



FEDERAL CONTRACTS



REPORT

Reproduced with permission from Federal Contracts Report, Vol. 80, No. 12, 10/7/2003. Copyright © 2003 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Ethics

The New Era of Corporate Governance and Ethics: The Extreme Sport of Government Contracting

JOHN S. PACHTER

The concept of what it takes to be a “responsible” contractor—one that is eligible to bid on government contracts—is undergoing drastic overhaul.¹ Until recently, contractors could assume that suspension or debarment proceedings, or an integrity-based challenge to their responsibility, would relate specifically to performance of their government contracts. Or, that the issue would have something to do with their business relationship with the government. Those days are gone.

In this post-Enron, post-Arthur Andersen era, we can anticipate that suspension and debarment proceedings will now address a wide variety of matters far removed from specific government contract performance. Public outrage over the Enron and Arthur Andersen debacles prompted passage of the Sarbanes-Oxley Act, Pub. L. No. 107-204, and has generated higher standards of conduct for employees, officers and directors, along with stricter ethical requirements and disclosure obliga-

tions. The ramifications of these higher standards and obligations on government contracting are unfolding almost on a daily basis, and have permeated government determinations of contractor responsibility, along with suspension and debarment.

Now, practically any aspect of a company’s operations is open to scrutiny, including financial accounting, ethics, commercial practices, dealings with state and local governments, and compliance with a host of statutory obligations. Areas unrelated to contract performance—previously considered beyond the purview of contracting officers and suspension and debarment officials—now appear to be under their umbrella,

John S. Pachter is a partner in Smith, Pachter, McWhorter & Allen, Vienna, Va. The author expresses appreciation to Stephen D. Knight, a partner in the firm, and to Jonathan L. Spear, director, Law & Public Policy, MCI Corp., for their thoughtful comments and suggestions.

¹The government awards contracts only to “responsible” bidders. The Federal Acquisition Regulation (“FAR”) Section 9.103 states: “Purchases shall be made only from, and contracts shall be awarded to, responsible contractors only.” The test of “responsibility” includes not only adequate financial resources and production skills, but also “a satisfactory performance record,” a “satisfactory record of integrity and business ethics,” as well as necessary “accounting and operational controls.” FAR 9.104-1(d). “Suspension” is an interim step, “pending the completion of investigation or legal proceedings, when it has been determined that immediate action is necessary to protect the Government’s interest.” FAR 9.407-1(b)(1). “Debarment” is a more permanent action, commensurate with the seriousness of the cause or causes, usually for a period of up to three years, based on the results of investigations or legal action. FAR 9.406-4. The sanctions of suspension or debarment apply to federal government contracts and to non-procurement transactions, which include such things as federally funded grants and cooperative agreements. FAR 9.401, 9.403.

welcome or not. Contractors must be aware of how these changes can affect their ability to remain “responsible,” and must consider appropriate defensive measures.

The Federal Acquisition Regulation states: “The serious nature of debarment and suspension requires that these sanctions be imposed only in the public interest for the Government’s protection *and not for purposes of punishment.*” FAR 9.402(b) (Emphasis added.) This distinction is seldom reflected in media reports, and is often disregarded by headline-seeking politicians. In fact, the line between punishment of contractors and protection of the government’s interest is in serious danger of erosion, and the current trend picks up the thread of previous efforts to punish government contractors for past infractions, without regard to remedial steps the contractor may have taken. See *The New Contractor Responsibility Regulation, Public Meeting on FAR Case 2001-014*, Statement of John S. Pachter, June 18, 2001.²

The consequences become magnified when you consider that it is not just the company’s future that is at stake. The company’s affiliates, principals and employees are likewise subject to suspension or debarment.³ This new environment provides a fertile breeding ground for ventilation of grievances by competitors, disgruntled employees, and labor unions with axes to grind. Indeed, the suspension and debarment arena has become a virtual bid protest forum for companies seeking to eliminate competition. You might even say we are witnessing the emergence of the extreme sport of government contracting. No longer will aggressive competitors be content to challenge a single award if they sense the opportunity to chill competition in a pending procurement, or even knock the opponent out of the game for several years by demanding suspension or debarment. Combine this with calls from opportunistic politicians for punitive measures against government contractors, and you have—to put it mildly—an intensely challenging business environment.

² Available at http://www.smithpachter.com/labor_relations.htm.

³ The definition of “contractor” for purposes of suspension and debarment includes an entity that submits bids directly or through an affiliate. FAR 9.403. In addition, fraudulent, criminal or other seriously improper conduct of any “individual associated with a contractor may be imputed to the contractor when the conduct occurred in connection with the individual’s performance of duties for or on behalf of the contractor, or with the contractor’s knowledge, approval or acquiescence. The contractor’s acceptance of the benefits derived from the conduct shall be evidence of such knowledge, approval, or acquiescence.” FAR 9.406-5(a) (Emphasis added). Conversely, “[t]he fraudulent, criminal, or other seriously improper conduct of a contractor may be imputed to any officer, director, shareholder, partner, employee, or other individual associated with the contractor who participated in, knew of, or had reason to know of the contractor’s conduct.” FAR 9.406-5(b) (Emphasis added).

