

I N S I D E T H E M I N D S

Government Contracts Compliance

*Leading Lawyers on Cooperating with Government
Investigations, Navigating Reporting Rules, and
Implementing Compliance Programs*

2011 EDITION



ASPATORE

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Designing and Implementing
an Ethical Compliance
Program: A Primer

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Introduction

As the single largest consumer of goods and services in the United States, the federal government presents an attractive opportunity for many businesses to increase the sales of their products and services. However, as any business that sells its products or services to the government can attest, contracting with the federal government is very different than contracting in the private sector. There are numerous laws and regulations that a government contractor must comply with that go far beyond the usual duties and responsibilities of a private contract. Failure to abide by these requirements can potentially lead to suspension or debarment from future contracting, civil actions resulting in the payment of treble damages, and, in some cases, criminal prosecutions for the parties involved. To successfully mitigate these risks and remain in full compliance with its legal and contractual obligations, it is vital that a contractor implement a robust ethics compliance program.

Perhaps the main benefit of implementing a robust compliance program would be to minimize a contractor's exposure to the significant risks of non-compliance. Although designing and implementing such a program may seem daunting at first, with proper guidance and a sincere desire to foster a culture of compliance, a company may well find that an effective compliance program not only helps minimize its exposure to potential compliance violations, but also improves its efficiency and competitiveness for future government business. Indeed, studies have shown that implementing a robust ethical compliance program can lead to increased employee satisfaction and help to grow a company's bottom line. Tiffany McDowell, PhD, *Deloitte's three ways to instill ethical guidelines: How promoting and enforcing ethical policies can have a positive impact on the bottom line*, Strategic HR Review, Vol. 5 Iss: 5, pp. 16–19 (2006). More specifically to the world of government contracting, having a robust compliance program signals to the world that the company is committed to doing business ethically, which in turn makes the company more competitive in the marketplace due to contracting officers' increased trust. See TERRENCE M. O'CONNOR, FEDERAL PROCUREMENT ETHICS: THE COMPLETE LEGAL GUIDE xvi-xvii (rev. ed. 2010).

FCA

There are numerous statutes that allow the federal government to raise claims against contractors that fail to comply with their contract provisions, but historically the primary enforcement mechanism has been the False Claims Act (FCA) (31 U.S.C. §§ 3729-33), which provides for penalties and treble damages for anyone who knowingly submits or causes the submission of false or fraudulent claims. Specifically, in order for there to be an actionable “false claim” under the FCA, a contractor must have violated a statute, regulation, or contractual provision that is a precondition to the government’s obligation to pay. *U.S. ex. rel. Steury v. Cardinal Health Inc.*, 635 F.3d 262, 268 (5th Cir. 2010).

One particularly troublesome aspect of the FCA for contractors are what are known as the “qui tam” provisions, which allow any person with evidence of fraud to file suit on behalf of the government against the allegedly fraudulent party, and then directly share in any money the government may recover. A recent study indicates that, on average, successful qui tam whistleblowers collect \$46.7 million. Alexander Dyck, Adair Morse, & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, European Corporate Governance Institute, Finance Working Paper No. 156/2007, p. 5 (2009). Thus, through these provisions, the government provides significant financial incentives for whistleblowers (employees and non-employees alike) to seek out evidence of ethics and contract violations.

The past several years have shown a steady increase in the number of FCA cases filed on behalf of the federal government against allegedly non-compliant contractors. In 2010 alone, the US Department of Justice collected roughly \$3 billion from contractors in civil settlements and judgments in FCA cases, which is a significant increase from the \$2.4 billion that was collected in 2009 and the \$1.3 billion collected in 2008. *See* Press Release, U.S. Department of Justice, Department of Justice Recovers \$3 Billion in False Claims Cases in Fiscal Year 2010 (Nov. 22, 2010), *available at* <http://www.justice.gov/opa/pr/2010/November/10-civ-1335.html> (Last visited Jan. 6, 2011); Press Release, U.S. Department of Justice, Justice Department Recovers \$2.4 Billion in False Claims Cases in Fiscal Year 2009; More Than \$24 Billion Since 1986 (Nov. 19, 2009), *available at* <http://www.justice.gov/opa/pr/2009/November/09-civ-1253.html> (Last

visited Jan. 6, 2011); and Press Release, U.S. Department of Justice, More Than \$1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008 (Nov. 10, 2008), *available at* <http://www.justice.gov/opa/pr/2008/November/08-civ-992.html> (Last visited Jan. 6, 2011).

