTRACTOR CODE OF BUSINESS ETHICS AND CONDUCT

The proposed rule contains "guidance" for all contractors (including small business concerns) regarding internal ethics policies. It states that "[g]overnment contractors must conduct themselves with the highest degree of integrity and honesty," and that they "should have a written code of business ethics and conduct." The proposed rule further states that,

[t]o promote compliance with such a code . . . contractors should have an employee business and ethics compliance 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 of improper conduct in connection with Government contracts; and (3) Ensure corrective measures are promptly instituted and carried out. 72 Fed. Reg. 64,022.

While the establishment of an internal training program and internal control system is merely "guidance," the inclusion of ethics and compliance provisions in solicitations and contracts (except as discussed below) is mandatory. *Id.* According to the notice of proposed rulemaking, DOJ (among other entities) requested the inclusion of these provisions in contract solicitations and contracts "to more closely match" factors set forth

¹ The proposed rule builds upon a previous proposed rule that the Councils issued in February 2007 under FAR Case 2006-007, Contractor Code of Ethics and Business Conduct. See 72 Fed. Reg. 7,588 (Feb. 16, 2007). The Councils still intend to issue a final rule under that case. *Id.* at 64,019 (Nov. 4, 2007).

in the U.S. Sentencing Guidelines. *Id.* at 64,019. This means that if the proposed rule is adopted, contracting companies would be on direct notice that in the event of a criminal conviction, they will face greater obstacles in seeking lenience at sentencing if they have not fully complied with the ethics and internal control provisions explicitly contained in their contracts.

The proposed rule amends FAR Part 52 (“Solicitations and Contract Clauses”) to add a new ethics and compliance clause in solicitations and contracts if the value of the contract is expected to exceed \$5 million and the performance period is 120 days or more.² This clause is *not* required to be included, however, in contracts that will be for the acquisition of a commercial item awarded under FAR Part 12,³ or for contracts that will be “performed entirely outside the United States.” 72 Fed. Reg. 64,022. Thus, for example, the ethics and internal controls clause need not be included in solicitations or contracts for service contracts to be performed entirely in Iraq or Afghanistan.

Under the proposed rule, the ethics clause inserted into solicitations and contracts must provide that the Contractor will exercise due diligence to prevent and detect criminal conduct and “promote an organizational

culture that encourages ethical conduct and a commitment to compliance with the law.” *Id.* at 64,023. The clause also must provide that within 30 days after contract award (unless the contracting officer establishes a longer time period), the Contractor must have a written code of business ethics and conduct and provide it to each employee engaged in performance of the contract.

The proposed rule requires the Contractor to notify the relevant Office of the Inspector General and the Contracting Officer in writing “whenever the Contractor has *reasonable grounds to believe* that a principal, employee, agent, or subcontractor of the Contractor has committed a violation of the Federal criminal law in connection with the award or performance of this contract or any subcontract thereunder.” *Id.* (emphasis added). The term “principals” is defined to mean officers, directors, owners, partners, and persons having primary management or supervisory responsibilities within a business entity (down to the level of a plant manager).

Except for small business concerns, contractors must establish a business ethics awareness and compliance program *and* an internal control system within 90 days after contract award, unless the contracting officer establishes a longer time period. The business ethics

² The Councils “estimate that this clause will apply to 1800 prime contractors per year, of which 700 companies are small business concerns.” 72 Fed. Reg. 64,021.

³ The term “commercial item” is defined, in pertinent part, to mean “[a]ny item, other than real property, that is of a type customarily used by the general public or by non-governmental entities for purposes other than governmental purposes, and . . . [h]as been sold, leased, or licensed to the general public . . . or . . . [h]as been offered for sale, lease, or license to the general public.” FAR 2.101(b). It also includes (1) “[i]nstallation services, maintenance services, repair services, training services, and other services if . . . [s]uch services are procured for [certain designated commercial items], regardless of whether such services are provided by the same source or at the same time as the [commercial] item”; and (2) “[s]ervices of a type offered and sold competitively in substantial quantities in the commercial marketplace based on established catalog or market prices for specific tasks performed or specific outcomes to be achieved and under standard commercial terms and conditions.” *Id.*

awareness and compliance programs must include “reasonable steps to communicate periodically and in a practical manner the Contractor’s standards and procedures and other aspects of the Contractor’s business ethics awareness and compliance program and internal control system. . . .” 72 Fed.Reg. 64,023. The Contractor must accomplish this by “conducting effective training programs and otherwise disseminating information appropriate to an individual’s respective roles and responsibilities.” *Id.* Such training must be provided not only to the Contractor’s principals and employees, but also, “as appropriate,” to its agents and subcontractors. *Id.*

