



Special Edition

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Commentary on Final Rules for Contractor Code of Business Ethics and Conduct

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The FAR Council issued the final rule on "COBEC" (Code of Business Ethics and Conduct) requirements for certain government contracts, on November 12, 2008, the provisions of which have long-term and significant effects on both small and large businesses.

Coupled with the existing regulation, effective December 24, 2007, the contractual clauses (FAR 52.203-13 and 52.203-14) will now impose a number of requirements on contracts in excess of \$5 million issued on or after December 12, 2008. As noted in the following discussion points, not all FAR 52.203-13/14 requirements apply to all contracts, notably small business and commercial contracts are provided exemptions from specific requirements (to be discussed). However, corollary changes in FAR 9.406-2 and 9.407-2, Causes for Debarment or Suspension, will affect every government

contract, including those contracts in effect on or before December 12, 2008. In that context, it is most important to note that noncompliance with certain mandatory disclosure requirements may be the basis for debarment or suspension from government contracting.

The changes to FAR Subpart 9.4 create a sense of immediacy otherwise missing from the more publicized changes to FAR subpart 52. The bottom line, assuming a company wants to remain in government contracting and considering the potential penalties for noncompliance, understanding and implementing the new rules is not a matter of choice, these new rules are a must and not an option.

Although the Department of Justice (DOJ) represents these "sea changes" to be mutually beneficial, the "mutuality" is anything but obvious. DOJ also represents these to be carefully crafted to avoid asking government contractors to do anything not already expected of their counterparts in other industries. Of note the "other industries" of reference, identified as role models for their "self-governance" (including mandatory disclosures of certain violations) are none other than **banking, securities and healthcare**.

Apparently, neither DOJ nor the FAR Council followed current events before publishing the final rule on November 12, 2008. Even more astounding, DOJ's own November 10, 2008 announcement of more than \$1.34 billion in fraud and false

claims recoveries in 2008, which stated: “As in the last several years health care accounted for the lion’s share of fraud settlements and judgments-\$1.12 billion”. Regardless of the logic flaws (bordering on the absurd given the current state of banking, securities and healthcare), the final rule is what it is.

The new rule, effective December 12, 2008, incorporating recent changes to FAR Subpart 9.4 and FAR 52.203-13 as well as the requirements of the prior rule including FAR 52.203-14, fundamentally requires:

- Contractor Code of Business Ethics and Conduct made available to all principals and to employees engaged in performance of the government contract.
- Contractor due diligence to prevent and detect criminal conduct.
- Timely disclosure in writing to the agency OIG (Office of Inspector General) when in connection with a contract, the contractor has credible evidence of a violation of federal criminal law, conflict of interest, bribery, gratuity or a violation of the Civil False Claims Act , and/or significant overpayments.
- For other than a small business or a commercial item acquisition, an ongoing business ethics awareness and compliance program and an internal control system.
- Flow down of these provisions to subcontracts (\$5 million threshold) noting that “subcontracts” is defined to include any supplier, distributor, vendor or firm which furnished supplies or services.

Original Rule, Effective December 24, 2007

FAR 52.203-13 Contractor Code of Business Ethics and Conduct (COBEC)

- Written Code of Business Ethics and Conduct or COBEC are applicable within 30 days of contract award.
- COBEC policies or statements shall be provided to each employee engaged in performance on the contract.
- Contractor shall promote compliance with its COBEC.
- Ongoing Awareness Program and Internal Control System (for other than small business) shall be implemented within 90 days of contract award (unless extended by the contracting officer).
- Contractor shall include the substance of this clause in subcontracts if:
 - Subcontract value greater than \$5 million and performance more than 120 days.

- Exception for acquisition of a commercial item(s) or contracts performed entirely outside the United States (these exceptions were subsequently removed from the final rule).