FERA

This rise in FCA actions should be further bolstered by the fact that, under recent revisions to the FCA, contractors can no longer claim as a defense the fact that the false claim was a mistake and that it did not intentionally defraud the government. In May of 2009, new legislation titled the Fraud Enforcement and Recovery Act (FERA) was signed into law, which significantly increased the scope of the FCA. Pub. L. No. 111-21, 123 STAT. 1622, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ21/pdf/PLAW-111publ21.pdf> (Last visited Jan. 6, 2011). One of the most significant changes that FERA implements is to eliminate the contractor's intent from FCA claims, and replace it with a requirement that the contractor's false claim was material to the government's decision to pay the claim. Therefore, under the new FERA standard, a contractor is no longer required to actively make an intentional false statement or intentionally submit a false record, so long as the false statement or record is a material factor in the government's decision that the contractor is entitled to payment.

This more stringent requirement is likely just the beginning, as Congress and the Obama administration have passed several new laws that will significantly increase the federal oversight of contractors' compliance. *See e.g.*, Improper Payments and Elimination and Recovery Act of 2010, 31 USCA § 3301; Overseas Contractor Reform Act, H.R. 5366, 111th Congress (2010); Fraud Enforcement and Recovery Act of 2009, 18 USCA § 1. With this new emphasis on enforcement in mind, it is vital for companies that do business with the federal government to implement robust compliance programs to ensure that they fully comply with all of their contract requirements.

Compliance Requirements

Specifically, a number of the provisions in government contracts reference Federal Acquisition Regulations (FAR) provisions that address a contractor's duty to implement an ethical compliance program. For example, for contracts that are expected to exceed \$5 million over the term of the contract and that are expected to take 120 days or longer to perform, the FAR states, among other things, that contractors must conduct themselves with the highest degree of integrity and honesty (FAR 3.1002(a)), promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law (FAR 52.203-13(b)(2)(ii)), and exercise due diligence to prevent and detect criminal conduct (FAR 52.203-13(b)(2)(i)). As part of this requirement, the provision requires that contractors implement a written code of business ethics and conduct and make a copy of that code available to each employee that is engaged in the performance of the contract. Should the contractor come across "credible evidence" that a principal, employee, agent, or subcontractor has violated one of the provisions of U.S.C. Title 18 related to fraud, conflicts of interest, bribery, or gratuity violations, or violated the civil False Claims Act, in connection with the government contract, the contractor must timely disclose that evidence to the Office of the Inspector General of the contracting agency. FAR 52.203-13(b)(3).

Additionally, for contractors that meet the above requirements and are not small business contractors or commercial item contractors, the FAR requires the implementation of a business ethics and compliance program and an internal control system for detecting and reporting unethical conduct.

Put more simply, the FAR's broad outline for an acceptable compliance program includes three main facets: (1) a business code of ethics, (2) an ethics and compliance program, and (3) an internal control system, as well as corresponding policies related to each. This is the mandated starting point for an effective compliance program, but each of these elements will require analysis and tailoring to ensure that the program that the contractor implements thoroughly addresses the specific risk areas that are faced under a particular contract.

It should also be noted that, though the FAR can at times be difficult to read and understand, the governing body that drafts, issues, and maintains the FAR (referred to as the FAR Council) issued several documents that provide some insight into how it envisions these rules being implemented and enforced. *See* Proposed Contractor Code of Ethics and Business Conduct, 72 Fed. Reg. 65873 (Nov. 23, 2007) (amending 48 C.F.R. pts. 2, 3, and 52); Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 65873 (Nov. 12, 2008) (amending 48 C.F.R. pts. 2, 3, 9, 42, and 52).

