

# MAJOR FRAUD ACT OF 1988

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## HEARINGS BEFORE THE SUBCOMMITTEE ON CRIME OF THE COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST AND SECOND SESSIONS

ON

**H.R. 3500 and H.R. 3911**

MAJOR FRAUD ACT OF 1988

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DECEMBER 3, 1987, AND MARCH 16, 1988

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**Serial No. 92**



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# MAJOR FRAUD ACT OF 1987

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THURSDAY, DECEMBER 3, 1987

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CRIME,  
COMMITTEE ON JUDICIARY,  
*Washington, DC.*

The subcommittee met, pursuant to call, at 11:00 a.m., in room 2226, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, Mazzoli, and McCollum.

Staff present: Hayden Gregory, chief counsel; Edward O'Connell, counsel; Paul McNulty, associate counsel; and Phyllis Henderson, clerk.

Mr. HUGHES. Good morning, and welcome to the Subcommittee on Crime's hearing on H.R. 3500, the Major Fraud Act of 1987.

[A copy of H.R. 3500 follows:]

100TH CONGRESS  
1ST SESSION

# H. R. 3500

To amend title 18, United States Code, to provide increased penalties for certain major frauds against the United States.

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## IN THE HOUSE OF REPRESENTATIVES

OCTOBER 15, 1987

Mr. HUGHES (for himself, Mr. MCCOLLUM, Mr. HERTEL, Mr. MAZZOLI, Mr. FEIGHAN, Mr. SMITH of Florida, Mr. STAGGERS, Mr. SHAW, Mr. CROCKETT, and Mr. SMITH of Texas) introduced the following bill; which was referred to the Committee on the Judiciary

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## A BILL

To amend title 18, United States Code, to provide increased penalties for certain major frauds against the United States.

1        *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4        This Act may be cited as the "Major Fraud Act of  
5 1987".

6 **SEC. 2. CHAPTER 47 AMENDMENT.**

7        (a) **IN GENERAL.**—Chapter 47 of title 18, United  
8 States Code, is amended by adding at the end the following:

1 **“§ 1031. Major fraud against the United States**

2       “(a) Whoever, having devised or intending to devise any  
3 scheme or artifice to defraud, or for obtaining money or prop-  
4 erty by means of false or fraudulent pretenses, representa-  
5 tions, or promises, defrauds or attempts to defraud the United  
6 States in any procurement of property or services for the  
7 Government, if the consideration for such property or serv-  
8 ices is \$1,000,000 or more shall be fined under this title or  
9 imprisoned not more than 7 years, or both. The fine imposed  
10 for an offense under this section may exceed the maximum  
11 otherwise provided by law if such fine does not exceed twice  
12 the amount which is the object of the fraud. A prosecution of  
13 an offense under this section may be commenced any time  
14 not later than 7 years after the offense is committed.

15       “(b) Upon application by the Attorney General, the  
16 court may order a payment from a criminal fine under this  
17 section to an individual who furnished information leading to  
18 the conviction under this section. The amount of such pay-  
19 ment shall not exceed \$250,000. An officer or employee of a  
20 government who furnishes information or renders service in  
21 the performance of official duties is not eligible for a payment  
22 under this subsection.”.

1           (b) CLERICAL AMENDMENT.—The table of sections at  
2 the beginning of chapter 47 of title 18, United States Code,  
3 is amended by adding at the end the following new item:  
“1031. Major fraud against the United States.”

○

Mr. HUGHES. This hearing continues the subcommittee's long-standing interest in the area of white collar crime with today's emphasis being on procurement fraud, one of our most significant economic crimes.

In today's hearing, we will discuss a disturbing trend of successive scandals in procurements for spare parts, overhead charges, malfunctioning equipment and various other fraudulent schemes that bilk the American taxpayers of billions of dollars and at the same time diminish their confidence in the Executive Branch's ability to efficiently administer essential governmental functions.

To put this in perspective, in the Defense Department area alone, we spend about \$600 million every day in over 5,500 installations where we, directly or indirectly, employ 6.3 million people. In this process, the Department of Defense deals with over 60,000 prime contractors to meet its requirements for items ranging from basic supplies and equipment to major weapon systems.

This tremendous quantity of procurement makes the potential dollar impact of this type of fraud enormous and, unfortunately, as in Murphy's Law, the worst possible case often happens.

As a consistent advocate for a strong defense, the testimony we will hear today is particularly distressing to me. It contains documentation of greed and malfeasance in the private sector of astronomical proportions, combined with inefficiency and acquiescence by the Federal Government.

Today, we will consider the Major Fraud Act of 1987, a bill I introduced, with some of my colleagues, on October 15 to address the problem of procurement fraud. H.R. 3500 creates a new procurement fraud offense. In situations involving \$1 million or more, the time-tested language in the Mail Fraud Act would be applied, with a new enhanced penalty of up to seven years imprisonment upon conviction.

The bill also would provide an extension of the statute of limitations in which prosecutions could be initiated to seven years, rather than the normal five years, to accommodate the extensive investigation often required in this type of fraud. Increased fines, based upon double the object of the fraud—for example, a \$20 million fine in the case of a \$10 million contract—are permitted rather than existing criminal law which is couched in terms of pecuniary gain to the defendant or loss to the Government.

Finally, the bill establishes a reward system under which up to \$250,000 can be paid from the criminal fine to individuals who provide information leading to the convictions under this act. This will add incentives to individuals, particularly employees of Government contractors, who are privy to illegal activities to volunteer information to Government authorities.

To date, such persons have had little to look forward to for their own good citizenship efforts other than recriminations by their employers, which frequently could include the loss of their jobs.

I am looking forward with great interest to the testimony of our witnesses today. They are uniquely qualified to inform us of the



nature and extent of procurement fraud as well as advise us on potential solutions.

Our first witness today is a colleague of mine. Unfortunately, Senator Grassley has a conflict and can't be with us.

[The statement of Mr. Grassley follows:]

TESTIMONY OF SENATOR CHARLES E. GRASSLEY  
on  
HR 3500  
Before the  
HOUSE JUCICIARY COMMITTEE SUBCOMMITTEE ON CRIME

DECEMBER 3, 1987

GRASSLEY

Mr. Chairman, I wish to thank you for the invitation to testify before this subcommittee, and to commend you for your continued efforts to protect against the pilfering of taxpayer dollars through fraudulent schemes. HR 3500, in my view, represents a large and necessary step in our battle against defrauders of the Treasury.

I will not belabor the point, Mr. Chairman, about the existence and magnitude of the fraud problem facing the citizens of this nation. Suffice it to say that when the federal government becomes as large as it is today -- with spending over one trillion dollars a year, or nearly three billion dollars a day -- clearly the managability of such numbers becomes nearly impossible, and the opportunity for fraud becomes great.

In that context, the estimate of perhaps ten percent of the federal budget being lost each year due to fraud, which is an estimate given by the Justice Department, is totally believable, although unfathomable. In today's dollars, that is one hundred billion dollars. One hundred billion dollars today buys all the weapons for all the services that we plan to buy in this year's defense budget. In addition, there would still

be enough left over to fund the entire array of military research and development programs that also are in this year's defense budget. Looking at it another way, one hundred billion dollars would fund our entire agriculture budget for rural America, plus our entire transportation budget, plus our education budget, plus housing, plus Food Stamps, and there would still be billions of dollars left over. That, Mr. Chairman, should give us some idea of the dimensions of what we are dealing with when we speak about fraud against the taxpayers of this country.

My first point, then, Mr. Chairman, is that as the federal budget grows to unmanageable proportions, so do the opportunities for fraud grow proportionately. When taking that point, together with the rash of recent incidents that have peppered our reading and viewing pleasure on an almost daily basis, these are solid grounds for moving in the direction you are with HR 3500. Simply put, when major fraud occurs, you need a major tool to combat it.

During the last Congress, Mr. Chairman, I authored the False Claims Reform Act of 1986, which was signed into law by the President, and is now part of the U.S. Code. The False

Claims Reform Act constituted a much-needed and pragmatic reform of our civil fraud enforcement laws. HR 3500 is compatible with that act in a criminal context. For that reason, I believe it is instructive to indicate, here, some of the findings, insights and suggestions that were raised during the passage of our False Claims Bill, that would be relevant to your endeavors, Mr. Chairman, as your subcommittee considers HR 3500.

In hearings before the Senate Judiciary Subcommittee on Administrative Practice and Procedure, witnesses offered three general recommendations for more effective enforcement against fraud: 1) increased penalties for more meaningful deterrence; 2) enhanced investigation and litigative tools, as well as monetary recoveries; and, 3) protections for those who step forward.

Using this framework as a guideline for our legislative efforts in Congress, I would offer the following two suggestions to be considered by the subcommittee as amendments to HR 3500. The first and most important relates to protections for those who step forward. Few individuals would come forth and supply information if they feared their

disclosures would lead to harassment or retaliation. This is as true in a criminal context as it is in a civil context.

The False Claims law now contains a section providing so-called "whistleblowers" with "make whole" relief. In drafting that provision, we were guided by provisions found in Federal safety and environmental statutes. With your permission, Mr. Chairman, I would like to provide for the record a copy of that statute as it now appears in the U.S. Code, as well as the section in the legislative history of S. 1567 which describes the protection provisions, and which also lists the sources of other protection provisions in current law that we used as a guideline. It would be my suggestion, then, Mr. Chairman, that the subcommittee consider adding such protections to HR 3500, adapting the protections, of course, to meet the requirements of your bill. It would apply to the section of the bill that deals with individuals who furnish information leading to a conviction. Circumstances would certainly be more favorable for someone to come forward with information if he or she had some statutory assurances protecting against retaliation.

The second suggestion I would have, Mr. Chairman, would be to increase from seven years to ten years the length of

imprisonment for conviction. The rationale behind this suggestion is that ten years would match that of the major current statute governing "conspiracy to defraud" the government. That citing is 18 U.S.C. section 286. In my opinion, Mr. Chairman, the penalty in a major criminal fraud case should be at least equal to that conspiracy statute.

Finally, Mr. Chairman, I would like to provide for the record an investigative report prepared for the Subcommittee on Administrative Practice and Procedure, as well as the Joint Economic Subcommittee on National Security Economics. This report is dated March 19, 1987, and is entitled "Justice Department Investigations of Defense Procurement Fraud: a Case Study." The significance of this report is that it shows, using a case example of an alleged major fraud, that the prosecutors of the case had great difficulty prosecuting because of insufficient statutory tools and statutory flexibility. It also contains a section that is a critique of the Defense Procurement Fraud Unit, whose majority of cases involve criminal fraud. I believe that this report would be of helpful value as background information for this subcommittee, Mr. Chairman, as it considers HR 3500.

In conclusion, I would again like to extend my thanks for the opportunity to testify before you today, Mr. Chairman, and join you and others of my colleagues in doing what we can, legislatively, to guard the Treasury against fraud. I look forward to working with you further on this bill as it moves its way through the process, particularly on the Senate side.



Mr. HUGHES. We are joined by Congressman Dennis Hertel. Dennis is a Congressman from the 14th Congressional District of Michigan.

He was first elected to Congress in 1980, and has been a very positive force in the House since then. Prior to being elected to Congress, he had a distinguished record as a State representative in Michigan.

I have had the pleasure of serving with Dennis on the Merchant Marine and Fisheries Committee and the Select Committee on Aging where he is an extremely valued and active member. He also is a member of the Armed Services Committee where he has been on the front lines in Congress' attempts to prevent fraud against the Federal Government. This has included measures to improve the quality of defense acquisitions personnel, realistic testing of weapons systems and reforming defense contracting procedures.

He also is a past chairman of the House Democratic Task Force on Waste, Abuse and Fraud on the Department of Defense.

Dennis, we are just delighted to have you with us today. We have your statement. Without objection it will be made part of the record; and you may proceed as you see fit.

**TESTIMONY OF HON. DENNIS M. HERTEL, A UNITED STATES  
REPRESENTATIVE FROM THE STATE OF MICHIGAN**

Mr. HERTEL. Thank you, Mr. Chairman.

I would like to submit for the record, my testimony of last year in consideration of the very same issue and I want to commend you for your continued efforts in this role.

The staff and the committee have been very helpful. I believe H.R. 3500 will be a very useful enforcement tool. It has been a privilege for me to work with the Judiciary Committee on efforts to protect our defense acquisition process from abuse and misuse.

I have previously worked with the Administrative Law Subcommittee on false claims and program fraud civil penalties. I have included a copy of that testimony because the statistics I presented then have relevance to today's proceeding.

First, let me say that as in any case, even in dealing with something which is the biggest single budget, the biggest single entity in the entire world, the Department of Defense, looking at a procurement, and all the other decisions and processes they deal with, the bill, H.R. 3500, has other remedies aimed at only a few bad apples.

We have bad apples in every profession, every way of life, and the law, of course, is aimed at applying to them. The vast majority of people work in our defense industry—I have been able to see this first hand from meetings and travels—are very patriotic and hard working.

What we are trying to do, in stopping the waste, fraud and abuse, is to say that we are going to be tough with those that we discover, so that the others won't be painted with that very same brush. The others are making the dedicated efforts, and there are others that are working very hard making sacrifices. The other patriotic Americans who work in the defense industry will not be painted with the same brush of waste, fraud and abuse.

If we look at the figures, we see that the Department of Defense statistics on prosecution of waste, fraud and abuse has an average recovery of only \$1,800 on cases referred for prospective or administrative action in 1983. The rate of successful prosecutions can only be described as dismal.

The President's Council on Integrity and Efficiency, reporting on efforts to prevent fraud, waste and mismanagement for the first six months of fiscal year 1987, show that despite major legislation passed by Congress, rampant waste persists particularly at the Department of Defense.

During this six-month period 10,451 allegations of waste, fraud and mismanagement were made to inspectors general government-wide. Fully 55 percent of the allegations were concerned with the Department of Defense.

However, only 22 percent of the successful prosecutions and only 34 percent of the total recoveries in these cases were made by the Department of Defense.

Clearly DOD is not keeping pace with government-wide efforts in fighting waste and fraud. Furthermore, on March 19, 1987, a staff report presented to the Subcommittee on National Security Economics of the Joint Economic Committee and the Subcommittee on Administrative Practices of the Judiciary Committee concerning "Justice Department Investigations of Defense Procurement Fraud: A Case Study" found:

One, the Justice Department's Defense Procurement Fraud Unit has not sufficiently corrected the numerous problems encountered with previous investigations of major shipbuilders.

Two, DPFU has experienced excessive staff turnover, and effective coordination with the Defense Department still appears to be in need of improvement.

Three, DPFU has produced few successful prosecutions of major contractors. As of July 1986, the unit had participated in only three convictions of major defense contractors. In all three cases, the sentences were limited to fines.

Four, DPFU appears to lack an adequate recording system for cases referred to it. According to the General Accounting Office, the unit could not produce records showing reasons for actions, if any, taken with regard to 58 case referrals.

The vast amount of money that channels through the Department of Defense and the comparatively low risk of successful prosecution make defense fraud and abuse an inviting and lucrative area.

We are talking about clearly not much of a risk if, in effect, you commit a fraud and if it is discovered, and if very few of those cases are prosecuted, and very few of those lead to any type of sentence.

In fact, if we are talking about only civil fines, we are talking about the fact that there really isn't any risk at all, because if you are not barred from doing business with the Government after you are discovered in committing the fraud, you can recoup the fine in further contracts.

I think my testimony of today, and in 1986, create a sketch of a failure of legal deterrence which has existed and been documented for at least six years.

I think it is ironic because when this Administration came into office it talked about combating waste, fraud and abuse in all quarters of Government.

Clearly we have a problem in the administration of justice. It is complicated by the unique nature of the military bureaucracy. The Defense Acquisition Policy Panel of the Armed Services Committee on which I serve held a hearing on November 19, 1987 on Military Whistleblower Protection.

Witness Eugene R. Fidell, commenting on his study for the Administrative Conference of the United States, "There were surprising gaps in protection afforded to private sector whistleblowers," and, "Congress cannot assume that the kinds of mechanisms that might in another context serve as a surrogate for institutional protection of whistleblowers will be effective in protecting uniformed whistleblowers."

In essence, we have trouble making cases because we have trouble getting witnesses.

In addition, because of the uniqueness of the Department of Defense and the contractors, and the entire industry, we are talking about an industry that can only be used for one purpose, selling to the Department of Defense, as far as weapon systems, and as far as people in uniform working in the entire defense area, unlike other areas where somebody could be a whistleblower and then move into another profession, another area of work.

It is a very limited circle, even admitting the size of the defense area, there their experience is in that one area, so they are not going to go out and become a banker the next week, or go into other related areas with the experience they have achieved in defense related industries, or the Pentagon, and therefore, they have even more of a closed door, even more of risk to whistleblowers coming forward if he is going to limit his future employment and current possibility of having a job and that type of protection.

This brings us to today's legislation. I believe H.R. 3500 is an important tool because it provides an essential element in legal deterrence. It creates uncertainty in the mind of the wrongdoer to conceal his activity, if there were economic incentives for individuals to come forward and testify.

The discretionary aspects of the bill would balance claims of possible abuse by disgruntled employees. This is not criticism of important whistleblower protection legislation. We need all the tools we can get to stem the tide of waste and abuse. I recommend H.R. 3500 as an important weapon in that arsenal.

You know we look back at 1980, and we see that the subcommittee wanted an across-the-board cut, but a great deal more was spent on the defense of this country. All of the public opinion poles showed that it was upward 75 percent of the American people feeling, because of what has gone on around the world, we had to have a stronger defense.

Beginning in 1984 and up to the present time, we see the public asking for a freeze in defense spending, again overwhelming percentages, 67-72 percent, according to public opinion poles. Almost entirely because they feel that money has been misspent in the defense budget.

They know that money that is misspent does not make for a stronger defense. In fact, they know that money that is misspent is actually stealing from our defense and stealing from the men and women who are making the sacrifices on behalf of our country today.

If we look at the Presidential candidates, we see that across the board, practically every one, including conservative Republican presidential candidates, are talking about a cut in the defense budget. They are talking about cuts ranging from \$30 billion to higher figures.

Those are substantial cuts. It is clear to me, that without changing our responsibility in defending our country and our allies around the world, the only to have that kind of savings is doing after the waste, fraud and abuse in the Pentagon.

While I don't see the presidential candidates talking about how they are going to do that, I do see H.R. 3500 as presenting that kind of alternative for the future and letting people stand up when they know about waste, fraud and abuse with some feeling of protection and some incentive to do so. Because people are willing to put themselves at risk, they need some protection so they are not out there alone. In fact, they do take a risk. It is followed up and that's all that is done. All the sacrifices they have made are for nothing.

Mr. Chairman, I will be glad to answer any questions.

[The statement of Mr. Hertel follows.]

COMMITTEES  
 ARMED SERVICES  
 MERCHANT MARINE AND  
 FISHERIES  
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November 30, 1987

STATEMENT OF THE HONORABLE DENNIS M. HERTEL  
 ON  
 H.R. 3500, THE MAJOR FRAUD ACT

MR. CHAIRMAN:

I want to thank you for allowing me to testify today on H.R. 3500, the Major Fraud Policy Act of 1987. I want to commend you and your staff on this legislation, I believe it will prove to be a very useful law enforcement tool. [It has been a privilege for me to work with the Judiciary Committee on efforts to protect our defense acquisition process from abuse and misuse. I have previously worked with the Administrative Law Subcommittee on false claims and program fraud civil penalties. I have included a copy of that testimony because the statistics I presented have relevance to today's proceeding.] (1)

An examination of these figures show Department of Defense statistics on prosecutions of waste, fraud and abuse cases had an average recovery of \$1800 on cases referred for prosecutive or administrative actions in FY 1983. The rate of successful prosecutions can only be described as dismal.

[The President's Council on Integrity and Efficiency, reporting on efforts to prevent fraud, waste and mismanagement

for the first 6 months of fiscal year 1987 show that despite major legislation passed by Congress, rampant waste persists particularly at the Department of Defense. During this 6 month period 10,451 allegations of waste, fraud and mismanagement were made to inspectors general government wide. Fully 55% of the allegations were concerned with the Department of Defense. However, only 22% of the successful prosecutions and only 34% of the total recoveries in these cases were made by the Department of Defense.

Clearly DoD is not keeping pace with government-wide efforts in fighting waste and fraud. Furthermore, on March 19, 1987, a staff report presented to the Subcommittee on National Security Economics of the Joint Economic Committee and the Subcommittee on Administrative Practices of the Judiciary Committee concerning "Justice Department Investigations of Defense Procurement Fraud: A Case Study" found :

- 1) The Justice Department's Defense Procurement Fraud Unit has not sufficiently corrected the numerous problems encountered with previous investigations of major shipbuilders.

- 2) DPFU has experienced excessive staff turnover, and effective coordination with the Defense Department still appears to be in need of improvement.

- 3) DPFU has produced few successful prosecutions of major contractors. As of July 1986, the Unit had participated in only three convictions of major defense contractors. In all three cases, the sentences were limited

to fines.

4)DPFU appears to lack an adequate recording system for cases referred to it. According to the General Accounting Office, the Unit could not produce records showing reasons for actions, if any, taken with regard to 58 case referrals.

The vast amount of money that channels through the Department of Defense and the comparatively low risk of successful prosecution make defense fraud and abuse an inviting and lucrative area.(2)

I think my testimony of today and in 1986 create a sketch of a failure of legal deterrence which has existed and been documented for at least six years.(3)

Clearly we have a problem in the administration of justice. It is complicated by the unique nature of the military bureaucracy. The Defense Acquisition Policy Panel of the Armed Services Committee on which I serve held a hearing on November 19, 1987 on Military Whistleblower Protection. Witness Eugene R. Fidell commenting on his study for the Administrative Conference of the United States, "...there were surprising gaps in protection afforded to private sector whistleblowers," and, "...Congress cannot assume that the kinds of mechanisms that might in another context serve as a surrogate for institutional protection of whistleblowers will be effective in protecting uniformed whistleblowers." In essence, we have trouble making cases because we have trouble getting witnesses.(4)

<sup>Thus</sup>  
~~Which~~ brings us to today's legislation. I believe H.R. 3500 is an important tool because it provides an essential element in legal deterrence. It creates uncertainty in the mind of the wrongdoer to conceal his activity, if there were economic incentives for individuals to come forward and testify. The discretionary aspects of the bill would balance claims of possible abuse by disgruntled employees. This is not criticism of important whistleblower protection legislation. We need all the tools we can get to stem the tide of waste and abuse. I recommend H.R. 3500 as an important weapon in that arsenal./



Statement of the Honorable  
Dennis M. Hertel  
Before the Subcommittee on  
Administrative Law and  
Government Relations of the  
Committee on the Judiciary

February 5, 1986

MR CHAIRMAN:

I thank the Subcommittee for the opportunity to testify before you on the topic of false claims and program fraud civil penalties legislation.

I commend the subcommittee for taking up this issue and I salute my colleagues, particularly the ranking member of the Judiciary Committee Mr. Fish and Senator Cohen for their work and leadership on this issue.

I came to this problem a number of years ago as a member of the House Armed Services Committee. A survey of the Department of Defense statistics on efforts to curb waste, fraud and abuse in Secretary Weinberger's Annual Report to Congress for fiscal year 1986 is presented in the following chart:

	FY 1984	FY 1983	FY 1982
INVESTIGATIVE CASES			
--Cases closed	15,837	16,357	13,668
--Cases referred for prosecutive or administrative action	5,436	8,023	6,688
--Convictions	548	657	384
--Fines, penalties, restitutions and recoveries collected from referrals:			
----Justice Dept.	\$18,031,000	\$5,228,100	\$6,717,500
----Military depts.	\$11,151,000	\$9,577,800	\$7,062,300

What is not immediately apparent from the chart is the dismal success rate for prosecutions: 5.7% for FY 1982; 8.2% for FY 1983 and 9.8% for FY 1984. Equally striking is the comparison of the average recovery per conviction and the average recovery per case referred for action.

In FY 1982, the average recovery per conviction was \$35,880. The average recovery per case referred for action was 2,060. In FY 1983, the average recovery per conviction dropped to \$22,500. The average recovery per case referred for action also dropped to a mere \$1,845. In FY 1984, the average recovery per conviction increased to \$43,250. The average recovery per case referred for action increased to \$5,260. The number of cases referred for action, however, dropped 2477 cases from the previous year, or 31%.

These figures have twofold significance. The first aspect is an apparent failure of legal deterrence. The Congress has made vast resources available for our nation's defense. Three hundred billion dollars have inundated a procurement system which has been unable to properly manage it. From 1981 to 1983, the backlog of unspent funds awaiting selection of a contractor rose by 78% from \$24 billion to \$43 billion. Figures for 1984 show no decrease in this problem. This creates a fertile environment for corruption. When the chances of being convicted are small, or penalties are only a few thousand dollars, the risk versus financial reward weighs heavily in favor of charging \$9,000 for a single alien wrench.

The second aspect of DoD waste, fraud and abuse statistics bear directly upon today's hearing. It is clear that the average case pursued by DoD and Justice falls far below the jurisdictional cap of \$100,000 found in any of the program fraud civil penalties bills.

In May of 1981, GAO issued a study "Fraud in Government Programs: How Extensive Is It? How Can It Be Controlled?" That study indicated 61% of the cases referred to the Justice Department were declined for prosecution. Budget cutbacks since 1981 and projected through the remainder of the decade show little hope for improvement. Assessing both the GAO and the DoD statistics, there is little doubt that our government's efforts to stem waste, abuse and fraud have not been effective.

It is vital that we pass program fraud civil penalties legislation. We must enact the tools for expeditious but fair prosecution of these cases. To fail to act is a genuine threat to our national security both economically and militarily.

There are other tools I hope the Committee also acts upon. I applaud my colleagues who have introduced "qui tam" legislation. This type of legislation has a fine tradition dating back to President Lincoln. It could be a very effective anti-waste weapon allowing individuals to proceed where the government has not.

Finally, it is essential that protection for employees who report violations must be strengthened. The front line in law enforcement is always the honesty and integrity of our citizens. We must encourage and protect their honesty. In conclusion, I thank you for the opportunity to address you and I ask that you act swiftly and effectively.

Mr. HUGHES. Thank you very much, Dennis, for a good statement.

One of the things you single out is the tremendous potential for fraud, since so much of our budget is committed to defense. I think 29 percent is going to defense needs. In the budget compromise we have agreed at a \$285.4 billion level for defense in fiscal year 1988.

It, therefore, is not unreasonable that many allegations of fraud are directed at the defense industry. But, the figures you have just recited are astounding. During the six-month period ending early this year, over 10,451 allegations of waste, fraud and mismanagement, were made to inspector generals and of those numbers, fifty-five percent, dealt with Department of Defense. That definitely seems to be disproportionate to the amount of money being spent by defense.

My question is do you think that the reason there seems to be a disproportionate number of allegations of waste, fraud and abuse directed at the defense spending, is because of the amount of money that we are spending or the sheer volume of activities that are involved?

Mr. HERTEL. I think it is number one that, total amount of money, the higher percentage. If we look at things like R&D, things that fluctuate, you will see more of that in Department of Defense than you will in other departments. Other departments are purchasing things that are more straight forward and used year in and year out.

Now when we have seen them move to things that are more technical, as we have in the Department of Defense, we have seen problems with computers systems, and so forth, on a larger scale, but other departments are doing that as often because of their size being smaller and their role being more consistent with the private society, than the Department of Defense.

Secondly, I think there has been a problem, maybe it is because as I said, it is more of a closed operation, it is almost an internal circle, that people leave the Pentagon and with that experience they can only work in the defense area, in many cases. Then some of those people get back into the Administration and go back into the industry.

If you look at other departments there is a little more flexibility. That might cause the closed relationship long term that has unfortunately set up a relationship of not being as clear cut as to what fraud is, as it might have been in looking at how other departments do their business in the past.

There is no doubt that we have to realize that the Department of Defense is unique in its responsibilities and therefore as to its applications and as to the way they entire circle operates.

Mr. HUGHES. We are trying to provide some new tools to the law enforcement community to deal with fraud in Government procurement, but I have had the sense for some time that it is not just a matter of having tools, it is a matter of committing sufficient resources to the problem. You alluded to and it is a chronic problem in the Department of Justice and the Department of Defense turnover of personnel. We have experienced that for a number of years. Assistant U.S. Attorneys become very experienced and develop a lot of expertise in a particular area and then the private sector rec-

ognizes their ability and after a couple of years, why they have moved on to more fertile ground.

So there is no continuity. We find that to be the case in areas such as monopoly and antitrust matters, which are very complex, which sometimes require a prosecution over a period of 10 or 15 years. We will sometimes have a turnover of five and six members of the Justice team during that period of time when that case is pending.

Do you sense we have a major resource problem also committed to investigating defense fraud?

Mr. HERTEL. Two things. Number one, that is true. We are the only country, aside from the Congo in Africa, that does not have a professional procurement corps. Every other country, whether it be Communist, or any of Western Europe, what they have instead of turnover that we do, within the three services and within the Department of Defense itself, in civilian employees, is they have a permanent procurement profession, that is protected in many ways and insulated in many ways and compensated correctly; and people make a career, 20, 25, 30 years, of work in the procurement area alone, not only gaining this experience but also have this pride in doing the job right, and, more importantly from our perspective, the responsibility of not being able to blame the next person or the last person in that position for the mistakes that have been made in the judgments that have been made.

I can't emphasize enough that we are the only country really that does not have that kind of professional procurement acquisition corps, and it is one that I have introduced into legislation because it just makes common sense. It would call from design to capabilities to testing to production. That would be the responsibility of one procurement corps.

We have a problem that is unique in having the three services make decisions based on what their own priorities are rather than what the nation's defense requires, and they also have an understanding very clearly if the Navy wants two carriers or 600 ships, the Air Force is not going to say anything about that. Even though it would be clear to us that we would be using resourcing that maybe the Air Force needs in their defense of the nation, priorities, the agreement instead is that we would never talk about the other services' requests; instead we will just make a fight for our own requests.

What does that do? First of all, when we have a Secretary of Defense like the last one, who sees himself as an advocate for the three services rather than a decision-maker for the nation's priorities, that means that he just takes the three services' requests and passes them on to the Congress, making no real judgments or hard decisions as to priorities and the needs and the spending involved. That message, of course, filters right through the services, that they can ask for what they want with no responsibility, they are absolved from responsibility by the Secretary of Defense as to what their requests might do to impinging on other necessary things.