FAR 52.203-14 Display of Hotline Posters

- Prominently display, in common work areas, agency hotline posters during contract performance in the United States.
- Electronic version of hotline posters displayed on company website (if contractor maintains a website as a means of providing information to employees).
- Agency hotline posters, other than Dept. of Homeland Security (DHS), are not required if a contractor maintains a COBEC awareness program including an internal reporting mechanism such as a hotline poster.
- Contractor shall include the substance of this clause in subcontracts (subject to same threshold and exceptions as 52.203-13).

Before the FAR Council could publish the original rule (December, 2007), they were publishing a proposed rule (on November 14, 2007) to address additional requirements related to **mandatory disclosure** of violations of criminal law related to government contracts or subcontracts. That proposed rule was followed by a second proposed rule, May 16, 2008, to address “public and other interested parties” concerns about FAR 52.203-13 exemptions for contracts performed entirely outside the United States or contracts for the acquisition of commercial items. Additionally, the Department of Justice (DOJ) was identified as suggesting that mandatory disclosure include violations of the Civil False Claims Act (additional grounds for debarment or suspension under FAR Subpart 9.4, which ultimately added mandatory disclosure of significant contract overpayments).

Final Rule, Effective December 12, 2008

The final rule, published November 12, 2008, achieved the objectives of the DOJ as well as other interested parties (including Congress which passed the “Close the Contractor Fraud Loophole Act” which eliminated most of the FAR 52.203-13 exemptions). In final form, the provisions of FAR 52.203-13 now provides definitions of several terms, i.e. Agent, Full Cooperation, Principal, Subcontract/Subcontractor and United States and incorporates the following detailed requirements (including those subtle additions within FAR Subpart 9.4) into applicable contracts:

1. Written Code of Business Ethics and Conduct must be prepared within 30 days of an applicable contract award

and a copy made available to each employee engaged in the performance of the contract.

2. Contractor shall exercise due diligence to prevent and detect criminal conduct and promote an organizational culture that encourages ethical conduct and compliance with the law.
3. Contractor shall timely disclose in writing to the OIG (Office of the Inspector General) with a copy to the Contracting Officer, whenever in connection with the award, performance or close-out of this contract or any subcontract there under, the contractor has credible evidence of violations of:
 - a. Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the USC.
 - b. Violation of the civil False Claims Act 31 USC 3729-3733.
 - c. Significant contract overpayments other than those resulting from contract financing as defined in FAR 32.001 (note: this is added by virtue of a change in FAR subpart 9.4).
4. For other than a small business or contracts meeting the FAR 2.101 definition of a commercial item, the contractor shall have an ongoing business ethics awareness and compliance program including:
 - a. Periodic communications and effective training otherwise disseminating information appropriate to an individual's role and responsibilities.
 - b. Training provided to contractor's principals and employees and as appropriate the contractor's agents and subcontractors.
5. For other than a small business or contracts meeting the FAR 2.101 definition of a commercial item, the contractor shall have an internal control system which shall i) establish standards and procedures to facilitate timely discovery of improper conduct in connection with Government contracts and ii) ensure corrective measures are promptly instituted and carried out. At a minimum, the contractor's internal control system shall provide the following:
 - a. Assignment of responsibility at a sufficiently high level and adequate resources to ensure effectiveness.
 - b. Reasonable efforts to not include as a principal, whom due diligence would have exposed as having engaged in conduct in conflict with contractor's COBEC.
 - c. Periodic reviews of company business practices, procedures, policies and internal controls for

compliance with COBEC and the special requirements of government contracting including i) monitoring and auditing to detect criminal conduct, ii) periodic evaluation of the effectiveness of the awareness program and internal controls, especially if criminal conduct has been detected and iii) periodic assessment of the risk of criminal conduct with appropriate steps to modify the awareness and compliance program and internal controls as necessary to reduce the risk of criminal conduct.