Indeed, the suspension and debarment arena has become a virtual bid protest forum for companies seeking to eliminate competition. You might even say we are witnessing the emergence of the extreme sport of government contracting.

These developments open up a new world of compliance reviews, and call for strong *defensive measures* by government contractors. More than ever before, it is incumbent on contractors to police their own activities, and to notify government investigative agencies and cooperate with them in eliminating improper practices, rooting out wrongdoing, and promptly instituting corrective action. Contractors can now expect that *any* allegation of improper activity—whether or not related to performance of a government contract—could potentially result in a determination of nonresponsibility, and, ultimately, suspension or debarment. The same might be true in the case of noncompliance with government contract terms that were previously viewed as garden-variety contract administration issues. Among other things, investigators may ask whether these non-compliance items are indicative of weaknesses in internal controls.⁴ This would include such things as defective pricing audits, determinations of unallowable cost, Cost Accounting Standards violations, quality assurance, timely delivery, and potential grounds for default termination. With each issue, the contractor must now ask itself whether it presents a potential suspension or debarment problem.

The regulations put the onus on the contractor to make prompt voluntary disclosure when the contractor has reason to know that a cause for suspension exists: “A contractor has the burden of promptly presenting to the suspending official evidence of remedial measures or mitigating factors when it has reason to know that a cause for suspension exists.” FAR 9.407-1(b)(2). Given the expanded view of the potential causes for debar-

⁴ The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act, has adopted rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934 to include in their annual reports an internal control report (1) stating management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the company’s most recent fiscal year, of the effectiveness of the company’s internal control structure and procedures for financial reporting. In its final rule, the SEC uses the term “internal control over financial reporting.” Final Rule, “Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,” Securities and Exchange Commission (August 14, 2003 effective date). Available at <http://www.sec.gov/rules/final/33-8238.htm>.

ment, contractors must now decide whether to make a disclosure *each time* they face a serious issue, whether or not it is related to government contracts. Without an upgraded compliance program, it will be difficult, if not impossible, for the contractor to have the information immediately needed to make this decision, much less meet the burden of disclosure.

Yet, the idea of taking these steps, and especially of making voluntary disclosure to government officials, is counterintuitive to many a company's concept of how to project a trustworthy image. Here are some typical responses:

"Why raise a fuss?"

"We don't air our dirty laundry in public."

"We prefer to keep a low profile."

"We've never been in trouble before."

"We can't afford an expensive overhead function to address these issues. We must keep costs down to be competitive."

And finally, perhaps the least reliable of all:

"We deliver a superb product at a reasonable price. Our customers have nothing but praise for us. They will stick up for us in a showdown."

Don't count on it. The company that succumbs to such self-delusion is setting itself up for bitter disappointment. Moreover, that company may be allowing a valuable opportunity to slip through its grasp. The fact is that prompt notification to and cooperation with government investigative bodies can be influential in determining outcomes that could otherwise spell doom for a contractor.

On the brighter side, the heightened emphasis on compliance programs can bring enormous positive dividends for contractors. One result will be to minimize the possibility of submission of false claims for payment to the government, and to facilitate a successful defense to false claims allegations. False claims can take a variety of forms of mischarging, such as including unallowable items in overhead, improper billing of overhead items as direct costs (and vice versa), use of incorrect pricing terms, and a host of other possibilities. Contractors will be in for an especially rough ride if they do not have in place adequate compliance mechanisms that enable them to demonstrate that the errors were inadvertent, and occurred despite the exercise of reasonable care.

Moreover, if contractors are not set up for aggressive self-policing, voluntary disclosure, and prompt offers of restitution, there are incentives for others to capitalize on their vulnerability. These include disgruntled employees, competitors, labor unions, and politicians with their own agendas. Their incentives range from the chance for windfall self-enrichment through a whistleblower action to the opportunity to impose the corporate death penalty on the competition by having it blacklisted—suspended or debarred—from doing business with the government.

The civil False Claims Act, 31 U.S.C. §§ 3729-3733, imposes a civil penalty of not less than \$5,500 nor more than \$11,000 plus up to treble damages for each false claim submitted to the government. Each individual invoice, bill, or request for payment is considered a "claim." The government can establish liability without showing that the contractor had a specific intent to defraud. The act states "no proof of specific intent to defraud is required." 31 U.S.C. § 3729(b). The government need only prove that the act is committed knowingly,

meaning the person (1) has actual knowledge of the information, (2) acts in deliberate ignorance of the truth or falsity of the information, or (3) acts in reckless disregard of the truth or falsity of the information.

