Vol. No. XX,

Issue No. 2

March 2010

The Clause

A Quarterly Publication of the Boards of Contract Appeals Bar Association

The President's Column
Susan Warshaw Ebner

Dear BCABA Members:

It's March and it looks like 2010 is going to be another year for significant changes in the federal procurement arena!

- While tens of billions of dollars were spent in 2009 under the American Reinvestment and Recovery Act (Recovery Act), we can expect the Government to engage in additional procurements using the tens of billions of Recovery Act dollars that remain available for obligation in 2010. More procurements mean more contracts, subcontracts, grants and subrecipient agreements to perform, report on, audit and investigate at the Federal, State and local levels.
- As the application of the FAR Mandatory Disclosure Rules goes into its second year, contractors and subcontractors are making sure their compliance programs, hotlines and internal control systems are in order. Answers to questions about the new disclosure provisions in these rules, such as what is reportable, what needs to be contained in a report, who does one report to, what needs to be done to fully cooperate, what can be protected, and so on, are still being sought however.
- The Defense Contract Audit Agency (DCAA), criticized last year by the Hill and GAO for not being independent or objective enough, has issued audit guidance that makes clear that its auditors are going to be looking at

(*continued on page 4*)

Table of Contents

BCABA Board of Governors/Officers 2

In Memoriam—Judge Krempasky 5

New FAR Rule on Compliance Programs and Ethics: A Hidden Assault on the Corporate Attorney-Client Privilege 6
by
Jeremy A. Goldman

Collateral Damage: The Impact on Contractors of GAO's DCAA Reports 27
by
John A. Howell
and
Peter A. McDonald

Organizational and Consultant Conflicts of Interest 38
by
Glenn Sweatt

A Look Back—Judicial Review of the Retroactivity Provisions Of the Fraud Enforcement and Recovery Act of 2009 47
by
David M. Nadler and David Yang

Boards of Contract Appeals Bar Association
Officers

President:
Susan Warshaw Ebner
Buchanan Ingersoll & Rooney PC
1700 K Street, NW, Ste. 300
Washington, DC 20006
(w): 202-452-7995

Vice President:
David Black
Holland & Knight
1600 Tysons Boulevard, Ste. 700
McLean, VA 22102
(w): 703-720-8680

Secretary:
Francis E. "Chip" Purcell
Williams Mullen
8270 Greensboro Drive, Ste. 700
McLean, VA 22102
(w): 703-760-5232

Treasurer:
Thomas Gourlay
Army Corps of Engineers
441 G Street, NW
Washington, DC
(w): 202-761-8542

Boards of Contract Appeals Bar Association
Board of Governors

Scott Dalton (2009-2012)
Transportation Security Administration
Office of Chief Counsel
601 South 12th Street, TSA-2
Arlington, VA 20598-6002

J. Chris Haile (2009-2012)
Crowell & Moring LLP
1001 Pennsylvania Avenue, NW
Washington, DC 20004-2595

James McCullough (2008-2011)
Fried, Frank, Harris, Shriver & Jacobson
1001 Pennsylvania Ave., NW
Washington, DC 20004

Hal J. Perloff (2008-2011)
Akerman Senterfitt
8100 Boone Boulevard, Ste. 700
Vienna, VA 22182-2683

Holly E. Svetz (2009-2012)
Womble Carlyle Sandridge & Rice PLLC
8065 Leesburg Pike, 4th Fl.
Tysons Corner, VA 22182

Anissa Parekh (2008-2011)
Bracewell & Giuliani LLP
2000 K Street, NW, Ste. 500
Washington, DC 20006

Anne M. Donohue (2007-2010)
SRA International, Inc.
4300 Fair Lakes Court
Fairfax, VA 22033

Peter Pontzer (2008-2011)
US Army Legal Services Agency
Contract & Fiscal Law Division
901 N. Stuart Street, Ste. 500
Arlington, VA 22203

Neil Whiteman (2008-2011)
Lockheed Martin Space Systems Co.
1111 Lockheed Martin Way, O12-12
Sunnyvale, CA 94089

Bored of Contract Appeals
(a.k.a. The Editor's Column)

by
Peter A. McDonald
C.P.A., Esq.
(A nice guy . . . basically.)

Leading this issue is an excellent article by Jeremy Goldman on the erosion of the corporate attorney-client privilege, a matter of significance to all attorneys. The next article is a an analysis of current issues related to DCAA by John Howell and yours truly. Following that is a cogent review of the recent developments affecting OCIs by Glenn Sweatt. Finally, Dave Nadler provides a comprehensive review of the cases that address FERA's retroactivity provisions.

The Clause will reprint, with permission, previously published articles. We are also receptive to original articles that may be of interest to government contracts practitioners. But listen, everybody: Don't take all this government contract stuff too seriously. In that regard, we again received some articles that were simply unsuitable for publication, such as: "Demi & Pete: Reunited!"; "Susan Ebner Grows in Stature!!"; and "Tiger Apologizes—And Unfriends Pete!!!"

President's Column (cont'd):

And asking for more information and documentation from contractors, while providing these same government contractors less information. The new guidance, coupled with the recent memorandum issued by Shay Assad, DOD's Director of Defense Procurement, Acquisition Policy and Strategic Sourcing (DPAP), which provides that DCAA auditors can raise their concerns about Contracting Officer actions on audits to higher levels to and including going directly to Mr. Assad, may well result in a more independent, more confrontational DCAA, and more issues being litigated. As you will read in this edition, concerns are being raised that these actions may also impair the Contracting Officer's exercise of his or her authority.

- 2010 also is expected to bring us new regulations to address conflicts of interest issues and to define what is and is not inherently governmental. These issues are critical to what can and can not be contracted out.

- DOD says it is poised to reduce the number of government contractor personnel and increase the number of DOD procurement, audit and investigation personnel.

The impact of each of these developments will have consequences for how government procurements are run and administered and claims are handled. The articles in this month's issue of *The Clause* touch on some of the tough questions emanating from these developments and provide some provocative answers.

Staying informed has never been more important than it is today. At the BCABA, we hope to conduct events that help keep you informed of some of the key issues of the year. Our plans are in process. Please mark your calendars for some of our upcoming events -- our Colloquium will be held this year on May 20th, from 9:30 a.m. to 11:00 a.m., at The George Washington University Law School, and our Annual Fall Conference is set for October 7, 2010. As in years past, the Annual Conference will be an all day event. It will be held at The M Street Renaissance Hotel in Washington, D.C. More on these and other BCABA events will follow as plans are firmed up.

In the meantime, please enjoy reading this issue of *The Clause*. And, to help us continue our efforts to keep members abreast of new developments in the procurement area, we invite you to send in articles for future issues.

Note: As this issue was going to press, we received the sad news of Judge Richard W. Krempaski's passing. I would like to acknowledge Judge Krempaski and his many accomplishments. Please see his obituary from the www.PubKLaw.com listserv; it is reprinted in this issue with the permission of Judge Walters and Jerry Walz.

Best regards,

Susan Warshaw Ebner
President

In Memoriam
Hon. Richard W. Krempasky

Honorable Richard W. Krempasky, Oak Hill, retired Administrative Judge, Department of Veterans Affairs Board of Contract Appeals and retired Lt. Colonel DC Army National Guard, passed suddenly on March 9, 2010 surrounded by his family. He was 61 years old. He was born October 6, 1948, in Washington, D.C., son of the late Joseph and Thelma E. Thompson Krempasky of Clinton, Md. He was married in 1974 to his loving and devoted wife, Ramona M. Oshetski, of Danville, Pa. He is survived by four children, Katrina R. of Oak Hill, Rachel E. of Fairfax, Laura P. Sherman and husband Michael of Herndon, and Richard J. and wife Jennifer (Macken) of Centreville. He is also survived by two brothers, Joseph R. and wife Mary (Hertzog) of Lewiston, Idaho and John H. of Greenbelt, and two sisters Elizabeth A. Krempasky, Denton, Maryland and Alice P. K. Peach and husband Glenn, Virginia Beach.

Judge Krempasky graduated from the College of William and Mary in Virginia in 1970 and from the University of Maryland School of Law in 1973. His active duty military service was served in the U.S. Army from 1974-1978 in the Judge Advocate General's Corps at Ft. Benning, Georgia. and as Post Judge Advocate for Ft. Drum, New York.

He was a member of the 428th Judge Advocates General DC Army National Guard from 1983-1992. Upon promotion to Lieutenant Colonel he was Commander of the 340th Judge Advocates Detachment, DC Army Reserve National Guard, from 1992-1998.

From 1978-1990, he was an attorney for the Federal Railroad Administration, Department of Transportation.

Judge Krempasky was appointed Administrative Judge, Department of Veterans Affairs Board of Contract Appeals in 1990, retiring in 2007.

He was a lifelong avid outdoorsman who loved to fish. He would fish in any body of water, but especially loved fishing the Chesapeake Bay. He loved cooking and spent his retirement trying out recipes on his grateful family.

He was an extremely devoted husband, father, brother and son. His family and many friends will miss him dearly. He was always, by every definition, the most honorable of men.

A viewing will be at St. John Neumann Roman Catholic Church, 11900 Lawyers Road, Reston on Saturday, March 13, 2010 at 10:00 a.m., immediately followed by celebration of a Funeral Mass at 11:00 a.m.

Judge Krempasky will be buried with full military honors at Arlington National Cemetery on May 5, 2010 at 9:00 a.m.

Memorial contributions may be made to the Chesapeake Bay Foundation, 6 Herndon Avenue, Annapolis, Maryland 21403 or to Oblates of St. Francis de Sales, 2200 Kentmere Parkway, Wilmington, Delaware 19806. No flowers, please.

New FAR Rule on Compliance And Ethics: Hidden Assault On the Corporate Attorney-Client Privilege

by
Jeremy A. Goldman*

[*Note*: © The American Bar Association, *The Public Contract Law Journal*, 39:1, pp. 71-92, 2009. Reprinted with permission. All rights reserved. This information or any or portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.]

I. Introduction—The New Rule

On November 12, 2008, the Federal Acquisition Regulation Councils issued a final rule amending Federal Acquisition Regulation (FAR) 52.203-13 to "amplify the requirements for a contractor code of business ethics and conduct, an internal control system, and disclosure to the Government of certain violations of criminal law, violations of the civil False Claims Act, or significant overpayments."[1] The rule provides for the suspension or debarment of a contractor for knowing failure by a principal to disclose in a timely manner certain violations of criminal law, violations of the civil False Claims Act, or significant overpayments.[2] This new rule became effective December 12, 2008, and requires reporting misconduct under contracts until three years after final payment.

The implementing regulation, FAR 3.1004(a), mandates that contracts and solicitations for projects with a value expected to exceed $5 million and with a performance period of 120 days or more include the clause at FAR 52.203-13. The revised FAR 52.203-13 requires contractors to have a code of business ethics and conduct within thirty days of award.[3] If a contractor has not represented itself as a small business concern or if the contract is for the acquisition of a commercial item as defined at FAR 2.101, the contractor, within ninety days after contract award, unless the Contracting Officer establishes a longer time period, must (i) implement "an ongoing business ethics and compliance program"[4] and (ii) develop internal controls to support the code. [5]

The new rule also removes exclusions from compliance program requirements for commercial item contracts and contracts to be performed entirely outside the United States.[6] This means that all FAR-covered contracts performed anywhere in the world must comply with the new requirements unless the contract is expected to be less than $5 million or with a performance period of less than 120 days.[7] The far-reaching implications for contractors and subcontractors of all sizes are obvious, and, based on the public comments published with the final rule, it appears that many contractors may struggle to comply with the burdens imposed by the new requirements.[8]

Contractors and subcontractors must quickly adjust to this new era of ethics compliance, most significantly to the additional time and expense associated with providing "full
(*continued on next page*)

New Rule on FAR Compliance (cont'd):

cooperation" to the Contracting Officer and the agency's Office of the Inspector General any time it has "credible evidence" of certain criminal violations in connection with the award, performance, or closeout of a contract or any subcontract.[9] Failure to disclose can now result in either suspension or debarment.[10] Given this new threat, contractors and subcontractors are left scratching their heads while they try to discern the meaning and scope of "full cooperation" and "credible evidence."

The least-clear aspect of the new rule is how the requirements for "mandatory disclosure" and "full cooperation" will affect the corporate attorney-client privilege. How do contractors balance the desire to protect information with the threat of suspension and debarment for failure to timely disclose and fully cooperate? The new rule's combination of mandatory disclosure and full cooperation gives birth to a new assault on the attorney-client privilege—an issue thought to have been recently resolved. Although the new rule superficially upholds the attorney-client privilege, contractors' in-house attorneys are less sure than ever that they will continue to be protected.

This Note first reviews the longstanding doctrine of the corporate attorney-client privilege. Next, this Note discusses the erosion of that doctrine by the U.S. Department of Justice (DOJ). This Note then considers the terms "full cooperation" and "mandatory disclosure" within the context of the FAR clause. This Note concludes with a discussion of the future of the corporate attorney-client privilege in light of the new FAR clause.

II. The Attorney-Client Privilege

The attorney-client privilege (the "Privilege") exists to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[11] The Privilege is one of the oldest legal principles in existence, dating as far back as ancient Rome, when "governors were forbidden from calling their advocates as witnesses out of concern that the governors would lose confidence in their own defenders."[12] English common law first recognized this evidentiary privilege in 1577 as the "attorney-client privilege."[13] This concept was later codified in the American colonies, e.g., through the absorption of English common law into Delaware's Constitution of 1776.[14]

While the soundness of the Privilege has not gone unchallenged, "the [P]rivilege is so ingrained in our law that for centuries it has been steadily upheld."[15] The policy behind the Privilege was summarized by American jurist and expert in the law of evidence John Henry Wigmore: "In order to promote freedom of consultation of legal advisers by clients, the apprehension of compelled disclosure by the legal advisers must be removed; hence the law must prohibit such disclosure except on the client's consent."[16]

For much of the 1960s and 1970s the corporate Privilege applied only to a "control group"—i.e., officers and agents responsible for directing the company's actions in response to (*continued on next page*)

New Rule on FAR Compliance (cont'd):

legal advice.[17] In 1978 the U.S. Court of Appeals for the Eighth Circuit recognized that the inherent problem with applying the Privilege only to high-level corporate officers was that the in-house attorney was often left with a paradox: "If he interviews employees not having 'the very highest authority,' their communications to him will not be privileged. If, on the other hand, he interviews *only* those employees with 'the very highest authority,' he may find it extremely difficult, if not impossible, to determine what happened."[18] In 1981 the U.S. Supreme Court criticized the "control group"[19] test and held that in order to remain consistent with its underlying purposes, the Privilege must protect the communication between a corporation's employees and its in-house counsel from compelled disclosure.[20]

A series of corporate scandals in the 1980s and 1990s brought about an assault against corporate entities from federal prosecutors with little guidance from the DOJ, resulting in a series of policy statements issued by the DOJ, which sought to compel corporations to waive the Privilege in exchange for clemency and proof of cooperation.[21] This strategy was interpreted by the U.S. corporate community as an abuse of the historical understanding of prosecutorial discretion:

> The United States Attorney . . . is in a peculiar and very definite sense the servant of the law, the twofold aim of which is that guilt shall not escape or innocence suffer. He may prosecute with earnestness and vigor—indeed, he should do so. But, while he may strike hard blows, he is not at liberty to strike foul ones. It is as much his duty to refrain from improper methods calculated to produce a wrongful conviction as it is to use every legitimate means to bring about a just one. [22]

A 2005 survey by the Association of Corporate Counsel ("ACC"), an association of attorneys who practice in the legal departments of corporations, associations, and other private-sector organizations, reported that "approximately 30% of in-house respondents and 51% of outside respondents said that the government expected waiver in order to engage in bargaining or to be eligible to receive more favorable treatment."[23] Moreover, roughly half of all investigations experienced by survey respondents resulted in Privilege waivers.[24] The Privilege appeared to be eroding before our collective eyes. [25] Where does the Privilege stand given the new FAR rules? Is the threat against it gone or simply hidden from view?