When you hear the fact we only have enough ammunition now, as opposed to six years ago, for two weeks for our NATO forces to defend Western Europe, well then it is clear that we haven't even started answering the basics of what our priorities should be, and

yet we have doubled the defense budget within the last six years without addressing the very basics of having ammunition and fuel for our troops, in a priority theater recognized not only by treaty by a third of the defense budget being spent in that. That is number one.

Number two, there has never been an emphasis in this decade on the problems of procurement. You double the defense budget without having any real increase in accountants and procurement people. Clearly you are going to have not only mistakes, you are going to have major embarrassments in major areas of waste, fraud and abuse. It would be simple for any person without experience to realize that if you are going to double the amount of money you are going to spend, that you are going to have to make some changes as to how you are going to watch how that money is spent. That wasn't done.

I must at the same time say that the three services have made progress in the last three years of training more people in procurement areas, sending them to business colleges, for instance, in making it not as important as it must be, but making it part of the responsibility and credit as far as promotions in the three services. That hadn't been done before. So, as they began to realize the mistakes that were being made, and as they began to realize the lack of responsibility, finally, as they began to see the public's outrage as to how money was being wasted, we have had some responsibility from the services.

Unfortunately, in the area of the Department of Defense, at the very highest levels, we have not seen that. We have not seen, for instance, examples made of big or small contractors when they are caught committing waste, fraud or abuse, barring them from future contracts and holding to the line on that type of bar. We have not seen, as I have discussed already, the type of prosecution that would hold up these individuals and companies as examples. What we have seen is, as you say, is a difference from what would be done in other areas of Government or done in the private sector.

I go back to what I said originally. There are only a few that are committing the waste, fraud and abuse on purpose with intent. And, as in other areas of crime and simple punishment, what we do is take those few and let everybody else know if they are going to go down the same road they are going to be punished as the few that we have caught, and that is where the system has broken down regarding these figures, 55 percent without adequate prosecution.

As I said in the beginning of this answer, we have seen this type of breakdown, a type of different relationship, and a different treatment of the Department of Defense over other Government agencies, and I am glad to say on a positive note it appears our new Secretary of Defense, Mr. Carlucci, is realizing, number one, that he is going to have only the same amount of millions to spend under the budget, and therefore he is going to have to make cuts; therefore, he is going to have to spend his money more wisely; therefore, he is going to give straight answers to the Congress when they are asking questions about priorities. I do see one bright spot in that.

Mr. MAZZOLI. Thank you, Mr. Chairman. I don't have any questions, but I guess I am a little bit curious. On page two of your shorter statement, you say that 55 percent of these allegations, some 10,451 allegations of waste, fraud and mismanagement concerned the Department of Defense. However, as you say, only 22 percent resulted in successful prosecution, and only 34 percent of the recoveries came.

Is it because those were unfair allegations? Is it because they were unfounded? There is a lot of effort to curry favor with certain bosses or try to destroy the careers of other bosses. Is that possible, or is this a kind of favoritism, a sort of inner circle which is protecting DOD people?

Mr. HERTEL. I would say that as in other departments we looked at, we see a lot of unfair allegations, a lot of untrue allegations; when we see them extrapolated to those percentages, then we see that there has to be something beyond a certain amount of unfounded or untrue allegations.

Now, I would like to hear, I think your subcommittee probably will be able to get into the fact for other reasons it is harder to prosecute because of the uniqueness, because of the problem of intent, maybe that is a problem with some of our regulations. There are people that say we micromanage. Well, I think that any time we see waste, fraud and abuse on the scale that we have, any time we see figures like this, percentages like this, as opposed to other departments, then I think it is time for us to micromanage. If the department isn't going to do it, it is our responsibility. We are the ones that are elected. We try to explain this to the debt we have, in fact have to answer to the people that we can't come up with reasons that just try to rationalize why these changes are done. If the department says to us, and to our subcommittee, that they have unique circumstances, they have different problems, they have a problem of proving intents, or showing the connection, and all of that, then, fine, let's change the laws and regulate and help them do what they haven't done.

I am certain that in all cases if they want to, they have the administrative powers to change the regulations and requirements, but if they want to tell us that they need assistance, let's give them every bit of assistance they need in making sure that they are more like other departments.

Mr. MAZZOLI. I gather from the hearing record that the Chairman has certain Inspectors General who will come before us. Has it been your experience working from the Defense Committee's standpoint that they are able to do their job? That is, that the Inspector Generals are able to make an objective call, that they have before them the tools and they have the people and they have the support of their various groups to do the right sorts of job? Or do you feel they have some intimidation, that they have some pressures brought on them that they can't do the job that they are set up to do?

Mr. HERTEL. No, I think that in our working with the Inspector Generals that they do have the tools and have been making the recommendations; it is what happens to it after it leaves there.

Mr. MAZZOLI. You are satisfied with what happens at DOD or at Health and Human Services, but what happens when it gets to the Justice Department, is that essentially your concern?

Mr. HERTEL. Right.

Mr. MAZZOLI. Is that where the slip occurs?

Mr. HERTEL. I believe it is.

Now, I think the Justice Department has been asking for more tools, and I think they may be supportive of this particular legislation that we are discussing now. But it is hard for the Justice Department to go forward with a full case if the Department of Defense is not as cooperative as possible. I guess that is another thing I would like to hear about from the Justice Department, if they think that in all of these cases the Department of Defense has been as cooperative as possible. These cases are difficult. It is not easy. It takes time to resolve and to work them out. It is always easier to settle and always easier to agree on a monetary find. I would be interested to know, because it is one thing my task force has not been able to gather information on, as to the Justice Department's requirement and their feelings about working with the Department of Defense.

Mr. MAZZOLI. I am going to be interested. Of course, prosecutorial discretion is something we hear quite a bit about. Prosecutors have certain resources that they have to allocate across the spectrum and make certain choices on what cases to proceed to trial and which to settle, and that happens in Michigan as well as in Kentucky and elsewhere.

Mr. HERTEL. I would never take away that prosecutorial intent because we can't force them to do something. Hit a percentage or whatever else. That won't work. But instead of a problem of people, if they need more people, more resources, then I think, yes; we have all seen the figures, if we had more IRS agents, we would be able to collect more in taxes. Well, if it is a case also in this area they need more resources, as we see, as you say, in the prosecutor's offices around the country, let's give them those tools.

Mr. HUGHES. Thank you. Just a couple of questions.

I know we want to discuss a little resources, of the Justice Department and the Inspector General's office, but dealing with just H.R. 3500, one of the provisions in the bill, as you know, provides up to \$250,000 in reward money for people coming forward. Should we also be looking at provisions here to protect whistle blowers, protect individuals that do come forward? That is an area that clearly we haven't done enough on. You touched on it. Do you think there is more we can do in the context of this legislation?

Mr. HERTEL. I think that the ideas in the legislation are good now, if we can think of others, that there can't be enough protection for the whistle blowers, because, as I mentioned, especially in the area of Defense, they are taking more of a rise not being able to look toward employment in that same area with that same experience. They are, I think, in a more limited area. Here I am trying to identify the fact employees' concerns in the defense industry, that their training is very often limited to working in the defense industry, and so if they lose their career by coming forward and blowing the whistle, they have few alternatives very often than people in other professions.



Mr. HUGHES. That is a vote, Dennis. Thank you very much for your testimony. We are going to be asking Justice about resources and resource allocations and we will be able to ask the Inspector General about a whole host of issues such as the problem that we often run into that we only have single-source suppliers. That problem still persists.

General Dynamics comes to mind as one instance where, you have one-source supplier and the problems that that portends in trying to determine adequate punishments.

We are looking forward to working with you in your capacity as a senior member of the Armed Services Committee in trying to develop a strategy that will deal with this problem. It is certainly a lot broader than H.R. 3500. I am not under any illusion we are going to solve all the problem. We are going to provide some additional tools but the problem is much broader than what we see.

Mr. HERTEL. There is no solution. When you deal with anything as large as the Department of Defense, there are always going to be honest mistakes, those of malfeasance, misfeasance. What we need are different venues and different ways of meeting the needs of going after these things that have outraged the citizens and are wasting money. So I think H.R. 3500 is a step in that direction. I thank the Chairman.

Mr. HUGHES. Thank you. I would invite you to make some suggestions to the committee as to how we can perhaps strengthen the provisions dealing with rewards and whistle blower problems. I would invite you to do that.

Mr. HERTEL. I would be glad to do that.

Mr. HUGHES. The subcommittee is going to stand in recess for about 15 minutes.

[Recess.]

Mr. HUGHES. The subcommittee will come to order.

Our next panel consists of John C. Keeney and Donald J. Davis. Mr. Keeney is a Deputy Assistant Attorney General in the Criminal Division of the Department of Justice, a position he has held since 1973.

Mr. Keeney has a B.S. degree from the University of Scranton, an LL.B. from Dickinson School of Law, and an LL.M. from George Washington School of Law.

He joined the Department of Justice in 1951, and has held various supervisory positions since that time. He is a member of the Pennsylvania and District of Columbia Bars, and a member of the Federal and American Bar Associations. I might add that John is no stranger to this subcommittee, and we are just delighted to have him before us again.

Our next panelist is Donald J. Davis who is the Manager of the Fraud and Prohibited Mailings Branch of the United States Postal Inspection Service. Inspector Davis has 16 years of experience as a postal inspector and has served as a field inspector in Chicago and various other assignments in external mail thefts and fraud.

He is a graduate of the Lafayette College and holds Master of Arts degrees in public administration and criminal justice from Roosevelt University and the University of Illinois, respectively.

Gentlemen, let me welcome you before the Subcommittee on Crime today. We have your prepared statements which, without ob-

jection, will be made a part of the record. You may proceed as you wish. Why don't we start with you, Mr. Keeney.

**TESTIMONY OF JOHN C. KEENEY, DEPUTY ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, UNITED STATES DEPARTMENT OF JUSTICE, ACCOMPANIED BY WILLIAM C. HENDRICKS, CHIEF, FRAUD SECTION; AND DONALD J. DAVIS, MANAGER, FRAUD AND PROHIBITED MAILINGS BRANCH, UNITED STATES POSTAL INSPECTION SERVICE**

Mr. KEENEY. Mr. Chairman, I will briefly discuss my statement, but I think it would be helpful to you and the committee if I had William C. Hendricks, Chief of the Fraud Section, join me at the witness table. Some of the details he can answer and I cannot.

Mr. HUGHES. Mr. Hendricks, why don't you join us?

Mr. KEENEY. H.R. 3500 would enhance existing law by providing that "whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations or promises, defrauds or attempts to defraud the United States in any procurement of property or services, if the consideration for such property or services is \$1,000,000 or more" shall be fined up to twice the amount which is the object of the fraud or imprisoned not more than seven years, or both.

The major enhancements to existing law are contained in the increased fines and imprisonment provided for major procurement cases, the extension of the statute of limitations for such cases to seven years, and the authority to seek payments for persons who provide information which leads to conviction for procurement fraud violations.

Mr. Chairman, one thing I should emphasize, offenses committed on or after November 1, 1987 will be subject to the recently-proulgated sentencing guidelines. Until we have acquired a body of experience under the guidelines, it is impossible to predict with any certainty the effect they will have.

We note, however, that an initial reading of the guidelines would suggest that a first offender, the typical defendant in procurement cases, who organized a group of more than five persons which conducted a planned procurement fraud costing the Government more than \$5 million, would receive a guideline sentence of 46 to 57 months. This guideline sentence, arising out of a very serious fraud, would be within the statutory maximum permitted by existing law, even without H.R. 3500.

While we do not oppose enhancing the statutory term of imprisonment for major procurement fraud to seven years, we doubt that the practical effect over the near term of such an increase would be substantial in day-to-day applications over a five-year term. I am prepared to discuss that a little further, Mr. Chairman, if you have any questions in that area.

I would like to mention, too, the alternatives in existing law and in proposed law with respect to sentencing: H.R. 3500 would apply to all Government procurement of \$1 million or over. It would provide, in addition to the seven-year imprisonment, a fine double the object of the fraud. The Sentencing Reform Act covers all felonies,

not only procurement felonies, and provides for a \$250,000 fine for individuals and \$500,000 fine for corporations.

H.R. 3483, if enacted, and our people tell me it is likely to be enacted, would provide for twice the defendant's gain or twice the victim's loss in all fraud causes.

In addition, with respect to DOD, we have in the Defense Authorization Act a DOD false claim provision carrying \$1 million fine plus civil penalties of three times the false claims.

Mr. Chairman, briefly, we fully concur with the goal embodied in H.R. 3500 of extending the statute of limitations for prosecution of procurement cases. In addition, the proposed Anti-Fraud Enforcement Act of 1987, which we transmitted to the Congress on September 23, 1987, contains a provision which would extend the statute of limitations in cases involving fraud or a breach of fiduciary obligation to one year after the facts relating to the offense became known, or should have become known, to the responsible authorities. The maximum extension under this provision would be three years.

We believe that this provision, which would apply to other forms of fraud as well as procurement cases, would enhance our ability to prosecute well-concealed fraud cases.

Both our proposal and H.R. 3500, the seven-year statute of limitations extension, would be very helpful from a prosecution standpoint.

In reviewing the bill, we noted some ambiguities. They are technical and we are prepared to work with the staff in resolving them, because we, as you, want a truly effective bill.

Mr. Chairman, that concludes my remarks. I and Mr. Hendricks are available for your questions.

[The statement of Mr. Keeney follows:]

STATEMENT

OF

JOHN C. KEENEY  
DEPUTY ASSISTANT ATTORNEY GENERAL  
CRIMINAL DIVISION

BEFORE THE

SUBCOMMITTEE ON CRIME  
COMMITTEE ON THE JUDICIARY  
HOUSE OF REPRESENTATIVES

ON

H.R. 3500  
MAJOR FRAUD ACT OF 1987

ON

DECEMBER 3, 1987

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear before you today to discuss the Department of Justice's views on H.R. 3500, the "Major Fraud Act of 1987."

The Justice Department makes the investigation and prosecution of procurement fraud cases, and particularly those cases arising out the procurement activities of the Department of Defense, a top priority. These cases typically are prosecuted under the false claims statute (18 U.S.C. §287), the false statements statute (18 U.S.C. §1001) and both clauses of the conspiracy statute (18 U.S.C. §371). Generally, we have not encountered situations where conduct relating to fraud against the United States does not fall within the prohibitions of one or more of the foregoing statutes. Nevertheless, we welcome the commitment, manifested by the introduction of this bill, to continue to support our enforcement efforts in the area of procurement fraud. We also welcome legislation which will enhance our prosecutive efforts and protect the government against those who would cheat or mislead it in the procurement of property or services.

H.R. 3500 would enhance existing law by providing that "whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises,

defrauds or attempts to defraud the United States in any procurement of property or services, if the consideration for such property or services is \$1,000,000 or more" shall be fined up to twice the amount which is the object of the fraud or imprisoned not more than 7 years, or both. The bill further provides for a statute of limitations of 7 years after the commission of such an offense. In addition, upon application by the Attorney General, the proposed legislation would allow payment to an individual who furnished information leading to conviction under this section from funds generated by a criminal fine imposed under the section; the amount of such payment would not exceed \$250,000, and officers and employees of the government who furnish information or render service in the performance of official duties would be ineligible for payment under this provision.

The major enhancements to existing law are contained in the increased fines and imprisonment provided for major procurement cases, the extension of the statute of limitations for such cases to seven years, and the authority to seek payments for persons who provide information which leads to conviction for procurement fraud violations. We support each of these objectives in principle, and with your permission, I would like to discuss each of these areas.

We believe that there is no better deterrent to white collar crime than the imposition of lengthy jail sentences on

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convicted white collar criminals. When appropriate, we charge multiple counts in prosecutions founded on existing fraud statutes, such as the banking offenses (18 U.S.C. §§215, 656, 657 1005, 1006 and 1344), fraud against the government (18 U.S.C. §§287 and 1001) or conspiracy (18 U.S.C. §371). Each of these offenses carries a potential sentence of five years imprisonment. By charging multiple counts, the sentencing court is given the discretion to impose a sentence in excess of five years.

However, offenses committed on or after November 1, 1987 will be subject to the recently promulgated sentencing guidelines. Until we have acquired a body of experience under the guidelines, it is impossible to predict with any certainty the effect they will have. We note, however, that an initial reading of the guidelines would suggest that a first offender, the typical defendant in procurement cases, who organized a group of more than five persons which conducted a planned procurement fraud costing the government more than \$5 million, would receive a guideline sentence of forty-six to fifty-seven months. This guideline sentence, arising out of a very serious fraud, would be within the statutory maximum permitted by existing law. Thus, while we do not oppose enhancing the statutory term of imprisonment for major procurement fraud to seven years, we doubt that the practical effect over the near term of such an increase would be substantial in day-to-day applications.

We have long believed that the potential fine of \$10,000 set forth in several of the statutes commonly utilized in procurement prosecutions was insufficient to deter crime and discourage its repetition. However, with the passage of the Sentencing Reform Act of 1984, now in effect, conviction under the statutes presently utilized in procurement prosecutions exposes the criminal to a alternative maximum fine of \$250,000 in the case of an individual defendant and \$500,000 in the case of a corporate defendant. In many cases, such fine levels will be sufficient. Nevertheless, we recognize that there will be instances where larger fines will be appropriate in cases involving fraud against the United States.

We anticipate that these fine levels will be further enhanced in the immediate future by a provision permitting imposition of a fine up to twice the defendant's gain or twice the victim's loss. The House passed H.R. 3483, which contains this provision, earlier this week. The Senate also has passed such a provision.

Moreover, the Department of Defense Authorization Act of 1986 provides that "the maximum fine that may be imposed . . . for making or presenting any claim upon or against the United States, related to a contract with the Department of Defense, knowing such claim to be false, fictitious, or fraudulent, is \$1,000,000." This recently enacted, and as yet uncodified, provision is applicable to claims made on or after November 8,



1985. It makes penalties proportionate to the potential monetary gain for criminals, and should act as a serious deterrent to procurement fraud in the defense area. This fine provision, taken together with the recent amendments to the False Claims Act which provide for a civil money penalty of three times the amount of the claim, acts as a substantial deterrent. We suggest that the Subcommittee may want to consider broadening the defense procurement fine provision to extend to all government procurement cases. In any event, it would be helpful if this fine provision appeared in Title 18 of the United States Code.

We fully concur with the goal embodied in H.R. 3500 of extending the statute of limitations for prosecution of procurement fraud cases. These cases often require long and difficult investigations of very complex facts. In addition, because concealment and secrecy are the hallmarks of financial crime, there is often a lapse of time before the cases come to our attention in the first instance. It is for these reasons that the proposed "Anti-Fraud Enforcement Act of 1987", which we transmitted to the Congress on September 23, 1987 and which I will discuss further in a moment, contains a provision which would extend the statute of limitations in cases involving fraud or a breach of a fiduciary obligation to one year after the facts relating to the offense became known, or should have become known, to the responsible authorities. The maximum extension under this provision would be three years. We believe that this provision, which would apply to other forms of fraud as well as

procurement cases, would enhance our ability to prosecute well concealed fraud cases.

The provision contained in H.R. 3500 to reward persons who provide information leading to conviction in major procurement cases parallels recently enacted legislation in the narcotics area. We recognize that such a provision may encourage spurious claims for rewards in many cases. However, we also believe it would encourage persons who might otherwise file qui tam suits on behalf of the government to communicate directly with law enforcement authorities. A reduction in the number of qui tam suits would, in turn, lessen the burden on the courts and on the Department of Justice. Accordingly, we support the provision.

In reviewing the bill, we noted some ambiguities in the proposed language. For example, the new offense would have both the element of devising a scheme to defraud and the element of defrauding or attempting to defraud the United States. The courts might well construe this language to require specific intent. The problem could be obviated by tracking the language of the bank fraud statute, 18 U.S.C. §1344, which prohibits the execution or an attempt to execute a scheme to defraud a bank. Similarly, by using the term "consideration for property or services" as a trigger for the prohibitions of the new offense, the bill appears to be directed to procurements having a contract value of one million dollars or more. We believe this should be made more explicit. Finally, the term "object of the fraud"

which is used to define the amount payable to a person providing information leading to conviction poses substantial difficulties. It is not clear whether this term is directed to the entire contract value of a procurement (which might be appropriate in a product substitution case), the total profit realized by the vendor from a procurement contract (which might be appropriate in a case in which a contracting officer was bribed during the award process), or only to the fraudulent portion of a procurement contract (which might be appropriate in a mischarging case). We would be happy to work with the Subcommittee's staff to clarify these matters.

In closing, I want to emphasize our commitment to the investigation and prosecution of major fraud against the United States. In this connection, on September 23, 1987 we submitted three proposed bills; the "Anti-Fraud Enforcement Act of 1987" which I mentioned earlier, the "Contracts Disputes Act and Federal Courts Improvement Act Amendments of 1987", and the "Bribes and Gratuities Act of 1987" to the Congress. Each of these bills would substantially assist our efforts to combat procurement fraud. In particular, the "Anti-Fraud Enforcement Act of 1987" would, in addition to the statute of limitations amendments I discussed earlier, amend Rule 6 of the Federal Rules of Criminal Procedure to permit us to communicate more freely within the Department of Justice and with our sister agencies, specifically make it an offense to obstruct a federal audit, expand the government's right to audit contractor's books, permit

the government to collect the costs of a successful procurement fraud prosecution, expand the current criminal injunction statute to cases involving fraud perpetrated on the government, and eliminate the practice of allocating the costs of successful prosecution to future government contracts. The other two bills contain similar needed legislation. We would welcome, and indeed we ask, the support of the members of this Subcommittee for this necessary legislation.

Mr. Chairman, that concludes my prepared statement. I would be happy to answer any questions you or the other members of the Subcommittee may have.

Mr. HUGHES. Thank you.

Mr. Davis?

Mr. DAVIS. Thank you, Mr. Chairman.

We appreciate the opportunity to testify this morning. I would like to briefly summarize parts of my written testimony to give you an idea of why we are interested in this bill.

The U.S. Postal Service is the world's largest postal system. It is supported by a procurement subsystem which in fiscal year 1987 let contracts in excess of \$3.8 billion. Approximately 612 of those contracts were worth \$1 million or more, and thus would be subject to this bill.

The Inspection Service is a law enforcement organization, and as such, we investigate allegations of improprieties and illegal actions in the procurement process. While we feel the procurement system within the Postal Service has significant checks and balances in place, any procurement system is vulnerable to criminal attack.

My written testimony gives several examples of procurement frauds directed against the Postal Service to give an idea of the amount of money involved which can be gained in a fraud directed against the Postal Service.

While the Inspection Service is proud of the success we have had in investigating procurement fraud within the Postal Service, the enactment of the Major Fraud Act would fill voids in existing statutes. The cases I have cited in the written testimony involve the use of cooperating individuals who provide necessary information.

These individuals frequently provide the initial tip that something is wrong in the procurement process. The reward system in H.R. 3500, in which up to \$250,000 could be paid from the criminal fine to individuals providing information leading to convictions, could be a valuable tool.

The extension of the statute of limitations on major fraud actions from five to seven years, as provided in H.R. 3500, could also be critical in accommodating the extensive investigation often necessary in this kind of fraud.

I cannot say we have lost a case of this nature due to exceeding the current five-year limitation, but we are seeing more complex schemes with elaborate paper trails and exotic money laundering techniques. These cases take longer to detect and to investigate.

Finally, the increased sentences and fines proposed in H.R. 3500 are a strong message to those who might be tempted to defraud the Government that we are serious in our efforts to remove the profit and incentive from this type of crime.

A further enhancement you might wish to consider would be the addition of forfeiture authority to Federal statutes dealing with fraud. We believe H.R. 3500 would provide investigative agencies, such as the Inspection Service, with additional tools to have an impact on procurement fraud and we support its enactment.

I will be pleased to take your questions, sir.

[The statement of Mr. Davis follows:]

TESTIMONY OF DONALD J. DAVIS  
MANAGER, FRAUD AND PROHIBITED MAILINGS BRANCH  
U. S. POSTAL INSPECTION SERVICE  
BEFORE THE  
SUBCOMMITTEE ON CRIME  
HOUSE COMMITTEE ON THE JUDICIARY  
DECEMBER 3, 1987

MR. CHAIRMAN:

I APPRECIATE THIS OPPORTUNITY TO TESTIFY BEFORE THE SUBCOMMITTEE ON H.R. 3500, THE MAJOR FRAUD ACT OF 1987. THE POSTAL SERVICE FULLY SUPPORTS ANY PROPOSAL WHICH AFFORDS INVESTIGATIVE AGENCIES NEW TOOLS IN THEIR EFFORTS TO IDENTIFY AND ELIMINATE PROCUREMENT FRAUD. H.R. 3500 IS A MAJOR EFFORT WHICH WE WELCOME IN SUPPORT OF OUR MISSION OF DETECTING AND INVESTIGATING FRAUD, WASTE AND ABUSE WITHIN THE POSTAL SERVICE.

MR. CHAIRMAN, THE POSTAL SERVICE IS THE WORLD'S LARGEST POSTAL SYSTEM; IT IS A COMPLEX AND FAR-REACHING BUSINESS. EVERY CITIZEN FROM FLORIDA TO ALASKA AND MAINE TO CALIFORNIA IS TOUCHED IN SOME WAY BY THE POSTAL SERVICE EVERY WORKING DAY. ALMOST 800,000 EMPLOYEES NATIONWIDE PROVIDE SERVICE TO THE AMERICAN PUBLIC FROM ALMOST 40,000 FACILITIES. IN FY 1987, THE POSTAL SERVICE HANDLED OVER 153 BILLION PIECES OF MAIL AND HAD TOTAL REVENUES OF MORE THAN \$32 BILLION. A SIGNIFICANT CORNERSTONE TO THIS SYSTEM IS AN ONGOING SUBSYSTEM OF AWARDED CONTRACTS FOR SUPPLIES AND SERVICES, WHICH IN FY 1987 INVOLVED 77,701 SEPARATE CONTRACTS TOTALLING MORE THAN 3.8 BILLION DOLLARS. APPROXIMATELY 612 OF THOSE CONTRACTS WERE WORTH 1 MILLION DOLLARS OR MORE.

THE INSPECTION SERVICE INVESTIGATES ALLEGATIONS OF IMPROPRIETIES IN THE PROCUREMENT PROCESS. POSTAL INSPECTORS CONSTANTLY REVIEW POSTAL SERVICE CONTRACTING PROCEDURES TO GUARD AGAINST FRAUD. WHILE WE FEEL THIS PROCUREMENT EFFORT HAS SUBSTANTIAL CHECKS AND BALANCES IN PLACE TO WARN OF MOST DEVIATIONS FROM PROPER PROCEDURES, ANY PROCUREMENT SYSTEM IS VULNERABLE TO CRIMINAL ATTACK. I WOULD LIKE TO CITE SEVERAL EXAMPLES OF CASES WE HAVE INVESTIGATED TO UNDERSCORE THE ENORMITY OF THIS SYSTEM AND TO REVEAL THE COMPLEXITY OF THE SCHEMES TO DEFRAUD.

THE FIRST EXAMPLE INVOLVES TWO FORMER USPS OFFICIALS WHO USED INSIDE INFORMATION TO MASTERMIND A MASSIVE PROCUREMENT FRAUD. ON AUGUST 6, 1985, A FEDERAL GRAND JURY IN WASHINGTON, DC RETURNED AN INDICTMENT CHARGING FIVE PEOPLE WITH MAIL FRAUD, CONSPIRACY AND RACKETEERING IN A BRIBERY AND KICKBACK SCHEME INVOLVING PROCUREMENTS AT THE POSTAL SERVICE AND THE SMALL BUSINESS ADMINISTRATION. TWO OF THOSE CHARGED WERE FORMER USPS OFFICIALS. IT WAS ALLEGED THAT THEY AND OTHERS SCHEMED TO RIG PROCUREMENTS BY INFLUENCING THE AWARDED OF CONTRACTS TO BIDDERS WHO HAD AGREED TO PAY KICKBACKS. IN OTHER INSTANCES, BRIBES WERE PAID FOR: (1) PASSING INSIDE INFORMATION TO NON-POSTAL CONSPIRATORS WHO HAD TEAMED WITH PROSPECTIVE BIDDERS; AND (2) FOR INFLUENCING THE AWARD OF A CONTRACT TO A PROSPECTIVE BIDDER. FROM 1978 THROUGH 1985, OVER 1 MILLION DOLLARS IN BRIBES AND KICKBACKS WERE PAID. THE TWO FORMER USPS OFFICIALS PLEADED GUILTY AND ANOTHER CO-CONSPIRATOR, A FORMER ASSISTANT

POSTMASTER GENERAL FOR FINANCE, WAS GRANTED IMMUNITY IN RETURN FOR HIS TESTIMONY, AS WELL AS AN AGREEMENT TO REPAY \$40,000 IN BRIBE MONEY. THE TRIAL OF THE OTHER INDIVIDUALS WAS CONCLUDED ON MARCH 14, 1986. THEY WERE FOUND GUILTY AND SENTENCED TO 4 TO 10 YEARS' IMPRISONMENT.

ANOTHER CASE FURTHER DEMONSTRATES THE POTENTIAL FOR FRAUDS INVOLVING POSTAL CONTRACTS. IN MID-1984, A FORMER SENIOR ASSISTANT POSTMASTER GENERAL FOR RESEARCH AND DEVELOPMENT PLEADED GUILTY TO A ONE-COUNT INFORMATION CHARGING THE VIOLATION OF TITLE 18, U. S. CODE, 1001, MAKING FALSE STATEMENTS. IN ADDITION, HE VIOLATED A REGULATION FORBIDDING HIM TO SEEK EMPLOYMENT WITH OR BE EMPLOYED BY ANY POSTAL SERVICE CONTRACTOR FOR A PERIOD OF ONE YEAR AFTER LEAVING THE POSTAL SERVICE. HE WAS FINED AND PLACED ON PROBATION.

