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BRIEFING PAPERS

PRACTICAL TIGHT-KNIT BRIEFINGS—INCLUDING ACTION GUIDELINES—ON GOVERNMENT CONTRACT TOPICS

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ACCESS TO CONTRACTOR RECORDS/EDITION II

Basic Principles and Guidelines

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Your contracts with the Government contain numerous clauses that provide the Govt with wide-ranging access to your records. Recently, the Govt has used these clauses to *increase* its demands for access to your records in a variety of contexts. In addition, the Govt's broad right of access to your records has been reinforced by recent legislation expanding the Govt's right to *subpoena* your contract documents.

The procurement regulations also require you to *retain* a vast array of records. Often this requirement catches contractors by surprise. Therefore, as the Govt has become more aggressive in asserting its rights to your records, it has become increasingly imperative that you have in place a comprehensive *records management policy* before the Govt seeks access to your records. It is too late to establish a records management policy *after* the Govt has made such a request. This policy must address not only the records *retention* requirements specifically set forth in the regulations and contract clauses, but must also control the *creation* of what are known as "discretionary" records.

This BRIEFING PAPER discusses (1) the Govt's *records retention* requirements for contractors, (2) the Govt *agents* and *agencies* that have the right to examine or "audit" your records, (3) the scope of the *contract clauses* that grant the Govt access to your records, (4) the recent use of *subpoenas* by the Govt to enforce record requests, and (5) several considerations you should keep in mind in establishing a unified and coherent *records management policy*. This PAPER follows up and expands on a prior PAPER¹ on the same subject, but focuses on new developments in the law and the recent efforts by the Govt to obtain access to an ever-broader range of contractors' records. Like the earlier PAPER, however, it does not discuss administrative records you may be directed to prepare for the Govt (such as payroll records or labor compliance records), or records you are required to maintain for tax purposes.

BASIC PRINCIPLES

Records Retention Requirements. Contracting with the Govt imposes a substantial obligation on contractors to maintain various records. Subpart 4.7 of the

Federal Acquisition Regulation (FAR) sets out policies and procedures for retention of records by contractors to meet the records review requirements

of the Govt. In addition, numerous contract clauses include records retention requirements.

■ The Regulations

The stated purpose of the FAR subpart on contractor records retention is "to generally describe records retention requirements and to allow reductions in the retention period for specific classes of records."² The subpart applies to records generated under contracts that contain the "Examination of Records by Comptroller General," "Audit-Sealed Bidding," or "Audit-Negotiation" clauses.³ The regulations require that, unless otherwise provided, you "shall make available books, records, documents, and other supporting evidence to satisfy contract negotiation, administration, and audit requirements" for *three years after final payment*.⁴

The regulations further provide, however, that you must maintain several categories of records for *four years*. These categories are listed below:⁵

- (1) Financial and cost accounting data such as accounts receivable invoices.
- (2) Material work order or service files.
- (3) Cash advance recapitulations.
- (4) Paid, cancelled, or voided checks.
- (5) Accounts payable records to support disbursements.
- (6) Payroll sheets, registers, or their equivalent of salaries and wages paid to employees.
- (7) Work orders for maintenance and other services.
- (8) Equipment records.
- (9) Expendable property records.
- (10) Receiving and inspection reports.
- (11) Purchase orders.
- (12) Production records.

The regulations also require that you maintain the following records for *two years*:⁶

- (a) Labor cost distribution documents.

- (b) Petty cash records.
- (c) Clock cards or other time and attendance cards.
- (d) Store requisitions for materials, supplies, and services.
- (e) Evidence of payments for services rendered by employees.

The four-year and two-year retention periods are calculated from the end of the contractor's fiscal year in which an entry is made charging or allocating a cost to a Govt contract.⁷ However, if "records generated during a prior contract are relied upon for cost or pricing data in negotiating a succeeding contract, then the retention periods shall run on the date of the succeeding contract."⁸ Finally, if two or more record categories are combined in the same file ("interfiled"), and screening for disposal is not practical, then you must retain the entire record series for the longest prescribed period.⁹

In view of these criteria, it can be seen that there is no easy answer to the question of how long you should maintain certain records. The regulations require some records to be maintained for at least two years *from entry* while they require that other records be maintained for at least four years *from entry*. Still other records must be maintained for three years *from final payment*. The regulations also require that if records fall into two categories, the records must be maintained for the longer period. Thus, when faced with an uncertainty regarding the length of time a document should be retained, the prudent contractor will retain the document for the *longer* required period.

