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## SECOND SERIES

PRACTICAL TIGHT-KNIT BRIEFINGS INCLUDING ACTION GUIDELINES ON GOVERNMENT CONTRACT TOPICS

### CONTRACTOR BUSINESS ETHICS COMPLIANCE PROGRAM & DISCLOSURE REQUIREMENTS

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&  
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**F**or several decades, the concept of voluntary disclosures in Government contracting seemed to work well for the procurement community. Neither the Government nor contractors saw a need to change the system and the prevailing attitude was more or less captured by the old adage, “if it ain’t broke, don’t fix it.” However, beginning in 2007, the Criminal Division of the U.S. Department of Justice believed the system needed to be “fixed.” As a result, such disclosures are now mandatory, not voluntary, the disclosure requirements reach back to contracts that may have been awarded several years ago, and a contractor may be suspended or debarred for failing to disclose underlying conduct that, viewed separately, might not warrant such a severe administrative penalty. This BRIEFING PAPER discusses the development of the final rule, FAR Case 2007-006, “Contractor Business Ethics Compliance Program and Disclosure Requirements,”<sup>1</sup> timing and applicability issues presented by the final rule, the rule’s mandatory disclosure, contractor

code of business ethics and conduct, ongoing business ethics awareness and compliance program, and internal control system requirements, and enforcement. In addition, the PAPER addresses

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- Development Of The Final Rule
- Timing Issues
- Application To Contracts & Contractors
- Mandatory Disclosure Requirements
- Contractor Code Of Business Ethics & Conduct
- Ongoing Business Ethics Awareness & Compliance Program
- Internal Control System
- Enforcement
- Disclosure Consideration Factors
- FAS 5 Considerations
- Mergers & Acquisitions Considerations
- Benefits Of Developing A High-Performance Compliance Program

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factors contractors should consider when complying with the rule's mandatory disclosure requirements, considerations related to Financial Accounting Standard No. 5 and mergers and acquisitions, and the benefits of developing a high-performance compliance program to reduce risk while improving business operations.

## Development Of The Final Rule

### ■ DOD Voluntary Disclosure Program

Disclosing wrongdoing, albeit voluntarily, is nothing new to Department of Defense contractors. In 1985, President Ronald Reagan established the President's Blue Ribbon Panel on Defense Management. Also known as the Packard Commission, the Panel was tasked with conducting a broad assessment of defense management policies, with the goal of presenting action plans that could be easily transitioned into executive branch policy.<sup>2</sup> The Packard Commission began its work by focusing on DOD procurement. As part of its mandate, the Packard Commission investigated contractor conduct and accountability, offered proposals for reform, and recommended the establishment of a system by which contractors could voluntarily disclose misconduct to the Government.<sup>3</sup> This recommendation was consistent with the Packard Commission's general conclusion that the dynamic between the DOD and contractors had become damagingly adversarial, likely discouraging innovative companies from contracting with the DOD.<sup>4</sup>

The DOD responded to the Packard Commission's recommendations quickly and, in 1986, unveiled the DOD Voluntary Disclosure Program

(VDP).<sup>5</sup> The DOD VDP was "intended to afford contractors the means to report self-policing activities" and to create "a framework for Government verification of the matters voluntarily disclosed and an additional means for a coordinated evaluation of administrative, civil, and criminal actions appropriate to the situation."<sup>6</sup> The VDP was, as noted by former DOD Inspector General Susan Crawford, "not an amnesty or immunity program."<sup>7</sup> However, contractors could generally expect some benefits for participating in the DOD VDP.<sup>8</sup> A 1996 report by the U.S. General Accounting Office (now the Government Accountability Office) identified five specific benefits contractors often enjoyed by participating in the program. These included (1) "liability in general to be less than treble damages; (2) action on any suspension to be deferred until after the disclosure is investigated; (3) the overall settlement to be coordinated with government agencies; (4) the disruption from adversarial government investigations to be reduced; and (5) the information [disclosed] may be kept confidential to the extent permitted by law and regulation."<sup>9</sup>

Under the DOD VDP, a contractor attempting to make a disclosure needed to have the disclosure accepted into the VDP. Acceptance was based on a number of criteria, including the contractor's provision of sufficient information and whether the disclosure was triggered by the contractor's knowledge that the matter would soon be discovered by the Government on its own initiative or would be reported by third parties.<sup>10</sup> Following the initial disclosure, the Government would begin a multi-agency inquiry to determine if the Government had prior knowledge of the matter disclosed by the contractor.<sup>11</sup> Prior Government knowledge could bar acceptance of the matter

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in to the VDP but was not conclusive.<sup>12</sup> If the matter was accepted into the VDP, the contractor and the Government then entered into an agreement governing the disclosure.<sup>13</sup> The contractor would then launch an internal investigation into the matter and forward a timely final report to the Government.<sup>14</sup> Following receipt of the final report, the Government usually instituted a verification investigation and audit led jointly by DOD criminal investigation organizations and the Defense Contract Audit Agency.<sup>15</sup> The contractor was required to cooperate with the Government during the verification process and abide by the terms of its agreement with the Government or risk withdrawal of the matter from the VDP.<sup>16</sup> Following the completion of the verification process, as well as the assessment of any civil or criminal penalties, the contractor would be notified that the matter was closed.<sup>17</sup>

The DOD VDP led to the recovery of over \$462 million from the program's creation in 1986 through Fiscal Year 2007.<sup>18</sup> Contractors made upwards of 470 disclosures under the program during the same period.<sup>19</sup> However, both the number of disclosures and the amount recovered have been relatively lopsided, with the first 10 years of the program seeing the bulk of disclosure activity. Approximately 80% of the \$462 million was recovered by the close of FY 1997.<sup>20</sup> Similarly, around 80% of the total 476 disclosures under the DOD VDP were made before the close of FY 1997.<sup>21</sup>

In practice, the DOD VDP seemed to be a qualified success. Comment letters from the DOD and the DOJ to a draft of a 1996 GAO review of the program indicated that both agencies wholeheartedly supported the continuation of the DOD VDP.<sup>22</sup> The DOJ noted that "we think the program has been remarkably effective in nurturing business honesty and integrity and in bringing good new cases to our attention."<sup>23</sup> The DOD concurred, writing that the VDP "generates positive results and is clearly in the Government's best interests."<sup>24</sup> However, the 1996 GAO report also highlighted issues that may have affected the program's effectiveness. The report initially noted that "the total number of disclosures under the program has been relatively small, and the dollar recoveries have been modest."<sup>25</sup> This assertion, however, was challenged by both the DOD and

the DOJ. The DOD argued that the method used to determine the relative number of disclosures (comparing the number of voluntary disclosures to the total number of contractors doing business with the DOD) was not reasonable, as it did not account for the fact that the 100 contractors that received approximately 70% of DOD contracting dollars would inherently be the largest and most significant source of disclosures.<sup>26</sup> Revising the method to give more weight to the top 100 contractors would produce a more accurate picture of the program's effectiveness, according to the DOD.<sup>27</sup> Moreover, both the DOJ and the DOD agreed that the number and dollar amount of disclosures under the VDP was an imperfect measure of the program's success. Both agencies argued that the program had other significant positive impacts, especially the internal corporate compliance reforms undertaken by contractors after making voluntary disclosures.<sup>28</sup> Further, as noted by some of the comments offered on the proposed mandatory disclosure rules (discussed below), the growth of voluntary disclosures made in other fora may have further weakened the correlation between the number of the disclosures and the program's usefulness.<sup>29</sup>

A more contemporary, systemic review of the DOD VDP program on the scale of the 1996 GAO report has not been undertaken (or at least made publicly available) and is not likely to be forthcoming due to the transition from the VDP to the new mandatory disclosure program. Thus, any evaluation of the DOD VDP post-1996 is inherently based on statistics regarding the number and amount of disclosures.