MY LAST EXAMPLE, MR. CHAIRMAN, INVOLVES THE SCHEME DEvised BY A FORMER VICE CHAIRMAN OF THE POSTAL SERVICE BOARD OF GOVERNORS. THIS INDIVIDUAL AND OTHERS OUTSIDE THE POSTAL SERVICE CONSPIRED TO MANIPULATE THE POSTAL SERVICE, AND MORE SPECIFICALLY THE PROCUREMENT AND CONTRACTING PROCEDURES, TO THE POINT WHERE THEY EACH STOOD TO RECEIVE AS MUCH AS ONE-FOURTH OF ONE PERCENT OF A USPS EQUIPMENT CONTRACT VALUED AT 230 TO 380 MILLION DOLLARS. THIS SCHEME RESULTED IN 4 YEARS' IMPRISONMENT AND A \$11,000 FINE FOR THE VICE CHAIRMAN. ONE OF HIS CO-CONSPIRATORS WAS SENTENCED TO THREE YEARS' IMPRISONMENT



AND A \$10,000 FINE; THE OTHER WAS SENTENCED TO SIX MONTHS' IMPRISONMENT AND A \$10,000 FINE.

ALTHOUGH THE INSPECTION SERVICE IS PROUD OF ITS SUCCESSES IN INVESTIGATING PROCUREMENT FRAUD, WE BELIEVE ENACTMENT OF THE MAJOR FRAUD ACT WOULD FILL IMPORTANT VOIDS IN EXISTING STATUTES. FOR INSTANCE, THE CASES I'VE CITED AND MOST OF THOSE WE INVESTIGATE INVOLVE THE USE OF COOPERATING INDIVIDUALS WHO PROVIDE NEEDED INFORMATION TO FIT THE PIECES OF THE INVESTIGATIVE PUZZLE TOGETHER. THESE INDIVIDUALS FREQUENTLY PROVIDE THE INITIAL TIP THAT SOMETHING IS WRONG IN THE PROCUREMENT PROCESS. THE REWARD SYSTEM IN H.R. 3500, IN WHICH UP TO \$250,000 COULD BE PAID FROM THE CRIMINAL FINE TO INDIVIDUALS PROVIDING INFORMATION LEADING TO CONVICTIONS, WOULD BE A VALUABLE TOOL.

THE EXTENSION OF THE STATUTE OF LIMITATIONS ON MAJOR FRAUD ACTIONS FROM FIVE YEARS TO SEVEN YEARS, AS PROVIDED FOR IN H.R. 3500, COULD BE CRITICAL IN ACCOMMODATING THE EXTENSIVE INVESTIGATIONS OFTEN REQUIRED IN THIS TYPE OF FRAUD. WHILE I CANNOT SAY THAT WE HAVE LOST A CASE OF THIS NATURE DUE TO EXCEEDING THE CURRENT FIVE-YEAR LIMITATION, I CAN SAY WITH CERTAINTY THAT WE ARE SEEING MORE COMPLEX SCHEMES, OFTEN WITH ELABORATE PAPER TRAILS AND SOMETIMES INVOLVING EXOTIC MONEY LAUNDERING TECHNIQUES. THESE CASES DO TAKE LONGER TO INVESTIGATE PROPERLY.

FINALLY, THE INCREASED FINES AND SENTENCES PROPOSED IN H.R. 3500 ARE A STRONG MESSAGE TO THOSE WHO MAY BE TEMPTED TO DEVISE A SCHEME TO DEFRAUD THE GOVERNMENT THAT WE ARE SERIOUS IN OUR EFFORTS TO REMOVE THE PROFIT AND INCENTIVE FROM THIS TYPE OF CRIME. A FURTHER ENHANCEMENT MIGHT BE THE ADDITION OF FORFEITURE AUTHORITY TO FEDERAL STATUTES DEALING WITH FRAUD.

AS WE BELIEVE H.R. 3500 WOULD PROVIDE INVESTIGATIVE AGENCIES WITH THE ADDITIONAL TOOLS NECESSARY TO HAVE A MAJOR IMPACT ON PROCUREMENT FRAUD, WE FULLY SUPPORT ITS ENACTMENT.

MR. CHAIRMAN, I WILL BE PLEASED TO ANSWER ANY QUESTIONS YOU OR OTHER MEMBERS OF THE SUBCOMMITTEE MAY HAVE.

Mr. HUGHES. Thank you.

Mr. Keeney, in testimony last July before the Energy and Commerce Committee on this subject, Assistant Attorney General Weld made this statement before the committee:

"Finally, let me offer the view that in many investigations, we have found rather venal or improper acquiescences on the part of Government officials, a merging and mutual reinforcement of interest, a desire to accomplish the mission on the part of the military.

"Military officials might overlook or ignore infractions on the part of the defense contractor not because of any evil intent or personal gain, but because of a belief in the importance of the project or the new technology as to national security.

"In the absence of fraudulent intent, resulting overcharges may not be prosecutable or even recoverable. However, that is not to say there are no circumstances where the collusion or connivance of public and private contracting personnel would not rise to the level of criminal fraud."

Now, I happen to think he is right. I believe he is right in some instances. My question is: What can we do to reach that contractor?

Mr. KEENEY. Well, you could address it in the legislation, I think, Mr. Chairman, and take it away as a defense or attempt to take it away. You, as an experienced prosecutor, know that if there is condonation involved in contract procurement and with respect to irregularities, that you are not going to convince a jury to convict individuals in that situation. You may get convictions on corporations. That is a problem which we have had in the past.

We may have it to some extent today, but it is a much lesser problem. With all the interest of Congress and the attention you, Senator Grassley and others have focused on defense procurement it is difficult to conceal condonation. I think that everybody is aware of the fact that they are being looked at very carefully and for that reason, the conduct, I think, is pretty straightforward.

Mr. HUGHES. It is basically a violation of public trust at the very minimum. I realize that, as I indicated earlier in one of my colloquys with Dennis Hertel, that we are often between a rock and a hard place because many of the contractors engage in improper activity and they are the sole source of that particular system or that particular equipment.

It puts us in a very, very difficult position vis-a-vis national security. But certainly, we have to stop the attitude that, "well, maybe it is wrong and maybe they are taking more money or doing other things they should not be doing, and perhaps it does violate the contract, but there is a higher goal to be achieved, so I am going to look the other way." That is a violation of public trust, wouldn't you agree? That is not a decision that individual should make.

Mr. KEENEY. Yes, sir, but that is a problem that is primarily of concern to DOD in connection with debarment of the individuals. We still can, maybe with difficulty in the situation you postulate, prosecute.

Mr. HUGHES. You make the statement that you believe juries wouldn't convict.

Mr. KEENEY. Wouldn't convict individuals.

Mr. HUGHES. That may or may not be the case. I have learned in 10 years prosecuting that you cannot predict what a jury will do in individual cases. That is no reason why you should not make an effort, if it is wrong.

If public policy is being violated and it is significant, we should prosecute.

Mr. KEENEY. I agree. We should proceed.

Mr. HUGHES. My question is, and I don't expect you to answer today, but I ask you to think about it, how do we reach that conduct to send a very clear signal? I am interested in more than H.R. 3500. I am interested in developing a strategy that includes additional resources if we need them, additional strategies to deal with procurement fraud of all kinds, not just for the defense industry.

I want to strengthen the law that provides new tools. I want to work with Justice and others to try to get sufficient resources to deal with the problem, but I am also interested in developing new initiatives, being a little more inventive if we have to be, to reach conduct that may not result in pecuniary gain to those contractors, Federal and other employees who are in fact bilking the public, but also those who are doing it for other reasons which should not be sanctioned.

Mr. KEENEY. Mr. Chairman, I share your view that where we can, we should proceed against individuals in these types of cases, and I assure you we will if we have any reasonable probability of conviction.

Mr. HUGHES. Mr. Keeney, has the DOJ ever responded to the staff report entitled "Justice Department Investigations of Defense Procurement Fraud," a case study dated February 19, 1987?

Mr. HENDRICKS. Mr. Chairman, I am aware of the report. Assistant Attorney General Weld, after the issuance of the report, asked me and another member of my staff to discuss our views about it with an Alice Milder, who I believe is on Senator Grassley's staff.

We have provided information regarding a number of the comments made in that study relating to staff turnover, recordation of information we received, coordination techniques and many of the other things covered by the report.

I do not believe that a formal response was made, and I am not aware that a formal response was requested.

Mr. HUGHES. Let me ask you if you would please submit for the record of this committee any responses you made to that staff report. I suspect, for instance, that one of the criticisms that perhaps has some merit, and that is the turnover. You have had a turnover problem for years. Unfortunately, we don't have a lot of Keeneys that stay on and become professional.

It has been a tremendous problem for years. We have talked about all kinds of strategies to try to deal with the problem. It is not just indigenous to the fraud unit.

Mr. KEENEY. Could we address that a little bit? There is a turnover problem in the Department of Justice and also in the Defense Procurement Unit. We are trying to address that, and we are trying to get people, but you cannot chain people down.

We get good people, they get opportunities, and they go. It is a continuing problem. We have hired just within the last year, we

have gone to the law firms, the senior associates, we have gotten people with all sorts of experience from the law firms.

Some of these people are taking 40 and \$50,000 cuts to come with us. That is the problem we have. We have scoured the United States Attorney's Offices throughout the country. Between the experienced law offices and experienced AUSAs and State prosecutors, we have added something like 10 people, 8 to 10 people in the last year. That is not a net gain, because we have lost some people. Frankly, it is almost an insoluble problem. (See additional response in appendix.)

Mr. HUGHES. We are not going to solve it today, but it is an issue we will have to come to grips with. We have had the problem in other sectors, other disciplines. We have developed all kinds of initiatives such as scholarship programs for law students and required a commitment for a number of years just like we do in the military with the ROTC.

I am not sure that is the answer, but certainly it is a problem that we will have to come to grips with, because it does impact adversely our ability to provide any continuity, particularly with complex cases. Cases seem to be getting more complex, not just in anti-trust, but other areas.

Fraud cases are very difficult to handle. They take a longer period to investigate and a long period to prosecute. I am sympathetic. Can you share with us whatever you have shared with the other body?

Mr. KEENEY. Yes, indeed.

Mr. HUGHES. Or react to the criticisms in there so we know what Justice's position is with regard to the criticisms?

Mr. HENDRICKS. I have no problem with that. One of the things identified in the Norfolk investigation was the fact that the investigation went on for a long period of time and for large portions of that time, it was effectively staffed by one Assistant United States Attorney with assistance from other attorneys who came in and left the investigation during its pendency.

The supervision of the investigation was criticized as being on again and off again in nature. We have taken this criticism to heart, and as Mr. Keeney indicated, there are certain aspects of the problem that are really insoluble.

There are other things we can do, and one is to try to make a commitment from the outset of a significant investigation, to staff it with people we believe will be dedicated to that investigation and will not leave the investigation until the underlying allegations have been resolved.

Another thing we do to reduce the period of the investigation is to try to staff it with more attorneys, two or three in some cases, so that allegations can be resolved at the earliest possible date.

Unfortunately, in the last four or five years, there has been a tremendous growth in pretrial litigation, in connection with the issuance of subpoenas duces tecum and certain problems arising from the adoption of ethical rules by State Bar Associations regarding contact that can be made by prosecutors with employees of large corporations.

These have gone a long way toward creating further problems which result in longer periods of time devoted before the return of

indictments. This has a frustrating effect on our personnel. But we are trying to address the problem of staffing fragmentation as best we possibly can, because we know it has a deleterious effect on a major investigation.

Secondly, one of the other areas of concern, I think, in the report was the notion of ineffective or insignificant sentences handed out in many of these cases. We believe that particularly in areas where the defendants are individuals who would otherwise have a substantial degree of respect in the community, that unless there is a clear demonstration before the trial judge of patent impropriety, especially in the context of an plea as distinguished from the trial, where the judge has been fully familiarized with the facts, that judges typically are not inclined to impose significant sentences in these cases.

As a result, we in the fraud section and many U.S. Attorney's Offices are beginning to discuss the technique of using very extensive sentencing memoranda and if necessary, having hearings relating to facts which the judge should take into consideration to fully familiarize himself with the problems involved in the case, so that they can become as familiar and as sensitive as the Department of Defense is to the great dangers represented by certain of these type of cases, cases such as product substitution cases, where the very lives of armed services personnel are put at risk because of the nefarious practices engaged in by some of the contractors.

So, we are trying to do that to sensitize sentencers to the problems that are particularly difficult for them to appreciate because of the complexity of the case.

Mr. HUGHES. Those are excellent and innovative ways of approaching these problem. I don't mean to suggest that I am in any way critical of your unit because of some of these problems.

They are really systemic in many respects and there are problems we are going to have to deal with. It would be helpful to us if you can provide us with your observations, your explanation of why some of the criticisms directed at Justice are unwarranted, where there is some merit to the criticisms and how you are dealing with the problem. That could be of benefit to us.

Mr. Davis, thank you for your testimony. The Postal Service has had a great deal of experience in this area. I have a couple of short questions of you.

First, your suggestions with regard to forfeiture, I think is an excellent one, we will take a look at that. You have had a lot of experience with white collar crime generally. Has it been your experience that personal liability is a major deterrent?

Mr. DAVIS. I think most white collar criminals are judging the risks they are facing and I think most of them are more afraid of the financial liability they may face in terms of penalties they face, in terms of restitution and fines as they often anticipate a fairly short prison sentence.

I think the enhanced fines avenue is the most beneficial way to proceed as far as deterrence.

Mr. HUGHES. Do any laws you enforce for the Postal Service provide compensation for information leading to a conviction.

Mr. DAVIS. We have two main ways to provide compensation. We have a formal reward program.

Mr. HUGHES. How much reward can you offer?

Mr. DAVIS. We offer up to \$50,000 on certain types of crimes such as mailing of a bomb, robbery or burglary of a post office.

Mr. HUGHES. Specific offenses.

Mr. DAVIS. Yes, primarily. We also make payments to confidential informants.

Mr. HUGHES. That is system-wide for any offense.

Mr. DAVIS. Yes.

Mr. HUGHES. How much can you pay under that statute? What is your jurisdictional limit?

Mr. DAVIS. I think our regional chief inspectors can authorize up to \$10,000 in a particular case.

Mr. HUGHES. Thank you. The gentleman from Florida.

Mr. McCOLLUM. Mr. Keeney, in your prepared text you say that, "we have not encountered situations where conduct relating to fraud against the United States does not fall within the prohibitions of one or more of the foregoing statutes", referring to the false claims and the false statements statutes and the conspiracy statutes you are now using for procurement fraud.

Would the bill H.R. 3500 give you any additional tools? Are there any cases that you can think of where you could not prosecute today but you could prosecute under H.R. 3500?

Mr. KEENEY. I don't think so. I think the main forces of what that bill would do for us, and it is very important, it would extend the statute of limitations and give us authority to pay rewards to people who come forward with information.

I really can't come up with a violation that we could not proceed against, but what you give us is substantially increased fines and the extension of the statute of limitations, very important.

Mr. McCOLLUM. Is there anything harmful in the substantive crime in H.R. 3500 other than these ambiguities you suggested at the end of your written testimony?

Mr. KEENEY. No, sir.

Mr. McCOLLUM. You made a comment during your oral presentation that the sentencing guidelines will have some difficulties meshing with what we propose here. I would like to have you elaborate on that.

Mr. KEENEY. The sentencing guidelines will control with respect to a sentence, say a DOD procurement violation under one of the existing statutes that carried a five-year penalty. If we proceeded under that we would end up probably with the same sentence as though we proceeded under H.R. 3500 which is a seven year sentence.

That is our best interpretation of the sentencing guidelines which will control. They take various types of offenses and then factor in negative and positive variables and come up with a range of sentences.

Now, having said that, we don't anticipate, at least over the near-term, that the seven-year statute will result in an increase in incarceration time, we nevertheless like the seven-year statute for these reasons:

One, the Sentencing Commission is a continuing body mandated to make revisions in the sentencing guidelines. The fact that Congress singles out DOD procurement fraud as something they con-

sider a very serious crime has to have an impact on the Sentencing Commission.

Also, it has to have some impact on the sentencing judge and might encourage him to go outside the guidelines in the sentence and he would have to justify doing so.

One of the justifications very well could be the fact that Congress thinks this is a very serious offense.

Mr. McCOLLUM. I was a big supporter and still am in the sentencing guidelines concept. It was a major innovation, but it has some kinks to be worked out of it.

I have a question: Should we in legislation like this, and this is one of our first bills since the sentencing guidelines became effective, consider any kind of a preemptive floor on really egregious offenses such as higher dollar crimes under the procurement fraud situation where we actually go in and mandate something that is a minimum sentence at a higher level than the sentencing guidelines may now have? Or do you think we would be better off leaving them to the discretion of the Commission and the revisions you think that might occur as you describe?

Mr. KEENEY. I think it is better as it is in H.R. 3500. Congress may want to do what you are talking about if, in fact, implementation of the guidelines by the judiciary is unsatisfactory, but I would give it a chance.

Mr. McCOLLUM. Let me ask you where some of these pieces of legislation stand. You outlined the Anti-fraud Enforcement Act of 1987, and you named a couple of other bills you would like to see passed. Where do they stand now?

Mr. KEENEY. I will have to ask Mr. Copeland of our legislative group.

Mr. COPELAND. They have been submitted to the Speaker and have not yet been introduced.

Mr. McCOLLUM. They are not before any committee at this point?

Mr. COPELAND. No. We are actively seeking sponsors. So far without success.

Mr. McCOLLUM. If you want to go further down the line than the Speaker, some of us might like to look at it.

Mr. COPELAND. We will be by this afternoon.

Mr. McCOLLUM. Thank you.

Mr. HUGHES. Mr. Keeney, you were here during Congressman Hertel's testimony and he mentioned four conclusions pertinent to the future DOJ activities. I want your brief response and if you want to elaborate more, you can submit something for the record.

One says, "The Justice Department Procurement Fraud Unit has not sufficiently corrected numerous problems encountered with previous investigations of major ship builders.

Mr. KEENEY. I will defer to Mr. Hendricks.

Mr. HENDRICKS. Our response is that since early this year we have taken steps to address all those concerns. We believe we are presently conducting our investigations in a fashion which would be looked upon with favor by the Senator. (See complete response in appendix.)

Mr. HUGHES. Would you supply for the record information of how you are correcting the situation or proposing to correct some of the alleged abuses or shortcomings?



It says, "DPFU has experienced excessive staff turnover." We have dealt with that.

"It appears to be in need of improvement." I think we have sufficiently talked about that today. I don't think that is criticism of the fraud unit. I think that is a problem we have experienced not just at Justice but in many, many other agencies.

Three, "DPFU has produced few successful prosecutions of major contractors." As of July of 1986, the unit has participated in only three convictions of major defense contractors. In all three cases the sentences were limited to fines.

Mr. HENDRICKS. We are involved in a number of significant investigations which may bear fruit in the near future. We look forward to being able to testify in a positive fashion about that in early 1988.

Mr. HUGHES. There is a serious problem at the present time because there is a perception that if you are rich and you have a corporate veil to hide behind and you are well connected, you walk, and if you are poor, you go to jail. That is unfortunate.

Many of those perceptions deal with defense frauds in many cases which have generated quite a bit media attention in the last couple of years.

Mr. HENDRICKS. We recognize that perception. In the last four months alone we have hired four or five attorneys who are substantially experienced, State prosecutors or ex-assistant United States Attorneys who have dedicated their professional careers to disabusing the public of this improper perception.

We are dedicated to the prosecution of offending corporate subjects and responsible officers.

Mr. HUGHES. Can you tell me what you are doing to try to beef up your unit and some of the steps you are taking to try to deal with this whole area of procurement fraud?

Mr. HENDRICKS. One of the first things we did was hire a Deputy Chief who was Assistant United States Attorney in the Eastern District of Virginia. He is very familiar with the Norfolk case.

He has been associated with DOD prosecutions much of his professional life and has an outstanding record of accomplishments in that area, is an aggressive person who has been associated with major cases involving significant, complex crimes. His name is Theodore S. Greenberg.

Mr. HUGHES. How many staff attorneys do you have?

Mr. HENDRICKS. At the present time, there are eight full time lawyers, DOJ lawyers, in the Defense Procurement Fraud Unit. There are two additional lawyers who are working about half of their time.

They are DOJ lawyers in the fraud section who are not particularly assigned to the Defense Procurement Fraud Unit.

We have hired a number of other people and because of the background checks, et cetera, those people will probably not be onboard until Spring 1988 and that will bring it to 13 or 14 people.

So we will have a net increase in excess of 50 percent in the last six months. Many of them are people not only especially dedicated to this difficult area but they are people who have had substantial experience and sensitivity toward the particular problems of the DOD.

One is a lieutenant commander in the Navy who is getting a SJD from George Washington University in Procurement Law.

Another person is employed by the U.S. Army with the Judge Advocate General's corp in an appellate capacity. These are people who we think will make an excellent complement to our staff in an area where cooperation with the DOD is an absolute necessity.

I have hired a Deputy Chief to focus on the development and prosecution of significant defense cases. We have also increased our staff. As Mr. Keeney mentioned, this has not been without some problem.

We have had some turnover.

Mr. HUGHES. How many investigators do you have detailed to your unit?

Mr. HENDRICKS. We have investigators from the uniformed services, from the DCIS. I don't have the figure right in front of me, but I think the figure is four or five. In addition, the Defense Procurement Fraud Unit has attorneys who represent the various components in the DOD. They are a fine complement to the Department of Justice people in the Defense Procurement Fraud Unit.

In addition, there are coordinating attorneys from the Civil Division of the Department of Justice and a representative of the FBI.

Mr. HUGHES. At the present time, what is your caseload?

Mr. HENDRICKS. The caseload, Mr. Chairman, is basically divided into two categories. One of them relates to early screenings so that some of the stats you may see, the numbers in hundreds, many relate to our attempts to review at a very early stage cases which may or may not have prosecutive potential.

They are either retained or rejected out of hand as not having significant potential, so we don't waste precious resources on them. They are retained by the Defense Procurement Fraud Unit and in many instances they are referred to the various U.S. Attorneys around the country.

That is one category of case that takes up to about two attorney years in the process of receiving, evaluating and documenting the decision we make with respect to those early referrals.

There is another area and that is the significant cases we assign to the attorneys. It is very difficult, Mr. Chairman, for an attorney to work on more than, I would say, two or a maximum of three significant defense procurement cases at the same time.

We try to keep the case load on the attorneys as low as possible so that they can do full justice to the cases and avoid the fragmentation problem the committee has already addressed.

At the present time, I would say we have something approximating an average—some attorneys have case loads as high as six or seven, if they are not too complex, but some with major corporations and significant allegations, the case load is around three.

Mr. HUGHES. Obviously, it would be very difficult for any staff attorney to handle seven or eight very complex fraud cases at any given time. In fact, it would be a challenge to handle more than one in many instances, I would think.

So you are obviously stretched very thin.

Mr. HENDRICKS. That is correct. In addition, the Defense Procurement Fraud Unit has a multitude of tasks. The prosecution of cases is one of those tasks.

By necessity, we have to be selective about what we can do. We are responsible to assist U.S. attorneys around the country. We also take very seriously the responsibility to collect data so that appropriate executives from the Department of Justice can be responsible to oversight hearings such as this and provide committees with accurate information from cases around the country.

So we have that administrative responsibility in connection with liaison screening. We have a legislative responsibility. We have an assistance responsibility to other U.S. attorneys and we have our own responsibility in connection with prosecution of the cases we handle.

Mr. HUGHES. We run into the problem all the time when you talk about resource allocation for U.S. attorneys in particular, but also Justice generally, when we mark up the authorization bill, without identifying specific, ongoing criminal investigations, by category, I would like you to provide the general nature of the cases that you have under investigation now, how many of those cases are handled by specific staff attorneys, and give us some idea of just how thin you are stretched.

Also at the same time, if you could provide for this committee your policy guidelines, written or otherwise, in bringing cases to headquarters and farming them out to U.S. attorneys. Do you keep a record of the number of major fraud cases that are being handled by U.S. attorneys throughout the country?

Mr. HENDRICKS. In certain cases. It depends on the class of the case. There are certain cases we may not be aware of. I would say we are aware of most of them. In certain classes of cases such as sensitive programs, voluntary disclosure programs which we are jointly involved in with the DOD, we are aware of all of those.

So it is all the significant investigations.

Mr. HUGHES. Why don't you provide us with all that information, too, talking about numbers and types of cases without identifying the ongoing criminal investigations as such.

Thank you. You have been very helpful.

Now, Mr. Keeney, and Mr. Davis, we look forward to working with you in trying to develop the very best piece of legislation and also to address concerns such as where Government employees and contractors are making changes that are not necessarily in the public interest and where no pecuniary gain is necessarily involved.

We would like to work with you to see if we can't develop something to deal with that problem.

Mr. KEENEY. We would like to do that, too, Mr. Chairman.

Mr. HUGHES. Our next panel consists of Derek J. Vander Schaaf and Fred J. Newton.

Mr. Vander Schaaf is Deputy Inspector General of the Department of Defense, a position he has held along with its predecessor, the Office of the Assistant Secretary of Defense for Review and Oversight, since 1981. Prior to this, he was a senior staff advisor with the House Appropriations Committee Staff from 1972 to 1981, on the staff of Office of Assistant Secretary of Defense (Comptrol-

ler) from 1968 to 1972, and as a program analyst in the Office of the Secretary of Defense from 1965 to 1968. He holds a B.A. degree from the University of South Dakota and an M.A. degree in Public Administration from the University of Massachusetts.

Mr. Newton is the Deputy Director of the Defense Contract Audit Agency, a position he has held since 1984. Prior to this position, he led DCAA's cost accounting standards activities, supervised audits of two major contractors and many small contractors in the Los Angeles area and practiced public accounting for several years. Mr. Newton has a B.A. degree from the University of Houston and an M.A. degree from Central Michigan.

Gentlemen, welcome, on behalf of the Subcommittee on Crime. We have your written statements which, without objection, will be made a part of the record. You may proceed. Why don't we begin with you, Mr. Vander Schaaf.

Welcome, all of you, to the subcommittee today. We have all your statements which will be made a part of the record. You may proceed as you see fit.

Why don't we begin with you, Mr. Vander Schaaf?

**TESTIMONY OF DEREK J. VANDER SCHAAF, DEPUTY INSPECTOR  
GENERAL, UNITED STATES DEPARTMENT OF DEFENSE**

Mr. VANDER SCHAAF. It is a privilege to be here, and I will put my statement in the record.

If you would give me an opportunity, I would like to take a minute to address some of the comments Congressman Hertel made, because I think they are appropriate to all we have heard this morning. I do this with some trepidation because I very much want to come across as independent and credible in our business, that is something we hold near and dear. I don't want to look like a lackey or spokesman for anyone when I make these comments, but I think there is a misperception that Mr. Hertel may have made.

Don't get me wrong, Mr. Hertel has been a strong supporter of our business. In fact, in 1983 he offered some legislation that would have given the Inspector General authority to restructure, reorganize, amend and otherwise change contracts, something that we thought went somewhat beyond the responsibilities of the Inspector General. We appreciated his efforts in that area and he has since that time been a fine supporter of our efforts.

But I think he has a perception that we are not going after fraud, waste and abuse in the Department of Defense. Believe me, we are going after it. Part of the erosion in the consensus for defense spending in this country is due to the many stories and publications and articles that deal with fraud, waste and abuse in our procurement. Most of those stories detail the results of the efforts of my office and other investigative and inspection type organizations within the Department of Defense.

We issue semiannual reports, press releases, prevention efforts. Appended to my statement you will see four or five paragraphs there that indicate the kind of efforts we are making and the increases that we are having as we attempt to uncover fraud and cor-

rect mismanagement wherever we find it in the department. I wanted to mention that briefly.

The other thing I felt should be mentioned, he used this figure of 10,451 allegations. I believe that figure came out of a President's Council on Integrity and Efficiency report, semiannual report, and refers to hotline calls. We have in the Department of Defense, by far the most active hotline in the Federal Government. We probably devote more resources to our hotline efforts than all of the other Inspectors General combined.

We receive about a thousand calls a month from everyone from uniformed employees, civilian employees, contractor employees, all manner of sources. Many of those don't represent the kind of things that one would pursue in a fraud case or criminal case, they involve management issues. But I would say we take some interest in half of those calls we receive. We give them to somebody to look into. A fourth of them we take very seriously, and we track and do follow-up investigations.

During the six month reporting period ending March 31, 1987, the DOD Hotline received 5,742 calls. Of this number, only 561 contained sufficient information to be referred to a DOD audit, investigation or inspection organization for further inquiry; 3,716 were closed without further sufficient information for us to act. These statistics are not correlated by the Office of Inspector General or the President's Council on Integrity and Efficiency with statistics relating to prosecution and convictions, since the majority do not deal with criminal misconduct. During the same time period, we obtained 146 indictments, 133 convictions and recovered over \$8 million in fines, settlements and restitutions.

The third and final point then I will get on to more of the business directly at hand, is the fact that we have increased the number of investigators, auditors and inspectors. When we started the Inspector General's office back in the 1982, we were about 500 strong. Today we have about 1,400 people, and the total number of auditors, investigators and inspectors in the Department of Defense has grown from some 18,000 to approximately 21,000. So that has been an increase. I am not saying it is enough. We do need to do more audit work. We have a problem there.

We are going to be faced this year with a cut when the appropriations bill for the Department of Defense comes back from the Hill, we need \$87 million to operate the office at the current level. We will be lucky if we come back with \$82 million to operate the office. So we are going to go through a period of decline, I am afraid, unless somebody takes some interest and does something.

Those points I wanted to make quickly in response to what Mr. Hertel said, to try to convince you that in partnership with the Department of Justice, we are pursuing fraud prosecution to the limit. We are not trying to let anybody, contractors or anyone else, off when it comes to these kinds of offenses and problems.

Let me tell you from the start that our top priority has been procurement, and it has been from day one. Within that area, our number one priority is product substitution. As someone said earlier in the hearing, it involves the health and safety of our personnel. We can't tolerate it. As soon as we receive an allegation of a product being defective, we go to that before we do anything else.

Another priority is mischarging of costs. It is a very simple crime to commit, but, it is a difficult crime to detect, and it is even a far more difficult to prosecute. There are large dollars involved in cost mischarging in this business. I have become convinced of that over my five or six years in this job.

Another priority is defective pricing, which we put a lot of emphasis on for much the same reason as cost mischarging. I can explain to you the differences between mischarging and defective pricing, but I won't do that now.