■ Contract Clauses

In addition to the regulations discussed in the preceding section, several contract clauses include records retention requirements. Some of the clauses specify the kinds of records contractors must maintain, while other clauses do not. Moreover, some of these clauses specify the retention period, while other clauses provide no such guidance. In addition to the "Audit" clauses (the "Examination of Records by Comptroller General," the "Audit-



■ Although prepared by experts these papers are, of course, generalized and should not be considered a substitute for professional advice in specific situations ■

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Sealed Bidding,” and the “Audit-Negotiation” clauses, which provide the Govt *access* to your records and are discussed later in this PAPER), examples of these clauses include:

- (1) “Termination for Convenience of the Government” clauses.¹⁰ These clauses require that you maintain all records and documents relating to the terminated portions of the contract for *three years* after the final settlement.
- (2) “Payment” clauses.¹¹ These clauses require that you give the Govt a reasonable opportunity to examine and verify your books, records, and accounts, and require you to maintain payment records. Some of the “Payment” clauses provide an independent basis for audit.¹²
- (3) “Inspection” clauses.¹³ These clauses require you to maintain inspection records and make them available to the Govt.
- (4) “Required Source” clauses.¹⁴ These clauses require you to maintain records showing compliance with the clauses.
- (5) “Patent Rights” clauses.¹⁵ These clauses give the Govt the right to examine any books (including laboratory notebooks), records, and documents relating to the conception or the first reduction to practice of certain inventions.
- (6) “Rights in Data” clauses.¹⁶ These clauses give the Govt the right to inspect data you withhold from the Govt. In addition, these clauses require you to maintain records to justify the validity of any restrictive legends. The FAR clauses permit the Govt to challenge your restrictive legends *at any time*.
- (7) “Cost” clauses.¹⁷ These clauses give the U.S. Comptroller General the right to examine books relating to your costs.
- (8) “Government Property” clauses, including special tooling clauses.¹⁸ These clauses require you to establish and maintain documents for administration of property control systems.
- (9) “Change Order Accounting” clause.¹⁹ This clause requires you to maintain separate accounts for all segregable direct costs allocable to a change.

In addition to the clauses listed above, several

other contract clauses *implicitly* require you to maintain records. This is particularly true where you either intend to bring a claim or where you may be required to defend against a claim by the Govt.²⁰ For example, proper records retention can become an especially important issue in the rights in technical data and defective pricing areas.²¹

The Auditors

The Govt’s access rights to your records are grounded in its audit rights. The three primary auditors—using that term loosely—of contractors’ records are (1) the Comptroller General—the head of the General Accounting Office (GAO), (2) the agencies’ Inspectors General (IGs), and (3) the agency auditors, such as the Defense Contract Audit Agency (DCAA), which is discussed separately below. The Comptroller General and agency auditors generally obtain their access rights through three contract “Audit” clauses—the “Examination of Records by Comptroller General” clause, the “Audit-Sealed Bidding” clause, and the “Audit-Negotiation” clause (all discussed later in this PAPER). In contrast, the IGs have a wide-ranging statutory access to all records relating to the agency’s programs and operations, including its procurements.

You should note that the Govt’s right of access to contractors’ records has been broadened by recent legislation. For example, the 1986 revision to the Anti-Kickback Act provides that, to ascertain whether there has been a violation of the Act, the Comptroller General and the IG of the contracting agency “shall have access to and may inspect the facilities and audit the books and records” of any contractor.²² In addition, the Defense Acquisition Regulatory Council has proposed a rule that would give DCAA auditors broad access to company records to verify contract cost estimates.²³

■ Comptroller General

By statute, the Comptroller General is authorized to have access to and to examine certain books, documents, papers, and records involving transactions related to certain contracts.²⁴ Thus, the “Examination of Records by Comptroller General” clause²⁵ is included by the Govt in all *negotiated* and *sole-source* procurements, *except* for: (1) *small purchases* under \$10,000 for civilian contracts and under \$25,000 for defense contracts, (2) certain contracts for *utility services*, or (3) contracts with

foreign contractors for which the agency head authorizes the omission of the clause.²⁶ This clause authorizes the Comptroller General to have access to and examine any of your “directly pertinent books, documents, papers, or other records involving transactions related” to the contract until three years after final payment under the contract.²⁷

The “Audit-Sealed Bidding” clause²⁸ is included in all advertised contracts if the contract amount is expected to exceed \$100,000.²⁹ This clause gives the Comptroller General access to records related to negotiating, pricing, or performing negotiated modifications to sealed bid contracts when cost or pricing data is submitted.³⁰

■ Inspectors General

Another potential auditor of your records—and often the most problematic because criminal repercussions can flow from his scrutiny—is an agency IG. Because of widespread allegations of contractor fraud, waste, and abuse, Congress passed the Inspector General Act of 1978³¹ establishing IGs for 15 agencies (not including the Department of Defense (DOD)), each with the responsibility to supervise or coordinate “the promotion of economy and efficiency in the administration of, or the prevention and detection of fraud and abuse in, programs and operations” and to identify and prosecute “participants in such fraud or abuse.”³² In 1982, Congress amended the Act to create a DOD IG whose responsibilities, in addition to those stated above, are to “initiate, conduct, and supervise such audits and investigations” as the IG considers appropriate, and to “provide policy direction for audits and investigations relating to fraud, waste and abuse and program effectiveness.”³³