III. The History of the Assault

During the past twenty-two years the Privilege has come under fire more than it has throughout its entire history. An important step in understanding the future is analyzing the past.

A. *Defense Industry Initiative and Voluntary Disclosure Program (1989)*

In 1986 thirty-two major defense contractors, including The Boeing Company,

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

Lockheed Corporation, Martin Marietta Corporation, NorthropGrumman, and Raytheon Company, drafted and signed the Defense Industry Initiatives on Business Ethics and Conduct (the "DII"). A key principle of the DII was that each signatory company "has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and of corrective actions taken." [26] That same year, the Department of Defense (DoD) adopted a Voluntary Disclosure Program that encouraged internal investigations and the early reporting of criminal violations by defense contractors in exchange for leniency.[27] At the time, both the DII and the Voluntary Disclosure Program were thought to have been positive steps; it is now known, however, that these programs unintentionally ignited an assault on the Privilege that would continue for more than two decades.

B. *The Holder Memo (1999)*

In 1999 Eric Holder Jr., then-Deputy Attorney General (currently the U.S. Attorney General),[28] released a guidance memorandum entitled "Federal Prosecution of Corporations," informally referred to as the "Holder Memo."[29]

In this unprompted memorandum, Holder listed eight factors to be considered by prosecutors in deciding whether to prosecute a corporation for alleged criminal violations.[30] One factor was the corporation's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, *the waiver of the corporate attorney-client and work product privileges* ."[31] The Holder Memo also advised federal prosecutors that they may "request a waiver in appropriate circumstances" but that the DOJ does not consider waiver of a corporation's privileges "an absolute requirement, and prosecutors should consider the willingness of a corporation to waive the privileges when necessary to provide timely and complete information as only one factor in evaluating the corporation's cooperation."[32]

While the Holder Memo advised that waiver of the Privilege was "only one factor" in evaluating whether a corporation cooperated in a federal criminal investigation, its mere inclusion in the list of factors nonetheless caused great concern for corporations. For example, the ACC [33] sent a letter to the DOJ that stated:

> Legal compliance is a critical aspect of the corporate counsel's job . . . . To require a waiver of the privilege works against, and not in favor of, sound policy designed to protect the public and to encourage good corporate citizenship. Knowing that sensitive and confidential conversations with their lawyers will be used as bargaining chips by the [G]overnment, clients may be reluctant to create such chips for the [G]overnment's use.[34]

In other words, the ACC posited that the ironic consequence of the Holder Memo would be to create unwillingness on the part of the employee to confide in corporate counsel, and

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

therefore criminal activity within corporations could actually increase. Despite the ACC's argument that the practical result of the Holder Memo would be the antithesis of its intention, the DOJ stood by the memorandum.

During a flurry of corporate scandals between 1999 and 2003, federal prosecutors relied on the Holder Memo to force corporate cooperation.[35]

C. *The Thompson Memo (2003)*

On January 20, 2003, then-Deputy Attorney General Larry D. Thompson[36] issued a memorandum that modified and superseded the Holder Memo's advisory guidelines. The so-called Thompson Memo[37] outlined a revised set of factors to be considered by prosecutors in deciding whether to charge a corporate entity with criminal wrongdoing. The Thompson Memo explained that the revisions were necessary "to put the results of more than three years of experience with the principles [of the Holder Memo] into practice."[38] Further, it explained that the impetus behind the revisions was the need for a higher level of "scrutiny of the authenticity of a corporation's cooperation,"[39] and the "efficacy of the corporate governance mechanisms in place within a corporation" to ensure they weren't just "mere paper programs."[40]

Whatever cynical motivation was put forth as justification for the Thompson Memo, one familiar factor quietly was included: "the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, *the waiver of corporate attorney-client and work product protection* ."[41] What proved to be the most controversial aspect of the Thompson Memo was the reaffirmation, almost verbatim, of the waiver factor from the Holder Memo.[42] Thompson reinforced Holder's view that waiver of the Privilege was "critical in enabling the [G]overnment to evaluate the completeness of a corporation's voluntary disclosure and cooperation."[43] While the substantive changes to the *advisory* Holder Memo were slight, the Thompson Memo became *mandatory*.

Moreover, the Thompson Memo did more than merely reinforce existing DOJ policy; it appears to have created a culture of waiver, whereby federal prosecutors seemed to routinely require corporations to choose between waiving the Privilege or exposing the company to increased penalties and indictments.[44] Any reasonable corporate officer faced with this Hobson's choice likely would choose to waive the Privilege. Indeed, in a March 2006 survey of over 1,400 in-house and outside corporate counsel, almost seventy-five percent of the respondents believed that, in the wake of the Thompson Memo, governmental agencies expected a company under investigation to broadly waive attorney-client or work product protections.[45]

D. *U.S. Sentencing Guideline Amendments (2004)*

In May 2004 the U.S. Sentencing Commission followed in lockstep with the Holder and Thompson Memos when it amended the U.S. Sentencing Guidelines. The amendments provide: "[T]he two factors that mitigate the ultimate punishment of an organization are (i) the

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

existence of an effective compliance and ethics program, and (ii) self-reporting, *cooperation*, or acceptance of responsibility."[46] These two factors were crafted in such a way as to hide the Privilege issue; in order to determine whether an organization "cooperated," one would look to whether it waived the Privilege as informed by the guidelines in the Holder and Thompson Memos. While the amendments merely used the term "cooperation," the Holder and Thompson Memos instructed that part of the measure of cooperation was whether a corporation waived the Privilege.

The amendments to the U.S. Sentencing Guidelines stated that waiver of the Privilege "is not a prerequisite to a reduction in culpability score . . . unless such a waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization."[47] It seems obvious that during the course of an investigation a competent lawyer would inevitably gain some amount of "pertinent" information. With the amendments in place, the Government was entitled to have "all" of it.

In short, the amendments provided a perfect complement to the Holder and Thompson Memos, i.e., the new U.S. Sentencing Guidelines neither expressly condemned nor approved waivers of the Privilege. Furthermore, now that federal prosecutorial practices regarding waiver were essentially codified by the amendments, prosecutors were vindicated when they ignored protests from target corporations that a waiver of the Privilege was not necessary. The amendments and the memoranda were three pieces of a puzzle that fit together perfectly.

E. *The McCallum Memo (2005)*

In October 2005 Robert D. McCallum Jr., then-Associate U.S. Attorney General,[48] issued what informally is referred to as the "McCallum Memo."[49] The McCallum Memo boldly flew in the face of those critical of the Thompson Memo by failing to denounce the waiver of the Privilege as a factor in determining corporate cooperation. In his one-page memorandum, McCallum merely added the requirement that each U.S. Attorney's Office ("USAO") disseminate a set of protocols before a waiver request could be made to a corporation.[51] In-house attorneys were advised to ask the Government to confirm whether the protocols required by the McCallum Memo regarding waiver were observed, and to make a record when those protocols were ignored.[52]

McCallum testified before the House Subcommittee on Crime, Terrorism, and Homeland Security on March 7, 2006, regarding his memorandum.[53] McCallum stated that his memorandum "ensure[d] that no Federal prosecutor may request a waiver without supervisory review," and "require[d] each United States Office to institute a written waiver review policy governing such requests."[54] He explained:

> The Thompson Memorandum carefully balances the legitimate interests
> Furthered by the privilege, and the societal benefits of rigorous enforcement
> of the laws supporting ethical standards of conduct . . . .

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

> [V]oluntary disclosure is but one factor in assessing cooperation, and cooperation in turn is but one factor among many considered in any charging decisions . . . .
>
> Nor can the Government compel corporations to give waivers. Corporations are generally represented by sophisticated and accomplished counsel who are fully capable of calculating the benefits or harms of disclosure.[55]

While McCallum's testimony attempted to quell concerns over the McCallum Memo and legitimize the purpose for requesting waivers, it did little towards achieving those goals.

In a statement before the same House Subcommittee, former U.S. Attorney General Dick Thornburgh[56] wondered "what has changed in the past decade to warrant such a dramatic encroachment on the attorney-client privilege."[57] He criticized the McCallum Memo as setting forth protocols without consistency and as "striking a defiant tone that can only embolden prosecutors."[58] Thornburgh continued:

> . . . [I]n order to be deemed cooperative, an organization under investigation must provide the government with all relevant factual information in its possession . . . . But in doing so, it should not have to reveal privileged communications or attorney work product.
>
> That limitation is necessary to maintain the primacy of these protections in our system of justice. It is a fair limitation on prosecutors, who have extraordinary powers to gather information for themselves. This balance is one I found workable in my years of federal service, and it should be restored.[59]

As the Subcommittee's questioning of Mr. McCallum became more heated, Rep. William Delahunt (D-Mass.)[60] asked Mr. McCallum what had changed recently to warrant such a drastic departure from existing protocols:

> Mr. MCCALLUM: Let me respond to the first question, Mr. Delahunt, And that is what has happened recently over the years? I think we only have to look back to the 1997 through 2006 era to see a spate of very complicated, very complex, very arcane, very difficult to determine corporate frauds of immense proportions in terms of the dollar amounts involved which also . . .
>
> Mr. DELAHUNT: With all due respect, Mr. McCallum, I got to tell you something. That just doesn't—that doesn't hold water. You know, I am sure immense complex fraud has been being [sic] perpetrated, you know,

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

> since the days of the robber barons. If we don't have the resources in the Department of Justice to conduct the necessary investigations to deal with it, then let's assess it on a resource basis. Let's not do it the easy way that erodes, I believe, a fundamental principal of American jurisprudence.[61]

It is because of the ambiguous terminology and conflicting mandates (*see* Part IV, The Attorney-Client Privilege Protection Act, *infra*) that attorneys are becoming increasingly frustrated with the Government's incessant pursuit of a mandatory waiver of the Privilege.

F. United States v. Stein *(The KPMG Case)*

Corporations across the country had been waiting for help since the 1999 Holder Memo and were hoping for some assistance from the courts. It was not long before a case highlighted the Thompson Memo's coercive and unconstitutional power when in the hands of certain prosecutors. The fight over the extent to which federal prosecutors could demand cooperation and insist on privilege waivers reached a climax in the tax and fraud investigation of KPMG, an accounting firm, and the ultimate prosecution of many of its executives and employees. Components of the Thompson Memo were held to be unconstitutional in *United States v. Stein*, a case arising out of allegedly illegal tax shelters promoted by KPMG.[62] The district court issued two opinions holding that the Government acts unconstitutionally when it relies on the Thompson Memo to pressure companies to stop advancing legal fees to their employees, and to cause companies to coerce their employees into incriminating themselves.[63]

The *Stein* case centered on an Internal Revenue Service investigation into allegedly illegal, KPMG-sponsored tax shelters.[64] In early 2004 the IRS made a criminal referral to the DOJ, which in turn passed it on to the USAO in Manhattan.[65] KPMG had good reason to fear that the reputational damage associated with an indictment would be enough to destroy the firm. Attorneys for KPMG made it known to the Government that they believed an indictment "would result in the firm going out of business."[66]

In its two decisions the district court ruled in favor of KPMG. In the first opinion the court found that the Government, through its use of the Thompson Memo and the USAO's action, violated the Fifth and Sixth Amendment rights of the KPMG defendants by causing KPMG to cut off payment of legal fees and other defense costs upon indictment.[67] In the second opinion the court ruled that the Government similarly violated the Fifth Amendment rights of two of the KPMG defendants by causing KPMG to coerce them into making incriminating statements to the Government.[68] The court was not asked specifically to assess the constitutionality of the Thompson Memo's privilege waiver provision. The KPMG defendants appealed to the U.S. Court of Appeals for the Second Circuit and a decision was issued in August 2008.[69]

G. *The McNulty Memo (2006)*

In December 2006 then-Deputy Attorney General Paul McNulty[70] issued a memorandum that modified the 2003 Thompson Memo by, among other things, removing

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

waiver of the Privilege as a factor in determining cooperation.[71] One reason for this change was McNulty's awareness that "the corporate legal community [had] expressed concern that [DOJ] practices may be discouraging full and candid communications between corporate employees and legal counsel."[72] McNulty stated, "[I]t was never the intention of the [DOJ] for our corporate charging principles to cause such a result."[73]

The McNulty Memo categorized attorney-client privilege and attorney work product material into two groups. Category I material included factual attorney work product and noncore attorney communications, e.g., copies of key documents, witness statements, purely factual interview memoranda regarding the underlying misconduct, organization charts created by company counsel, factual chronologies, factual summaries, and reports containing investigative facts documented by company counsel.[74] Category II material included nonfactual attorney work product and core attorney-client privileged communications, e.g., attorney notes, memoranda or reports containing company counsel's mental impressions and conclusions, legal determinations reached as a result of an internal investigation, and legal advice given to the corporation.[75] The McNulty Memo cautioned, "Category II information should only be sought in rare circumstances."[76]

McNulty did not expressly prohibit waiver demands but rather placed significant obstacles before any federal prosecutor seeking a Privilege waiver from a corporation. First, prosecutors requesting Category I information "must obtain written authorization from the United States Attorney who must provide a copy of the request to, and consult with, the Assistant Attorney General for the Criminal Division before granting or denying the request."[77] Second, and only if the Category I information "provides an incomplete basis to conduct a thorough investigation," prosecutors may request Category II information, only after obtaining "written authorization from the Deputy Attorney General."[78]

Even after the McNulty Memo modified existing guidelines, DOJ policy still permitted prosecutors to measure a corporation's willingness to cooperate in a federal investigation by considering its willingness to waive the Privilege for Category I materials. The result has been that corporations, fearful of being perceived as noncooperative, continue to waive the Privilege for Category I materials, effectively becoming assistants in government investigations.

In August 2006 the American Bar Association (ABA) House of Delegates approved recommendations supporting the preservation of the Privilege and opposing government policies and procedures that "have the effect of eroding constitutional and other legal rights of employees, past or present, if that employee decides to exercise his or her Fifth Amendment right against self-incrimination."[79] Similarly, in May 2006 the ABA's Task Force on the Attorney-Client Privilege wrote to then-Attorney General Alberto Gonzalez expressing concerns over the DOJ's Privilege waiver policy and urging it to adopt specific new language,[80] a strategy affirmed in September 2006 by at least one former high-ranking DOJ official.[81] It appears that Gonzalez failed to respond in light of comments made in September 2006 by then-ABA president Karen Mathis, who said the response from the DOJ "was most disappointing";

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

she added: "They failed to address the specific concerns we raised and just reasserted the DOJ policy."[82]

IV. The Attorney-Client Privilege Protection Act

In response to the growing outrage over the Thompson Memo and the concern over the erosion of the Privilege, Senator Arlen Specter (R-Pa.)[83] introduced the Attorney-Client Privilege Protection Act of 2006.[84] Senator Specter commented, "Cases should be prosecuted on their merits, not based on how well an organization works with the prosecutor."[85] The preface to the bill stated: "It is the purpose of this Act to place on each agency clear and practical limits designed to preserve the attorney-client privilege and work product protections available to an organization and preserve the constitutional rights and other legal protections available to employees of such an organization."[86] The Act, in its proposed form, prohibited government lawyers from forcing organizations into disclosing information protected by the Privilege or work product doctrine.[87] The Act accused the DOJ and other agencies of creating and implementing policies that undermined the adversarial system of justice, such as encouraging organizations to waive the Privilege to avoid indictment or other sanctions, despite the existence of numerous investigative tools that do not impact the attorney-client relationship.[88] The proposed Act recognized that waiver demands and related policies of government agencies encroached on the constitutional rights and other legal protections of employees.[89]

The 2006 proposed Act died in the Senate; an identical Act was reintroduced to the Senate in January 2007,[90] where it again died. In June 2008 Senator Specter introduced a redesigned, but substantially similar, bill, cosponsored by Senators Biden, Carper, Cochran, Cornyn, Dole, Feinstein, Graham, Kerry, Landrieu, McCaskill, and Pryor.[91] One noticeable change was that the 2008 bill divided the provision prohibiting the Privilege waiver demands into three sections:

> [A]n agent or attorney for the United States shall not . . . (A) demand or request [waiver of] . . . ; (B) offer to reward or actually reward an organization . . . for waiving . . . ; or (C) threaten adverse treatment or penalize an organization . . . for declining to waive . . . the attorney-client privilege [and work product protections].[92]

The 2008 bill died in committee after being read twice.[93] The U.S. House of Representatives, meanwhile, passed its own version of the Attorney-Client Privilege Protection Act in 2007.[94] It too died in the Senate, in response to what some refer to as the "Filip Memo."[95]

A. *U.S. Attorneys' Manual § 9-28.760 (The Filip Memo) (2008)*

In response to the numerous proposed bills, in August 2008 then-Deputy U.S. Attorney

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

General Mark Filip[96] issued modifications to section 9-28.000 *et seq*. of the U.S. Attorneys' Manual, prohibiting prosecutors from seeking a waiver of the Privilege.[97] Ironically these new guidelines were issued the same day that the U.S. Court of Appeals for the Second Circuit issued its opinion affirming the dismissal of the KMPG case, holding "the [G]overnment . . unjustifiably interfered with defendants' relationship with counsel and their ability to mount a defense, in violation of the Sixth Amendment . . . ."[98]

Filip stated in his memorandum that this latest set of principles "should not bear the name of any particular individual at the [DOJ], as prior iterations sometimes became known."[99] He argued that this naming convention (e.g., Holder Memo, Thompson Memo, etc.) led to the implication that DOJ policy was "subject to revision with every changing of the guard."[100] In another departure from previous memoranda, Filip published his modifications in the U.S. Attorneys' Manual so that the principles would become binding on all federal prosecutors. The most notable substantive modification to the previous guidelines concerned "what measures a business entity must take to qualify for the long-recognized 'cooperation' mitigating factor . . . ."[101] Section 9-28.720 states: "Eligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection," but rather upon "disclosure of the relevant *facts* concerning [the] misconduct."[102] Subsection (b) states that, except in cases of an advice-of-counsel defense or in furtherance of a crime or fraud, "a corporation need not disclose and prosecutors may not request the disclosure of such communications as a condition for the corporation's eligibility to receive cooperation credit."[103]

On its face, the principles outlined in Filip's memorandum satisfied the congressional concern over the continued erosion of the Privilege. The prohibition against Privilege waiver demands, however, was limited. The Filip Memo left the door open to Privilege waiver demands for other purposes; it only prohibited waiver demands as a condition for a corporation to receive cooperation credit.

