

DENTONS



PCI Financial Forum Series

Managing Internal Investigations into Accounting Matters: Mandatory Disclosures

September 12, 2017

Agenda

- The Rising Use of False Claims Act ("FCA") to Pursue Accounting Issues
 - "Implied Certification" after *Escobar*
- Investigating Potential Accounting Issues
 - Initiating and Conducting the Investigation
 - Engaging the Legal Department and/or Outside Counsel
 - Privilege Issues
- Mandatory Disclosure Rule
 - Internal Control Requirements
 - Disclosable Conduct/Credible Evidence
 - Significant Points
- Post-Disclosure Considerations and Best Practices

The Rising Use of the FCA for Accounting Issues

- Trend over last 10 to 15 years has been for COs and auditors to ask whether an accounting issue is a basis for FCA liability
 - No longer solely relying on contract cost adjustments and regulatory penalties to remedy accounting discrepancies
- Trend makes it necessary for companies to approach accounting issues with a greater level of care, with an eye toward liability beyond the specific accounting adjustment
 - As a contractor's accounting and finance group deal with the accounting issue and any corrections to accounting practices, the company needs to understand how the issue arose and whether there is potential liability

The Rising Use of the FCA for Accounting Issues

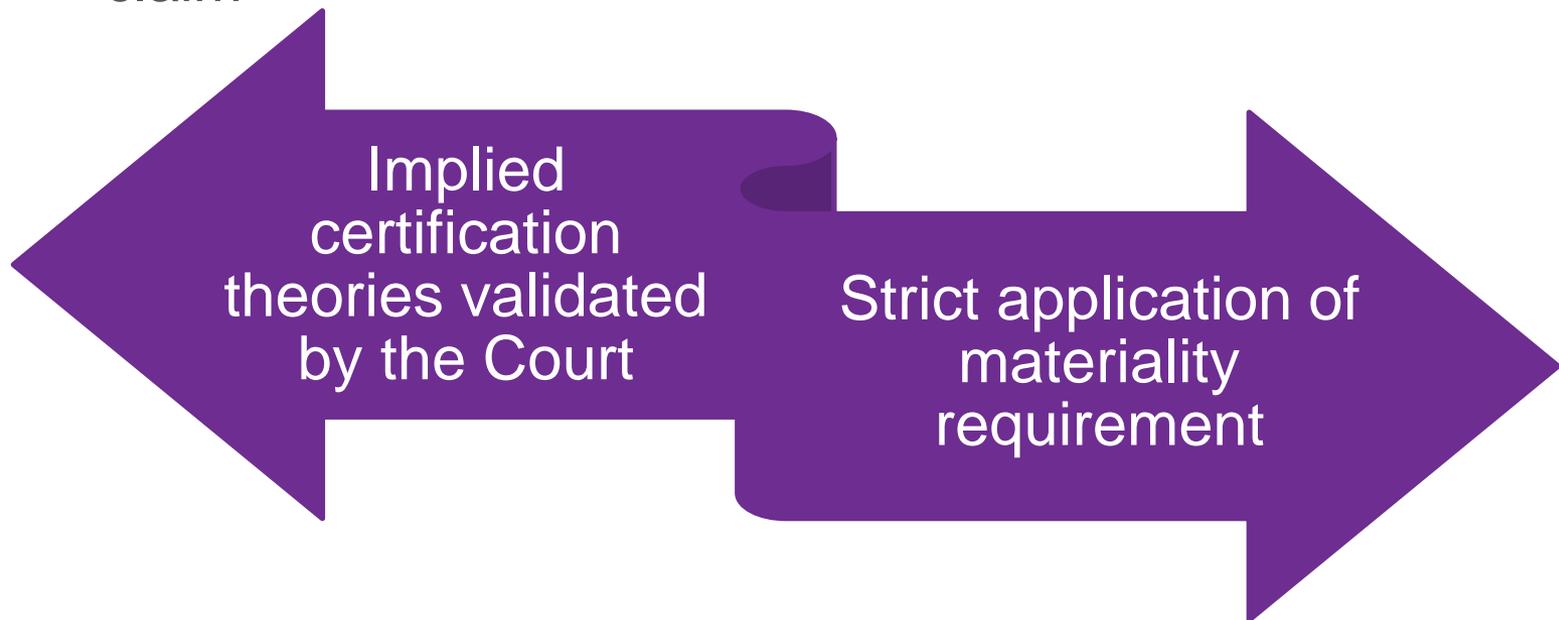
- Some of the examples we see from our practice and the headlines
 - Allocation of indirect costs, such as IR&D
 - Accrual of compensated absence time
 - Labor rate mischarging
 - Inclusion of unallowable costs in indirect rate pools
 - After-the-fact challenges to commercial item designations
 - Failures to adhere to price adjustment clauses
 - TINA
 - SCA/Davis Bacon wage issues
 - Shifting costs between FFP and flexibly-priced contracts
 - Inflated subcontractor costs