■ Agency Auditors

In addition to the Comptroller General’s and the IGs’ right to audit, individual agencies have the statutory right to audit the books and records of any prime contractor or subcontractor engaged in the performance of any cost or cost-plus-fixed-fee contract.³⁴ Specifically, agencies are permitted to examine “all books, records, documents, and other data of the contractor or subcontractor related to the proposal for the contract, the discussions conducted on the proposal, pricing or performance of the contract or subcontract.”³⁵ Two contract clauses give effect to this statutory right. First, sealed bid procurements expected to exceed \$10,000 include

the “Audit-Sealed Bidding” clause.³⁶ Second, the “Audit-Negotiation” clause is included in all negotiated procurements, unless the acquisition is a small purchase.³⁷

■ DCAA

The DCAA is a separate agency within DOD with responsibility for performing “all necessary contract auditing” for DOD and providing accounting and financial advice to DOD procurement personnel “for the negotiation, administration and settlement of contracts.”³⁸ Traditionally, DCAA has functioned as the independent financial advisor to the Contracting Officer. However, in the new atmosphere in which alleged contractor fraud and other misconduct play a large role, DCAA has become more aggressive in asserting broad claims to contractors’ records.

Much of this change may be traced to the entry of the DOD IG into the contracting process. In an effort to ferret out alleged contractor fraud, the IG has redefined the DCAA auditor’s role. Thus, in a 1984 report reviewing DCAA’s access to contractor records, the IG stated:³⁹

Full and unrestricted access to contractor’s records is essential in order to examine sufficient competent evidential matter to afford a reasonable basis for an informed opinion in the variety of contract audit functions performed. Restrictions on access to contractor’s records can impair the auditor’s ability to render informed opinions and must be promptly resolved through appropriate actions with the contractor, contracting officers, and acquisition authorities.

These pronouncements were made without statutory or regulatory expansion of DCAA’s access rights, and without regard to judicial decisions in this area.

In an attempt to further expand the role of the DCAA auditor to include investigatory functions, the DOD IG defined the role of the DCAA auditors in a 1985 *Handbook on Labor Fraud Indicators* as follows:⁴⁰

The purpose of this handbook is to stimulate the contract auditor’s imagination regarding the detection of labor fraud indicators.

Fraud does exist. *It is the auditor’s responsibility to identify and make examples of those contractors who consider themselves above the law.* The auditor must also identify and minimize those areas where the government’s risk of and vulnerability to fraud is the greatest. (Emphasis added.)

This part of an auditor’s job description probably came as a surprise to those who believed that DCAA’s role was to review and verify cost data.

The DOD IG's definition of a broader role for DCAA appears to have influenced DCAA itself. At least one DCAA Regional Director has articulated the position that the auditing procedures adopted by the American Institute of Certified Public Accountants are applicable to Govt contracts.⁴¹ The same official stated that a DCAA audit "commences with a study and evaluation of the adequacy of the contractor's financial and administrative internal controls systems."⁴² Thus, he continues, an auditor *must examine* a contractor's: (a) internal audit reports, (b) budgets and forecasts, (c) corporate tax returns, (d) Securities & Exchange Commission filings, (e) internal controls regarding labor charges, (f) minutes of board of directors meetings, and (g) operational audits.⁴³ In addition, in a move which deeply disturbs many contractors, DCAA claims that it has a right to conduct *unannounced floor checks* and *employee interviews*.⁴⁴

DCAA's conception of its new role also includes efforts to pierce longstanding evidentiary privileges. The DCAA has urged auditors to scrutinize any claims of *attorney-client* and *attorney work product* privilege which you may raise to protect your documents.⁴⁵ The General Counsel of DCAA stated in a letter to DCAA Regional Directors that the attorney-client privilege was judicially created "primarily to limit disclosure of information in a litigative setting."⁴⁶ The DCAA General Counsel continued that the privilege may be waived "by contractually consenting to permit examination of all necessary audit information in exchange for monetary consideration."⁴⁷ In other words, it is his view that merely by entering into a contract with the Govt you unwittingly waive your rights to assert the attorney-client privilege to protect documents that reflect confidential communications made for the purpose of obtaining legal advice.

This interpretation of the law regarding the attorney-client privilege has been criticized. It is well settled that the attorney-client privilege attaches where legal advice *of any kind* is sought from an attorney.⁴⁸ DCAA's position is indicative of the Govt's current full-scale effort to obtain access to every piece of paper you have in your files, however, despite the absence of a legal foundation for its efforts.

Understandably, contractors are concerned by DCAA's recent position regarding the extent of its access to contractors' records and seek to avoid disclosing materials that would harm their competitive position if disclosed to a third party. They also

have no *duty* to disclose any records that are not covered by the relevant statutes, regulations, and clauses.

You may face harsh *sanctions*, however, if you refuse a DCAA request, regardless of the merits of your position. For example, DCAA may *suspend payment* of costs on flexibly-priced contracts. Alternatively, the DCAA auditor may take action that results in a decision to *deny progress payments*. Where your denial of access relates to a proposed contract price or forward-pricing rate, the DCAA may withdraw from the assignment and recommend that the Contracting Officer not negotiate the contract or rates until you accede to DCAA's request. DCAA has gone as far as to recommend that a Contracting Officer withhold progress payments in a dispute over access to records with one contractor.⁴⁹

The Armed Services Board of Contract Appeals has held, however, that a contractor is entitled to interest on funds that were arbitrarily withheld as a result of a dispute with DCAA over access to internal audit reports, current board minutes, and work papers.⁵⁰ It remains to be seen, however, whether the prospect of rendering the Govt liable for additional costs because of a recommendation to withhold payment will have a chilling effect on DCAA's practice of recommending withholding payments to gain access to records.

