

# ***THE CLAUSE***

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## The President's Column

As summer approaches, I marvel at how quickly this year is passing! I recently represented our Association at the annual reception honoring the BCA judges, which we host jointly with the Federal Bar Association. Shortly before submitting this column, several of our members and I attended the June Colloquium that the BCABA co-hosted with the George Washington University (GWU) Law School Government Procurement Law Program. At both co-hosted programs, and at our June quarterly Association meeting, there were insights and perspectives shared, and I was struck by how many excellent opportunities our members have through the BCABA to further effective and best practices in contract administration issues and dispute resolution.

Along those lines, I'm pleased to invite our readers to reserve dates in September and October for two upcoming programs we sponsor in Washington, D.C. On September 22, we will again host *Practice Skills for New Practitioners Before the Boards*. The program is generally open to members of our Gold Member affiliates (law firms and corporations), as well as government attorneys. October 20th is the date for our *Annual Meeting* at the Army-Navy Club. While the formal agenda will be distributed and posted on our website in early September, I can confirm now that we are looking at *Recent Key Developments* and *Board/BCA Practice Evolution* among the topics to be presented in this 8 hour, CLE-certified program.

As I recount our completed and upcoming Association activities, I see a broad cross section of participation by some of the most respected professionals established in government contracts practice – particularly in the D.C. area. The Board of Governors and officers join me in inviting *each* reader's active participation with your Association. So even - and especially - if you're new in town, or new in practice, or outside the D.C. area, and interested in becoming more active but unsure how to initiate involvement, call me or any of the officers or Board members listed and we'll be happy to get the ball rolling! In addition to making sure you participate in person or by phone at meetings and programs, we'll offer opportunities to get involved as we track pertinent legislation, co-host additional colloquia with GWU's Government Procurement Law Program, work with other allied practice area bar associations, and offer authors the opportunity for expedited publication in *The Clause*. In the meantime, I wish you all a great summer, and look forward to seeing many of you in the fall!

Elaine Eder

## Editor's Column

I normally make a modest effort to keep my personal opinions out of this column, but inasmuch as I am writing this during President Reagan's state funeral, perhaps a personal opinion can be pardoned. President Reagan was in my partisan, biased opinion, our third greatest President--far and away better than any of the others I have lived under, even if you include FDR.

He restored faith in America, in democracy, in capitalism, in freedom. That is why his detractors still hate him. *He took the ball away from them.* He made us love ourselves again. I will never forget how he told Vietnam veterans during the 1980 campaign that our war "was, in fact, a noble cause." No one else had ever said that. He told the Soviet Union and its many adherents that their evil system was headed for history's ash heap, and soon they were, despite an utter failure to appreciate that fact by many of our opinion making elites. Ronald Reagan forever turned America around. This is why some of those who pretend to like him now will always hate him in their heart of hearts.

A semi-personal anecdote follows: Procurement, particularly Defense procurement, was heavily criticized during Reagan's tenure. I was the chief attorney for one of the less outstanding government buying commands in that era, and some of those criticisms had merit. And yet, when I came under pressure a couple of times from some of our corrupt contractors, Casper Weinberger's DOD hotline came to the rescue like the Seventh Cavalry. Casper Weinberger was hired by Ronald Reagan.

CICA was passed while Reagan was President. Within two years after the enactment of that law, the same agency went from competing approximately zero percent of its contracts to competing most of them, a cultural change of tectonic proportions. These changes were not easily enforced, and yet the job eventually got done. Reagan's positive legacy will be with us for a long time.

In this issue we have two excellent articles by two long time BCABA officials. But a word of caution is necessary. These are advocate's positions. They are not a substitute for agency counsel's advice. In particular, the contracting officer "Do's" in Jim McAleese's article need to be scrutinized with care.

Hugh Long

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## BCABA Dues Procedures

- Dues notices are emailed on or about August 1<sup>st</sup>.
- Annual dues are \$30 for government employees, and \$45 for all others.
- Dues payments are due NLT September 30<sup>th</sup>.
- There are no second notices.

- BCA judges are exempt from paying dues, but are invited to do so.
- Members who fail to pay their dues by September 30<sup>th</sup> do not appear in the Directory.
- Annual Directories are distributed in October.
- The BCABA Constitution and By-laws are posted on our web site: [www.BCABAR.org](http://www.BCABAR.org).

## **Creation of Safe Harbors of Ethical Conduct in Major DoD Procurements to Speed the Fielding of Transformational Technologies for U.S. Warfighters**

by

James McAleese, Esq.

It is fundamental that all actions must have both a compelling National Security case for the benefit of U.S. National Security, and also a compelling business case for the benefit of the defense contractor shareholders. This dual benefit, for both National Security and shareholders alike, has been at the heart of both DoD and its defense industrial base for the past fifty years. The vast majority of uniformed and civilian government employees, along with their contractor counterparts, have made major personal and professional sacrifices, often over ten, twenty, or sometimes thirty years, for the benefit of our long-term National Security. It would be absurd to suggest that government personnel, from the program level to the General/Flag level and Secretariat level, are driven by anything but the strong desire to support U.S. National Security.