#### ■ DOJ Letter

The impetus for the "Contractor Business Ethics Compliance Program and Disclosure Requirements" final rule originated with the DOJ's Criminal Division. In a May 23, 2007 letter to the Administrator of the Office of Federal Procurement Policy, Assistant Attorney General Alice S. Fisher initially proposed certain modifications to the Federal Acquisition Regulation.<sup>30</sup> The letter requested that "the FAR be modified to require that contractors establish and maintain internal controls to detect and prevent fraud in their contracts, and that they notify contracting officers without delay whenever

they become aware of a contract overpayment or fraud, rather than wait for its discovery by the government.”<sup>31</sup>

Fisher’s letter offered several rationales for the request. Noting that the request was modeled on existing requirements in other areas, and explicitly referring to the Sarbanes-Oxley Act of 2002, the letter argued that, in requesting the modifications, the DOJ has “been careful not to ask contractors to do anything that is not already expected of their counterparts in other industries.”<sup>32</sup> Fisher’s letter also referenced a then-recent effort by the National Reconnaissance Office to include a contract clause requiring its contractors to disclose contract fraud and other illegal activities,<sup>33</sup> noting that the NRO believed the effort improved its relationship with its contractors.<sup>34</sup> Finally, while Fisher’s letter granted a respite for small businesses in regards to the institution of a compliance program, it argued that “all contractors, regardless of size, should be expected to report fraud when they become aware of it.”<sup>35</sup>

The letter also highlighted the history of compliance and governance reforms in the industry. Fisher argued that while the procurement industry was instrumental in creating compliance and governance reforms in the 1980’s, “since that time, our government’s expectation of its contractors has not kept pace with reforms in self-governance in industries such as banking, securities, and healthcare.”<sup>36</sup> Only one line of the letter was devoted to the DOD VDP, the program that the DOJ’s proposals have now replaced, stating that “our experience suggests that few [contractors] have actually responded to the invitation of the [DOD] that they report or voluntarily disclose suspected instances of fraud.”<sup>37</sup> The letter concluded with a request to expedite the review and approval process for the DOJ’s recommendations, arguing that the reform presents a “sufficiently ‘urging and compelling circumstance’” to justify the use of an interim rule.<sup>38</sup>

### ■ First Proposed Rule

The first proposed rule regarding contractor business ethics compliance programs and disclosure requirements was published in the *Federal Register* on November 14, 2007.<sup>39</sup> However, this first proposed rule was in fact an offshoot of a somewhat similar proposed rule issued by the Civilian Agency Acquisi-

tion Council and the Defense Acquisition Regulations Council on February 16, 2007.<sup>40</sup> Because this earlier proposed rule predated the DOJ letter, it included only a portion of the DOJ’s recommended changes. While the earlier related proposed rule contained requirements for a contractor code of ethics and business conduct, it did not address the mandatory reporting requirements requested by the DOJ, among other things. Thus, the FAR councils issued a new proposed rule on November 14, 2007, in part to incorporate the requests included in the DOJ’s proposal.<sup>41</sup> This first proposed rule included requirements for a contractor code of business ethics and conduct, business ethics awareness and compliance program and internal control system, and mandatory reporting that were similar to those included in the new final rule. Specifically, for contracts expected to exceed \$5 million and a performance period of 120 days or more, with the exception of commercial item contracts and contracts performed entirely outside the United States, the first proposed rule required contractors to maintain a code of business ethics and conduct.<sup>42</sup> The rule also required such contractors, with the exception of small business contractors, to maintain a business ethics awareness and compliance program and internal control system.<sup>43</sup> Finally, the first proposed rule required a similar 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.<sup>44</sup>

There are a few notable differences, however, between the first proposed rule and the later iterations. The first proposed rule would have required a different standard of awareness to trigger the mandatory reporting requirement and mandated the reporting of a significantly different scope of misconduct compared to later drafts of the rule. Under the first proposed rule, contractors would have been required to report to the agency Office of Inspector General when they had “*reasonable grounds* to believe that a principal, employee, agent, or subcontractor...has committed a violation of *Federal criminal law* in connection with the award or performance” of any Government contract or subcontract.<sup>45</sup> Both the “reasonable grounds” standard and the scope of misconduct were altered in the second proposed and final rules, as discussed below.



The first proposed rule also lacked the “look back” provision included in the final rule, which requires reporting of misconduct associated with contracts on which final payment has been made less than three years ago.<sup>46</sup> However, under the first proposed rule, a contractor could be suspended or debarred for a knowing failure to report misconduct in connection with “the award or performance of *any* Government contract or subcontract,” regardless of the inclusion of proposed “Contractor Code of Business Ethics and Conduct” clause in its contract.<sup>47</sup> Thus, the question whether disclosure was required for misconduct relating to contracts already closed-out or still in progress on the effective date of the rule was an important one. Nevertheless, the first proposed rule did not include any temporal guidance on the date of the alleged misconduct vis-à-vis the requirement to report it. Later comments by the FAR councils in the final rule, however, indicate that the intended effect was to require disclosure of misconduct on all Government contracts and subcontracts held by the contractor, regardless of their current status.<sup>48</sup>

The first proposed rule received 43 comments.<sup>49</sup> Included in these comments were numerous submissions that expressed support for the rule but desired to see it become more robust by removing the exemptions for commercial item contracts and contracts to be performed wholly outside the United States. Indeed, a comment prepared by the Ethics Resource Center stressed that the possible complete exemption of small businesses was misplaced, as “the overwhelming majority of organizations sentenced for federal criminal offenses are companies with less than 50 employees.”<sup>50</sup> The DOJ also requested the inclusion of a requirement to report violations of the civil False Claims Act, as well as the addition of a cause for suspension or debarment upon the failure to do so.<sup>51</sup>

The Government contracting industry also responded to the first proposed rule. The Council of Defense and Space Industry Associations, for example, submitted a comment letter that offered five broad criticisms of the first proposed rule. CODSIA argued that (1) there was not a demonstrated need to abandon regulatory approaches that have successfully leveraged contractor cooperation; (2) numerous federal agencies considering the implementation of mandatory reporting

requirements had opted instead for a voluntary program; (3) the existing system provided sufficient incentives to address fraud; (4) the proposed rule failed to meet a standard of fundamental fairness and would require a waiver of the right to assert confidentiality; and (5) the FAR councils’ analyses failed to comply with both the Regulatory Flexibility Act and the Paperwork Reduction Act. CODSIA emphasized the first proposed rule’s apparent lack of foundation on any empirical data supporting the switch from a voluntary to a mandatory reporting regime and requested that any such data supporting the proposed rule be made available for comment and analysis.<sup>52</sup> Specifically targeting the DOJ’s reliance on the NRO mandatory disclosure program in proposing the new mandatory disclosure requirement, CODSIA argued that “[t]he NRO rule, however, requires disclosure of potential illegal activity related to the conduct of intelligence operations in the interest of national security and, thus, is not an appropriate model for all government contractors.”<sup>53</sup>

### ■ Second Proposed Rule

The second proposed rule was issued on May 16, 2008.<sup>54</sup> The second proposed rule attempted to increase both the scope of misconduct that must be reported and the type of contractors required to detect and report the misconduct. Upon the suggestion of the DOJ, the second proposed rule added violations of the civil False Claims Act to the list of misconduct that should be detected and disclosed.<sup>55</sup> The failure to report violations of the civil False Claims Act was also added as a third ground for suspension and debarment.<sup>56</sup>

Acting on concerns voiced by “the public and other interested parties,” the second proposed rule also removed the previous exemptions for commercial item contracts and contracts performed wholly outside the United States.<sup>57</sup> In discussing the removal of the commercial item exemption, the FAR councils noted that it was “in some ways more fair to contractors providing commercial items, because even though the clause was not included in contracts for the acquisition of commercial items, the contractors were still subject under the initial proposed rule to debarment or suspension for knowing failure to notify the Government of violations of Federal criminal law

in connection with the award or performance of a contract (or subcontract).<sup>58</sup>

While the FAR councils adopted many of the recommendations offered in the comments on the first proposed rule, the majority of the issues raised regarding the initial draft of the rule were still outstanding following the second proposed rule. Further, the second proposed rule offered few, but substantive, changes. Therefore, many of the comments concerning the second proposed rule addressed these changes. For example, many of the substantive comments focused on the addition of civil False Claims Act violations to the disclosure requirements, as well as the removal of exceptions for commercial item contractors and contracts being performed wholly overseas. However, some of the contentious aspects of the first proposed rule continued to be criticized—and new issues were also attacked. The FAR councils agreed with one commenter who argued that the addition of the causes for suspension and debarment would have a disproportionate effect on small businesses that lacked the leverage to successfully navigate the suspension and debarment arena.<sup>59</sup> However, the councils stated that they could not “give further flexibility here,” citing the removal of the requirement for an internal control system for small business concerns as good a compromise as was able to be reached, as there cannot be two separate standards for debarment or suspension.<sup>60</sup>

Additionally, the DOJ and one agency IG argued that disclosure of significant overpayments should also be included in the rule. Despite noting that the mandatory reporting of overpayments is addressed in the “Payment” clauses, the FAR councils later accepted the suggestion.<sup>61</sup> Additionally, many agency IGs supported the second proposed rule’s removal of the exemption for commercial items, arguing that the duty to report misconduct and safety issues should not be dependent on the type of contract used.<sup>62</sup>

### ■ Final Rule

The final rule, FAR Case 2007-006, “Contractor Business Ethics Compliance Program and Disclosure Requirements,” was issued on November 12, 2008.<sup>63</sup> Among other changes, the final rule revises FAR Subpart 3.10, “Contractor Code of Business

Ethics and Conduct,” the causes for suspension and debarment in FAR Subpart 9.4, and the “Contractor Code of Business Ethics and Conduct” contract clause at FAR 52.203-13.<sup>64</sup> Though similar in structure to the first and second proposed rules, the final rule incorporates a number of significant additions and modifications. The final rule was accompanied in the *Federal Register* by a lengthy preamble, discussed further below, that responded to many of the concerns over the rule voiced by earlier comments and explained the changes made to the final rule that were not present in the first or second proposed rules.<sup>65</sup>