And fourth, we have gone after cases that involve undermining the integrity of our procurement system, and here I am speaking of crimes involving bribery of our Government employees, kickbacks between prime and subcontractors, collusive bidding or antitrust activities.

For example, in the textile and clothing industry, we have a large number of cases pending where we have uncovered graft, corruption, bribery, contract fixing and those kinds of problems, and we are pursuing them. We also have had some of those problems with the wire and cable suppliers to the Department of Defense.

To illustrate that, in terms of numbers in the past four years, we have had about 1250 convictions and have recovered some \$400 million in fines, restitutions and other recoveries.

Mr. HUGHES. For what period of time?

Mr. VANDER SCHAAF. The last four years, fiscal years 1984 through 1987. We have increased the number of fraud trained investigators in the department from about 375 in 1981 to roughly a thousand. Investigators in my office have obtained some 85 indictments in the past year, half against contractors for product substitution. Some major problems have evolved there and we continue to push for tougher sentences in that area. I have in my statement some examples of the companies and the cases of product substitution, and I won't go through those now. I welcome any questions you might have on that.

I also put some examples in the statement on cost mischarging and defective pricing. You will find some of the major suppliers to the Department of Defense listed such as Rockwell, Litton, and TRW. There have been others as well.

Finally, we have emphasized suspension and debarments. We believe that it is a terrific administrative tool that we must use in pursuing these cases, and you will note there is a chart covering suspensions and debarments on the back of my statement. We have increased the number of suspensions and debarments in the Department of Defense tenfold since 1981. We were doing fewer than 100 in 1981, but something like 800 last year. We are close to 900 suspensions and debarments this year. So that's a tremendous change.

I think you can go out to the defense industry and you will find that contractors, big and small are well aware of this change, and, in fact, are acting more cautiously with respect to some of these matters. Many are putting programs into their own organizations to ensure that they don't get themselves into trouble with the Office of the Inspector General.

Now, what I would like to do is turn to H.R. 3500.

For the most part we support the legislation. I have a couple of concerns with one aspect of it, but as far as the increase in the statute of limitations from five to seven years, it is absolutely essential to some of our more difficult cases. It provides our people an opportunity to get their act together before the Government has to make a prosecutive decision. An extension will provide more time to get information to the Department of Justice and its prosecutors. So an extension will reduce the pressure.

It also prevents us having to drop cases from time to time, or at least having to go back to a contractor and ask his agreement that the statute no longer tolls. We have to do that from time to time and that is a poor way to go. So with respect to the increase in the length of the statute of limitations, we support it.

With respect to the reward provision in the legislation, I think that is a tremendous improvement. I think that provision will be very helpful. I had an opportunity a few weeks ago to try to make an award to employees of a contractor that did yeoman's duty in helping us out with a product substitution case. I found I have really no authority or no way to provide them with a reward.

These particular contractor employees had lost their jobs as a result of providing us information. Our criminal case would never have been made without their assistance. I had to use what we call Extraordinary and Emergency funds that the department had to provide them with a very minimal award of \$5,000 for one and \$7,500 for the other individual. This offers some real possibilities when you are talking a quarter of a million dollars as a reward. So, I support these reward for information provision.

Finally, I support the third part of the bill that would provide an increase in the penalties. I think there are some things that need to be ironed out to clear up what is meant, and I will quote for you the words that are currently in H.R. 3500:

"The fine imposed for an offense under this section may exceed the maximum otherwise provided by law if such fine does not exceed twice the amount which is the object of the fraud."

Our problem is defining what is the object of the fraud, and I would hope that you and the staff will give further consideration to how we do that. If that isn't cleared up, I am afraid you will have prosecutors who simply won't use this statute in their indictments because they won't want to get wrapped up in having to build a whole information base on what constitutes the amount of a penalty that could be incurred as a result of this legislation.

The second concern regards maximum fines under existing law, and I wanted to make you aware that we have had some improvements in maximum fines that are already allowed under existing law.

One amendment of two years ago to the Defense Authorization Act did not get codified for some reason and many United States attorneys and their assistants are not aware of the fact that penalties for frauds against the Department of Defense can go as high as a million dollars count. Apparently there has been some language that the Sentencing Commission has recommended with respect to fines on individuals and corporations that has not addressed the statute. I urge the subcommittee to take actions to ensure that this

statute is codified and applied in sentencing in cases dealing with DOD fraud.

A third concern which is somewhat minor, but may prove to be important, is that we would like to see the committee add some language to the bill that will not require specific intent to prove fraud. We only want to have to prove that the data was false or fictitious, and that it was knowingly made. We do not want to get into the business of proving specific intent. That is often impossible to prove. I can discuss that in more detail with you if you desire.

I want to thank the committee and the Congress. I think you have been very responsible to the Administration in providing us with the tools that we need to pursue these major fraud cases. In the past three years there has been a wealth of new laws that enhances our ability to proceed in these cases. I am talking about the amendments to the False Claims Act of a year ago, and your action here—The Civil Fraud Remedies Act, the Anti-Kickback Act, and others. Thank you very much, Mr. Chairman, for those efforts.

Mr. HUGHES. Thank you.

[The statement of Mr. Vander Schaaf follows:]



HOLD FOR RELEASE  
UNTIL DELIVERY  
EXPECTED 10:00 A.M.  
DECEMBER 3, 1987

STATEMENT OF  
MR. DEREK J. VANDER SCHAAF  
DEPUTY INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
BEFORE THE  
SUBCOMMITTEE ON CRIME  
COMMITTEE ON THE JUDICIARY  
UNITED STATES HOUSE OF REPRESENTATIVES  
DECEMBER 3, 1987

*Vander Schaff*

It is a particular pleasure to be here today to testify regarding the role of the Office of the Inspector General, Department of Defense, and especially as that role relates to the investigation and prosecution of major fraud cases.

When Congress passed the Inspector General Act of 1978, the Department of Defense was not included among the agencies covered by that legislation. Rather, the Secretary of Defense was asked to staff a study group to determine how best to attack fraud and waste in the Department. The group concluded that a senior official, reporting directly to the Secretary, was required to coordinate the overall effort to achieve economy and efficiency in Defense programs. Secretary Weinberger followed that recommendation in April 1981 by creating the position of Assistant to the Secretary of Defense (Review and Oversight).

Because, in large part, of the success of the Review and Oversight Office, and the perceived need by the Congress to arm that organization with full investigative tools, such as the power to subpoena books and records, the Fiscal Year 1983 Defense Authorization bill contained language which created a statutory Inspector General for the Department of Defense and consolidated under that official the Defense Audit Service, the Defense Criminal Investigative Service, the Inspector General for the Defense Logistics Agency, and the audit policy function

formerly held by the Office of the Comptroller. The new Inspector General further created an office for Audit Followup and one for Criminal Investigations Policy and Oversight, the latter of which issues investigative policy applicable to all criminal investigative organizations within the DoD and generally oversees the Department's effectiveness in conducting fraud investigations. Special emphasis has been placed on ensuring the effective coordination of all available criminal, civil and administrative remedies for fraud, and in encouraging voluntary disclosure of fraud by Defense contractors.

As the Inspector General function grew in DoD, so did its paybacks. While the organization has doubled in size since 1982 to meet the increasing challenges of watching over tax dollars entrusted to the Department, the monetary benefits and cost avoidance identified by the Inspector General auditors alone have averaged 25 times the cost of supporting the entire DoD Inspector General organization.

We have also built an impressive record in pursuit of criminal allegations against those who seek to defraud the Department of Defense.

In partnership with the Department of Justice, we have aggressively pursued prosecutions of procurement fraud and

corruption. Our top priorities are offenses involving product substitution, mischarging of costs, and fraudulent defective pricing, as well as schemes which undermine the foundation of our integrity based system of contracting, such as bribery, kickbacks, and antitrust matters.

From Fiscal Year 1984 through Fiscal Year 1987, the Defense criminal investigative organizations have had a major impact on contract fraud. The Defense criminal investigative organizations are the four criminal investigative organizations within the Department of Defense that are responsible for contract fraud investigations: the Army Criminal Investigation Command, the Naval Security and Investigative Command, the Air Force Office of Special Investigations, and the Defense Criminal Investigative Service, which is the criminal investigative arm of my office. Together, these offices are responsible for over 1,250 convictions and the return of over \$400 million to the United States Treasury in criminal fines, civil fraud judgments, and other forms of recoveries. Attached to my statement is a series of charts which show the rise in criminal fines, restitutions, and other recoveries such as False Claims Act judgments.

I should also note that in order to achieve these results, my office has encouraged each of the Defense investigative

organizations to increase the number of agents who are dedicated to fraud investigations. Another chart attached to my statement shows that in Fiscal Year 1982, the Department of Defense fraud agent strength was 375. As of the end of Fiscal Year 1987, that number had risen to almost 1,000.

Product Substitution. Our number one priority has been, and will continue to be, product substitution. Product substitution is when a contractor deliberately provides an inferior product on a DoD contract. It is that offense which can most directly cost service members their lives. Substandard, defective, or counterfeit goods in our weapons systems have no place on the battlefield and can only lead to horrendous consequences.

Since January 1986, the Defense Criminal Investigative Service has obtained indictments against more than 85 individuals and contractors who were found to be involved in product substitution schemes. Currently, the Defense Criminal Investigative Service is carrying over 225 open product substitution investigations. Let me provide you with some representative samples of our most successful product substitution cases:

Spring Works, Incorporated - This company deliberately provided defective springs which were ultimately installed in critical assemblies of the CH-47 helicopters, the Cruise Missile, as well as the F-18 and B-1 aircraft. The company falsified testing and inspection certificates. Two corporate officials were convicted, fined, and imprisoned.

Diversified American Defense - This company had a scheme to provide defective fins to be installed on 60 millimeter mortar rounds. The defective fins caused the mortar rounds to veer off target. The vice president of the company ordered company employees to pack and ship defective parts, then falsified testing documents to show that the fins were in compliance with the contract. The company and the vice president were convicted. The vice president was imprisoned for one year, and the vice president and the company were fined over \$900,000.

MKB Manufacturing - This company deliberately provided defective gas pistons which were to be installed in the M60 machine gun. Once installed, the defective part would cause the machine gun to jam. One corporate officer was sentenced to serve 18 months, while another

was sentenced to provide a few hundred hours of community service.

Waltham Screw Company - This company engaged in a pattern of deliberately providing defective flash suppressors for the M16 rifle. A corporate officer, when informed of the damage which could be caused by a defective rifle, stated that if one soldier was killed, there would be more around to complete the job. This official and the company were convicted. The company was fined \$125,000, and the official was given a year in jail.

As you can see, while these criminal schemes are often life threatening and can have a disastrous effect on the ability of our troops to complete their mission, we have not received a significant sentence on most of these cases. A recently completed study by my office concluded that more information must be provided to the court at time of sentence which will identify the adverse safety and mission impact of product substitution schemes. My office and the Department of Justice are working on procedures to implement this recommendation. Furthermore, based on our recommendation, the recently enacted sentencing guidelines provide for an increased criminal sentence for product substitution cases.

Cost Mischarging/Defective Pricing. As representatives of my office have testified before the Senate Armed Services Committee and elsewhere, the investigation of cost mischarging and defective pricing by contractors is a top priority of our agents. Those cases represent two of the most common and serious abuses found in public contracts. They are also among the most complex investigations, with a myriad of cost allocation systems and procedures to be untangled, and the need for expert audit assistance. Not only do those schemes undermine our procurement process, but the impact is always greater than the actual dollars lost to misallocation or overpricing. For example, when direct labor costs are intentionally overcharged, so are the associated overhead and administrative expenses. Since those costs often exceed 100 percent of the labor costs, such mischarging ultimately results in greater than double the loss to the Government.

Let me share with you some of the mischarging and defective pricing cases which we have recently completed:

Cost Mischarging:

TRW - An investigation conducted by the Defense Criminal Investigative Service and the Defense Contract Audit Agency concluded that TRW had mischarged cost



overruns on fixed price contracts on to DoD cost type contracts. TRW pled guilty in September 1987 and has repaid over \$17 million in fines and restitution.

AVCO - An investigation conducted by the Defense Criminal Investigative Service and the Defense Contract Audit Agency concluded that AVCO had improperly charged Independent Research and Development and Bid and Proposal costs on to DoD cost type contracts. In June 1987, AVCO pled guilty to criminal charges and agreed to pay over \$6 million in fines and recoveries.

Rockwell International - An investigation conducted by the Defense Criminal Investigative Service and the Defense Contract Audit Agency concluded that Rockwell had engaged in cost mischarging on Air Force radio contracts. Rockwell pled guilty and repaid over \$1.2 million in criminal fines and recoveries.

Defective Pricing:

JETS, Incorporated - An investigation conducted by the Army Criminal Investigation Command and the Small Business Administration Inspector General resulted in the racketeering conviction of a contractor who

submitted false cost estimates on numerous DoD laundry contracts. The contractor and its officers were sentenced to repay over \$7 million in criminal fines and forfeitures.

Hayes International - An investigation conducted by the Air Force Office of Special Investigations, the Naval Security and Investigative Command, and the Federal Bureau of Investigation resulted in the conviction of an aircraft maintenance contractor for a consistent pattern of deliberate overstatement of labor costs. The contractor repaid over \$2 million in fines and civil penalties.

Litton Industries - A Defense Criminal Investigative Service and Army Criminal Investigation Command investigation proved that the Clifton Precision subsidiary of Litton Industries had repeatedly overpriced Army contracts. Litton officials would add a "chicken fat" factor on to legitimate costs in order to overstate prices. Litton pled guilty and paid over \$10 million in fines and recoveries.

Harris Corporation - An investigation by the Defense Criminal Investigative Service and the Federal Bureau

of Investigation resulted in the conviction of the Harris Corporation for a pattern of submitting false cost estimates on Army and NASA contracts. Harris paid over \$9 million in fines and restitutions.

I would like to particularly emphasize the fact that many of these investigations were prosecuted in the offices of the United States Attorneys in whose jurisdiction the offenses occurred. Our ability to work directly with local United States Attorneys is an important complement to our effective relationship with the Defense Procurement Fraud Unit at the Department of Justice in Washington, D.C. The Unit handles some of our large cases and is a constant source of legal advice on difficult accounting and contract issues which often surface in mischarging and defective pricing cases.

Coordination of Remedies. As I mentioned earlier, a high priority of the Office of the Inspector General, through the Office of the Assistant Inspector General for Criminal Investigations Policy and Oversight, has been to ensure that all available civil, criminal, contractual, and administrative remedies are appropriately considered and used in each case.

We are very proud of our record in this regard. Early on, we recognized a number of areas where the Department clearly

needed to enhance its procedures to effectively resolve issues involving fraud. One of those was suspension and debarment -the procedure whereby corrupt contractors can be barred from doing business with the Government.

In a report issued in 1984, the Inspector General concluded that more positive steps were required to improve the effectiveness of these tools. More information from criminal investigators was recognized as a vital element to enhance suspension and debarment activity. All three Services and the Defense Logistics Agency concurred, and the DoD record on suspension and debarments has subsequently improved.

Since 1982, the number of DoD suspension and debarment actions has increased by over tenfold. A chart attached to my statement demonstrates the dramatic rise in suspension and debarment actions over the last four years.

While we believe that we have demonstrated success in many of our antifraud initiatives, we are constantly aware of the need to improve the framework of laws under which we seek to attack major procurement fraud.

With respect to the proposed legislation, H.R. 3500, the Office of Inspector General supports the language in the bill

which extends the statute of limitations to seven years after the offense is committed. This is particularly appropriate in light of the practical constraints on the Defense Contract Audit Agency auditors, who often cannot even commence incurred cost type audits until months or often years after the submission of contractor claims for payment. Once commenced these audits often take months to complete. It is from these incurred costs audits that the Defense Contract Audit Agency sometimes identifies indications of fraudulent accounting practices on the part of contractors. In such cases, it is not unusual, because of the unavoidable delays in scheduling these audits, for criminal investigators to first receive these indications well into the current five year statute of limitations. Given the complexity of accounting issues involved, the criminal investigations of these audit referrals often may require many months or years to complete. The consequence of this series of events is that it is not uncommon for our investigations to run to a point where the current five year statute of limitations becomes a pressure factor in the ultimate prosecutive decision-making process. Alleviation of this pressure through extension of the statute of limitations to seven years is a revision of current law which we therefore greatly support. An extension of the criminal statute of limitations would further the efforts begun by Congress last year when the statute of limitations in the Civil False Claims Act was extended.

Another provision which the Office of the Inspector General endorses is the reward provision which permits payment of up to \$250,000 to any individual who furnished information leading to conviction under the provisions of this legislation. This mechanism, as contrasted to the qui tam provisions of the Civil False Claims Act, provides for a more direct means of rewarding true whistleblowers whose information leads to a conviction under this section. We would be glad to work with the Committee and the Department of Justice in developing a clearer language to specify how this reward provision will be administered.

One provision of the legislation which we believe requires reexamination relates to the fine to be imposed as a result of a violation of H.R. 3500. Currently, H.R. 3500 provides that "the fine imposed for an offense under this section may exceed the maximum otherwise provided by law if such fine does not exceed twice the amount which is the object of the fraud."

We believe that if the Bill is designed to improve the fines which can be imposed for contract fraud, it is necessary to provide a better definition of the "object of the fraud." For example, if a false statement regarding a contractor's performance is provided to the Department of Defense to induce acceptance and payment for defective goods, it is unclear whether the object of the fraud would be the entire value of the

contract, or the difference between the value of the product required by the contract and the value of the defective product which was actually provided. This is a difficult question of fact to be determined and may require time consuming factual inquiry by the court in order to determine the maximum allowable fine.

I would like to point out an additional concern regarding maximum fines under existing law. As you are aware, with the November 1987 implementation of the Federal Sentencing Guidelines, there is an element of uncertainty regarding the maximum allowable fine for violation of Title 18 of the United States Code. While Congress is moving swiftly to rectify this problem, I am concerned that one element of existing law may have been unintentionally nullified. Under Section 931(a) of the Department of Defense Authorization Act of 1986 (Public Law 99-145), Congress increased the criminal penalty for a violation of the False Claim Act (18 U.S.C. 287) on Department of Defense contracts to a maximum fine of \$1 million. This provision has never been codified. Our discussions with the staffs of Congress, the Department of Justice, and the Sentencing Commission have resulted in a concern that both the Federal Sentencing Guidelines and subsequent clarifying legislation may have overlooked this provision. Therefore, its current status is open to question. We are strongly in favor of

the \$1 million maximum penalty per claim for false claims on Department of Defense contracts, particularly as it applies to claims by corporations. I urge this Committee to provide clearer guidance in this area.

We are also concerned that the Bill, as currently written, would require proof of a specific intent to defraud in order to obtain a conviction. Currently, most fraud cases are prosecuted under the False Statements Act (18 U.S.C. 1001) and the False Claims Act (18 U.S.C. 286, 287). The majority of courts have held that these statutes penalize the provision of false or fictitious or fraudulent claims and statements. If the indictment only alleges that false or fictitious, and not fraudulent, information was knowingly submitted to the Government, then the Government is not required to show a specific intent to defraud. Specific intent is often impossible to prove. The Bill should be amended to clearly state that specific intent need not be proven in order to establish liability under the Act. This would be consistent with the amendments which were passed by Congress last year which clarified that specific intent need not be proven in order to establish liability under the Civil False Claims Act.

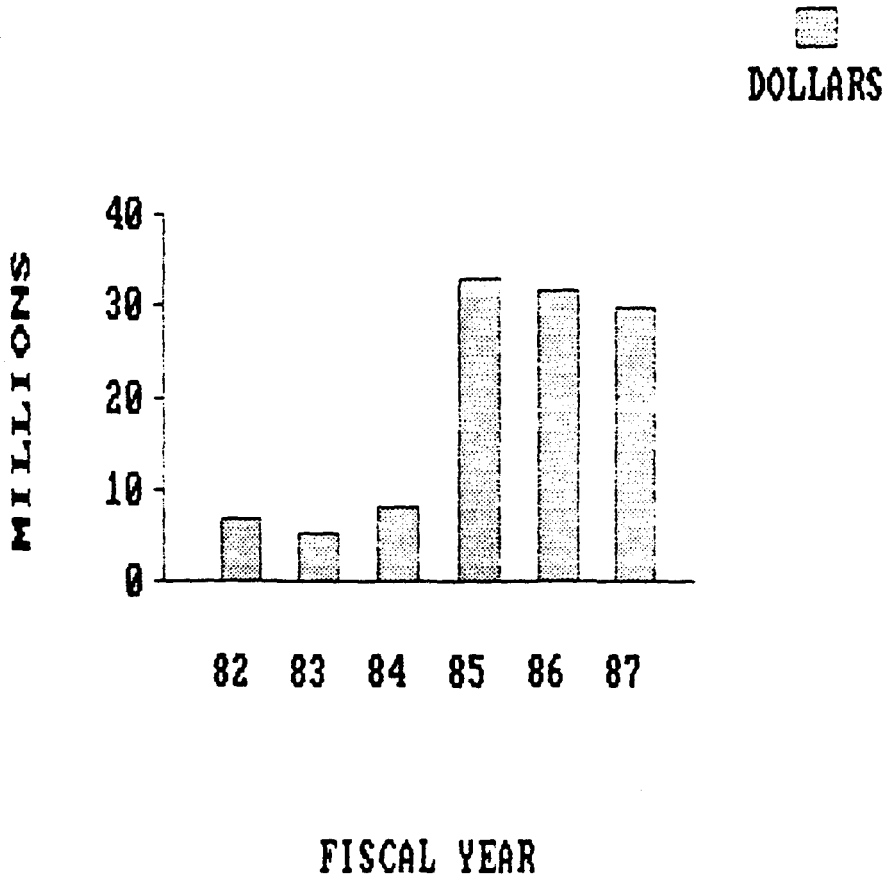
Over the past few years, Congress has clearly acted responsibly in providing the executive branch with more tools



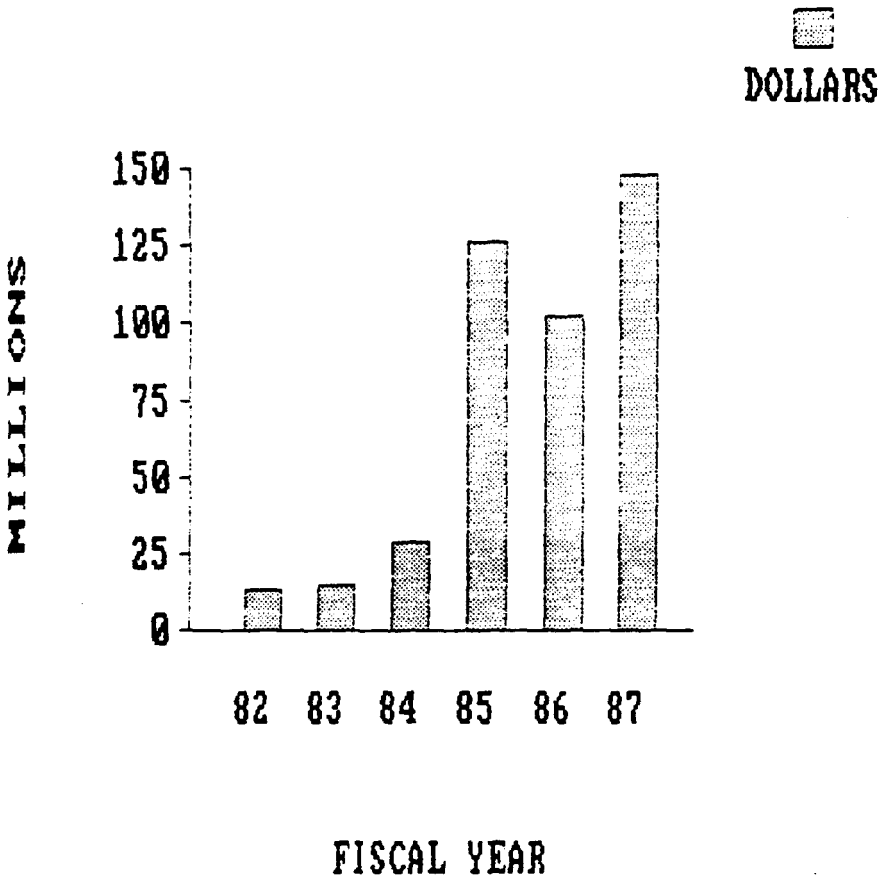
and remedies to combat fraud. The best examples of such Congressional initiative are found in the Program Fraud Civil Remedies Act and the 1986 Amendments to the False Claims Act. The proposed Major Fraud Act of 1987 compliments these recent Congressional actions.

Mr. Chairman, that concludes my statement. I would be glad to answer any questions you may have.

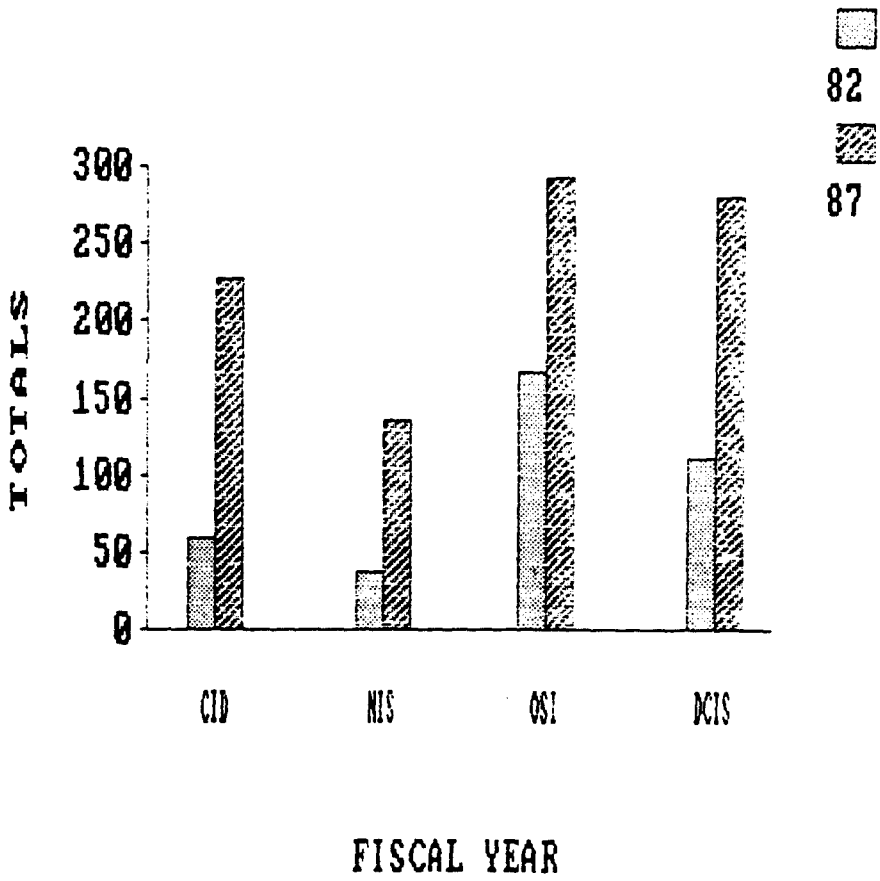
## CRIMINAL FINES AND RESTITUTIONS



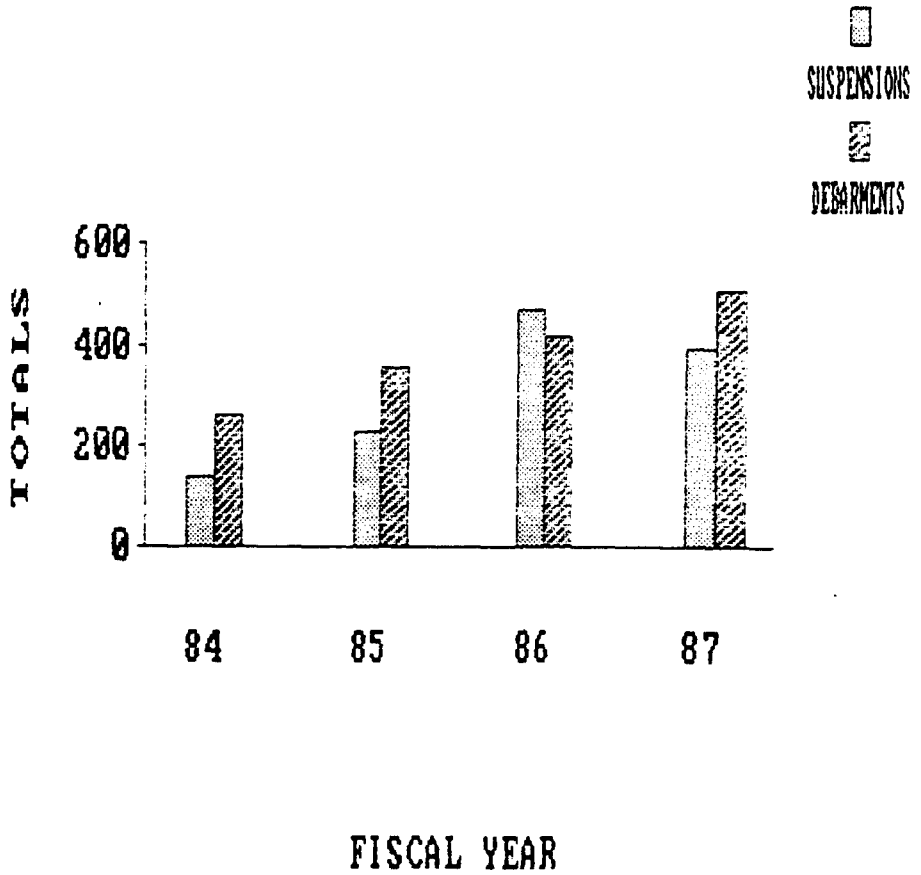
## OVERALL MONETARY OUTCOMES



### FRAUD AGENT STRENGTHS



## SUSPENSIONS AND DEBARMENTS



Mr. HUGHES. Mr. Newton.

**TESTIMONY OF FRED J. NEWTON, DEPUTY DIRECTOR, DEFENSE  
CONTRACT AUDIT AGENCY**

Mr. NEWTON. Thank you, Mr. Chairman. With my statement on the record, I would like to just highlight some of the features that are included.

I share the concern of you and our fellow taxpayers about white collar crime in the Government contracting environment. We certainly welcome any efforts to prevent fraud or to impose stiff penalties on the perpetrators.