■ Others

Although not actually "auditors" of contractors' records, other offices of the Govt may obtain access to your records. For instance, both the U.S. Attorneys and the Defense Procurement Fraud Unit at the Department of Justice have access to the records of contractors under investigation.⁵¹ Recent legislation also permits the Department of Justice to obtain access to contractor records that are relevant to a false claim allegation.⁵²

Access By Contract Clause

■ "Examination Of Records" Clause

As stated above, virtually all negotiated Govt contracts contain the "Examination of Records by Comptroller General" clause which authorizes the Comptroller General to examine any of your *directly pertinent* books, documents, papers, or other records involving transactions related to any contract containing that clause.⁵³ The clause gives auditors only a *right of access* to the documents. It does *not* give

auditors the right to insist that you *locate* specific documents for them.

Under the clause, the Comptroller General also has authority to review direct cost records for fixed-price or cost-reimbursement negotiated contracts. The clause permits the Comptroller General access to cost projections in fixed-price negotiated contracts.⁵⁴

Although the clause has been said to be limited to *financial* data, the *type* of financial materials that you must produce has been the subject of protracted litigation, culminating with a 1983 Supreme Court decision.⁵⁵ The "Examination of Records" clause and its underlying statutory provision were first reviewed in 1967 by the U.S. Court of Appeals for the Ninth Circuit.⁵⁶ There, the Govt brought suit to enforce its right to examine a company's books and records following the contractor's refusal to provide records of production costs that were not used in pricing its Govt contracts. The Ninth Circuit construed the clause's "directly pertinent" language as "embracing not only the specific terms and conditions of the agreement, but also the general subject matter." The Court reasoned that the contract's subject matter was the procurement of specified products and, therefore, production costs were directly related to the procurement even though the contract prices were not based on production costs.

In another case 10 years later, the U.S. Court of Appeals for the Seventh Circuit took a broader view of the scope of the Comptroller General's right to examine contractors' records.⁵⁷ This case was one of a number arising from a GAO study of prices charged by pharmaceutical companies for drugs sold under negotiated Govt contracts. The Comptroller General sought access to a broad range of the contractor's books and records, including (1) records of experienced costs including costs of direct materials, direct labor, overhead, and other corporate costs, (2) support for prices charged to the Govt, and (3) other information "as may be necessary" to review "the reasonableness of the contract prices and the adequacy of the protection" afforded the Govt's interests. The Seventh Circuit held that costs could be "directly pertinent" to a contract even if they were not all assigned to the product.

The Court based its decision on the legislative history of the statute authorizing the Comptroller General's review of contractors' books and records which indicated that the legislators were concerned

with "excessive pricing." The Seventh Circuit concluded that an item is "directly pertinent" to a contract if it has "a significant input in the cost of the product purchased in the contract." This broad interpretation of the access to records provision was applied again by the Seventh Circuit in a later case⁵⁸ where it held that the Govt's demands under the "Examination of Records" clause for information relating to costs of research and development, marketing, promotion, and distribution and administration were proper.

The U.S. District Court for the Southern District of New York articulated a narrower view of the scope of the Comptroller General's access rights.⁵⁹ In that case, the Comptroller General sought access to certain cost records that included both direct and indirect cost data. The District Court rejected the Govt's argument that the Comptroller General may inspect a contractor's records with respect to "any and all costs met in whole or in part from revenues earned" on Federal contracts, whether or not the contractor specifically assigned those costs to the contracts or the products delivered. In determining which records were "directly pertinent," the District Court held that the contractor need only produce its "records relating to manufacturing costs and the pricing of the products sold" to the Govt. It need not provide data regarding research and development, marketing and promotion, and segments of distribution and administration expenses. The U.S. Court of Appeals for the Second Circuit affirmed the District Court.⁶⁰

The Supreme Court finally resolved the issue of the meaning of "directly pertinent" records in 1983.⁶¹ In that case, the Supreme Court rejected a broad construction of the Comptroller General's access rights under a fixed-price contract for standard commercial items. The Court held that the Comptroller General "may inspect the contractor's records of direct costs, but not records of indirect costs." The Court defined "indirect costs" to mean "costs incurred in the areas of research and development, marketing and promotion, distribution, and administration, which are not directly attributable to a particular product." In contrast, the Court defined "direct costs" as those costs, including direct manufacturing and overhead, which were incurred or "attributable" to a contract or product, either directly or by allocation.

Based on an analysis of the statute from which the "Examination of Records" clause is derived, the Court concluded that the term "directly pertinent"

records restricted "the class of records to which access is permitted by requiring some close connection between the type of records sought and the particular contract." The Court went on to say that Congress did *not* intend to authorize "unrestricted 'snooping' by the Comptroller General into the business records of a private contractor."

