

Aerospace And Defense Industries

DR. SANDEEP GOPALAN*

Perceptions about ethical violations and corrupt practices in government contracting have prompted a push, initiated by the Department of Justice (DOJ), to propose new rules that would mandate that government contractors take measures designed to prevent illegal activity. The proposed rules are being drafted at the DOJ's prodding by the Civilian Agency Acquisition Council (CAAC) and the Defense Acquisition Regulations Council (DARC). They seek to amend the Federal Acquisition Regulation (FAR).¹ The proposed rule was issued on November 14, 2007,² in addition to final rules that took effect on December 24, 2007, covering substantially the same ground.³ The final rules from December require, *inter alia*, that contractors put in place a written code of ethics⁴ and display a poster containing the fraud hotline provided by the Office of Inspector General of the contracting agency.⁵

* Associate Professor of Law, Arizona State University. The author expresses his gratitude to Howard Stanislawski for his insightful comments. The standard disclaimers about errors and omissions apply.

1. 48 CFR pts. 3, 9, 42, 52 (2008).

2. Federal Acquisition Regulation; FAR Case 2007-006, Contractor Compliance Program and Integrity Reporting, 72 Fed. Reg. 64,019 (proposed Nov. 14, 2007) (to be codified at 48 C.F.R. pts. 3,9, 42, & 52) [hereinafter "Contractor Compliance Program"].

3. Federal Acquisition Regulation; FAR Case 2007-006, Contractor Code of Business Ethics and Conduct, 72 Fed. Reg. 65,873 (Nov. 23, 2007) (to be codified at 48 C.F.R. pts. 2,3, & 52).

4. *Id.* at 65,881-82 (3.1002 (b)):

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; (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).

5. *Id.* at 65,882 (3.1003):

(a) Requirements. Although the policy in section 3.1002 applies as guidance to all Government contractors, the contractual requirements set forth in the clauses at 52.203-13, Code of Business Ethics and Conduct, and 52.203-14, Display of Hotline Poster(s), are mandatory if the contracts meet the conditions specified in the clause prescriptions at 3.1004; (b) Fraud Hotline Poster. (1) Agency OIGs are responsible for determining the need for, and content of, their respective agency OIG fraud hotline poster(s); (2) When requested by the Department of Homeland Security, agencies shall ensure that contracts funded with disaster assistance funds require display of

The proposed rules are more wide-ranging than the December final rules. The meat of the proposed rules, in Part 3, deals with codes of ethics and business conduct. It exhorts contractors to “conduct themselves with the highest degree of integrity and honesty”⁶ and mandates that contractors have a written code of ethics and business conduct.⁷ This code is expected to be written within thirty days of the award of the contract, unless otherwise agreed. The code of ethics must be provided to every employee of the contractor, and every contractor is required to have an employee business ethics and training program. The contractor is also expected to exercise “due diligence” to detect and prevent criminal conduct and to maintain a work environment that promotes ethical behavior and a “commitment to compliance with the law.”⁸

The obligations of the contractor do not end there. In language reminiscent of Section 404 of Sarbanes-Oxley, contractors are expected to set up an “internal control system”⁹ aimed at ensuring that there is “timely discovery of improper conduct” in order to “[e]nsure corrective measures are promptly instituted and carried out.”¹⁰ In addition, the proposed rules set out a minimum standard that the internal control system must satisfy:

- It must delegate responsibility at a “sufficiently high level . . . and [allocate] adequate resources to ensure [the] effectiveness of the business ethics awareness and compliance program and internal control system.”¹¹
- The contractor must make “[r]easonable efforts” to exclude principals who have been identified as being in contravention of the law or the contractor’s code of business ethics and conduct.¹²
- The contractor must periodically review its business practices, procedures, policies, and internal controls for compliance with its code of business ethics and conduct.¹³
- The review must monitor and audit in order to detect criminal conduct.¹⁴
- The review should evaluate the effectiveness of the ethics awareness and compliance program and internal controls, particularly if any evidence of criminal conduct exists.¹⁵

any fraud hotline poster applicable to the specific contract. As established by the agency OIG, such posters may be displayed in lieu of, or in addition to, the agency’s standard poster.”)

6. Contractor Compliance Program, *supra* note 2, at 64,022 (3.1002 : “(a) Government contractors must conduct themselves with the highest degree of integrity and honesty”).

7. *Id.*

8. *Id.* at 64,023.

9. Such a system is also required of subcontractors when the contract value exceeds \$5 million and has a time for performance that exceeds 120 days, except when the subcontract is for the production of a commercial item or is entirely performed outside the United States.

10. Contractor Compliance Program, *supra* note 2, at 64,023.

11. *Id.* at (c)(2)(ii) (“(A) Assignment of responsibility at a sufficiently high level of the organization and adequate resources to ensure effectiveness of the business ethics awareness and compliance program and internal control system”).