Designing an Effective Compliance Plan

As discussed above, to obtain the substantial benefits of a lucrative government contract while mitigating the potential risks, a contractor has to implement a thoughtfully designed compliance program. While each program is different and must be tailored to the specific company and industry, typically the development of an effective program involves the following: (1) performing an initial risk assessment; (2) reviewing and understanding the specific contract requirements; (3) adopting a written code of conduct; (4) adopting internal compliance policies and monitoring and reporting mechanisms; (5) implementing employee awareness and training programs; and (6) auditing, evaluating, and updating each of the programs and policies on a regular basis.

Contractors should be aware that these compliance programs involve highly technical requirements that are spread across numerous different laws and regulations. In order to ensure that the contractor is in full compliance with these laws, but not wasting valuable time and resources trying to implement aspects of a program that it may not need, it is important that the contractor hire outside consultants (typically an attorney and an accountant) that are well versed in procurement contract compliance to perform this initial risk assessment and help guide the contractor in the subsequent drafting of the code and internal policies. For example, when implementing a compliance program for our clients, we might provide any or all of the following services, as needed: (1) thoroughly review the contract and the laws and regulations that are incorporated into the contract by reference; (2) audit the company's existing corporate structure, compliance policies, and any existing compliance programs; (3) ensure that the corporate structure

includes a sufficiently high-level compliance officer position with sufficient resources; (4) draft additional compliance policies as needed to ensure compliance with the contract and applicable laws and regulations; (5) set up a hotline or other anonymous reporting mechanism for employees to report potential violations; (6) structure a training and awareness program and provide training to employees and management on the specific obligations under the contract; and (7) perform periodic follow-up audits and revisions to the program to ensure that the contractor stays current with changes to the law and industry best practices. Additionally, though it is beyond the scope of this chapter, contractors should consider hiring an accounting firm with specific experience in government contracts, as many of the FAR requirements are highly technical cost accounting standards that must be followed.

Perform an Initial Risk Assessment

The first step to building an effective compliance program is for the contractor to evaluate its exposure to the compliance risk areas that federal contractors commonly face. For example, a contractor that acquires raw materials or components from foreign sources will need to ensure it remains in compliance with the requirements set forth in the Foreign Corrupt Practices Act (FCPA). Therefore, that contractor would have to spend more time developing a section of its code and internal policies related to FCPA compliance than a contractor that has no such interactions with foreign entities.

Though it is impossible to draft an exhaustive list of all of the potential risk areas that a contractor might be exposed to, some of the common risk areas that contractors typically include in compliance plans are: (1) Anti-kickback/Anti-bribery; (2) Antitrust; (3) Business Courtesies/Gratuities; (4) Company Assets; (5) Conflicts of Interest; (6) Cost Accounting; (7) Environmental; (8) Export Control; (9) Foreign Corrupt Practices Act; (10) Government Contracting Issues; (11) Procurement Integrity/TINA; (12) Proprietary Information; (13) Safety Rules/OSHA; (14) Teaming; (15) Time Charging; (16) Non-harassment; and (17) Non-Discrimination/ EEO/ Affirmative Action.

As part of the initial risk assessment, the contractor must thoroughly review and understand the numerous requirements that must be complied with under each of its contracts with the federal government. The majority of these requirements can be identified by reviewing the specific contract language. While this may sound simple, parsing through a procurement contract and thoroughly reviewing each of the references to the federal statutes and regulations that are incorporated by reference can be an overwhelming undertaking. Therefore, obtaining the advice of an attorney and an accounting professional familiar with these provisions can be enormously helpful.

The majority of a federal contractor's duties and obligations are outlined in the FAR (codified in Title 48 of the United States Code of Federal Regulations), and are incorporated by reference into the specific contract. A complete listing of the standard contractual provisions that relate to the FAR can be found in FAR Subpart 52. Additionally, the individual agency that grants the contract might have enacted supplements to the basic requirements of the FAR, and contractors must abide by those supplementary requirements as well.

