ReedSmith

Global Regulatory Enforcement Alert

If you have questions or would like additional information on the material covered in this Alert, please contact one of the authors:

Lorraine M. Campos
Partner, Washington, D.C.
+1 202 414 9386
lcampos@reedsmith.com

Steven D. Tibbets
Associate, Washington, D.C.
+1 202 414 9242
stibbets@reedsmith.com

…or contact other key members of the Global Regulatory Enforcement Group:

Leigh T. Hansson
Partner, Washington, D.C.
+1 202 414 9394
lhansson@reedsmith.com

Jason P. Matechak
Partner, Washington, D.C.
+1 202 414 9224
jmatechak@reedsmith.com

Christopher L. Rissetto
Partner, Washington, D.C.
+1 202 414 9206
crissetto@reedsmith.com

…or the Reed Smith lawyer with whom you regularly work.

Client Alert 09-012

January 2009

reedsmith.com

Hot Issues in Government Contracts: 2009 and Beyond

We offer this Alert to inform Reed Smith clients and others about the major issues that are likely to impact their government contracts businesses in the coming months and years. Our attorneys possess a wealth of knowledge and experience in guiding clients through the delicate and complex issues they face when the federal government is simultaneously a customer, business partner, and potential prosecutor. The following discussion highlights developments that are shaping, and will shape, the legal landscape government contractors face in 2009 and beyond.

Major Issues:

- Compliance with the New Mandatory Disclosure Rule
- Preparing for Enforcement Actions Brought Pursuant to the Mandatory Disclosure Rule
- Increased FCPA Enforcement

Minor Issues:

- Trade Agreements Act Compliance
- New Acquisition Personnel
- Fewer Sole-Source Awards
- IT Coordination – Responsibility Database
- Information and "Green" Technology Funding
- E-Verify

Major Issues

Compliance With the Mandatory Disclosure Rule: Traps for the Unwary and Wary Alike

On Nov. 12, 2008, the Federal Acquisition Regulation Councils issued a Final Rule requiring all contractors to disclose wrongdoing to the government. As of Dec. 12, 2008, all federal contractors must disclose to the federal government certain violations of federal law, and violations of the False Claims Act. Specifically, contractors must "timely" disclose, in writing and to the Inspector General and the contracting officer (in that order), whenever, in connection with the award, performance, or closeout of a contract, the contractor has "credible evidence" that a principal, employee, agent, or subcontractor has committed a violation of federal criminal law involving fraud, conflict of interest, bribery or gratuity violations under Title 18 of the U.S. Code, or a violation of the False Claims Act. In addition, the rule requires contractors to establish a "business ethics awareness and compliance program," as well as an "internal control system" with certain attributes. In addition, significant overpayments by the government must be disclosed to the contracting officer. Failure to disclose violations of federal criminal law or violations of the False Claims Act may lead to criminal sanctions, civil penalties, suspension, or debarment.

The Final Rule itself is non-specific with regard to precise information to be reported, but the Department of Defense ("DOD") and the General Services Administration ("GSA") have issued forms for contractors to submit mandatory disclosures. GSA, for example, requires contractors to report "a complete description of the facts and circumstances surrounding the reported activities, including the evidence forming the basis of this report, the names of the individuals involved, dates, location, how the matter was discovered, potential witnesses and their involvement and any corrective action taken by the company." DOD, on the other hand, requires the following items: (1) "Date Contractor learned of potential violation"; (2) "Provide a full description of the nature of the violation(s) being disclosed, including the period during which the violation occurred, names of individuals involved and an explanation of their roles in the allegations and the relevant periods of their involvement";

(3) “safety or operational hazards”; (4) Measures taken to mitigate safe or operational hazards”; (4) “Estimated financial impact to the Government”; (5) “Did an overpayment occur?” (6) “Estimated financial impact to the Government”; (7) “Has an investigation been conducted?” (8) “Describe the scope of the investigation (records reviewed, number and positions of employees interviewed, etc.”; (9) “Is the company willing to provide a copy of the investigative report?” and (10) “Measures taken to prevent recurrence.” Thus, the information contractors must now self-report is detailed and potentially self-incriminating.

How The Mandatory Disclosure Rule Complicates Life For Contractors

The fundamental difficulty with the mandatory disclosure rule is that, when they have “credible evidence,” contractors are forced to admit in a “timely” fashion liability that can lead to criminal sanctions, civil penalties, suspension, or debarment, and failure to make this disclosure can lead to the same penalties. To compound this problem, the terms “credible evidence” and “timely” are not defined.