- d. An internal reporting mechanism, such as a hotline which allows for anonymity or confidentiality by which employees may report suspected improper conduct and instructions that encourage employees to make such reports.
 - e. Disciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct.
 - f. Timely disclosure of violations to the agency OIG.
 - g. Full cooperation with any Government agencies responsible for audits, investigations, or corrective actions.
6. Inclusion of the substance of FAR 52.203-13 in subcontracts valued at \$5 million or more with period of performance of at least 120 days (same thresholds as applicable to prime contracts).

Contractor Timing for Compliance with the Regulations

Although the final rule, effective December 12, 2008, appears to be effective upon the award of a contract including the new rule/FAR contract clauses, the fact is that the final rules are effective on existing government contracts on December 12, 2008, even though awarded or closed before this date.

In this case, the immediately applicable change to contracts already awarded (in progress or closed as of this date) is within FAR Part 9.4 wherein the knowing failure by a principal to timely report certain violations may result in suspension or debarment.

A "principal" is defined as an officer, director, owner, partner or person with primary management or supervisory responsibilities. "Reportable violations" (incorporated into the final FAR 52.203-13) are those in connection with the award, performance, or close-out of a government contract and the reporting period extends to 3 years after final payment. Hence, a principal is required to report a violation (based upon credible evidence) regardless of the date(s) of the violation as

long as the final contract payment was less than 3 years before December 12, 2008.

Presumably, the requirement for immediate mandatory disclosure would involve credible evidence known on December 12, 2008; however, it also confirms that there is no line in the sand eliminating mandatory disclosure for any prior violation except for a violation on a contract which had a final payment on or before December 11, 2005. By implication, the Office of Inspector's General (OIG) could very well be flooded with mandatory disclosures on December 12, 2008.

In a more sinister, if not perverse, application of this immediate requirement, existing actions, such as Qui Tams or any ongoing contract fraud investigation, may give rise to investigators who now have reason to expect a "mandatory disclosure" based upon suspicions that a contractor principal may have knowledge of a previous violation (based upon OIG knowledge gained through ongoing investigations).

Just remember that in spite of appearances to the contrary, a contractor, according to the DOJ, should remind itself that all of this is "mutually beneficial". Additionally, it helps to remind oneself that similar law and regulations have been so effective in other industries; **notably banking, securities and healthcare.**

Given the subtle, almost hidden changes in FAR Subpart 9.4, all government contractors must immediately apply due diligence in determining if in fact it has an immediate (December 12, 2008) mandatory disclosure because failure to do so could result in suspension or debarment under FAR Part 9.406-2 or 9.407-2.

Beyond the immediate actions arising from changes to FAR subpart 9.4, the more obvious changes may have already occurred with the original COBEC regulation effective December 24, 2007. Contracts awarded subsequent to that date would have triggered (within 30 days) the requirement for a "COBEC", providing a copy to employees and promoting compliance. For other than small businesses, the original rule also required an ongoing business ethics and business conduct awareness program and internal controls; the former without any detailed requirements nor any compliance requirements, the latter with "examples" of specific controls. Effective December 12, 2008, the awareness program has added **compliance and the internal controls have been changed from examples to requirements** (albeit "minimum" requirements).

As one would expect, the mandated internal controls are circuitous, that is specifically incorporating other requirements of COBEC, not the least of which is mandatory disclosure of

certain violations. In order to comply with the business ethics awareness and compliance program and internal control requirements, a contractor must gain some understanding of the "violations" subject to mandatory disclosure. Notwithstanding the fact that provisions of the regulation refer to generic terminology (i.e. "improper conduct"), the more specific references (violations which are subject to mandatory disclosure) implicate specific training. In particular, principals, employees, agents and subcontractors, depending upon their respective roles and responsibilities, must have an understanding of federal criminal law covering i) fraud, ii) conflict of interest, iii) bribery, and iv) gratuities as well as some understanding of the Civil False Claims Act and significant overbillings on government contracts. A contractor and its principals and employees with primary responsibility for compliance with COBEC, must have a common understanding of the more specific categories of "improper conduct" to which mandatory disclosure applies.

