Analysis
Corporate Monitors

Federal Contractors Should Expect Increased Use of Monitors

BY RICHARD J. BEDNAR AND MICHAEL C. EBERHARDT

Over the past several years, where companies have violated criminal or civil fraud statutes, there has been an important and growing insistence by the federal government that these offending companies engage an independent monitor as a condition to either avoid criminal prosecution or to allow these companies to continue their eligibility for future federal contracts, grants, and claims reimbursement. The evolution of the independent monitor has its origins in three somewhat distinct enforcement settings, but each, as discussed below, has some remarkable parallels that are likely to grow even stronger as the value of the monitor role becomes more apparent. These three enforcement settings are reflected in:

- agreements entered into by various agency debarment officials where a monitor or ''external compliance officer'' or ''ombudsman'' is imposed as a condition of avoiding suspension or debarment;
- corporate integrity agreements utilized at Department of Health and Human Services where an ''Independent Review Organization'' is required to avoid exclusion; and
- deferred prosecution agreements where a monitor requirement is imposed by the Department of Justice as one of the conditions of avoiding criminal prosecution.

Regardless of the federal agency driving the increased usage of monitors, this technique has consistently become an important tool in providing expert independent oversight to assure corporate responsibility and accountability, particularly with respect to government contractors, where prior misconduct requires special oversight. This article examines this tool, the characteristics of a qualified monitor, and the likely upward trend toward even greater use of monitors, particularly in light of the new federal regulation titled ''Contractor Business Ethics Compliance Programs and Disclosure Requirements'' at 73 Fed. Reg. 67084 (Nov. 2008). That regulation provides for mandatory disclosure, under penalty of suspension and debarment, of any ''violation of a Federal criminal statute involving fraud, or a violation of the civil False Claim Act.''

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Historically, when faced with the requirement to engage an independent monitor or compliance officer, a company or its legal counsel simply found a convenient resource—often an attorney—who could provide some rudimentary form of oversight. Some who served in this role had a prior or continuing relationship with the company as legal counsel—hardly ensuring any true sense of ''independence.'' The basic services would have typically entailed setting up a company hotline and regularly reporting to the company's board of directors and to the affected federal agency or supervising court regarding the institution of a code of conduct and compliance training. The individual selected for this role may have had no particular expertise associated with the type of business or regulatory framework of the company whose conduct exposed it to criminal, civil, or administrative penalties.

Agencies Getting Sophisticated

The events of the past few years reflect a sharp change in these prior practices. There is now a clear sophistication on the part of federal agencies in terms of their expectations of not only what an independent monitor is required to do but also what qualifications an individual or entity must possess to be eligible to serve as a monitor. An examination of some recent representative agreements demonstrates how the rudimentary requirements of the past have been displaced by the types of exacting and sophisticated specifications now in use.

A growing number of federal agencies—large and small—now utilize the requirement of a monitor or independent compliance officer as a condition of an agreement to avoid debarment. As an example of one of the more active debarment agencies, the Army suspension and debarment official has utilized the monitor, or ''ombudsperson,'' as an effective means of independent oversight of contractors under administrative compliance agreements in lieu of debarment. In fact, in one Army compliance agreement, both an independent monitor and an ombudsperson were utilized. The independent monitor was defined as the ''independent attorney, CPA, or other expert knowledgeable in the area of Federal Government Contracting policies and

(continued on page 221)

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(continued from page 224)

procedures *who will act to ensure the Contractor's compliance with the terms of their Agreement*.'' (Emphasis added.)

On the other hand, the ombudsperson is defined as the person ''who will act as an alternative channel of communication for [Company] employees regarding the disposition of the charges against the contractor for violation of the Arms Export Control Act,'' the statute that was the focal point for violations that served as the basis for a Deferred Prosecution Agreement between DOJ and the contractor.