However, there have been a recent series of isolated, highly controversial public scandals with respect to several major defense acquisition programs. It is critical to address these isolated issues immediately to create “safe harbors” of conduct, so that both government and contractor personnel can work as a single cohesive team to speed the fielding of critical technologies for both the War on Terror and DoD’s fundamental Transformational Initiatives.

Responding to a government investigation over possible procurement improprieties is costly and diverts a defense contractor’s attention away from the primary objective of supporting the National Security Customer. However, DoD has a critical interest in preserving the integrity of the federal procurement system, to ensure strong public confidence in government expenditure of the \$2 Trillion annual federal budget. It is therefore within the mutual interests of both the government and contractors to create “safe harbors” of future conduct.

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To establish perspective, this article identifies examples where appearances of procurement improprieties have arisen in the recent past. This illustrates scenarios that could give rise to potential allegations, ranging from mere “appearances of impropriety;” to personal conflicts-of-interest; to the voiding of tainted contracts; to potential civil claims by the government against contractors; and ultimately to potential criminal charges that could be brought by the government against contractor personnel and their corporations, as well as, government personnel. This is followed by an overview of laws that protect the integrity of the federal procurement system. Finally, this article provides a “safe harbor” listing of the “Do’s and Don’ts,” to avoid even the appearance of impropriety in major defense procurements. As before, creation of safe harbors of conduct between contractor and government personnel is key to achieving the dual challenges of winning the War on Terror, while introducing both the cultural changes, and technological advances, to maximize lethality, combat capability, and Warfighter survivability for DoD’s Transformation.

## **I. Recent Claims Of Procurement Improprieties**

Claims of alleged procurement improprieties arise under several different scenarios. A wide array of prohibited conduct is covered by statutory and regulatory procurement restrictions. To avoid inadvertent procurement improprieties, both government employees and contractors must know these fundamental rules. Examples of recent appearances of procurement improprieties are listed below. We have identified a range of potential issues that trigger the “appearance of impropriety” in procurements; bases for contract cancellation; bases for civil claims by the government; and bases for criminal enforcement by government as an option of last resort.

1. Misuse of Another Company’s Trade Secrets. On July 24, 2003 the Air Force announced the reassignment of \$1 billion worth of launches from Boeing’s Delta IV rocket program to Lockheed Martin. The Air Force also suspended three Boeing Divisions from future government contract competitions, pending corrective Boeing action. The Air Force concluded that Boeing was in possession of proprietary Lockheed documents during the 1998 Evolved Expendable Launch Vehicle (EELV) source selection.

Most recently, the Department of Justice is publicly rumored to be contemplating asserting civil damages against Boeing as a result of the alleged improper conduct during the EELV source selection. These damages potentially range from \$100M - \$170M in projected USAF program costs to shift launches to Lockheed Martin, which could arguably be trebled (tripled) to \$300M - \$500M, if applied in a controversial offensive

manner. Generally, civil damages have traditionally been limited to actual overpayments to the offending contractor, and have not included reimbursement of additional program costs incurred by the government to competing contractors to maintain competitive balance after a procurement impropriety.

2. Improper Employment Discussions. Boeing announced its termination of its Chief Financial Officer and another senior Boeing management official, (who had previously served with the USAF), for allegedly violating company policy governing employment discussions with government officials during the \$17B USAF tanker lease negotiations.

3. Appearance of Conflicts of Interest. On March 27, 2003, Richard Perle, Chairman of the Defense Policy Board, resigned his chairmanship in the face of "appearance of impropriety" and potential conflict-of-interest allegations. As chairman, Mr. Perle advised the Pentagon on policy and National Security matters. Public allegations were made by some Congressional members, that Richard Perle's representation of bankrupt Global Crossing, Ltd., in the proposed sale of the company to Singapore Technologies Telemedia Pte., created an appearance of impropriety because of the potential that Global Crossing might benefit from undue influence and beneficial DoD treatment as a result of Mr. Perle's strong public support for the Administration to initiate Operation Iraqi Freedom. Public evidence strongly suggests that the representation was legal, but still created the appearance of a conflict-of-interest.

4. Submitting False Statements to the Government. In 1999, Samtech Research, a defense contractor, concealed the identity of a company owner, by using alias names, who had previously been debarred from future contracts by the government. This allegedly resulted in other Samtech employees certifying falsely that no principal of the company was currently suspended or debarred from government contracting, violating the criminal False Statements Act. (18 USC §1001).

5. Failing to Disclose Government Overpayment. The owner of Tech Data Management, received an eight month prison sentence for improperly concealing a \$584,000 inadvertent overpayment by the U.S. Army. The owner allegedly failed to inform the Army of the inadvertent overpayment, and then used a portion of the overpayment money for personal matters, creating a clear intent to conceal the overpayment and divert U.S. Taxpayer monies. The owner was charged with converting government property for personal use in violation of Embezzlement of Government Property statute. (18 USC §641).

6. Gratuities/Bribery. A U.S. Navy electrical foreman was fined \$10,000 and sentenced to 36 months probation for illegally accepting \$9,300 in gratuities from a government contractor. The foreman had assisted a government contractor, McCaffrey Electric Inc., in obtaining a Naval Air Warfare Center (NAWC) contract. The government employee had decision making authority over certain NAWC base maintenance contracts. He was charged with violating the Federal Anti-Bribery Act (18 USC 201).