Government Contract Administration and Oversight

A contractor's first encounter with the government vis-à-vis COBEC compliance may be as early as a December 12, 2008 mandatory disclosure requirement for a pre-existing "violation". Beyond that, the original and final rule both indicated that compliance with COBEC would be determined through traditional contract administration which is most likely through government audits by DCAA or any other audit agency responsible for contract audits.

In the context of overall COBEC implementation, we believe that the final rule will potentially have the least impact on large contractors which were previously considered "major" contractors by DCAA (over \$90 million in reimbursable annual government contracts/subcontracts), thus automatically subject to DCAA's ICAPS (Internal Control Audit Planning System) audits. Specifically, the Control Environment and Overall Accounting System Controls whose internal controls matrix (**available at DCAA.mil**) had previously applied elements of DFARS 203.7001 as contractually required (notwithstanding that the implementation of FAR 52.203-13 and -14 confirmed otherwise).

Translated, "major" contractors have always been held to DCAA expectations for i) written business ethics or codes of conduct, ii) awareness/communications/training, iii) periodic management reviews of the effectiveness of its business ethics, iv) compliance mechanism such as hotlines, v) reporting or disclosures to "government officials", vi) cooperation with government agencies, and vii) hotline posters if the contractor

did not otherwise have an adequate system of standards of conduct controls.

In reaction to the final rules for FAR 52.203-13 and -14, DCAA will most likely refine its existing internal control matrix to conform to the final rules; however, beyond refining its internal control objectives matrix, DCAA will likely reconsider the number of contractors subject to audit oversight under the new rules. In particular, all contractors other than small business or commercial item contracts will be subject to the “minimal internal controls” specified in the FAR. This is a much larger universe of contractors than those “majors” previously audited under DCAA’s ICAPS process. In terms of deciding if and how to expand these audits to additional contractors, it is unlikely that DCAA will follow the lead of the FAR Council, which stated in November 2007: “the government will not be routinely reviewing (COBEC) plans unless a problem arises”. Similarly, in pursuit of DCAA’s unwritten, but commonly deployed philosophy that more is better, we believe that DCAA will supplement the minimum internal control criteria stipulated in FAR 52.203-13 (the FAR reference to a “minimum” simply opens that door). As a matter of course, DCAA will be reviewing (auditing) COBEC plans and compliance; it remains to be seen exactly how it approaches these audits for both the major contractors as well as the greatly expanded universe of other contractors.

Lastly, it will be interesting to see if DCAA expects a higher standard of contractor cooperation when DCAA is auditing for specific compliance with FAR 52.203-13 (which includes a provision for “full cooperation”). It will not necessarily matter that the FAR Council stated that “the (full cooperation) rule has no application to routine DCAA audits”. Unfortunately there is no definition of a “routine DCAA audit” as distinguished from an audit of contractor compliance with FAR 52.203-13; hence, this too could be subject to DCAA’s interpretation.

Summary

Every government contractor must determine “how” and “when” it will be impacted by the final rules inclusive of FAR 9.4 and FAR 52.203-13 and -14. The “when” appears to be December 12, 2008 although it remains to be seen how this impacts any given contractor on that date. For those with “skeletons in its closet” (a principal’s knowledge of a category of improper conduct now subject to mandatory disclosure because of FAR Subpart 9.4), December 12 could be a very important, if not a traumatic date.

Small businesses and contractors selling only commercial items appear to be the least impacted in terms of not having the onerous requirements for developing and maintaining an

ongoing awareness program nor establishing “minimum internal controls”. In spite of these exceptions, small businesses maybe the entities which are at greatest risk because they typically lack a system of internal controls or an active compliance program. As a result they simply have an increased risk for having “reportable” violations. In fact, when the original rule was published in November 2007, a published comment (Department of the Army) stated that the majority of small businesses encountered in review of Army contractor misconduct had not implemented contractor compliance programs.