The Defense Contract Audit Agency's role in this arena is important. We recognize that by working closely with the Department of Justice, the Department of Defense Inspector General's Office and other investigative organizations in developing guidelines for auditors to apply to assure that we are doing the best we can to be supportive.

First and most importantly, we try to work on preventive measures. With that objective in mind we design audits so we are encouraging very strong systems of internal control.

While we do have an important role in trying to prevent fraud and to help it be uncovered where we can, it is important to recognize that the Defense Contract Audit Agency is not an investigative organization. Our mission is to review cost statements submitted by contractors and to provide attestations on the fairness of those presentations to the contracting community.

Since we are looking at contractor accounting records in some detail, we obviously have an environment which offers opportunities for observations of potential fraud. But there are limitations even there that need to be recognized by all. Fraud evidence may not be in the accounting records at all, particularly when we are dealing with situations of collusion. We are interested in making sure that where our auditors do have an observation of a reasonable potential for fraudulent conduct, that they are able to recognize such instances.

In this direction, we have provided special training to all of our audit staff. It is routine training now in a program which was developed in concert with the Defense Procurement Fraud Unit. We make sure that our auditors all recognize that we consider the reporting of observations of potential fraud as not just a contract audit responsibility but also a civic responsibility.

I would offer what I believe is needed for reliance to prevent fraud. Obviously, from my comments here it is not just having a contract auditor on the scene. Prevention of fraud is a management responsibility. I believe this has been recognized very well in the President's Blue Ribbon Commission, called the Packard Commission, where they have called for strong systems of self-governance to be developed within the contracting community.

Another way of describing self-governance is a strong system of internal controls, which again, is what we have been encouraging as a means of preventing fraud. It is very important as an element of that system of internal control that there be a clear element of the corporate culture that indicates that the company as a whole,

under the leadership of its very top management, is opposed to condoning any incidents that might lead to potential fraud.

This, we believe, is reflected in such things as codes of conduct that have been developed by the top management of the companies and vigilantly enforced by the management at all levels of the company. This is something that we look to in our audits as one element that would be an indicator of strong system of internal controls.

Another feature which is needed is to have reviewers who are alert and trained to recognize fraud. By this I mean not just a Defense Contract Audit Agency reviewer who has been trained in observing what fraud is, but also to have management at the various levels of the organization, and most certainly the internal auditors of the corporate structure, to be trained to know what fraud is when they see it, and to have some very definitive procedures for assuring that it gets dealt with.

Unfortunately, there are circumstances where we are not able to determine whether the internal auditors are doing anything to prevent fraud or not. In that vein, I cite the Newport News situation, where that contractor is engaged in litigation to prevent the Defense Contract Audit Agency from exercising its right of subpoena and its right of access to seeing what their internal auditors are doing to prevent fraud.

There is a need for thorough investigations, obviously, of whatever referrals are made of potential fraud, whether they are made from the internal audit organization, from the contractor, or from Defense Contract Audit Agency.

I believe that the investigative organizations have been doing a commendable job here, notwithstanding thin short resources, which have already been mentioned in this hearing.

Finally, there is a need for strong penalties to provide deterrence to acts of fraud. I believe H.R. 3500 certainly would make a substantial addition to this area.

Let me mention briefly some of the audit actions that Defense Contract Audit Agency has taken to try to prevent fraudulent conduct. I mentioned how we have encouraged strong systems of internal controls, and some other specific things. In the area of computers, we are increasingly observing a circumstance where we have a paperless flow of transactions throughout the accounting systems. In order for us to effectively test those programs to assure that there is not fraudulent activity or just inappropriate allocations of costs taking place, we have been actively developing our own test programs. We are planning to use them increasingly in this paperless environment.

We are also conducting unannounced floor checks of labor. The area of labor mischarging is the most significant area in which we are observing incidents of fraudulent conduct. That has been the case for a long time, and unfortunately it continues. So, we are giving a great deal of emphasis to labor tests and require that as a mandatory audit function before we buy off on any contractor's cost.

We also are increasingly conducting estimating system surveys. Here we are dealing with an environment for pricing new con-

tracts where there is a substantial amount of judgmental estimating, and consequently, the opportunity for manipulation.

We are looking for opportunities to require contractors to have very good written estimating procedures. We are pursuing that to be a requirement in proposals. This has been recommended to the acquisition regulatory organization.

Regarding Defense Contract Audit Agency fraud referral procedures, I would call your attention to a diagram, which is attached to my written statement that has been submitted. This illustrates the process that we have now for submitting an observation where the individual auditor believe that there is a reasonable basis for suspicion. See the various elements of our organization depicted there, I'll just mention that while we have always had a fraud referral procedure, that up until '85, our procedure required each one of those elements to review the writeup of the observation before that observation would be referred to the investigative organization.

In 1985, we recognized that this was a too cumbersome review process; that there was a need for getting these referrals into the law enforcement organization as quickly as possible, So we streamlined that process considerably. Now the referral goes directly from the contract auditor on a form which we call Defense Contract Audit Agency Form 2000. It was devised through consultation with the investigative organizations as being what information they would require to be able to make a decision on whether they should proceed with an investigation.

That form goes to our General Counsel's Office, where the function is merely to see that it gets in the hands of the proper investigative organization. An information copy is given to the field manager, who is instructed to send a copy of it directly over to the local investigator, marked "early alert." We have an information copy coming into our Headquarters Operation Directorate where we make an assessment on whether there is impact on agency audit guidance.

We think this has been a very effective streamlining process. Before 1985 the number of referrals per year was 154. Now in the most recent year, we issued 287 referrals. There are examples of those referrals in my detailed statement.

I have also included some examples of audit observations of fraudulent conditions which have run the gamut, that means that the prosecutions have been settled. I refer those to your attention and will be happy to talk more about them or answer questions about them if you wish.

I would emphasize here that we have a very effective supporting role for the investigations and prosecutions. We have trained some specialists in our organization, and they are stationed in each one of our regions, who are in a role of trying to make sure that the investigators get the contract audit support which they need to be able to conduct their investigations.

Again, we are not investigators, but when the investigator needs to have some information of a cost accounting nature, needs to be able to determine how much a particular event costs, we stand ready to help them and think that our role there has been quite effective. We have had auditors in the courtroom and certainly



have been active before grand juries aiding prosecutors in providing expert testimony. Again, we have been pleased with our activity there. We believe that Defense Contract Audit Agency has been quite effective in its achievement in fostering systems of internal controls to prevent fraud and in supporting investigations and prosecuting efforts.

We are just as pleased to see significant actions being taken within the industry now toward eliminating opportunities for fraudulent conduct. The strong penalties you are proposing also act as a deterrent. While we may never see a Government contract environment devoid of crime, the collective actions should certainly move us in that direction.

Thank you.

Mr. HUGHES. Thank you.

[The statement of Mr. Newton follows:]

STATEMENT OF

FRED J. NEWTON

DEPUTY DIRECTOR

DEFENSE CONTRACT AUDIT AGENCY (DCAA)

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON THE JUDICIARY

SUBCOMMITTEE ON CRIME

HEARING ON MAJOR FRAUD ACT OF 1987 (H.R. 3500)

3 DECEMBER 1987

NOT FOR PUBLICATION UNTIL RELEASED BY THE SUBCOMMITTEE

SUMMARY

DCAA role:

Encourages strong systems of internal control.

Is not an investigative organization.

Reports observations of potential fraud to law enforcement officials.

What is needed for reliance to prevent fraud:

Strong systems of internal control.

Reviewers who are alert and trained to recognize fraud.

Thorough investigations.

Strong penalties to provide deterrence.

DCAA audit actions to prevent fraud.

DCAA fraud referral procedures.

Examples of audit observations of fraudulent conditions.

*Newton*

Mr. Chairman and members of the Subcommittee, I share the concern of you and our fellow taxpayers about white collar crime in the government contracting environment and, consequently, welcome any efforts to prevent it or impose stiff penalties on the perpetrators. Toward this objective, the Defense Contract Audit Agency has worked closely with other elements of the Department of Defense and with the Department of Justice. We have focused audit attention upon encouraging contractors to maintain strong systems of internal control. We have established training and procedures for our auditors to be alert to observe potential fraudulent conditions and to report those observations to law enforcement officials. I will describe these important DCAA initiatives for you and provide some examples of the results.

First, though, I want to make sure that there is a clear understanding of the limitations on the role of the contract auditor in discovering fraudulent acts. As contract auditors, we are responsible for performing sufficient tests of statements of costs estimated or incurred submitted by contractors for pricing or reimbursement and to report the results of those tests to the government contracting officer along with our opinion on the fairness of the cost statements. Tests for this purpose are not of sufficient depth to observe all potential incidents of fraud. Indeed, there may be no evidence of the fraudulent acts in the accounting records, especially when collusion is involved. Therefore, no one should rely completely upon contract audits as a means of preventing or discovering

contract fraud. What is needed for reliance are (i) strong systems of internal control by contractor management, including codes of conduct for all personnel, (ii) reviewers who are alert and trained to recognize fraud indicators, (iii) thorough investigations of referrals by law enforcement officials, and (iv) strong penalties which provide a deterrent to those who might consider criminal actions.

Now, I will describe the DCAA initiatives.

Preventing fraud in the government contracting environment is a management responsibility. Your proposed legislation certainly makes contractor management accountable for that responsibility. It is also noteworthy that the Presidents Blue Ribbon Commission on Defense Management (generally referred to as the Packard Commission) emphasized in their June 1986 report the need for strong contractor self-governance programs. As an initiative toward implementing the Packard Commission recommendations, DCAA has taken significant actions which foster contractor self-governance.

In our examinations, we first look for evidence of a positive corporate culture. The attitudes which permeate an organization are usually a reflection of the tone set at the top. We look for codes of ethics which are commonly known and vigilantly enforced. We review the

minutes of board of directors meetings for evidence of top management attention to fraud prevention controls.

Next, we give consideration to internal reviews. We ascertain whether contractor internal auditors are trained in fraud recognition and have included tests of key elements of the system of internal controls. Unfortunately, some contractors deny access to internal audit records. For example, Newport News Shipbuilding has engaged in litigation to prevent our exercise of a subpoena to obtain access for DCAA review of their internal audit records. While we are pursuing subpoena enforcement in the courts, our contract audits have to proceed without knowledge of whether the internal auditors are doing anything to prevent fraud.

In response to an initiative of the Deputy Secretary of Defense, many contractors have established voluntary disclosure programs in which they formally advise the government of internal observations of fraudulent conduct. DCAA reviews these programs to determine the extent they may be relied upon as systematic internal controls. Unfortunately, the accuracy of cost impacts disclosed by contractors to date has been disappointing. For example, a San Jose, California contractor disclosed some incidents of labor mischarging on twelve subcontracts and one prime contract. They offered to accept price adjustments totalling \$2.7 million. Our review found the proper measure of price adjustments to be \$9.9 million, a difference of \$7.2 million due the government.

With the advent of computers creating a paperless trail for the flow of transactions affecting contract costs, DCAA is preparing special computer programs to test the internal controls in contractor programs. Unfortunately, some contractors are tightening up access to electronic data. While we believe existing contract clauses provide a right to such access, we have requested specific acquisition regulation coverage of this increasingly important subject.

The most frequent type of fraud observed in DCAA audits is labor mischarging. Consequently, considerable audit attention is directed to labor charging and distribution systems. We require our auditors to perform unannounced floor checks (i.e., observations of work with subsequent tracing of charges to contract cost records) before acceptance of costs for any accounting period. This is an effective deterrent, especially when augmented by contractor internal tests.

The initial pricing of contracts is subject to fraud exposure because of the use of judgmental estimates and opportunities to manipulate supporting data. Consequently, DCAA carefully reviews estimating systems and encourages strong internal controls. As a recent initiative, we recommended that the acquisition regulations include specific requirements for contractors to maintain written procedures for their estimating systems. We have also increased our post award reviews of contracts for defective pricing (Price adjustments may be obtained where negotiations

were based upon cost or pricing data submissions which were not current, accurate, or complete).

DCAA has recently increased audit surveillance of subcontract pricing procedures because of the vulnerability to irregularities. Our tests are designed to disclose situations such as use of high bids for pricing the prime and low bids for the actual buy or the use of single sources for common products. Either of these conditions could be an indicator of kickbacks.

One may reasonably conclude from these DCAA initiatives that serious consideration is given to the systems of internal control. In fact, we have devised risk assessment procedures governing the extent of our tests which specifically relate the reliability of internal systems to the scope of audit. Thus, a conscientious and cooperative contractor may reap the very positive benefit of reduced government audit surveillance by effective self-governance actions.

Now that you have a picture of some of our audit activity to prevent fraud, I will describe what we do to observe and report it.

DCAA auditors are well trained accountants and knowledgeable about contracts and attestation techniques. They are not trained investigators. However, since the audits put them in circumstances where



fraud indicators are likely to be observed, we worked with the investigative organizations to develop a special training seminar for our personnel on fraud recognition. That seminar is now a regular part of our internal training curricula. We encourage our auditors to be alert to observe fraud indicators and, where there is a reasonable basis for suspicion of fraud, to report the observation to law enforcement officials. We view this as a civic responsibility as citizens as much as a contract audit responsibility.

To refer observations for investigation, DCAA has a procedure which is easy for auditors to do and assures that the information provided to the investigator is sufficient to decide whether it deserves investigation. While DCAA has always had a referral procedure, we streamlined it in 1985 after consultation with the investigative organizations. The revised procedure, which is illustrated on the attached diagram, has proven very successful. The year before the revision 154 referrals were sent to investigators by DCAA. This past year, 287 referrals for investigation were made. The referrals have substance. Here are some examples:

-- A contractor charged the government for personal expenses such as his children's college costs.

-- A contractor claimed \$141 thousand in a contract termination for an inventory which doesn't exist.

-- Memos written by a contractor employee previously convicted for actions at another division show intentional overstating of labor costs by \$1 million.

There is usually some continuing involvement of DCAA after the referral goes to an investigator. To the extent that the investigator needs contract audit support, such as examination of travel cost records to determine the amount allocable to irregular activity, DCAA is responsive in the same manner as to requests from contracting offices. There are occasions when the prosecuting United States Attorney requires contract audit assistance in analyzing evidence accumulated by the investigators or in providing expert testimony in court. We are responsive to such requests and have trained some regional office personnel to be specialists in providing this service.

The DCAA effort in supporting criminal investigations and prosecutions has been very effective. Here are some examples:

1. Litton-Clifton Precision Division.

A series of reviews led to a plea of guilty to a 325 count criminal indictment and payment of \$15.1 million in restitution. The auditors discovered that the contractor had systematically inflated and duplicated material costs on 45 military spares contracts over a five year period.

2. Talley Industries, Inc.

A review of the contractor's labor charging practices resulted in the criminal convictions of three contractor executives and government recovery of \$2.5 million. The auditors found that the contractor had repeatedly made false claims and representations related to the mischarging of labor from fixed-price contracts to flexibly-priced contracts and R&D expense. The matter was referred for further investigation that culminated in criminal convictions on 37 counts of defrauding the government.

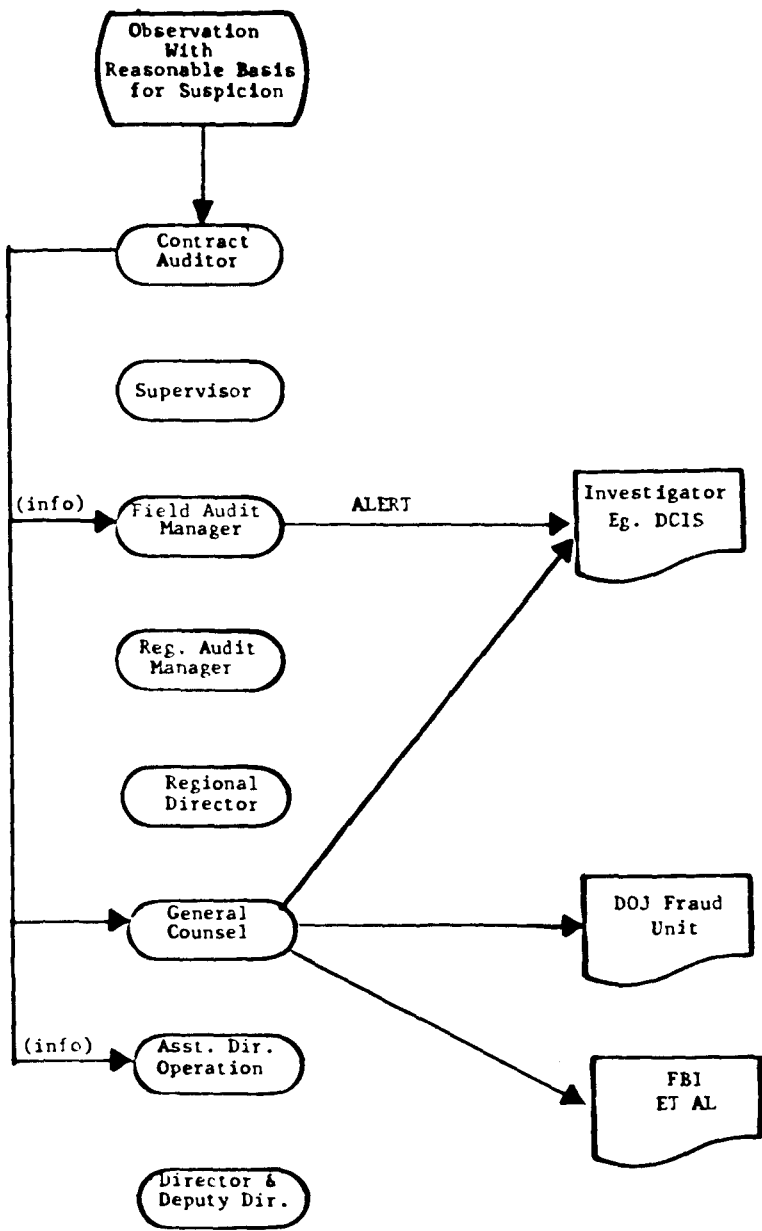
3. Harris Corporation.

A postaward review of several contracts valued at \$167 million resulted in the contractor's agreement to restitution, fines, penalties, and negotiated contract reductions to the government in the amount of approximately \$9.3 million. The contractor failed to disclose that it had received a proposal from its sister division to build the required units at a price approximately two-thirds less than that which it had certified to the government. The review identified suspected irregular conduct for which a joint investigation was conducted by the Federal Bureau of Investigation and the Defense Criminal Investigative Service. The contractor

pleaded guilty to four felony counts of defrauding the U.S. Government and agreed to administrative settlements on associated contracts.

DCAA is proud of its achievements in fostering systems of internal control to prevent fraud and in supporting investigation and prosecution actions. We are just as pleased to see significant actions being taken within the industry toward eliminating opportunities for fraudulent conduct. The strong penalties you are proposing will also act as a deterrent. While we may never see a government contract environment devoid of crime, the collective actions should certainly move us in that direction.

DCAA FRAUD REFERRAL SYSTEM



Mr. HUGHES. Ms. Rasor, we likewise have your statement. Without objection, it is part of the record. We hope you can summarize.

### TESTIMONY OF DINA RASOR, PROJECT ON MILITARY PROCUREMENT

Ms. RASOR. Thank you very much for having me here. I would like to introduce my assistant, John Riley.

I would first like to explain a bit about my organization so that you have an idea of where we are coming from, because we are not a Government agency. A lot of people over the years have thought we were part of the Government.

The idea of the Project on Military Procurement, which is a small, nonprofit organization, is to be a place where people who are inside the system come as sort of like a last resort. They have maybe been through the hotlines, been through the various Inspector Generals of the Services, and maybe even Department of Defense Inspector General, or they have gone there out in the field, they have gone through the usual different things that are set up, and they feel that either they are unwilling to go any further, because they aren't getting satisfaction, or also there is a very deep fear that a lot of times that—I think partially this is done because of just the nature of bureaucracy—their complaints and their evidence is given to a high level person in whatever—whether it be Defense Contract Audit Agency, whether it be IG's Office, or whatever, it is then proceeded to be bumped down, usually to their boss, to investigate.

So lots of times the people in the bureaucracy that come to me feel sometimes that these investigations are more sting operations rather than to find out who is bringing the bad news rather than trying to solve it. I think this is just the nature of a bureaucracy—bump it down to the person you think is responsible. That person usually should figure out from the information, even though this is supposedly anonymous, who the person was providing the information.

Our job is to investigate their claims. We investigate them much as investigative journalists do. We turn a lot of people away, because of lack of documentation, and we, if necessary, we assure the anonymity of the people.

The idea is that whistle blowing is a dead art, it doesn't work, people coming forward and getting their picture in the Washington Post, that is the end of their career. The idea of the project which we set up seven years ago—I was asked to set it up by a group of whistle blowers saying we don't want to come forward any more. We want to leak unclassified information through you and others, get it out to the Congress, get it out to the Project, so something could be done while we continue to retain our jobs, so we can stay in the bureaucracy to see if the changes are really happening.

That is what the project has been doing for the last seven years. We have surfaced a lot of what the Administration has called horror stories—I somehow have to agree. And there has been a big effort to show that something is being done about that, and there has been a Packard Commission and there has been all kinds of bills passed, whatever.

There are Members of Congress, for example, like Senator Grassley, who have done some serious work, coming to us, saying what do the people in the inside coming to you say they need, and the False Claims Act was a tremendous victory in that area. There should be some loopholes that could be closed, but as a result, I am afraid that this Administration—I am not saying this especially of Mr. Vander Schaaf, whom I have worked with in the past—but higher up there is an attitude that if there is an appearance problem, public appearance of fraud, isn't really fraud, it is an appearance of fraud, because of the terrible things reporters keep writing about, and so as a result, they have done their efforts as a PR effort.

In other words, we have to change the policies, because the polls show that the public perceives there is a problem we have to change the appearance and there has been more efforts going on now and less efforts going on saying Hey, there is fraud here. I think Congress is trying to tackle that. I am not so sure that the Administration is dedicated to it. I think I was quite astonished to look at a U.S. News and World Report poll from September of this year, where 86 percent of the respondents answered what the next President should devote more resources to is fighting waste and fraud and abuse in Government. Responses higher than anything else, including immunization for children, food programs, anything like that. And I think the public has just basically, because of the stories in the press, are fed up. So that I am very pleased that your subcommittee is working towards, and you are introducing a bill working towards trying to change some of the problems.

We have documented in our statement quite a few examples of where we thought what I call some of the big boys got away. It is pretty easy to go after very small defense companies, because they don't have a lobby, they don't have a cadre of lawyers, don't have a cadre of accountants. So as a result, a lot of these convictions are for small defense companies. They will throw the book at them.

I have had some small defense companies come to me in total shock how much fines they have had to pay compared to the large defense companies, and I think that we have the Department of Justice and Department of Defense investigators are in a terrible jam. Going after the large defense companies not only is a very difficult thing, because of the quality of lawyers and accountants that they can hire, but because of the political ramifications.

It is a real—you are asking prosecutors and investigators in the Department of Defense to really take a brave stand and to go after someone like General Dynamics or General Electric, and I think that there an attitude in what we call the underground people who are in the Department of Defense and out in the field, that you really can't win against the big companies. I really would like that to change.

I also would say that even though there have been recoveries—for example, there has been numbers thrown around here all morning about how much has been saved. The most recent I could find was that they had crimes—from 1985 to 1987 criminal fines of approximately \$11 million and the latest civil recoveries of \$56 million.

Now, to the average taxpayer, that sounds like a lot of money, but when you think of the hundreds of billions of dollars that have been spent in the last six years, it is a really small percentage.

So, I would also like to say that I very much support Senator Grassley's bill. It is trying to set up regional fraud centers and put more resources to it. And I also think the most important thing on your bill is, besides giving the prosecutors the better tools to go after fraud is, the \$250,000 award, because basically if you are asking somebody to come forward in the defense industry and/or in the Government and testify or work with investigators, that is the end of their career in the field. Two hundred and fifty thousand is a small amount of money to compensate somebody for basically ending their career.

I spend a lot of time with whistle blowers who have labored for years and I would like to think I get to work with some of the best people in the Department of Defense, and these are people that have been willing to risk their careers all the way through to do the right thing.

I think the way the system is set up we are asking the people who are in the inside, who are doing contracts and following contracts, to either think about their career or think about doing the right thing, and this \$250,000 reward makes a big difference.

I am also concerned about the lack of going after individuals, because I also think that whenever I see a large judgment against a company, especially a company that is practically a wholly owned subsidiary of the United States Government, like General Dynamics, I think that is going to come out of somebody's overhead somewhere. The bottom line is we are going to be paying our own fine, because when you pick up the overhead of almost all of the company, because the United States Government picks up the overhead of the company, they will find a way to do it.

However, if you go after the individuals, the high corporate individuals, criminally, I think there is a big, big difference in their attitude.

Finally, I would like to say I think it is very hard for some of the investigators in the Department of Defense and Department of Justice to go after certain large cases. It is the way the contracts are written, with so many loopholes on purpose, because they are sort of very close, chummy relationships between the contracting office and the large company, and that is partially due to because the contracting officer knows he better get along with the large company or he may have all kinds of political pressure put on him.

For example, such as the DIVAD case with General Dynamics. It came down to one word, supposedly, that kept them from prosecuting. If the Department of Justice and Department of Defense Inspector General find that contracts are written that loosely and it keeps you from going after and recovering money, then the remedy to that is to go after the individuals who are involved in the contract administratively and warranted criminally.

So I would like to conclude by saying the people on the inside will not think that this new bill, with tougher sanctions, will really be anything more than another public relations try, unless the Judiciary Committee does really a tough followup with the Department of Justice, work with the Department of Justice and help



them, but make them feel accountable. I just feel a lot of legislation will not be effective, the bureaucracy finds a way—the bureaucracy is like you put a pavement over grass. Sooner or later that grass will find a way to work its way around that pavement, taking weak points, loopholes and whatever. And it is only oversight, constantly going up, and every time you see one poking up, pulling that weed out of the pavement, that it is only oversight that keeps bills like this, makes bills like this work, and makes the people inside who are trying to do the right thing feel like well, maybe, maybe I can come forward and we can win. Maybe we can do something.

And so I hope that the committee efforts beyond this bill—which you have already indicated you want to go beyond this bill—is the kind of thing where, like Senator Grassley, you lead the charge in saying to the Department of Justice we want to know why these large defense contractors got away with this.

Mr. HUGHES. I can assure you that that is the intent of this member. I recognize H.R. 3500 is only a small step in the direction that we want to go and that we have major problems, resource problems as well as institutional problems. We have identified some problems that affect people that can provide information that is. Some of the problems whistle blowers have experienced has been a tremendous deterrent for people to come forward when they have to make that decision as between their career and their conscience.

Ms. RASOR. I just would like to end up by saying one of the things I could be the most happy about is if this committee and other committees and the Inspector General's Office, and the DOD, would really beef up their investigations and gain the confidence of my sources so I could go out of business. Nothing could make me happier.

Mr. HUGHES. Thank you.

Mr. Vander Schaaf, has your office responded to the report that Senator Grassley provided this subcommittee this morning?

Mr. VANDER SCHAAF. I don't know what the report is. Is this the one dealing with the actions of the General Accounting Office?

Mr. HUGHES. Newport News.

Mr. VANDER SCHAAF. Yes sir, we have responded to it.

Mr. HUGHES. Can you provide that for the record?

Mr. VANDER SCHAAF. Yes, sir.

Mr. HUGHES. Without objection.

[Material not submitted:]

Mr. HUGHES. I have an article from the Washington Post dated June 30, 1987, which stated that the Navy was planning to promote two officers who the Department of Defense IG office found broke almost every rule in the book to get a patrol boat built. The incident involved RMI, Inc., of National City, California. Is there follow-up on that?

Mr. VANDER SCHAAF. Yes, sir. There has been considerable follow-up now by the new Secretary of the Navy and his Inspector General to determine culpability in that matter. I have to check the record on that.

I believe one of the individuals was promoted before we had finished the investigation. The other I believe was never made and

the individual has resigned from the Navy. But I have to check that.

Mr. HUGHES. Will you supply that also for the record?

Mr. VANDER SCHAAF. Yes, sir.

[The information follows:]

There were two officers involved, an admiral and a commander. The admiral was promoted before we finished our investigation. I have been advised that the Navy aggressively reviewed the circumstances surrounding the commander's actions as they related to his possible promotion to captain. Based on that review, his promotion was denied.

Further, I understand that the Navy is reviewing in depth the performance and behavior of the former Special Warfare Medium Craft Project Manager, a civilian, to determine whether any adverse administrative action against him is in order.

Mr. HUGHES. Mr. Newton, would you further explain your suit with Newport News Shipbuilding regarding access to internal audits?

Mr. NEWTON. We have had access to the records of the internal audits performed by that contractor. Our objective in asking for those is to see how well the internal audit function is accomplishing the internal control activities that we believe an internal audit there should be doing. We are concerned about what testing they are doing to assure that there is no fraudulent activity or other activity that would be leading to inappropriate allocations of cost to our Government controls. We were denied that.

Mr. HUGHES. Doesn't Newport News do practically nothing but Government contracts?

Mr. NEWTON. Yes, sir, that is correct. We pay a considerable sum for the internal audit function as an allocation of cost to our contracts. We asked for access. We were denied that. We issued a subpoena for those records.

The contractor appealed that into the district court. The district court has ruled in favor of the contractor, basically on an argument that all we have is the right to see whether they have paid the costs for the internal audit function, not that we have a right to see the results of those functions themselves, the actual activities of the internal auditors. That has been appealed by the Department of Justice and we are awaiting a more appropriate ruling on that subject.

Mr. HUGHES. I am hopeful that we are successful on appeal. I find it absolutely unacceptable that they could deny access to that information. Looking ahead, why don't we require that as part of the contract? Why don't we require that in fact we have access to that information as part of the contract?

Mr. NEWTON. We believe that the provisions that we have for access do give us the right to that, and that is what we pursue. If we are not successful in the appeal, we would ask to have a specific statement to that effect in the regulation, to turn it around.

At this time, we think that the access rights clauses do give it to us, and we have asserted that at the majority of contractors around the country, we do in fact have such access.

Mr. HUGHES. Ms. Rasor, from your perspective, apparently you have dealings with all the agencies we talked about today?

Ms. RASOR. Yes, sir.