B. *The 2009 Act*

Notwithstanding Filip's modification to the U.S. Attorneys' Manual, in February 2009 Senator Specter proposed the Attorney-Client Privilege Protection Act a fourth time; this newest version was nearly identical to the 2008 bill.[104] In his remarks, Senator Specter discussed evidence of the insufficiency of the Filip Memo because, although requests for privilege waivers were prohibited, the guidelines failed to carry the force of law:

> [A]s evidenced by the numerous versions of the Justice Department's corporate prosecution guidelines over the past decade, the Filip reforms cannot be trusted to remain static . . . . Though an improvement over past guidelines, there is no need to wait to see how the Filip guidelines will operate in practice. There is similarly no need to wait for another Department of Justice or executive branch reform that will likely fall short and become the sixth policy in the last 10 years. Any such internal reform may prove fleeting and might not address the privilege waiver

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

> cooperation credit, and (3) pass legislation that altogether protects the Privilege. Once the new FAR rules, the policies of other government agencies that refer matters to the Department of Justice, thus allowing in through the window what isn't allowed through the door . . . . The prosecutor has enough power without the coercive tools of the privilege waiver, whether that waiver policy is embodied in the Holder, Thompson, McCallum, McNulty, or Filip memorandum.[105]

The 2009 proposed Act is cosponsored by Senators Carper (D-Del.), Cochran (R-Miss.), Kerry (D-Mass.), Landrieu (D-La.), and McCaskill (D-Mo.). As this Note went to publication, the proposed Act had been referred to the Senate Judiciary Committee. Should the 2009 version of the bill become law, it could clash with the new FAR rules and the Filip Memo. It sends an unclear message for the Government simultaneously to (1) require mandatory disclosure and full cooperation (see discussion *infra*), (2) limit Privilege waiver demands to a corporation's cooperation credit, and (3) pass legislation that altogether protects the Privilege. Once the new FAR rules, the Filip Memo, and the 2009 Act (if passed) reach their first conflict, one of them will require amendment.[106]

V. Mandatory Disclosure

The new FAR rule establishes three different disclosure obligations: (1) disclosure to avoid suspension and/or debarment,[107] (2) disclosure required by the contract clause,[108] and (3) disclosure required by internal control systems.[109] The most critical disclosure obligation is the disclosure to avoid suspension and/or debarment because it applies to all contracts regardless of their value or duration.

The new mandatory disclosure requirements are muddied when read alongside the DOJ's charging guidelines. The Filip Memo only prohibits prosecutors from demanding a corporation waive the Privilege in order to be eligible for cooperation credit. That certainly is not an outright prohibition against Privilege waivers. When facing a mandatory disclosure rule and limited prohibition against Privilege waiver, most corporations would voluntarily waive the Privilege. The new mandatory disclosure requirement does not distinguish between protected and nonprotected communications; it merely requires the disclosure of all relevant documents.

Additionally it has not been determined exactly what needs to be disclosed, or when, under the new FAR rules. The rules state that a disclosure must be made where "credible evidence" of a criminal violation exists. When does "credible evidence" become ripe for reporting? Is it upon receipt of mere allegations, upon conclusion of an internal investigation, or some other point along the timeline? What if the DOJ or a *qui tam* relator[110] alleges a violation that the contractor did not discover during an internal investigation? Must a corporation disclose only a summary of the possible violation, or must it produce every factual detail, document, and employee who might have information that, analyzed collectively, gives

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

rise to "credible evidence"? And what if the "credible evidence" is protected by the Privilege?

An example highlights the need for additional clarity. With the appropriate set of facts, creative *qui tam* counsel or the DOJ could reshape an otherwise simple contract breach into a False Claims Act matter. In such a scenario, the Government would argue that a contractor who fails to disclose every instance of nonconforming contract performance does not meet its disclosure obligation. As noted above, failing or refusing to fulfill this obligation is a factor in denying cooperation credit under the U.S. Attorneys' Manual and supports the possibility of suspension and/or debarment under FAR Part 9. Thus, notwithstanding the DOJ's claim that it does not seek to assault the Privilege, past practices and beliefs, coupled with unclear limits and requirements, suggest that contractors might still feel compelled to undermine their position by disclosing more than is necessary or appropriate. Absent further clarification, and for the avoidance of prosecution, most corporations will continue to provide privileged documents, even in light of the new FAR rules and the Filip Memo.

VI. Full Cooperation

The new rule requires contractors and subcontractors (other than small businesses and commercial-item contractors) to "fully cooperate" with government investigations. On its face the regulation suggests that the full cooperation element might be satisfied once a contractor discloses "information sufficient for law enforcement to identify the nature and extent of the offense and the individuals responsible for the conduct," and provides "timely and complete responses to government investigators' requests for documents and access to employees with information."[111] Such cooperation specifically does not require a contractor to "waive its attorney-client privilege or the protections afforded by the attorney work product doctrine."[112] Nor does it require officers, directors, owners, or employees to waive their Fifth Amendment rights.[113] These requirements mirror the posture of the Filip Memo.

Nevertheless, questions remain concerning the practical boundaries of full cooperation. While "full cooperation" does not expressly require disclosure of information covered by the Privilege, contractors may still feel obligated to disclose Privileged material as the threat of prosecution looms. A contractor may still "cooperate" if it conducts an internal investigation and defends proceedings or disputes relating to potential or disclosed violations,[114] provided that it fully cooperates by disclosing the essential facts underlying the violations.

Neither the clause nor the U.S. Attorneys' Manual provides a roadmap for determining whether a contractor's cooperation may be deemed "full." Without a clear boundary contractors likely will release everything and waive the Privilege, intentionally or otherwise, simply to secure the sought-after mitigation credit. This ambiguity allows DOJ to have its cake and eat it too: on the one hand DOJ declares that it "respects the rights of criminal defendants and others involved in the criminal justice process"[115] and protects the Privilege as "one of the

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

oldest and most sacrosanct privileges under the law,"[116] while on the other hand DOJ continues to tacitly offer credit for receiving privileged information.

It is entirely possible that the FAR Councils did not intend to require waiver of the Privilege through their use of the phrase "full cooperation." Absent additional clarifying language, however, contractors likely will ignore the exemption and continue releasing otherwise protected information in the hope that it will receive more favorable treatment by the DOJ.

In sum, further revisions are necessary to clarify the boundaries of, and expectations regarding, "full cooperation." How does one know whether an internal investigation was thorough enough? What if an internal investigation identified—and the contractor fully disclosed—only one of two violations? These and other questions must be answered so that all interested parties can take the appropriate steps to fully and fairly comply with the law. Until the key terms and concepts discussed in this Note are clarified, doubts will remain as to the status of the corporate Privilege.

VII. The Future of the Privilege

The FAR Councils acknowledge "[t]here is no doubt that mandatory disclosure is a 'sea change' and 'major departure' from voluntary disclosure . . . ."[117] According to the DOJ, the requirement for mandatory disclosure is necessary because few companies have actually responded to the invitations of the past to voluntarily disclose suspected instances of violations of federal criminal law relating to the contract or subcontract. The FAR Councils stated:

> It is doubtful any regulation or contract clause could legally compel a contractor or its employees to forfeit [their attorney-client privilege or Fifth Amendment] rights. However, the Councils have revised the final rule to provide such assurance. To address concern that cooperation might be interpreted to require disclosure of materials covered by the work product doctrine, the Councils have added a definition of "full cooperation" at 52.203-13(a) to make clear that the rule does not mandate disclosure of materials covered by the attorney work product doctrine . . . . Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction . . . *unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization* .
>
> It also is worth pointing out the [DoD] Voluntary Disclosure Program never required waiver as a condition of participation. Contractors in that program routinely found ways to report wrongdoing without waiving the attorney-client privilege or providing their attorney memoranda

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

> reflecting their interviews that normally are covered by the work product doctrine.
>
> Any limitation in this rule should not be used as an excuse by a contractor to avoid disclosing facts required by this rule. Facts are never protected by the attorney-client privilege or work product doctrine.[118]

Nevertheless, concerns remain. Contractors fear the italicized "unless" statement in the above quotation. While a waiver of the Privilege is not required and is not in the definition of "full cooperation," it is clear from this statement that a waiver may be necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization. Such doubletalk is the source of contractors' distress.

Mandatory disclosure and full cooperation raise serious concerns about whether waiver of the Privilege will be necessary. Although the 2008 revisions to the U.S. Attorneys' Manual generally make it more difficult for federal prosecutors to extract Privilege waivers from corporations, many companies still feel pressure to waive the Privilege to demonstrate cooperation and avoid more onerous sanctions. The Filip Memo provides that prosecutors may not condition cooperation credit upon waiver of the Privilege. The new FAR rules, however, increase the existing pressure on contractors to waive the Privilege by requiring mandatory disclosure and full cooperation.

Knowing that their employers could be required to disclose any information they provide to the Government, employees may be less inclined to cooperate with internal investigations. Moreover, the combined requirements of mandatory disclosure and full cooperation could implicate employees' constitutional rights against self-incrimination when they are interviewed by company counsel as part of an internal investigation that is effectively conducted at the Government's behest.[119]

Several recent actions seek to counter the erosion in the Privilege. As noted in Part IV, *supra*, both the 2008 revisions to the U.S. Attorneys' Manual and Senator Specter's continuing push to pass some form of an Attorney-Client Privilege Protection Act are positive steps towards reestablishing the strength of the corporate Privilege.

Another positive step was almost seen with the implementation of new Federal Rule of Evidence 502 ("Rule 502"),[120] which primarily protects against waivers for inadvertent disclosures.[121] In drafting Rule 502, the Advisory Committee considered adding language that would allow persons and entities to cooperate with government agencies without waiving all privileges as to other parties in subsequent litigation, i.e., "selective waiver."[122] In other words, disclosure of protected information would waive the Privilege only to the Government and not to any other person or entity. This section was removed from the final version of the rule because of the controversy surrounding the proposed rule.[123]

Contractors seeking to cooperate with government investigations were disappointed

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

first by the Filip Memo, then by the failure to enact previous versions of the Attorney-Client Privilege Protection Act, and now by Rule 502. Corporations under investigation may choose to waive the Privilege in the face of indictment and other penalties. But later those corporations may find themselves defending against a plaintiff claiming that the Privilege was waived when disclosed to the Government. Unfortunately, a "selective waiver" clause was not included in Rule 502 to protect against disclosures made during the course of a criminal investigation. Once again, contractors face the uncertainty surrounding how their quasi-required waivers to a governmental official will be treated in subsequent litigation.

This is a subject that is being closely monitored by all contractors and subcontractors, in-house and outside attorneys, and those interested in the protection of one of the oldest legal principles in practice.[124] The series of DOJ memoranda that specifically spelled out waiver of the Privilege as a factor in determining cooperation prompted much criticism. In response the new FAR rules leave terms vague, unexplained, and open to misinterpretation absent additional clarification. By requiring both mandatory disclosure and full cooperation without explicitly mandating against corporate waivers of the Privilege, the FAR has created a new hidden assault on the Privilege that will take some time to understand and interpret.

The only recommendations with which contractors may proceed are to review and revise existing corporate procedures for internal investigations and reporting, or create new procedures specifically designed to comply with the new FAR rules. It is the contractors themselves who will be forced to interpret the practical meanings of the new requirements. They must decide whether to hold strong against waivers of the Privilege and find other ways in which to comply, or to entertain the willingness to voluntarily waive the Privilege to avoid potential noncompliance. Either way, the interested parties need to come to a resolution that will protect the Privilege and reduce both the number and expense of corporate criminal investigations. This is a goal that is attainable, but not likely in the short term.

Perhaps interested parties on both sides of the debate would benefit from a reminder from the 1935 U.S. Supreme Court:

> The United States Attorney is the representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all; and whose interest, therefore, in a criminal prosecution is not that it shall win a case, but that justice shall be done.[125]

---

* - Jeremy A. Goldman (jgoldman77@verizon.net) is a 2009 graduate of the University of Baltimore School of Law, where he earned concentrations in both Intellectual Property and Business Law. He wishes to thank his professors in the Government Contracts Workshop at UB Law School, Richard C. Loeb, Kelley P. Doran, and William A. Shook. He reserves the greatest thanks for his wife, Allison, and children, Brandon and Mallory, for their unending love and support.

