

NEW RULE WILL REQUIRE CONTRACTORS TO REPORT WRONGDOING TO THE GOVERNMENT AND IMPOSE STRICTER ETHICS AND COMPLIANCE OBLIGATIONS

On December 12, 2008, a new ethics and compliance regulation will take effect that impacts all Government prime contractors and subcontractors. The new regulation will establish an affirmative obligation to disclose certain civil and criminal wrongdoing to the Government. In addition, the regulation will require contractors to report to the Government past wrongdoing that is related to an ongoing contract or a contract on which final payment was made during the past three years. Contractors failing to meet their disclosure obligations may be foreclosed from future Government contracting through debarment proceedings. The regulation also amplifies existing requirements that contractors implement a code of business ethics and conduct, provide ethics and compliance training to employees, and maintain a system of internal controls. See 73 Fed. Reg. 67064-93 (Nov. 12, 2008).

The disclosure requirement was added to the Federal Acquisition Regulation ("FAR") in the wake of growing pressure from Congress and the Department of Justice to require contractors to report suspected wrongdoing to the Government. The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council have described this regulation as a "sea change" and a "major departure" from the current voluntary disclosure regime. All contractors doing business with the Federal Government at the prime or subcontract level should take immediate steps to ensure compliance with the newly imposed obligations.

I. Affirmative Disclosure Obligation

The new regulation will require a contractor to make a "timely" written disclosure to the Government whenever the contractor has "credible evidence" that:

- One of its principals, employees, agents, or subcontractors, in connection with the award, performance, or closeout of a Government contract, violated either:
 - (i) a Federal criminal law involving fraud, conflict of interest, bribery, or gratuity or
 - (ii) the civil False Claims Act, 31 U.S.C. §§ 3729-3733.
- The contractor has received a "significant" overpayment from the Government.

Disclosures must be made to the contracting agency's Office of the Inspector General, with a copy sent to the Contracting Officer.

After December 12th, all new prime contracts with a value in excess of \$5 million dollars and a performance period of more than 120 days will contain a

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revised FAR 52.203-13 clause that will mandate “timely” disclosure of wrongdoing connected to the contract. The obligation will remain in effect until three years after the Government’s final contract payment. Prime contractors will be required to include the revised FAR 52.203-13 clause in all subcontracts above the same dollar and time threshold.

In addition, the regulation will place all contractors, regardless of the value and performance period of their contracts, at risk for suspension or debarment if a “principal” of the contractor “knowingly” fails to make a timely disclosure of wrongdoing to the Government.¹ Disclosure is required even for civil and criminal violations and significant overpayments which occurred *prior to* the effective date of the regulations if the wrongdoing is related to an ongoing contract or a contract on which final payment was made during the past three years. Disclosure of prior violations will be considered “timely” if they are made in a timely manner from the effective date of the regulation or the discovery of “credible evidence,” whichever is later.

The new suspension or debarment threat will apply broadly to all prime and subcontractors, including those selling to the Government through a multiple-award schedule contract. There is no exemption for small businesses, contracts for commercial items, or contracts that will be performed entirely outside the United States.

Initially, Government contractors will bear the burden of interpreting key terms in the new regulation to determine if, and when, a disclosure must be made. For instance, the regulation does not define the term “credible evidence,” and the notice published with the new regulation simply indicates that the term is intended to establish a “higher standard” than “reasonable grounds to believe” that a reportable violation has occurred. 73 Fed. Reg. at 67073. Additionally, the definition of “timely” is open to interpretation, although the notice suggests that a disclosure will be timely if made after an internal investigation to determine the credibility of an alleged violation. Finally, the rule provides little guidance as to when an overpayment should be deemed to be “significant.” Accordingly, I contractors will need to make legal judgments about what constitutes a reportable violation requiring written disclosure and when a disclosure must be made.

II. Ethics Code, Training, and Internal Controls

The new regulation will also revise FAR 52.203-13 to require contractors to provide periodic training on the company’s business ethics awareness and compliance program and to establish a more robust system of internal controls. This new requirement will not take effect until the revised FAR 52.203-13 clause is incorporated into a prime or subcontract with a value in excess of \$5 million dollars and a performance period of more than 120 days. Although all contracts above the dollar and duration threshold will incorporate the new version of the clause, the ethics program and internal control system requirements described below will not apply to small businesses or contracts for commercial items.

The requirement for a contractor to maintain an ethics code and an awareness program has existed since December 2007. The new regulation will amplify this requirement by specifying that an awareness program must include training related to standards and procedures and other aspects of a contractor’s ethics awareness and the internal control system. This training must be provided to the contractor’s principals, employees, agents, and subcontractors, as appropriate.

¹ A “principal” is defined as an officer, director, owner, partner, or “person having primary management or supervisory responsibilities within a business entity,” such as a general manager, head of a subsidiary, division, or business segment and any similar positions. The accompanying explanation of the new rule states that “this definition should be interpreted broadly, and could include compliance officers or directors of internal audit, as well as other positions of responsibility.” 73 Fed. Reg. at 67079.

The new regulation will also set out new minimum requirements of an internal control system. In addition to the previous requirements, an internal control system must:

- Assign responsibility for compliance at a sufficiently high level and allocate sufficient resources to ensure effectiveness;
- Ensure that reasonable efforts are made to avoid hiring principals who have engaged in conduct conflicting with the code of business ethics and conduct;
- Provide for periodic reviews of company practices, procedures, policies and internal controls in order to monitor and audit the detection of criminal conduct, evaluate the system's effectiveness, and assess risks of criminal conduct;
- Provide for timely disclosure of violations and significant overpayments in accordance with the amended regulations; and
- Provide for full cooperation with any Government agencies responsible for audits, investigations, or corrective actions.

III. Implications for Government Contractors

Although many questions remain open regarding how the new regulation will be interpreted and enforced by the various contracting agencies and the Department of Justice, contractors should take immediate actions to protect themselves from the potentially serious consequences of suspension or debarment. All Government contractors should reexamine their existing ethics and compliance program in light of these changes. To comply with the mandatory disclosure obligations, contractors must ensure that systems are in place to detect and deter wrongdoing, and to evaluate whether reporting is necessary. Additionally, all current and former Government contractors should assess whether disclosure may be required for any prior civil or criminal violation or significant overpayment and take appropriate action.

Contractors are further advised to establish a protocol for reporting to the Government to ensure that the information conveyed to the Government is protected from public disclosure, to the extent possible. Finally, contractors must educate their principals, employees, business partners, and subcontractors of the requirements imposed by this new regulation and discuss with them how best to promote compliance.

This client alert is not intended to constitute legal advice, which often turns on specific facts. Readers should seek specific advice as to how these regulations apply to their business. If you have any questions concerning the material discussed in this client alert, please contact the following members of Covington & Burling's Government Contracts practice group:

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