Mr. HUGHES. I wonder if you could give us your perspective on your own sense. I realize it is going to be subjective, but give us your observation about how actively the following agencies are pursuing Government fraud for instance, DOJ and the DOD IG's office?

Ms. RASOR. Those two? OK, you put me in a difficult situation to talk about Mr. Vander Schaaf. Let's start with Department of Justice.

I have people coming to me who have been in the investigative, parts of the investigative arms of the DOD. I can't get more specific than that because of the protected sources and this is a sure-fire way to kill a case, is send it over to the Department of Justice.

Almost all my sources that I have dealt with have absolutely no confidence in the Department of Justice. In other words, yes, it is true I get people that collectively feel totally thrown out of the system, but—

Mr. HUGHES. Ms. Rasor, I would like to advise you that we have a time problem. We are both due at a House-Senate conference on the Department of State authorization, and I want to ask several other questions and Mr. Mazzoli has some questions.

Ms. RASOR. Sure. So basically in the Department of Justice there is just a feeling that you are not going to get on the administrative side aggressive action against high-level defense contractors who have an enormous amount of political clout in the Government.

The Office of Inspector General, I have to sort of say in a 50-50 way—I have gone to Mr. Vander Schaaf several times with cases and he has done a very good job. We have sort of an agreement that if something is in his area, I will go and tell him about it before he reads about it in the Post. But the Inspector General's Office also, I think, is under tremendous political pressure, and I think, I have to say that I think Caspar Weinberger put undue pressure on the Inspector General's Office not to pursue things, large cases more vigorously. I am sure he might disagree. I am hoping that a new Secretary of Defense, maybe a new administration, will have a different attitude. I do have to say that the Inspector General's Office has done much better.

Mr. HUGHES. How about Army?

Ms. RASOR. Army Inspector General's Office? I find most of the services' Inspector General's Offices are not very good at all. They are the ones most specifically that will buck it back down to the guy's boss, and they are also I don't think very cooperative with the DOD IG when I have seen it.

I had a specific case where the Department, DOD IG and the whistle-blower were trying to expose a problem and the Army contracting agency and the Army IG were trying to hide the problem. That is something Mr. Vander Schaaf and I worked on and got through.

Mr. HUGHES. So would you include all the services, Army, Navy, Air Force and Marines, in the same category?

Ms. RASOR. Not the Marines so much. They are not involved so much in procurement. Yes, I would say one of my frustrations of people coming to me with the hot lines is when something is called in the hot line, oftentimes the DOD IG hot line it is the bucked down to the Navy IG and Navy, they say sometimes they will wait

up to a year before they will look into the Navy IG. The Navy IG bucks it down to NAVSEA and their friends, and it gets covered up. So the problem is I think the Inspector Generals of the services are not independent enough.

Mr. HUGHES. DCAA, how actively do they pursue these cases?

Ms. RASOR. I was very much involved in the George Spanton case very many years ago where there was—who was head of the regional auditor's DCAA down in Florida, against Pratt & Whitney. I think the DCAA should have the power to withhold the money if they can't get the information, because there is a guarantee, no guaranteed faster way. GAO, when they had the auditing function back in the early 1960s, actually did withhold the money, and its example, if you can't get the internal audits, you hold up the payment. You hold up the payment, you will get the internal audit. I have had many, many people, including some assistant secretaries of Defense, talking to me, saying, "That is our biggest problem; we cannot hold up the money."

Mr. HUGHES. Your response is DCAA has been fairly positive?

Ms. RASOR. No, I would say that they just do not have the mandate. They have been told that they are advisers and I think they ought to have the right, just like any company, when you say "I don't have all the travel vouchers here for my trip," they say, "Fine, I don't have the money." If you have dealt with the auditing arm, something like that, they need the right to withhold the money. That is what talks.

Mr. HUGHES. I have asked the question. I have to give Mr. Vander Schaaf and Mr. Newton an opportunity to respond.

Mr. NEWTON. We do, in fact, withhold the money. We have prerogatives under the billing practice to do so. In the Newport News case, the subject of appeal has included the money that we were withholding.

Mr. HUGHES. That is generally pretty effective.

Mr. NEWTON. Normally it is. For the majority of the contractors, that has been the point, telling point that has brought forward their internal audit records.

Mr. HUGHES. Mr. Vander Schaaf?

Mr. VANDER SCHAAF. I guess I am happy to get a 50-50 rating from Ms. Rasor, but I would like to get a 90 plus rating, a passing grade from everyone—the Congress, the American public, her organization—and everyone else. We strive hard to do that.

With respect to her comments regarding Secretary Weinberger's support of the Inspector General, I think she is wrong. I think the Secretary has supported us wholeheartedly. There are other elements in the Department that have not supported us.

I ask you to look at his allocation of resources to the office attended the Secretary's morning staff meeting for the past two years, since we haven't had an Inspector General. He in no way inhibited me from making comments with respect to what we felt were appropriate actions and actions that his staff needed to take sometimes to the embarrassment of the people present. So I just have to respectfully disagree on that point.

Mr. MAZZOLI. Thank you very much.

Maybe I don't know enough about the background, and I am asking questions which I should have asked earlier. The Inspector

General, is that a person who comes up through the ranks of a particular agency or department? Did you, for example, come up through the Department of Defense?

Mr. VANDER SCHAAF. Yes, sir, I spent my full Government career in some ways either in or very directly related to the Department of Defense. I will have 24 years of service.

Mr. MAZZOLI. I absolutely thank you for good service. Do you find that is a problem to you more than a benefit? Would you be an Inspector General in the Department of Agriculture?

Mr. VANDER SCHAAF. Absolutely not. I think it is very much essential that the individuals who hold these jobs have two things. They have to have some experience in the finance, procurement, auditing, or investigating world and they have to know their agency. Hopefully you can find a combination of both and get the right people in the right places.

Mr. MAZZOLI. It occurs to me there might be a decent argument made for the fact that once you have worked your way up through the ranks, say the Department of Defense, for example, and you have reached the point where you could be considered for that kind of a job, maybe the best thing is to move you over to Agriculture. I was talking to a reporter earlier today, saying that I was one who entered politics without having taken a political science course. Sometimes I don't think it hurt me. I think it might have helped because I didn't have any preconceptions, any problems.

Mr. VANDER SCHAAF. I don't disagree with that comment, but I think the crucial factor is the individual personality and the kind of person he or she is. There have been movements of the Inspector General historically from one agency to another. When the Reagan Administration came in, all the Inspectors General were fired. This created an uproar. About half were hired back and assigned to other agencies.

Mr. MAZZOLI. Are you a cadre? Does your paycheck come from Defense?

Mr. VANDER SCHAAF. It comes through the appropriations process, yes.

Mr. MAZZOLI. Has there been any thought given by you people, because you are at the highest ranks of civilians, that maybe there should be some kind of a Corps of Inspector Generals created and therefore you would be interchangeable parts? With respect to you, it does seem to me if you are a good auditor, you can be auditing apples and oranges, you can be auditing M-1 guns or tanks, or something like that. I think the auditing skills, the ability to understand numbers and array them correctly, to portray a story, seems to me interchangeable, and I wonder has there even been any thought given to a corps or cadre?

Mr. VANDER SCHAAF. There is in many respects a corps, a cadre of people who serve in that capacity. I don't know the name, but the President's Council on Integrity and Efficiency has a review committee that looks at potential applicants for Inspector General positions in the Government, and that is one of the reasons why it takes so long to get an Inspector General nominated, confirmed and approved.

Mr. MAZZOLI. Let me ask you something, because you mentioned you thought it would help because you know the arrangements and

the apparatus of the Department of Defense. Would it not mean that you also know the human beings involved, and like any human being, you might be unwittingly and unintentionally a bit more persuaded by one person than another, a little bit more sympathetic to one another because you are their friend—you grew up with them, you went to the same schools, you might come from the same development?

Mr. VANDER SCHAAF. I guess in my personal case, I have a bridge. I have ten years with the House Committee on Appropriations who review the Department of Defense budget in a very detailed manner. You can check with previous Members of Congress and look at my reputation along those lines.

But you make a point which I think has some truth to it. However, the turnover of personnel at the highest level within the Department of Defense at the admiral/general, the SES level 2, 3, 4, assistant secretary, political official level, is extremely high. I have not known any of the current incumbents significant length of time, if you will, other than the period of time I have been with the Inspector General.

Mr. MAZZOLI. Well, it is interesting. I appreciate that very much. I don't know whether this bill is the proper area, but it has always concerned me, because we are having the same problem on the Hill. You have been reading the newspapers about the various ethics committees, whether or not they can really investigate their own members, because you come into the same political class with someone, you come into Congress together, you serve on the same committees, you participated in one another's political activities, and all of a sudden you are sitting in judgment about what sort of behavior they have put forth. It is a very ticklish thing. I sometimes think that in those cases maybe if there were some outsider, some third party, it might be a little quicker call.

Mr. VANDER SCHAAF. There is somebody in the room who can attest to my ability to grill generals and admirals. The reporter at this hearing has heard me sit on that side of the table and grill admirals and generals.

Mr. MAZZOLI. One question. May I ask Mr. Newton just to address briefly, because we don't have time, but briefly talk to me a little bit about what I was speaking to Mr. Vander Schaaf about, and that is this whole question of the potential seduction of being in a position where you have to make a call on your own people as against some outsider making that call?

Mr. NEWTON. It is something that we have to be very concerned about, because compliance with one of the auditing standards imposed upon us, requires independence. We have one feature to assure compliance: a rotational policy for our auditors. We do not permit an auditor to be responsible for a contractor, making management decisions on the audit of that contractor, for longer than five years. We require that rotation and that rotation policy goes all the way up into the Senior Executive Service.

Mr. MAZZOLI. My last question, Mr. Chairman, would be to the gentlelady.

You used the term a moment ago "horror stories" you have the source of a lot of horror stories we read. You used that term. I have used it myself. How much of those horror stories and how much of

those are actually real stories—I use the \$600 toilet seats as a case in point. Everyone waved that bloody handkerchief around for months and months and then I read an article—I don't know how reliable—that says that was really very misleading, because it was only if you took every cost that is possible in the Department of Defense and allocated some fragment of this cost to the toilet seat, could you ever reach \$600. No one paid the toilet seat manufacturer for \$600 seats.

So how much of what you are putting out there is horror, misleading, misrepresentation and how much is accurate?

Ms. RASOR. Well, first, that is a very complicated subject. What I would like to is provide you with an actual cost breakdown of the—

Mr. MAZZOLI. Am I not correct?

Ms. RASOR. No, I disagree with that.

Mr. MAZZOLI. Did we actually send a check for \$600 to the guy that made that toilet seat?

Ms. RASOR. I wasn't involved in the direct toilet seat. I can tell you about the hammer, for \$435. Yes, they did a few breakdowns of the costs.

Mr. MAZZOLI. Did somebody send a check for \$435?

Ms. RASOR. Yes sir. It was part of the package.

Mr. MAZZOLI. I understand that didn't happen.

Ms. RASOR. It did happen. Very much. If it didn't, then Casper Weinberger got ten cents back on the dollars we didn't pay.

Mr. MAZZOLI. Can anybody amplify?

Ms. RASOR. Let me answer the question. It was not just for a hammer.

Mr. VANDER SCHAAF. That included the packing and crating, but the end product that the department received was a hammer.

Ms. RASOR. The hammer was bought by a subcontractor for \$7.

Mr. VANDER SCHAAF. The department had a problem. We have got to be vigilant to the problem.

Mr. MAZZOLI. When you write a check for \$4 million to the XMY manufacturing company, which includes an array of things, including a hammer which you do some accounting gyrations will cost out at \$435, that is when we go and have these after the fact inspections. Maybe, if we change the way people get paid for their procurement, we might know in advance of this thing, cause people at the Department of Defense say hey, there is something crazy.

Ms. RASOR. I think probably the biggest horror story came out when we bought spare parts from the prime contractor. We asked Gould Electronics to give us a hammer. That just doesn't make any sense. It would be the same as asking Mercedes Benz to make a go cart. So the idea was this is something that Congresswoman Boxer worked very hard on, were statutes to break out those spare parts. They were saying that since we drew this screw we have proprietary rights, you can only buy this screw from us. So the idea is to break it out.

Mr. MAZZOLI. I think that makes sense. It is like asking Manufacturers Hanover to make a hammer. They could make it. The question, therefore, is even with the gentleman's bill, which is a very good bill—I am a co-sponsor of it—something like this doesn't need legislation.

Mr. VANDER SCHAAF. That problem doesn't need legislation.

Mr. MAZZOLI. Can't a lot of the problems be dealt with if there were smarter controls put in—more alert accounting procedures, even check drafting procedures?

Mr. VANDER SCHAAF. We have had all kinds of legislation that deal with it. The Competition in Contracting Act of 1984, the Procurement Enhancement Act of 1985—it goes on and on—various amendments to other existing laws. That is not necessarily the answer in this spare parts problem. I don't think it ever has been. I think it is well trained buyers, good pre-award reviews, and, as Ms. Rasor said, not buying hammers from multi-billion dollar electronics companies, you buy hammers from the XYZ hardware company that makes hammers.

Mr. MAZZOLI. Well, the Chairman has been very diligent with me on time. I will yield at this point. Maybe there are some ways you all can help us—Ms. Rasor, your agency. Maybe there are some things that can be done very, very simply instead of writing one check for a ten million dollar glob of stuff, write 50 checks, because in writing the 50 checks, you are going to find out some crazy things that are going on. Just in that alone, you may find some way to solve in advance some of these things which then wind up being horror stories that we all are chagrined about and unable to explain.

It will take a bill like ours along with it, but it may take other things.

Ms. RASOR. I would be happy—I have surveyed a lot of sources over the years. We have come up with suggestions of all kinds that I would be happy to provide to you.

[The information follows:]



SPARE PARTS

"Administrative reforms instituted by the Pentagon are not working because military and civilian employees who actually do attempt to identify and report overpricing problems are thwarted by their own system." Congresswoman Barbara Boxer, Hearing before the Subcommittee on Administrative Practices and Procedures of the Committee on the Judiciary, Sept. 19, 1984, p.22.

"I don't think the procurement community was happy with the way we were doing business. The community has jumped at this (reform program)..." RADM Edward Walker, Jr., commander of the Naval Supply Systems Command, Baltimore Sun, December 9, 1984, p.21.

"I believe it is fair to say that the acquisition community is in a state of turbulence and trauma." Gen. Lawrence Skantze, head of the Air Force Systems Command, Defense Week, November 4, 1985.

"Horror stories will be gone ... in about a year." Brig. Gen. Donald J. Stukel, director of the Air Force Contract Management Division at Kirtland AFB, N.M., Navy Times, January 7, 1985, p.22.

"Politicians who seize and create opportunity to embarrass and attack our nation's defense contractors and the Pentagon simply to achieve media attention for themselves ... (and) Public advocates and government employees who make careers of finding and publicizing alleged wrongdoing, whether real or imagined...all contribute to a climate that demoralizes the millions of men and women in and out of uniform....I submit that these activities are substantial breaches of the ethical and professional codes of those professions, and violate the trust and security of the American people." Robert Ormsby, Pres. of Lockheed Aeronautical Systems Group, Defense News, May 5, 1986.

"When you see a beautiful jet flying overhead, you're seeing a collection of overpriced parts flying in close formation." A. Ernest Fitzgerald, Management Systems Deputy for the Air Force, People Magazine, Dec 9, 1985

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Nothing has better served to focus public attention on the issue of waste and high priced weapons in defense procurement than the "horror" stories of \$9,609 hexagonal wrenches, \$1100 plastic stool caps and \$436 hammers. Despite promises of reform by the Department of Defense and attempts by Congress to

legislate increased competition in spare parts procurement, other examples of waste in spare parts have recently come to light. According to press accounts, the Pentagon has known for years about the practice of routinely discarding billions of dollars worth of useable and needed spare parts each year to clear inventory stocks. In some cases the military has been buying back, at inflated prices, the very components it previously sold for scrap. Meanwhile, our depleted spare parts inventories continue to jeopardize the readiness of our Armed Forces. In short, the lack of concern and oversight has resulted in a generous flow of money from the taxpayers to defense contractors without a commensurate improvement in our military capability.

The Pentagon's annual budget has increased dramatically under the Reagan Administration. That increase is reflected in the status of the spare parts budget, which is up just as dramatically. For Fiscal Year (FY) 1984, for example, the Air Force received a 50% increase in their spare parts allotment, from \$6 billion in FY 83 to \$8.7 billion. The allotment continued to climb to \$9.3 billion in FY 85, and dropped slightly to \$9 billion in FY 86. Unless there are significant reforms in the way DoD purchases spare parts, however, a destructive pattern will continue: we will spend more to get less.

#### KEY PROBLEM: NOT ENOUGH COMPETITION

The lack of competition in spare parts purchasing is at the heart of the problem.

Over the years, major or prime defense contractors have successfully, and legally, excluded an increasing number of small businesses from competing for government contracts to produce parts more cheaply. They use a system of coding to maintain control of who can actually produce a part. If the prime does not produce a needed part in-house, it may order that part from a subcontractor and then charge the government for "middleman" services. Most prime contractors have been successful at blocking these subcontractors from dealing directly with the government by designating parts as being either "proprietary" or coding them as requiring such critical manufacturing techniques or material that the prime must maintain control over production. In some cases, the prime must maintain control over production to provide necessary quality control. However, often the prime's only effort, as with simple items, is adding a hefty mark-up to the sub's original prices.

The primes also reduce competition by exercising considerable control over what is known as the "qualified bidder list". This is a list of those contractors who are considered eligible by the Department of Defense to compete to produce certain items. Representatives of small businesses have complained that the primes can exercise their influence by having potentially competitive subcontractors removed from those lists.

## CODING

The prime contractors (primes) use federal money to develop a weapons system and the parts that comprise that weapon system, and then they often affix a "proprietary" or other restrictive coding designation to the technical drawings and specifications that are used to manufacture replacement parts. This coding is supposed to be a guide or recommendation to the government. But the designations are usually accepted by government contracting officers. This means that for an unlimited period of time, the primes control who manufactures that part, including such simple, ordinary items as nuts, bolts, and washers. Because it is in the primes' interest to maintain control of spare parts manufacturing, the government should exercise aggressive oversight in reviewing primes' coding to see that they are justified. By not doing so and relying instead on "sole-source" purchases of spares from the prime, the government has allowed itself to be charged unnecessarily inflated prices.

Because the government has traditionally preferred to accept contractors' coding designations on data, the primes cannot be legally faulted. However, extensive testimony before a half dozen Congressional committees by witnesses from small business, the military services and the General Accounting Office revealed that this procedure is being abused by the primes. For instance, 80% of the spares for Pratt & Whitney (P & W) engines are controlled by P & W including those notorious nuts, bolts and washers highlighted in recent spare parts "horror stories".

## TECHNICAL DATA

The revelations of overpriced spare parts have demonstrated the need for the government to assert its claim to technical data that the taxpayer has paid for when the government has underwritten the research and engineering costs of a major weapon system. The data then must be provided to businesses that would bid for a government contract to produce an item.

A DoD regulation, in effect since the early 1960's, specifies that the government should receive 100% unlimited rights to any technical data developed with any government money whatsoever. However, any regulation is only as good as those who would enforce it. Over the years, the Pentagon has lacked the aggressiveness and a sufficient number of technically knowledgeable personnel to challenge contractors' coding designations which restrict the flow of data. Even those government buyers or contracting officers who are willing and qualified to challenge the primes and assert the public's right to government-financed innovations are stymied when they push for open bidding because they lack the necessary data and technical drawings to pass on to other companies. Often when data is provided by the primes, it is outdated, or once turned over, it is somehow "lost" in the records.

## HOW REASONABLE IS REASONABLE?

After four years of spare parts "horror" stories and hearings (see APPENDIX A), the Department of Defense Inspector General issued in June 1984 the findings of a year-long study of spare parts overpricing conducted by his office and the military services. The IG concluded that more than half of the 2,300 spare parts it surveyed were "unreasonably" priced or had the potential to be unreasonably priced. Yet DoD would have us take comfort from the fact that only 6% of the total dollars surveyed, \$291 million, were "unreasonable" and 94% "reasonable." The Project on Military Procurement questions the criteria the Inspector General and the Department of Defense use to define "reasonable" prices.

When Air Force Management Systems Deputy A. Ernest Fitzgerald asked the Department of Defense to define a fair and reasonable price, they referred him to the Air Force Auditor General's Report which gives the following definition:

"A price that closely approximates the seller's cost to make or acquire the part plus a reasonable profit."

The danger in the DoD definition is that uncritically accepting the contractor's stated cost as a basis for evaluation often means accepting a price reflecting built-in inefficiency, waste, and high labor and overhead costs. On the other hand, the criteria the Inspector General used to determine a reasonable price was whether or not a spare part could be supplied at a cheaper cost by another manufacturer. This technique eliminates price comparisons on those more complex components and sub-assemblies that can only be procured by one source because of the notoriously low degree of true competition exercised in defense procurement generally.

The \$436 claw hammer makes an excellent example of the danger in relying on what the contractor claims are his "actual" costs to produce an item. In March 1984, Congressman Berkely Bedell (D-IA) gave the House Armed Services Committee an example of the pricing formula that was supposed to justify the expenditure of \$436 for that claw hammer. (See example 1, APPENDIX B). In a formal statement, the Navy conceded that the prime contractor, Gould Inc., had "government approved purchasing and estimating systems" based on reviews by DoD's audit agencies when it priced the hammer. They also said that the markup for the hammer was "exorbitant but legal." We wonder whether the pricing formulas for the spare parts that the IG and the Services concluded were "reasonable" may be just as excessive.

Even accepting on good faith the IG's definition of "reasonable," an "unreasonable" rate of 6% projected to the current \$22 billion spare parts budget for FY 86 means that at least \$1.3 billion will be wasted this year because of spare parts overcharging.

The IG claims that the overpricing is confined to "low value" items. The problem appears broader than that. There are serious doubts within the government about the true extent of the problem and whether it is in fact confined to cheaper, smaller items.

As the Office of Management and Budget said on June 1, 1984, the problem in spare parts pricing is "fundamental" and is "not a series of isolated aberrations." A. Ernest Fitzgerald has often made the point that all the parts DoD buys, not just the low value parts, are overpriced. This is because the same excessive pricing formulas with their unconscionable levels of mark-up are applied across the board by the major prime contractors who control spare parts procurement.

Deputy Secretary of Defense William H. Taft was quick to issue a statement after the 1984 release of the IG's report on spare parts, assuring the public that the reforms instituted by the Department of Defense are "on the right course." Since the summer of 1983, he said, the Department of Defense had collected more than \$1.4 million in refunds from offending contractors. To put that in perspective, \$1.4 million represents only 1/10 of 1% of what was wasted if the IG's 6% is applied to the \$22 billion spare parts budget for FY 84. Nor is the Project satisfied with the Air Force's own projections of savings through competition. According to a briefing prepared by Major General Dewey K.K. Lowe in August 1983, the Air Force expects to spend approximately \$11 billion in FY85 for spare parts, but save only \$225 million through competition. Projected savings represent only 2% of expenditures. The Department of Defense owes the taxpayer a better rate of return than that on its reform efforts.

In 1984, the prices of seven C-5A Cargo Plane spare parts chosen for investigation were found to be extraordinarily high. Some examples are a flight engineer seat which cost \$12,394, a landing light which was \$2,320, a wind-up eight day clock which cost \$591.37, and an emergency flashlight which was priced at \$170.98. Even a year after these outrageous prices made headlines in the press, all but one of the seven had either remained the same or had actually increased in price. (See Appendix A, p.12, Sept. 1984 and Sept. 1985.)

#### NEEDED REFORMS

The most fundamental reforms must be aimed at increasing competition in spare parts procurement. One important initiative is called "break-out." It consists of removing or "breaking out" spare parts from prime contracts for competitive bidding. Parts that were developed with public funds and simple parts that could be readily manufactured are most easily "broken out". Small Business Administration Representative Frank Miller, in charge of "breaking out" spare parts at Tinker Air Force Base, Oklahoma, told a Congressional Committee in April 1984 that he saved the government over \$121,000 by breaking out only six parts for competition. The examples he used were:

1.	<u>Bolt</u>		
	Price charged by Original Equipment		
	Manufacturer (OEM)	\$	328.00
	After competition		13.00
	Savings on total buy	\$	14,000.00
2.	<u>Bulkhead</u> (piece of aluminum)		
	High bid	\$	175.00
	Low bid		7.47
	Total savings		27,800.00
3.	<u>Angle Bracket</u>		
	Prime contractor	\$	60.00
	Low bidder		3.96
	Total savings	\$14,386.00	
4.	<u>Support</u>		
	Prime contractor	\$	16.46
	Low bidder		3.80
	Total savings	\$	2,025.00
5.	<u>Bracket</u>		
	Prime contractor	\$	153.32
	Low bidder		5.87
	Total savings	\$27,900.00	
6.	<u>Fitting Assembly</u>		
	Before competition	\$	1,500.00
	After competition		52.00
	Total savings	\$36,000.00	

Without competition the six buys would have cost \$127,707.00. After breakout the charge to the government was approximately \$6,000 for a total savings of approximately \$121,650.00

#### Spare Parts Representatives

Legislation to reform spare parts procurement has been passed, which contains provisions for establishing Small Business Administration procurement center representatives at every major government buying center who will challenge the restrictive coding affixed to data by prime contractors. Hopefully, this law will prevent a reoccurrence of the conditions that led to the recent scandal in spare parts purchasing. If properly implemented, the law could save millions of dollars per year.

Proprietary Rights

The government's rights to technical data must be spelled out in initial development and production contracts and this should also be codified in law. We support the 1962 DoD directives which state that the government owns all rights to data where even one penny of government money has funded the research and development of an item. This regulation was cited by the General Accounting Office in 1972 and according to the GAO is still valid.

Restrictive Codes

DoD regulations stipulate that contractors should justify any restrictive coding whereby the contractor claims that special quality control or tooling make it necessary for the prime to control the manufacture of the spare part. In April 1983, the Office of the Defense Department Inspector General (IG) issued a report on the management of technical data. He surveyed 234 items that had been restrictively coded and concluded that "there was not an adequate basis to support the restrictive (procurement methods) codes for 220 of the items with a forecasted annual buy value of \$327 million". The IG pointed out that the assignment of these codes is the government's responsibility, however, it is the contractor that "recommends" the codes and they are rarely challenged. The Project concurs with the IG's recommendation that contractor codes be reviewed by the government and justification for restrictive coding be provided by the contractor. Further, we feel financial penalties should be levied against contractors whose claims to data are not upheld by the government or other arbiters.

Incentive Bonuses

A system of rewards or incentives should also be established so that those responsible for increasing competition or "break out" receive financial bonuses or merit points for achieving a certain level of savings for the government.

ACTION IN THE RIGHT DIRECTION

The Project on Military Procurement applauds the efforts of the Inspector General and the Services in surveying spare parts purchases and assessing their "reasonableness." There is, however, a long way to go towards lowering these costs.

The analysis of overpriced spare parts by the Naval Audit Service contained in the Inspector General's audit was very revealing. The report is included in Section B, page 10 of the IG's report. It concluded that 26, or

about one-quarter of the 114 items they surveyed, "could have been purchased at lower prices." Twenty-two of those parts had been purchased from subcontractors "at substantially lower prices....There was no evidence of value added to these parts by prime contractors." Four of the 26 overpriced items were the result of "inordinate amounts of labor hours." The Naval Audit Service said the pricing methods used by one of the contractors had been approved, the other was in excess of the Naval Audit Service's engineering estimate. The major reason for the overcharges, said the Navy, was lack of competition.

Competition would have helped the Navy avoid the pass-through costs tacked on by the prime contractors to the first 22 of those over-priced spare parts. But the reason for the last four abuses, excess labor hours, was a lack of sound, industrial engineering estimates of pricing proposals at the time the weapon system was initially procured. Nor, apparently, were these abuses caught by government auditors who might have challenged the mark-ups for labor, overhead and profit which contributed to the inflated prices. But even a hard-headed auditor will have to find costly spare parts "reasonable" as long as the Pentagon accepts current pricing formulas.

#### WHERE TO FROM HERE?

Reform is needed in the current system of pricing weapon systems, and competition and tough auditing throughout the life of a weapons program are required. The adoption of true "should-cost" price analysis of weapon systems, in contrast to the current method of initially accepting contractor's excessive pricing formulas and building on them year after year, would also be an important improvement. (See SHOULD COST)

We note the Air Force spare parts budget for FY84 was 50% higher than the previous year, rising from \$6 billion to \$8.7 billion, while the DoD spare parts budget is up 40% from approximately \$15 billion to \$22 billion in FY 84. The spare parts budget has remained stable since then. Continuing efforts to reduce the costs of spare parts, individually and in aggregate, to measurably improve the situation by means other than simply throwing money at the shortage problem are required.

The Navy's competition advocate, RADM Stuart Platt, and the General Accounting Office said in 1983 that at least 30% could have been saved if there was competition in spare parts procurement. That means that approximately \$7 billion of the \$22 billion in the total spare parts budget could be saved if the DoD makes good on its promises. An ambitious, DoD-wide goal of savings through competition of at least that amount in spare parts procurement is highly desirable. If not, Congress could cut the Services' spare parts budgets the amount by which they fall short of their competition goals.



The Office of Management and Budget has underlined the importance of maintaining the current momentum for reform on the part of the Pentagon and the Services. As OMB Deputy Director Joseph R. Wright said in a June 1, 1984 statement, "10 percent of any job is giving an order—the other 90% is following up to make sure its carried out." The Project on Military Procurement urges aggressive oversight on the part of Congress and the government's watchdog agencies to save taxpayer's dollars by putting an end to the wasteful practices that contribute to unjustified prices for both spare parts and the "big ticket" items.

A ceiling should be set by Congress on the spare parts budget based on the material that is needed and the application of true "should-cost" estimating procedures for pricing that material. Realistic cost estimating, where the prices paid by the government are no greater than the prices companies charge each other in the private sector, should be aggressively applied and enforced. We feel the Department of Defense should set savings goals and report their savings to Congress and to the public through appropriate agencies. These savings should be reflected in future budget requests.

