

## *New Compliance and Reporting Requirements for Government Contractors*

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Two rules issued by the Federal Acquisition Regulation (FAR) councils in November – one proposed, the other final – are about to raise the compliance bar for many government contractors, at least on paper. In particular, contractors will be required to implement codes of conduct and internal controls, and may become subject to mandatory disclosure requirements with respect to wrongdoing in the performance of government contracts. Portions of the new rules are designed to track factors that can improve a convicted corporation's sentence under the Federal Sentencing Guidelines, while others, like the mandatory disclosure requirement, would go beyond those Guidelines.

Both rules originated with a proposed rule issued in February 2007 addressing the requirements for contractor codes of ethics and business conduct. The councils received comments on the proposed rule, and on November 23 issued a Final Rule on Contractor Code of Business Ethics and Conduct, published at 72 Fed. Reg. 65873, which will

become effective on December 24. But the final rule did not address a controversial aspect of the proposed rule – a requirement that contractors must notify contracting officers *whenever* they become aware of violations of Federal criminal law regarding their contracts. In addition, the Department of Justice (DOJ) wanted to impose other obligations on contractors not even contemplated by the proposed rule. The mandatory disclosure rule and the new DOJ proposals are the subject of a new Proposed Rule on Contractor Compliance Program and Integrity Reporting, published at 72 Fed. Reg. 64019-01, on which comments are due January 14, 2008.

The Final Rule provides that all contractors "must conduct themselves with the highest degree of integrity and honesty" and "should have a written code of business ethics and conduct." Several more specific requirements will be inserted into contracts whose value exceeds \$5 million, unless the contract is for the acquisition of commercial items or will be performed

entirely outside the United States. First, contracts with a performance period of 120 days or more will have a clause requiring that within 30 days after the contract award, the contractor shall have a written code of business ethics and conduct, which must be provided to each employee engaged in performance of the contract. The contractor must promote compliance with that code. Unless the contractor is a small business concern, it must also, within 90 days after the contract award, establish an ongoing business ethics and business conduct awareness program and an internal control system designed to facilitate timely discovery of improper conduct and ensure that corrective measures are promptly instituted. The rule suggests that the internal control system "should" provide for period reviews of practices, procedures, policies and controls, provide for an internal reporting mechanism such as a hotline, provide for internal and/or external audits, and provide for disciplinary action for improper conduct.

The contractors also “shall” require that subcontractors abide by the same requirements where the value of the subcontract is in excess of \$5 million. Second, regardless of the length of the performance period, contracts in excess of \$5 million that are either with agencies that have fraud hotline posters, or that are funded with disaster assistance funds, will have a clause requiring that the contractor display hotline posters. Except for disaster relief contracts, however, contractors can continue to use their own hotline posters. The new rule does not supplant the existing NISPOM requirement that companies inform employees at cleared sites that they can call the agency hotlines to report national security issues, which companies may choose to communicate by means other than posting the agency hotline poster.

The Proposed Rule, drafted to cover certain requirements requested by the DOJ, builds on the Final Rule and generally applies where the value of the contract is over \$5 million and the performance period is 120 days or more. Most significantly, the proposed rule would impose a clause in such contracts requiring the contractor to notify the government in writing “whenever the Contractor has reasonable grounds to believe that a principal, employee, agent, or subcontractor of the Contractor has committed a

violation of Federal criminal law in connection with the award or performance of [the] contract or any subcontract thereunder.”

Contractors would be also required to “exercise due diligence to prevent and detect criminal conduct” and “otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” Except with respect to small business concerns, the Proposed Rule would require that the contractor’s internal control system contain a number of specific components (some of which are advisory under the Final Rule, as described above), including: assignment of high-level responsibility and adequate resources to ensure effectiveness of the compliance program and internal control system; reasonable efforts not to include within the organization principals who have engaged in illegal or unethical conduct (where due diligence *would have* exposed the individuals’ misconduct, not just where the company actually knows about it); periodic compliance reviews of practices, procedures, policies and internal controls; an internal reporting system, such as a hotline; disciplinary action for improper conduct or for failing to take steps to prevent or detect improper conduct; timely reporting of violations; and “full cooperation with any Government agencies responsible for audit,

investigation, or corrective actions.”

The Proposed Rule would also heighten the scrutiny agencies will give to contractors regardless of the size of the company or the value or scope of the contract. Most notably, the Proposed Rule would amend FAR 42.1501, regarding contract administration and audit, to require that a contractor’s satisfactory record of integrity and business ethics be included in the past performance information considered in awarding new contracts. The Proposed Rule would also make clear that contractors may be “suspended and/or debarred for knowing failure to disclose a violation of federal criminal law in connection with the award or performance of any Government contract performed by the contractor or a subcontract awarded thereunder.”

Many of these proposed changes will have little practical impact on sophisticated contractors. To a large extent, the business ethics requirements merely bring the FARs in line with the Federal Sentencing Guidelines, contractually requiring contractors to do what they were doing anyway. Even so, the new rules may create additional risk for contractors. If compliance obligations are inserted into government contracts, then failure to comply with the letter of those requirements could be the basis for a suit under the False Claims Act. One can imagine it

becoming common practice among *qui tam* relators to include in every complaint allegations of inadequate compliance procedures. Even if the new compliance obligations will not materially affect most contractors' approach to compliance, the mandatory disclosure requirements are another matter. DOJ insists that mandatory disclosure is necessary because not enough companies have been voluntarily disclosing criminal conduct to DoD. The voluntary disclosure program gave companies the flexibility to make assessments about

whether violations of the FARs were sufficiently culpable to constitute criminal conduct, and whether potential criminal conduct could be stopped and remedied without submitting to the formal disclosure process. Now contractors who have a doubt about whether conduct rises to the level of criminal conduct will err on the side of reporting, which will impose significant burdens on them, as well as on the DoD. And, of course, violation of the clause requiring disclosure is likely to find its way into many *qui tam* suits.

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