In the Army's description of the independent monitor's role:

- The monitor is independent and not an agent of the contractor.
- The work of the monitor is not subject to the contractor's assertion of attorney client privilege or the work product doctrine.
- The monitor is to work closely with the contractor's management team to implement the terms of the agreement, and shall consult as required with both the Army and the contractor concerning questions of implementation.
- The monitor, at his discretion, will investigate complaints concerning the contractor's implementation of the agreement.
- The monitor will report to the Army concerning contractor's compliance with the agreement.
- The monitor may, as reasonably required, consult with other counsel, at contractor's reasonable expense, in performing the monitor's duties.
- The monitor shall annually certify to the Army his absence of any financial interest or conflict of interest relating to his role as monitor.
- The monitor shall have sufficient staff and resources to monitor the contractor's agreement and may hire independent experts necessary to monitor the agreement.
- The monitor is to verify the contractor's responsibility program.
- The monitor will annually meet with the contractor's board of directors to discuss status of the implementation of the agreement and status of ongoing investigations.
- The monitor shall provide quarterly reports to the Army relating to employee training, number of hotline calls or contacts made or referred to the monitor, types of misconduct reported, disciplinary action taken, and corrective actions taken.
- Following the third anniversary of the agreement, the monitor shall respond to the Army regarding the status of contractor's compliance and training programs, ''lessons learned,'' and a summary of actions taken by the monitor.
- At the conclusion of the five-year term of the agreement, the monitor shall provide a similar report to the Army as described above.

All of the costs associated with the independent monitor are borne by the contractor and are not allowable costs. Also, the monitor is not intended to replace the contractor's own ethics director, who will typically also report his/her activities to the monitor.

The Navy debarment authority has also agreed to the use of monitor or an ''external compliance officer'' and provides that the monitor:

- serve as the contact person for employees with questions regarding ethics or compliance;
- provide ethics and compliance training;
- review company compliance policies and procedures;
- report any instance of suspected illegal conduct;
- investigate all instances of suspected illegal conduct and report to management;
- provide the investigation and management response to the Navy Debarment Authority; and
- perform an annual audit and compliance review.

The Navy, like the Army, typically requires debarring-official approval of the person serving as monitor or external compliance officer.

Military Agreements Vary

The Navy and Army agreements also provide that the replacement of the monitor or the external compliance officer is the exclusive authority of the agency. The Navy further requires that the external compliance officer have no attorney-client relationship with the company and that the officer act as an ''independent advisor and monitor.''

The Air Force has taken a somewhat more case-specific approach to the use of independent oversight and auditing of administrative agreements. In surveying five administrative agreements entered into during 2009, several different approaches were observed, each apparently tailored to specific circumstances. In one case, an independent ombudsman was required to provide an assessment of the contractor's operations, effectiveness of internal controls, operating procedures pertaining to the timeliness of shipments to government customers, billing practices, self-governance program, and compliance with the administrative agreement.

In another administrative agreement, the contractor had previously appointed a compliance officer/ombudsman and the Air Force required that person to make reports to the government concerning the contractor's compliance with the administrative agreement. Another 2009 agreement required no ombudsman. And yet another agreement required no ombudsman but did require the contractor to engage an independent auditor to conduct a review of its ethics and compliance program. Finally, one recent Air Force agreement utilized both a monitor and an independent auditor to review the contractor's ethics program.

Other Agencies Adopt Monitors

Civilian agencies with debarment officials have also adopted the concept of utilizing independent monitors to ensure company compliance and responsibility. The General Services Administration debarment official has recently incorporated the use of a monitor in one of its agreements. Also, in an agreement entered into by a company subject to debarment by the National Science Foundation, the use of an outside compliance officer was authorized to perform the following duties:

- all responsibilities for operations of the compliance program, which includes a code of conduct, accurate time reporting, accurate cost charging, monitoring of cost sharing, accurate reconciliation of accounting records, and document management and retention;
- review of NSF awards to the company;
- development of employee training programs;
- written reports to company management and the NSF IG;
- monitoring of internal controls to ensure compliance with federal laws and regulations; and
- annually auditing the company with specific emphasis on risk assessment and internal controls.

HHS has developed comprehensive and stringent requirements in its corporate integrity agreements for

companies seeking to avoid exclusion. One very carefully tailored feature of many CIAs relates to the duties of the monitor or Independent Review Organizations, which are often very specifically detailed. Indeed, some IRO duties are so diversified within a single CIA that multiple IROs might have to be engaged by the company to meet the HHS requirements. Consider one CIA, which required a large hospital chain to utilize IROs for the following types of highly varied reviews:

- an outlier payment review to include an analysis of hospital cost-to-charge ratios, review of hospital cost reports, and charge and price increases;
- diagnosis related groups claims review including overpayments through appraisal of inpatient charges;
- unallowable cost review;
- focus arrangement review;
- clinical quality system review.

The scope of each of these five reviews is outlined in specific work plans appended to the CIA, and the qualifications of the entities to perform the reviews are detailed as well. The CIA also typically requires IRO independence and objectivity and a certification to that effect by the company that has engaged the IRO.

