

**Compliance Update: New FAR Requirements on
Business Ethics and Internal Controls**

By Thomas P. Barletta

The FAR Council recently promulgated a new rule on contractor business ethics and conduct. The rule provides that contractors should have a code of business conduct, business ethics training, appropriate internal controls, and a mechanism for internal reporting of improper conduct or display applicable agency “Hotline” posters. The new rule is similar in substance to the coverage that has been at DFARS Subpart 203.70, but, unlike the DFARS, it prescribes mandatory contract clauses that require contractors to have a business ethics program and internal controls. As discussed below, there is an exemption for contracts and subcontracts for commercial items under FAR Part 12 and small businesses are exempt from selected requirements of the rule. For some contractors, the new rule may require further action to ensure compliance, and contractors who already have a code of business conduct and a system of internal controls may want to review them against the requirements of the new rule. Similarly, even contractors who are exempt from its mandatory requirements should familiarize themselves with its provisions.

The new rule was effective December 24, 2007 and emphasizes that government contractors “must conduct themselves with the highest degree of integrity and honesty.” FAR 3.1002(a). It goes on to state that contractors “should have” a written code of business ethics, a business ethics and compliance training program, and an internal control system that is “suitable to the size of the business and extent of its involvement in Government contracting.” *Id.* 3.1002(b)(1). According to the rule, an internal control system should “[f]acilitate timely

discovery and disclosure of improper conduct in connection with Government contracts and [e]nsure corrective measures are promptly instituted and carried out.” Id. 3.1002(b)(2)-(3).

The Implementing Contract Clauses

The new rule is implemented through two contract clauses at FAR 52.203-13, Contractor Code of Business Ethic and Conduct, and 52.203-14, Display of Hotline Poster(s). These clauses are mandatory for contracts that are expected to exceed \$5,000,000, inclusive of options, and have a performance period of more than 120 days. See FAR 1.108(c) (Contracts for commercial items under FAR Part 12 and contracts to be performed entirely outside of the United States are exempt.) These clauses will bind contractors when they are included in new contracts.

Where applicable, FAR 52.203-13 *requires* a contractor to have a written code of business ethics and conduct in place within 30 days of contract award, to provide a copy of that code to all employees and to “promote compliance” with it. FAR 52.203-13(b). This clause also *requires* contractors to establish an “ongoing business ethics and business awareness program and an internal control system” within 90 days of award. Id. 52.203-13(c). (The contracting officer may extend either of the above deadlines.) The clause provides that an internal control system “*shall* facilitate timely discovery of improper conduct in connection with Government contracts,” and ensure that appropriate corrective action is taken promptly, id. 52.203-13(c)(2)(i) (emphasis supplied), and goes on to provide examples of what the Government expects to see in a system of internal controls, namely:

- “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;”

- An internal reporting mechanism, such as a hotline, through which employees can report suspected misconduct, and “instructions that encourage employees to make such reports;”
- “[I]nternal and/or external audits as appropriate;” and
- “Disciplinary action for improper conduct.”

Id. 52.203-13(c)(2)(ii).

FAR 52.203-14, Display of Hotline Poster(s), requires affected contractors to display designated agency (IG) and/or DHS fraud hotline posters and, if the contractor uses a web site to provide information to its employees, to display electronic versions on its web site. However, a contractor is exempt from the requirement to display agency hotline posters (other than DHS posters when requested by DHS for contracts funded with disaster relief funds) if it has implemented a business ethics awareness program that includes a reporting mechanism.

The preamble to the rule indicates that COs will not be expected to verify compliance with the rule, but may inquire about and review compliance as part of “normal contract administration.” 72 Fed. Reg. 65878. Both clauses also provide for mandatory flowdown to subcontracts expected to exceed \$5,000,000, except for contracts for the acquisition of commercial items and for contracts performed entirely outside of the United States. FAR 52.203-13(d); 52.203-14(d). The preamble to the rule states that “[t]he intent is that the flowdown applies to all subcontracts, including purchase orders.” 72 Fed. Reg. 65880. It also indicates that prime contractors are “not required to judge or monitor the ethics awareness program and internal control systems of the subcontractors – just check for existence.” Id.

Exemptions for Small Business and Contracts for Commercial Items

As noted above, the new rule includes exemptions for small businesses and for contracts for commercial items under FAR Part 12. Contracts with small businesses will include the two new clauses and those businesses are required to have and distribute a code of business ethics

and conduct pursuant to FAR 52.203-13(b), and to post pertinent posters pursuant to FAR 52.203-14. However, those businesses are exempt from the requirements for an “awareness [formal training] program and internal control system” in FAR 52.203-13(c). Since the clause will be included in contracts with small businesses, they will be required to flow them down to their subcontractors. See 72 Fed. Reg. 65881.

