LANDMARK FEDERAL REGULATION MANDATES NEW DISCLOSURE AND COMPLIANCE REQUIREMENTS FOR FEDERAL CONTRACTORS

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To Our Clients and Friends:

In what the Executive Branch acknowledges to be a "sea change" and "major departure" in disclosure requirements, all federal contractors now face suspension or debarment for failure to disclose "credible evidence" of significant overpayments and violations of certain federal criminal and civil laws.[1] In addition to mandatory disclosure obligations, the new rule, which amends the Federal Acquisition Regulation ("FAR") and took effect on December 12, 2008, also imposes heightened obligations related to ethics training, compliance and internal controls for government contractors, with only limited exceptions. The new requirements represent a landmark development in procurement law with implications for all federal government contracts – even those that are performed entirely overseas.

MANDATORY DISCLOSURE

All federal contractors can now be debarred or suspended from government contracting for a "knowing failure by a principal…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 "significant overpayment," a violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuity, or a violation of the civil False Claims Act.

Importantly, this cause for suspension or debarment applies not only to existing and future contracts, but also to any contract on which a final payment was made within the last three years. "Principal" is defined in the regulation and commentary to include officers, directors, owners and partners of the contractor, as well as individuals with "primary management or supervisory responsibilities," including compliance officers and internal audit directors.

In addition, all contracts valued in excess of $5 million and with a duration of at least 120 days must, as of December 12, 2008, contractually require "timely disclosure in writing whenever…the Contractor has credible evidence that a principal, employee, agent, or subcontractor" has violated a federal criminal law involving fraud, conflict of interest, bribery or gratuity, or the civil False Claims Act in connection with the award, performance or closeout of a contract or subcontract. Contractors are in turn responsible for contractually

[1] *Final Rule on Mandatory Disclosure and Contractor Business Ethics, 73 Fed. Reg. 67,064 (Nov. 12, 2008).*

binding subcontractors to the same obligations, which may present particular difficulty in transactions with overseas subcontractors not subject to U.S. procurement laws.

The regulation does not define "timely disclosure" or "credible evidence," but official commentary indicates that both phrases should be construed to allow a contractor opportunity to conduct a preliminary examination to determine the credibility of evidence before deciding whether to disclose to the relevant agency. Disclosed information will be treated as confidential or proprietary, if so designated by the Contractor, and will not be disclosed pursuant to Freedom of Information Act requests without prior notice to the contractor. Disclosed documents can, however, be transferred within the Executive Branch. Moreover, the information may also be transferred to foreign jurisdictions through existing cooperative processes, such as Mutual Legal Assistance Treaties and other information-sharing agreements, subjecting contractors to the possibility of investigations by multiple jurisdictions (and potentially leading to automatic debarment from government contracting for criminal violations in some countries).

APPLICATION TO FCPA VIOLATIONS

It is worth pointing out that the new rule technically requires disclosure of credible evidence of, among other things, Foreign Corrupt Practices Act ("FCPA") violations. Outside of disclosure laws and regulations related to Securities and Exchange Commission filings, disclosure of FCPA violations to government regulators has previously been voluntary. Given the increasing scrutiny and aggressive enforcement devoted to FCPA violations, contractors should pay particular attention to the possible need to disclose potential foreign bribery under the new FAR requirements (particularly in light of the elimination of any exemption for overseas contracts).

COMPLIANCE AND INTERNAL CONTROLS

The new FAR mandates also impose heightened and more specific compliance and internal controls obligations for certain contracts[2] as of December 12, 2008. Along with the preexisting requirement that contractors adopt a written code of ethics within 30 days of contract award, contractors are now contractually required to establish a "business ethics awareness and compliance program" and implement specific internal controls within 90 days of award. Included in these requirements is ethics and compliance training of principals and

[2] *Contracts valued at over $5 million and performed over the course of at least 120 days are subject to the new requirements, with the exception of contracts with small businesses and those for acquisition of commercial items.*

employees, and – "as appropriate" – even agents and subcontractors. The rule also sets forth seven specific "minimum requirements" for a satisfactory internal control system, including:[3]

- devoting adequate resources and senior responsibility to compliance and internal controls;
- conducting ethics due diligence on principals of the company;
- performing periodic evaluation, risk assessment, monitoring and auditing of the effectiveness of the compliance program and internal controls;
- establishing mechanisms for anonymous or confidential reporting of improper conduct;
- imposing disciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct;
- ensuring compliance with the requirement (discussed above) that the contractor disclose "credible evidence" that a principal, employee, agent or subcontractor has violated certain federal criminal laws or the civil False Claims Act; and
- ensuring "full cooperation" with any government agencies responsible for audits, investigations or corrective actions.[4]

Although the internal controls requirements are not as comprehensive as the U.S. Federal Sentencing Guidelines, they are, according to official commentary, intentionally consistent with those guidelines in order to place a contractor "in a better position if accused of a crime."

TAKEAWAYS

The new FAR amendments obligate every federal government contractor to review existing contracts and those with a final payment within the last three years to determine whether any issues merit follow up or implicate mandatory disclosure. Additionally, it would be advisable to take a fresh look at the current compliance program and system of internal controls to determine whether any "gaps" need to be filled to comply with the new requirements.

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[3] *Significantly, contracts with subcontractors must also contain these compliance and internal control requirements if they exceed $5 million in value and last at least 120 days.*

[4] *"Full cooperation" by definition does not necessitate waiver of protections afforded by the attorney-client privilege or work product doctrine, nor does it preclude an internal investigation or defending a proceeding or dispute related to the disclosed violation.*

Although the rule allows for 90 days from award to implement these requirements, this is an uncomfortably narrow window for most companies. Particular attention should be paid to policies and procedures relating to mandatory disclosure, subcontracting, training and hiring of principals. Companies should be sure to document all diligence, investigation and assessment efforts to best protect themselves in the event of government inquiry down the road.

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