#### APPENDIX A—THE WAY IT WAS

The following is a chronology of some key events regarding the uncovering of DoD's spare parts "horror stories":

- October 1982            Project on Military Procurement releases the "Hancock Memo" to reporters. The memo is written by Robert Hancock, Chief of Commodities Division, Tinker Air Force Base, Oklahoma City. It reveals that the price of 34 Pratt & Whitney aircraft engine spare parts increased 300% in one year. The parts covered everything from turbine blades to nozzles, rotors, shafts, and exhausts. One part jumped 1600%, from \$1,759 to \$30,223.23.
- Fall 1982              Air Force Ad Hoc Pricing Review Team reviews the findings made by Hancock. They conclude that Pratt & Whitney has reaped "windfall profits" in the sale of its 34 spare parts. One reason for the price hike is that prices for spares were often "renegotiated" between time of order and time of delivery. The team finds that markup accounted for 67% of the increase. P & W's negotiated markup rate was 24% higher than it was fairly entitled to if it had been limited to reimbursement for actual costs plus negotiated profit. Combining excess markup with its negotiated profit, the team found that P & W had received 32% more compensation than its expected costs.

December 1982

Mr. Colin Parfitt, Assistant for Air Force financial systems in the office of Mr. A. Ernest Fitzgerald, investigates the cause of the 300% growth in Pratt & Whitney's 34 spare parts. He visits the P & W plant in East Hartford, Connecticut.

He finds that the Navy Basic Ordering Agreement (BOA) permits P & W to reprice parts between order and delivery and in some cases, after delivery of spare parts to the government. In analyzing P & W's pricing formula, he finds the same degree of inflated mark-up rate applying to the entire TF-30 engine as a whole as to each individual spare part. He recommends that BOAs be dropped and spare parts contracts be on a firm fixed price basis. He also recommends that prices be established through meaningful competition and what the products should-cost under conditions of efficient production.

March 1983

The official Air Force response to press inquiries about the P & W spare parts price escalations is that they were "proper because growth could be attributed to changes in the materials or techniques used to fabricate the part....The Air Force verified the contractor established 1981 prices on 33 of 34 items."

April 1983

House Government Operations Committee holds hearings on spare parts. GAO testifies about the lack of competition in spare parts procurement. It gives examples of savings achieved by "breaking out" spare parts for competition: A #15 "support" cost \$14,960 before competition, \$6,310 after. A #58 "seal" went from \$2,020 per unit to \$476.

House Armed Services Committee holds hearings on spare parts pricing. Congressman John Kasich (D-OH) submits list of 125 spare parts provided by an Air Force base in his district. This list includes: a screw for the guidance system of a Minuteman II missile which increased 3400% between FY83 and FY84, (\$1.08 to \$36.77). A connector electric plug for the FB-111 jumped from \$7.99 to \$726.86.

July 1983

In hearings before the House Armed Services Committee, Secretary of the Navy John Lehman discusses a Naval Audit Service audit that finds

the government paying \$110 for a 4-cent diode.

Project on Military Procurement releases a draft of the Inspector General's review of aircraft engine spare parts pricing which shows that over a three year period, more than 4,000 spare parts increased in price more than 500%. Reasons included the lack of concern on the part of buyers for the increases in prices and reliance on sole-source procurements.

August 1983

Defense Secretary Caspar Weinberger issues his 10-point proposal for reforming spare parts procurement. He vows to eliminate excessive pricing, recover unjustified payments and punish offending contractors and DoD employees who contribute to overpricing.

October 1983

The Air Force releases its own study of spare parts overpricing. The Air Force Management Analysis Group concludes that 1) the competition rate for spare parts purchasing is low for new systems, only 5% to 8%; 2) Air Force efforts to obtain the data necessary for competitive purchasing have not been effective; and, 3) the Air Force has taken "minimum action" to determine the validity of contractor's restrictive coding of spare parts.

Fall 1983

The regulations governing the coding of technical data (Military Standard 789) are re-written to reflect DoD's efforts to re-assert its responsibility for accurately coding data.

Fall 1983—  
Spring 1984

The following congressional committees hold hearings on spare parts procurement:

House Small Business Committee  
Senate Appropriations Subcommittee on Defense

Senate Armed Services  
 Senate Governmental Affairs  
 Senate Small Business Committee

- Summer 1984      Legislation is passed in House and Senate to reform spare parts procurement. It is aimed at increasing competition and asserting government's rights to technical data.
- June 1984      Department of Defense Inspector General issues findings of year-long study of spare parts overpricing. He finds that over one-half of the 2300 items surveyed are either unreasonably priced or have the potential to be unreasonably priced.
- June 1984      Ompal Chauhan, Chief of the Manufacturing Operations Assessment Branch, AFCMD testifies before Senator Grassley's Judiciary Subcommittee on Administrative Practices and Procedures. He tells Congress of how the Chief of the Manufacturing Operations Division wrote to Boeing that the government had no confidence in the accuracy of data generated by the Boeing Financial Management Cost System, and asked that Boeing suspend the use of such data for price support. Boeing however disregarded the directive and continued to charge the government for the information by changing the name of the system to Job Cost History. It is this data which is used for determining costs for future proposals, hence making the inaccuracies and high prices inherent to the system. As evidence of spare parts overcharging, he brought a pair of pliers sold by Boeing to the government for \$748.00. He was able to find the same pliers in a hardware store for \$7.61. Boeing had in fact paid \$80 for them, and had then charged the Air Force a 935% markup.
- September 1984      Thom Jonsson, an enlisted man in the Air Force, testifies before Senator Grassley's Judiciary Subcommittee on Administrative Practices and Procedures on the listed prices of \$670.06 for a C-5A armrest and \$7622 for a C-5A coffeemaker. Jonsson had tried to correct these outrageous prices through the system, but was repeatedly stymied in his attempts to save the taxpayers money. In frustration, Jonsson contacted the Project. We worked with members of Congress to

bring these problems to light. The Air Force contended that the problem was one of few bad parts slipping through the cracks and that they would be fixed.

- September 1985 Using information supplied by Jonsson at Senator Grassley's request, The Project and Reps. Kolbe and Boxer hold a press conference showing that the price of the armrest was now \$654.74 and \$455.14. This was a far cry from the \$25 it was estimated it would cost to build the armrests on base.
- January 1986 Rep. John Dingell (D-MI) releases a letter to Weinberger, expressing outrage at the price of a \$317.79 Lockheed toilet pan for the C-5A transport. Dingell also accuses the Pentagon of creating "systematically wasteful practices."

#### APPENDIX B--EXAMPLES OF "REASONABLE" PRICING FORMULAS

The following are breakdowns of the pricing formulas once considered reasonable by DoD purchasing agents:

##### 1. The \$436 Hammer

The following pricing formula for a Gould hammer was submitted to Congress by the Navy.

#### PRICING EXAMPLE - Gould, Simulation Systems Division

##### Purchased Item

Item - hammer, hand, sledge - Qty. - 1 each

Direct Material		\$ 7.00
Material Packaging		1.00
Material Handling Overhead @ 19.8%		2.00
* Spares/Repair Dept.	1. hr	
* Program Support/Admin.	.4 hr	
* Program Management	1. hr	
* Secretarial	.2 hr	
	<hr/>	
	2.6 hrs Engr. support	37.00
Engr. O/H @ 110%		41.00

* Mechanical Sub-assembly	.3 hr	
* Quality Control	.9 hr	
* Operations Program Mgt.	1.5 hr	
* Program Planning	4. hr	
* Mfg. Project Engr.	1. hr	
* Q.A.	.1 hr	
	<hr/>	
	7.8 hrs Mfg Support	93.00
Mfg O/H @ 110%		102.00
		<hr/>
		\$283.00
G & A @ 31.8%		90.00
		<hr/>
		\$373.00
Fee		56.00
Facilities Capital Cost of Money		7.00
		<hr/>
TOTAL PRICE		\$436.00

According to the Navy, Gould's purchasing and estimating system for the hammer had been approved by government auditing agencies including the DCAA which, said the Navy, "ensured that the contractor maximized competition and complied with cost accounting standards and generally accepted business practices".

## 2. The \$1,100 Plastic Stool Cap

The following is a breakdown of the cost of the cap, designed by the Boeing Company, for a navigator's stool on an AWACS plane. At the time the Air Force bought the cap, it cost \$900.

Overhead (executive salaries, lights, heat)	\$459.00
Labor	204.00
Eight hours of inspection	34.00
Fringe Benefits	127.00
State and Local Taxes	32.00
Profit	119.00
Plastic Material	.26

Source: NBC News

As reported in the Washington Post (8/21/83), one spokesman from the Defense Industrial Supply Center which ordered the cap defended Boeing in a statement: "Rates contained in the Boeing cost breakdown were consistent with approved rates [Emphasis added]."

3. The \$9,609 Hexagonal Wrench

The following pricing formula was provided to the Fort Worth Star Telegram which reported that the wrench was approved by several layers of Air Force bureaucracy before it was cancelled.

## The cost of the \$9,609 wrench

Research and engineering:	\$1,002	Program office support:	\$21
Status accounting:	128	Quality assurance support:	4
Engineering overhead:	531	Overtime premium	15
Procurement quality assurance	26	Direct fringe benefits	485
Manufacturing overhead:	27	Product liability	6
Subcontracting costs:	5,205	Administration:	509
Material overhead:	193	Interest:	21
Miscellaneous charges:	12		
Engineering travel:	80	COST OF PRODUCTION	\$8,322
Graphic services:	34	PROFIT	\$1,287
Logistic support:	23	TOTAL COST OF WRENCH	\$9,609

The wrench was originally forged in a Pennsylvania factory and sold for the first time for 8.4 cents. A Baltimore industrial supplier sold the wrench to Westinghouse. Westinghouse performed some modifications on the wrench and asked General Dynamics to pay \$5,205 for it. General Dynamics added on \$1,613 for engineering, \$509 for administration, and \$1,287 in profits. \$995 was added for other extraneous expenses. The total mark-up, according to the Telegram, was 115,000% from original manufacturer to the Air Force.

4. The \$7,400 Hot Beverage Unit

The Project on Military Procurement discovered the \$7,400 coffee brewer, and Rep. Barbara Boxer (D-CA) reported her findings to the Air Force. After an investigation, the Air Force found that they only had themselves to blame. The specifications required for the brewer were so involved, that it required two thousand parts to operate, and was able to brew under the force of 40 g's of gravity. All the passengers on the plane would be killed under such pressure.

## Price Breakdown on the \$7,400 Hot Beverage Unit

Material	\$2,856
Material Handling	337
Labor (137 hours)	1,181
Mfg Burden	<u>1,760</u>
	6,134

G & A (11.6%)	718
Incurring Costs	6,852
Profit (8%)	548
Contract	\$7,400

These examples are offered to illustrate that the Pentagon is capable of rationalizing away the real problems in spare parts and weapon system procurement and falling back on the traditional government practice of spending more money to solve the problem. It is typical of a mindset that takes for granted that the funds will always be there in great quantity and that the rules and expectations that govern sound financial management in the private sector are reversed when it comes to spending taxpayers' money. Spending money is the name of the game, saving money is not encouraged, and those who try to save money are punished.



Mr. MAZZOLI. Thank you.

Mr. HUGHES. Thank you.

I just have a few other matters. First, Mr. Vander Schaaf, I want to tell you that I asked a question that was a little embarrassing. Your reputation is an excellent one as a straight shooter and doing a good job. I want that to be in the record.

Mr. VANDER SCHAAF. I appreciate that.

Mr. HUGHES. And number two, I get the feeling that the overwhelming majority of the overcharges and abuses are perhaps not criminal, but we do need to develop some fraud cases and have people go to jail.

The thing that troubles me most about our long and drawn out E.F. Hutton hearing in the last Congress, conducted by this subcommittee, was that we had a corporation convicted on 2,000 counts of mail and wire fraud, plead guilty, and everybody walked. All the people that participated in that conspiracy walked as if you could have a corporation committing crimes and not have the individuals participating in it. Corporations don't act except through their officers. So we need to send a very clear signal, and H.R. 3500 is just one of them, because we do need to look at some additional tools. We need also to have more resources and more of a commitment on the part of a number of different agencies.

Mr. VANDER SCHAAF. I just want to second your thoughts there. I heard the inspector from the Postal Service this morning, and he emphasized the fines, and frankly, the fines and dollars are not the answer on our end. I don't think that fines are overly effective in cases like cost mischarging. We can get the money from major contractors. That is part of the answer, but putting someone in jail for that kind of crime is a difficult process. We are not very effective because of all the appeals to the jury that take place. The upstanding citizen of wealth and stature in the community, and you want to put him in jail? It is a difficult decision.

The product substitution area is the same way. Sentences in these cases have not been very good. We have taken steps to fix that in cooperation with the Justice Department. I have to say they have cooperated with us to a great degree there, because here we have a crime where the dollar value might be low if you don't break out what it costs the department to go back and rescue all that bad material that gets incorporated in the weapon systems. Then there is the cost of accidents, and other things that can happen as a result of substandard or non-conforming items, we don't begin to address the real harm.

So if you have to look beyond the \$20,000 item the company sold you, you have to look at the \$20 million that is affected by the \$20,000 item, and take it from there.

Mr. HUGHES. Well, we can save the Government a lot more money if we send a very clear signal and start putting some individuals in jail, because the deterrent value may save tens of billions of dollars.

What is your estimate as to the dimension of the problem we are talking about? We have a \$285.4 billion proposal for this fiscal year, and the present fiscal year is in that same range. We are talking about big money, as Everett Dirksen once said. What is your estimate of the amount of procurement fraud?

Mr. VANDER SCHAAF. I wouldn't like to give you a flippant answer. I can't answer it off the top of my head. I wouldn't doubt it is a three to five percent. When I say that, I want to emphasize that I think that number is going to go down as far as our big corporations are concerned. I think they realize now that they don't really have to cheat to make money. There is no advantage for them to cheat us to make money. The risks are too great.

Often when companies get in trouble on one contract they put a lot of pressure on employees to migrate costs to another contract not in trouble, so the company doesn't have to bear any burden or costs. There is some of that going on out there. In the end, I think we are getting the message across. I believe that in the big corporations, you can't tolerate your people cheating the Government because the risk is too great, the down side potential is far greater now than the up side potential from that sort of thing.

Mr. HUGHES. I think your latter point is correct. I am not so sure, you know, that you can work on the assumption that by persuading industry or individuals they can make money is going to stop them from cheating. Cheating is directly proportionate to the amount of risk involved.

Mr. VANDER SCHAAF. Yes sir.

Mr. HUGHES. We have corporate executives today that are flying to Columbia because the risk is so low that they are going to get caught with a load of cocaine on their return flight so they chance it. So we are going to have to increase the risk.

Mr. VANDER SCHAAF. It takes what this committee is doing. When you hold these hearings you are discussing increasing the risk, if you will, with the kind of bill you are proposing. That is also what we do when we enforce suspensions and debarments and make it very clear we don't want to deal with non-responsible contractors. That is what happens when we hire fraud investigators, train them and get them out in the field.

I am not saying that we are going to dry these things up and these companies are going to "fly right" all on their own without any help from anybody, but we have got in place now at least the mechanisms to force their behavior in the right direction. This isn't going to happen because they are a bunch of saints, they got religion, and now are going to behave properly.

Mr. HUGHES. I perhaps should not use the corporate executives. We have all kinds of people today that never thought of committing crimes who are now thinking about it, because the risk is so low. Unfortunately, that is what has happened in the criminal justice process over the years. We have seen that certainty of getting caught and certainty of going to jail has been reduced, diminished considerably in the whole criminal justice system, and that is unfortunate, because that is where the deterrent comes in.

Let me ask a couple of other questions. You have problems from time to time with various U.S. attorney's offices, getting cooperation?

Mr. VANDER SCHAAF. We have had some problems from time to time. I guess we could say we still have occasional problems, and you would expect to have problems.

Mr. HUGHES. How do you deal with a resistant U.S. Attorney?

Mr. VANDER SCHAAF. A couple of ways. One, first and best way, usually one that works the best, is to have the Director of the Defense Criminal Investigative Service, the investigative arm of the IG, and someone else from my Investigative and Oversight Office, pay a visit and try to work it out. Why weren't we in the district of X getting any attention on defense contractor procurement fraud, for example. We have done that. The lights go on and we have been able to show the way.

Mr. HUGHES. Any offices in particular in this country that you have particular problems with?

Mr. VANDER SCHAAF. Let me have an opportunity to go back and I can give that to you. I don't think I am going to do myself any good pointing the finger.

Mr. HUGHES. You are not. I don't want you to get in trouble.

Mr. VANDER SCHAAF. I have been in trouble all the time.

Mr. HUGHES. I would like you to furnish the committee with the offices around the country you have had some difficulties with, where you have had to ultimately either gone to Justice headquarters, or where you have had to pay a visit. I would like to know if there is any patterns.

Mr. VANDER SCHAAF. Yes sir.

Mr. HUGHES. Would you supply that to the committee?

Mr. VANDER SCHAAF. I will supply it for the record. I will do the best I can. I would hope it is not going to become a public document in the sense it doesn't help my case. Maybe I can come talk to you about it.

Mr. HUGHES. Furnish it to us. Well, just furnish it to me.

Mr. VANDER SCHAAF. Yes.

Mr. HUGHES. Mr. Vander Schaaf, you touched on H.R. 3500 ambiguity with regard to what is meant by object of fraud. That gives me some concern. We are going to have to refine and redefine what we are talking about. We are generally talking about contracts, and the amount of money involved. That is a problem we are going to have to deal with more closely.

Mr. Newton, your auditors probably can be aptly described as on the front line in any discussion of procurement fraud. I realize they are not investigators. You have made that clear but they really are in the contractors plants and they have a sense of what is happening, they are doing the auditing. What is your perception about procurement fraud? Is it getting worse, getting better, about the same?

Mr. NEWTON. We are referring more incidents of potential fraud each year as we go along, but I don't believe that that is necessarily an indicator of a growing number of incidents of fraud. I think that it is because our people have been trained. They are better recognizing what fraud is when they see it. Also, since we have made the procedure for doing it less inhibiting, we are seeing more referrals.

I share the comments that Derek made about the extent of major corporations' activities toward self-governance. We really are seeing some programs being established within the large corporate structures—hotline programs of their own, which in many cases are made absolutely open to the Government people, including Defense Contract Audit Agency people. Where it is going on, it is a

great move forward for preventing fraud. We are hopeful that the numbers of incidents of fraud are going down. Notwithstanding the fact that there are growing numbers of referrals for now, we hope to see that number go down.

Mr. HUGHES. Mr. Vander Schaaf, in your testimony you talked about the various areas of fraud you look at, product substitution, defective pricing, bribery and so forth. Let me ask you a question. What category does writing special specs, for a friend, fall into?

Mr. VANDER SCHAAF. I do not understand you question.

Mr. HUGHES. Writing specs in a contract so you take care of someone?

Mr. VANDER SCHAAF. Generally you will find that is a form of bribery. I have been involved in cases like that where somebody will write a special spec for only one supplier.

Mr. HUGHES. How serious a problem is that?

Mr. VANDER SCHAAF. Again, it is so hard to quantify these things in this business.

Mr. HUGHES. Let me tell you the sense I have. I have been around here for 13 years.

Mr. VANDER SCHAAF. I will go this far and say: In the commodities area, I am not talking about now any specific item but in certain commodity areas that can be a problem from time to time. In subsistence, for example, where somebody has the right delivery dates and you get the delivery dates in relation to the crop availability or in the clothing area, or lumber or some of those commodity areas—everything from catsup, to peanut butter, the Government can write a spec that can in fact favor somebody. Those are areas where that has been a problem.

In other areas such as the building of weapons systems I don't think the spec writing to the very top end is in fact a problem.

Mr. HUGHES. I don't think the problem is at the lower end of the scale. My perception is that it is widespread. I am not saying exactly what percentage of cases in which this is a problem, but I just get that sense, just from the number of cases that have been brought to our attention here.

Mr. VANDER SCHAAF. It is a self-fulfilling kind of thing. If I can explain what I mean by that to you, what happens is the Government writes a spec for example, on a meat product, how the Government wants the meat to be cut and packaged and sold.

A supplier decides that is a good deal. He starts processing according to this new spec. The major packing companies in the United States aren't interested in changing all their procedures—and this is an old case I am giving you, not something we have currently ongoing. So you develop this industry that solely serves the Department of Defense, a series of brokers or suppliers and their only business is with us. You will find this same thing happens in the lumber industry to some extent, where the big people in the lumber industry for the most part at least the last we looked at it they didn't seem to want to deal with the Department of Defense. There was a series of brokers who had small time lumber makers behind them who sold to the Department of Defense. That is the kind of problem you develop when you create a a special spec or a special procurement procedure.

Mr. HUGHES. I appreciate that.

With regard to suspensions and debarments, my perception—and it might be erroneous, and correct me if you have a different view—is that if you are a small government contractor, you are going to get clobbered but if you are a General Dynamics we have a major problem, because we need them.

Mr. VANDER SCHAAF. There is a large degree of truth in what you say. The problem hasn't been because we are afraid to suspend or debar the big contractors. It is happening today. The suspensions have been short. The pressures are great and I have to say that the contractors, the big contractors, become very, very responsive to getting their houses in order after they have undergone a suspension. Now——

Mr. HUGHES. Let me interrupt you. That may be the case, but I have no sympathy for anybody that has violated the law. They should be dealt with harshly, but I find that the small contractors are being dealt with very harshly but the larger ones are basically being restored. General Dynamics is a good example since they were restored within five months.

Mr. VANDER SCHAAF. Something like that.

Ms. RASOR. They were debarred twice.

Mr. HUGHES. The last time, they restored within what length of time?

Mr. VANDER SCHAAF. I think five months.

Ms. RASOR. Yes sir.

Mr. HUGHES. That is my view anyway.

Mr. VANDER SCHAAF. Let me add to that, when we go after the small company, quite often the fraud goes right to the front office, right to the owner, president, manager—all combined—and you have to put that individual out of business.

When you do business with the big company, the trail often doesn't lead to the very top of the corporation, and therefore, you don't put the corporation out of business when some lower level employee is involved in that. If there is a pattern and it leads to the front offices, I am for suspending the entire corporation and, or at least that major segment of a corporation where this incident took place. I don't have any problems with that. Remember the Inspector General doesn't play a big role in that process. We make recommendations to suspension and debarment boards, who then go through the procedures and make a decision on those matters.

Mr. HUGHES. Well, do you keep records of the debarments?

Mr. VANDER SCHAAF. We keep records of the numbers, yes sir.

Mr. HUGHES. Can you give us an assessment of a number of firms? I heard some testimony there were 800 or so.

Mr. VANDER SCHAAF. The problem is that 35 major defense contractors or there about receive 70 percent of the procurement dollars. Eventually much of the work trickles down, but the dollars flow first to those major companies. There are approximately 35,000 or more contractors that we have significant contract dealings with. Then, if you go to base suppliers and maintenance contractors, the roofer and that sort of thing, you would deal with thousands of contractors out there. There are going to be far more of the small contractors, than major contractors.

Mr. HUGHES. If you have some information you collect on that, if you could share that with the committee, I would like to see it. It is not terribly germane to our committee jurisdiction, but I would like to take a look at the total picture.

[The information follows:]

INSERT FOR THE RECORD					
HOUSE SENATE	APPROPRIATIONS COMMITTEE	HOUSE SENATE	ARMED SERVICES COMMITTEE	X HOUSE SENATE	OTHER Judiciary
HEARING DATE	TRANSCRIPT PAGE NO.	LINE NO.	INSERT NO.		
December 3, 1987	121	2795			

(The information follows:)

The legal authority for suspension and debarment holds that these activities are not a punishment. They are designed to ensure that the Federal Government is protected from doing business with an unscrupulous contractor. A contractor which is indicted or convicted for contract fraud is obviously untrustworthy and should be barred from contracting with DoD, unless the contractor can demonstrate to our satisfaction that the cause of the problem has been eliminated, that the problem will not recur and that the harm to DoD will be corrected. When a large corporation is involved with fraud, we have used the suspension process to require the contractor to fire or remove the responsible corporate personnel, change accounting or production practices and repay the damage done to DoD. Smaller contractors are often unable or unwilling to take such corrective action because the culpable corporate officials usually own and run the company. If these persons are unwilling to remove themselves from the company, DoD cannot assume that the company is responsible. Whenever smaller companies have proposed meaningful corrective actions, DoD has accepted these actions and lifted any outstanding suspension and debarment. I should also point out that 10 U.S.C. Section 2409 mandates the debarment of persons who have been convicted of defrauding DoD for at least one year. The statute also prohibits the employment of such felons by a DoD contractor in managerial or supervisory capacity.

I have enclosed a copy of a recent GAO report that provides additional statistical information on DoD suspension and debarments.

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United States General Accounting Office

**GAO**

Briefing Report to the Senate Committee  
on Small Business

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December 1987

# PROCUREMENT

## Small Business Suspension and Debarment by the Department of Defense







United States  
General Accounting Office  
Washington, D.C. 20548

**National Security and  
International Affairs Division**

B-224072

December 2, 1987

The Honorable Dale Bumpers  
Chairman, Committee on Small Business  
United States Senate

The Honorable Lowell Weicker, Jr.  
Ranking Minority Member  
Committee on Small Business  
United States Senate

This report responds to your October 30, 1986, request for information regarding small businesses that have been suspended and debarred by the Department of Defense (DOD). Suspensions and debarments are used to protect the government against fraudulent and unethical contractors. You were concerned that small firms may not always be given adequate opportunity to present their cases and to demonstrate their "present responsibility" before being suspended, or to implement a program of "remedial actions" designed to eliminate the bases for the suspension or debarment action.

Our overall assessment of federal suspension and debarment procedures was presented in our February 1987 report to the Chairman, House Committee on Government Operations, entitled Procurement: Suspension and Debarment Procedures (GAO/NSIAD-87-37BR). In that report, we noted that the current process, with some changes and clarifications, provides an effective tool for protecting the government against the risks associated with doing business with fraudulent, unethical, or nonperforming procurement contractors. We believe the current process maintains an appropriate balance between protecting the government's interests in its contractual relationships and providing contractors with due process.

As agreed, the objective of our review was to supplement our recently-completed work by identifying, to the extent possible, those contractors suspended by DOD in fiscal years 1983 and 1985 that were small businesses, and determining the current status of those suspended contractors.

Neither DOD nor the Small Business Administration (SBA) has an information system that records the sizes of all defense contractors or identifies whether suspended contractors are small businesses. As a result, the information we collected regarding how many suspended contractors

were small businesses was incomplete. Furthermore, DOD's statistics on the number of suspensions include both firms and individuals. For example, the suspension of a company and its three top officials is reported as four suspensions. Therefore, we needed to examine each suspension case to determine how many actions were taken against firms as opposed to individuals.

We reviewed 262 of the 380 suspension actions taken by DOD against firms and individuals in fiscal years 1983 and 1985. Of the actions we reviewed, 112, or 42.7 percent, involved firms, 45, or 40.2 percent of which were listed in DOD's contracting activity reporting (DD-350) system, indicating they had held contracts valued at more than \$25,000. Of these 45 suspended firms, 40, or 88.9 percent, were identified as small businesses. The number of small firms suspended as a percentage of total suspended firms listed decreased from 14 of 15, or 93.3 percent in fiscal year 1983, to 26 of 30, or 86.7 percent in fiscal year 1985.

DOD suspension and debarment officials told us that a firm's size has no bearing on whether or not it is suspended. They stated that since most suspensions are based on indictments, a firm's size is irrelevant. These officials told us they do not believe DOD should keep track of how many small businesses are being suspended since size has no bearing on their decision. To highlight size would, in their view, serve no useful purpose.

DOD officials also believe that by suspending and debarring fraudulent and non performing small businesses they have created opportunities for legitimate and capable small businesses to be awarded contracts through the various SBA programs.

DOD officials believe that most of the remaining 67 (112 minus 45) suspended contractors which were not listed in the DD-350 system were probably also small businesses. Assuming they all were small businesses, the number of known or assumed small firms suspended is 107 (40 plus 67). Of these, 69, or 64.5 percent, were later debarred, while 18, or 16.8 percent, entered into settlement agreements with DOD in place of a continued suspension or debarment. Such agreements, usually reached after the firm has already been suspended, outline the measures the contractor has taken, or agrees to take, which the government has identified as needing improvement or correction. In this way, the contractor is able to demonstrate present responsibility, and be reinstated to do business with the government.

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B-224072

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DOD suspension and debarment officials said they apply the same rules to all contractors, large or small, when deciding whether to lift a suspension or debarment. Basically, they look to

- protect DOD from the individual(s) who perpetrated any fraud or misconduct,
- ensure that the contractor has taken corrective actions within the company to help ensure that the fraudulent activity will not be repeated, and
- ensure that the government will be reimbursed for its losses.

According to a DOD official, these three remedial actions are considered to be the key factors in determining whether a company has regained its present responsibility. Regarding the first remedy, a contractor would need to remove those individuals responsible for the problems that led to the suspension. DOD officials noted that this can be difficult, if not impossible, for those small businesses where the company president is the individual involved.

The third remedial action may also be difficult for small businesses to carry out. For example, the Special Assistant for Contracting Integrity at the Defense Logistics Agency (DLA) commented that one small contractor told DLA the only way it could afford to repay the government would be to obtain more government contracts—an unacceptable solution. On the other hand, large contractors are much more likely to have the financial resources to repay the government in order to have their suspensions lifted and resume defense contracting.

In performing our analysis, we supplemented the information obtained during our review of government wide suspension and debarment procedures with a case-by-case review of suspended contractor files maintained by the Army, Air Force, Navy, and DLA. Using DOD's contracting action reporting system, we manually matched the names of suspended firms against the names of those firms listed in the system. We also spoke with DOD suspension and debarment officials and SBA officials to obtain their views and comments. We performed our review in accordance with generally accepted government auditing standards from March to August 1987.

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B-234072

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We are sending copies of this briefing report to the Secretaries of Defense, Air Force, Army, and Navy and to the Director, DLA. Copies will also be made available to other interested parties upon request.

If you have any questions, please call me on 275-4587.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with a large, sweeping initial "P" and a distinct "M".

Paul F. Math  
Associate Director



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Abbreviations

DLA	Defense Logistics Agency
DOD	Department of Defense
PASS	Procurement Automated Source System
SBA	Small Business Administration

## DOD Suspensions and Debarments

### Information on Size of Suspended Contractors Is Incomplete

We found that neither the SBA nor DOD maintains an automated information system which tracks the sizes of all DOD contractors, or which identifies whether suspended contractors are small businesses. The suspension/debarment offices within the Army, Navy, Air Force, and DLA do not track such information. Therefore, information as to whether contractors suspended by DOD were small businesses was neither complete nor readily available.