DOJ View on Monitors

Deferred prosecution agreements for corporations are a relatively recent DOJ initiative driven largely by the Jan. 20, 2003, memorandum from then Deputy Attorney General Larry Thompson. Thompson encouraged the use of this type of agreement for companies that had committed criminal offenses but otherwise demonstrated a willingness to cooperate with DOJ and exhibited certain characteristics of responsibility and future accountability. Factors such as voluntary disclosure, existence of a compliance program, and an ability to discipline offending employees are some of the considerations that determine whether a DPA is appropriate in a given circumstance.

As the number of DPAs began to grow, some prosecutors began to include a monitor requirement as part of the agreement. With a total of 37 DPAs in 2007, many of which incorporated the monitor requirement, then Acting Deputy Attorney General Craig S. Morford issued a memorandum March 7, 2008, titled ''Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations.'' In seeking to develop some consistency in terms of how federal prosecutors utilized monitors, the Morford memorandum set out nine principles. They are:

> 1. Before discussing the process of selecting a monitor in connection with deferred prosecution agreements and non-prosecution agreements, the corporation and the Government should discuss the necessary qualifications for a monitor based on the facts and circumstances of the case. The monitor must be selected based on the merits. The selection process must, at a minimum, be designed to: (1) select a highly qualified and respected person or entity based on suitability for the assignment and all the circumstances; (2) avoid potential and actual conflicts of interest; and (3) otherwise instill public confidence . . . . The Government should obtain a commitment from the corporation that it will not employ or be affiliated with the monitor for a period of not less than one year from the date the monitorship is terminated.
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> 2. A monitor is an independent third party, not an employee or agent of the corporation or of the government.
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> 3. A monitor's primary responsibility should be to assess and monitor a corporation's compliance with those terms of the agreement that are specifically designed to address and reduce the risk of recurrence of the corporation's misconduct, including, in most cases, evaluating (and where appropriate proposing) internal controls and corporate ethics and compliance programs.
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> 4. In carrying out his or her duties, a monitor will often need to understand the full scope of the corporation's misconduct covered by the agreement, but the monitor's responsibilities should be no broader than necessary to address and reduce the risk of recurrence of the corporation's misconduct.
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> 5. Communication among the Government, the corporation and the monitor is in the best interest of all parties. Depending on the facts and circumstances, it may be appropriate for the monitor to make periodic written reports to both the Government and the corporation.
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> 6. If the corporations chooses not to adopt recommendations made by the monitor within a reasonable time, either the monitor or the corporation, or both, should report that fact to the Government, along with the corporation's reasons. The Government may consider this conduct when evaluating whether the corporation has fulfilled its obligations under the agreement.
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> 7. The agreement should clearly identify any types of previously undisclosed or new misconduct that the monitor will be required to report directly to the government. The agreement should also provide that as to evidence of other such misconduct, the monitor will have the discretion to report this misconduct to the government or the corporation or both.
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> 8. The duration of the agreement should be tailored to the problems that have been found to exist and the types of remedial measures needed for the monitor to satisfy his or her mandate.
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> 9. In most cases an agreement should provide for an extension of the monitor provision(s) at the discretion of the Government in the event that the corporation has not successfully satisfied its obligations under the agreement. Conversely, in most cases, an agreement should provide for early termination if the corporation can demonstrate to the Government that there exists a change in circumstances sufficient to eliminate the need for a monitor.

Monitors Must Be Specialists

While a review of DPAs reveals a wide variety of monitor duties often tailored to meet unique business circumstances and the type of misconduct committed by the corporation, the following set of monitor duties from a DPA covering securities fraud involving revenue recognition is illustrative of how specialized the duties and expertise of a monitor can be. This DPA required an independent monitor to conduct a comprehensive review of:

- the company's practices for the recognition of software license revenue;
- the company's internal accounting controls;
- the company's implementation of an improved information technology system;
- the company's audit department; and
- the company's record management and retention policies.

The DPA further required the monitor to issue reports to the Securities and Exchange Commission and the company's board of directors making recommendations regarding best practices for the areas outlined above. It also required quarterly monitor reports to the SEC and board regarding the company's compliance with all the terms of the DPA which included a wide-ranging set of provisions relating to company cooperation with the government, restitution to shareholders, corporate reforms involving a new compliance committee and a new disclosure committee,

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a revised set of corporate governance procedures, and new compliance policies.