One government official involved in creating the Mandatory Disclosure Rule has stated, off the record, that “[w]e envision that a lot of these disclosures may very well be administrative matters that can be handled by the contracting officer and the contractor, and we will encourage that to happen wherever it can. We are also going to ask of our criminal investigative organizations in the department as these matters are disclosed, to be able to tell us at a high level up front as these disclosures are reviewed whether or not they intend to investigate.” In addition, the preamble to the Mandatory Disclosure Rule states that, although suspension and debarment are possible penalties for failing to disclose a reportable event, “it is unlikely that any contractor would be suspended or debarred absent that a violation had actually occurred.” As explained by another government official speaking off the record, “No agency has ever suspended where there was in fact a disclosure. The question is non-disclosure and it’s that early in the process, what is credible evidence? What is a reasonable period of time for a contractor to determine that the evidence exists in conducting their internal inquiry?” In the current environment, with the Mandatory Disclosure Rule recently published and relatively untested, the answers to these questions are unclear.

In addition, contractors must be aware of the competitive harm that mandatory disclosures can inflict. For instance, when asked whether any regulations would be promulgated to prevent contracting officers from making “contract-by-contract present responsibility determinations” based on mandatory disclosures, one government official speaking off the record stated, “IGs don’t tell the contracting officers what to do.” In addition, it is an unresolved question whether the contents of mandatory disclosures, or the fact of disclosure alone, would be subject to Freedom of Information Act (“FOIA”) requests. One can easily imagine situations in which costly protests are lodged based on responsibility determinations that do not reflect disclosures, where the protester has obtained disclosures, or the fact of disclosure, via a FOIA request. An awardee could be forced, at a minimum, to make an embarrassing acknowledgment of the contents of a disclosure to its customer agency, even if the disclosure was unrelated to the contract award it is defending.

Ultimately, the Mandatory Disclosure Rule creates a dilemma for contractors. They must disclose potential violations of law, thereby inviting investigation and potential prosecution and penalties, but they have an opportunity to assess whether “credible evidence” exists, and an incentive to find that “credible evidence” does not exist. Meanwhile, if a contractor declines to disclose a situation, but an agency subsequently learns of the situation, the contractor faces the compounded problem of the underlying situation and a failure to comply with mandatory disclosure. In this event, the contractor must have a well-documented course of action it has taken to address the issue, and a compelling “story to tell” the agency to avoid suspension or worse. We are well-positioned to assist clients in handling these delicate situations and creating documentation to protect the company, regardless of the decision it makes.

Moreover, contractors must contend with the lack of definition of the terms “timely” and “credible evidence” as they attempt to comply with the Mandatory Disclosure Rule. The following discussions address each of these issues.

What Does “Timely” Mean?

The term “timely” is not defined in the Mandatory Disclosure Rule. Therefore, it is impossible to predict with much certainty what a particular agency will find to be “timely” in a particular situation. To complicate matters, government officials involved in the creation of the Mandatory Disclosure Rule have, in off-the-record statements, acknowledged that the Rule is ambiguous about the relationship between the Rule’s effective date, Dec. 12, 2008, and the time periods applicable to principals’

knowledge of events that could lead to a duty to disclose. In other words, if, on Dec. 13, 2008, a principal had knowledge about events that occurred months or years before that may have involved a violation of law, a duty to disclose may arise, and it is risky for contractors to decline to disclose on the basis of their own opinions regarding the materiality of information, or whether the staleness of the information renders it not subject to disclosure. We are ready to assist clients in developing strategies for surveying principles and investigating any matters potentially subject to disclosure in an efficient manner so that they avoid facing retroactive application of the Mandatory Disclosure Rule, but do not squander precious resources investigating specious matters.

As one government official involved in drafting the Mandatory Disclosure Rule stated in off-the-record comments, he envisioned "cooperation" between IGs and contractors, which is undefined but which is "much more than responding to a subpoena." Trouble for contractors will arise when the government learns about an issue, asks the contractor how long it delayed reporting, and the contractor lacks a good "story to tell" regarding the investigative efforts that justified any delay in reporting. We are well-equipped to assist clients in creating a "plan of attack" and documenting events that occur between revelation of a potential problem and any eventual reporting, or decision not to report, to the government, to ensure that the client has an opportunity to investigate events that might give rise to a mandatory disclosure without exposing itself to accusations that it unduly delayed reporting.

What Does "Credible Evidence" Mean?