Implied Certification at the Supreme Court

- Implied certification is a theory of FCA liability based on contractor's presentation of a claim for payment that may be facially accurate, but which is false based on breach of an implied certification of compliance with a statute, regulation or contract provision
- Presents a significant risk to contractors that is hard to quantify because it potentially turns ordinary contract breaches into fraud
- In *Escobar*, the Supreme Court had the opportunity to rein in this risk but validated use of implied certification as appropriate under FCA (*Universal Health Servs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016))

Implied Certification after *Escobar*

- Supreme Court held in *Escobar* that implied certification is a valid theory, but
 - Claim must make specific representation about goods or services
 - Contractor noncompliance must be material to payment claim



Identifying Potential Issues

- Identification
 - Hotline or employee allegation
 - Government notice or investigation
 - Periodic internal audits by compliance personnel examining past problem areas
- Initial evaluation: immediate action or formal investigation?
 - Deciding whether to terminate employee immediately
 - Consider temporarily holding costs from being billed
- Coordination among the finance/accounting organization and counsel is key

Designation and Attorney Involvement

- Designate individual to lead the investigation; provides updates to compliance/management/in-house counsel
- Engage in-house legal department early; necessary to maintain attorney-client privilege (discussed later)
- Assess whether it is necessary to engage outside counsel
 - Any basis to question independence of Legal Department?
 - Potential cost/penalty impact
 - Seriousness or pervasiveness of issue
 - Complexity of issues: is subject matter expertise required?
 - History of related issues
 - Customer relationship
- Issue legal hold/do not destroy memorandum as soon as practicable

Maintaining Attorney-Client Privilege

- Issue an *Upjohn* memo (*Upjohn Co. v. United States*, 449 U.S. 383 (1981))
 - Direction from management to the Legal Department to conduct an internal investigation
 - Provides evidence of attorney-client relationship
 - Memorializes management's request for legal advice
- Legal counsel must supervise entire process
- *Upjohn* admonitions during employee interviews
- Mark documents and reports with privilege/work product legends
- Consider internal policy regarding whether/when to disclose internal investigation reports

Maintaining Attorney-Client Privilege (cont.)

- *United States v. ISS Marine Servs., Inc.*, No. 12-481, 2012 WL 5873682 (D.D.C. Nov. 21, 2012)
 - Government sought access to internal audit report
 - Not privileged because not related to legal advice; minimal attorney involvement
 - Not attorney work product because not clearly prepared in anticipation of litigation; minimal attorney involvement
 - Lessons learned: attorneys must be involved in all aspects of the investigation to maintain the privilege (witness interviews, drafting of report, etc.)
 - Avoid “consultation lite” scenario: do not retain counsel in watered down capacity
- Beware of inadvertent waivers (*United States ex rel. Frascella v. Oracle Corp.*, No. 07-cv-529 (E.D. Va. Mar. 30, 2011) (contractor provided internal compliance report in response to IG subpoena, which constituted a subject matter waiver)

Conducting the Investigation

- Many tools in investigator's toolbox
 - Statistical sampling of higher-risk transactions
 - Close working relationship with compliance/accounting personnel
 - Interviewing employees
 - One-on-one, in-person interviews are more likely to elicit candid responses and eliminates "group-think"; greater credibility
 - Compliance personnel or in-house counsel may participate
 - Separate participant should take detailed notes; later conversion to interview memoranda
 - Outside subject matter experts (e.g., accounting consultants); but conclusions are ultimately the company's
- Document the results
 - Investigation report with conclusion regarding credible evidence determination
 - Be mindful of what is put in writing

Valuing the Potential Cost Impact

- Calculate rough order of magnitude (ROM)
 - Sampling and extrapolation
 - If government lawyers or agents already involved, get buy-in upfront for sampling methodology
 - CAS net aggregate increased costs (FAR 52.230-6)
 - Amount by which increased costs exceed decreased costs
 - Affected contracts
 - Consider potential interest issues (CAS, TINA, cost of money)
- Cost impact may require reconciliation of accounting records to source documents
- Determine whether more precise valuation is appropriate (GDM/DCI)

Mandatory Disclosure Rule

- For contracts >\$5.5M and performance >120 days
 - Contractors must disclose credible evidence of any of the following (FAR Subpt. 3.10 and 52.203-13)
 - Violation of federal criminal law involving fraud, conflicts of interest, bribery or gratuities (Title 18)
 - Violation of the civil False Claims Act (FCA)
 - Must maintain internal control system to detect improper conduct
 - Suitable to the size of the company and extent of its involvement in government contracting
 - Facilitates timely discovery and disclosure of improper conduct
 - Ensures corrective measures are promptly instituted and carried out
- For all contracts/contractors: failure to timely disclose credible evidence of either the above violations or significant overpayments” is a cause for suspension or debarment (FAR 9.406-2 and 9.407-2)