7. Kickbacks to Prime Contractors from Subcontractors. In October 2003, the Department of Justice filed a civil complaint against Dynamics Research Corporation (DRC), which has a strong history of supporting USAF and DoD programs, for penalties and damages incurred by the government due to an alleged \$10 million kickback scheme of two former DRC Officers. The government's complaint alleged that DRC violated the Anti-Kickback Act of 1986 by allegedly engaging in a scheme of kickbacks and overcharges for computer systems.

## **II. Federal Law Governing Procurements**

While not exhaustive, the following represents a list of the key procurement integrity principles that are imposed upon both contractors and government employees:

1. Preventing Even the Appearance of Impropriety. Contractors and government employees should always strive to avoid even the appearance of impropriety, including the appearance of any personal Conflict of Interest. The general test is whether a "reasonable person in possession of the relevant facts" would see anything wrong or improper in the conduct. (Office of Government Ethics, 5 CFR 2635.502; Joint Ethics Regulation DOD 5500.7-R).

2. Avoiding Civil, and Criminal, Conflicts of Interest. A personal conflict of interest arises when a government employee's relationships compromises the integrity of the procurement system. A personal conflict of interest is separate and distinct from an organizational conflict of interest, where potential bias can often be mitigated by firewalls or non-disclosure agreements. There is also a criminal statute which prohibits government employees from participating personally and substantially in any government matter that may affect the employee's financial interests or those financial interests imputed to him or her. (18 USC §208),

3. Bans on Gifts From Contractors. Generally, government employees are prohibited from soliciting or accepting significant gifts from government contractors. Regulations also prohibit gifts given by contractors to influence performance of official duties, or frequent gifts that create the appearance of use of public office for private gain. The primary rule is to avoid even the appearance of bias, favoritism, or impropriety in any federal procurement. If there appears to be favoritism toward one particular contractor, the integrity of the procurement process will have been compromised due to potential loss of public confidence in the integrity of the procurement process. (Office of Government Ethics 5 CFR 2635.202(c)).

4. Prohibition Against Employment Discussions Without Recusal by Government Decision Makers. A government employee is prohibited from working on any matter that has a direct impact on the financial interests of his/her prospective employer without first receiving a written waiver. Criminal sanctions include up to 1-year imprisonment or, if willful, 5 years, and a possible fine of \$50,000 for each violation. (Financial Conflict of Interest, 18 USC §208, Office of Government Ethics 5 CFR 2635.402. This is also reflected in the Procurement Integrity Act, 41 USC §423).



5. “Revolving Door” Restrictions. Former government employees are also prohibited by criminal statute from representing a contractor on specific programs with which they were involved while still employed by the government. This includes a lifetime ban on communications that are intended to influence the government on a particular matter, where the former government employee participated personally in matter in his or her official capacity. There is also a 2-year ban on communications by former government employees, who knew or should have known that the matter was pending under his or her official responsibility during the year prior to leaving government employment. There is also a 1-year general ban, imposing a “cooling off” period for “senior employees,” that restricts substantive communications with the government employee’s former agency on behalf of a contractor. (Post-Employment Restrictions, 18 USC §207)

6. Misuse of Official Position. government employees are precluded from using their positions or government title “in a manner that is intended to coerce or induce another person, including a subordinate, to provide any benefit” to third parties. (Office of Government Ethics, 5 CFR 2635.702)

7. Covenant Against Contingency Fees.  
As a matter of public policy, contractors may not pay contingency fees for obtaining government contracts because of the potential for disguised bribes or kickbacks to government officials indirectly through contractor consultants. There is a narrow exception, allowing contingency fees to be reimbursed to the contractor from the government for bona fide employees/firms who specialize in marketing and consulting, so long as they do not seek to assert improper influence upon the government. (Contingency Fees, FAR Subpart 3.4)

8. Procurement Integrity Act Prohibitions Against Employment Offers, or Seeking of Proprietary or Source Selection Information Prior to Contract Award. The Procurement Integrity Act generally prohibits contractors from knowingly (1) having employment discussions with procurement officials during competitions, unless the official recuses himself or herself; and (2) making any effort to improperly obtain access to either proprietary competing contractor information or to government source selection information during a competition. Violations of the Procurement Integrity Act are subject to a variety of penalties, including criminal prosecution, civil claims, and administrative actions. (Procurement Integrity Act, 41 USC §423).

9. The civil False Claims Act. This Act imposes civil monetary damages of treble damages (triple the amount of actual government overpayment, plus a \$5,000 - \$10,000 civil penalty per false claim submitted) on any person who knowingly submits a false or fraudulent claim for payment to the United States government. (31 USC §3729). As a general rule, civil damages are brought against contractors for billing the government for the contracted product, and then actually delivering a lesser/substandard item; or damages can be asserted for actual payments to contractors where the contractor never should have been awarded the contract due to improper conduct in the award. The

government generally elects pursuit of treble (triple) civil FCA damages against the contractor, rather than criminal prosecution of individual contractor employees, because of the lower burden of proof for the government, greater recovery of damages to benefit of government, and greater financial deterrent to contractors to police employees. Subcontractors may also be held liable for submitting false claims, where the subcontractor submits false information to prime contractors with the expectation that the prime contractor will then bill the government based upon the subcontractor's false information. (Ebling v. United States, 355 U.S. 907 (1957).)