New Rule on FAR Compliance (cont'd):

Endnotes

1. Contractor Business Ethics Compliance Program and Disclosure Requirements, FAR Case 2007-006, 73 Fed Reg. 67,064, 67,064 (Nov. 12, 2008).
2. *Id*. at 67,065.
3. FAR 52.203-13(b)(1)(i).
4. FAR 52.203-13(c)(1).
5. *Id*.
6. FAR 3.1004(b).
7. FAR 3.1004.
8. *See* Contractor Business Ethics Compliance Program and Disclosure Requirements, FAR Case 2007-006, 73 Fed Reg. 67,064, 67,066–89 (Nov. 12, 2008); *see also* Rand L. Allen & John R. Prairie, *Now You Have to Tell the Government*, Legal Times, Feb. 9, 2009, *available at* http://www.wileyrein.com/resources/documents/pu4199.pdf ("Some in industry . . . have struggled to find consistent, practical guidance for effectively implementing the various requirements.").
9. FAR 52.203-13(b)(3), (c)(2)(ii)(F).
10. A suspension may not extend beyond eighteen months in the absence of legal proceedings. FAR 9.407-4(b). If proceedings are commenced within that period, the suspension may extend until such proceedings are completed. FAR 9.407-4(a). Debarments are for "a period commensurate with the seriousness of the cause(s)," usually not more than three years. FAR 9.406-4(a)(1).
11. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).
12. Shirelle Phelps & Gale Cengage, Attorney-Client Privilege, Encyclopedia of Everyday Law, http://www.enotes.com/everyday-law-encyclopedia/attorney-client-privilege (2003).
13. *See* Christopher B. Mueller & Laird C. Kirkpatrick, Evidence: Practice Under the Rules 430 (2d ed. 1999) (citing Berd v. Lovelace, (1577) 21 Eng. Rep. 33 (Ch.)).
14. *See* Del. Const. of 1776, art. XXV.
15. People *ex rel*. Vogelstein v. Warden of County Jail, 150 Misc. 714, 717 (N.Y. Sup. Ct. 1934).
16. 8 John Henry Wigmore, Evidence in Trials at Common Law §2291 (Little, Brown & Co. 1961).
17. Phila. v. Westinghouse Elec. Corp., 210 F. Supp. 483, 485 (E.D. Pa. 1962).
18. Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 608–09 (8th Cir. 1978) (en banc) (quoting Alan J. Weinschel, *Corporate Employee Interviews and the Attorney-Client Privilege*, 12 B.C. Indus. & Com. L. Rev. 873, 876 (1971)).
19. Upjohn Co. v. United States, 449 U.S. 383, 392 (1981).
20. *Id.* at 395.
21. Joshua G. Berman & Machalagh Proffit-Higgins, *Prosecuting Corporations: The KPMG Case and the Rise and Fall of the Justice Department's 10-Year War on Corporate Fraud*, 2 Am. U. Crim. L. Brief 25, 25 (2007), *available at* http://www.sonnenschein.com/docs/Prosecuting_Corporat.pdf.
22. Berger v. United States, 295 U.S. 78, 88 (1935).
23. Ass'n of Corporate Counsel et al., The Decline of the Attorney-Client Privilege in the Corporate Context: Survey Results Presented to the United States Congress and the United States Sentencing Commission 3 (2006), *available at* http://www.acc.com/Surveys/attyclient2.pdf [hereinafter Decline].
24. *Id*.
25. William R. McLucas et al., *The Decline of the Attorney-Client Privilege in the Corporate Setting*, 96 J. Crim. L. & Criminology 621, 629 (2006).
26. Def. Indus. Initiative on Bus. Ethics & Conduct, 2006 Annual Public Accountability Report 49 (2007), http://www.defenseethics.org/images/AnnualReport2006.pdf (emphasis added).
27. *Id*.

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

Endnotes (cont'd)

28. Holder was appointed Deputy U.S. Attorney General by President William Clinton in 1997 and served until 2001. He subsequently worked in private practice until 2009, until he was appointed Attorney General by President Barack Obama. See U.S. Department of Justice, USDOJ: Offi ce of the Attorney General, http://www.usdoj.gov/ag/ (last visited July 28, 2009);
WhoRunsGov.com, Eric Holder, http://whorunsgov.com/Profi les/Eric_Holder (last visited July 28, 2009).
29. Memorandum from Eric H. Holder Jr., Deputy Attorney Gen., to All Component Heads & U.S. Attorneys, Bringing Criminal Charges Against Corporations (June 16, 1999), http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html.
30. *Id*. §II(A).
31. *Id*. §II(A)(4) (emphasis added).
32. *Id*. §VI(B).
33. Until 2003 the Association of Corporate Counsel ("ACC") was known as the American Corporate Counsel Association. The name change was intended to refl ect the increasingly global interests of its members. *See* Association of Corporate Counsel, History of ACC, http://www.acc.com/aboutacc/history/index.cfm (2009).
34. Pritida Desai, Practical Law Company, ACCA Set to Challenge "Quid Pro Quo" Government Policy, http://employment.practicallaw.com/9-101-2248 (June 20, 2000).
35. Berman & Proffit-Higgins, *supra* note 21, at 26.
36. Thompson was appointed Deputy U.S. Attorney General by President George W. Bush in 2001 and served until 2003. He is currently vice president and general counsel for PepsiCo. *See* Meredith Hobbs, *Why Pepsi Chose Thompson as New GC*, Law.com, Aug. 26, 2004, http://www.law.com/jsp/article.jsp?id=1090180424852.
37. Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys, Principles of Federal Prosecution of Business Organizations 1 (Jan. 20, 2003), http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter Thompson Memo].
38. *Id*.
39. *Id*.
40. *Id.*
41. *Id*. §II(A)(4) (emphasis added).
42. *See* Ann Graham, *New Memo Won't Ease Attorney-Client Privilege Concerns*, Texas Law., Feb. 11, 2008, *available* at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202469642951 (discussing concerns of the ABA, the ACC, the National Association of Criminal Defense Lawyers, the American Civil Liberties Union, the U.S. Chamber of Commerce, and Senator Arlen Specter).
43. Thompson Memo, *supr*a note 37, §VI(B).
44. *See* Decline, *supra* note 23, at 3.
45. Marty Steinberg, *Coping with a "Culture of Waiver*," 23 Fin. Executive, Sept. 2007, at 46–47, *available at* http://www.allbusiness.com/company-activities-management/company-strategy/5503146-1.html.
46. Amendments to the Sentencing Guidelines for United States Courts, 69 Fed. Reg. 28,994, 29,019 (May 19, 2004) (emphasis added).
47. *Id*. at 29,021.
48. McCallum served as Associate U.S. Attorney General from 2003 to 2006, and subsequently served as U.S. Ambassador to Australia from 2006 to 2009. See U.S. Department of State, McCallum Robert D., http://www.state.gov/outofdate/bios/68646.htm (last visited July 28, 2009).
49. Memorandum from Robert D. McCallum Jr., Acting Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys, Waiver of Corporate Attorney-Client and Work Product Protection (Oct. 21, 2005), *available at* http://lawprofessors.typepad.com/whitecollarcrime_blog/files/AttorneyClientWaiverMemo.pdf.

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

Endnotes (cont'd)

50. *Id*.
51. *Id*.
52. *Id*.
53. *White Collar Enforcement: Attorney-Client Privilege and Corporate Waivers: Hearing Before the Subcomm. on Crime, Terrorism, and Homeland Security, H. Comm. on the Judiciary*, 109th Cong. 5 (2006), *available at* http://bulk.resource.org/gpo.gov/hearings/109h/26409.pdf [hereinafter *White Collar Enforcement*].
54. *Id*.
55. *Id.* at 6–7.
56. Thornburgh was appointed as U.S. Attorney General by President Ronald Reagan in 1988, where he served until 1991. *See* Dick Thornburgh, http://dickthornburgh.com (last visited July 28, 2009).
57. *White Collar Enforcement*, *supra* note 53, at 14.
58. *Id*.
59. *Id*.
60. Delahunt, who represents the 10th District of Massachusetts, was first elected to the U.S. House of Representatives in 1997. *See* House.gov, Congressman Bill Delahunt, Proudly Serving the People of the 10th District of Massachusetts, http://www.house.gov/delahunt/about.shtml (follow "About Bill Delahunt" hyperlink; then follow "Biography" hyperlink) (last visited July 28, 2009).
61. *White Collar Enforcement*, *supra* note 53, at 46–47.
62. United States v. Stein (*Stein I*), 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006), *aff'd*, United States v. Stein (*Stein III*), 541 F.3d 130 (2d Cir. 2008); United States v. Stein (*Stein II*), 440 F. Supp. 2d 315 (S.D.N.Y. 2006).
63. *Stein I*, 435 F. Supp. 2d at 382.
64. *Id*. at 353.
65. *Id*. at 339.
66. *Id*. at 341.
67. *Id*. at 382.
68. *Stein II*, 440 F. Supp. 2d 315, 337 (S.D.N.Y. 2006).
69. *See Stein III*, 541 F.3d 130 (2d Cir. 2008); discussion *infra* Part IV.A.
70. McNulty was appointed Acting Deputy U.S. Attorney General by President George W. Bush in 2005 and sworn in as Deputy U.S. Attorney General on March 17, 2006, where he served until 2007. See U.S. Department of Justice, COPS Offi ce: Paul J. McNulty, http://www.cops.usdoj.gov/default.asp?Item=1735 (last visited July 28, 2009).
71. Memorandum from Paul J. McNulty, Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Dec. 2006), http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf [hereinafter McNulty Memo].
72. *Id*.
73. *Id*.
74. *Id*. at 9.
75. *Id*. at 10.
76. *Id*.
77. *Id*. at 9.
78. *Id*. at 10.
79. Press Release, Am. Bar Ass'n, ABA Adopts New Policy on Presidential Signing Statements, Attorney-Client Privilege and Inspector General for the Federal Judiciary (Aug. 8, 2006), http://www.abanet.org/media/releases/news080806_1.html (internal quotation marks omitted).
80. *See* Letter from Michael S. Greco, President, Am. Bar Ass'n, to Alberto Gonzalez ("Colleague")(May 2, 2006), http://www.abanet.org/buslaw/attorneyclient/materials/stateandlocalbar/20060502000000.pdf.
81. *The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 18–19 (2006), *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=2054&wit_id=5741 (statement of Edwin Meese III, former U.S. Attorney General).

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

Endnotes (cont'd)

82. Melissa Klein Aguilar, *DOJ Defends Thompson Memo Amid Clamor*, Compliance Wk., Oct. 11, 2006, *available at* http://www.complianceweek.com/article/2787/doj-defends-thompsonmemo-amid-clamor.
83. At the time this bill was proposed, Senator Specter was a member of the Republican Party. He has since announced that he will run for reelection as a member of the Democratic Party. The Democratic Party, *DNC Chairman Tim Kaine Welcomes Arlen Specter to Democratic Party with "Open Arms*," Apr. 28, 2009, http://www.democrats.org/a/2009/04/dnc_chairman_ti_8.php.
84. *See* Attorney-Client Privilege Protection Act of 2006, S. 30, 109th Cong. (2006), *available at* http://thomas.loc.gov/cgi-bin/query/z?c109:S.30:.
85. Berman & Proffit-Higgins, *supra* note 21, at 31.
86. S. 30, §2(b).
87. *Id*. §3(b).
88. *Id*. §2(a)(5)–(6).
89. *Id*. §2(a)(8).
90. *See* Attorney-Client Privilege Protection Act of 2007, S. 186, 110th Cong. (2007), *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:S.186:.
91. Attorney-Client Privilege Protection Act of 2008, S. 3217, 110th Cong. (2008), *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:S.3217:.
92. *Id*. §3014(b)(1)(A)–(C); *see also* Andrew Gilman, *The Attorney-Client Privilege Protection Act: The Prospect of Congressional Intervention into the Department of Justice's Corporate Charging Policy*, 35 Fordham Urb. L.J. 1075, 1101 (2008).
93. U.S. Library of Congress, All Congressional Actions, http://thomas.loc.gov/cgi-bin/bdquery/z?d110:SN03217:@@@X (last visited July 28, 2009).
94. Attorney-Client Privilege Protection Act of 2007, H.R. 3013, 110th Cong. (2007), *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:HR.3013:.
95. *Id*.; *see* U.S. Library of Congress, All Congressional Actions, http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR03013:@@@X (last visited July 28, 2009).
96. Filip was appointed as Deputy U.S. Attorney General by President George W. Bush in 2008 and served until 2009. *See Former Federal Judge Back in Private Practice*, Chi. Trib., May 6, 2009, at 28, *available at* 2009 WLNR 8591539.
97. Section 9-28.760 of the U.S. Attorneys' Manual, entitled "Oversight Concerning Demands for Waivers of Attorney-Client Privilege or Work Product Protection by Corporations Contrary to This Policy," states:

> The Department underscores its commitment to attorney practices that are consistent with Department policies like those set forth herein concerning cooperation credit and due respect for the attorney-client privilege and work product protection. Counsel for corporations who believe that prosecutors are violating such guidance are encouraged to raise their concerns with supervisors, including the appropriate United States Attorney or Assistant Attorney General.

U.S. Dep't of Justice, United States Attorneys' Manual § 9-28.760 (2008) [hereinafter U.S. Attorneys' Manual].
98. *Stein III*, 541 F.3d 130, 136 (2d Cir. 2008).
99. Memorandum from Mark Filip, Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys, Principles of Federal Prosecution of Business Organizations 2 (Aug. 28, 2008), http://www.usdoj.gov/dag/readingroom/dag-memo-08282008.pdf [hereinafter Filip Memo]. With all due respect to Mr. Filip and his preference for nomenclature, for the purposes of this Note the memorandum containing his modifications will be referred to as the Filip Memo.
100. *Id*. at 1.
101. *Id*.

(*continued on next page*)

New Rule on FAR Compliance (cont'd):

Endnotes (cont'd)

102. U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations §9-28.720 (2008), *available at* http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf.
103. *Id*. §9-28.720(b).
104. Attorney-Client Privilege Protection Act of 2009, S. 445, 111th Cong. (2009), *available at* http://thomas.loc.gov/cgi-bin/query/z?c111:S.445:.
105. 154 Cong. Rec. S2331–32 (daily ed. Feb. 13, 2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2009_record&page=S2331&position=all (statements of Sen. Specter).
106. Some may argue that because the Act will apply to corporate criminal activities and the new FAR rules apply strictly to government contractors, companies may avoid the FAR's mandatory disclosure requirement simply by declining to bid on government contracts. However, this is not a viable business option for any government contractor whose existence is based in large part on contracting with the Federal Government.
107. *See* FAR 3.1003(a)(2)–(3).
108. *See* FAR 3.1004(a), 52.203-13(a).
109. *See* FAR 52.203-13(c)(2)(ii)(F).
110. Qui tam is from a Latin phrase meaning "he who brings a case on behalf of our lord the King, as well as for himself." This legal device allows for a private citizen, known as a "relator," to bring a lawsuit on behalf of the United States for suspected violations of the False Claims Act. These legal actions are colloquially referred to as "whistleblower suits." U.S. Dep't of Justice, False Claims Act Cases: Government Intervention in Qui Tam (Whistleblower) Suits, http://www.usdoj.gov/usao/pae/Documents/fcaprocess2.pdf (last visited Aug. 1, 2009).
111. FAR 52.203-13(a)(1).
112. FAR 52.203-13(a)(2).
113. *Id*.
114. FAR 52.203-13(a)(3).
115. Filip Memo, *supra* note 99.
116. U.S. Attorneys' Manual, *supra* note 97, §9-28.710 (quoting Upjohn Co. v. United States, 449 U.S. 383, 389 (1981)).
117. Contractor Business Ethics Compliance Program and Disclosure Requirements, FAR Case 2007-006, 73 Fed Reg. 67,064, 67,069 (Nov. 12, 2008).
118. *Id*. at 67,077 (emphasis added) (quotations omitted).
119. Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. Rev. 311, 352–78 (2007) (arguing that the Fifth Amendment should afford employees some protection against coerced disclosures, even when an agent of the corporation poses the questions).
120. Fed. R. Evid. 502.
121. Fed. R. Evid. 502 advisory committee's note.
122. *See id*. at subdiv. (a).
123. Letter from Lee H. Rosenthal, Chair of Comm. on Rules of Practice and Procedure of the Judicial Conference of the U.S., to Patrick J. Leahy and Arlen Specter, U.S. Senate Comm. on the Judiciary (Sept. 26, 2007), *available at* http://www.uscourts.gov/rules/Hill_Letter_re_ EV_502.pdf.
124. *See generally* Graham, *supra* note 42 (listing the American Bar Association, the Association of Corporate Counsel, the National Association of Criminal Defense Lawyers, the American Civil Liberties Union, and the U.S. Chamber of Commerce, among others, as groups monitoring these developments).
125. Berger v. United States, 295 U.S. 78, 88 (1935).

Collateral Damage:
The Impact on Contractors of GAO's DCAA Reports

by
John A. Howell, Esq.
Sullivan & Worcester LLP
and
Peter A. McDonald, C.P.A., Esq.
Navigant Consulting, Inc.*

[Note: Reprinted with permission from *Federal Contracts Report*, Vol. 93, No. 4, February 2, 2010, The Bureau of National Affairs, Inc. (800-3782-1033). www.bna.com.]