Disclosable Conduct

- Overbilling/double billing
- Timekeeping issues
- Improper billing of indirect costs as direct costs
- CAS violations
- Unallowable costs
- Improper retention of overpayments; “reverse” false claim
- Inaccurate cost estimates

Determining Credible Evidence

- The Mandatory Disclosure Rule does not define “credible evidence”
 - “[M]ay lie somewhere between reasonable grounds to believe . . . and a preponderance of the evidence” (FAR Councils)
 - Unrelated DFARS provision defines “credible information” as “information that, considering its source and the surrounding circumstances, supports a reasonable belief that an event has occurred or will occur” (DFARS 252.246-7003, Notification of Potential Safety Issues)
 - Higher standard than "reasonable grounds to believe"
 - A conclusion that a violation occurred is not required
 - It is a flexible standard; the government prefers it this way
 - Keep in mind that you are setting precedent of what is disclosable!

Determining Credible Evidence (cont.)

- The Mandatory Disclosure Rule requires contractors to investigate potential issues to determine if credible evidence exists
 - Contractor can “take some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the government” (FAR Councils)
 - Credible evidence disclosure trigger may be reached before investigation complete
 - Contractor not expected to conduct "complex investigation," but only to take "reasonable steps" to determine whether evidence credible
 - “Until the contractor has determined the evidence to be credible, there can be no ‘knowing’ failure to timely disclose” (FAR Councils)

Significant Points

- Disclosure obligation continues for three years after final payment
- Disclosure obligation relates to any prime contract or subcontract thereunder regardless of amount
- Criminal disclosure obligation is potentially very broad
 - Common element in all criminal violations is wrongful intent
 - Examples include: violations of post-employment restrictions, providing meals, gifts, entertainment, etc., to public officials or members of Congress
- Enforces existing obligation to notify CO of overpayments under Prompt Payment clauses

Making a Disclosure

- Mandatory Disclosure Rule requires “timely” disclosure
 - Determining whether credible evidence exists can be time consuming
 - Valuing potential accounting issues can take months
- If investigation confirms credible evidence before the investigation is complete, consider a preliminary disclosure
 - Explain that credible evidence exists
 - Describe investigation status
 - Provide a date for a final disclosure/follow-up report
- Early engagement with agency SDO may be advisable depending on circumstances
 - Keeping SDO apprised of allegations indicates responsibility
 - Consider administrative agreements where necessary

The Disclosure

- Review relevant agency OIG guidance
- Generally a disclosure should include the following
 - Name and location of company or affected division
 - Affected contract(s)
 - Date when company learned of the issue
 - How the company learned of the issue
 - Steps taken by the company to investigate the issue
 - Credible factual evidence
 - Cost impact, if any
 - Corrective action taken or under consideration
 - Point of contact for government questions

Post-Disclosure Considerations

- Process may unfold quickly (or be slow to develop, if at all); but have documentation assembled in anticipation of government document requests/subpoena
- Investigator will likely refer cost impact calculations to DCAA for audit
 - DCAA poised to demand access to employees
 - DCAA convinced it already has authority to interview employees
- Consult with government counsel to maintain cooperative atmosphere while resisting government strong-arming
 - Strive to provide workable solutions
 - Evaluate privilege waiver issues

Best Practices

- Ensure awareness of requirements through training programs
- Establish policies and procedures for handling reported wrongdoing and making disclosures
- Internal investigation should be steps ahead of government investigation
 - No surprises
 - No scrambling for data and documentation in response to subpoena or CID
 - Take control of any government investigation (if possible)
- Maintain consistent willingness to engage and follow up; quick and candid responses to inquiries are helpful
- Set up a separate charge number for potentially unallowable investigation-related time

Best Practices

- Distribute litigation hold and “do not destroy” notices to key employees
 - Required when litigation is “reasonably anticipated”
 - Work with IT: backup/archive data
 - Training and periodic follow-up required: not enough to simply notify employees
- Document productions
 - Review all documents produced
 - Carefully consider whether to produce attorney communications
 - Ensure documents are properly marked; ensure that markings are removed from documents provided to the government
- Carefully consider how to handle Yates memo/individual liability issues; separate counsel may be appropriate for individuals

Questions?



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Thank you

The logo for Dentons, featuring the word "DENTONS" in white, uppercase letters inside a purple arrow-shaped box pointing to the right.

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