The first notable change in the final rule is the standard of awareness required to trigger a contractor principal’s duty to report the misconduct. The final rule changes the standard from “reasonable grounds to believe” to “credible evidence.” As explained in the preamble, the change was made based on consultations between the DOJ Criminal Division and industry representatives.<sup>66</sup> The “credible evidence” standard, at least as explained by the preamble, is meant to be a higher standard and one more favorable to contractors.<sup>67</sup> As the preamble notes, “[t]his term indicates a higher standard, implying that the contractor will have the opportunity to take some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the Government.”<sup>68</sup>

The final rule also adds a more concrete definition to the type of federal criminal violations required to be disclosed. Under the previous two proposed rules, contractors were required to disclose any “[v]iolation[s] of Federal criminal law in connection with the award or performance of any Government contract or subcontract.”<sup>69</sup> The final rule adds limiting language, stating that contractor principals must disclose credible evidence of “[v]iolation[s] of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18” of the *U.S. Code*.<sup>70</sup>

In addition, as mentioned briefly above, the final rule also adds a “look back” provision to specify the extent of the contracts covered under the rule. While no contracts prior to the effective date of the rule will contain the contractual requirements of the revised FAR 52.203-13 “Contractor Code of Business Ethics and Conduct” contract

clause, the knowing failure of a contractor principal to disclose covered misconduct could still be grounds for suspension and debarment. Under the previous versions of the rule, the suspension and debarment disclosure requirement could have been read to reach back to contracts that may have been closed out for a decade or more. The preamble to the final rule states that the three-year period set forth in the final rule was selected to mimic the record retention period applicable to many federal contractors.<sup>71</sup>

The final rule also reflects concerns expressed in many of the comments on the first and second proposed rules regarding the preservation of attorney-client privilege and the protection of sensitive information submitted in the disclosures. Many offered the criticism that the previous rules, if read literally, could be argued to require a contractor to waive its attorney-client privilege to cooperate fully with an investigation resulting from a disclosure under the rule. An explicit provision was added to the FAR 52.203-13 clause stating that nothing in the final rule requires a contractor, or any officer, director, owner, or employee of the contractor, to waive the attorney-client privilege.<sup>72</sup> Similarly, language was added to the contractual disclosure and compliance requirements to address concerns regarding the ability of business competitors and others to obtain sensitive information included in a disclosure for their own benefit.<sup>73</sup> While the final rule does not fully preclude this possibility, the revised FAR 52.203-13 clause states that the “Government, to the extent permitted by law and regulation, will safeguard and treat information obtained pursuant to the Contractor’s disclosure as confidential where the information has been marked ‘confidential’ or ‘proprietary’ by the company.”<sup>74</sup> The practical application of this qualified assurance remains to be seen, especially after the recently issued presidential memorandum requiring federal guidance that would direct executive agencies and departments to develop a presumption towards disclosure under FOIA.<sup>75</sup>

Finally, the final rule incorporates a response to criticisms regarding the previous versions’ requirement that a “knowing failure to timely disclose an overpayment on a Government

contract” may be cause for suspension or debarment.<sup>76</sup> Some of the public comments argued that this would require disclosure of virtually every routine contract payment issue that could be interpreted as an overpayment. In the final rule, this cause for suspension and debarment was rephrased to include only “significant overpayment(s).”<sup>77</sup> According to the final rule’s preamble, the determination of what constitutes a significant overpayment is not based purely on dollar amount, but is also dependent on the surrounding circumstances.<sup>78</sup>

## Timing Issues

The final rule went into effect on December 12, 2008.<sup>79</sup> Set forth below is a step-by-step analysis of the timing issues attendant to both the implementation and the disclosure requirements of the rule.

### ■ Mandatory Disclosure Requirements

The mandatory disclosure requirements included in the final rule include three separate timing components. The first timing component determines the applicability of the rule to contracts, certain of which may have been previously completed. The new causes for suspension and debarment state that a “[k]nowing failure by a principal, until *three years after final payment* on any Government contract awarded to the contractor, to timely disclose” credible evidence of misconduct can be grounds for suspension or debarment.<sup>80</sup> For contractors meeting the requirements for the inclusion of the internal control system and disclosure requirements of FAR 52.203-13, paragraph (c), the revised clause imposes the same retroactive applicability that “continues until at least 3 years after final payment on the contract.”<sup>81</sup> This is consistent with the disclosure requirements set forth in the suspension and debarment provisions, which require all contractors to disclose contract- or subcontract-related misconduct as long as it has been fewer than three years since final payment on the contract or subcontract.

The second timing issue presented by the mandatory disclosure scheme is the timeliness of the disclosure, as the contractor principal must “*timely* disclose” misconduct. The preamble to the final rule at least implicitly recognizes the

ambiguity of the word “timely” but states that the transition from the “reasonable grounds to believe” standard to the “credible evidence” standard implies that contractors will have some time for a preliminary investigation to determine the credibility of the evidence before making a disclosure.<sup>82</sup> However, the preamble also cautions that “[t]his does not impose upon the contractor an obligation to carry out a complex investigation, but only to take reasonable steps that the contractor considers sufficient to determine that the evidence is credible.”<sup>83</sup>

The final component of timeliness of disclosures is when misconduct occurred before the effective date of the rule or the institution of the compliance and control systems required by a contract containing the FAR 52.203-13 clause. The preamble to the final rule notes that “[t]o some extent, the effective date of the rule actually trumps the other events” due to the fact that the requirement of disclosure as a cause for suspension and debarment is independent of the inclusion of the FAR clause or the institution of an internal control system.<sup>84</sup> However, where a disclosure may not be timely in reference to the rule’s effective date but is disclosed immediately after insertion of the contract clause or establishment of the internal control system, the “Councils consider that suspension or debarment would be unlikely.”<sup>85</sup> In any event, it is important to note that the mandatory disclosure requirements, for purposes of the suspension and debarment regulations, became effective on December 12, 2008, the effective date of the rule.

#### ■ Contractor Code Of Business Ethics & Conduct

The final rule requires all contractors with contracts including any portion of the FAR 52.203-13 clause, including small business concerns and commercial item contractors not subject to the internal control system requirements,<sup>86</sup> to have a written code of business ethics and conduct and to make a copy of the code available to each employee engaged in the performance of the contract.<sup>87</sup> Both the existence of the written code and its transmission to employees must occur within 30 days of contract award.<sup>88</sup> However, the Contracting Officer has the discretion to allow for a longer time period for implementation of the code.<sup>89</sup>

#### ■ Business Ethics Awareness & Compliance Program & Internal Control System

Contractors with contracts including FAR 52.203-13, paragraph (c) must adopt a formal business ethics awareness and compliance program and internal control system.<sup>90</sup> This program and system must be instituted within 90 days of a covered contract award, as discussed below.<sup>91</sup> Again, that period may be extended in the discretion of the CO.<sup>92</sup> Many large contractors will already have similar programs and systems in place. However, it is prudent to review the existing programs and systems to ensure that they fully comply with the requirements of the new rule so that any necessary changes can be made within 90 days of a covered contract award.

### Application To Contracts & Contractors

The application of the final rule’s provisions to contracts and contractors varies, as discussed below and summarized in the chart on page 9.

#### ■ Contract Size & Duration

The applicability of the final rule based on contract size depends on the particular section at issue. The provisions for suspension and debarment based on a knowing failure to disclose credible evidence of misconduct apply to all contracts, regardless of their size and duration.<sup>93</sup> However, the requirements of the final rule included in the FAR 52.203-13 clause (mandatory disclosure, codes of business ethics and conduct, and business ethics awareness and compliance program and internal control system) are more limited in application. FAR 52.203-13 only applies to solicitations and contracts if the value is expected to exceed \$5 million and the performance period is 120 days or more.<sup>94</sup> A similar threshold applies to determine whether the contractor must include the contents of FAR 52.203-13 in contracts with subcontractors at any tier.<sup>95</sup>

#### ■ Contract Type & Contractor Status

The final rule applies, at least in part, to almost every Federal Government contract that is covered by the FAR. However, contractors with contracts for commercial items will not be required to



institute the formal business ethics awareness and compliance program and internal control system contained at FAR 52.203-13, paragraph (c). Small business contractors, regardless of the contract type, are also exempted from the requirements of FAR 52.203-13, paragraph (c). Unlike under earlier drafts of the rule, contracts that will be performed wholly outside the United States do not receive any special treatment or exemptions under the final rule.