I. Introduction

In the summer of 2008, the Government Accountability Office (GAO) issued a report (2008 Report) that addressed allegations that certain audits done by the Defense Contract Audit Agency (DCAA) did not comport with generally accepted government auditing standards.[1] This Report was presented to the Senate Committee on Homeland Security and Governmental Affairs in September 2008. The Committee subsequently requested GAO to expand its review to determine to what extent the audit quality problems identified in the instances examined in the 2008 Report existed in the rest of the agency. In September 2009, GAO issued two reports on its review of 37 diverse DCAA audits. In brief, all 37 were found to be defective. As others have already noted, these reports essentially meant that "DCAA is currently a spectacular failure."[2]

This article briefly discusses these two follow-up GAO Reports and applicable case law, and then points out the impact these reports may have on DCAA's relationships with government contractors.

II. GAO's Findings

The introductory paragraph in a DCAA audit report typically contains the following standard language:

> We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the data and records examined are free from material misstatement.

The statement that the audit "was conducted in accordance with generally accepted government auditing standards" (GAGAS) accords the report the imprimatur of quality.

(*continued on next page*)

Collateral Damage (cont'd):

Because of that assertion, users of the report may rely on the validity of its findings since they are consistent with applicable professional standards. Adherence to professional standards is what provides an authoritative foundation to any audit report. Conversely, departing from applicable professional standards impairs audit quality, and calls a report's findings into question. For this reason, maintaining audit quality is a significant responsibility for any auditor. This fundamental principle is just as applicable to DCAA auditors as to auditors in the private sector.[3] As discussed in greater detail below, the lack of audit quality in DCAA audits was found by GAO to be a significant problem throughout DCAA.

A. GAO Report 09-468, "*Widespread Problems with Audit Quality Require Significant Reform*," September 23, 2009 ('Long Report')

GAO found quality deficiencies in virtually every DCAA audit it examined, and the failure to comply with GAGAS was so pervasive it concluded that the quality problems were "rooted in DCAA's poor management environment."[4] Stated bluntly, management is responsible when things are this bad. The GAO Report put it this way:

> DCAA's production-oriented culture is deeply imbedded and likely will take several years to change. Under the decentralized management environment, there has been little headquarters oversight of DCAA regions, as demonstrated by nationwide audit quality problems. Further, DCAA's culture has focused on hiring and promoting from within the agency and most training has been conducted by agency staff. This has led to a very insular culture where there are limited perspectives on how to make effective organizational changes.[5]

Unfortunately, DCAA's management was too insular to realize it even *had* audit quality problems. Speaking of DCAA's mismanagement, GAO's review also stated that they "found no evidence that supervisors and auditors who did not follow GAGAS and DCAA policy were disciplined, counseled, or required to take additional training."[6]

Other audit problems identified by GAO stemmed from auditors' routine use of boiler-plate language in their audit reports.[7] This practice masked the fact that DCAA auditors almost invariably did not perform enough audit testing to substantiate their conclusions. This is a very serious shortcoming, and one that goes to the core of any audit report's credibility, yet this problem existed in almost every audit GAO reviewed:

> The most pervasive audit deficiency we identified was insufficient testing to support DCAA's reported conclusions and opinions.[8]

This was not the only significant problem. Section 3.55 of the GAGAS requires an organization performing audits to have its work periodically evaluated by an external organization. The process of evaluating an organization's compliance with GAGAS is called a peer review. The GAGAS state the peer review requirement as follows:
(*continued on next page*)

Collateral Damage (cont'd):

> 3.55 Audit organizations performing audits and attestation engagements in accordance with GAGAS must have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every 3 years.
>
> 3.56 The audit organization should obtain an external peer review sufficient in scope to provide a reasonable basis for determining whether, for the period under review, the reviewed audit organization's system of quality control was suitably designed and whether the audit organization is complying with its quality control system in order to provide the audit organization with reasonable assurance of conforming with applicable professional standards.[9]

Regarding its peer review process, the Defense Contract Audit Agency's Contract Audit Manual (CAM) states:

> Organizations conducting audits in accordance with government auditing standards should have an external quality control review at least once every three years by an organization not affiliated with the organization being reviewed. The external quality control review program should determine whether the organization's internal quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed. For DCAA this function is performed primarily by the Department of Defense, Office of the Inspector General.[10]

Accordingly, DCAA's peer reviews are conducted by the Department of Defense Inspector General (DoD IG). In its most recent "peer review," the DoD IG looked at the same DCAA internal audit quality assurance reviews that GAO reviewed. In May 2007, the DoD IG issued a "peer review" report that concluded as follows:

> Accordingly, we have determined that the DCAA system of quality control used on audits and attestation engagements for the review period ended September 30, 2006 is adequate.[11]

The DoD IG came to this surprising conclusion despite the fact that its review also found numerous audits with "serious deficiencies in audit quality."[12] After reviewing the same DCAA internal audit quality assurance reviews that the DoD IG reviewed, the GAO concluded that the DoD IG had clearly arrived at an erroneous conclusion. Recognizing this, GAO recommended that the DoD IG reconsider its "clean opinion." In response, the DoD IG stated in a letter dated August 24, 2009 that it was "not prudent to allow the adequate opinion from

(*continued on next page*)

Collateral Damage (cont'd):

our May 2007 report to carry forward."[13] This was a bewildering statement because, as any C.P.A. knows, peer review reports do not "carry forward" anyway. It was obvious that this letter evidenced the DoD IG's complete lack of understanding of the issues involved. In short, DCAA's problems were made worse by the fact that the DoD peer review process had failed.

Because DCAA does not currently meet the peer review requirement, its audit reports now use revised boilerplate language that states:

> We conducted our examination in accordance with generally accepted government auditing standards, except DCAA does not currently have an external opinion on its quality control system as required by GAGAS 3.55.

This innocuous sounding language is much more significant than it looks, because it essentially means that DCAA does not have a quality control system that meets professional standards. Stated differently, the inability of DCAA to meet the quality criteria of applicable professional standards indicates that the findings in the audit report may or may not be reliable.

In order for the DCAA to be able to issue reliable audit reports, GAO concluded that "significant changes will be needed in [DCAA] policy guidance and training on audit standards, appropriate procedures, and audit documentation in order to comply with GAGAS."[14] In this regard, GAO estimated that "it will take considerable time to develop a revised training program to address the range of changes in audit policies, processes, and procedures for performing quality audits in accordance with GAGAS."[15]

B. GAO Report 09-1009T, "*Widespread Problems with Audit Quality Require Significant Reform*," September 23, 2009 ('Short Report')

The so-called 'short report' was issued simultaneously with the 'long report,' but was more in the nature of an executive summary. This Short Report discussed in general terms (1) DCAA's management and quality controls; (2) DCAA's responses to GAO's 2008 Report, as well as two non-peer Department of Defense (DoD) reviews[16]; and (3) GAO's recommendations for improvement.

Regarding DCAA's management and agency-wide quality control problems, GAO summarily stated that many audit reports had been issued where the auditors lacked in dependence (a prerequisite for any audit).[17] In addition, as detailed in the Long Report, almost all audit reports reviewed had insufficient testing, which in turn meant the audit opinions were unsupported. Nonetheless, DCAA audit reports were routinely accepted despite "significant deficiencies and noncompliance with GAGAS and DCAA policy."[18]

It is beyond the scope of this article to address either the two DoD non-peer reviews or GAO's recommendations for improvement.

(*continued on next page*)

Collateral Damage (cont'd):

III. Impact on Contractors

As the GAO Reports now make clear, it is unlikely that DCAA auditors have been or even now are complying with GAGAS. This systemic failure undercuts the authoritative basis for their audit findings. Historically, contractors always assumed that the standard GAGAS language was correct, and rarely challenged the underlying validity of DCAA audits. As a result of these GAO Reports, however, it is now apparent that the assumed veracity of DCAA audits may frequently be absent.

The GAGAS do not pertain to everything DCAA does. For example, prior to the award of a cost-reimbursement contract, DCAA auditors review the contractor's accounting system to determine its adequacy for performing such a government contract.[19] In like manner, DCAA auditors also review the adequacy of a contractor's estimating system, and for contracts covered by the Cost Accounting Standards (CAS) DCAA auditors review CAS Disclosure Statements (CASB Form DS-1 and -2). These matters are in the nature of compliance reviews, not audits, and for that reason the GAGAS are inapplicable.

On the other hand, the GAGAS do apply to DCAA audits of numerous widely divergent contractor activities, such as an incurred cost submission,[20] healthcare claims processing, Davis-Bacon price adjustments,[21] approval of invoice payments,[22] defective pricing audits,[23] executive compensation reviews,[24] requests for equitable adjustments and/or claims,[25] termination settlement proposals,[26] and contract close-outs.[27] Given the breadth of DCAA audit activity governmentwide, the inability of DCAA auditors to comport with professional audit standards adversely affects the entire contract administration process.

Speaking of contract administration, the usual procedure for resolving audit issues is an iterative one with the contracting officer serving as the intermediary. Specifically, the draft audit report goes through the contracting officer to the contractor for comment. In turn, the contractor's responses to the draft audit report also go through the contracting officer to the auditor. During this process, some or possibly all of the audit findings may be accepted by the contractor. However, audit findings not accepted by the contractor would usually be the subject of a contracting officer's final decision, which the contractor may either accept or appeal.[28] This is because only contracting officers are authorized to render final decisions – auditors, like other members of the government's procurement team (quality assurance inspectors, contract specialists, property administrators, attorneys, and so on), are only advisors. Where contracting officers do not concur with an auditor's recommendations (i.e., where audit findings are not accepted by a contracting officer), that is simply the decision of the government's contracting officer.

Unfortunately, this process has been seriously undermined by a recent DCAA policy change that essentially encourages an auditor to complain to the DoD Inspector General when the auditor disagrees with a contracting officer's decision not to uphold DCAA's audit findings. This new DCAA *Action Guidance Memo* states in pertinent part:

(*continued on next page*)

Collateral Damage (cont'd):

> Certain unsatisfactory conditions related to actions of Government officials will be reported to the Department of Defense Inspector General (DoDIG) in lieu of reporting the conditions to a higher level of management. The unsatisfactory conditions reported to the DoDIG will be those cases where DCAA determines an independent assessment and related actions are necessary due to the significance and/or sensitivity of the matter.
>
> *Unsatisfactory conditions include actions by Government officials that appear to reflect mismanagement*, a failure to comply with specific regulatory requirements or gross negligence in fulfilling his or her responsibility that result in substantial harm to the Government or taxpayers, or that frustrate public policy.[29] [Emphasis added.]

Recently, DCAA announced that this policy memo only relates to actions of government officials that rise "well above simple disagreements between the audit position and the contracting officer decision."[30] Inasmuch as no guidance has been issued for auditors to be able to distinguish a "simple disagreement" from an "unsatisfactory condition," this clarification is a distinction without a difference. The fact remains that contracting officers who disagree with audit findings still run the risk of being caught up in an IG investigation, while merely rubberstamping audit findings, no matter how egregious, entails no such risk.

As a result, the role of the contracting officer as a decisionmaker has been effectively emasculated by this new DCAA policy, notwithstanding a recent memorandum by the Director of Defense Procurement and Acquisition Policy.[31] Because contracting officers are now reluctant to disapprove audit findings, DCAA audit findings generally cannot be resolved at the contracting officer level. Accordingly, the only alternative available to contractors unwilling to accept DCAA audit findings is to seek relief through the appeals process. In the opinion of many knowledgeable observers, this will likely increase the number of contract disputes.[32] That's the bad news.

The good news for contractors is that it will be difficult for DCAA audits to withstand judicial scrutiny. As a rule, courts and boards are unlikely to rely on DCAA audit reports that fail to meet applicable audit standards. Understandably, government attorneys will be very hesitant to use such evidence at trial. As the recent GAO Reports have conclusively shown, there is a general lack of adherence to professional standards in DCAA audit reports, and the collateral damage to the Government is that contractor attorneys can now prove it. That being so, it is worthwhile to consider whether there is any instructive current case law.

IV. The General Dynamics Case: Attacking DCAA Malpractice

Defective DCAA audits are, of course, nothing new in the world of government contracts. One of the most egregiously defective DCAA audits led to an accounting

(*continued on next page*)

Collateral Damage (cont'd):

malpractice suit against the agency by the General Dynamics Corporation ("General Dynamics") under the Federal Tort Claims Act ("FTCA"). In the 1996 General Dynamics case, the United States District Court for the Central District of California awarded almost $26 million to General Dynamics. While the United States Court of Appeals for the Ninth Circuit reversed the district court two years later, the appeals court may have left the door open for contractors to use the FTCA to attack defective DCAA audits, at least where prosecutorial discretion is not involved. As such, the General Dynamics case deserves extended discussion.

In 1978, the Department of the Army awarded a contract to General Dynamics to develop two prototypes for the Divisional Air Defense ("DIVAD") System, a computer-operated antiaircraft weapon mounted on a tank chassis. Following an audit, the DCAA issued a report in 1984 which concluded that General Dynamics had mischarged approximately $8.4 million to the contract. On the basis of the DCAA audit report, the Department of Justice ("DOJ") indicted General Dynamics and four of its executives. In addition, the DOJ sued General Dynamics under the civil False Claims Act with respect to the alleged mischarges. During its subsequent pretrial work, the DOJ determined that the DCAA had erroneously interpreted the DIVAD contract and related acquisition regulations – by failing, in particular, to understand that the contract was a firm-fixed-price (best efforts) contract rather than a firm-fixed-price contract – and that no mischarging had in fact occurred. Thereafter, the DOJ dismissed the indictment and related civil action, and the Attorney General sent letters of apology to the four General Dynamics executives.

In 1989, General Dynamics sued the Government under the FTCA to recover its costs of defending the civil and criminal actions, alleging that the DCAA had negligently prepared the audit report. The Government initially moved to dismiss the case, arguing that the FTCA's discretionary-function exception applied. The Government asserted that its decision to investigate, prosecute, and civilly charge General Dynamics constituted a permissible exercise of a policy judgment and that the DCAA's actions were "so intertwined with this prosecutorial function as to be themselves discretionary." The district court rejected the argument, noting that General Dynamics had not alleged that the DCAA was acting in any discretionary capacity, but rather had alleged that the agency had failed to follow its prescribed procedures in the DCAA *Contract Audit Manual* ("CAM").[33] Significantly, the court further observed that the DCAA's auditing function could be distinguished from the Government's prosecutorial function. Finally, the court found that General Dynamics had pled a *prima facie* case of professional malpractice under California law - the applicable state law under the FTCA. Accordingly, the court denied the Government's motion to dismiss and permitted the case to go to trial.

Following trial, the district court issued an exhaustive opinion.[34] In analyzing whether

(*continued on next page*)

Collateral Damage (cont'd):

the DCAA had committed malpractice in erroneously concluding that General Dynamics was guilty of mischarging, the district court first noted that DCAA auditors must adhere to the standards of the auditing profession when performing their audit work. Here, the court found that the DCAA auditors had failed to meet even minimal professional standards. As a result, the findings, conclusions, and recommendations in the audit report were not supported by the evidence in the workpapers.

In excoriating the DCAA auditors, the district court pointed to a lengthy list of misdeeds: (1) negligence in not understanding the purpose of the audit; (2) negligence in reviewing and briefing the DIVAD contract; (3) negligence in preparing the audit program; (4) negligence in not conducting an entrance conference; (5) negligence in preparing workpapers; (6) negligence in not obtaining technical assistance; (7) negligence in failing to resolve conflicts in the evidence; (8) negligence in failing to draft the audit report based on the workpapers; and (9) negligence in failing to discuss the audit conclusions at an exit conference and in failing to include General Dynamics' response in the audit report. After again finding that the FTCA's discretionary-function exception was inapplicable, the court awarded almost $26 million in damages to General Dynamics.

In 1998, the Ninth Circuit reversed the district court, holding that the discretionary-function exception precluded suit.[35] In a divided opinion, the Ninth Circuit held that "the buck stopped at the prosecutors" and that "the decision to prosecute was all their own." Accordingly, the court held that the United States was immune from suit under the FTCA.