Once a contractor has thoroughly reviewed the contract provisions and understands the compliance risks applicable to its business, the next step is to determine how extensive its compliance program needs to be. The FAR does not provide much guidance on what specifically a contractor must include in its code of ethics, compliance program, and internal control system, and is likely intentionally ambiguous on this point, as FAR 3.1002(b)(1) states that the contractor must implement programs that are suitable to the size of the company and extent of its involvement in government contracting. Thus, there is no such thing as a "one size fits all" compliance program, and each contractor must carefully design a program that is appropriate for the type and amount of government work that it engages in. Contractors should seek the guidance of experienced legal and accounting professionals when performing initial risk evaluations, rather than attempting to rely upon boilerplate checklists or generic programs that fail to take into account the complexities of the specific business.

Adopt a Written Code of Conduct

A written Code of Conduct that is distributed to all of the contractor's employees who work on a government contract is arguably the backbone of the entire compliance program, as it is the resource that employees will first turn to when faced with an ethical dilemma. The FAR does not offer much information on exactly what this code should cover. The most detail is found in FAR 52.203-13(b), which states that “[w]ithin 30 days after contract award, unless the Contracting Officer establishes a longer time period, the Contractor shall—(i) Have a written code of business ethics and conduct; and (ii) Make a copy of the code available to each employee engaged in performance of the contract.”

The FAR requirements are founded on the simple principle that contractors must disclose violations of U.S.C. Title 18 related to fraud, conflicts of interest, bribery, or gratuity violations, as well as violations of the civil False Claims Act. Therefore, presumably the business code of ethics must, at a minimum, help employees identify credible evidence of these violations, and then provide a description of the processes and procedures that must be carried out to report any potential violations up the contractor's chain of command.

Although the FAR does not provide much guidance, the codes of many of the largest and most successful government contractors reveal best practices. An excellent resource for establishing a benchmark industry standard are the ethical codes of conduct that have been posted online by the members of the Defense Industry Initiative (DII). A full listing of these companies, along with links to their various websites, can be found at <http://www.dii.org/our-companies>. As a general rule, the purpose of the code should be to set forth the contractor's values and important business conduct information for the contractor's employees. It should be brief, straightforward, understandable, and a useful tool for employees who might come across ethical violations in the workplace. Though the specifics of the document will depend on the contractor's business, the code should at a minimum set forth a description of the contractor's ethics and business conduct policies, a description of the minimum acceptable conduct, a clear statement that the contractor will discipline anyone who violates applicable laws, regulations, or the basic tenants of business integrity, and provide

clear instructions for how employees can ask questions or report any potential violations without fear of retaliation.

Internal Compliance Policies, and Monitoring and Reporting Mechanisms

Once a code has been drafted and adopted by the contractor, the next step is to flesh out the procedures outlined in the code through a series of government contract-specific policies, referred to in the FAR as the “Internal Control System.” FAR 52.203-13(c)(2)(i) states that the Internal Control System should establish standards and procedures to facilitate timely discovery of improper conduct in connection with government contracts, and ensure corrective measures are promptly instituted and carried out for any ethical or legal violations.

FAR 52.203-13(c)(2)(ii) provides more detail about the specific minimum requirements for an acceptable Internal Control System, stating that it should: (1) assign the duty to oversee the ethical compliance program to a high-level management employee within the company; (2) ensure the program receives adequate funding and resources; (3) detect and avoid potential conflicts of interest for high-level employees; (4) ensure periodic audits, evaluations, and updates to the code, the Internal Control System, and the Awareness and Training programs; (5) provide for the training of employees in the ethical conduct of their duties and the detection and reporting of improper conduct; (6) adopt an internal reporting system that allows employees to anonymously report improper conduct; (7) discipline employees who have acted unethically or failed to detect or prevent unethical behavior; (8) disclose in writing to the contracting agency credible evidence of ethical violations in connection with the contract (although it should be noted that it is always advisable for a contractor to consult with an attorney prior to making such a disclosure to ensure that they are aware of their rights and obligations); and (9) guarantee full cooperation with government agencies.

