

Mandatory Disclosure Now in Effect for Government Contractors

Today, a new mandatory disclosure rule takes effect that dramatically alters the legal dynamic between government contractors and federal agencies. Specifically, an amendment to the Federal Acquisition Regulation (“FAR”) becomes operational that henceforth requires all contractors to “timely” disclose certain violations of law and overpayments to the government on penalty of suspension and debarment. The new disclosure requirement applies not only to prospective violations, but also to violations known to a contractor “principal” as of the effective date of the rule (i.e., December 12, 2008). Also in effect as of today are new minimum standards for internal control systems intended to preclude violations by contractors.

New Mandatory Disclosure Requirements

Under the new regulatory regime, all contractors, regardless of their size or the value of the procurement, must now make a “timely” written disclosure to the Office of Inspector General at the agency that awarded the contract – with a copy to the contracting officer – whenever, in connection with an award, performance, or closeout of a contract or subcontract, the contractor has “credible evidence” that a principal, employee, agent, or subcontractor has committed (1) a violation of federal criminal law involving fraud, conflict of interest, bribery, or illegal gratuities; or (2) a violation of the civil False Claims Act. (According to the FAR Councils, contractors are already obligated to report overpayments under pre-existing payments provisions in the FAR.) In response to extensive public comment, the

final rule eliminates recommended exemptions that were included when it was first proposed in November 2007. The mandatory disclosure requirement therefore now applies both to acquisitions for commercial items and to contracts performed outside of the United States. In addition, it applies to subcontractors as well as prime contractors. Correspondingly, it mandates that the new ethics clause at FAR 52.203.13, established in 2007 under FAR Case 2006-007, be included in qualifying contracts and subcontracts for acquisitions of commercial items and contracts to be performed outside of the United States.

Contractors face stiff penalties for non-compliance with the new disclosure requirement. Specifically, any contractor or subcontractor may be suspended or debarred upon the “knowing” failure by a “principal” to “timely” disclose to the government, in connection with the award, performance, or closeout of a contract or performed by the contractor or a subcontractor thereunder, “credible evidence” of the following: (1) a violation of federal criminal law involving fraud, conflict of interest, bribery, or illegal gratuities; (2) a violation of the civil False Claims Act; or (3) “significant overpayments” on a contract (i.e., overpayments other than those resulting from contract financing payments). Debarment in the event of non-disclosure is not a certainty; however, according to the FAR Councils, the ten mitigating factors set forth in FAR 9.406-1(a) will continue to apply in proceedings to determine whether debarment should occur.

The disclosure obligation continues until three years after final payment on a contract. Moreover, contractors must now disclose known violations relating to an *ongoing* contract even if they occurred *prior* to December 12, 2008, the effective date of the regulation. The knowing failure to disclose specified violations

remains a cause of action for suspension and debarment for three years after final payment on a contract.

Key Elements of the Disclosure Requirement

The definitions of key terms in the new regulation underscore the breadth of the disclosure requirement's application.

“Principal.”

A “principal” – who must have knowledge in order for mandatory disclosure to be applicable – is broadly defined in the regulation to include “an officer, director, owner, partner, or a person having primary management or supervisory responsibilities within a business entity,” such as a general manager, plant manager, or the head of a subsidiary, division, or business segment. In commentary on the regulation equivalent to a statute’s legislative history, the FAR Councils stressed that the “definition should be interpreted broadly, and could include compliance officers or directors of internal audit, *as well as other positions of responsibility.*” (Emphasis added.)

“Credible Evidence.”

The FAR Councils expressly noted that “[u]ntil the contractor has determined the evidence to be credible, there can be no ‘knowing failure to timely disclose.’” In addition, they commented that “[i]t is unlikely that any contractor would be suspended or debarred absent the determination that a violation had actually occurred.” However, the term “credible evidence,” is not defined in the regulation. The FAR Councils did indicate that mere allegations of wrongdoing may not suffice to trigger the disclosure requirement. They commented that “credible evidence” is a “higher standard” than “reasonable grounds to believe” (the standard advanced when the regulation was first proposed) and that it “impl[ies] that the contractor will have the opportunity to take some time for preliminary examination of the evidence to determine its credibility for deciding to disclose to the Government.” Similarly, they observed that the mere filing of a *qui tam* action, by itself, does not constitute credible evidence of a violation.

“Knowing.”

The FAR Councils declined to define “knowing” in the context of a “knowing failure to disclose.” In a tautological observation, they commented only that “knowing” refers to “the failure to disclose,” adding that “principals are only required to disclose what they know.”

“Timely.”

The FAR Councils devoted substantial consideration to how quickly a contractor must disclose information about a violation or an overpayment to the government in order to comply with the new regulation and avoid potential suspension or debarment. Although the term “timely” is not defined in the regulation, the FAR Councils explained that timeliness is measured from the date the contractor determines that evidence is credible, or, in a case where credible evidence of a violation was known prior to contract award, from the December 12, 2008, effective date of the Final Rule. A contractor has “some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the Government.” Contractors are not obligated to conduct a “complex investigation,” and are expected to take only “reasonable steps” that they “consider sufficient to determine that the evidence is credible.” Citing input from the Department of Justice, the FAR Councils added that the relevant Office of Inspector General or contracting officer is expected to encourage the contractor to complete its internal investigation so that it may make a full report of its findings.

“Overpayment.”