The court may assess not less than twice the amount of damages if the court finds that (a) the person made disclosure to the government within 30 days after first obtaining the information, (b) the person fully cooperated with any government investigation, and (c) when the information was furnished, no criminal prosecution, civil action, or administrative action had commenced, and the person making disclosure did not have actual knowledge of the existence of an investigation. A person violating the act also is liable to the United States for the costs of a civil action brought to recover fines or damages.

**Government contractors can be determined
nonresponsible—and potentially suspended or
debarred—not only for fraud and contract-specific
issues but also for any conduct indicating lack of
business integrity. In this new world, the
possibilities can arise from noncompliance in the
context of government contracts as well as purely
commercial activities.**

Any person with knowledge of the wrongdoing may bring a qui tam suit in the name of the United States, under the bounty hunter provisions of the False Claims Act. The plaintiff, known as a relator, is entitled to a percentage of the government's recovery, plus attorney's fees from the defendant. 31 U.S.C. §§ 3729-3733.

Finally, the criminal False Claims Act, 18 U.S.C. § 287, provides up to five years' imprisonment plus fines for knowing submission of false, fictitious, or fraudulent claims.

Members of the qui tam bar are vigilant in advertising their services on Web sites, encouraging potential bounty hunters to file as relators under the civil False Claims Act. Because defense of these suits is often a "bet the company" proposition, the temptation for a disgruntled employee or former employee to sue in hopes of a striking it rich can be great.

The United States government also disseminates information encouraging the filing of these suits. For example, the following information is posted on the Web site of the U.S. Attorney for the Western District of Kentucky (<http://www.usdoj.gov/usao/kyw/>):

The primary civil weapon against fraud is the False Claims Act, 31 U.S.C. §§ 3729-3733. Enacted in 1863, the Act allows the United States to collect triple damages and civil penalties of \$5,500 to \$11,000 per violation from persons who submit fraudulent claims for federal monies. This includes health care fraud, defense procurement fraud, workers' compensation fraud, and a variety of other frauds against the federal government.

The False Claims Act also allows citizens who have knowledge of fraud against the government to file a “qui tam” or “whistle blower” lawsuit in the name of the government. 31 U.S.C. § 3730. These complaints by individuals must first be filed under seal to allow the United States time to decide whether to join in the suit. The complaint must be served both on the United States Attorney General and the United States Attorney’s Office. The whistle blower is also required to disclose to the government all material evidence supporting the allegations.

Aggressive compliance programs and self-disclosure can keep False Claims Act allegations at bay and make it more difficult for a qui tam relator to recover. In addition, the FAR debarment mitigation standards, which parallel the Federal Sentencing Guidelines, provide for favorable treatment for contractors that report wrongdoing, conduct their own investigation, cooperate with the government, and take other steps, including offers of prompt restitution. FAR 9.406-1(a). Accordingly, thorough and prompt compliance reviews are essential, as the company and its owners are also at risk of suspension or debarment for having condoned wrongful conduct by not acting quickly enough to discover and correct it and provide restitution to the government.

There is no stigma attached to voluntary disclosures. To the contrary, government agencies, including the Department of Justice, look upon voluntary disclosures as a sign of good corporate citizenship and responsible behavior. Once the company has completed its preliminary review and begun its investigation, it should make a timely voluntary disclosure to its primary customers.

Consider for a moment the implications of undertaking corrective action without voluntary disclosure. The company could draw the attention of the government customer, prompt questions, and force the company to disclose the underlying issues after the fact. This in turn could arouse suspicion and trigger an agency inspector general or audit investigation, even while the company is quietly trying to set things right. The auditors and in-

vestigators are not likely to look kindly on the contractor’s attempt to undertake corrective action without upfront disclosure. Rather, their tendency will be to view it as surreptitious, perhaps even a cover-up. Indeed, it is fair to say that with each internal, external, or government audit that raises an integrity-related issue, the company should consider whether to make a disclosure to the agency’s suspension and debarment authority. The nature and timing of these disclosures require close analysis.

Conclusion

Suspension, debarment, and contractor responsibility are now cast in a different light. Contractors can be determined nonresponsible—and potentially suspended or debarred—not only for fraud and contract-specific issues but also for any conduct indicating lack of business integrity. In this new world, the possibilities can arise from noncompliance in the context of government contracts as well as purely commercial activities.

The adverse impact of improper financial reporting disclosures, for example, now extends to eligibility to bid on government contracts. The government’s suspension of Enron was based on allegations of financial reporting fraud and deficient business controls, and the suspension of Arthur Andersen was based on financial auditing issues as well as document destruction. These actions preceded the congressional enactment of heightened reporting obligations in Sarbanes-Oxley. In the case of WorldCom, which arose following enactment of Sarbanes-Oxley, the General Services Administration proposed the company for debarment based on unresolved material deficiencies in its financial controls, as well as weaknesses in its ethics-compliance program.

In short, with virtually no area of activity immune from scrutiny, contractors must be more vigilant than ever to ensure the adequacy of their internal compliance mechanisms.