For example, under typical compliance program policies, an employee that witnesses a potential ethical violation would be able to report that potential violation via an anonymous reporting mechanism, such as an ethical hotline. The contractor should assign a high-level executive to review those potential violation reports, perform appropriate investigations of the people

and circumstances involved, and then, if there is credible evidence that a violation may have occurred, report that evidence to the contractor's board of directors. The board should then consult with legal counsel that is familiar with government contracting to determine whether the potential violation warrants disclosure to the pertinent agency authorities and, if so, how to ensure that the disclosure is made in such a way as fully complies with the contractor's obligations while still protecting the contractor's interests to the fullest extent possible. Finally, the contractor should request counsel's advice on how to properly reprimand the individual that violated the ethical standard and how the ethics program can be modified to prevent similar kinds of violations in the future.

Additionally, it is a good practice for companies that are implementing these policies to also implement a centralized record system that will allow for the retention of any documentation of the contractor's efforts to comply with these various requirements for a reasonable amount of time. The exact nature of the documentation that should be kept and the length of the retention will be specified in the contract, but as a general rule the FAR states that a contractor should keep records of compliance efforts for at least three years after the date of the final payment under a contract. FAR 4.703.

Awareness and Training

Policies and procedures can only be useful to a contractor if its employees are aware of their existence and trained in their use. Therefore, once the contractor has all of the proper policies in place, the next step is to establish an employee awareness and training program.

The FAR does not provide much information about what exactly should be covered in the awareness and training program. It only states that

[t]his program shall include reasonable steps to communicate periodically and in a practical manner the Contractor's standards and procedures and other aspects of the Contractor's business ethics awareness and compliance program and internal control system, by conducting effective training programs and otherwise

disseminating information appropriate to an individual's respective roles and responsibilities.”

FAR 52.203-13(c)(1)(i).

The vagueness of this description was raised during the comment period when these regulations were being developed, but the FAR Councils essentially stated that more specific guidance would not be in contractors' best interests:

The Councils do not agree that it is necessary under this case to dictate to contractors what they need to cover in business ethics training. If we highlight education on the civil FCA, or other specific areas, the contractors may place undue emphasis only on those areas mentioned in the regulations. The business ethics training courses may cover appropriate education on the civil FCA, as well as many other areas such as conflict of interest and procurement integrity and other areas determined to be appropriate by the contractor, considering the relevant risks and controls.

73 FR 67067.

At a minimum, it is clear that the training program should help employees avoid, identify, and report violations of the FCA and federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations. *Id.* However, the FAR Councils' statements above indicate that companies should also cover areas appropriate to the relevant risks and controls that are specific to the contract.

As a best practice, it is advisable that the contractor's training program cover at least the following issues: (1) the specific elements and use of the Code of Conduct; (2) the mechanisms for reporting potential violations of the Code of Conduct, the FCA, or federal criminal law or for obtaining advice as to how to respond to ethical dilemmas; (3) the criminal, civil, and employment sanctions that could be imposed for violations of these standards; and (4) any other topics that appear relevant in light of the contractor's initial risk assessment and contract evaluation.

Once the contractor has outlined the topics that will be included in its training program, the next question is who exactly must be trained. The FAR states that the contractors must provide training for its principals and employees, as well as for its agents and subcontractors, as appropriate. FAR 52.203-13(c)(1)(ii). The FAR defines principals broadly as “an officer, director, owner, partner, or a person having primary management or supervisory responsibilities within a business entity (e.g., general manager, plant manager; head of a subsidiary, division, or business segment, and similar positions).” FAR 52.203-13(a). Ultimately, though not expressly required, a conservative interpretation of this training requirement would be for the contractor to train all employees, agents, and subcontractors that are in any way involved in the performance of the government contract.