12. *Id.* at (c)(2)(ii) (“(B) Reasonable efforts not to include within the organization principals whom due diligence would have exposed as having engaged in conduct that is illegal or otherwise in conflict with the Contractor’s code of business ethics and conduct”).

13. *Id.* at (c)(2)(ii)(C).

14. *Id.* at (c)(2)(ii)(C)(1).

15. *Id.* at (c)(2)(ii)(C)(2).

- There must be an assessment of the risk of criminal conduct and steps to lower the risk so identified.¹⁶
- The contractor must put a system in place that facilitates and encourages anonymous and confidential whistleblowing by employees.¹⁷
- It must make provision for sanctions for improper conduct and for failure to take reasonable steps to detect improper conduct.¹⁸
- There must be reporting to the contracting officer and Office of the Inspector General when there is criminal conduct.¹⁹
- The contractor is required to fully cooperate with relevant regulatory agencies.²⁰

Failure to comply with provisions of the proposed rule may result in penalties. Contractors may be suspended and/or debarred for a knowing failure to disclose in a timely manner overpayment on a government contract or a violation of the criminal laws.²¹ The proposed rule contains no guidance as to when suspension is more appropriate than debarment. Clearly, however, either sanction only applies if the failure to disclose is “knowing.”²² Somewhat confusingly, however, the standard of care imposed upon contractors is whether they have “reasonable grounds to believe that a principal, employee, agent, or subcontractor . . . has committed a violation of Federal criminal law.”²³ If the contractor finds that there is a reason to believe that such a violation has occurred, it must provide written notice to the contracting officer and the agency Office of the Inspector General.²⁴

Small businesses are expressly excluded from the proposed rule, presumably upon the idea that compliance would be too expensive.²⁵ All other contractors have ninety days after contract award to comply with the proposed rule’s requirements.²⁶ A contractor code of ethics and business conduct is mandatory if the value of the contract exceeds \$5

16. *Id.* at (c)(2)(ii) (“(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”).

17. *Id.* at (e)(2)(ii) (“(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.”).

18. *Id.*

19. *Id.* at (c)(2)(ii)(F):

Timely reporting, in writing, to the agency Office of the Inspector General, with a copy to the Contracting Officer, whenever the Contractor has reasonable grounds to believe that a principal, employee, agent, or subcontractor of the Contractor has committed a violation of Federal criminal law in connection with the award or performance of any Government contract performed by the Contractor or a subcontract thereunder[.]

20. *Id.*

21. *Id.* at 64,022 (3.1002 “(c) A contractor may be suspended and/or debarred for knowing failure to timely disclose a violation of Federal criminal law in connection with the award or performance of any Government contract performed by the contractor or a subcontract awarded thereunder”).

22. *Id.* at 9.406-2 and 9.407-2.

23. *Id.* at 64,023 (c)(2)(ii) (F).

24. *Id.*

25. *Id.* at 64,023 (“This paragraph (c) does not apply if the Contractor has represented itself as a small business concern pursuant to the award of this contract. The Contractor shall establish the following within 90 days after contract . . .”).

26. *Id.*

million, and the time for performance is equal to or greater than 120 days.²⁷ But contracts for the acquisition of a commercial item awarded under FAR Part 12 and contracts performed wholly outside the United States are excluded.²⁸

Unfortunately, the language of the proposed rule is often vague and lacking in precise guidance on what kinds of conduct will invite sanction. Rules of this sort must satisfy the tests of certainty and predictability; it is apparent that the proposed rules fail in this regard. Aside from the lack of precision and clarity is the problem of cost. Given the unhappy experience with Sarbanes-Oxley with regard to the costs imposed by the internal control requirements provisions,²⁹ there is little reason to suppose that the results will be any different here.

Finally, the *raison d'être* for legislative intervention is dubious when the Defense Industry Initiative on Business Ethics and Conduct (DII) has been in existence since 1986 and has significant overlap with the rules proposed.³⁰ The DII principles already require contractors to have a written code of ethics and to train their employees about their ethical responsibilities.³¹ Contractors are also required to have internal reporting mechanisms to facilitate whistleblowing.³² To the extent there are lacunae in the ethical standards required of government contractors, it might have been preferable to amend the DII principles. This would have been a less costly and more market-friendly solution.

In any event, interested parties have until January 14, 2008, to comment on the proposed rules, and since the previous instance of rule-making in this area took over six months after the closure of the comment period, the content of the final rules are only expected to be determined in the latter half of 2008. Contractors ought to use this time to examine their internal mechanisms for compliance.

27. *Id.* at 64,022.

28. *Id.*

29. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 765 (2002).

30. The Defense Industry Initiative on Business Ethics and Conduct, <http://www.dii.org/Statement.htm> (last visited March 9, 2008).

31. *Id.*

32. *Id.* (“(3) Signatories shall encourage internal reporting of violations of the Code, with the promise of no retaliation for such reporting”).