VENABLE LLP

government contracts update

A PUBLICATION OF VENABLE'S GOVERNMENT CONTRACTS GROUP

AUTHORS

Thomas J. Madden
tmadden@venable.com
202.344.4803

Robert A. Burton
rburton@venable.com
202.344.4776

James Y. Boland
jyboland@venable.com
202.344.8273

Final Rule Issued Mandating Disclosure of Criminal Violations and Civil Fraud When the Contractor has "Credible Evidence"

On November 12, 2008, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council ("Councils") issued a final rule requiring government contractors to disclose in writing whenever the contractor has "credible evidence" of a violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuities, or a violation of the civil False Claims Act, by one of its principals, employees, agents or subcontractors. See 73 FR 67064, FAR Case 2007-006. The new rule also creates, among other things, a new cause for suspension and debarment based on a contractor's knowing failure to make a required disclosure under the new rule. This final rule amends FAR Clause 52.203-13, Contractor Code of Business Ethics and Conduct, and will be effective on December 12, 2008. The new requirements are applicable to all government contracts exceeding $5 million and 120 days in duration, including contracts for the acquisition of commercial items and contracts performed outside of the United States.

Background—Creation of FAR 52.203-13, Contractor Code of Business Ethics and Conduct: The final rule significantly expands obligations that were first imposed last year by a final rule under FAR Case 2006-007. On November 23, 2007, the Councils published a final rule creating a new FAR Clause 52.203-13, which required that contractors:

- Have a written code of business ethics and conduct. FAR 52.203-13(b)(1)(i).
- Provide a copy of the code to each employee engaged in performance of the contract. FAR 52.203-13(b)(1)(ii).
- Promote compliance with its code of business ethics and conduct. FAR 52.203-13(b)(2).
- Establish an ongoing business ethics and business conduct awareness program. FAR 52.203-13(c)(1).
- Establish an internal control system that facilitates timely discovery of improper conduct in connection with government contracts and ensures that corrective measures are promptly instituted and carried out. FAR 52.203-13(c)(2). The first

proposed rule suggested that the internal control system provide for (a) periodic reviews of company business practices, procedures, policies, and internal controls, (b) an internal reporting mechanism, such as a hotline, (c) internal and/or external audits, as appropriate, and (d) disciplinary action for improper conduct.

When published, the Councils noted that the rule was intended to "allow for flexibility and, where appropriate, contractor discretion." 72 FR 65873 at ¶ (A)(2)(e). At the time, FAR 52.203-13 did not apply to commercial item contracts nor contracts that would be performed overseas.

The First Proposed Rule: On November 14, 2007, shortly before the issuance of the final rule under FAR Case 2006-007, the Councils published a proposed rule under FAR Case 2007-006 ("first proposed rule") enhancing the requirements of FAR 52.203-13 due in part to heavy lobbying from the Department of Justice. Notable changes in the first proposed rule included:

- Mandatory notification to the Office of Inspector General ("OIG") when the contractor has "reasonable grounds to believe" that a violation of criminal law has been committed in connection with a federal contract or subcontract.

- Requirement that contractors exercise "due diligence" to prevent and detect criminal conduct.

- Requirement that contractors fully cooperate with the government during any audits or investigations.

- New cause for suspension and debarment based on a contractor's failure to timely report a known overpayment under a government contract or a known violation of criminal law in connection with a government contract.

- Make relevant a contractor's record of integrity and business ethics for purposes of a past performance evaluation.

- Convert suggested elements of internal control mechanism to mandatory elements.

- Adjust requirements for ethics compliance and awareness program to more closely match the U.S. Sentencing Commission Guidelines on effective compliance programs.

Like the original FAR 52.203-13, the first proposed rule did not change the exemption of the clause from contracts to be performed overseas and in contracts for commercial items.

Second Proposed Rule: On May 16, 2008, after receiving public comments and additional input from the DOJ on the first proposed rule, the Councils published a second proposed rule further expanding the reach of FAR 52.203-13. This proposed rule expanded the scope of the first proposed rule by mandating the disclosure of known violations of the civil False Claims Act, rather than just criminal violations, and adjusted the new cause for

suspension and debarment identified in the first proposed rule to include the knowing failure to timely disclose a violation of the civil False Claims Act or to disclose a significant overpayment on the contract. The second proposed rule also eliminated the exemption of FAR 52.203-13 from commercial item contracts and contracts to be performed overseas. Note, however, that small businesses and commercial item contracts remain exempt from the requirements for a formal ethics awareness and compliance program and internal control mechanisms.