Finally, though the FAR does not discuss how often these training sessions should be provided, a good training program probably does not solely include a single session. Instead, the contractor should consistently and periodically reinforce the lessons conveyed in the training session through multiple mediums delivered in engaging and diverse ways (such as through e-mails, live meetings, posters, company newsletters, intranet, etc.). All levels of the contractor’s leadership should take advantage of opportunities to verbalize the importance of a personal commitment to the ethical standards set forth in the Code of Conduct. In this way, the contractor can begin to foster the culture of compliance that is so vital to ensuring that every employee complies with the various statutes and regulations.

Audit, Evaluate, and Update the Program

In the ever-evolving world of contract regulation and oversight, even the most cutting-edge compliance programs can quickly become outdated and non-compliant. Therefore, the final piece to implementing a robust compliance program is to implement policies that require a periodic audit, evaluation, and update of the various initiatives. Indeed, the FAR requires that the contractor’s internal control system include “periodic reviews of company business practices, procedures, policies, and internal controls” to ensure they stay compliant with the various government contracting requirements. FAR 52.203-13(c)(2)(ii)(C). Essentially, these audits should recreate the processes that the contractor undertook in the initial risk

evaluation, with a particular eye toward ensuring that the contractor is in compliance with any new or modified laws, regulations, or contract provisions.

For most contractors, it may be beneficial for these audits to be performed by an outside party that is well versed in the various legal requirements that are unique to government contracting. Bringing in an outside perspective serves a few purposes: (1) it ensures that the audit report does not have any appearance of bias; (2) it helps to ensure that the contractor is in compliance with all the pertinent requirements, including recent modifications to the requirements that the contractor may not be aware of; and (3) permits the contractor to implement current best practices within the industry into the compliance program, which can help to make the program a more innovative and effective tool for preventing non-compliance. Though there is no required time frame, as a best practice these audits should be performed on an annual basis to ensure that the program has adapted to accommodate any new requirements.

Conclusion

Gaining access to the largest consumer of goods and services in the United States can be beneficial to the financial health of a company, but it comes with a significant amount of unique business risks. By undertaking a thorough risk analysis, understanding the specific requirements found in the contract, and undergoing the steps detailed above to implement a robust compliance program, much of this risk can be mitigated. Although it may seem overwhelming at first, the decreased risk of non-compliance and the long-term benefits to the contractor should substantially outweigh the costs and inconveniences that may be experienced. The most important thing to keep in mind throughout this process is that it is vital to have a robust compliance program in place to prevent potential violations that could lead to financial and even criminal penalties, and to ensure that the contractor is prepared to react appropriately should a violation occur.

Key Takeaways

- An effective compliance program not only helps minimize a company's exposure to potential compliance violations, but also improves its efficiency and competitiveness for future government business. Studies have shown that implementing a robust ethical compliance program can lead to increased employee satisfaction, help to grow a company's bottom line, and signals to the world that the company is committed to doing business ethically, which in turn makes the company more competitive in the marketplace due to contracting officers' increased trust.
- The FAR states, among other things, that contractors must conduct themselves with the highest degree of integrity and honesty, promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law, and exercise due diligence to prevent and detect criminal conduct. The provision requires that contractors implement a written code of business ethics and conduct and make a copy of that code available to each employee that is engaged in the performance of the contract.
- The FAR's broad outline for an acceptable compliance program includes three main facets: (1) a business code of ethics, (2) an ethics and compliance program, and (3) an internal control system, as well as corresponding policies related to each. Each of these elements will require analysis and tailoring to ensure that the program the contractor implements thoroughly addresses the specific risk areas that are faced under a particular contract.
- Typically, the development of an effective program involves the following: (1) performing an initial risk assessment; (2) reviewing and understanding the specific contract requirements; (3) adopting a written code of conduct; (4) adopting internal compliance policies and monitoring and reporting mechanisms; (5) implementing employee awareness and training programs; and (6) auditing, evaluating, and updating each of the programs and policies on a regular basis.
- In order to ensure that the contractor is in full compliance with the various laws and regulations, but not wasting valuable time and

resources trying to implement aspects of a program that it may not need, it is important that the contractor hire outside consultants (typically an attorney and an accountant) that are well versed in procurement contract compliance to perform this initial risk assessment and help guide the contractor in the subsequent drafting of the code and internal policies.

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