■ "Audit" Clauses

Although contractors may have welcomed the Supreme Court's 1983 decision⁶² restricting the scope of the "Examination of Records" clause, as discussed in the preceding section, that case does not impede the Govt's access to your indirect cost records under other clauses. This is because the "Audit-Sealed Bidding" and "Audit-Negotiation" clauses give the Govt broader inspection and audit rights than those provided by the "Examination of Records" clause.

Specifically, the "Audit-Sealed Bidding" clause provides that if you submit cost or pricing data in connection with any modification of the contract, the agency has the right to examine and audit all your "books, records, documents and other data . . . (including computations and projections) related to negotiating, pricing or performing the modification."⁶³ Similarly, the "Audit-Negotiation" clause provides that if the contract is a cost-reimbursement or certain cost-type contract, you must maintain, and "the Contracting Officer or representatives of the Contracting Officer shall have the right to examine and audit—books, records, documents, and other evidence and accounting procedures and practices, sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred in performing this contract."⁶⁴ If you submit cost or pricing data, the agency also has the right to examine and audit all books, records, documents, and other data "related to negotiating, pricing, or performing the contract or modification."⁶⁵ Thus, the "Audit" clauses permit the Govt to examine both *direct* and *indirect* costs related to the contract. This right to examine indirect costs is granted, however, only for the purpose of evaluating the accuracy, completeness, and currency of *cost or pricing data* submitted to the Govt.

Although the Govt's audit rights are limited under formally-advertised, fixed-price contracts to data related to contract modifications in excess of \$100,000, considerable leeway has been afforded

auditors in conducting audits under cost-type or negotiated firm-fixed-price contracts.⁶⁶ For example, the Court of Claims held that under a prior version of the "Audit-Negotiation" clause auditors were permitted to *reproduce* "proprietary" information and *remove* it from the contractor's plant.⁶⁷ In reaching this result, the Court apparently relied on standard commercial practice of non-Govt auditors where "proprietary" data is routinely photocopied and removed from a firm's premises.

Access By Subpoena

The Govt's broad right of access to contractors' records has been bolstered by recent legislation expanding the Govt's subpoena power. How this subpoena power has been recently used, and the limits the courts have placed on that power, are discussed below.

■ General

The Inspector General Act of 1978⁶⁸ not only authorized each civilian agency IG to "have access to all records, reports, audits, reviews, documents, papers, recommendations, or other material" that relate to programs and operations over which that IG has responsibility,⁶⁹ it also gave the IG the power to subpoena documents.⁷⁰ In 1982, Congress also gave the DOD IG subpoena power under the Act.⁷¹

In addition to the agency IGs, Congress gave subpoena power to both the Comptroller General⁷² and DCAA.⁷³ The General Accounting Act of 1980 provides that the Comptroller General may subpoena documents to which he otherwise has access "by law or agreement."⁷⁴ The DCAA has statutory authority⁷⁵ to subpoena documents subject to the Truth in Negotiations Act.⁷⁶ In addition, DCAA can subpoena documents of a contractor performing a cost or cost-plus-fixed-fee contract.⁷⁷

■ Scope Of IG Subpoena Power

The newly-granted subpoena power has been frequently invoked by the DOD Inspector General. For the six-month period from Apr. 1 through Sept. 30, 1987, the DOD IG issued 399 subpoenas for use in audits and investigations conducted by his office. During this same period, the DOD IG served as the coordinator for approval and issuance of another 228 subpoenas.⁷⁸ The IG has stated frankly that IG subpoenas have encountered increased acceptance by prosecutors because the subpoenas "avoid grand

jury secrecy problems which arise from the use of grand jury subpoenas.”⁷⁹

Although the issue is not settled, the scope of the DCAA and the DOD IG subpoena power is not identical. The courts have given broad latitude to the DOD IG's subpoena power, but have taken a more restrictive view regarding DCAA's subpoena power, as discussed more fully in the next section. For example, in one case,⁸⁰ a contractor challenged an IG subpoena issued at the request of DCAA for an internal audit report. The contractor argued that the IG's subpoena power did not authorize him to subpoena documents on behalf of the DCAA. The U.S. Court of Appeals for the Third Circuit rejected this contention and held that the IG could properly issue the subpoena. In enforcing the subpoena, the Third Circuit focused on the *wide-ranging* subpoena power of the IG and did not address the narrower issue of the extent of DCAA's right of access to contractors' records.

The wide latitude given to the DOD IG in exercising his subpoena power is also reflected by a recent U.S. Court of Appeals for the D.C. Circuit case.⁸¹ In that case, the DOD IG issued subpoenas at the request of the Justice Department, which was investigating allegations of price-fixing in the moving and storage industry. The van lines, which were the targets of the subpoenas, contended that the IG merely “rubber stamped” the Justice Department's request. They sought discovery to substantiate their position. The D.C. Circuit denied the van lines' discovery request and held that there are no restrictions on the DOD IG's ability to cooperate with the Justice Department in criminal investigations. Thus, the Court enforced the IG subpoena.