The FAR Councils also declined to define “overpayment” for purposes of the Final Rule, instead referring respondents to existing descriptions of overpayments in current FAR provisions. They did indicate, however, that *de minimis* overpayments will not trigger the disclosure requirement, explaining that “[t]his rule is aimed at the type of overpayment that the contractor knows will result in unjust enrichment, and yet fails to disclose it.” The FAR Councils also remarked that the term “significant” “implies more than just dollar value and depends on the circumstances of the overpayment as well as the amount.”

“Flowdown Obligations.”

Although a prime contractor could face sanctions in connection with misconduct by a subcontractor, the FAR Councils commented that “[t]he prime contractor is subject to debarment only if it fails to disclose *known* violations by the subcontractor.” (Emphasis added.) A prime contractor is not required to review or approve a subcontractor’s code of ethics or internal control system; rather, it must only verify that the subcontractor has them.

Minimum Standards for Internal Control Systems

Building upon the ethics requirements instituted under FAR Case 2006–007 in 2007, the new regulation mandates several minimum standards for the internal control system required of large contractors. First, the contractor must assign responsibility at a sufficiently high level within the organization, and provide adequate resources to ensure the effectiveness of its business ethics awareness and internal control system. Second, it must make “reasonable efforts” not to include principals within the organization 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. Third, the contractor must conduct periodic reviews of company business practices, procedures, policies, and internal controls to assess compliance with its code of business ethics and conduct, including: (1) monitoring and auditing to detect criminal conduct; (2) periodic evaluations of the effectiveness of its business ethics awareness and compliance program and its internal control system, “especially if criminal conduct has been detected”; and (3) periodic assessments of the risk of criminal conduct, with appropriate remedial measures to reduce the risk of any criminal conduct identified. Fourth, contractors must establish an internal reporting mechanism that allows for anonymity or confidentiality, such as a hotline, and must instruct employees on how to use it. Fifth, contractors must institute disciplinary action for “improper conduct” (a lower threshold than a violation of law), or for failing to take reasonable steps to prevent or detect “improper conduct.” Sixth, contractors must comply with the

“timely disclosure” requirements detailed above. Finally, a contractor must provide “full cooperation” to any government agencies responsible for an audit, investigation or corrective action.

The issue of what constitutes “full cooperation” is particularly noteworthy. Consistent with the Department of Justice’s new enforcement policy on the prosecution of business organizations, the term is defined in the new regulation as “disclosure to the Government of the information sufficient for law enforcement to identify the nature and extent of the offense and the individuals responsible for the conduct.” In response to numerous public comments, the FAR Councils elaborated, explaining that “full cooperation” does not prevent a contractor from conducting an internal investigation or defending a proceeding or dispute arising under a contract or related to a potential or disclosed violation. They remarked that “full cooperation” includes “providing timely and complete responses to Government auditors’ and investigators’ requests for documents and access to employees with information,” adding that it is “reasonable to expect” that “compliant contractors” will “encourage” employees “both to make themselves available” to investigators and prosecutors, and to cooperate with the government’s investigation. Manifesting the risk of criminal prosecution looming over the new ethics regime, the FAR Councils noted that “[i]gnoring or offering little attention to detail in responding to auditor or investigator requests or subpoenas for documents or information may, in some circumstances, be obstruction of justice”

Consistent with the new DOJ policy on corporate prosecution, the FAR Council stressed that “full cooperation” does not require a waiver by a contractor of the attorney–client privilege or protections of the attorney work–product doctrine. Nor does it require an officer, director, owner, or employee to waive their attorney–client privilege or Fifth Amendment rights. Similarly, the FAR Councils stated that there is “no reason to think” that “employees forfeit their right to indemnification from their employers.”

Issues and Recommendations

Although the FAR Council's responses to public comments shed some light on how the new mandatory disclosure rules will be applied, several issues await further illumination. It is unclear whether companies that disclose violations to the government will continue to receive credit for cooperation in a debarment proceeding – or in a criminal prosecution – now that disclosure of wrongdoing is now mandatory. The determination of what constitutes “credible evidence” will likely be a subjective assessment particular to a given case, impacted by such variables as documentary proof of a violation and the quality and extent of witness statements and other corroborating evidence. Only with experience will empirical benchmarks develop that provide more visible guidelines. It also remains uncertain how much latitude contractors will be given to engage in fact-finding activities in order to satisfy the timeliness element of the new disclosure standard. The FAR Councils have indicated that the term “principal” might be applied to any position of responsibility with respect to performance, but only time and experience with the new enforcement regime will indicate how deep into a contract management system agencies will reach to impute knowledge of a violation.

For now, contractors would be wise to undertake, at a minimum, the following prudential measures. First, they should reexamine existing codes of business conduct and ethics, and existing internal control systems, to ensure they comply with the new rules. Second, training of company personnel on the new rules – from principals down to accounting personnel and administrative staff engaged in contract administration – should be accomplished as soon as possible. In the event of a problem, government auditors and investigators will be examining, among other things, whether the contractor merely has a compliance program on paper or has meaningfully implemented it. Third, companies should consider instituting incentives to report violations – both to strengthen their existing ethics culture and to facilitate timely disclosure of violations to the government. In that regard,

contractors should reexamine the adequacy of hotline procedures and other existing reporting mechanisms to ensure that they provide a reliable and confidential means for personnel to report violations, and that employee reports of violations are acted on promptly. Finally, prime contractors should ensure that prospective subcontracts contain the requisite ethics clauses and should obtain a written certification from subcontractors that they have the required ethics code and internal control procedures in effect.

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