■ **Prime Contractors, Subcontractors & Vendors**

Contractors and subcontractors with contracts awarded after the effective date of the rule expected to exceed \$5 million and with performance periods of 120 days or more will be subject to at least a portion of the requirements of FAR 52.203-13, with FAR 52.203-13, paragraph (c) not applicable to small businesses or contracts for commercial items. Therefore, the final rule places the burden on prime contractors to “flow

down” some or all of the requirements of FAR 52.203-13 to subcontractors, at any tier, that meet a similar threshold.<sup>96</sup> Although application to below first-tier subcontractors may not be apparent on the face of the rule, it should be noted that the definition of “subcontractor” in the FAR is not tier based. Rather, a “subcontractor” is defined as “any supplier, distributor, vendor, or firm that furnished supplies or services to or for a prime contractor *or another subcontractor*.”<sup>97</sup>

The question of the rule’s applicability to vendors is a more complicated matter and hinges on the FAR’s definition of the term “subcontract.” The FAR defines a “subcontract” as “any contract entered into by a subcontractor to furnish supplies or services *for performance* of a prime contract or subcontract.”<sup>98</sup> Thus, when combined with the definition of “subcontractor” discussed above, it is clear that some entities that may consider themselves vendors would in fact be subcontractors if they are providing supplies or services

**Application Of Final Rule**

	<b>Code of Business Ethics and Conduct</b>	<b>Business Ethics Awareness and Compliance Program</b>	<b>Internal Control System</b>	<b>Mandatory Disclosure / Suspension and Debarment</b>
<b>Contractors with commercial item contracts</b>	Yes, with contracts containing FAR 52.203-13	Not required, but recommended by the FAR	Not required, but recommended by the FAR	Yes
<b>Contractors with noncommercial item contracts</b>	Yes, with contracts containing FAR 52.203-13	Yes, with contracts containing FAR 52.203-13	Yes, with contracts containing FAR 52.203-13	Yes
<b>Small business contractors</b>	Yes, with contracts containing FAR 52.203-13	Not required, but recommended by the FAR	Not required, but recommended by the FAR	Yes
<b>Contracts being performed wholly overseas</b>	Yes, with contracts containing FAR 52.203-13	Yes, with contracts containing FAR 52.203-13	Yes, with contracts containing FAR 52.203-13	Yes
<b>Subcontracts</b>	Yes, with subcontracts containing FAR 52.203-13	Yes, with subcontracts containing FAR 52.203-13	Yes, with subcontracts containing FAR 52.203-13	Yes

for the performance of a specific subcontract or contract. For example, on a project for the construction of a building, an entity that is supplying the carpeting is performing a portion of the scope of work required by the contract and would likely be a subcontractor. In that case, the substance of FAR 52.203-13 would flow down to the entity if it exceeds the dollar and duration threshold discussed above. However, if the entity is providing supplies and services to a subcontractor or prime contractor that are not directed towards a specific contract or subcontract, it is not likely to be considered a subcontractor to which the provisions of FAR 52.203-13 could be applicable. For example, an entity on that same project that provides telephone, copying, and delivery services that are part of the contractor's normal business operations would likely not be a subcontractor.

## Mandatory Disclosure Requirements

One of the most significant aspects of the final rule is its requirement that contractors disclose credible evidence of certain types of misconduct. The final rule amended the FAR to add three separate sections requiring mandatory disclosure of specified contract or subcontract-related misconduct. The first is included in the causes for suspension and debarment. A contractor may be suspended or debarred for the following:<sup>99</sup>

Knowing failure by a contractor principal, until 3 years after final payment on any Government contract awarded to the contractor, to timely disclose to the Government, in connection with the award, performance, or closeout of the contract or a subcontract thereunder, credible evidence of—

(A) Violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code;

(B) Violation of the civil False Claims Act (31 U.S.C. 3729–3733); or

(C) Significant overpayment(s) on the contract, other than overpayments resulting from contract financing payments as defined in [FAR] 32.001.

Two sections of FAR 52.203-13 also require contractors to timely disclose credible evidence of violations of the enumerated federal criminal laws above and violations of the civil False Claims

Act but do not require disclosure of significant overpayments. These provisions are almost identical, with one exception. The disclosure requirements of FAR 52.203-13, paragraph (b)(3)(i) relate only to the contract in which the clause is included, while the disclosure requirements under the internal control system in FAR 52.203-13, paragraph (c) are meant to cover all active contracts and contracts on which final payment has been made fewer than three years ago. The mandatory disclosure provision in FAR 52.203-13, paragraph (b)(3)(i) requires as follows:

The Contractor shall timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed—

(A) A violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or

(B) A violation of the civil False Claims Act (31 U.S.C. 3729–3733).

The mandatory disclosure requirement included in the internal control system requirements of FAR 52.203-13, paragraph (c), which applies to fewer contractors, is identical except that it requires disclosure of misconduct “in connection with the award, performance, or closeout of *any* Government contract performed by the Contractor or a subcontractor thereunder.”<sup>100</sup> However, as in other areas, this distinction is essentially made partially moot by the fact that the new grounds for suspension and debarment apply to all contractors and any of their covered contracts and subcontracts.<sup>101</sup> In a related vein, it is important to understand that while the disclosure of significant overpayments is not included in FAR 52.203-13, failing to do so is still a possible cause for suspension and debarment and may also violate other FAR “Payment” clauses.<sup>102</sup>

### ■ Preliminary Investigation To Determine Credibility Of The Evidence

The requirement for mandatory disclosure is triggered by the discovery of “credible evidence” of the three types of misconduct discussed above. The “credible evidence” standard was purportedly

adopted to give contractors adequate time to conduct a preliminary investigation to determine the credibility of evidence relating to the misconduct discussed in the rule.<sup>103</sup> The FAR councils, however, cautioned that this preliminary investigation period should not be a “complex investigation,” but rather should consist of “reasonable steps that the contractor deems sufficient to determine that the evidence is credible.”<sup>104</sup>

Note that the rule does not prevent a contractor from conducting its own comprehensive internal investigation.<sup>105</sup> However, the disclosure mandated by the rule cannot be tolled until the completion of a full investigation, but rather must be made immediately after determining the evidence’s credibility.<sup>106</sup>

#### ■ **Timeliness**

As discussed above, mandatory disclosures prescribed by the final rule must be “timely.” In this regard, the credible evidence standard is also meaningful to the timeliness of the disclosure. Because disclosure is not mandated until credible evidence has been discovered, the timeliness of the disclosure is relative to the credibility determination. However, it is important to note that this does not allow for an open-ended credibility investigation as a mechanism for delaying disclosures. The timeliness of the disclosure will likely be evaluated in any ensuing Government investigation. While the final rule does not grant any type of guaranteed immunity or sentencing break for contractors disclosing misconduct, pushing the boundaries of timeliness will likely reduce the Government’s willingness to grant any concessions to the contractor. Moreover, waiting a longer period of time than necessary to make a disclosure increases the risk that the Government will discover the misconduct absent a disclosure, either on its own or in some cases with the help of a *qui tam* relator. Thus, a timely disclosure immediately following a determination that credible evidence of relevant misconduct exists is likely to be the most prudent course of conduct.

#### ■ **Persons Who Must Disclose Credible Evidence Of Misconduct**

The mandatory disclosure provisions of FAR 52.203-13 state that disclosure is required when the

“Contractor has credible evidence that a principal, employee, agent, or subcontractor” has committed any of the enumerated offenses.<sup>107</sup> And, the provisions for suspension and debarment state that the cause for suspension or debarment occurs where a “knowing failure by a principal to timely disclose to the Government” credible evidence of misconduct.<sup>108</sup> The rule defines a contractor “principal” as an “officer, director, owner, partner, or a person having primary management or supervisory responsibilities within a business entity.”<sup>109</sup> A representative, but not exhaustive, list of examples includes general or plant managers, heads of subsidiaries, divisions, or business segments, and other comparable positions.<sup>110</sup> While the determination of which positions will be considered principals is obviously left at least partially to the discretion of the contractor, the preamble to the final rule suggests that the term be interpreted broadly, and that it might also include compliance officers and internal audit directors.<sup>111</sup>

#### ■ **Form & Procedure For Disclosure**

Disclosures mandated by the contractual disclosure provisions of the final rule must be made to the OIG of the agency that issued the contract, with a copy given to the CO.<sup>112</sup> If the misconduct being disclosed pertains to more than one contract, the contractor should disclose to the agency OIG and the CO responsible for the contract of the highest value.<sup>113</sup> In the case of a multiple award schedule contract, or other similar multi-agency contract vehicles, the contractor must make the disclosure to the agency OIG and the CO of both the ordering agency and the agency responsible for the basic contract.<sup>114</sup>

Disclosures under the new rule primarily function off web-based platforms, with online disclosure forms available through the OIG websites at most federal agencies. The disclosure form can normally be submitted online, as well as by mail. While agency disclosure forms are unique, the form generally contains a mix of questions regarding basic identification of the contractor and contract(s) at issue, as well as questions regarding the act or acts of misconduct. For example, the General Services Administration requires the contractor to identify the names of the individuals involved in the misconduct,

dates and location of the misconduct, how the matter was discovered, and potential witnesses and their involvement in the misconduct.<sup>115</sup> Aside from providing an overview of the misconduct, the contractor must often indicate the existence of any safety hazards posed by the misconduct and any attempts to mitigate those hazards. Further, the contractor must estimate the financial impact of the misconduct on the Government and indicate whether it has undertaken its own investigation into the matter. If the contractor has indeed undertaken its own investigation, it must describe the scope of the investigation, the evidence reviewed during the investigation, and any measures taken to prevent a recurrence of the same type of misconduct. Some disclosure forms request that the contractor indicate whether or not it is willing to provide a copy of its internal investigation to the OIG and the CO.