The Contractor’s internal control system must be multifaceted. It must “[e]stablish standards and procedures to facilitate timely discovery of improper conduct in connection with government contracts,” and to “ensure corrective measures are promptly instituted and carried out.” *Id.* “At a minimum,” the Contractor’s internal control system must incorporate several provisions to prevent and detect violations of law.” *Id.* First, it must assign responsibility “at a sufficiently high level of the organization and adequate resources to ensure effectiveness of the business ethics awareness and compliance program and internal control system.” *Id.* Second, it must provide for “[r]easonable efforts not to include within the organization principals whom due diligence would have exposed as having engaged in conduct that is illegal or otherwise in conflict with the Contractor’s code of business ethics and conduct.” *Id.* Third, it must call for periodic reviews of company business practices, procedures,

policies, and internal controls for compliance with the Contractor’s code of business ethics and conduct “and the special requirements of Government contracting,” including:

- Monitoring and auditing to detect criminal conduct;
- Periodic evaluation of the effectiveness of the organization’s business ethics awareness and compliance program and internal control system, “especially if criminal conduct has been detected”; and
- Periodic assessment of the risk of criminal conduct, with “appropriate steps” to design, implement, or modify the business ethics awareness and compliance program and the internal control system “as necessary to reduce the risk of criminal conduct identified through this process.” *Id.*

Fourth, the Contractor’s internal control system must also:

- Provide both for an internal reporting mechanism (such as a hotline) “which allows for anonymity or confidentiality, by which employees may report suspicious instances of improper conduct,” and provide employees with “instructions that encourage employees to make such reports.”
- Require disciplinary action for improper conduct “or for failing to take reasonable steps to prevent or detect improper conduct.”
- Require “[t]imely reporting,” in writing, to the agency Office of the Inspector General and Contracting Officer, “whenever the Contractor has *reasonable grounds to believe* that a principal,

⁴ The Councils explain in the notice of proposed rulemaking that “[t]he requirement for mandatory reporting is limited to violations of Federal criminal law in connection with performance or award of a Government contract or subcontract, rather than requiring report of any improper conduct, even that which is not a violation of Federal criminal law.” 72 Fed. Reg. 64,021.

employee, agent, or subcontractor . . . has committed a violation of Federal criminal law⁴ in connection with the award or performance of any Government contract performed by the Contractor or a subcontractor thereunder.” 72 Fed. Reg. 64,023 (emphasis added). (According to DOJ, this mandatory disclosure requirement “is necessary because few companies have actually responded to the invitation of DOJ that they report or voluntarily disclose suspected instances[s] of violations of Federal criminal law relating to the contract or subcontract.”)⁵ *Id.* at 64,020.

- Require “[f]ull cooperation with any Government agencies responsible for audit, investigation, or corrective action.”⁶

Contractors must include “the substance” of the above internal control measures in subcontracts that have a value exceeding \$5 million and a performance period of more than 120 days, except when the subcontract (1) is for the acquisition of a commercial item; or (2) is performed outside the United States.

CONTRACTOR QUALIFICATIONS

At DOJ’s request, the proposed rule amends the general standards of responsibility at FAR 9.104-1 to treat a contractor’s record of “integrity and business ethics” as relevant information to be included at FAR 42.1501 in past performance information. *Id.* at 64,019. The proposed rule states that “[f]or contractors that have had prior contracts

subject to these new requirements, compliance as reflected in past performance rating will be an element for consideration in assessing whether a contractor meets the standard of integrity and business ethics.” *Id.*

CONSEQUENCES FOR NON-DISCLOSURE OF VIOLATIONS

At DOJ’s request, the proposed rule amends the FAR to impose harsh penalties for non-disclosure of contractor misconduct. 72 Fed. Reg. 64, 020. It amends FAR 9.407-2 to provide for suspension “upon *adequate evidence*” that a contractor has knowingly failed to timely disclose “(i) An overpayment on a Government contract; or (ii) [a] Violation of Federal criminal law in connection with the award or performance of any Government contract or subcontract.” *Id.* at 64,022 (emphasis added); *see* FAR 9.407-2(a). Similarly, the proposed rule amends FAR 9.406-2 to provide for debarment if there is a *preponderance of the evidence* that a contractor has knowingly failed to “timely disclose . . . (A) An overpayment on a Government contract; or (B) [a] Violation of Federal criminal law in connection with the award or performance of any Government contract or subcontract.” *Id.* (emphasis added).

PRUDENTIAL ACTIONS FOR CONTRACTING COMPANIES

In anticipation that the proposed rule will become final in the coming months, contracting firms that do not already have a code of business ethics and internal controls system in place to detect and preclude

⁵ The Councils observe that a contractor’s disclosure under the mandatory disclosure requirement “would probably involve legal assistance to prepare.” *Id.*

⁶ For this requirement, the Councils specifically have invited “public comment and analysis” with respect to whether “full cooperation” could result in “waiver of the attorney-client privilege.” *Id.* at 64,020.

criminal misconduct should take steps now to establish them. Those companies with such measures already in effect should reexamine them to assess whether they fully satisfy the requirements of the impending regulatory scheme.

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institutions fraud; environmental crimes; RICO prosecutions; and customs cases.

FOR MORE INFORMATION

For further information on this proposed regulation or any other enforcement or investigative matter of concern, including the development of an effective compliance program to help prevent violations of law, please contact:

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