Notwithstanding the Ninth Circuit's reversal on other grounds, the General Dynamics district court decision stands for the proposition that DCAA audits are subject to applicable professional standards. What is less clear, however, is whether – given the appeals court's ruling on the discretionary function exception – the DCAA may be held accountable in a given case when those standards are not met. On the basis of the Ninth Circuit's opinion, the answer appears to be "no," at least where a defective DCAA audit report results in a DOJ decision to charge the contractor and/or sue it under the civil False Claims Act. Assume, however, that a contracting officer simply relies on a defective DCAA audit report to deny a contractor's claim or assert a claim against the contractor. Simply put, the discretionary-function exception may not apply.[36]

V. Conclusion

The GAO Reports suggest that DCAA's quality problems are so severe that the agency

(*continued on next page*)

Collateral Damage (cont'd):

is currently unable to issue an audit report in accordance with professional standards. This is a very disturbing development for everyone in the government contracts community, because the use of DCAA audits is interwoven with the entire contracting process from preaward through contract administration to contract close-out. Indeed, the government audit function is integral to the integrity of the entire procurement system.

While acknowledging DCAA's crucial procurement role, the GAO Reports document DCAA auditors' pervasive and systemic lack of adherence to GAGAS. The failure of DCAA auditors to meet minimal professional standards calls the credibility of their audit reports into question, because audit reports that do not comport with professional standards have skewed or unreliable results. Under these circumstances, contractors now have every incentive to attack adverse DCAA audit reports. Should a DCAA audit report not state – without qualification – that it was performed in accordance with GAGAS, there is no presumption of the report meeting minimal professional standards.

Finally, with its recent policy encouraging complaints to the DoD IG, DCAA has impaired contract administration by essentially usurping the role of the contracting officer. For this reason, government contractors desiring to challenge DCAA audit findings have little to lose by resorting to litigation. In litigation, the most fertile ground for contractors would be a thorough examination of the auditor's documented compliance with professional standards. Between the pervasive audit quality problems documented by the recent GAO Reports, as well as the holding in General Dynamics, contractors have ample basis to challenge DCAA audit reports.

---

* - John A. Howell is a partner in the law firm of Sullivan & Worcester, Washington, D.C. Peter A. McDonald, an attorney-C.P.A., is a director in the Government Contracts practice of Navigant Consulting, Inc.

Endnotes

[1] - *See* GAO Report 08-857, "*Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*," July 22, 2008.
[2] - "Reforms to the DCAA: The Potential Effect on Contract Management," by Jack Horan, NCMA *Contract Management Journal*, p. 92, December 2009.
[3] - *See* Defense Contract Audit Agency, *Contract Audit Manual*, Section 10-103: "The DCAA audit report must satisfy generally accepted government auditing standards (GAGAS) as outlined in 2-400 and 2-600."
[4] - GAO Report 09-468, "*Widespread Problems with Audit Quality Require Significant Re-form*," September 23, 2009 ('Long Report'), p. 14.

(*continued on next page*)

Collateral Damage (cont'd):

Endnotes (cont'd)

[5] - *Ibid.*, p. 42.
[6] - *Ibid.*, p. 41.
[7] - *Ibid.*, p. 16-17.
[8] - *Ibid.*, p. 37.
[9] - *Government Auditing Standards*, Sections 3.55 and 3.56, Government Accountability Office, 2003.
[10] - Defense Contract Audit Agency, *Contract Audit Manual*, Section 2-205(b).
[11] - DoD Inspector General, *Oversight Review: Review of the Defense Contract Audit Agency Quality Control System*, Report No. D-2007-6-006 (Arlington, VA: May 1, 2007).
[12] - GAO Report 09-468, "*Widespread Problems with Audit Quality Require Significant Reform*," September 23, 2009 ('Long Report'), p. 35.
[13] - *Ibid.*,p. 81.
[14] - *Ibid.*, p. 46.
[15] - *Ibid.*, p. 58.
[16] - Of these two nonpeer reviews, one was a "tiger team" review performed by the Under Secretary of Defense (Comptroller/Chief Financial Officer), while the other was a study conducted by the Defense Business Board.
[17] - DCAA auditors had apparently provided material non-audit services to the same contractors they later audited.
[18] - GAO Report 09-1009T, "*Widespread Problems with Audit Quality Require Significant Reform*," September 23, 2009 ('Short Report'), p. 10.
[19]- DCAA used to participate in source selection evaluation boards, but ceased to do as of September 12, 2008 in response to independence concerns expressed in a review by the Defense Business Board. *See* GAO Report 09-468, "*Widespread Problems with Audit Quality Require Significant Reform*," September 23, 2009 ('Long Report'), p. 54.
[20] - FAR 52.216-7. Non-profits would follow the cost principles in OMB Circular A-122.
[21] - FAR 52.222-32.
[22] - FAR 32.111.
[23] - 10 U.S.C. §2306a; 41 U.S.C. §254b.
[24] - DCAA's many shortcomings in performing executive compensation reviews have already been noted. *See* "*Compensation Is Not a Four-Letter Word: Coping With a DCAA Executive Compensation Review*," by Richard B. O'Keefe, Jr., American Bar Association's *The Procurement Lawyer*, Vol. 45, No. 1, Fall 2009.
[25] - 41 U.S.C. §§601 *et seq*.
[26] - FAR 52.249-2.
[27] - FAR 42.708.
[28] - FAR 233-1.
[29] - DCAA *Action Guidance Memo* PAS 730.4.A.4, dated March 13, 2009.
[30] - Statement by DCAA Spokesperson Tara Rigler, BNA *Federal Contracts Report*, Vol. 92, No. 384, November 24, 2009.

(*continued on next page*)

Collateral Damage (cont'd):

Endnotes (cont'd)

[31] - The "Assad Memo" essentially establishes little more than high level, intra-agency ADR procedures for disagreements related to contract proposals over $10 million, and where the contracting officer does not agree with 75% of the questioned costs. These procedures are of very limited applicability. *See* Memorandum, "*Resolving Contract Audit Recommendations*," Director, Defense Procurement and Policy (DPAP), December 4, 2009; *available at* http://www.acqosd.mil/dpap/ops/policy_vault.html.
[32] -"*Reforms to the DCAA: The Potential Effect on Contract Management*," by Jack Horan, NCMA *Contract Management Journal*, p. 95, December 2009.
[33] - General Dynamics Corp. v. United States, No. CV 89-6762JGD, 1990 WL 267366 (C.D. Cal., Nov. 7, 1990) (not reported in F.Supp.).
[34] - General Dynamics Corp. v. United States, No. CV 89-6762JGD, 1996 WL 200255 (C.D. Cal., Mar. 25, 1996) (not reported in F.Supp.).
[35] - General Dynamics Corp. v. United States, 139 F.3d 1280 (9th Cir. 1998).
[36] - In addition, a defective audit report may result in a finding that the Government's litigation position was not "substantially justified" - the predicate for awarding attorneys' fees under the Equal Access to Justice Act. *See* Application under Equal Access to Justice Act - Shirley Contracting Corp., ASBCA No. 29,848, 87-2 BCA (CCH) ¶19,759 (1987) (noting the DCAA's "obviously inadequate and superficial analysis"); *see also* Vernon J. Edwards, "*Reliving History: The New DoD Policy on Resolution of Contract Audit Recommendations*," 24 Nash & Cibinic Report ¶3, Jan. 2010, at 12 (discussing the Shirley case).

Organizational and Consultant Conflicts of Interest

by
Glenn Sweatt*

[Note: Reprinted with permission from the *Contract Management Journal*, National Contract Management Association, February 2010.]

Government contracting officers (COs) and contractors alike are busier than ever with acquisition activity under the American Recovery and Reinvestment Act of 2009[1]—and the primary themes of the Barack Obama administration are "transparency," "accountability," and "openness." One area where these themes clearly come into play in government acquisition is in the field of organizational conflicts of interest (OCIs). For a contractor, an unidentified or unmitigated OCI is a sure way to lose job opportunities, be declared ineligible to bid, or to lose contracts when your competitors file successful protests. For the government, unmanaged OCIs can lead to a bid protest, decreased competition, acquisition delays, and even a canceled solicitation or award. A thorough understanding of OCI rules, and how to comply, is necessary to ensure your contract doesn't fall victim to an OCI trap. A common law dictionary defines "conflict of interest" as:

> …a situation in which a person has a duty to more than one person or organization, but cannot do justice to the actual or potentially adverse interests of both parties. This includes when an individual's personal interests or concerns are inconsistent with the best for a customer, or when a public official's personal interests are contrary to his/her loyalty to public business.[2]

A judge recently described it more concisely as "a situation in which regard for one duty tends to lead to disregard of another."[3]

In the world of government acquisition, the concept of an organizational versus personal conflict of interest brings on a host of new rules and issues. Thus, to begin an analysis of OCI rules, it is germane to review the Federal Acquisition Regulation (FAR) section that governs them. FAR 9.5, "Organizational and Consultant Conflicts of Interest," lays out the rules and procedures for identifying, evaluating, and resolving OCIs and provides guidance to COs and contractors in handling these situations.

Who Can Be Affected by an OCI, and When Can an OCI Arise?

The FAR defines who may be affected by an OCI, including the *marketing consultant*, defined as "any independent contractor who furnishes advice, information, direction, or assistance to an offeror or any other contractor in support of the preparation or submission of an offer for a government contract by that offeror."[4] Though the definition of "advice,

(*continued on next page*)

Conflicts of Interest (cont'd):

direction, or assistance" is rather broad, the FAR excludes a number of areas from these rules, including congressional advice, routine engineering, technical services (installation or system operation), legal or accounting services, and training services. Also, government COs and contractors must understand where and when an OCI can arise. While the short answer is that an OCI can arise *anytime, anywhere*—whether it be profit or non-profit entities; on fixed-price or cost type contracts; or on supplies, services, construction, research and development, etc.—the longer answer is that the FAR specifically recognizes certain contracts that are more likely than others to be affected by the OCI rules, specifically in contracts involving:

- Management support services,
- Consultant or other professional services,
- Contractor performance of or assistance in technical evaluations, or
- Systems engineering and technical direction work performed by a contractor that does not have overall contractual responsibility for development or production.[5]

In recent years, the government has been outsourcing more management support, consultant, and professional services. As such, we have and will continue to see a rising trend of OCI issues during the acquisition process and at the various bid protest forums.

When Does an OCI Exist?

FAR 9.502(c) states than an OCI exists when "factors create an actual or potential conflict of interest on an instant contract, or when the nature of the work to be performed on the instant contract creates an actual or potential conflict of interest on a future acquisition. In the latter case, some restrictions on future activities of the contractor may be required." Common cases of this type of OCI include a company seeking a contract award that has previously been involved in some way in developing the scope, design, schedule, estimates, surveys, testing, or engaged in acquisition support. For example, an architect or engineering firm that creates the design for a government project will almost always be precluded from bidding on the construction of that same project.[6] However, there must be indicia of bias or unfair advantage—merely being an incumbent on a particular program is not in and of itself sufficient to automatically create a conflict.[7] The mere existence of an OCI is not, however, automatically fatal to a contractor's ability to bid the work. An OCI may be adequately mitigated through an effective OCI plan, and, as discussed later, waivers may also be granted when it is found to be in the best interest of the government.

So You've Identified an OCI—Now What?

FAR 9.504 places the burden on COs to identify, avoid, neutralize, and mitigate conflicts. First, potential conflicts must be identified early in the acquisition process. This would entail a review of potential bidders from those who have requested the solicitation, or existing indefinite delivery/indefinite quantity (IDIQ) contract holders, and a review of their teaming partners, especially architectural/engineering team members, architects, and other

(*continued on next page*)

Conflicts of Interest (cont'd):

design professionals who may be more likely to have a potential conflict. It would also involve a review of previous work done on the program, at the project site, or specifically on the planning phases of the solicitation. Actual, potential, or perceived conflicts should then be noted and then the contractor provided written notice of the conflict with either an opportunity to provide additional information or a determination that they would not be eligible to bid.[8]

The two underlying principles are:

- Preventing the existence of conflicting roles that might bias a contractor's judgment, and
- Preventing unfair competitive advantage.

An unfair competitive advantage exists where a contractor competing for award of any federal contract possesses:

- Proprietary information that was obtained from a government official without proper authorization, or
- Source selection information (as defined in FAR 2.101[9]) that is relevant to the contract but is not available to all competitors, and such information would assist that contractor in obtaining the contract.[10]

Providing Systems Engineering and Technical Direction

According to FAR 9.505-1:

> A contractor that provides systems engineering and technical direction for a system but does not have overall contractual responsibility for its development, its integration, assembly, and checkout, or its production shall not—
>
> - Be awarded a contract to supply the system or any of its major components; or
> - Be a subcontractor or consultant to a supplier of the system or any of its major components.

Systems engineering is defined as a combination of determining specifications, identifying and resolving interface problems, developing test requirements, evaluating test data, and supervising design. *Technical direction* includes developing work statements, determining parameters, directing other contractors' operations, and resolving technical controversies. In both cases, a "combination of substantially all" of the factors must be present. The FAR further states that "a contractor occupies a highly influential and responsible position in determining a system's basic concepts and supervising their execution by other contractors. Therefore this contractor should not be in a position to make decisions favoring its own products or capabilities,"[11] which is the crux of the conflict language and rationale for

(*continued on next page*)

Conflicts of Interest (cont'd):

these preventative rules.

Preparation of specifications or work statements are covered in FAR 9.505-2, which states that if a contractor writes the specification for a given item or service, it shall be precluded from bidding on it. The rule is as obvious as it is necessary: if a contractor were allowed to bid a specification it had written, the specification could be easily tailored to be written in a way that only the contractor could successfully respond to, or at least in a way that specifically gave the contractor an advantage over its competitors. It would also leave in question the contractor's motives in writing the specification to begin with—did the contractor write a specification for what the government wants and needs, or one that is more biased toward what the contractor could sell and deliver?

Evaluation services are contracts for the evaluation of offers for products or services that shall not be awarded to a contractor that will evaluate its own offers for products or services, or those of a competitor, without proper safeguards to ensure objectivity to protect the government's interests. A situation in which a contractor was assisting in the technical evaluation of its own products or services, is, on its face, a clear conflict. However, it is not uncommon that a contractor may end up providing technical evaluation services on the services of a competitor, or potentially a teaming partner, subcontractor, or client. Though less stark, this situation clearly still carries many of the issues the FAR rules seek to avoid. Note that evaluation services conflicts can arise at any time—pre- or post-award. In the pre-award stage, an evaluation of a competitor's proposal or services can potentially be inappropriate. Post-award, you could have a contractor doing quality control, invoice review, testing, or inspection on a competitor (or potential subcontractor, teaming partner, etc.). While not prohibited outright, these situations also present the opportunity for conflicts and unfair competitive advantage.

On a recent cost type contract administered by the Air Force, a contractor was informed that a competitor would be conducting invoice review; thereby giving the competing firm access to proprietary financial information such as wage rates, indirect rates, structures, etc. FAR 9.505-4 deals with these issues and addresses preventative measures such as confidentiality agreements.

What Can a CO do to Resolve an Identified OCI?

There are a number of alternatives available to COs once an OCI has been identified. Ideally, the identification of the OCI has been made before the solicitation has been released, and the CO has provided a recommendation ahead of time.[12] The CO may elect to bar a particular contractor from bidding. They may prohibit various lower tier conflicted parties from participating as subcontractors or teaming partners. They may draft the solicitation in a way that all parties are given as much information as is needed to eliminate any concern that one party had an unfair advantage. For example, if a party had provided analytical sampling results to the agency, the mere disclosure of those results to all interested bidders may be sufficient to

(*continued on next page*)

Conflicts of Interest (cont'd):

eliminate any potential conflict or unfair advantage that the sampling contractor held.

Mitigation Plans

If a conflict cannot be prevented or avoided, a contractor and CO may attempt to mitigate the OCI, versus the more draconian alternative of disqualifying the contractor from the acquisition. FAR 9.504(e) allows a CO to make an award to an apparent successful offeror, even if such an offeror had an identified OCI, as long as the OCI has been successfully mitigated. If the CO feels the OCI has not been mitigated, he or she should notify the offeror with his or her rationale, and allow the offeror an opportunity to respond.