#### ■ Protection Of The Information Disclosed

An obvious concern with such a mandatory disclosure system is the protection afforded to the information being disclosed to the Government. The nature of the information disclosed will often be sensitive and could easily be used by competitors or others to undermine the competitive position of the contractor that made the disclosure. In this regard, the final rule provides some protections for information disclosed by contractors under the rule. The revised FAR 52.203-13 clause states that if the company marks the information it discloses as “confidential” or “proprietary,” the Government, “to the extent permitted by law and regulation, will safeguard and treat information obtained pursuant to the Contractor’s disclosure as confidential.”<sup>116</sup> Further, “[t]o the extent permitted by law and regulation, such information will not be released by the Government to the public pursuant to a Freedom of Information Act request, [5 U.S.C.A. § 552], without prior notification of the Contractor.”<sup>117</sup> The Government, however, reserves the right to transfer the information to any executive department or agency if the information falls within its jurisdiction.

While this certainly states a strong policy goal not to release information contained in the disclosure to the public, it arguably falls far short of guaranteeing that the contractor’s sensitive

information will not fall into the wrong hands. Despite the FAR councils’ statement that the language quoted above would “provide appropriate assurance to contractors about the Government’s protection afforded to disclosures,”<sup>118</sup> as those now subject to this final rule are likely well aware, the status of “law and regulation” can change substantively and in a relatively short time. A relevant example of such change is President Obama’s January 21, 2009 memorandum on the Freedom of Information Act, discussed earlier in this PAPER, which stated, in part, that “[a]ll agencies should adopt a *presumption in favor of disclosure*.”<sup>119</sup> The memorandum directed the Attorney General to issue new guidelines to the heads of each executive agency and department regarding the shift towards this presumption in favor of disclosure.<sup>120</sup> In this regard, on March 19, 2009, the Attorney General issued new FOIA guidelines stating that the DOJ will defend a denial of a FOIA request only if “the agency reasonably foresees that disclosure would harm an interest protected by one of the statutory exemptions” or “disclosure is prohibited by law.”<sup>121</sup> These new guidelines are a clear shift from the former Attorney General’s prior guidance that the DOJ would defend denials of FOIA requests “unless they lack a sound legal basis or present an unwarranted risk of adverse impact on the ability of other agencies to protect other important records.”<sup>122</sup> As of yet, it is unclear what effect this policy shift will have on the mandatory disclosure program. However, the memorandum and related guidance certainly call into question the extent of the protections afforded to contractor information by the final rule. Nevertheless, pending any change in the law, the contractor can still likely find protection from public disclosure due to the exceptions included in FOIA<sup>123</sup> and the Trade Secrets Act.<sup>124</sup>

#### Contractor Code Of Business Ethics & Conduct

A contractor code of business ethics and conduct is required for all contractors and subcontractors with contracts containing FAR 52.203-13, including small business concerns and contracts for commercial items. The contractor or subcontractor must have a written code of business ethics and conduct and make the code available to all



employees engaged in performance of the contract.<sup>125</sup> Both of these actions must occur within 30 days of a covered contract award, with extensions subject to the CO's discretion.<sup>126</sup> While the code itself must be in writing, the preamble explicitly notes that the means of making the code available to employees is purposefully flexible.<sup>127</sup> The contractor or subcontractor must also "[e]xercise due diligence to prevent and detect criminal conduct" and "[o]therwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."<sup>128</sup>

### Ongoing Business Ethics Awareness & Compliance Program

For contractors and subcontractors with contracts incorporating FAR 52.203-13, paragraph (c), which does not include small business concerns and contracts for commercial items, an ongoing business ethics awareness and compliance program must be implemented within 90 days of a covered contract award, or later with the approval of the CO. The "program shall 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, by conducting effective training programs and otherwise disseminating information appropriate to an individual's respective roles and responsibilities."<sup>129</sup> The rule mandates that the training conducted under this program should be given to contractor principals and employees.<sup>130</sup> Moreover, training should also be given to agents and subcontractors "as appropriate."<sup>131</sup> The FAR councils did not believe a more specific enumeration of training topics or of situations that would warrant training of agents and subcontractors was necessary.<sup>132</sup> However, it would be prudent to include such topics as conflicts of interest, fraud, bribery, and gratuities, in any training program.

### Internal Control System

In addition to an ongoing ethics and compliance program, contractors and subcontractors with contracts subject to FAR 52.203-13, para-

graph (c) must also institute an internal control system within 90 days of a covered contract award or a longer period at the CO's discretion. Most broadly, the internal control system must "[e]stablish standards and procedures to facilitate timely discovery of improper conduct in connection with Government contracts" and "[e]nsure corrective measures are promptly instituted and carried out."<sup>133</sup> Moreover, the final rule also mandates more specific minimum requirements for certain aspects of the internal control system. These requirements are discussed immediately below.

#### ■ Resources & Responsibility

The final rule mandates that the responsibility for overseeing the internal control system, as well as the business ethics awareness and compliance program, be assigned at a "sufficiently high level" and be given "adequate resources" to ensure its effectiveness.<sup>134</sup> The rule does not provide more specific guidance or examples to aid in the determination of definitions for the phrases "sufficiently high level" and "adequate resources." In the face of this uncertainty, and with the knowledge that the internal control system will only be reviewed by the Government after an incident has occurred, contractors should endeavor to remove any doubt regarding the level of responsibility and amount of resources devoted to their internal control system.

#### ■ Screening Of Contractor Principals

As a minimum requirement of the internal control system, contractors also must make "[r]easonable efforts not to include an individual as a principal, whom due diligence would have exposed as having engaged in conduct that is in conflict with the Contractor's code of business ethics and conduct."<sup>135</sup> The preamble makes it clear that the amount and type of due diligence required when hiring or promoting principals is a context specific business judgment left to the contractor, despite numerous requests for more guidance on the type of preemployment screening contemplated by the rule.<sup>136</sup> However, the FAR councils did explicitly note that evidence of past *criminal* conduct, even if unrelated to contracting, should seriously call into question the ability

of the prospective principal to act with integrity and as a role model for other employees.<sup>137</sup> Some criticized this requirement as one that would force contractors to fire principals with any record of criminal behavior. The preamble responds to this criticism by stating, “This is not a mandate to fire the individual, but to determine whether the individual is currently trustworthy to serve as a principal of the company.”<sup>138</sup>

An important distinction should be made in relation to the rule’s mandatory disclosure requirements between the promotion of principals from within the company and the hiring of principals from outside the company. If misconduct of the type otherwise required to be disclosed under the final rule is discovered during the due diligence process of a prospective outside hire, it is not required to be disclosed by any portion of the final rule. This would not be the case for the same misconduct uncovered during the process for promoting a principal from within the company, assuming that the newly discovered misconduct otherwise met the criteria for information required to be disclosed under the contractual or suspension and debarment disclosure provisions of the final rule.<sup>139</sup> This is not to say, however, that the type of misconduct at issue during the due diligence process is limited solely to the misconduct required to be disclosed under the mandatory disclosure provisions of the final rule. Rather, the stated goal is to expose conduct that was contrary to the contractor’s code of business ethics and conduct and thus could include misconduct not of the type required to be disclosed under the rule. Note that any potential noncriminal misconduct of a prospective hire should be judged based on its relation to the contractor’s standards and written codes of conduct and ethics in existence at the *time of the misconduct*.<sup>140</sup>

#### ■ Monitoring & Periodic Reviews

The internal control system mandated by FAR 52.203-13, paragraph (c) under the final rule also requires the contractor to make “[p]eriodic 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 Govern-

ment contracting.”<sup>141</sup> A contractor’s monitoring and periodic review should, at a minimum, be targeted at three distinct goals: (1) continuous efforts to monitor and audit to detect criminal conduct, (2) recurring evaluations of the effectiveness of the contractor’s business ethics awareness and compliance program and internal control system, especially if evidence of criminal conduct does exist, and (3) a period risk assessment, focusing on identifying and mitigating the risk of criminal conduct through the continual revision of the contractor’s business ethics awareness and compliance program and internal control system mandated by this rule.<sup>142</sup> The FAR councils noted that established business practices for auditing and monitoring that conform to the generally acceptable accounting principles are likely sufficient to fulfill this requirement.<sup>143</sup>

#### ■ Internal Reporting Mechanism

As part of the internal control system, contractors must also establish an internal mechanism, such as a hotline, for employees to report allegations of misconduct.<sup>144</sup> The rule grants discretion to the contractor to determine whether the reporting mechanism should provide for “anonymity or confidentiality,” but it must rely on one or the other under the express terms of the rule.<sup>145</sup> Moreover, the contractor must issue instructions that encourage employees to use the reporting mechanism.<sup>146</sup> It should be noted that this portion of the rule only appears to require that such a reporting mechanism be developed for use by the employees of the contractor. Nothing in the rule explicitly requires that this mechanism be made available to the contractor’s agents or subcontractors.

#### ■ Disciplinary Action

The internal control system must also allow for “[d]isciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct.”<sup>147</sup> Requiring the contractor to take disciplinary action while also reporting the same misconduct to the Government, which can also take disciplinary action, may seem to spur the threat of double punishment. However, it is likely that the conscientious use of disciplinary action by the contractor will be

viewed favorably by the Government during an investigation.