10. The criminal False Claims Act. This Act makes it a crime to knowingly submit a false claim for payment to the government with actual personal knowledge of the falsity of the claim. Criminal false claims occur when a contractor knowingly attempts to be paid by the government for a false or fabricated claim. (18 USC §287) As noted above, subcontractors may also be subject, under both the civil, and criminal, False Claims Act standards, for submission of false claims to prime contractors, with the expectation that the claim will be submitted by the prime contractor to the government.

11. The criminal False Statements Act. This criminal statute prohibits a party from knowingly making any false statement (or material omission) to the government. (18 USC §1001). Violation of the False Statement Act does not require the government to have relied upon the false statement or even have knowledge of the false statement.

12. Prohibitions of Government Employee Disclosure of Source Selection Information Under The Trade Secrets Act. This criminal statute prohibits government employees from disclosing "to any extent not authorized by law" specific categories of information, including confidential and trade secret data of any third party. (18 USC §1905)

13. Prohibitions Against Subcontractor Kickbacks Under the Anti-Kickback Act. This Act prohibits subcontractors from offering any form of a kickback to prime contractors in the inducement of a subcontract from the prime contractors. It also prohibits the prime contractor from soliciting any form of a kickback from the subcontractor in exchange for the subcontract. This has both potential contractual remedies, civil damages remedies, and also criminal penalties, as a result of a violation of the Anti-Kickback Act. (41 USC §51)

### **III. The Do's and Don'ts of Procurement Integrity**

While not exhaustive, the following explanation of the "Do's and Don'ts" serves as a useful tool for both government and contractor personnel at all levels. The "Do's" include those activities that a contractor may properly engage in to promote its business with the government. Because every situation is unique, one should always consult with his or her counsel whenever there is a question that raises even the appearance of impropriety. This listing is provided for general guidance only and must not be relied upon as legal advice.

**Contractor Do's:**

Request government personnel to serve in an unpaid capacity on contractor Management Councils, Business Process Reengineering Teams, Integrated Process Teams or similar entities.

Serve on Government Integrated Process Action Teams or similar entities.

Participate in market surveys for products and services as described in FAR Part 10. This can include providing product demonstrations or permitting the government to "test drive" a product for a reasonable period of time.

Upon government request, provide existing contractor product specifications; or in situations where contractor acts in capacity as a defense industry representative, assist government in the preparation, refinement, or coordination of specifications or statements of work (as permitted by FAR 9.505-2(a)(1)(i) and (ii)).

Engage in public exchanges with the government to enhance the understanding of program requirements and industry capabilities before government's issuance of Solicitations. (responding to draft SOWs and draft RFPs). (FAR 15.201).

Submit unsolicited proposals as contemplated by FAR Subpart 15.6, where the contractor has identified innovative solutions to current government processes, or new innovative solutions to unidentified government requirements.

Communicate freely with Members of Congress. (Subject to registration requirement of Lobbying Disclosure Act, 2 U.S.C. §1601.)

Ask former government personnel who are employment candidates to obtain and provide an ethics opinion from their former agency regarding the propriety of their potential employment as a pre-condition to their employment.

Have systems in place that require company officers and employees to comply with the highest ethical standards, and that make individuals accountable for failures to do so.

Become thoroughly familiar with the Government-Wide Ethics Regulations (Title 5 of the Code of Federal Regulations) and the DoD Joint Ethics Regulation (DoD Directive 5500.7-R).

Provide employees with periodic training in procurement ethics.

Comment upon proposed changes to the FAR and Agency Supplements in accordance with FAR 1.501-2.

Sponsor or participate in public meetings to discuss possible changes to the FAR or agency supplements.

Be part of industrial associations that present the government with industry views on acquisition policy matters.

Participate in trade shows where the latest advances in products and technology are demonstrated.

Market products and services listed on GSA schedule contracts as contemplated by those contracts.

Write articles for scientific, technical, academic and professional publications describing new products or services or comment critically on government procurement policies.

**Contractor Don'ts:**

Offer gratuities to government personnel (except as permitted by the Government-wide Ethics Regulation and the DoD JER).

Seek or obtain source selection information or competing proposal information (except as permitted under the Procurement Integrity Act, 41 USC §423, and FAR 3.104).

Seek special favors or consideration directly or indirectly from government officials.

Make any representation to anyone that the contractor can achieve certain results because of its relationship with government personnel.

Take any action that would compromise a government official's ability to faithfully and properly perform the functions of his/her position.

**Government Employee Do's<sup>1</sup>:**

Recognize that contractors are a part of the Acquisition Team (as formally acknowledged by FAR 1.102(c)) and treat them accordingly.

Serve in an unpaid capacity on contractor Management Councils, Business Process Reengineering Teams, Integrated Process Teams or similar entities.