Mitigation steps and techniques may include:

- Clauses prohibiting some subsequent or lateral work by the contractor,
- Constraints on what a contractor (or subcontractor) will be allowed to perform,
- Nondisclosure and confidentiality agreements,
- Data protection agreements, or
- The exclusion and "fire-walling" of certain individuals or business units from participation in the work.

Mitigation plans are subject to challenge, which makes them slightly more risky than seeking formal waivers. That said, the Government Accountability Office (GAO) statistically has a low sustain rate on protests related to mitigation plans, as it will give deference to a CO's judgment. Those cases where GAO has sustained protests reflect situations where the government has failed to identify OCIs, or failed to even consider mitigation plans as a necessary step.[13] Even in some of those cases, sustained protests can be overcome if a mitigation plan is put in place and appropriately considered.[14]

Waivers

If the agency prefers the certainty of uninterrupted award, then a waiver may be preferable to accepting a mitigation plan. However, waivers are difficult to obtain. As a result, they are virtually unassailable in protest situations. Waivers are granted in accordance with FAR 9.503 and 9.504(e) per the following basic principles:

- Requests must be submitted in writing and can be issued by an agency head or delegate—but in no case may the authority be delegated any lower than the head of a contracting activity.

- Factors that would be considered in a waiver request include the seriousness and clarity of the conflict, availability of other solutions, cost and schedule differences between the contractor with an OCI and the next best alternative, system compatibility, and other exigent circumstances.

(*continued on next page*)

Conflicts of Interest (cont'd):

- Waivers may be seen in emergency circumstances and frequently in cases where conflicts have been created in the context of corporate mergers and acquisitions.

- In cases where a smaller company has designed a project and then been acquired by a larger company who wishes to bid the work, there may be reasons to allow this with safeguards in place to prevent unfair competitive advantage or bias in the acquisition.

Hypothetical Cases

FAR 9.508 provides examples in the systems development context that describe several common OCI situations and the recommended course of action for each. However, OCI situations are usually very fact-intensive, and are frequently handled on a case-by-case basis. Below are two such hypotheticals.

Case 1.
A Construction Project OCI

On a large construction project, Alpha Corp. is one of four holders of an IDIQ contract with an agency. When bidding for the IDIQ, Alpha listed several teaming partners (who were not contract holders, but subcontractors) including architect and engineering firm, Bravo. Under a separate contract directly to the agency, Bravo had previously prepared the design for this work.

In this case, the potential OCI is easily identified. Bravo cannot participate in the construction because they have previously provided technical services (design) that would give them an advantage.[15] But Alpha had not provided such technical services. Are they automatically conflicted out of the acquisition?

Lets assume that Alpha had prepared for this exact occurrence. They had the foresight to have two separate and distinct teaming partners for this exact reason so that they would always have at least one other resource available in the event one was prohibited from participating on a particular acquisition. In this case, the "neutralization and mitigation" would be to avoid using Bravo in any context, and bid the work with the other architect and engineering partner.

Whether this is an effective mitigation plan may lie in the eyes of the beholder. There have been many cases where this separation is an acceptable solution, but there have also been occurrences where the government CO did not accept this as adequate mitigation, and excluded the contractor from bidding.

Factors to be taken into account by the government CO may include the remaining

(*continued on next page*)

Conflicts of Interest (cont'd):

competitive field; the length, duration, and nature of the relationship between the prime and the conflicted subcontractor; and the nature of the work the conflicted subcontractor had previously performed.

Case 2.
OCI in a Quality Control Context

An agency hires Alpha to perform the inspection and quality control on Bravo Construction Co. Alpha also expresses a desire to subcontract on other, unrelated projects, to Bravo. Though Alpha and Bravo have no current contractual relationship, the potential exists for Bravo to exert its influence on Alpha by offering a "carrot" in exchange for favorable treatment on the quality control and inspection on the original construction contract. Conversely, Alpha could use its power inappropriately to gain favor with Bravo, to the potential detriment of the government.

In this scenario, the potential for conflict is more attenuated, but still exists. Could Alpha faithfully fulfill its duties to the agency while at the same time trying to appease Bravo?

While FAR 9.508 doesn't provide an example like this one, it is always prudent to refer back to the basics. In this case, refer to the basic conflict of interest definition discussed earlier: "a situation in which a person has a duty to more than one person or organization, but cannot do justice to the actual or potentially adverse interests of both parties. This includes when an individual's personal interests or concerns are inconsistent with the best for a customer…."

In this context, it is possible to see how facts could arise that would put Alpha in a bind; having to make a decision that would displease one of its two interests—either the government or Bravo. The facts of this case are slightly analogous to those in a 2006 GAO case involving contractors overseeing each other.[16]

When in doubt, think of the worst case scenario if the media, investigative agency, or other public watchdog group were to portray your facts in the worst possible light. In the above two scenarios, think about opening the paper to read: "AE Firm Prohibited from Working on Government Project Funnels Sensitive Information to Team Partner." Or for Case 2: "Government Contractor Inspector Receiving Funds from Contractor He is Supposed to Inspect."

Are these headlines a bit sensationalistic compared to the fact patterns described above? Perhaps. But government contract law and regulatory compliance can be a hyper-technical field of study. No media outlet, watchdog group, or political inquiry will have the luxury of time and effort to spell out the intricacies and nuances of multiple FAR parts. Instead, these situations will be characterized with vocabulary of the lowest common denominator. The media will use words like "fraud," "unfair," and "biased." These are easier, and more attention grabbing than lengthy descriptions of a "technical violation of FAR 9.5 in which there exists a

(*continued on next page*)

Conflicts of Interest (cont'd):

potential OCI with a mitigation plan that was later deemed to allow a risk that a subcontractor who provided technical assistance to the government may not have objectively carried out his duties in a subsequent acquisition…"

Recent Developments

As comprehensive as these rules are, given the current emphasis on transparency, openness, and accountability in government contracting, it should come as no surprise that the rules may get more attention, with the end result being rules that are tougher, tighter, or more detailed. In May 2009, the Weapons System Acquisition Reform Act was passed,[17] which calls for a revision to the Defense FAR Supplement (DFARS) rules on OCIs[18] to provide uniform guidance and to tighten existing regulations. Among the specific issues the act seeks to revise are lead systems integrators contractors on major defense acquisition programs, as well as situations where there are business units performing systems engineering and technical assistance functions, professional services, etc., where these business units are owned by contractors who simultaneously own other business units competing for work on the same programs. The act will also review situations in which major subsystem contracts are awarded by a prime contractor to affiliates of the same parent company.[19] In March 2008, GAO issued a report indicating better safeguards were needed for DOD contractor employees.[20] This contributed to the FAR Council's recent proposed rule regarding personal conflicts of interest for contractor employees performing acquisition functions.[21] The rule adds significant compliance requirements, including screening, disclosure, and prohibition of certain individuals from performing certain tasks.

Summary

Understanding what OCIs are—situations that allow for bias, unfair advantage, or impaired judgment—is the first step to their early identification. In turn, that identification is the first step in being able to plan, mitigate, and address the potential and actual OCI issues at the earliest stages. Properly considered and mitigated, most OCI issues can be overcome—a number of the sustained protests at GAO that deal with OCI issues reflect cases where OCIs were simply not considered or factored into an evaluation at all.

As continued industry consolidation occurs, along with the government continuing to purchase more services that involve the exercise of discretion and judgment, we can expect to see OCI issues increase in the coming years, making the steps of "identify, avoid, neutralize, and mitigate" that much more important.

---

* - GLENN SWEATT, CPCM, is the general counsel for ECC in Burlingame, California. He is a member of the NCMA Executive Advisory Council and is also a Certified Compliance and Ethics Professional (CCEP). He may be reached at gsweatt@ecc.net.

(*continued on next page)*

Conflicts of Interest (cont'd):

Endnotes

1. *See* **www.recovery.gov** for information regarding contracting activity—including over $275 billion to be distributed in the form of contracts, grants, or loans.
2. *See* **http://dictionary.law.com**, *accessed* August 17, 2009.
3. *U.S. v. Miller*, C.A. Mass. 463 F. 2nd, 600, 602.
4. FAR 9.501.
5. FAR 9.502(b)(1)–(4).
6. *See* "SSR Engineers," GAO B-282244, June 18, 1999.
7. *See* "Leader Communications Inc.," B-298734 and B-298734.2, 2006 US Comp Gen Lexis 200 (December 7, 2006).
8. FAR 9.504(e): "Before determining to withhold award based on conflict of interest considerations, the contracting officer shall notify the contractor, provide the reasons therefore, and allow the contractor a reasonable opportunity to respond."
9. *Source selection information* means any of the enumerated information in FAR 2.101 that is prepared for use by an agency for the purpose of evaluating a bid or proposal to enter into an agency procurement contract if that information has not been previously made available to the public or disclosed publicly.
10. FAR 9.505.
11. FAR 9.505-1(b).
12. *See* FAR 9.504(c).
13. *See* "Johnson Controls Worldwide Svcs. Inc.," B-286714.2 (February 11, 2001); and *Axiom Resource Mgmt v. US,* 78 Fed Cl. 576 (2007). *See* also "Purvis Sys., Inc.," B-298807.3, B-293807.4, August 16, 2004, detailing a case where a protest was sustained where the agency did not consider an OCI created by the awardee's involvement in evaluating the performance of themselves or their competitors.
14. *See* "Science Applications Int'l Corp.," B-293601, B293.601.5, September 21, 2004, where a protest was sustained where the agency failed to consider an OCI. The contract was later allowed to be awarded based on the agency's corrective actions in implementing procedures for independent assessment of potential conflicts and the awardee's ongoing activities in the context of compliance with environmental regulations.
15. *See* FAR 905-2 and 9.508(a).
16. *See* "Greenleaf Constr. Co, Inc.," B-293105.18, B-293105.19, January 17, 2006; the protest was sustained where the Department of Housing and Urban Development failed to consider the OCI that one contractor was receiving payments from another, the activities of which the first contractor was to oversee.
17. S. 454.
18. DFARS 209.570, *et seq*.
19. The secretary of defense was required to make these revisions within 270 days of May 22, 2009, and DFARS 209.5 has been revised as of July 15, 2009.
20. GAO-08-169, "Additional Personal Conflict of Interest Safeguards Needed for Certain DOD Contractor Employees."
21. 74 Fed. Reg. 58, 584 (November 13, 2009).

A Look Back—
Judicial Review of the Retroactivity Provisions of the Fraud Enforcement and Recovery Act of 2009

by
David M. Nadler
and
*David Yang**

[Note: Reprinted from *The Government Contractor* with permission of Thomson Reuters. For more information about this publication please visit www.west.thomson.com

I. Introduction

The Fraud Enforcement and Recovery Act of 2009 (FERA) was passed by Congress and signed into law by the president on May 20, 2009. See P.L. 111-21, 123 Stat. 1617. As has been extensively discussed in the press and elsewhere, FERA significantly expands the liability provisions of the False Claims Act, 31 USCA §3729 et seq., which had been in effect since the statute's last amendments more than 20 years ago in 1986. The impetus for FERA's enactment was Congress' dissatisfaction with a number of court decisions in recent years that Congress believed were overly restrictive of the FCA. Although the decisions were sensible and well-reasoned, Congress believed that they were inconsistent with the purpose of the FCA and failed to protect the Government from contractor fraud. Accordingly, in a departure from the long-standing view that the FCA was not an all-purpose antifraud statute, in passing FERA, Congress dramatically transformed the FCA into an all-frauds statute, by expanding both the universe of defendants potentially liable under the FCA and the types of conduct that are actionable under the statute.

II. Retroactive Application of FERA

Although most of FERA's amendments to the FCA were stated to apply prospectively to cases filed on or after May 20, 2009, Congress specifically intended that one particular set of amendments—those directed at former §3729(a)(2) of the FCA—apply on a retroactive basis. In §4(f)(1) of FERA, Congress provided that the amendments "shall take effect as if enacted on June 7, 2008, and apply to all claims under the False Claims Act that are pending on or after that date." 123 Stat. at 1625. Congress did so in order to legislatively overrule the U.S. Supreme Court's unanimous decision in *Allison Engine Co. v. U.S. ex rel. Sanders*, 128 S. Ct. 2123 (2008), which was issued two days later on June 9, 2008.

Allison Engine involved Navy contracts to build destroyers. The prime contractor shipyards subcontracted with Allison Engine Co. to build electrical generators for the vessels, and Allison Engine, in turn, subcontracted some of the work to a lower-tier subcontractor. The Navy contracts required that the generators be built according to Navy specifications and that every generator be delivered with a certificate of conformance that the unit met applicable contract requirements. In 1995, ex-employees of Allison Engine's subcontractor filed a qui tam action under the FCA.

(*continued on next page*)

A Look Back (cont'd):

Before Judge Thomas Rose in the U.S. District Court for the Southern District of Ohio, the relators contended that Allison Engine and its subcontractors violated former FCA §3729(a)(2), among other provisions, by knowingly submitting invoices for nonconforming generators. See *U.S. ex rel. Sanders v. Allison Engine Co*., 2005 WL 713569 (S.D. Ohio Mar. 11, 2005). Former §3729(a)(2) imposed FCA liability on any person who "knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government." 31 USCA §3729(a)(2).

Judge Rose held that to stake a §3729(a)(2) violation, the relators had to prove that the defendants had presented false claims to the Government, and he granted the defendants' motion for judgment as a matter of law because the relators failed to do so. At trial, although the relators had evidence that the subcontractors had submitted certificates of conformance and invoices for payment to the prime contractor, they had no evidence that any of the invoices had been submitted by the prime to the Navy. Accordingly, although the relators could show that Allison Engine and its subcontractors had been paid with federal funds, they had no evidence that any false claims were presented directly to the Government.

On appeal to the U.S. Court of Appeals for the Sixth Circuit, a divided panel of the court reversed. See *U.S. ex rel. Sanders v. Allison Engine Co*., 471 F.3d 610 (2006). The Sixth Circuit held that liability under former §3729(a)(2) of the FCA did not require proof of presentment or that the defendants had intended to cause a false claim to be paid by the Government. According to the Sixth Circuit, all that was needed for liability to attach under §3729(a)(2) was evidence that the defendants had intended to cause a private entity to pay a false claim using Government funds.

The Supreme Court granted certiorari. Justice Alito, for a unanimous Court, overruled the Sixth Circuit. See *Allison Engine Co. v. U.S. ex rel. Sanders*, 128 S. Ct. 2123 (2008). The Supreme Court held that although the direct presentment of a false claim to the Government was not required to establish a violation of former §3729(a)(2) of the FCA, the Government or a relator must still prove that a defendant made false statements for the purpose of getting a false or fraudulent claim paid by the Government, as opposed to by a private party using Government funds. This was because the statute specifically used the phrase "to get," which the Court held denotes purpose, and also the phrase "paid by the Government."

In response to the Supreme Court's decision, Congress, through FERA, amended former §3729(a)(2) of the FCA. Specifically, the amendments replaced the phrase "to get" with "material to" under former §3729(a)(2) of the FCA, eliminated the phrase "paid or approved by the Government," and renumbered the provision as §3729(a)(1)(B). As amended, §3729(a)(1)(B) now imposes liability if a person "knowingly makes, uses or causes to be made or used, a false record or statement material to a false or fraudulent claim." 31 USCA §3729(a)(1)(B). The amendments effectively removed the intent and presentment requirements from the FCA, thereby extending FCA liability to certain additional situations involving subcontractors and grantees that were not covered under the prior version of the statute. These parties often

(*continued on next page*)

A Look Back (cont'd):

indirectly receive payment from federal funds from a third party, but do not intend to defraud the Government, do not directly present claims to the Government for payment and do not have claims directly paid by the Government, thus relieving them of liability under former §3729(a)(2) of the FCA.

Section 4(f)(1) of FERA, the effective date provision of FERA, indicates that the amendments would "take effect as if enacted on June 7, 2008, and apply to all claims under the False Claims Act that are pending on or after that date." 123 Stat. at 1621. By expressly stating that these amendments were effective as of June 7, 2008, Congress hoped to circumvent the Supreme Court's decision in *Allison Engine* that FCA liability does not attach if the plaintiff cannot show that a defendant made a false statement or record for purposes of getting the Government to pay a false claim. To date, however, courts that have substantively addressed the issue have squarely rejected the Government's attempt to apply the provisions retroactively.

