

## **December 2008 Changes to the FAR Regarding Codes of Business Ethics, Internal Controls, and Mandatory Disclosure**

Overall the revisions to the Federal Acquisition Regulations (“FAR”) provide three changes to the FAR – the requirement to have a Code of Business Ethics, the requirement to maintain internal controls and training, and the requirement to disclose criminal violations, civil violations, and significant overpayments. These requirement changes provide contractors with an opportunity to review their practices and consider taking steps to ensure compliance and to enhance their internal procedures and practices.

### **I. Code of Business Ethics**

The first major change is that, effectively, most government contractors will now be required to have a Code of Business Ethics and to provide education and training to their employees regarding that Code of Business Ethics. The FAR accomplishes this requirement by mandating the inclusion in government contracts expected to exceed \$5 million and the period of performance is 120 days or more of a standard contract clause – FAR 52.203-13 – requiring that contractors have a Code of Business Ethics. See FAR 3.1004(a).

This requirement is not entirely new. A similar FAR provision, implementing a Code of Business Ethics requirement was instituted in December 2007, however, that provision provided for two exceptions: (a) acquisitions of commercial items and (b) acquisitions where the contract would be performed entirely outside the United States. The recent changes to the FAR eliminate both of those exceptions, so now the contract clause – FAR 52.203-13 – must be included in all government contracts expected to exceed \$5 million and with a performance period of 120 days or more. See FAR 3.1004.

The key here is that the FAR itself does not require that contractors have a Code of Business Ethics. This mandatory requirement for a Code of Business Ethics will only be implemented in specific government contracts going forward. Technically this means that contractors are not required to have a Code of Business Ethics until the particular contract clause is added to a contract.<sup>1</sup> Practically, since this will be mandatory going forward, it appears inevitable that

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<sup>1</sup> Until the specific contract clause requiring a Code of Business Ethics is placed in a contract, contractors will be governed by the FAR’s back-up rule which only recommends that:

Contractors should have a written code of business ethics and conduct. To promote compliance with such code of business ethics and conduct, contractors should have an employee business ethics and compliance training program and an internal control system that—

- (1) Are suitable to the size of the company and extent of its involvement in Government contracting;

nearly all government contractors will have the clause placed in one or more of their contracts going forward.

The new provision will require that contractors:

- (1) Within 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;
  - (ii) make a copy of the code available to each employee engaged in performance of the contract.

FAR 52.203-13(b).

The FAR does not mandate exactly what must be included in the Code of Business Ethics. Indeed, when the FAR Counsel approved the original version of this rule in December 2007 it noted:

This rule gives businesses flexibility to design programs. Many sample codes of business ethics are available on-line. The specific issues that should be addressed may vary depending on the type of business. To provide more specific requirements would require public comment. The new FAR Case 2007-006 will propose the imposition of a set of mandatory standards for an internal control system. The Councils will welcome suggestions for further FAR revisions when the GAO finishes its study.

Federal Register Vol. 72, No. 225 at 65881.<sup>2</sup> Indeed, one of the best guides as to what should be in a Code of Business Ethics are the internal controls standards. This is one area where the new FAR Rules make major changes from the previous Rules.

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(2) Facilitate timely discovery and disclosure of improper conduct in connection with Government contracts; and

(3) Ensure corrective measures are promptly instituted and carried out.

FAR 3.1002(b).

<sup>2</sup> The GAO Study referenced is a GAO study of contractor ethics at DoD. At this time, it does not appear that this study is complete – in fact we have had clients respond to inquiries from the GAO regarding this study as recently as November 2008. Once that GAO Study is complete, we would expect to see this FAR provision further refined to make some specific requirements as to what a Code of Business Ethics must contain.

