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Government Contractors To Be Drafted Into the War on Corporate Misconduct

[A Government Contracting Alert from the Office of Jon W. van Horne.]¹

Sometime in the next couple of months, a change in the Federal Acquisition Regulation (FAR) will require contractors, upon award of a government contract over \$5,000,000, to have a code of ethics and business conduct and ethics and compliance training program and internal control systems.²

Although technically limited in scope, this anticipated requirement has broader implications for government contractors and, if a compliance program is not already in place, will increase the cost of doing business with the government, especially for small government contractors.

The proposed FAR change would require contractors, upon award of a contract in excess of \$5,000,000, to display the appropriate fraud hotline posters during contract performance at contract work sites in the United States. If the contract is in excess of \$5,000,000 and has a period of performance in excess of 120 days, in addition to displaying the posters, contractors will be required to have a written code of ethics and business conduct within 30 days of contract award. Within 90 days of award, the contractor would also be required to have in place an employee ethics and compliance training program and appropriate internal control systems “suitable to the size of the company and its involvement in government contracting.”

This requirement will not apply to contracts for “Commercial Items” (see Part 12 of the FAR) or to contracts performed outside the United States. Flow down to subcontracts over \$5,000,000 is also required.

The proposed FAR provisions do not explain what constitutes an acceptable code of ethics and business conduct or an acceptable compliance training program. The contractor's internal control system is required to “facilitate” timely discovery and disclosure of improper conduct in connection with government contracts and to “ensure” that corrective measures are promptly carried out. Examples are given as to what should be included in an internal control system:

- (i) periodic review of company business procedures;
- (ii) an internal reporting mechanism, such as a hotline;

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- (iii) appropriate audits;
- (iv) disciplinary action;
- (v) timely disclosure of any suspected violations; and
- (vi) full cooperation with any government investigations or corrective actions.

Even if the new clause is not included in the contract, the FAR will say that contractors “should have” a written code of ethics and business conduct and an employee ethics and compliance training program and an internal control system. While this may not be an explicit requirement, the government can award contracts only to “responsible” contractors. (FAR 9.103) To be determined “responsible,” a contractor must have “a satisfactory record of integrity and business ethics.” (FAR 9.104-1) So to not have the code of ethics and business conduct, the training program and the internal control system that the FAR says the contractor “should have,” is an invitation to a contracting office to find the contractor to not be “responsible,” which would provide a basis to not make an award.

Of course, businesses of any significant size should already have an effective compliance system. Under the federal sentencing guidelines for organizations, a corporation can alleviate the harshest aspects of its criminal vulnerability by demonstrating that it has put in place an “effective compliance program.” The organizational guidelines criteria embody broad principles that, taken together, describe a corporate “good citizenship” model. While the guidelines do not offer precise details for implementation, they do provide seven key criteria for establishing an “effective compliance program” and identify three additional factors to be considered. Implementing the principles of the guidelines would be a good place to start in meeting the new government contracting requirements. More detail on the sentencing guidelines may have to be a subject of a future alert.

Although both the proposed FAR provision and the federal sentencing guidelines recognize that a compliance program has to be tailored to the size, structure, context and market of an organization, it still will involve a significant on-going cost of doing business. However, given the negative impact of corporate malfeasance in marketplace, to say nothing of the legal implications, compliance programs are now an established feature of the business landscape.