Conduct market surveys for products and services as described in FAR Part 10, with an emphasis upon obtaining data from contractors on the availability of commercial items to satisfy agency needs. Market surveys can properly involve product demonstrations and the government "test driving" of a specific product for a reasonable time. (Market surveys require the disclosure of basic agency requirements to survey participants).

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<sup>1</sup> Before engaging in these activities it is best to discuss them with agency counsel. Hugh Long

Transparently request contractors or contractor associations to provide or assist in preparing specifications or statements of work (as permitted by FAR 9.505-2(a)(1)(i) and (ii)).

Speak before contractor symposia, workshops, conventions etc. on acquisition policy issues or general agency requirements.

Request contractors to speak and participate in government sponsored acquisition conferences, workshops, symposia, etc.

Attend industry trade shows, ship launches, and aircraft roll-out ceremonies.

Request contractors to serve on government business process re-engineering, Integrated Product Teams or similar entities intended to improve or ensure the quality of government procedures and processes that impact contractors.

Ensure that contractors receive impartial, fair and equitable treatment (consistent with the requirements of FAR 1.606-2).

Become thoroughly familiar with and comply with the Government-wide Ethics Regulation, found in Title 5 of the Code of Federal Regulations or the DoD Joint Ethics Regulation (JER), 5500.7-R.

As appropriate, discuss proposed changes to the FAR and agency supplements publicly and transparently (in accordance with FAR 1.502 and 1.503).

Discuss acquisition policy issues with industry associations and solicit the views of such associations when formulating acquisition policy.

Subject to specific agency clearance requirements, write articles on acquisition issues for contractor publications, as well as for general circulation, professional or academic publications.

Be familiar with the FAR provisions concerning organizational conflicts of interest (FAR Subpart 9.5) and take prompt and fair action to avoid, overcome, or mitigate the effects of a potential OCI on any competing contractors. (This is in addition to avoidance of personal conflicts of interest in FAR Part 3).

**Government Employee Don'ts:**

Provide source selection information or proprietary proposal information to any contractor (except as narrowly permitted by the Procurement Integrity Act, 41 USC §423, and FAR 3.104).

Provide special favors or consideration to any contractor either directly or indirectly.

Place personal gain or privilege above the faithful performance of their duties as government officials.

Retaliate or discriminate against a contractor who files a protest or claim against the government.

Engage in any conduct that is prohibited by the Government-wide Ethics Regulation and the DoD JER.

#### **IV. Conclusion**

The integrity of the government and its contractors in support of our strong National Security cannot be compromised. A fair procurement process that encourages healthy competition, and rewards innovation, ensures that our Warfighters have the decisive advantage on the battlefield. Procurement integrity problems, whether intentional or inadvertent, not only detract from the ability to drive leap-ahead advances in lethality, combat capability, and survivability for American troops in combat, but also fosters public distrust of our government.

It is impossible for all government and contractor personnel to fully understand all of the intricacies of the elaborate, and constantly evolving, federal procurement process at all times. However, if both government and contractor personnel always ensure that all actions have both a compelling National Security case for the Customer, and a compelling business case for the shareholders, and adopt these safe harbors (with advice from counsel at key points), we can work as one cohesive Team to drive advances in critical technologies to support both the War on Terror and DoD's Transformation.

# Were You Reasonable?

by

Peter A. McDonald\*

CPA, Esq.

McGladrey & Pullen LLP

## **I. Introduction**

In response to the massive audit failures associated with various financial scandals (*Enron, Worldcom, Qwest, Global Crossing, Arizona Baptist*, to name a few), Congress enacted the Sarbanes-Oxley Act. This Act was the most comprehensive legislation to affect the accounting industry since the 1930s. Sarbanes-Oxley also required the Securities & Exchange Commission (SEC) to issue regulations implementing the goals of the Act. Many of these new rules have now become final.

Over the past year, lawyers and accountants have spent a considerable amount of time familiarizing themselves with the new statutory and regulatory requirements. Much of the focus by attorneys has been on the so-called ethical dilemma, while the accounting firms have been concerned with the new §404 requirements, i.e., the auditor's opinion regarding management's representation of its internal controls.

It is not the intent of this article to review all that Sarbanes-Oxley mandates. There is an over abundance of resource materials readily available elsewhere for those seeking basic Sarbanes-Oxley information. Instead, the new requirements are only superficially addressed, because it is the purpose of this article to show that one aspect of the new regime will likely be a much greater professional hazard for attorneys than accountants. Moreover, attorneys advising government contractors might find themselves particularly vulnerable.

## **II. Analysis**

Sarbanes-Oxley provided explosive growth to one cottage industry – ethics consultants. Seemingly, every time major new legislation emerges a host of consultants appear overnight to provide guidance to the corporate world. Sarbanes-Oxley was no different. However, this article assumes that the reader does not need ethical counseling.

### **A. Changes Affecting Accountants**

Sarbanes-Oxley created new recordkeeping and reporting standards for accountants. Among the more significant changes, §404 (Managements Assessment of

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Internal Controls) requires entities to evaluate their internal controls every so often, and their auditors must express an opinion on those controls. There has been great concern among the accounting firms about this, i.e., the need for the audit opinion to include an opinion over an entity's internal controls. In fact, mandatory training for auditors on §404 has been almost universal. The accounting firms have also expended considerable time on a number of procedural matters, such as interpretations of the SEC's recent changes to the audit partner rotation requirements. Substantively, the accounting firms have revised their policies to address the new requirements associated with auditor independence, the performance of non-audit services, audit committee pre-approvals, audit committee communications, fee disclosures and cooling-off requirements.