By implication, small business contractor misconduct is a fact of life in the absence of compliance programs (i.e. more than just a code of ethics and conduct, but an active compliance program). Equally, a small business which encounters a violation may be without the necessary resources to perform any preliminary fact-finding and also lacking the resources to determine if it has “credible evidence” which would trigger a mandatory disclosure.

In addition to problems similar to those for categorically small businesses, some “non-major”, but large business contractors, will now find themselves subject to internal control audits previously reserved for the major contractors subject to DCAA’s ICAPS criteria.

Finally, major contractors with previous experience with ICAPS audits (including DCAA’s incorrect interpretations that DFARS contained mandatory disclosure requirements), should expect that DCAA audits will expect all of the mandatory COBEC and internal control requirements incorporated within FAR 52.203-13, in addition to those controls previously deemed necessary by DCAA (albeit not expressly stated in the prior nor the current FAR). DCAA will not reduce its internal control expectations (matrix) to match those now incorporated into the FAR because the FAR only established “minimum internal controls”.

For any contractor subject to a DCAA internal control audits, recognize that within DCAA’s criteria (Policy Memo 08-PAS-011, dated March 3, 2008) virtually any noncompliance with respect to an internal control is a reportable internal control deficiency; thus an audit opinion that a particular internal control system is inadequate or inadequate in part.

Noting that DCAA often utilizes its timesheet “floor checks” to determine if employees are aware of hotline posters, business ethic policies, etc., it is a foregone conclusion that DCAA will utilize similar “audit tests” to determine the effectiveness of a contractors COBEC awareness and compliance program. Perhaps “form over substance”, but nonetheless a long standing DCAA approach to measuring the effectiveness of

contractor ethics programs. If one or more of your employees do not remember your COBEC and/or where your hotline posters are located, your company's compliance will be deemed inadequate (at least in part).

Compliance with the FAR requirements for "COBEC" involves a number of interrelated considerations none of which is more important than the prevention of improper conduct in connection with a government contract. Beyond prevention, there is perhaps nothing as critical as determining if and when a contractor has credible evidence of a reportable violation, thus a mandatory disclosure.

As provided by FAR 52.203-13, the final rule does not restrict a contractor from conducting an internal investigation or defending a proceeding or dispute arising under the contract or related to a potential or disclosed violation. History has shown that timely, efficient and effective internal investigations (of actual or possible violations) are crucial in terms of establishing and focusing the facts, implementing corrective actions (including disciplinary actions) and timely disclosing to the government (previously voluntary disclosures, now contractors have been "invited" by DOJ through the FAR to make mandatory disclosures).

The final FAR rule stopped short of stating a specific limitation on an internal investigation; however, it must be effective, but time compressed to the maximum extent feasible to eliminate the possibility of "untimely" mandatory disclosures. Then and now, when an issue is disclosed to the Government, a contractor is giving up "process control".

Parting Thoughts

In terms of the fairness of the new regulations, quoting many sources and many situations, "no one said that life was fair". Government contract regulation(s) is/are rarely represented to be fair although in the aggregate the regulations are intended to yield a fair and reasonable price to the government.

In the case of the final COBEC rule, a deputy administrator for OMB's Office of Federal Procurement Policy (OFPP) has perhaps unintentionally confirmed that the new rule only has the appearance of fairness and only when there is uncertainty within the rule. Her statement:

"We want disclosure and (we) made it very strong that contractor's could be disbarred (sic) for not disclosing, but also want to show some semblance of fairness when there is uncertainty"

A "Semblance" of fairness is anything but fairness, but again, no one said that life (or contracting with the government) is fair.



Lunch Seminar

Tuesday, December 9, 2008

Lunch Seminar: The Latest FAR Rule on Business Ethics and Mandatory Disclosure of Violations

Location:

Beason & Nalley
Huntsville, AL

Time: 11:00 AM – 1:00 PM

Registration: Contact Liz Waggett, lwaggett@beasonnalley.com or register online,

www.beasonnalley.com/events/event120908.html

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