From a review of debarment agreements, corporate integrity agreements and deferred prosecution agreements, a common set of characteristics has evolved for monitors. They are:

Complete independence. No longer is it appropriate for a compliance monitor to be an individual or entity that has represented the company in the past or continues to represent the company even on unrelated matters during the term of the monitor's engagement. Indeed, the monitor might have restrictions placed on it in terms of future representation to ensure that the monitor is not using its service as a means of marketing future services once the monitor's term has expired.

Key Elements to Effective Monitors

The concept of ''complete independence'' is imperative if the monitor process is intended to reflect the type of candor and openness that the monitor will expect from the company as the monitor's functions are fulfilled. Whether those functions include the basic operation of a hotline or the much more difficult and specialized exercises involving compliance reviews of sophisticated accounting systems, charging and billing systems, and large internal company organizations, unfettered and unfiltered access to employees and documents is critical to a fair and complete assessment of the company's performance and compliance.

A detailed scope of work. Federal agencies imposing the independent monitor have a clear need to define the role and duties of the monitor and to do so with some recognition of the nature of the offense or problem that led to the requirement of an independent monitor. The DPAs and CIAs are particularly well developed in terms of specifying work plans; debarment agreements could probably be improved in this regard and thereby provide the affected agency with more insight into the company's compliance.

For example, a company that has violated the civil False Claims Act due to defectively priced contracts might be subjected to a requirement that the monitor perform a detailed review of the company's policies and procedures concerning compliance with the Truth-In-Negotiations Act. Or if a military contractor failed to adhere to certain contractually required quality standards, an important aspect of the compliance review process undertaken by the monitor might include a review of the contractor's adherence to, and modification of, relevant quality standards. This could be incorporated into a broader review of quality standard compliance but one that would have sufficient focus to look at the particular standards that were previously violated.

The monitor is not intended to replace the contractor's own ethics director, who will typically also report his/her activities to the monitor.

The use of a detailed scope of work for the independent monitor is a tool that accomplishes three important functions: First, it allows the affected federal agency to establish how it will assess the contractor's future responsibility and accountability in a very precise and measured fashion. Second, it allows the affected federal agency to set certain corresponding expectations for the performance of the independent monitor as the agency evaluates the information that is reported by the monitor. And third, it provides the monitor with a clear set of priorities as to what is important to the affected federal agency. This allows the monitor to plan and staff its oversight of the contractor consistent with those same priorities.

Subject matter expertise and qualifications. The DOJ guidelines for monitors issued in 2008 are the most recent, but not the only, reflection of the government's interest in ensuring that only qualified individuals serve in the monitor role. CIAs have qualification requirements for monitors; and debarment agreements, like those of the Navy, also provide clear guidance as to what types of individuals or entities can serve as monitors. It appears that many monitor assignments take into account the nature of the misconduct and the scope of the monitor's assignment to prescribe those qualifications.

An ability by the monitor to interact effectively with the affected federal agency. Whether it is the SEC in a revenue recognition case, DOJ in a Foreign Corrupt Practices Act case, the Department of Defense in a cost mischarging case, or HHS in the case of Medicare overpayments, monitor familiarity with the agency and an ability to communicate effectively with the agency are essential qualities that will affect the monitor's success.

More Oversight Coming

With the success and prevalence of monitor agreements in the past few years, there is no reason to expect that their use will diminish. Indeed, with the new federal regulation imposed on government contractors requiring that they mandatorily disclose any criminal or civil fraud violation where there is credible evidence of such, under penalty of debarment for failure to do so, one can reasonably anticipate that DPAs may increase as corporate criminal disclosures are made. And whether or not the disclosures warrant DPAs, one can reasonably anticipate heightened interest by debarment authorities and HHS to provide more oversight of offending companies through debarment agreements and CIAs with explicit monitor requirements.

These requirements will assist in the process of enabling contractors to continue to do business with the federal government without the collateral consequences to employees and investors arising from debarment or exclusion. At the same time, they will provide strict independent monitoring to verify the contractor's corrective actions and compliance procedures as required by the cognizant agency over the period of the administrative agreement.

It is also reasonable to anticipate in this environment where someone inevitably asks ''Who's auditing the auditors?'' that there will be government oversight of debarment agreements, CIAs, and DPAs, which could include the performance of the monitor. The Defense Contract Audit Agency already has the authority in Section 4-711 of its manual to evaluate contractor compliance with debarment agreements and, in one known instance where this authority has been invoked, the monitor has been questioned by DCAA.