### ■ Full Cooperation

The contractor's internal control system must provide for "[f]ull cooperation with any Government agencies responsible for audits, investigations, or corrective actions."<sup>148</sup> The absence of any definition or guidance on the meaning of "full cooperation" in the first two drafts of the rule caused many who submitted public comments to criticize the extent to which such a phrase could be employed to override protections such as the attorney-client privilege and Fifth Amendment protections.<sup>149</sup>

The final rule addresses these concerns by adding a fairly detailed section regarding the definition of the phrase, as well as explicitly listing many actions that would not be required by full cooperation. "Full cooperation" is defined 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."<sup>150</sup> This should include "providing timely and complete response to Government auditors' and investigators' request for documents and access to employees with information."<sup>151</sup> However, as now explicitly stated, full cooperation "[d]oes not foreclose any Contractor rights arising in law, the FAR, or the terms of the contract" and does not require a contractor to waive the attorney-client privilege or attorney work-product doctrine protections.<sup>152</sup> Nor does full cooperation remove or restrict the contractor's ability to conduct its own investigation or mount a defense in a proceeding arising out of a disclosed violation.<sup>153</sup> The rule also notes that individuals will not be required to waive their Fifth Amendment rights to achieve full cooperation.<sup>154</sup> (The provision on waiver of Fifth Amendment rights is directed at individuals, rather than the "Contractor," because Fifth Amendment protections generally do not apply to corporations.)

The detail added to the full cooperation requirement in the final rule is complemented by the FAR councils' attempt, in the preamble, to address some other pertinent questions regarding the full cooperation requirement. The FAR

councils provide some helpful contextual guidance regarding the meaning of the phrase "full cooperation" and its application in practice. For example, blocking investigators' access to employees and documents would certainly be considered less than full cooperation, even if attempted with an improper reliance on attorney-client privilege or the attorney work-product doctrine.<sup>155</sup> In addition, despite some concerns arising out of a district court ruling to the contrary, the councils stated that indemnification of an employee's legal costs pursuant to state law would not be considered less than full cooperation.<sup>156</sup> The FAR councils also contemplated that, at least "generally speaking," full cooperation would entail contractors' encouraging their employees to be available and cooperative for Government investigators.<sup>157</sup> As noted explicitly in the preamble, and implicitly in the rule itself, the U.S. Sentencing Guidelines' discussion of full cooperation also provides additional guidance on the meaning of the phrase.<sup>158</sup>

Another issue of import arising from the full cooperation requirement is the question of its effect in expanding the Government's current audit and access to records rights. Some commenters argued that the Government could take advantage of the requirement to fully cooperate by "providing timely and complete response to Government auditors' and investigators' request for documents and access to employees with information"<sup>159</sup> by using information gained under the requirement to bolster the Government's case during contract disputes.<sup>160</sup> The FAR councils noted that this provision of access to documents and employees required to maintain full cooperation with the Government is "primarily" meant to apply only to Government investigations into contract fraud and corruption, either arising through contractor disclosure or on the Government's own initiative.<sup>161</sup> Further, the councils stated that it should not affect the Government's access rights in "the routine contract administration context" and that "any application of this rule in any other context by the Government would clearly be overreaching."<sup>162</sup> Despite the strongly worded language regarding overreaching, the Government and contractors often disagree about the identification of a matter as one of routine contract administration. Moreover, the use of the qualifier

“primarily” seems to indicate that occasions may arise during which the Government’s expanded access to individual contractor employees under the rule may be used for purposes of something other than an investigation into contract fraud and corruption.

## Enforcement

### ■ Role Of The DOJ & OIG

The new mandatory disclosure regulations place the initial enforcement burden on the OIG of the agency that awarded the contract. Because contractors must disclose credible evidence of covered misconduct to the agency OIG, with a copy to the CO, the OIG will generally be the first mover in terms of any possible enforcement actions.<sup>163</sup> However, the new disclosure regulations do not provide ample explanation of the interrelationship between the OIG, the CO, the DOJ, and the contractor. Thus, the responsibilities and relative initiative of all the parties involved in a disclosure may vary depending on the agency involved and on the type and extent of misconduct disclosed. At a minimum, however, the final rule contemplates active cooperation and coordination between the CO and the OIG. Contractors making a disclosure under the new rule should seek to ensure that the OIG and the CO are coordinating the Government’s response to the disclosure. This will aid in avoiding any uncertainty regarding whether the OIG and the CO are taking different enforcement approaches to the disclosure.

Under the previous voluntary disclosure program, each disclosure generally required a follow-up investigation by the Government.<sup>164</sup> The new rule does not mandate such a result, although it also does not preclude it. Presumably, disclosures of minor misconduct may be handled solely between the contractor and the CO. If a contractor’s disclosure to the OIG gives the OIG reason to believe a crime has occurred, the Inspector General Act requires the OIG to notify the U.S. Attorney General (i.e., the DOJ or the U.S. Attorney’s Office).<sup>165</sup> Thus, at least in the case of a disclosure relating to possible criminal violations, the OIG is under an obligation to inform the DOJ.

### ■ Role Of Auditors

The new mandatory disclosure regulations require “[f]ull cooperation with any Government agencies responsible for audits” for contractors with contracts incorporating FAR 52.203-13, paragraph (c).<sup>166</sup> As discussed previously, this requirement for full cooperation essentially demands that contractors provide timely and thorough responses to auditor requests.<sup>167</sup> The preamble to the final rule indicates that the full cooperation requirement should have no relation to routine audits by the Defense Contract Audit Agency or similar auditing organizations, “except as the issue arises when a contractor discloses fraud or corruption or the Government independently has evidence sufficient to open an investigation of fraud and solicit the contractor’s cooperation.”<sup>168</sup> Thus, at least according to the preamble, contractors with contracts incorporating FAR 52.203-13, paragraph (c) should only be concerned with meeting the full cooperation requirement during audits relating to the type of misconduct required to be disclosed under the rule.

### ■ Suspension & Debarment

As discussed above, the final rule provides an additional cause for suspension and debarment for the knowing failure by a contractor principal to disclose the misconduct described in the rule.<sup>169</sup> Thus, contractors now face the risk of suspension or debarment not only for the underlying misconduct, but also for the failure to report such misconduct.<sup>170</sup> Notwithstanding, the FAR councils noted that suspension or debarment would be unlikely “absent the determination that a violation [of the underlying civil or criminal law] occurred.”<sup>171</sup>

The FAR councils also noted that the suspension and debarment policies under the new regulations are not meant to be punitive and that all suspension and debarment procedures continue to be based on the “responsibility standard.”<sup>172</sup> The responsibility standard is found at FAR Subpart 9.1.<sup>173</sup> Whether a contractor is suspended or debarred based on a failure to comply with the new mandatory disclosure regulations depends on facts and circumstances including how much money is at stake, how much information is available, how far the investigation has proceeded, and



how strong is the evidence against the contractor.<sup>174</sup> Mitigating factors under FAR 9.406-1(a) will continue to be used in the assessment (e.g., timely disclosure to the Government).<sup>175</sup>

These assurances, however, are largely absent from the regulation itself and included only in the preamble. While it is unlikely that suspension or debarment will be employed absent a showing that the underlying violation occurred, contractors should be aware that suspension or debarment for a failure to make a disclosure required under the new regulations is at least possible, pursuant to the express language of the new regulations, even absent a showing that the alleged underlying misconduct occurred. This could occur in the unlikely situation where a contractor principal had “credible evidence” of misconduct but failed to disclose that credible evidence, and the misconduct was later found not to have occurred.

#### ■ Financial Penalties

Contractors also face financial consequences under the final rule. Contractors must disclose “significant overpayment(s)” on covered contracts under the new regulation. If such an overpayment is disclosed, the contractor must remit the overpayment to the Government.<sup>176</sup> The contractor must provide evidence of the remittance to the CO with a description of the overpayment, details regarding the circumstances surrounding the overpayment, and an identification, if possible, of the affected contract line item.<sup>177</sup> Moreover, such overpayments can also form the basis for the Government to seek fines and treble damages under the False Claims Act, although timely disclosure of False Claims Act violations may be seen as a mitigating factor that could reduce any possible False Claims Act damages.<sup>178</sup> Thus, contractors should be aware of the financial consequences of a failure to disclose significant overpayments and violations of the civil False Claims Act.

#### ■ Past Performance Assessments

Contracting agencies must consider the contractor’s past performance record to make a determination that the contractor is responsible when considering the award a future contract.<sup>179</sup> Information related to a contractor’s record of

business ethics and integrity is expressly included in the type of past performance information that the contracting agency evaluates during responsibility determinations for future contracts.<sup>180</sup> Thus, contractors should be aware that information required to be disclosed under the new rule may also be used by the Government during assessments of the contractor’s past performance.