## II. Internal Controls Requirements

The Internal Control requirements – much like the requirement to have a Code of Business Ethics – are actually instituted through the same standard contract clause – FAR 52-203-13 – which must be included in a contract to be effective. Again, while this provision may not currently apply to contractors and will not apply until incorporated into a specific contract, the clause will apply to most government contracts valued at over \$5 million and requiring more than 120 days to perform going forward. However, unlike the Code of Business Ethics requirement, the Internal Control requirement maintains two exceptions: one for small businesses and one for contracts regarding the acquisition of commercial items. “This paragraph (c) [Internal Controls] does not apply if the Contractor has represented itself as a small business concern pursuant to the award of this contract or if this contract is for the acquisition of a commercial item.” FAR 52.203-13(c). Therefore, small businesses and commercial item contractors, while generally subject to the Code of Business Ethics requirement, are not subject to the Internal Controls requirement.<sup>3</sup>

Unlike previous versions of this FAR contract clause regarding internal controls, the government now more clearly spells out what internal controls and training requirements are required of contractors. Attached at the conclusion of this paper is a side-by-side comparison of the former contract clause with the one that went into effect on December 12, 2008.

The most immediate and obvious difference between the two is the mandatory nature of the new clause. Where the pre-December 12, 2008 clause only provides examples of what an internal control system should accomplish, the new clause effective December 12 specifically requires that the contractor’s internal control system accomplish certain tasks. Compare versions of FAR 52-203-13(c)(2)(ii).

The new clause mandates that the contractor assign responsibility for the internal control system at a high enough level that it will be effective and that individuals who have engaged in conduct in violation of the company’s code of Business Ethics not be included as principals on government contracts. See FAR 52-203-13(c)(2)(ii)(A) and (B) (Dec. 12, 2008). It also mandates the use of internal monitoring and auditing and periodic assessment of the contractor’s business practices. See FAR 52-203-13(c)(2)(ii)(C) (Dec. 12, 2008). The Clause further requires the use of an anonymous or confidential system for employees to report improper practices that they have encountered. See FAR 52-203-13(c)(2)(ii)(D) (Dec. 12, 2008). It further requires that the contractor have a system for disciplinary action not only for those employees and personnel who engage in improper action but also for those who fail to take steps to prevent or detect improper action. See FAR 52-203-13(c)(2)(ii)(E) (Dec. 12, 2008). Finally, the internal control system must require cooperation with government investigators and must also require the reporting to the government of “credible evidence” of a civil or criminal violation or a significant overpayment. See FAR 52-203-13(c)(2)(ii)(G) and (F) (Dec. 12, 2008).

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<sup>3</sup> As mentioned above, though not required, the FAR still recommends that all contractors have an effective Internal Control system: “contractors should have ... an internal control system ...” FAR 3.1002(b).

These internal control system requirements are significant, and they are new. While they may not currently apply to contractors, they will almost certainly in the near future and contractors can take steps to ensure that both their Codes of Business Ethics and their internal control procedures comply with these new requirements.

### III. Mandatory Disclosure

The most significant change to the FAR is the new mandatory disclosure requirements. Unlike the changes to the Code of Business Ethics and the Internal Controls discussed above, the mandatory disclosure requirement applies to all contractors – not only to those that have a specific contract clause included in a government contract.

In fact, the FAR makes clear that the new provision applies to everyone:

Whether or not the clause at 52.203–13 is applicable, a contractor may be suspended and/or debarred for knowing failure by a principal to timely disclose to the Government, in connection with the award, performance, or closeout of a Government contract performed by the contractor or a subcontract awarded thereunder, credible evidence of a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code or a violation of the civil False Claims Act.

FAR 3.1003(a)(2) (Dec. 12, 2008).<sup>4</sup> The standard contract clause discussed above regarding the Code of Business Ethics and Internal Controls – FAR 52.203-13 – also includes a similar provision regarding mandatory disclosure and there are other changes to the portions of the FAR governing suspension and debarment that also implement this provision. See FAR 9.406-2(b)(1)(vi); FAR 9.407-2(a). Below, is a brief explanation of the new mandatory disclosure rules.