■ Scope Of DCAA Subpoena Power

According to the drafters of the statute granting subpoena power to the DCAA, the stated purpose of the law is *not* to expand DCAA access to contractors' records. The legislative history is explicit:⁸²

This provision is not intended to expand the scope of books, documents, papers or records to which [DCAA] presently has access, but rather to provide the director of the agency with an enforcement mechanism if a contractor does not make such books, documents, papers or records readily available. The conferees believe that the subpoena power should be used sparingly, and generally only when alternative investigatory methods have proven inadequate to obtain the materials that are sought. In addition, it should be used only in the performance of the functions and purposes ascribed to the contract audit agency.

Thus, at the same time that the courts have held that the DOD IG has *broad* subpoena power, they also have held that the DCAA's right of access is much *narrower*. In one case, for example, a U.S. District Court held that DCAA did not have authority to subpoena a contractor's internal audit reports.⁸³ The Court expressly distinguished between *investigative* audits conducted by an IG and *contract* audits conducted by the DCAA. The Court held that both the statutory language and the underlying legislative history granting subpoena power to DCAA limit the DCAA's subpoena authority to “only those books and records, etc. which relate to costs of a particular contract.” The Court also stated that the power to issue subpoenas “did not license the DCAA for any ‘fishing expeditions through corporate records.’”

The District Court's decision was recently affirmed by the U.S. Court of Appeals for the Fourth Circuit.⁸⁴ The Fourth Circuit held that the “statutory subpoena power of the DCAA extends to cost information related to [Govt] contracts,” but that DCAA “does not have unlimited power to demand access to all internal corporate materials of companies performing cost-type contracts for the [Govt].” The Court further held that “cost verification data, not the work product of internal auditors, is the proper subject of a DCAA subpoena.”

The Court of Appeals based its decision on several factors. First, it stressed that the subpoenaed reports contained an analysis of *several* contracts evaluating the contractor's performance over an entire division or unit, rather than one particular contract. Second, the Court concluded that the internal audit reports contained “*subjective evaluation*” by the internal auditors of the contractor's operations, as well as the auditors' recommendations for change. The Court ruled that DCAA was not entitled to the work product of the company's internal auditors.

The final factor that influenced the Court of Appeals was the difference between the *functions* of the IG and the DCAA auditor. The Court noted that the IG is empowered by statute to “investigate fraud, waste and abuse” and is given broad subpoena power to discharge that responsibility. By contrast, the DCAA is charged with performing “a no less important, but different, function—cost accounting for the purpose of assisting in the negotiation and administration of defense contracts.” Given these differing functions, the Fourth Circuit concluded that the DCAA had no legal basis for access to the contractor's internal audit reports.

Shortly before the Fourth Circuit's decision, the same District Court refused to enforce a separate DCAA subpoena against the same contractor.⁸⁵ In this second subpoena, DCAA requested "[t]rial balance, adjusting entries, segment financial workpapers, consolidating entries, formal consolidated balance sheet and income statement, Federal income tax return, Virginia income tax returns, and any other supporting schedules, documentation or correspondence related to preparation or payments" of any Federal or local or state taxes for a period of four years. The contractor agreed to give DCAA only its state tax return. The District Court determined that both the statutory and regulatory language governing DCAA's subpoena power "clearly indicates that the cost and pricing data available to DCAA is contract-specific and is for the purpose of auditing costs incurred or anticipated in connection with a particular contract." Applying this standard to the information DCAA sought, the Court held that the subpoenaed information had "too tenuous and indirect" a relationship to any particular contract and thus was not subject to the subpoena power of DCAA.

These recent cases appear to refute DCAA's position that it has broad-ranging access to a contractor's internal company records. Although these decisions address the proper scope of a DCAA subpoena, they also implicitly address the proper scope of DCAA's *access to records*. This is so because the statute giving DCAA subpoena power, as noted above, was *not* intended to broaden DCAA's access rights. The cases therefore stand for the proposition that DCAA's access is limited to *objective cost data*.

DCAA has already taken steps to nullify these judicial precedents. Specifically, DCAA has sought to incorporate a provision in future contracts granting DCAA access "to internal audit reports and internal documents, whether they affect direct or indirect costs of a contract."⁸⁶ It remains to be seen whether DCAA's effort to exceed its statutory authority will be successful.

Your Records Management Policy

A prudent contractor must assume an environment of ever-increasing demands for its records. You should, therefore, rethink your entire record *retention and generation* process. This includes all areas of document creation and control. Notwithstanding any potential disadvantages, you should create a records management system that complies

with all appropriate statutes, regulations, and contract clauses. This policy should include appropriate *safeguards* to protect your legitimate and lawful interests in preventing disclosure of certain information.

Each contractor's records management policy must be tailored to its unique business needs. Because the specific factors that influence this policy (such as the nature of the business, its organization and size, and the industry in which it operates) vary greatly from contractor to contractor, it is not feasible to set forth a fixed policy that will apply to every contractor. Some of the general controls that apply to all such programs, however, are discussed below.