Communications with the audit committee will be a troublesome area, at least initially. In almost all situations, it will be difficult for management to know where to draw the line on information to be provided to the audit committee. The problem is exacerbated by directors who have little accounting training or experience (generally the case), even when they are on the audit committee. Hopefully, this difficulty will be partly ameliorated by the new requirement under §407 (Disclosure of Audit Committee Financial Expert) that the audit committee designate one member to be a "financial expert." Not surprisingly, the need for a financial expert has led to an increase in the demand for CPAs to serve on boards of directors, for both public and private companies.<sup>1</sup>

The changes wrought by Sarbanes-Oxley will undoubtedly generate much dissatisfaction among Chief Financial Officers (CFOs). After all, prior to Sarbanes-Oxley many CFOs considered themselves to be the rulers of all internal and external accounting and auditing functions. The power of their position has been substantially diminished, now that §301 (Public Company Audit Committees) gives the hiring authority for external auditors to the audit committee. As for their sway over internal auditors, §307 (Rules of Professional Responsibility for Attorneys) requires counsel to report to the CEO or the board of directors all material violations of securities laws, i.e., matters that could materially affect the financial statements (a topic addressed in greater depth in the next section). In other words, serious deficiencies uncovered by internal audits will rapidly go up the ladder, but through the legal chain of command. As a result, CFOs will be left to deal with the internal audit staff on only immaterial items. Adding to CFO displeasure (and human nature being what it is), oversight to one person is micromanagement to another. Although the regulatory requirements have grown, actual compliance for some items tends to be almost mechanical, which in turn diminishes the application of a CFO's professional judgment. In short, being a CFO will not be what it once was.

One problem for government contractors lies in the definitional differences of materiality. Specifically, for government contractors the threshold for materiality is *considerably lower* than the one applied to commercial contractors. Of course, the level of materiality is a judgmental determination made by the auditor, and may vary from one audit to the next, i.e., there are no specific criteria for materiality.<sup>2</sup> In practice, however, for the financial statements of a commercial contractor a matter is generally deemed material if the amount involves 5% or more of the reported revenues.



This is decidedly not the case with government auditors. For example, a government auditor may find pervasive instances of unallowable travel and entertainment costs in a contractor's overhead pool. The total amount of unallowable costs may involve an immaterial amount of money, i.e., less than 5% of the reported revenues. However, the government auditor is more concerned with the frequency of these occurrences, not the dollar amount. This is because the numerous instances of charging unallowable costs demonstrate a systemic deficiency – a valid point. If there are other audit findings and the government auditor concludes that the circumstances so warrant, there could be more serious consequences than a mere disallowance of costs, such as a finding of an inadequate accounting system, which would have an immediate negative impact on a contractor's cash flow. This is because a finding of an inadequate accounting system inevitably results in an immediate halt to the payment of a contractor's invoices.

Perhaps the worst aspect of the new requirements (such as §404) is that they are unfamiliar. However, all of the Sarbanes-Oxley changes involve matters accounting firms have long experience with (internal controls, disclosures to audit committees, auditor independence, performance of non-audit services, fee disclosures and cooling-off requirements). Accordingly, they do not present extraordinary professional hazards. The same cannot be said for attorneys.

#### B. Changes Affecting Lawyers

While attorneys need to be knowledgeable about all Sarbanes-Oxley requirements and the associated SEC rules in order to advise their clients, there is one requirement that impacts attorneys directly. As mentioned above, §307 (Rules of Professional Responsibility for Attorneys) require an attorney (whether in-house attorney or outside counsel) who "reasonably believes" that there is "evidence of a material violation" must report that violation to either the chief legal officer or the CEO of the company. If neither responds "appropriately," the lawyer must then report the matter to the audit committee or the board of directors.<sup>3</sup>

In response to the requirement that corporate counsel to report "material violations," considerable attention has been focused by the legal community on the attorney-client privilege issue.<sup>4</sup> For reasons set forth below, I believe this focus on attorney-client communications was misplaced because it is very unlikely to be the basis for litigation.

Assume a matter is brought to the attention of an attorney, and the attorney must decide whether the information is evidence of a material violation, i.e., one that would trigger the reporting requirement. On this point, the SEC's discussion about "evidence of a material violation" in 17 C.F.R. 205.2(e) states:

If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is

required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

The SEC's Final Rule defined the term, "reasonably believes," in the negative<sup>5</sup>:

'Reasonably believes' means that an attorney believes in the validity of the matter in question and the circumstances are such that the belief is not unreasonable.

The SEC's stated intent behind the rules related to the reporting requirement was not only to protect investors, but to "increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct."<sup>6</sup> For reasons discussed in Section III below, however, this confidence may be misplaced.