#### A. What must be disclosed?

As indicated above, the mandatory disclosure rules require the disclosure of criminal fraud, conflict of interest, bribery, or gratuity violations, as well as violations of the civil False Claims Act. See FAR 9.406-2(b)(1)(vi)(A) and (B); FAR 9.407-2(a)(8)(i) and (ii); FAR 52.203-13(b)(3)(i)(A) and (B); FAR 3.1003(a)(2).

In addition, the new mandatory disclosure rules also require the disclosure of “significant overpayment(s) on the contract ... ” FAR 3.1003(a)(3); FAR 9.406-2(b)(1)(vi)(C); FAR 9.407-2(a)(8)(iii). This of course begs the question as to what is a “significant” overpayment. While the FAR does not define that term, the discussion accompanying the rule in the Federal Register explains that “significant”:

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<sup>4</sup> The requirement to disclose “significant overpayments” is included in FAR 3.1003(a)(3); FAR 9.406-2(b)(1)(vi)(C); and FAR 9.407-2(a)(8)(iii).

implies more than just dollar value and depends on the circumstances of the overpayment as well as the amount. Since contractors are required by the Payment clauses to report and return overpayments of any amount, it is within the discretion of the suspension and debarment official to determine whether an overpayment is significant and whether suspension or debarment would be the appropriate outcome for failure to report such overpayment.

Federal Register Vol. 73, No. 219 at 67080. Some commentators have noted that whether an overpayment is “significant” may really turn much more on whether the overpayment appears to provide the contractor with “unjust enrichment,” rather than simply reviewing dollar values.

### **B. Who Needs to Know of a Violation to Require that It be Reported?**

The FAR does not require that absolutely every violation that any individual at the contractor suspects must be reported. Instead, the reporting obligation is effectively limited to a contractor’s “principals.” The FAR defines principals 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 2.101(b)(2) (Dec. 12, 2008). The FAR Councils in the Federal Register provided a little more information regarding who it considered to be a principal: “The Councils note that this definition should be interpreted broadly, and could include compliance officers or directors of internal audit, as well as other positions of responsibility.” Federal Register Vol. 73, No. 219 at 67079. While the reporting duty arises once a principal has learned of the violation, the contractor still must have systems in place to encourage the reporting of violations up the chain to principals.

### **C. What Level of Knowledge Must the Principal Have?**

The new FAR rules repeatedly require that the principal must report “credible evidence” of a violation. See FAR 9.406-2(b)(1)(vi); FAR 9.407-2(a)(8); FAR 52.203-13(b)(3)(i); FAR 3.1003(a)(2). The FAR Councils chose to use the term “credible evidence” because they believed that it provided more certainty than a previous draft that used “reasonable grounds to believe.” The FAR Councils explained: “The Councils have replaced ‘reasonable grounds to believe’ with ‘credible evidence.’ ... This term indicates a higher standard, implying that the contractor will have the opportunity to take some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the Government.” Federal Register Vol. 73, No. 219 at 67073.

Neither the FAR itself, nor the comments in the Federal Register appear to really explain what this standard means. At a recent American Bar Association (“ABA”) meeting we attended on this topic, a Department of Justice representative indicated his view that the “credible evidence” standard was a somewhat high standard that could take into consideration facts discovered by the contractor which might disprove some allegation or information. At the same time representatives from the NASA IG, DOD IG, and GSA IG indicated that they interpreted the “credible evidence” as a lower standard meaning only that the evidence was more than just speculation or conjecture.

How the term “credible evidence” will actually be applied and used may not be decided until this rule has been tested in litigation. The DOJ attorney indicated that he foresaw the interpretation of “credible evidence” as an issue that would be a judgment call – much like where a public company must decide whether information must be disclosed in an SEC filing.<sup>5</sup>

#### **D. To Whom Must Reports be Made?**

The Mandatory Disclosure rules require that the Contractor make reports to two different offices—the Inspector General and the affected contracting officer. See FAR 52.203-13(b)(3)(i). At the same ABA meeting mentioned above, the DOD IG made clear that any violation that occurs in relation to any Department of Defense contract should be reported to the DOD IG’s office and not the IG office of the particular branch of service or the affected Defense Agency.