■ General Considerations

You should create a *written official company policy* covering both *mandatory* and *discretionary* documents. This policy must cover *creation* and *maintenance* of the documents and should be coordinated among all segments of the company, including at least the following general departments or functions: contracts, legal, finance, manufacturing/production, and administration.

Your records management policy will not be effective unless your *employees* are made aware of its importance. By creating the wrong kind of documents or by refusing to follow the established procedures, employees can effectively nullify any policy you may institute. Thus, you should establish a *formal education program* to apprise employees of the importance of the records management policy.

Finally, in creating and maintaining documents, keep in mind the *appearance* of the documents, and what a person inexperienced in the area—like an Assistant U.S. Attorney or a Federal judge—might construe them to mean. Obviously, the more attractive (or less offensive) the document, the better.

■ "Discretionary" Records

As noted earlier in this PAPER, the records retention requirements in the procurement regulations are relatively straightforward, albeit susceptible to some interpretation disputes. Thus, a records management policy complying with these requirements is fairly easy to construct. The key to a truly *effective* policy, however, is control over the "discretionary" record.

Documentation of a job's progress and the events occurring on the job must, of course, be maintained for claims and other valid purposes. At the same time, however, you should recognize that every single record that is generated *may* eventually be seen by the Govt. It could even be said that, in today's climate, a defense contractor should expect that *every* document it creates *will* eventually be seen by the DCAA, the IG, and a representative of the U.S. Attorney or the Defense Procurement Fraud Unit. Therefore, you must construct a system which ensures that your company creates only those documents that the company would want the Govt, in any of its capacities, to see.

For example, you should control the creation of *personal journals* and *memoranda*. These documents often reflect misunderstandings or the author's incomplete understanding of a situation. In addition, you should warn employees against using words in their memoranda which cast conduct in an improper light, and against creating documents that contain false or inaccurate information. To the extent that records contain inaccurate or distorted information, a corrective memo should be created and filed. Similarly, official files should comment on any Govt foul-ups that relate to on-the-job performance.

The classic discretionary record that causes tremendous problems is the "Memo to the File" generated by an employee who is disturbed about a particular action the company is taking and wishes to record his displeasure with the action. Because the author feels it necessary to protect him/herself, the memo is often embellished with data that is inaccurate, incomplete, or just untrue. Unless employees are given another avenue for venting their frustration, the "Memo to the File" will be a fixture in every organization.

The best method for eliminating or decreasing the number of such memos is to establish formal procedures or an ombudsman to address complaints without retaliation. Some contractors have gone so far as to consider imposing disciplinary sanctions on employees who violate a prohibition on discretionary record creation. To counterbalance this, these contractors have considered implementing a "no retribution/always respond" program so that employees who otherwise would bury memos in files are assured that their concerns are noted and addressed. The advantage to the company in such cases is that someone with *full knowledge* of all the facts and circumstances can then set the record straight.

■ Duplicate Records

An effective records management policy should also limit all forms of *informal* record retention, even those that appear to be job-related. You should maintain only one official file on a contract and should *eliminate* all *duplicate* records. For example, you should assign one individual to take detailed minutes of meetings, and these minutes should be placed in the official contract file. You should also develop preprinted telephone memoranda which should be officially maintained.

■ Destruction Of Records

While there is absolutely no prohibition against your limiting the universe of documents that your employees create and maintain, you should only *destroy* records in accordance with a formal document retention policy that complies with all the applicable regulations. Record retention policies are always examined closely by prosecutors when a contractor is unable to locate documents that the Govt believes exist. The destruction of documents subject to subpoena or administrative process may constitute the crime of obstruction of justice.

There are three primary "obstruction of justice" criminal statutes. They prohibit (1) influencing or injuring a court officer, juror, or witness (§1503),⁸⁷ (2) obstructing proceedings before Federal departments, agencies, or legislative committees (§1505),⁸⁸ and (3) obstructing criminal investigations (§1510).⁸⁹ A major difference between the three statutes relates to the *type* and the *timing* of the proceedings involved. Section 1503 applies to *pending* judicial action, §1505 applies *after* an administrative or legislative investigation or proceeding has begun, and §1510 applies *before* a criminal proceeding has begun. Taken together, the three sections prohibit destruction of documents (a) *after learning* of an investigation but *before contact* by the investigating authorities, (b) during *voluntary cooperation* with the authorities, or (c) *following* the service of process calling for documents.

The three statutes set forth only generalized standards. Hence, they furnish little guidance regarding the culpability of particular conduct in concrete situations. It is clear, however, that an indictable offense under §1503 requires that records be destroyed *either* after a grand jury has been convened and subpoenas have been issued⁹⁰ or after a complaint has been filed in a civil case.⁹¹

The scope of §1505, however, is much less well defined. Section 1505 relates to the obstruction of congressional or agency "proceedings." The statute provides no clear definition of the term "proceedings." The courts nonetheless have defined the term broadly to include "the investigation or search for the true facts" which occurs *before* commencement of formal agency or congressional action.⁹² Thus, courts have held that a preliminary staff investigation into corporate pricing practices⁹³ and a formal order issued directing investigation to begin⁹⁴ constitute "proceedings" under §1505. Section 1505, however, only prohibits destruction of documents that may be *relevant* to a congressional or agency proceeding.