### C. Changes Affecting Investors

Not surprisingly, there has also been considerable growth in securities litigation. At one time, there was a body of cases under §10(b) of the Securities Exchange Act of 1934 that applied liability against defendants that aided and abetted in the fraud. This cause of action was referred to as secondary liability, i.e., these were not individuals who were the catalysts for the fraud that resulted in the harm to investors, but through omission or commission had otherwise assisted in the fraud or deception. In many instances, these were attorneys, accountants, investment bankers, or advisors. Secondary liability was important in these actions because the main defendants were frequently bankrupt, in prison, or beyond federal jurisdiction (i.e., they were judgment proof). In other words, imposing secondary liability became the vehicle for recovering damages.

The scope of secondary liability was diminished -- to an extent -- by the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.<sup>7</sup> In that case, the Supreme Court held that secondary liability could only be imposed where the defendant had met the same standards for primary liability, to "include a material misstatement (or omission) on which a purchaser or seller of securities relies."

The decision in *Central Bank* notwithstanding, it has been difficult for the courts to determine where secondary liability starts and where it stops.<sup>8</sup> In its more recent amicus briefs, the Securities & Exchange Commission has urged the courts to establish a standard of liability where a defendant played a "substantial role" in the creation of a material misstatement.<sup>9</sup> However, as of this writing the state of the law in this area is very uncertain. Even more uncertain is whether in-house counsel is even covered under the corporate directors and officers (D&O) general liability insurance policy.<sup>10</sup>

In seeking to impose liability, attorneys representing investors usually cite Rule 10(b)-5, which states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,  
To employ any device, scheme, or artifice to defraud,  
To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or  
To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Note that Rule 10(b)-5(b) prohibits the making of fraudulent statements. However, since the *Central Bank* decision there has been a rise in the number of cases brought under subsections (a) and (c) of Rule 10(b)-5. This trend is significant. At least one commentator has noted that the resort to causes of action under subsections (a) and (c) of 17 C.F.R. 240.10b-5 to impose secondary liability can be likened to the "aiding and abetting" theory the Supreme Court addressed in *Central Bank*.<sup>11</sup> This development should be particularly worrisome for those who are involved with the preparation and submission of financial statements, as they may be held liable under the so-called "scheme" theory, i.e., they need not have made any material misstatements.

### III. Discussion

There will be many problems encountered by counsel dealing with a reported matter, but among the first will be a determination of whether there is even a "material violation."

In the new Sarbanes-Oxley environment, much confidence is being placed on counsel to maintain the integrity of financial statements. Unfortunately, however, counsel advising government contractors have historically had, at most, peripheral involvement in the financial reporting process and usually no involvement at all. Moreover, attorneys are neither trained nor experienced in the intricacies of cash flow determinations, inventory valuations, revenue recognition issues, off-balance sheet liabilities, and a host of other accounting matters. Also, attorneys are not usually trained or experienced in the particular accounting rules applicable to the businesses they are advising. This is particularly true of government contractors, whose counsel may have little knowledge or understanding of the Cost Accounting Standards, FAR Part 31, progress payment determinations, indirect cost rates, and so on. Nonetheless, they will soon be called upon to decide whether to report "material violations." Because of the lower materiality threshold for government contractors, the reporting requirement may prove to be fertile ground for plaintiff lawyers in securities litigation against government contractors, moreso than its redactors likely intended.

As government contractors well know, the criminal and administrative penalties the government may assess for non-compliance can be substantial, depending on the

violations involved, and may even include the ultimate sanction: debarment and/or suspension from government contracts. The current realities are such that even being investigated for procurement fraud may be materially injurious to a contractor's prime and subcontracting opportunities. Aggravating the problem will simply be recordkeeping, because there is a big difference between the facts (i.e., what really happened) and the facts that were contemporaneously documented.

It is not difficult to perceive of episodes where an attorney advising a government contractor could easily make the wrong call. Assume that cost mischarging occurs between a contractor's fixed-price and cost reimbursement contracts. Assume further that the practice spans fiscal years. Although some of the transactions are brought to the attention of counsel, for whatever reason he decides not to report it. Subsequently, there is a government investigation (initiated by a disgruntled former employee), the potential liability grows, especially as government officials ponder whether the misconduct rises to a level adversely affecting the contractor's responsibility.<sup>12</sup> The value of the company's securities substantially declines. Stockholders (investors) suffer a severe diminution in the value of their securities, and sue. When they sue, they are likely going to pursue anyone that will accord them access to recovery for damages. A counsel's general liability insurance carrier is a tempting target. One path open to plaintiff's lawyers will be to show that counsel failed to report a matter that was a "material violation," one that materially affected the financial statements, and that failure was not reasonable.

Numerous other scenarios for government contractors can be readily envisioned, involving unaccounted for government property, labor mischarging, improper or non-existent quality assurance inspections, and so on. The probable impact on a contractor's financial statements would be the same.

#### **IV. Conclusion**

Inevitably, there will be some test cases. As noted above, the line between primary and secondary liability in securities litigation is indistinct, and each episode is likely to be fact-specific. The unfortunate attorneys caught up in litigation will have their every action minutely examined. After-the-fact determinations of unreported "material violations" will be made that apply one standard: Were you reasonable?

Counsel should not make these decisions in a vacuum. More particularly, counsel should ensure that accountants are involved in these determinations, and that their participation is documented.