Other commentators have explained that while reporting to the contracting officer and IG are the minimal requirements, additional disclosures may be necessary depending on the situation. For instance, if a task order on a schedule contract is implicated, disclosure should probably be made to both the agency that holds the schedule contract and with the agency that issued the task order. Depending on the circumstances additional disclosures may also be required.

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<sup>5</sup> The subject of exactly what “credible evidence” means appears to be one of the biggest problems with the regulations. That same DOJ attorney mentioned above, who participated in the drafting of the rule, also stated that “credible evidence” was used because it was a known standard from the world of securities law. One securities law source defines it as “Credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or about to occur.” This definition does not seem to add much more clarity.

One tax case has held that, for purposes of a specific statute, that: ““credible evidence,” ... is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue *if no contrary evidence were submitted* (without regard to the judicial presumption of IRS correctness).” That definition seems a little more helpful, but still not clear.

Finally, Black's Law Dictionary defines “credible evidence” as the following: “Evidence to be worthy of credit must not only proceed from credible sources but must, in addition, be ‘credible’ in itself, by which is meant that it shall be so natural, reasonable and probable in view of the transaction which it describes or to which it relates as to make it easy to believe it, and credible testimony is that which meets the test of plausibility. *Indiana Metal Products v. NLRB*, 442 F2d 46, 52.” Exactly what “credible evidence” means in these regulations is something that still needs to be settled.

### **E. How Quickly Must Reports Be Made?**

The new FAR Rules require that the disclosure of a violation must be “timely.” See FAR 9.406-2(b)(1)(vi); FAR 9.407-2(a)(8); FAR 52.203-13(b)(3)(i); FAR 3.1003(a)(2). Again, the FAR does not explain what “timely” means. How this term is applied will also be determined as these regulations are applied. The FAR Council does indicate that “timely” means that the contractor should have some opportunity to evaluate the information before it needs to report to the government: “[‘Timely’ in conjunction with ‘credible evidence’] implies that the contractor will have the opportunity to take some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the Government.” Federal Register Vol. 73, No. 219 at 67074. The FAR Councils also explained that the “timely” rule “does not impose upon the contractor an obligation to carry out a complex investigation, but only to take reasonable steps that the contractor considers sufficient to determine that the evidence is credible.” Federal Register Vol. 73, No. 219 at 67074.

### **F. When Did the Mandatory Disclosure Rule Become Effective?**

The Mandatory Disclosure rule, like the other rules discussed in this paper, became effective on December 12, 2008. However, unlike the Code of Business Ethics and Internal Controls which are only effective when a specific contract provision is incorporated, the Mandatory Disclosure rule was immediately effective. More importantly, as of December 12 all contractors have an obligation to timely report any credible evidence of a violation known by a principal. In effect, the Mandatory Disclosure rule is retro-active and requires that contractors “look back” to determine if incidents or information from the past must be reported. As the FAR Councils explained, “If violations relating to an ongoing contract occurred prior to the effective date of the rule, then the contractor must disclose such violations, whether or not the clause is in the contract and whether or not an internal control system is in place.” Federal Register Vol. 73, No. 219 at 67074.

In fact, the Mandatory Disclosure rule requires that contractors report violations for contracts for three years after final payment. See FAR 9.406-2(b)(1)(vi); FAR 9.407-2(a)(8); FAR 52.203-13(c)(2)(ii)(F). As explained at the ABA meeting, this essentially means that as of December 12, 2008, contractors have an obligation to report on any credible evidence of a violation dating back to any current contract or any contract that has closed since December 12, 2005 – three years prior.