III. Courts Have Held that FERA is Not Retroactive to any Cases that Were Pending on or After June 7, 2008

U.S. v. Aguillon: The first court to address whether the amendments applied retroactively was the U.S. District Court for the District of Delaware. In *U.S. v. Aguillon*, Judge Sue Robinson addressed the retrospective application of the FERA amendments using a two-step analysis promulgated by the Supreme Court in *Landgraf v. USI Film Prods*., 511 U.S. 244 (1994). See *Aguillon*, 628 F. Supp. 2d 542 (D. Del. 2009). Judge Robinson explained,

> First, the court must determine if Congress has unambiguously restricted the statute to prospective application. See *Mathews v. Kidder Peabody & Co.*, 161 F.3d 156, 160 (3d Cir. 1998) (unambiguous restriction to prospective application ends the inquiry). Second, the court must determine if retrospective application of the statute would create "retroactive effects" and if these effects are permissible pursuant to a congressional directive. *See Mathews*, 161 F.3d at 159-61 (only "Congress's **clear** intent to apply the statute retrospectively" will overcome the presumption against applying statutes with retroactive effects (original emphasis)).

Aguillon, 628 F.Supp.2d at 550. Applying this framework, Judge Robinson found that the first prong was satisfied because Congress "has not unambiguously precluded retrospective application of the FCA amendments." She noted that the congressional record states that "'courts should rely on these amendments to clarify the existing scope of False Claims Act liability, [even if the alleged violations occurred before the enactment of these amendments.']" Id. at 551 (bracketed text in original).

However, the court found that the second prong—whether the retrospective application of the amendments would cause retroactive effects—was unmet. The court found that the "application of the FCA amendments would cause retroactive effects because it would increase defendant's liability for past conduct." Id. at 550-51. Although Judge Robinson concluded that Congress had tacitly approved the retrospective application of FERA, she also concluded that

(*continued on next page*)

A Look Back (cont'd):

Congress had "directed against applying the amendments in a way that would cause retroactive effects." See id. (citing 155 Cong. Rec. E1295-03, at E1300 (Congress intended to avoid "extensive litigation over whether the amendments apply retroactively, as occurred following the 1986 False Claims Act amendments.")). Accordingly, because "Congress has not provided the requisite instruction necessary for the amendments to be used to cause retroactive effects," Judge Robinson held that the amendments could not be retroactively applied. Id. at 551.

U.S. v. Sci. Applications Int'l Corp.: Following the *Aguillon* decision, the U.S. District Court for the District of Columbia also held that the §3729(a)(2) amendments did not retroactively apply because of the plain language of §4(f)(1) of FERA. As noted, FERA §4(f)(1), the effective date clause, states that the amendments "shall take effect as if enacted on June 7, 2008, and apply to all claims under the False Claims Act that are pending on or after that date." See 123 Stat. 1617. In *U.S. v. Sci. Applications Int'l Corp*., Judge Richard Roberts held that the plain language of this clause and the legislative intent behind the provision indicate that the term "claims" meant claims for reimbursement or payment pending on June 7, 2008, and not court cases.

Judge Roberts first determined that the plain meaning of the phrase "claims under the False Claims Act" was a reference to the word "claim" as it was used under the FCA. Judge Roberts concluded that because statutory definitions control the meaning of statutory language, the definition of the word "claim" in the amendments controlled its meaning in the retroactivity provision, §4(f)(1) of FERA. See *SAIC*, 653 F. Supp. 2d at 107. Therefore, because "claims" is defined as a "demand for money or property" under the FCA, it refers to claims for payment or reimbursement and not to legal actions. Id.

As further support, Judge Roberts noted that FERA specifically used "cases" to refer to legal cases, thereby further indicating that the word "claim" did not also refer to court cases. Section 4(f)(2) of the amendments states that "section 3731(b) of title 31, as amended . . . shall apply to cases pending on the date of enactment." See *SAIC*, 653 F. Supp. 2d at 107 (citing 123 Stat. at 1625 (emphasis added)). Judge Roberts stated, "Surely, had Congress intended the retroactivity of subsection 4(f)(1) to be measured by 'cases,' it would have said so as it did in subsection 4(f)(2)." Id. Judge Roberts rejected the Department of Justice's view that "claims under the False Claim Act" somehow meant "legal claims," even though the most direct and straightforward read of the phrase would mean claims as defined *under* the statute. Id. Likewise, Judge Roberts rejected the Government's contention that FERA's legislative history supported the Government's interpretation. He noted that the Senate report for FERA used the term "claims" to refer to requests for payment, but the term "cases" to refer to legal actions under the FCA. Id. Because none of the claims for payment at issue in the case were pending as of June 7, 2008, Judge Roberts held there was no basis for retroactively applying the amendments. Id. at 106–07.

Since the *SAIC* decision, two other district courts have followed suit. See *U.S. ex rel. Parato v. Unadilla Health Care Ctr., Inc.*, No. 5:07-CV-76(HL), 2010 WL 146877, at *4 n.4

(*continued on next page*)

A Look Back (cont'd):

(M.D. Ga. Jan. 11, 2010); *U.S. ex rel. Sanders v. Allison Engine Co*., Nos. 1:95-cv-970, 1:99-cv-923, 2009 WL 3626773, at *4 (S.D. Ohio Oct. 27, 2009). And, to date, one appellate court has already applied the *SAIC* decision to hold that the §3729(a)(2) amendments are not retroactive. In *Hopper v. Solvay Pharms., Inc*., the U.S. Court of Appeals for the Eleventh Circuit, relying on Judge Robert's analysis, explained,

> In May 2009, Congress enacted the Fraud Enforcement and Recovery Act, which amended 31 U.S.C. §3729(a)(2) (2003), replacing the words 'to get a false or fraudulent claim paid or approved by the Government' with the words 'material to a false or fraudulent claim.' 123 Stat. at 1621. Section 4(f)(1) of the Act provides that this change 'shall take effect as if enacted on June 7, 2008, and apply to all claims . . . that are pending on or after that date.' Id. §4(f)(1), 123 Stat. at 1625 (emphasis added). We interpret the word 'claim' in section 4(f) to mean 'any request or demand ... for money or property,' as defined by 31 U.S.C. §3729(b)(2)(A) (as amended May 2009). While this case was pending on and after June 7, 2008, the relators do not allege that any claims, as defined by §3729(b)(2)(A), were pending on or after June 7, 2008. Therefore, we conclude the Fraud Enforcement and Recovery Act does not apply retroactively to this case. See *United States v. Sci. Applications Int'l Corp*., No. 04-1543, 2009 WL 2929250, at *13-14 (D.D.C. Sept. 14, 2009) (concluding Fraud Enforcement and Recovery Act not retroactive because no claims were pending on or after June 7, 2008).
>
> *Hopper*, 588 F.3d 1318, 1327 n.3 (11th Cir. 2009).

U.S. ex rel. Sanders v. Allison Engine Co.: The most significant contribution to the retroactivity debate to date has been the district court's most recent decision in *Allison Engine*, on remand from the Sixth Circuit after the Supreme Court's June 9, 2008 decision. *U.S. ex rel. Sanders v. Allison Engine Co*., Nos. 1:95-cv-970, 1:99-cv-923, 2009 WL 3626773 (S.D. Ohio Oct. 27, 2009). After FERA was enacted on May 20, 2009, the defendants filed a motion to preclude the retroactive application of FERA's amendments to former §3729(a)(2) of the FCA, or to declare that a retroactive application of FERA is unconstitutional. Id. at *2. On Oct. 27, 2009, Judge Rose granted the defendants' motion, and in doing so, gutted any remaining argument that the amendments to former §3729(a)(2) could ever retroactively be applied as of June 7, 2008, regardless of whether there were claims for payment pending as of that date.

First, following Judge Roberts' analysis in *SAIC*, Judge Rose held that the plain language of the retroactivity clause in §4(f)(1) of FERA most naturally lends itself to an interpretation that "claims under the False Claims Act" means claims for payment as opposed to legal actions. Id. at **3-4. However, Judge Rose did not stop there. In addition to finding that the retroactivity language in §4(f)(1) of FERA does not compel a retroactive application of the

(*continued on next page*)

<u>A Look Back (cont'd):</u>

statute, Judge Rose went on to hold that any retroactive application of FERA would violate the Ex Post Facto clause of the U.S. Constitution. Id. at **4–10. It is this portion of Judge Rose's opinion that completely destroys any attempt by the Government or relators to evade the Supreme Court's decision in *Allison Engine*.

Judge Rose began by observing that although Congress may enact laws with retroactive application, the laws must certainly conform to constitutional limits, including the Ex Post Facto Clause of the U.S. Constitution, which prohibits the enactment of laws that punish individuals for past acts. See U.S. Const. Art. I, §9, cl. 3. Judge Rose explained that the prohibition applies fully to civil laws that are punitive in intent or application:

> An ex post facto law may inflict penalties on a person or it may inflict pecuniary penalties. Id. Traditionally, criminal statutes have been examined for violation of the Ex Post Facto Clause. However, civil statutes may also violate the Ex Post Facto Clause. *Landgraf v. USI Film Products,* 511 U.S. 244, 281, 114 S. Ct. 1483, 128 L.Ed.2d 229 (1994); *Louis Vuitton S.A. v. Spencer Handbags Corp.,* 765 F.2d 966, 971-72 (2d Cir.1985) (the punitive nature of the treble damages provision in the Trademark Counterfeiting Act of 1984 could implicate ex post facto concerns).
>
> The threshold question in an ex-post-facto analysis is whether the legislature intended to impose punishment when it enacted the law. *Smith v. Doe,* 538 U.S. 84, 92, 123 S. Ct. 1140, 155 L. Ed. 2d 164 (2003). If the legislature intended to impose punishment, the inquiry ends and the law violates the Ex Post Facto Clause. *Id.* However, if the legislature's intention was to enact a civil and nonpunitive regulatory scheme, a court must further examine whether the statutory scheme is "so punitive either in purpose or effect as to negate [the State's] intention to deem it 'civil.'" Id. (quoting *Kansas v. Hendricks*, 521 U.S. 346, 361, 117 S. Ct. 2072, 138 L. Ed. 2d 501 (1997)).
>
> See *Allison Engine*, 2009 WL 3626773, at *5.

Judge Rose started with the threshold question of whether Congress intended to impose punishment when it enacted the statute. Id. at *5. He noted that if Congress' intention in enacting a statute is to impose punishment, then the retroactive application of the statute would violate the Ex Post Facto Clause because it would penalize acts that were not punishable before the statute's passage. Id. As to the FCA's punitive purpose, Judge Rose found that Congress, in debating the passage of the FCA, intended the FCA to punish fraudulent conduct. Id. at *6. Judge Rose thoroughly recited a litany of congressional statements attesting to the punitive nature of the FCA to conclude that the statute was in fact enacted for a punitive purpose. Judge Rose also found that Congress' punitive intent was clearly captured in the FCA's imposition of treble damages for a violation of the statute. He stated that "'[t]he very idea of

(*continued on next page*)

A Look Back (cont'd):

treble damages reveals an intent to **punish** past, and to deter future, unlawful conduct, not to ameliorate the liability of wrongdoers.'" Id. at *7 (quoting *Texas Indus. v. Radcliffe Materials, Inc.*, 451 U.S. 630, 639 (1981) (emphasis in original)). Accordingly, Judge Rose held that Congress intended to impose punishment when it enacted the FCA and, as such, the statute cannot be retroactively applied under any circumstances, pursuant to the Ex Post Facto clause of the Constitution. Id.

Next, Judge Rose held that even if it was not clear that Congress intended the FCA to serve a punitive role, the FCA still can not be applied retroactively because the statute is clearly punitive in purpose and effect. See *Allison Engine*, 2009 WL 3626773, at *8. He noted that a civil statute may still be unconstitutional pursuant to the Ex Post Facto clause if its regulatory scheme is so punitive either in purpose or effect as to negate its civil nature and transform the statute into a de facto criminal penalty. Id. In this regard, Judge Rose concluded that the retroactive application of FERA's amendments to the FCA would violate the Ex Post Facto clause because they would penalize past actions that were not punishable before the amendments' enactment. Id.

To demonstrate that a civil remedy has been transformed into a criminal penalty, Judge Rose explained that there must be "the clearest proof" to override legislative purpose deeming the statute non-punitive. See *Allison Engine*, 2009 WL 3626773, at *8. Judge Rose looked to the Supreme Court's decision in *Kennedy v. Mendoza-Martinez*, 372 U.S. 144, 168 (1963), in which the Court provided a seven-factor test for analyzing whether a statute is punitive or regulatory: (1) whether the sanction involves an affirmative disability or restraint, (2) whether the sanction has historically been regarded as a punishment, (3) whether the sanction is implicated only by a finding of scienter, (4) whether operation of the sanction promotes the traditional aims of punishment—retribution and deterrence, (5) whether the behavior to which the sanction applies is already a crime, (6) whether an alternative purpose with a rational connection to the sanction may be assigned to it, and (7) whether the sanction is excessive in relation to this alternative purpose. Judge Rose determined that the balance of the factors militated towards finding that the retroactivity provisions of FERA violates the Ex Post Facto clause. See *Allison Engine*, 2009 WL 3626773, at *10.

In analyzing the seven *Kennedy* factors, Judge Rose concluded that the FCA has a punitive purpose or effect. First, as noted, Judge Rose found that the FCA has historically been regarded as a punitive statute. See *Allison Engine*, 2009 WL 3626773, at *8. Second, because FCA actions also require scienter demonstrating that a knowing fraud occurred, Judge Rose concluded that the FCA's sanctions are punitive in nature and effect. Id. Third, Judge Rose found that the FCA promotes retribution and deterrence, which weighs further in favor of a punitive characterization. Id. at * 9. Finally, Judge Rose found that the FCA's treble damages provision is excessive because it can, and often does, result in damages that many times exceed the amount necessary to compensate the Government for fraud. Id. Accordingly, the court held that these factors support a finding that the FCA has a punitive purpose or effect. Id.

(*continued on next page*)

A Look Back (cont'd):

Judge Rose determined that the remaining three factors in the ex post facto analysis support a finding of civil effects: (1) the FCA's sanctions do not approach imprisonment, (2) behavior prohibited by the civil version of the FCA may also be punished by the criminal version of the statute, and (3) the FCA serves a compensatory function as well as a punitive one. See id. at **8-9. But he held that they did not supplant the four other factors that indicated that the FCA's regulatory scheme is punitive in purpose and effect. See *Allison Engine*, 2009 WL 3626773, at *10. Particularly significant to Judge Rose's decision is the FCA's allowance for treble damages, which he found constitutes an excessive remedy that clearly and forcefully highlights the punitive aspects of the statute. Id. at *7, *9. Therefore, Judge Rose concluded that both congressional intent and an analysis of the FCA's punitive intent and effects demonstrate that any retroactive application of the FERA amendments would amount to an illegal ex post facto law under the Constitution. Id. at *7, *10.

IV. Conclusion

To this day, the U.S. continues to assert that FERA should be retroactively applied, even though all courts to date that have substantively addressed the issue have rejected the argument. The courts have correctly concluded that the plain language of FERA renders any retroactivity applicable only to claims for payment or reimbursement that were pending with the Federal Government as of June 7, 2008, and not to court cases. Moreover, and absolutely fatal to the Government's continuing arguments, is Judge Rose's well-reasoned and well-supported decision in *Allison Engine* that the FCA is a punitive statute, and therefore, Congress may not use the blunt instrument of civil fraud liability, which often results in serious monetary and administrative sanctions, to punish conduct that was not prohibited at the time it occurred. The law, to say nothing of fundamental fairness, demands at least this much. We can expect that the issues raised in Judge Rose's decision in *Allison Engine* will be appealed to the Sixth Circuit and, from there, will work their way up to the Supreme Court once again.

- This **Feature Comment** was written for *The Government Contractor* by David M. Nadler, a partner, and David Yang, an associate, with Dickstein Shapiro LLP.