### Disclosure Consideration Factors

The final rule obviously presents new risks, questions, and concerns for Government contractors. Although the discussion above provides an in-depth analysis of each aspect of the rule, including mandatory disclosure, the section that follows provides a practical general summary of best practices for complying with the final rule’s mandatory disclosure requirements.

#### ■ Documenting & Monitoring The Credibility Determination

A contractor’s determination regarding the credibility of evidence is left, at least initially, to the contractor’s judgment. In this regard, contractors face the risk of failing to disclose evidence of misconduct that they determined was not credible, only to later face suspension and debarment, as well as any other penalties for the underlying misconduct, if the Government subsequently discovers the misconduct. Moreover, contractors also face the risk of over-disclosure, which could cause unnecessary Government involvement, waste valuable resources, and negatively affect the contractor’s business. To a certain extent, these increased risks are the unfortunate cost of doing business under the new rule.

These risks, however, can be substantially mitigated by properly documenting and monitoring the credibility determination investigation. Contractors should maintain records detailing every preliminary investigation conducted to determine the credibility of evidence of possible misconduct required to be disclosed under the rule. These records should indicate the evidence obtained, its relation to a covered contract, its source(s), and a detailed account of the steps

taken to determine its credibility. If the contractor determines that the evidence is not credible, a sound basis for that decision should be included as well. Following a determination that the evidence in question is not credible, contractors should document any further efforts taken to monitor the situation. Taken as a whole, this practice will provide a sound basis for contractors to argue that their credibility determinations were reasonable. Moreover, such a process will assist contractors in continually refining their compliance and control programs.

#### ■ Responsibility For Credibility Determinations & Investigations

Making a determination regarding the credibility of evidence of alleged misconduct can have wide-ranging implications for the contractor. Thus, contractors should ensure that credibility determinations and related investigations are managed by senior personnel with access to the resources necessary to reach an informed conclusion. For contractors with FAR 52.203-13, paragraph (c) included in their contracts, responsibility for the compliance and control system must be assigned “at a sufficiently high level” and with “adequate resources to ensure” effectiveness.<sup>181</sup> Those responsible should be as independent as possible and free from conflicts of interest. It may also be beneficial to rely upon external third parties with expertise in Government contracting and cost accounting issues. In the case of a disagreement between the Government and the contractor regarding a credibility determination, the individuals responsible for, and the resources devoted to, conducting the preliminary investigation will almost certainly be a variable examined by the Government. Thus, it is important to ensure that the personnel and resources assigned to the investigation and credibility determination are beyond reproach.

#### ■ Content

The mandatory disclosure requirements contained in the final rule do not specify what information is necessary in the disclosure, aside from the existence of credible evidence of covered misconduct. However, as discussed above, individual agencies have formulated electronically available disclosure forms in response to the new

mandatory disclosure requirements. It is generally in the contractor’s interest to submit disclosures in the form preferred by the agency that awarded the contract and to include the information specifically requested by that agency.

Many disclosures made under this new rule will necessarily contain confidential or proprietary information. Contractors should ensure that any sensitive information included in a disclosure be marked “confidential” or “proprietary.” Although the final rule does not guarantee that this information will not be disseminated, as discussed above, the FAR 52.203-13 clause provides that the “Government, to the extent permitted by law and regulation, will safeguard and treat information obtained pursuant to the Contractor’s disclosures as confidential where the information has been marked as ‘confidential’ or ‘proprietary’ by the company.”<sup>182</sup>

#### ■ Audience

Contractors with FAR 52.203-13 included in their contracts must send their disclosures to the OIG of the agency that awarded the contract, with a copy to the CO.<sup>183</sup> In the event that multiple agencies and contracts are implicated, contractors may make the disclosure to the OIG and the CO from the agency responsible for the highest dollar value contract.<sup>184</sup> If the misconduct arises out of a Government-wide acquisition contract, a multi-agency contract, or a supply schedule contract, the contractor must notify the OIG of the ordering agency and the IG of the agency responsible for the basic contract.<sup>185</sup>

For misconduct arising out of a contract that does not incorporate FAR 52.203-13, the contractor is only required to timely disclose credible evidence of covered misconduct to “the Government,”<sup>186</sup> Thus, contractors reporting misconduct arising out of contracts that do not include FAR 52.203-13 may make disclosures solely to the relevant CO.

### FAS 5 Considerations

While the mandatory disclosure requirements contained in the final rule were ostensibly intended to focus solely on reducing procurement

misconduct and fraud in the context of Federal Government contracting, many Government contractors engaged in numerous lines of business aside from federal agency contracting may now face separate and distinct regulatory burdens. The new requirements imposed by the final rule may intersect with regulatory requirements imposed upon the contractor through other entities not focused solely on Government contracting, such as the Securities and Exchange Commission. One area in which this intersection is clear is in the SEC requirement, through Financial Accounting Standard No. 5 (FAS 5), “Accounting for Contingencies,” that publicly traded companies disclose and account for loss contingencies in their financial statements. Therefore, contractors making mandatory disclosures under the final rule should consider the impact of such disclosures on their financial reporting requirements under FAS 5.

#### ■ Timing

FAS 5 defines the requirements for disclosure and measurement of a contingency.<sup>187</sup> Assessing the mandatory disclosure requirements in the final rule in conjunction with the requirements of FAS 5 will be critical in determining the timing and substance of disclosures required by FAS 5.

The timing of disclosure within a company’s financial statements under FAS 5 will be a critical consideration for any entity, and in particular an SEC registrant. Unfortunately, the mandatory disclosure requirements of the final rule and the disclosure requirements of FAS 5 do not share a similar lexicon. While the final rule is couched in terms of “credible evidence,” which is undefined, FAS 5 requires measurement and disclosure of a contingency if it is “probable,”<sup>188</sup> which *is* defined in FAS 5 as “future event or events are likely to occur.”<sup>189</sup> Even where the loss contingency is impossible to measure, and not probable, disclosure within the footnotes of a financial statement may still be required if the loss is reasonably probable. The key issue in including matters disclosed under the final rule in the footnotes of a financial statement is determining whether the credible evidence of misconduct disclosed creates a “probable” or

“reasonably probable” loss or liability.<sup>190</sup> This will not only require management to make a probability assessment, but will also require external parties such as attorneys, auditors, and subject matter experts to provide management with their probability assessment. As with the credibility determination, management and any external parties should carefully document their probability assessment to have a basis to defend against subsequent allegations from the SEC or shareholders.

The second half of a disclosure under FAS 5 consists of providing an estimate as to the impact of the probable loss or liability.<sup>191</sup> Aside from determining the dollar amount of significant overpayments, disclosures under the final rule do not require a similar estimation. Estimates may range from zero dollars upwards and may change over time. Therefore, management will need to maintain documentation as to changes in the estimate over time. For the purposes of FAS 5, it is critical that management have the ability to provide the Government, regulatory agencies such as the SEC, and shareholders, with a timeline and critical impact discussion that explains the evolution of the estimate.

#### ■ Content

As discussed above, FAS 5 requires that the nature of the contingency be disclosed within notes to the financial statements,<sup>192</sup> as well as an estimate as to the loss or possible range of losses that are probable or reasonably probable, although certain exceptions may apply. If no estimate can be made at the time, the disclosure only needs to include a statement that an estimate cannot be made at the time.<sup>193</sup>

The circumstances under which a disclosure of loss contingencies in financial statements under the proposed amendments to FAS 5 are no different. However, the proposed amendments would require significantly more extensive disclosures under FAS 5. For example, the proposed amendments required disclosure of detailed qualitative information about contingency will effectively require that each loss contingency be disclosed separately.<sup>194</sup> Thus, should a contractor’s mandatory disclosure to the Government contain three

distinct instances of misconduct, the proposed amendment would require each of those instances to be disclosed separately if a loss or liability is probable or in some cases reasonably probable. In certain circumstances, contingencies considered to be remote may have to be disclosed if they are likely to be resolved within a year and could have a severe impact on the company. The proposed amendments will no longer allow for a disclosure to not include an estimate of the loss. Rather, the proposed amendments require that in those instances where no amount is associated with the claim, the disclosure must include the “best estimate of the maximum exposure to loss.”<sup>195</sup> Moreover, if a claim against a contractor is pending regarding credible evidence of the misconduct disclosed, the contractor would be required to disclose an estimate of the loss or range of loss if the contractor believes that the claim does not represent its full exposure, which may especially be a concern for contractors disclosing credible evidence of civil False Claims Act violations.

The proposed amendments to FAS 5 additionally require the entity to include the following information in its financial statement disclosure: (1) a description of the loss contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution, (2) significant assumptions made in estimating the disclosed loss amount, (3) a description of insurance or indemnification arrangements that may result in recovery of all or part of the loss, (4) a description of factors that are likely to affect the outcome, including the potential impact on the outcome for each factor, (5) an assessment of the most likely outcome of the contingency, and (6) for each period in which a statement of income is provided, a reconciliation of the changes in the estimated loss.<sup>196</sup>

The requirement to specifically disclose each loss contingency may be waived in exceptional circumstances where the disclosure would be prejudicial to the company’s litigation position.<sup>197</sup> However, the entity would then need to aggregate its loss contingencies and disclose in the aggregate so that the disclosed information cannot be linked to a particular matter. In these instances, the contractor would need to disclose the reason that detailed information is not disclosed.