Close the Contractor Fraud Loophole Act: On June 30, 2008, prior to the close of public comments on the second proposed rule, the "Close the Contractor Fraud Loophole Act," Public Law 110-252, Title VI, Chapter 1 ("statute"), was enacted as part of the Supplemental Appropriations Act of 2008. This statute mandates that the FAR be revised under FAR Case 2007-006 (or any follow-on FAR case), to include provisions that "require timely notification by Federal contractors of violations of Federal criminal law or overpayments in connection with the award or performance of covered contracts or subcontracts, including those performed outside the United States and those for commercial items." While the second proposed rule already encompassed the requirements of the intervening statute, the rule included provisions that extend beyond those required under the statute.

Final Rule—Mandatory Disclosures Based on Credible Evidence: In publishing the final rule, the Councils changed the mandatory reporting standard from one based on "reasonable grounds to believe" to one of "credible evidence." The amended FAR 52.203-13 provides in relevant part:

> 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).

FAR 52.203-13(b)(3)(i) (as amended). The Councils rewrote the "reasonable grounds to believe" standard due to its possible vagueness. In explaining the change, the Councils noted that credible evidence "indicated 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." 73 FR 67073. Regarding the meaning of "timely," the Councils stated that "[u]ntil the contractor has determined the evidence to be credible, there can be no 'knowing failure to timely disclose.'" 73 FR 67074.

The final rule does not define "credible evidence" or "timely," which leaves contractors in a position of uncertainty when deciding whether they are under an obligation to file a report with the OIG and contracting officer. In response to comments, however, the Councils gave several illustrations that may be helpful when interpreting contractors' obligations. The Councils noted, for example, that the "mere filing of a qui tam action" does not represent credible evidence of a violation of the FCA. See 73 FR 67081. The Councils also explained that the government's decision not to intervene in a qui tam action would not be dispositive of whether the contractor has credible evidence of a violation. The implication is that the mandatory disclosure requirement would not be triggered even where credible evidence of a criminal violation or civil fraud exists if the contractor itself does not possess the credible evidence.

Notably, the final rule goes beyond the statute's requirements to include the mandatory disclosure of civil fraud. The Councils explained that expanding the rule beyond the requirements of the statute to include violations of the civil FCA is a "natural extension of the rule" that it is a "matter of policy" and is consistent with the intent of the statute. See 73 FR 67076.

Practitioner's Tips: The long-awaited final rule ends the current voluntary disclosure system and mandates that government contractors affirmatively report instances of certain crimes and civil fraud when the contractor has "credible evidence." The new rule also has "teeth" to ensure compliance, with serious suspension and debarment and past performance evaluation implications for failing to make the required disclosures.

- Government contractors and those seeking to do business with the federal government should review their current Codes of Business Ethics, ethics awareness and compliance programs, and internal control mechanisms to ensure that they comply with the strict requirements of the amended FAR 53.203-13.

- Mandatory disclosure is required when "principals" of contractors have knowledge of a violation. Principals include officers, directors, owners, and persons with primary management and supervisory responsibilities. Contractors should ensure that all principals, including compliance officers, understand the importance of the disclosure requirements.

- Based on the DOJ's level of interest and effort in the formulation of the final rule, contractors may reasonably expect rigid enforcement of the new requirements. While the precise definition of "credible evidence" and "timely" may not be entirely clear, it is recommended that contractors err on the side of caution. However, keep in mind that the mere existence of a violation, which may be known by others, does not necessarily trigger the disclosure requirement—rather, the contractor itself must have credible evidence of the violation.

- The Councils specifically noted that the new cause for

suspension and debarment under FAR Subpart 9.4 for failing to make a disclosure will be applicable to existing contracts (i.e., contracts that do not contain the amended FAR 52.203-13). See 73 FR 67073-74. Therefore, existing contractors must be aware of these new requirements and ensure that criminal violations, civil fraud, and significant contract overpayments are disclosed during the period of up to three years after final payment on the contract.

Venable office locations

BALTIMORE, MD
750 E. PRATT STREET
NINTH FLOOR
BALTIMORE, MD 21202
t 410.244.7400
f 410.244.7742

LOS ANGELES, CA
2049 CENTURY PARK EAST
SUITE 2100
LOS ANGELES, CA 90067
t 310.229.9900
f 310.229.9901

NEW YORK, NY
ROCKEFELLER CENTER
1270 AVENUE OF THE
AMERICAS
TWENTY-FIFTH FLOOR
NEW YORK, NY 10020
t 212.307.5500
f 212.307.5598

ROCKVILLE, MD
ONE CHURCH STREET
FIFTH FLOOR
ROCKVILLE, MD 20850
t 301.217.5600
f 301.217.5617

TOWSON, MD
210 ALLEGHENY AVENUE
TOWSON, MD 21204
t 410.494.6200
f 410.821.0147

TYSONS CORNER, VA
8010 TOWERS CRESCENT DRIVE
SUITE 300
VIENNA, VA 22182
t 703.760.1600
f 703.821.8949

WASHINGTON, DC
575 SEVENTH STREET NW
WASHINGTON, DC 20004
t 202.344.4000
f 202.344.8300