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## Endnotes

- <sup>1</sup> - "CPAs as Audit Committee Members," by Stephen Scarpati, *AICPA Journal of Accountancy*, September 2003, p. 32. The demand is such that the AICPA has even set up a web site to match audit committees with interested members.
- <sup>2</sup> - Neither the AICPA nor the Financial Accounting Standards Board (FASB) will even provide guidelines for materiality for fear that they would be misused. FASB's Statement of Financial Accounting Concepts No. 2, "*Qualitative Characteristics of Accounting Information*," defines materiality in only general terms.
- <sup>3</sup> - 17 C.F.R. 205. This rule became effective August 5, 2003.
- <sup>4</sup> - "Lawyers Pressed to Give Up Ground on Client Secrets," by Jonathan D. Glater, *New York Times*, Aug. 11, 2003.
- <sup>5</sup> - 17 C.F.R. 205.2(m).
- <sup>6</sup> - 17 C.F.R. 205, Summary.
- <sup>7</sup> - Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 1994.
- <sup>8</sup> - "Line Between Primary and Secondary Liability Still Blurred in Securities Cases," by Daniel L. Brockett, *The Federal Lawyer*, Vol. 50, No. 7, August 2003.
- <sup>9</sup> - In re Enron Corporation Securities, Derivative & ERISA Litigation, Memorandum and Order Re Secondary Actors' Motion to Dismiss (S.D. Tex., Dec. 20, 2002); Klein v. Boyd, 1998 U.S. App. LEXIS 2004 (1998), vacated and en banc rehearing granted, 1998 U.S. App. LEXIS 4121 (1998).
- <sup>10</sup> - "Naked and Nervous," by Molly McDonough, *ABA Journal Report*, Vol. 2, Issue 49, December 19, 2003.
- <sup>11</sup> - "Line Between Primary and Secondary Liability Still Blurred in Securities Cases," by Daniel L. Brockett, *The Federal Lawyer*, Vol. 50, No. 7, p. 32, August 2003.
- <sup>12</sup> - FAR Part 9.

## **The DCGS Decision**

On June 4, 2004, the GAO denied *in toto* the protest of Northrop Grumman (Matter of Northrop Grumman Systems Corporation, B--293036.5-7), a large dollar protest that is a continuation of a protest that had been on-going for nine months.

The Air Force DCGS is a family of fixed and deployable multi-source ground station processing systems that support a range of intelligence, surveillance and reconnaissance systems. The protester, Northrop Grumman, challenged nearly every discretionary decision made by the Air Force during the procurement process, claiming that the Air Force was biased against Northrop. The protests were lengthy and detailed--the basic pleadings alone comprised many hundreds of pages by the time all the iterative numbered protests were filed. The awarded price was 283 million dollars and the evaluated price was 267 million dollars for the initial first delivery order under the indefinite delivery order contract.

The basic allegations of the protest were that the Air Force had held the two offerors to two different standards in many different areas, including past performance; that we had given improper ratings to both competitors in many areas and that we had wrongly evaluated costs. There were several other grounds asserted as well. A massive discovery

expedition was launched in order find some substance to support the allegations. This discovery expedition was no casual affair, and involved the production of an extremely lengthy (forty- two linear feet) evidentiary file, and a vigorously contested hearing. Most of the package was produced during the first series of protests (B 296 036.1-.4)

The protest process was somewhat unique in that the Air Force undertook corrective action after a hearing in December 2003, but no decision was rendered until an additional series of protests were filed after the corrective action was completed two months later. The second series of protests were approximately 150 pages long, plus exhibits. This protest tied up five Air Force attorneys for months. From the Air Force point of view, all's well that ends well.

## BOARD OF CONTRACT APPEALS BAR ASSOCIATION

### TREASURER'S REPORT

**For the Period Ending June 4, 2004**

<u>Date</u>	<u>Activity</u>	<u>Balance</u>
4 March 2004		\$22,621.31
5 March 2004	Deposit (Dues)	\$22,801.31
	Parr	\$30.00
	Menegat	\$30.00
	Retson	\$30.00
	Gill	\$45.00
	Dewitt	<u>\$45.00</u>
	TOTAL	\$180.00
11 March 2004	Check #710 (\$108.00) Hugh Long – payments To Pitney-Bowes	\$22,693.31
11 March 2004	Check #711 (\$30.87) Pitney-Bowes <b>VOID</b>	\$22,693.31
29 March 2004	Check #712 (\$487.37) HF Copies, Inc. "The Clause"	\$22,205.94

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29 March 2004	Check #713	(\$188.75)	\$22,017.19
	Hugh Long		
	Postage		
28 April 2004	Check #714	(\$750.00)	\$21,267.19
	DC Bar, Judge's Reception		
1 June 2004	Deposit (Dues)		
	Delsordo	\$45.00	
	Elcessor	\$30.00	
	Stanco	<u>\$45.00</u>	
		\$120.00	\$21,387.19
3 June 2004	Check #715	(\$2,000)	
	Army-Navy Club		
	Deposit, 2004 Annual Meeting		\$19,387.19

Thomas H. Gourlay, Esq.  
Treasurer