As one government official involved in drafting the Mandatory Disclosure Rule explained in off-the-record comments: "No agency has ever suspended where there was in fact a disclosure. The question is going to be is, if there is a non-disclsoure and it's that early in the process, what is credible evidence? What is a reasonable period of time for a contractor to determine that the evidence exists in conducting their internal inquiry?" Likewise, the preamble to the Mandatory Disclosure Rule explains that the "credible evidence" standard replaced the standard "reasonable grounds to believe," so that the standard would reflect the fact that a contractor would have the opportunity to take some time for preliminary examination of the evidence to determine its credibility.

Thus, it seems less important that a contractor understand a particular definition of "credible evidence," than it is that a contractor document its investigative efforts and the reasoning underlying its determination whether, in a given situation, "credible evidence" exists of a violation giving rise to a Mandatory Disclosure. We can assist clients in creating procedures and policies to ensure the prompt investigation and resolution of situations that may give rise to a duty to disclose, and documentation of such situations to protect against penalties based on the government's second-guessing a contractor's decision-making.

Steps Contractors Can Take Now to Prevent Problems with Mandatory Disclosure in the Future

Contractors should undertake an effort to identify any "principal" in the organization with knowledge of a reportable event as of Dec. 12, 2008, and document this knowledge, or lack thereof. One approach for accomplishing this would be to send a survey to all "principals," with a sworn statement regarding whether they are aware of any information that should be reported to the government under the rule. In the event of any subsequent allegations that the company failed to comply with the Mandatory Disclosure Rule, a file containing the sworn statements of all principals that they knew of no reportable information would be powerful evidence to resist suspension or debarment. By repeating this exercise on a regular basis, a company can further protect itself by creating records showing that it is monitoring its "clean-slate" status.

To review, the Mandatory Disclosure Rule constitutes a "sea change" in the regulation of government contractors. Government contracts lawyers in Reed Smith's Global Regulatory Enforcement Group are abreast of the latest developments, and have the experience to guide government contractor clients as they grapple with this significant development.

Enforcement Actions Resulting from the Mandatory Disclosure Rule: The Other Shoe Drops

The Mandatory Disclosure Rule is an intermediate step in a sequence of events that will ultimately enhance the regulatory risks and potential liability government contractors face. In 2006, the White House Office of Federal Procurement Policy established a National Procurement Fraud Task Force. In July 2007, the Task Force issued a "White Paper" setting forth two broad policy recommendations: (1) improvements in the government's ability to prevent and detect procurement fraud (with proposed statutory language that mirrors the Mandatory Disclosure Rule); and (2) improvements in the prosecution and adjudication of procurement and grant fraud defendants. The Mandatory

Disclosure Rule was a manifestation of the first recommendation in the White Paper, so we expect that implementation of the "prosecution and adjudication" prong of the goals announced in the White Paper to occur next. Likewise, the "Performance Measures/Indicators" listed by the DOD Inspector General ("IG") in a December 2007 strategic plan included "Percentage of investigations accepted by the U.S. Attorney for prosecution." In its December 2008 progress report, the Task Force touted its record of recovering money and indicated that this record would only be improved upon passage of the Mandatory Disclosure Rule. Thus, we have every reason to believe that implementation of the second recommendation, i.e., increased enforcement and prosecutions, is soon to follow, and that agencies' IGs expect to recover money and instigate prosecutions based on now-mandatory disclosures.

Case in point, on Nov. 14, 2008, the White House Office of Federal Procurement Policy sent a memorandum to all Chief Acquisition Officers and Senior Procurement Executives alerting them that the new mandatory disclosure rules had been adopted, and noting specifically that "contractors are subject to debarment and suspension from government contracting for knowingly failing to disclose such violations and overpayments on government contracts in a timely manner." While some agency inspector generals have hinted that they do not intend for the Mandatory Disclosure Rule necessarily to create additional enforcement actions, it is clear that the OFFP and the Procurement Fraud Task Force view disclosures that contractors make as laying the groundwork for enhanced enforcement activity. As one official involved in drafting the new rule stated in off-the-record comments: "[under the former voluntary disclosure program] the contractors, when they would make the disclosures, would essentially make them, but then sort of say we didn't really mean to do anything bad and please don't make us pay any money back. Well, that is a formula for not resolving disputes, that's a formula for creating disputes."

Thus, contractors should expect that any disclosures are equivalent to an admission of guilt. On the other hand, existing DOJ guidelines addressing corporate prosecuting, while not providing amnesty, suggest that if a company discloses violations, any prosecution will be of individuals responsible for a violation, not the entire organization. Therefore, we are about to enter a period in which we will learn for the first time how various agencies' IGs view mandatory disclosures, and the extent to which prosecutors will be lenient in light of disclosures. Attorneys in Reed Smith's Global Regulatory Enforcement Group are actively monitoring activity under the new rule, and will, therefore, be well-positioned to provide contractor clients with wise counsel in mitigating the potential damage associated with disclosures and subsequent enforcement actions.