The two new FAR clauses are *not required* in contracts (or subcontracts) “for the acquisition of commercial items under [FAR] part 12.” FAR 3.1004. The regulation does not specifically address GSA FSS contracts, which are described in FAR Part 8. However, a sound argument can be made that GSA FSS contracts should be treated as contracts for the acquisition of commercial items under FAR Part 12 for purposes of this rule. GSA FSS contracts are contracts for commercial items. See FAR 8.402(a) (describing FSS contracts as a “simplified process for obtaining commercial supplies and services”); GSAM 538.271(a) (stating that “MAS contracts will be for commercial items as defined in FAR 2.101”). Also, GSA has recognized that FSS contracts effectively involve acquisitions under FAR Part 12. See, e.g., GSAM 512.203 (stating, that for the solicitation, evaluation and award of FSS contracts, “use the policies in FAR Part 12 and Part 512 in conjunction with the policies and procedures in FAR Part 38 and Part 538”); 512.301(a) (including MAS contracts in the prescription of solicitation provisions and contract clauses for the acquisition of commercial items).

Notwithstanding the partial exemption for small businesses and the exemption for contracts awarded under FAR Part 12, those contractors (including GSA FSS contractors) should familiarize themselves with the new rule and consider taking steps to comply with its substance in a manner appropriate to the size of the company and its government business:

- First, FAR 3.1002, states, as a matter of policy, that government contractors “should” have a compliance program that includes a code of business conduct

and adequate internal controls. This policy “applies as guidance to *all* Government contractors.” FAR 3.1003(a) (emphasis supplied); see also FAR 2.101 (defining “should” as “an expected course of action or policy that is to be followed unless inappropriate for a particular circumstance”).

- Second, the preamble to the final rule notes that “if a small business subsequently finds itself in trouble ethically, the need for a training program and internal controls will likely be addressed by the Federal Government at that time, during a criminal or civil law suit or debarment or suspension.” 72 Fed. Reg. at 65881. (The same rationale would no doubt be applied to a commercial item contractor that “finds itself in trouble ethically.”)

In that regard, FAR 9.406-1(a)(1) currently states that “whether the contractor had effective standards of conduct and internal controls in place at the time of the activity which constitutes cause for debarment,” is one of the factors to be considered in making a debarment (or suspension) decision. Likewise, the Federal Sentencing Guidelines provide that the sentence imposed upon a corporation for a criminal violation should be less severe if the corporation had an “effective compliance and ethics program” at the time of the offense. See United States Sentencing Commission, Guidelines Manual, §§ 8A1.2(b)(2)(D); 8B2.1 (Nov. 2007). (Although the Sentencing Guidelines envision a compliance and ethics program that, in some respects, goes beyond the features described in the new FAR rule, they also provide for consideration of “standards called for by any applicable government regulation” and state that “failure to incorporate and follow . . . standards called for by any applicable government regulation weighs against a finding of an effective ethics and compliance program.” Id. at 8B2.1, Commentary.)

Considerations in Developing a Code of Business Ethics and Internal Controls System

Contractor codes of ethics and business conduct typically emphasize the company’s commitment to ethical business conduct and its expectation that its employees will adhere to that standard; and they also often provide that employees will be disciplined for failure to comply with the code. Examples of subjects that might be addressed in a government contractor’s code

include the importance of keeping accurate books and records, complying with contract performance requirements, procurement integrity, and gratuities and kickbacks. Some contractor codes of ethics and business conduct also provide for an employee hotline or helpline.

Contractors also often require employees to acknowledge in writing that they have been provided with a copy of the code and that they have read, understood and agree to comply with it.

As the new rule suggests, an internal controls system should be appropriate to the nature of the company's government contracts. For an FSS contractor, this might include, for example, controls relating to preparation and submission of its CSPFs and compliance with the Price Reduction and IFF clauses.

More to Come?

When originally proposed, what became the new FAR rule stated that a contractor's internal control system "should" also provide for reporting of "any suspected violations of law" and "other irregularities in connection with" its government contracts to the Government and for "full cooperation" in any Government investigations. See 72 Fed. Reg. 7589, 7590 (Feb. 16, 2007). This was similar to DFARS 203.7001(a)(7), which currently states that a contractor's system of management controls "should" include reporting violations to the Government and cooperating with its investigations. (The Sentencing Guidelines (§ 8C2.5(g)) also provide for consideration of self-reporting and cooperation). Those provisions were excluded from the final rule, but are the subject of another proposed rule that was also issued in November 2007. See id. at 64019 (Nov. 14, 2007). The November 2007 proposed rule would cross a threshold that no previous FAR or DFARS provision has crossed, because it uses the mandatory word "shall" in the proposed contract clause regarding self-reporting and cooperation. Id. at 64023; see also FAR 2.101 (defining "shall" simply and starkly as "the imperative"). In addition, the proposed

rule would add a contractor's "record of integrity and business ethics" to the categories of contractor past performance information that are required to be evaluated under FAR 42.1501.

See id. at 64022.

In short, business ethics in connection with government contracts is a matter of increased Government emphasis and should be for contractors as well. Moreover, the proliferation and escalation of the laws and regulations relating to contractor business ethics and internal controls are creating a complex and challenging situation for contractors in structuring compliance programs that will reduce rather than increase their legal exposures and risks.

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