### **G. Does the Mandatory Disclosure Rule Affect other FAR Provisions?**

The Mandatory Disclosure rule and the other provisions mentioned here have an effect beyond the suspension and debarment process or the specific contract compliance provisions described above. In addition, the FAR has been amended to make consideration of business ethics appropriate in other areas. For instance, FAR 42.1501 regarding the use of past performance information was amended to add the bold text below:

Past performance information is relevant information, for future source selection purposes, regarding a contractor’s actions under previously awarded contracts. It

includes, for example, the contractor's record of conforming to contract requirements and to standards of good workmanship; the contractor's record of forecasting and controlling costs; the contractor's adherence to contract schedules, including the administrative aspects of performance; the contractor's history of reasonable and cooperative behavior and commitment to customer satisfaction; **the contractor's record of integrity and business ethics**, and generally, the contractor's business-like concern for the interest of the customer.

In addition, FAR 9.104-1(d) was amended so when evaluating a contractor's present responsibility that the standard of a "satisfactory record of integrity and business ethics" specifically refers to FAR Subpart 42.15 (quoted above) as an example.

#### **H. Must a Prime Contractor Flow Down the Mandatory Disclosure Rule?**

Prime contractors are required to flow down the Mandatory Disclosure requirements, as well as the requirements to have a Code of Business Ethics and an Internal Control System to all "subcontracts that have a value in excess of \$5,000,000 and a performance period of more than 120 days." FAR 52-203-13(d)(1). In addition, a change to the standard contract clause regarding subcontracts for commercial items – FAR 52.244-6 – also requires that 52.203-13 be flowed down to commercial items subcontracts.

**Internal Control Requirements Analysis**

<b>Prior Version of FAR Standard Contract Clause – FAR 52-203-13</b>	<b>FAR Standard Contract Clause Effective Dec. 12, 2008 – FAR 52-203-13</b>
(2) An internal control system.	(2) An internal control system.
(i) The Contractor's internal control system shall—	(i) The Contractor's internal control system shall—
(A) Facilitate timely discovery of improper conduct in connection with Government contracts; and	(A) Establish standards and procedures to facilitate timely discovery of improper conduct in connection with Government contracts; and
(B) Ensure corrective measures are promptly instituted and carried out	(B) Ensure corrective measures are promptly instituted and carried out.
(ii) <b>For example</b> , the Contractor's internal control system <b>should provide</b> for—	(ii) <b>At a minimum</b> , the Contractor's internal control system <b>shall provide</b> for the following:
	(A) Assignment of responsibility at a sufficiently high level and adequate resources to ensure effectiveness of the business ethics awareness and compliance program and internal control system.
	(B) Reasonable efforts not to include an individual as a principal, whom due diligence would have exposed as having engaged in conduct that is in conflict with the Contractor's code of business ethics and conduct.
(A) Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the Contractor's code of business ethics and conduct and the special requirements of Government contracting;	(C) Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the Contractor's code of business ethics and conduct and the special requirements of Government contracting, including— (1) Monitoring and auditing to detect criminal conduct; (2) Periodic evaluation of the effectiveness of the business ethics awareness and compliance program and internal control system, especially if criminal conduct has been detected; and (3) Periodic assessment of the risk of criminal conduct, with appropriate steps to design, implement, or modify the business ethics awareness and compliance program and the internal control system as necessary to reduce the

	risk of criminal conduct identified through this process.
(B) An internal reporting mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports;	(D) An internal reporting mechanism, such as a hotline, which allows for anonymity or confidentiality, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports.
(C) Internal and/or external audits, as appropriate; and	
(D) Disciplinary action for improper conduct.	(E) Disciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct.
	(F) Timely disclosure, in writing, to the agency OIG, with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of any Government contract performed by the Contractor or a subcontractor thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 U.S.C. or a violation of the civil False Claims Act (31 U.S.C. 3729–3733) ...
	(G) Full cooperation with any Government agencies responsible for audits, investigations, or corrective actions.