The Task Force's White Paper suggested the following additional enforcement-related policies: (1) amending Federal Sentencing guidelines to better define economic loss in procurement and grant fraud cases; (2) expanding OIG subpoena authority to include compelled interviews, and clarifying that current authority includes electronic and physical evidence; (3) authorizing OIG counsel staff to be detailed to DOJ to assist in prosecuting procurement and grand fraud cases; and (4) extending the applicability of the Program Fraud Civil Remedies Act Amendments to the Inspector General Act of 1978 to all IG offices. In addition, in a July 2008 report to the Senate Appropriations Committee, the DOD IG expressed an intention to beef up the agency's audit coverage of: (1) maintenance service contracts; (2) security service contracts; (3) air transportation contracts; (4) DOD financial systems used in Iraq and Afghanistan; and (5) staffing and training of contract oversight personnel. Moreover, in 2008, the Defense Criminal Investigative Service launched a proactive project that will analyze more than $14 billion in payment vouchers related to U.S. Army purchases in Iraq.

So these are the areas in which contractors should expect additional scrutiny and enforcement activity. In the uncertain environment created by the ambiguities of the Mandatory Disclosure Rule, our counsel can help contractors protect themselves, both by providing guidance to mitigate the risk of adverse consequences when situations that could create a disclosure obligation occur, and by implementing programs to avoid and contain potential liability in the first place.

In addition, for contractors operating in multiple countries, compliance with the Mandatory Disclosure Rule should be viewed in the context of "self-cleansing" governance, familiar to European contractors. Reed Smith's Global Regulatory Enforcement Group, with its trans-Atlantic footprint and geographically diverse experience, is well-positioned to assist clients in developing company-wide compliance programs that serve multiple purposes and satisfy the requirements of regulatory authorities of the various countries in which they operate.

Foreign Corrupt Practices Act Enforcement

Recent reports from the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ") indicate that these agencies will be increasing both the number of Foreign Corrupt Practices Act ("FCPA") enforcement actions, and the size of penalties that targeted companies will face. On Nov. 25, 2008, the *American Lawyer* quoted Scott Friestad, Deputy Director for the Securities and Exchange Commission's Enforcement Division, as stating, "The dollar amount in the [FCPA] cases that will be coming within the next short while will dwarf the disgorgement and penalty amounts that have been obtained in prior cases."

An additional reason to expect enhanced FCPA enforcement is the fact that other countries have recently passed tougher anti-bribery laws pursuant to the 1997 Organization for Economic Cooperation and Development Agreement. As the former deputy director of the DOJ's fraud section has been quoted as saying recently, "The United States and other countries are just becoming more skilled at investigating and prosecuting" FCPA violations. Thus, we expect both the SEC and the DOJ to bring more FCPA actions than ever before in 2009.

The attorneys of Reed Smith's Global Regulatory Enforcement Group have ample experience guiding clients through FCPA investigations, implementation of FCPA compliance programs, completion of due diligence exercises in connection with corporate transactions, and litigation of civil and criminal actions under the FCPA.

Additional Issues on the Horizon

Trade Agreements Act Compliance

The Trade Agreements Act ("TAA") requires government agencies to procure only products manufactured in particular countries under certain circumstances. In turn, agencies, particularly the Department of Veterans Affairs ("VA") and GSA, in managing multiple award schedule contracts, require contractors to certify that their products are TAA-compliant. Contractors' TAA compliance is currently under enhanced scrutiny, probably as a result of several recent high-profile False Claims Act cases involving allegations related to TAA compliance. In addition, the customs regulations that govern the "country-of-origin" concepts that guide TAA compliance are likely to undergo significant changes in the coming months. These developments will affect contractors' manufacturing processes, particularly for products sold via GSA and VA multiple award schedules.

Products from particular countries that provide affordable manufacturing platforms (e.g., China and Malaysia) may not be sold to the U.S. government under certain contracts. However, contractors frequently source parts and components from such countries, which are incorporated into TAA-compliant products by virtue of "substantial transformation" through manufacturing processes in the United States or other "designated" countries under the TAA. The current test for "substantial transformation" is whether the component emerges from processing as a new and different article of commerce that possesses a new name, character, or use. However, U.S. Customs and Border Patrol ("CBP") recently issued a proposed rule that would adopt a "tariff shift" test for "substantial transformation." The "tariff shift" test asks whether a product's classification under the Harmonized Tariff Schedule of the United States ("HTSUS") changes in the manufacturing process. We possess the experience and knowledge to assist clients in assessing their products' TAA compliance, and in complying with the new "tariff shift" rules.