While a liberal reading of §1505 might permit destruction of documents before you have *actual knowledge* of a "proceeding," under a stricter reading of the statute destruction may be prohibited where you have only a *suspicion* that a "proceeding" is underway. In the current climate in which charges of alleged contractor misconduct are so prevalent, to avoid potential liability under §1505 you should preserve *any* documents relevant to a suspected "proceeding."

The scope of §1510 is the broadest of the three statutes. It applies to the destruction of documents solely *before* judicial, administrative, or congressional proceedings have begun. By its terms, the section applies whenever an investigator is conducting a search for information about illegal activities. Section 1510 was enacted in 1967 and rarely has been construed by the courts. Nonetheless, it appears confined to situations in which documents are destroyed (a) before proceedings have begun and (b) in an intentional effort to preclude communication of incriminating information to an investigator. Routine, nonselective destruction of records, pursuant to an established records policy, would thus not appear to be within the scope of §1510.

It must be stressed that the key to liability under each of these three statutes is *criminal intent*. That is, the courts will require that the Govt prove that you *knew*,⁹⁵ or in some cases reasonably *should have known*,⁹⁶ that destruction of documents will impede the administration of justice. Absent such specific knowledge, destruction of documents pursuant to an established business practice should not run afoul of these criminal statutes.

In sum, you should maintain all records for at least the minimum period required by law and destroy

documents in accordance with a standard policy. The destruction procedures should include a mechanism that permits your managers to *halt* destruction of records when required—for example, when an investigation has been initiated. In addition, you should have a procedure for blocking employees who may have an incentive to destroy documents from obtaining access to the company records.

■ Self-Evaluative Records

Self-evaluative records should be created with caution. Although these records serve an important function in management, they generally are not privileged. Thus, you should examine the purpose of these reports and control their content. For example, if the goal of a report is to determine whether a problem exists, findings should be summary in nature. Moreover, once the final report is completed, there may be no need to retain the detailed notes and work papers underlying the report.

If, in creating self-evaluative records, there is an *indication* that fraud has occurred or is occurring within the company, then procedures should be in place requiring the internal investigation to stop until the matter has been brought to the attention of counsel. This will provide a basis to claim that any documents created after consultation with counsel are privileged. To maintain this claim of privilege, however, any communication must be made for the purpose of obtaining *legal advice*, and the *confidentiality* of the investigation must be maintained. Merely assigning a lawyer or deputizing nonlawyers to conduct an internal investigation is insufficient, without more, to bring the investigation under the cloak of privilege.

■ Potential Disadvantages

You should be aware of the potential disadvantages of a records management policy. The disadvantages include:

- (1) Inability to prove a fact because pertinent documents have been destroyed.
- (2) Diminished flexibility of response to formal and informal document requests.
- (3) Adverse inferences arising from incomplete compliance with the program.
- (4) Adverse inferences arising from selective destruction of documents outside the established procedures.

(5) Potential disclosure of your file types and organization during the course of litigation with competitors.

All of these disadvantages, however, must be weighed against the benefits of maintaining proper control over your records.

GUIDELINES

These *Guidelines* are designed to assist you in preparing for Govt requests to examine your contract records and in establishing a records management policy. They are not, however, a substitute for professional representation in any specific situation.

1. Contracting with the Govt imposes a substantial *obligation* on contractors to maintain records. Be aware of the record retention requirements expressly set forth in statutes, regulations, and contract clauses.

2. The Govt—through agency IGs, the DCAA, the U.S. Attorneys, and the Defense Procurement Fraud Unit—has become increasingly aggressive in seeking access to your records. Remember that the Govt may demand access to a broad range of your records, including certain records to which it may have *no legal right*.

3. As recent court and administrative decisions have shown, you can successfully oppose unlawful Govt requests for access to your records. There are, however, *practical consequences* that follow from taking this approach. The decision to oppose any request for access must be made carefully.

4. You should establish a comprehensive records management policy *before* the Govt seeks access to

your records. It is too late to do so after the Govt has initiated procedures to obtain your records.

5. A records management policy must be crafted so as not to violate any obstruction of justice statutes. Thus, your policy must include procedures to *halt* routine destruction of documents whenever you *suspect* that an investigation has begun.

6. You should create a *written official company policy* covering both *mandatory* and *discretionary* documents. It should include a mechanism to control the *creation of discretionary* records and should *limit informal record retention*.

7. You should maintain only *one* official file per contract, and that file should include *all* relevant materials relating to the particular contract.

8. You should create self-evaluative records with caution. If, in creating these records, you discover that the company may have committed *fraud* in connection with a contract, then you should have procedures in place requiring the investigation to stop until the matter has been brought to the attention of *counsel*.

9. Always keep in mind the *appearance* of documents. The more attractive, or less offensive, the document, the better.

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