## Mergers & Acquisitions Considerations

Whenever a Government contractor is acquired (either in whole or part, and whether by stock or asset purchase),<sup>198</sup> the buyer will want to know, among other things, whether the business unit in question is currently under investigation, is a defendant in any False Claims Act cases, and is in compliance with all laws. Typically, such inquiries are subject to materiality limits (in dollars) or temporal limits (e.g., for the two years prior to the sale). Armed with full disclosures from the seller, the buyer can evaluate the risks associated with this area of its diligence and adjust its purchase price accordingly, seek indemnifications, or perhaps forgo the deal in its entirety. The final rule, however, compels buyers to take additional actions and expand their diligence efforts before acquiring a Government contractor.

Given the “look back” provisions of the disclosure requirements and their direct connection to the suspension and debarment regulations,<sup>199</sup> the risks posed in buying a Government contractor could now be higher than before the final rule came into effect. Historically, a buyer that learns of a “problem” that was not disclosed during the diligence effort would argue that the problem “didn’t happen on my watch” and hope to avoid any exposure related to it. It is unclear whether the Government in general, and the enforcement divisions in particular, will be willing to provide anything resembling a “free pass” for such conduct in the future, especially if the buyer failed to take the necessary steps to discover the conduct during the diligence effort.

It is now incumbent upon buyers to include in their diligence requests questions that are geared to the disclosure obligations in the final rule. For example, a buyer may want to consider asking the seller whether there have been any internal compliance reviews or investigations related to current contracts with the Government or any prime contractor of the Government or any such completed contracts under which final payment was received by the business unit in question in the prior three years regarding any conduct covered by Title 18 of the *U.S. Code* (including fraud, conflict of interest, bribery, or gratuity), the civil False Claims Act or any significant overpayment. Of course, the seller might not have initiated the



reviews covered by the diligence questions, but at least the buyer can attempt to better evaluate its risks associated with the acquisition.

## Benefits Of Developing A High-Performance Compliance Program

### ■ Synergy In Internal Compliance & Control Systems

Many publicly traded contractors segregate their Sarbanes-Oxley Act<sup>200</sup> compliance infrastructure from the compliance and control systems required by federal regulations and statutes for Government contractors. While it is true that these two segments of compliance and control requirements are promulgated and enforced by separate bodies, it may often be the case that at least a portion of a contractor's internal compliance and control infrastructure can be configured in such a way as to accomplish the goals of Sarbanes-Oxley and Government contracts regulations with minimal duplication of cost or business disruption. Further, such a blending of compliance and control infrastructure may maximize the benefit of internal reviews and other compliance mechanisms.

An example of the principles discussed above would be the design of an internal audit to review a contractor's estimating system, policies, and procedures. Estimates for Government contracts include projections of effort and cost, used for a number of important applications, such as contract proposals, calculations for requests for equitable adjustments, submission of progress billings based on cost, and compliance with the "Limitation of Funds" clause.<sup>201</sup> For SEC purposes, estimates are often used to measure the percentage of completion based on cost for revenue recognition purposes. Although these two types of estimates are used in a distinct fashion, the principles governing the contract and SEC estimates are extremely similar. Both estimates require historical performance information, a foundation in qualified technical knowledge, and the projection of estimated cost at completion. Because of the shared principles, it should be both possible and efficient to develop an audit review that encompasses the utility of both esti-

mates rather than performing two distinct reviews. By adding an operational focus to a compliance or system audit, and consolidating the various audits (operational, financial, and regulatory), contractors will increase the opportunity to improve business processes, achieve cost savings, and mitigate contract performance problems.

Additional areas where traditionally separate compliance reviews may be able to leverage one another to realize synergies between the review processes or to provide insights towards achieving operational efficiencies include program management effectiveness, organizational structure efficiency, and cost recovery maximization.

(a) *Program Management Effectiveness*—Assessment of compliance and ethics programs related to areas such as labor charging, cost assignment, contractual funding, and budgets may provide an opportunity to leverage the review to not only assess potential violations or weaknesses, but also to identify program performance issues on individual contracts. For example, substantial labor charging or significant variances from budget may signify risks that establish conditions that could lead to overpayments, as well as indicating the possibility of performance issues with the program. Leveraging the reviews in this example may also help identify issues related to costs for changes in scope that have not been formalized as a change order or that may have been performed under the direction of someone other than the CO.

(b) *Organizational Structure Efficiency*—A review of the ethics and compliance program within a business unit may be leveraged to identify areas in which the current organizational structure is inefficient. For example, it may identify a structure that requires an excessive number of internal authorizations that could be slowing the overall contracting life cycle and producing other inefficiencies.

(c) *Cost Recovery Maximization*—A review of the overall project costs recorded to a project may uncover allowable costs that are not being properly recovered. A compliance review of the internal controls over project costs and billing may identify costs that are being improperly excluded. As discussed above, such a review

may also identify improper changes that affect the cash flow and overall margins of the program.

Leveraging these reviews provides an opportunity to create additional value by satisfying multiple compliance and control requirements in one package, while also providing a more comprehensive focus that is likely to produce gains in operational efficiency.

#### ■ Enhanced Market & Customer Perceptions

Robust compliance and control programs are increasingly becoming sources of competitive advantage for companies, including Government contractors. Currently, publicly available information on contractor misconduct is accumulated and made available by organizations such as the Project on Government Oversight, with the goal of increasing transparency and reducing waste in Government contracting. The current administration has also signaled its intent to focus on eliminating waste and fraud from Government contracts. Further, the increase in penalties and liability facing publicly traded Government contractors means that shareholders have a distinct interest in ensuring that a given contractor's compliance and control system is adequate. Finally, as past performance information and the contractor's record of business ethics and integrity is incorporated into future decisions regarding contract awards, an effective compliance and control system is likely to make a contractor more competitive for contract awards over the long term.

#### ■ Reduced Risk

The final rule's requirements for a business ethics awareness and compliance program leave contractors with ample discretion regarding the form, substance, and operation of the program. However, this discretion may be a double-edged sword. Because a contractor's ongoing business ethics awareness and compliance program will not be evaluated by the Government in light of the misconduct until *after* a disclosure of misconduct or independent Government investigation, it will necessarily always be evaluated in hindsight. Thus, to reduce any risk of a determination by the Government that the contractor's ethics and compliance program is insufficient or otherwise noncompliant with the new regulations, contractors should ensure not only that the program is as robust as it is feasible, but also that the contractor's efforts in establishing and maintaining the program are well documented.

Additionally, a robust ethics awareness and compliance program will reduce the contractor's risk of violations by effectively mitigating the potential for misconduct to occur, providing for the prompt identification and investigation of potential violations, and producing proper and efficient disclosures when required. Therefore, it is prudent for contractors to review their existing compliance programs to ensure that they fully comply with the requirements of the final rule and to seek outside guidance, if necessary, to develop a conforming and comprehensive ethics awareness and compliance program.

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## GUIDELINES

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These *Guidelines* are designed to assist you in complying with the contractor business ethics compliance program and disclosure requirements. They are not, however, a substitute for professional representation in any specific situation.

1. Ensure that the company's code of business ethics and conduct and compliance program complies with the requirements of the final rule.

2. Train all employees annually on topics such as conflicts of interest, fraud, bribery, and gratuities and require employees to execute an acknowledgement of receipt of training.

3. Provide a copy of the company's code of business ethics and conduct and compliance policies to all employees and require employees to execute an acknowledgement of receipt and review.

4. Provide training, where necessary, to key subcontractors with regard to the ethics, compliance, and reporting requirements of the final rule.

5. Review all past internal investigations of the company that have the possibility of identifying misconduct that may be required to be disclosed, paying particular attention to those

thought to be finally resolved because they were under completed contracts.

**6.** Document investigations of misconduct and promptly reach conclusions regarding the existence of credible evidence.

**7.** Once the credible evidence standard is achieved, properly and timely disclose misconduct to the Government.

**8.** Confirm that the company's hiring process will discover any prospective hire's past miscon-

duct or the misconduct of an employee being considered for promotion.

**9.** Review invoices that are provided to the Government or prime contractor to determine whether any such invoices include overpayments.

**10.** Identify, and if necessary retain, external resources such as auditors, attorneys, and consultants who have experience helping companies implement the various requirements of the final rule.

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- 198/ See generally West, Lee, Brennan, Wharwood & Speice, “National Security Implications of Foreign Investment in U.S. Government Contractors,” Briefing Papers No. 07-11 (Oct. 2007); Dover, “Mergers & Acquisitions—Special Considerations When Purchasing Government Contractor Entities,” Briefing Papers No. 04-8 (July 2004).
- 199/ FAR 9.406-2(b)(1)(vi), 9.407-2(a)(8), 52.203-13, para. (c)(2)(ii)(F)(3).
- 200/ 15 U.S.C.A. §§ 7201–7266.
- 201/ See FAR 52.232-22.

# **BRIEFING PAPERS**

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