Greater Numbers of Acquisition Personnel

An issue highlighted by the National Procurement Fraud Task Force's November 2006 White Paper was the fact that the federal procurement workforce has declined by 50 percent since the mid-1990s. Similarly, President Obama has called for increasing the size and training of the government's acquisition workforce. Likewise, in November 2008, *Washington Technology* reported that "the [acquisition] community has been undervalued and lacking in sufficient resources for too long."

Thus, we wish to highlight for our government contractor clients the possibility that they will soon be working with new and/or additional acquisition personnel. They may find themselves educating new personnel regarding their products and services, as well as contending with inexperienced contracting officers or specialists.

Fewer Sole-Source Awards

Parts of the Duncan Hunter National Defense Authorization Act for 2009, signed into law by President Bush Oct. 14, 2008, impose new requirements related to the manner in which agencies procure goods and services. These sections of the statute are known colloquially as the "Clean Contracting Act." Section 862, in particular, imposes a limit on the length of certain noncompetitive contracts. Specifically, the term of a contract that is procured using other than competitive procedures must meet the standard of "unusual and compelling" requirements, and agencies must issue written findings to justify the use of other than competitive procedures to a greater extent than is currently required under the Federal Acquisition Regulation ("FAR").

The goal of the Clean Contracting Act is to reduce the use of sole-source vehicles. As a result, contractors that currently perform, or hope to win, sole-source contracts should expect increased competition. Conversely, contractors that have felt shut out of sole-source procurements made to competitors should have additional opportunities to compete for such awards, in addition to enhanced grounds for protesting agencies' use of noncompetitive vehicles for awarding contracts.

IT Coordination

Section 872 of the Clean Contracting Act requires the White House Office of Management and Budget ("OMB") to establish and maintain a database of information regarding the integrity and performance of contract awardees and grant recipients. The database is to cover adverse results realized over the past five years by prospective contractors in criminal, civil, and administrative proceedings. Federal agencies are to review the database and consider all information in the database with regard to any offer or proposal. This database will present an additional repository of reputational information for contractors to monitor and correct as necessary. We are monitoring OMB efforts to implement this requirement. We are available to provide guidance to contractors regarding monitoring this information and utilizing procedures to correct inaccurate information.

Opportunities for IT and "Green" Technology Grants and Contracts

President Obama has pledged to invest $10 billion per year, over the next five years, to move the U.S. health care system to broad adoption of standards-based electronic health information systems. In addition, Obama has pledged to invest $150 billion over the next 10 years to enable American engineers, scientists, and entrepreneurs to develop "next generation" biofuels and fuel infrastructure, commercial hybrid vehicles, promote commercial-scale renewable energy, and transition to a digital electricity grid. These are just two examples of programs that will create numerous opportunities for firms in the information technology and "green" engineering sectors to obtain funding in the current climate of tight credit and reduced venture capital.

E-Verify

A Final Rule ("the Rule") amending the FAR to require federal contractors to use the E-Verify System was published in the *Federal Register* on Nov. 13, 2008. The E-Verify System is a free Internet-based program operated by the U.S. Department of Homeland Security, U.S. Citizenship and Immigration Service ("CIS") to allow employers to verify the employment eligibility of new hires. All federal contracts awarded and solicitations issued after Jan. 15, 2009 were to include a clause mandating use of E-Verify for all employees hired during the contract period, and those employees who will perform work under the contract, with a surprising exception for employees who perform support work on the contract, such as indirect or overhead functions.

However, on Dec. 23, 2008, the U.S. Chamber of Commerce sued the Department of Homeland Security, alleging that the Final Rule mandating E-Verify use was unconstitutional. In response, the Department delayed implementation of the Final Rule until Feb. 20, 2009. It remains unclear whether further delays will occur if the lawsuit remains pending. Regardless, it is important that contractors understand the E-Verify system and are prepared to use it in the event that it becomes mandatory in the near future.

ReedSmith

About Reed Smith

Reed Smith is one of the 15 largest law firms in the world, with more than 1,700 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

Founded in 1877, the firm represents leading international businesses from Fortune 100 corporations to mid-market and emerging enterprises. Its attorneys provide litigation services in multi-jurisdictional matters and other high stake disputes, deliver regulatory counsel, and execute the full range of strategic domestic and cross-border transactions.

Reed Smith is a preeminent advisor to industries including financial services, life sciences, health care, advertising and media, shipping, energy, trade and commodities, real estate, manufacturing, and education. For more information, visit **reedsmith.com**