

SMITH, CURRIE & HANCOCK'S



COMMON SENSE CONTRACTING

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Contractor Ethics Program Mandated

In the November 23, 2007 issue of the *Federal Register*, the Federal Acquisition Council published an amendment to the Federal Acquisition Regulation (FAR) mandating contractor ethics plans and awareness programs. The regulation became effective on December 24, 2007 (*See* 72 Fed. Reg. 65873). The purpose of this article is to provide a summary of that final rule, discuss a proposed FAR regulation that is related to it, and provide an update on the next chapter of the decision in *Morse Diesel International, Inc. v. United States*, 74 Fed. Cl. 601 (2007).

Overview: New FAR Regulation

The new regulation rule adds Subpart 3.10 – Contractor Code of Business Ethics and Conduct, FAR Clause 52.203-13 Contractor Code of Business Ethics and Conduct (DEC 2007), and FAR clause 52.203-14 Display of Hotline Posters (DEC 2007) to the Federal Acquisition Regulation. These provisions apply to most contracts awarded on or after December 24, 2007 of **\$5,000,000 or more and with duration in excess of 120 days**. Together with these provisions, the FAR Council published a summary of the comments. In some aspects, these comments can be important to a proper understanding of the new regulations. A summary of the new requirements follows:

- Within 30 days of contract award, contractors shall have adopted a written code of business ethics, provide a copy of the code to each employee engaged in performance of the affected contract, and “promote compliance with its code of business ethics and conduct.” (The

contracting officer may extend that 30-day period.)

- Within 90 days of contract award (unless extended by the contracting officer), contractors, other than small business concerns, shall establish an ongoing business ethics awareness program and “internal control system” to “facilitate timely discovery of improper conduct” and “ensure corrective measures” are instituted. FAR § 52.203-13(c)(ii) states that an internal reporting mechanism such as a hotline and instructions encouraging employees to report suspected instances of improper conduct are suggested elements of an “internal control system.”
- FAR § 52.203-14 Display of Hotline Poster(s) clause basically requires all contractors (**no exemption for small business concerns**) to display applicable federal agency fraud hotline posters unless that contractor has implemented a “business ethics and awareness program” including a reporting mechanism. This appears to be worded to induce small business concerns to adopt some version of an ongoing business ethics awareness program and internal reporting system.
- All contractors are required to flow down these clauses to subcontracts exceeding \$5,000,000. In response to comments regarding the draft regulations, the FAR Council expressly stated in its comments that “purchase” orders on construction projects are considered to be subcontracts for the purpose of this regulation.

- In response to comments questioning a prime contractor's obligation to monitor compliance with these clauses by its subcontractors, the FAR Council stated that the prime contractor is "not required to judge or monitor" the subcontractor's program, just "check for existence" of the program.

The only blanket exemptions provided by the new regulations were for "commercial items" and contracts performed entirely outside of the United States. The FAR's definition of "commercial item" is found at FAR § 2.101. While detailed, that definition can be difficult to apply in practical terms.

Proposed FAR Rule

On November 14, 2007, the FAR Council issued a proposed rule addressing contractor code of ethics and internal control systems applicable to contracts in excess of \$5,000,000 and with a performance period of more than 120 days. *See* 72 Fed. Reg. 64019. Elements of the proposed rule include:

- An amendment to the general standards of responsibility to include comments regarding the contractor's record of integrity and business ethics in past performance evaluations and information on the contractor's compliance with the new clauses discussed above.
- Require mandatory reporting by contractors and subcontractors of violations of federal criminal laws in connection with the award or performance of any Government contract or subcontract to the agency Inspector General and the contracting officer.
- Debar or suspend a contractor for a "**knowing**" failure to timely report:
 - (1) An "**overpayment**" on a Government contract; or
 - (2) Violation of federal criminal law in connection with the award or performance of any Government

contract or subcontract. (The draft clause has no time limit on the application of this provision.)

- Flow down requirements applicable to certain subcontracts.

While the proposed regulation specify that reports of violations of federal law are to be made to the agency Inspector General and the contracting officer, the draft is silent as to whom reports of "overpayments" should be made. Nor does it define what constitutes an "overpayment".

Morse Diesel Update

In our Fall 2007 newsletter we noted that in the *Morse Diesel International* decision reported at 74 Fed. Cl. 601 (2007), the Court of Federal Claims ruled that the contractor forfeited more than \$50 million in claims due to the findings that it had violated federal laws by improperly billing for surety bond premiums before those amounts had been paid to the surety and receiving rebates of a portion of the stated premiums. In a decision issued on October 31, 2007, that court imposed civil penalties and damages applicable under the Anti-Kickback Act of 1986, 41 U.S.C. §§ 51-58, and the Civil False Claims Act, 31 U.S.C. § 3729(a)(1)(a)(2).

In a detailed discussion of the purpose of the civil penalty and damages provisions of these two statutes, the court rejected the contractor's arguments that:

- Assessing penalties and damages under both acts would be "improperly duplicative."
- The Government's damages should be based upon the time-value of money related to the billing for the bond premiums.

Rather, the court awarded the Government the maximum statutory penalty for the violations of anti-Kickback Act (\$259,457.04). In addition, the court ruled that the contractor was liable to the Government for a civil penalty under the False Claims Act of

\$5,000-\$10,000 per violation plus treble damages. In that context, the court stated:

In fact, key executives knowingly defrauded the Government on six separate occasions involving four significant federal contracts. Plaintiff unlawfully claimed \$1,635,544 for false reimbursement on bond premiums and obtained \$688,678 for false indemnity payments to the parent company.

Based upon these findings of fact, the court imposed a civil penalty of \$50,000 and awarded treble damages of \$6,972,666 $((\$1,635,544 + \$688,678) \times 3)$. In total, Morse Diesel was found liable for \$7,022,666.