The two primary information systems we identified were DOD's DD-350 contracting action reporting system and the SBA's Procurement Automated Source System (PASS). We sought to match the names of the firms suspended by DOD against the names contained in these systems; however, each system had features which limited this effort.

For example, while the DD-350 system contains historical information on firms that received DOD contracts and identifies those that received awards because they were small businesses, it only records contract actions above \$25,000. Contracting information for actions under \$25,000 is not kept in any centralized DOD information system. One DLA official estimated that the DD-350 system captures about 97 percent of DOD procurement dollars but only about 3 percent of all procurement actions. According to an official from DOD's Directorate for Information Operations and Reports, small business accounted for 98.9 percent of all actions under \$25,000 in fiscal year 1986.<sup>1</sup>

The SBA's PASS system lists those businesses that request to be listed, regardless of whether or not they have received government contracts, in order to provide government procurement officials with information on potential supply sources. The system is not designed to identify or track government contractors. Of those small businesses that have received government contracts, the SBA tracks only minority and disadvantaged firms, and firms that have received SBA loans.

### Most Suspended Firms Are Small Businesses

The Federal Acquisition Regulation section on suspensions and debarments (section 9.4) defines a contractor as any individual or other legal entity that submits offers for or is awarded, or reasonably may be expected to submit offers for or be awarded, a government contract. The Federal Acquisition Regulation also states that affiliates of contractors

<sup>1</sup>While this information is not routinely kept in any centralized DOD information system, the Directorate did collect this information from the buying activities for fiscal year 1986. The Directorate did not have information on how many different small businesses received DOD contracts under \$25,000.



Appendix I  
DOD Suspensions and Debarments

and subcontractors under government contracts may also be suspended or debarred. In accordance with these regulations, the Army, Navy, Air Force, and DLA have suspended both individuals and companies, as well as affiliates and subcontractors.

We reviewed those suspension actions taken by DOD in fiscal years 1983 and 1985 for which complete documents were available. In all, we reviewed 262 of the 380 suspension actions taken by DOD in these two fiscal years. Of the total suspension actions we reviewed, less than half (112, or 42.7%) involved companies, as shown in table I.1. The individuals suspended were associated with these firms or, in a few cases, were suspended while the firm was not.

Table I.1: DOD Suspensions, Fiscal Years 1983 and 1985

Service/agency	Actions reviewed	Firms suspended	Firms in DD-350 system		Firms not in DD-350 system	Total presumed to be small businesses	
			Total	Listed as small			
Army	'83	7	3	2	2	3	
	'85	53	26	17	14	23	
Navy	'83	17	7	2	2	7	
	'85	41	15	5	5	15	
Air Force	'83	12	5	4	4	5	
	'85	28	11	1	1	11	
DLA	'83	57	28	7	6	27	
	'85	47	17	7	6	16	
<b>Total</b>	<b>262</b>	<b>112</b>	<b>46</b>	<b>40</b>	<b>67<sup>d</sup></b>	<b>107</b>	
			42.7% <sup>a</sup>	40.2% <sup>b</sup>	88.9% <sup>c</sup>	59.8% <sup>b</sup>	95.5% <sup>b</sup>

<sup>a</sup>Percentage of actions reviewed.

<sup>b</sup>Percentage of total firms suspended.

<sup>c</sup>Percentage of total suspended firms listed in DD-350.

<sup>d</sup>According to DOD officials these firms can be presumed to be small businesses.

To determine how many of the 112 suspended companies were small businesses, we selected the DD-350 system for matching because it can be used to search for firms by name and identification number, and because it contains prior year information (back to about fiscal year 1980). We found that 46, or 40.2 percent of the firms suspended by DOD in fiscal years 1983 and 1985 were listed in the DD-350 system. Of those listed, most (40, or 88.9 percent) were identified as having been awarded the contract because they were a small business. The number of suspended small businesses as a percentage of those listed decreased from

Appendix I  
DOD Suspensions and Debarments

fiscal year 1983 to 1985—from 14 of 15, or 93.3 percent, to 26 of 30, or 86.7 percent. (See tables I.2 and I.3.) By comparison, small businesses accounted for 70.9 percent of all DOD contractors with actions over \$25,000 in fiscal year 1986.<sup>2</sup>

DOD suspension and debarment officials noted that a suspended firm might not be recorded in the DD-350 system for any one of four reasons. The firm may have

- received a contract from DOD for under \$25,000,
- served as a subcontractor,
- been affiliated with a suspended DOD contractor, or
- been indicted along with defense contractors, although not itself a DOD contractor.

As stated previously, federal officials may suspend or debar any contractor that may reasonably be expected to compete for, or be awarded, a government contract.

**Table I.2: DOD Suspensions, Fiscal Year 1983**

Service/ agency	Actions reviewed	Firms in DD-350 system		Listed as small
		Firms suspended	Total	
Army	'83	7	3	2
Navy	'83	17	7	2
Air Force	'83	12	5	4
DLA	'83	57	28	6
<b>Total</b>		<b>93</b>	<b>43</b>	<b>15</b>
			46.2% <sup>a</sup>	34.9% <sup>b</sup>
				93.3% <sup>c</sup>

<sup>a</sup>Percentage of total actions reviewed.

<sup>b</sup>Percentage of total firms suspended.

<sup>c</sup>Percentage of total suspended firms listed in DD-350.

<sup>2</sup>The DOD Directorate for Information Operations and Reports has not published any reports and does not routinely compile this information. However, by using the DD-350 system, the Directorate made a special computer run for fiscal year 1986 to determine how many small businesses contracted with DOD.

Appendix I  
DOD Suspensions and Debarments

Table I.3: DOD Suspensions, Fiscal Year 1985

Service/ agency	Actions reviewed	Firms in DD-350 system		Listed as small
		Firms suspended	Total	
Army '85	53	26	17	14
Navy '85	41	15	5	5
Air Force '85	28	11	1	1
DLA '85	47	17	7	6
<b>Total</b>	<b>169</b>	<b>69</b>	<b>30</b>	<b>26</b>

40.8%<sup>a</sup>

43.5%<sup>b</sup>

86.7%<sup>c</sup>

<sup>a</sup>Percentage of total actions reviewed.

<sup>b</sup>Percentage of total firms suspended.

<sup>c</sup>Percentage of total suspended firms listed in DD-350.

## Debarments of Suspended Contractors

DOD suspension and debarment officials told us they believed most of the 67 suspended contractors not listed in the DD-350 system were probably also small businesses. If all the suspended contractors not listed were assumed to be small businesses, the total number of suspended firms known or assumed to be small would be 107 (40 plus 67) or 95.5 percent. (See table I.1.)

Of these 107 suspended contractors, 69, or 64.5 percent, were debarred—67 were based on convictions; 2 on "willful failure to perform." DOD reached settlement agreements and either terminated the suspension or limited the debarment period of 18, or 16.8 percent of the suspended contractors, as shown in table I.4. This percentage decreased slightly from fiscal year 1983 to 1985—DOD settled with 8 of 42, or 19.1 percent of these contractors in fiscal year 1983 as compared with 10 of 65, or 15.4 percent in fiscal year 1985. (See tables I.5 and I.6.)

DOD also terminated a number of suspensions either because the contractor was acquitted, the indictment was dropped, or court proceedings had not begun within the allotted 12 month period. In all, 11, or 10.3 percent, of the 107 contractors had their suspensions lifted for these reasons. (See table I.4.) Nine of the contractors, or 8.4 percent, remain suspended pending the resolution of court proceedings. All of those still suspended were suspended in fiscal year 1985, as shown in tables I.5 and I.6.

Appendix I  
DOD Suspensions and Debarments

Table I.4: Disposition of Suspensions of Known or Assumed Small Firms, Fiscal Years 1983 and 1985

Service/ agency	Total	Debarred*	Remains suspended	Suspension/debarments lifted			No indictment
				Settled	Acquitted		
Army '83	3	2	0	0	1	0	0
Army '85	23	11	6	1	4	1	1
Navy '83	7	6	0	1	0	0	0
Navy '85	15	9	0	6	0	0	0
Air Force '83	5	3	0	1	0	0	1
Air Force '85	11	10	0	0	1	1	0
DLA '83	27	21	0	6	0	0	0
DLA '85	16	7	3	3	3	3	0
<b>Total</b>	<b>107</b>	<b>69</b>	<b>9</b>	<b>18</b>	<b>9</b>	<b>2</b>	<b>2</b>
Percentage of total		64.5%	8.4%	16.8%	8.4%	1.9%	

Table I.5: Disposition of Suspensions of Known or Assumed Small Firms, Fiscal Year 1983

Service/ agency	Total	Debarred*	Remains suspended	Suspension/debarments lifted			No indictment
				Settled	Acquitted		
Army '83	3	2	0	0	1	0	0
Navy '83	7	6	0	1	0	0	0
Air Force '83	5	3	0	1	0	0	1
DLA '83	27	21	0	6	0	0	0
<b>Total</b>	<b>42</b>	<b>32</b>	<b>0</b>	<b>8</b>	<b>1</b>	<b>1</b>	<b>1</b>
Percentage of total			76.2%	0.0%	19.1%	2.4%	

\*All 32 debarments were based on convictions.

Table I.6: Disposition of Suspended Known or Assumed Small Firms, Fiscal Year 1985

Service/ agency	Total	Debarred*	Remains suspended	Suspension/debarments lifted			No indictment
				Settled	Acquitted		
Army '85	23	11	6	1	4	1	1
Navy '85	15	9	0	6	0	0	0
Air Force '85	11	10	0	0	1	0	0
DLA '85	16	7	3	3	3	3	0
<b>Total</b>	<b>65</b>	<b>37</b>	<b>9</b>	<b>10</b>	<b>8</b>	<b>1</b>	<b>1</b>
Percentage of total			56.9%	13.8%	15.4%	12.3%	

\*All but two of the 37 debarments were based on convictions.

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Ms. RASOR. I would like to say a few years ago, we looked at General Dynamics' two debarment, looked how much they got in contracts before they were debarred and how much they got in afterward, and basically they ended up getting more the next year. So the debarment in the General Dynamics cases was more like a dam building up. Like the money stopped but eventually you let the flood gates open and hope that doesn't send the wrong signal.

I would be happy to provide that study.

Mr. HUGHES. Well, this has been an endurance contest. You have been very patient.

There is a vote I have to go to in the conference committee. I want to thank you very much. You have been very helpful. We may want to have additional hearings.

Mr. VANDER SCHAAF. We are prepared to support you or your staff in any questions.

Mr. HUGHES. Well, thank you for your support of H.R. 3500. We, too, think it is a good bill, and we need your support to see if we can't make it the best bill we can.

Thank you very much.

Senator Grassley has been one of the leaders in the whole area of procurement fraud. He has done yeoman's work. He has a statement, which, without objection, will be made part of the record.

(Whereupon, at 2:20 p.m., the subcommittee was adjourned, subject to the call of the chair.)

# MAJOR FRAUD ACT OF 1988

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WEDNESDAY, MARCH 16, 1988

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CRIME,  
COMMITTEE ON THE JUDICIARY,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10:10 a.m., in room B-352, Rayburn House Office Building, Hon. William J. Hughes (chairman of the subcommittee) presiding.

Present: Representatives Hughes, Smith of Florida, Staggers, McCollum, and Gekas.

Staff present: Hayden Gregory, chief counsel; Ed O'Connell, counsel; Paul McNulty, associate counsel; and Phyllis Henderson, clerk.

Mr. HUGHES. The Subcommittee on Crime will come to order. The chair has received a request to cover this hearing in whole or in part by television broadcast, radio broadcast, still photographers and by other similar methods. In accordance with committee rule 5(a) permission will be granted unless there is objection.

Hearing none, permission is granted.

Good morning, and welcome to the Subcommittee on Crime's hearing on major procurement fraud. This is our second day of hearings on this subject and today we will receive formal testimony from representatives of private industry.

In December of last year we heard from the Department of Justice, the Department of Defense and knowledgeable congressional witnesses, among others, and the picture they painted about procurement fraud was not a pleasant one. In fact, the combined testimony of that hearing documented a story of greed, malfeasance and fraud in procurement law that is unacceptable. This testimony we believe was not an aberration or a history lesson, but is the accumulation of facts that have been played out repeatedly in the records of voluminous hearings before various House and Senate committees in the last few years and describes a relatively small, but extremely malignant cancer on our society.

For example, the DOD witnesses stated at our hearing that in product substitution cases alone, cases where contractors deliberately provide inferior products on DOD contracts which can most directly cost Americans their lives, the Defense Criminal Investigative Services has obtained 85 indictments since January of 1986, and they currently are carrying over 225 open investigations. The DOD testimony went on to cite numerous specific examples of this facet of the problem which they believe is ongoing.



Without objection, I will enter a recent report on this subject into the record at this time, and I would encourage our witnesses to comment, not on the substance of the report, but whether this type of activity is occurring in 1988 in their judgment.

[The information of Mr. Hughes follows:]

IG, DoD 7050.1-R

**REVIEW OF SIGNIFICANT  
PRODUCT SUBSTITUTION CASES  
WITHIN THE  
DEPARTMENT OF DEFENSE**



September 1987

**The Office of the Inspector General  
Department of Defense**

**Criminal Investigations Policy and Oversight**

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**A. INTRODUCTION**

In FY 1986, the Department of Defense (DoD) budget for operation and maintenance and procurement totaled more than \$176 billion. The procurement system to a large extent depends on the honesty and self-certification of the contractor to assure the Government that the product provided meets required specifications. Numerous instances have been documented in which DoD has been provided with nonconforming and faulty products. Often those defects are readily apparent, such as untreated lumber being supplied in place of treated lumber. Unfortunately, the substituted product usually contains a latent defect not readily identifiable particularly when the product is a component of a large system. Such defects have included faulty critical parts in weapon systems which could cause malfunction and failure in operation, thereby jeopardizing DoD missions and personnel.

It is well recognized that a significant effort in preventing this activity directed against the DoD requires prosecution in appropriate circumstances. Successful prosecution and meaningful sentencing will deter not only the individual concerned, but also send a clear message to those who may be contemplating similar activity that the Government will not countenance such a lack of business integrity.

In this regard, the Secretary of Defense identified the DoD position, in a March 30, 1985 letter to the Attorney General, that product substitution cases are considered the top law enforcement priority of DoD criminal investigative organizations. The Secretary of Defense noted that:

"I am making a personal commitment to ensure that all Defense personnel understand their obligation to identify and report any situation indicative of product substitution by Defense contractors. Intentional conduct causing product substitution will result in our use of all remedies available to the Department of Defense, including debarment.

"While I realize that the Justice Department generally recognizes the importance of product substitution cases, I would urge that you reiterate to all United States Attorneys that product substitution cases should be regarded as top priorities in commencing criminal and civil fraud actions."

In response, the Attorney General advised the Secretary of Defense on April 24, 1985, that he had notified all United States Attorneys of the DoD position and instructed them as follows:

"You are all aware of the Administration's efforts to eliminate waste, fraud, and abuse in government programs generally. Secretary Weinberger has determined that fraud involving shoddy and substandard products is a particular problem in defense procurement. Accordingly, I want you to treat cases of this sort as a priority of the Department of Justice. Please pursue appropriate criminal and civil actions vigorously."

B. PURPOSE AND METHOD OF REVIEW

The review focused on DoD product substitution cases with particular significance in terms of the effect of such substitution on DoD wartime mission and its personnel. While a specific sampling of 15 cases was made, the Office of the Assistant Inspector General for Criminal Investigations Policy and Oversight also took cognizance of numerous other product substitution cases which have been scrutinized as part of its ongoing oversight responsibilities.

Examples of the types of substituted, defective or untested products covered by the review include:

- o Valves for the safety eject system for the F-4 jet, and nozzles for fire suppression systems;
- o Landing gear, assemblies, seat belt anchors for aircraft ejection seats, washers for helicopter rotors, and gas caps for aircraft;
- o M-27 fins for 60mm mortar rounds;
- o Springs used in CH-47 helicopters, cruise missiles, F-18 fighters and B-1 bombers;
- o Dust and moisture seals for master cylinders;
- o Hydraulic bearings used in helicopters;
- o Breach bolts for the M-60 and M-85 machine guns;
- o Guidance fins for the Sidewinder missile; and
- o Fire retardant laminates to be used on board Navy ships.

An effort was made during the review to identify what factors were provided to the sentencing court by the Government as part of any demonstration of the mission or personnel impact of the substituted products. The Government's determination of whether to submit such factors for sentencing consideration was also reviewed. To this end, interviews were conducted with the investigators and the Federal prosecutors who presented the cases in court. In addition, probation offices provided information as to the actual procedures employed in preparing a presentence report for the court; the ability of the Government to provide meaningful input into presentence reports was also discussed with those offices.

#### C. BACKGROUND

The DoD Directive 5070.5, "Coordination of Remedies for Fraud and Corruption Related to Procurement Activities," dated June 28, 1985, established policies and procedures for the coordination of remedies regarding significant fraud cases relating to procurement activities. This includes product substitution cases. The head of each DoD component was tasked by the Directive to establish a "centralized organization to accomplish this function." That singular point is responsible for coordinating procurement actions with criminal investigators and prosecution authorities and providing prosecutors with program impact information regarding contract fraud cases. In the case of product substitution cases, the information relates to assessments regarding the DoD mission and personnel impact. As such, these "Victim Impact Statements," pursuant to the requirements of the Victim and Witness Protection Act of 1982, are to be provided to prosecutive authorities for use during the sentencing proceedings.

#### D. FINDINGS/RECOMMENDATIONS

##### 1. Few of the sampled product substitution cases involved sentences of significant deterrent value.

###### a. Findings:

A review of 15 significant product substitution cases involving the DoD that resulted in conviction and sentence from 1985 through early 1987 is attached (Appendices A and B). The cases include those in which there was either a high dollar loss or the product substituted had a serious impact on the readiness or mission requirements of the Armed Forces.

The 15 cases reveal the following sentencing pattern:

More than 18 months incarceration	3
12 - 18 months incarceration	4
6 - 12 months incarceration	1
1 day to 6 months incarceration	6
No incarceration	<u>9</u>
 Total defendants sentenced	 23

In one-third of the cases, prosecutors did not recommend incarceration.

In addition, monetary penalties (fines and restitution) were not generally significant. For example, in the case of Inland Marine Industries, the loss to the Government was estimated at \$67,300, yet the total of fines and restitution ordered amounted to just over \$35,000. The loss to the Government in the case of the Penrod Corporation amounted to approximately \$247,000, yet the defendants paid only \$30,000 in restitution, based on the offenses to which they pled guilty, and an additional \$10,000 fine was adjudged. In a third case involving the Beta Corporation, the loss on the 7 counts for which indictments were returned totaled \$30,000, however, the investigation disclosed that the actual loss to the Government was significantly higher. Nonetheless, the owner and the company paid a fine of only \$10,000 each and jointly paid restitution in the amount of \$10,622.

Relatively lenient sentences can be attributed to a number of factors. Often the defendants were able to argue against confinement due to a previously unblemished record. The picture presented to the court was of a defendant who, otherwise a pillar of the community, had, for varying motives, provided the DoD with an inferior product. The most frequent justifications offered to the courts by the contractors were that the product substituted was of no consequence to the DoD or that the improper conduct was necessary to keep the contractor solvent. In either case, there usually was a denial of knowledge by the contractor that lives or mission requirements would be in jeopardy as a result of the inferior product.

While the Government seems to have been successful in obtaining guilty pleas in the majority of the cases (11 of 15 resulted in guilty pleas), there appears to be much less success at sentencing. Realizing that the two are inextricably tied together, it appears that sentencing is possibly being sacrificed in order to obtain convictions. If that is the case, the Government practices at sentencing should be reviewed

realizing that a conviction without a meaningful sentence is probably of little deterrent value either to the defendant or other potential criminals.

In the context of enhanced monetary penalties, courts have recognized that the adverse impact of product substitution on DoD programs is a legitimate factor that may justify very harsh criminal sentences. For example, in U.S. v Busher (Slip Opinion, 5/26/87, 9th Cir.), the court reviewed a Racketeering and Corrupt Influenced Organizations (RICO) case arising from a Navy product substitution investigation in Hawaii. The contractor was convicted, inter alia, of supplying inferior materials on Navy construction contracts. The court ordered the contractor to forfeit over \$3 million in its interests in certain companies. On appeal, the court held that while the monetary impact of the contractor's fraud was substantively less than the amount of the forfeiture, such a forfeiture was appropriate as long as the Government could document the full measure of the harm of the defendant's conduct. The court recognized a number of factors in determining the extent of the crime's impact on the victim, including dollar loss, physical harm to persons, and other collateral effects. The court stated that any information presented regarding those factors would support a greater RICO forfeiture.

b. Recommendation:

The DoD and the DOJ should not agree as part of a plea bargain with defendants in product substitution cases to limit sentencing information presented to the court. In striking the initial plea bargain, the Government should resist all efforts to limit the Government's ability to present evidence at sentencing, to argue at sentencing, or to recommend an appropriate sentence. This is particularly necessary when the defective product has a significant mission impact. In such cases the Government should not waive the right to rebut evidence presented by the defendant at sentencing, either expressly or by agreeing to make no argument.

Furthermore, if the defendant presents extensive testimony during sentencing, the Government should give serious consideration to offering testimony by DoD program officials or by DoD employees who must use the defective product. This type of testimony can elicit direct evidence regarding the serious mission impact of the defendant's actions.

In addition, the Government should present at sentencing all available evidence not only on the charges on which the defendant was indicted and convicted, but also on other instances of product substitution that the investigation substantiated. Besides serving the primary purpose of fully demonstrating the complete nature of the defendant's misconduct, this procedure has the additional benefit of ensuring that all relevant evidence, some of which may



otherwise be precluded from disclosure by rule 6e of the Federal Rules of Criminal Procedure, is available as a matter of record for possible later use in administrative proceedings. This is also helpful in cases where serious product substitution evidence has been found, but the defendant is allowed to plead guilty to lesser charges or offenses unrelated to product substitution.

In response to the concerns surfaced here, DOJ has issued guidance to all United States Attorneys, consistent with the Attorney General's 1985 direction for vigorous pursuit of product substitution cases, that preserves the right and responsibility of the Government to present mission impact information at sentencing on all product substitution cases, including those resulting in guilty pleas. That guidance is found at Appendix D.

**2. Early notification by DoD criminal investigative organizations of product substitution cases to the DoD centralized points of coordination facilitates not only the ability of DoD to undertake precautionary safety actions, but also facilitates input for sentencing memoranda and Victim Impact Statements.**

**a. Findings:**

Presently, all product substitution cases are not provided to DoD centralized points of coordination for development of remedies plans, which would include safety alerts or related precautionary actions. While DoD criminal investigative organizations are generally aware of an obligation to notify appropriate authorities of possible defects, particularly where missions and personnel might be imperiled, this is often done on a local or decentralized basis without recognition of the multi-Service impact of some defective products. Enhanced reliance on the DoD centralized points of coordination would provide a better institutional basis for prompt response to problems with serious safety implications. Accordingly, any evidence of product substitution developed by the Defense criminal investigative organizations should be immediately provided to the centralized points for coordination of remedies to ensure that contract and safety actions are taken, as well as preindictment suspensions where sufficient evidence supports such action. Such action should not be delayed until the end of the investigation.

The appropriate centralized points for coordination of remedies should examine all DoD contracts that may be affected by the defective product, and coordination should be made with other affected centralized points for coordination of remedies. In cases where more than one DoD organization is adversely affected by the product substitution, a lead centralized point

of coordination should be selected. The lead agency should memorialize all contract and safety actions taken throughout DoD and should incorporate such information in a comprehensive Victim Impact Statement that is provided to the court for use at sentencing.

b. Recommendation:

(1) Each of the DoD criminal investigative organizations should establish written procedures requiring immediate notification of all product substitution cases to the cognizant centralized point of coordination within the Army, Navy, Air Force or the Defense Logistics Agency.

(2) Each of the centralized points of coordination should recognize product substitution matters as significant cases to be reviewed immediately for safety alert notification purposes. In addition, in monitoring product substitution matters which result in a criminal conviction, the DoD centralized points of coordination should assume the responsibility to develop Victim Impact Statements for use at sentencing and to provide any further assistance or information required to assist Federal prosecutors in developing sentencing memoranda.

3. The role of DoD criminal investigators is central to effective development of mission impact information for use at sentencing.

a. Finding:

While effective sentencing is dependent on many participants to the process, a central role must be achieved by the DoD criminal investigators. Suspension and debarment authorities are likewise only capable of instituting preindictment suspensions if factual information is provided promptly by criminal investigators. The DoD centralized points of coordination are dependent on investigative facts in developing information to be used in Victim Impact Statements, as is the probation office in any case where a presentence report is ordered by the court. Similarly, Federal prosecutors, often burdened with multiple case loads, must rely heavily on case investigators to assemble pertinent facts so that a sentencing memorandum can be used to justify significant deterrent sentences. The sentencing memorandum should fully identify the mission impact of the substituted product. A model sentencing memorandum is attached (Appendix C). While it is ultimately the responsibility of the prosecuting attorney to prepare such a sentencing memorandum, the investigator, working with the DoD centralized point for coordination of procurement fraud remedies, should take an active role in gathering all necessary impact information.

b. Recommendation:

Each DoD criminal investigative organization should issue guidance to its investigators concerning the need to:

(1) Notify promptly the cognizant DoD centralized points of coordination of all allegations involving substituted products.

(2) Participate with the centralized points of coordination and the assigned prosecutors in developing Victim Impact Statements and sentencing memoranda in all product substitution cases.

Special consideration should also be given by DoD criminal investigative organizations in particularly egregious product substitution cases to the issuance of formal letter requests to the cognizant United States Attorney's Office recommending substantial incarceration and monetary penalties. The letter requests could be issued by the responsible DoD criminal investigative organization or, in the alternative, by appropriate DoD representatives (including the Inspector General, DoD) when so requested by the responsible DoD criminal investigative organization.

## TABLE OF PRODUCT SITUATION CASES

<u>DEFENSE CONTRACTOR</u>	<u>EMPLOYEE</u>	<u>DISPOSITION</u>	<u>CONFINEMENT REQUESTED BY U.S. ATTORNEY</u>	<u>CONFINEMENT IMPOSED</u>
Alchemy, Incorporated	Leo. F. Schweitzer, III, Pres.	Convicted at Trial	Yes	15 years
Atlantic Construction, Co.	James E. Busher, President Diane L. Miller, Secretary, Tres.	Convicted at Trial Convicted at Trial	Yes Yes	4 years None
Beta Corporation	Edward Hastings, Owner	Plea	Yes	None
Diversified American Defense	Joel D. Helms, Vice President Mickey Ashley, Employee	Plea Plea	Yes No	1 year, 1 day None
Eric Rubber Works	Henry J. Tomko, President	Convicted at Trial	Yes	20 days
Fauconniere Manufacturing Company	William Ham, President	Plea	No	None
Genii Research, Incorporated	Luigino L. Castorini, Corp. Off. Louis De Vincento, Services Rep.	Plea Plea	No No	6 months None
Inland Marine Industries	Ruben Sutton, Owner Dirk Sutton, Employee	Plea Plea	Yes Yes	None None
MFB Manufacturing Corporation	Martin K. Burstein, President Garry Burstein, Manager	Plea Plea	Yes Yes	None 18 months
Newport Machine Tool Company	Alan Morrell, President	Plea	No	None
Penrod Corporation	Wayne R. Penrod, Chairman Craig M. Penrod, former VP	Plea Plea	No No	1 year, 1 day 5 weekends
Rausch Manufacturing Company	John E. Rausch, President Randall P. Rausch, Employee	Plea Plea	Yes Yes	2 years 18 months
Spring Works, Incorporated,	William McCullough, President Stewart Baron, Vice President	Plea Plea	Yes Yes	7 months 5 months
St. Charles Welding & Machine Co.	David Allen Bishop, Owner/Pres.	Plea	No	30 days

T.J. Enterprises

STANLEY W. BIRDA COMPANY

**APPENDIX B  
SYNOPSIS OF CASES**

**ALCHEMY, INCORPORATED:** U.S. District Court, Eastern District, Pennsylvania, 1985. Alchemy, Incorporated (Alchemy), falsely represented that the valves it provided for the safety eject system for the F-4 jet were manufactured by an approved source. The valves Alchemy supplied were manufactured by Alchemy using outdated specifications and could have resulted in serious injury or death. Alchemy also supplied defective nozzles for fire fighting equipment that had a 70 percent failure rate.

**LOSS TO THE GOVERNMENT:** \$433,254.68.

**SENTENCE:** Leo F. Schweitzer, III, President and sole stockholder of Alchemy, pled not guilty, was found guilty and was sentenced to 15 years confinement and ordered to pay \$433,254 in restitution.

**U.S. ATTORNEY:** U.S. Attorney requested confinement.

**ATLANTIC CONSTRUCTION COMPANY:** U.S. District Court, Hawaii, 1985. In addition to numerous instances of mischarging of costs to the Government, Atlantic Construction Company substituted 174,000 feet of green lumber for kiln dried lumber, which was required by the contract.

**LOSS TO THE GOVERNMENT:** In excess of \$1,000,000.

**SENTENCE:** James E. Busher, President of Atlantic Construction Company, also known as ATL, was sentenced to 4 years imprisonment. Diane L. Miller, Secretary and Treasurer, was given 4 years, sentence suspended during a 5 year period of probation. All company property was forfeited in order to settle claims of the Government.

**U.S. ATTORNEY:** Requested confinement.

**BETA CORPORATION:** U.S. District Court, Colorado, 1985. Beta Corporation provided substandard products used on at least 26 aircraft for the Air Force. The defective parts included aircraft landing gear, assemblies, seat belt anchors for aircraft ejection seats, washers for helicopter rotors, main doors, and gas caps for aircraft. All of the above were determined to pose serious safety hazards.

**LOSS TO THE GOVERNMENT:** The loss on the seven counts for which indictments were returned totaled \$30,000, however, the investigation disclosed the actual loss to the Government was significantly higher.

**SENTENCE:** Edward Hastings, owner of the company, pled to one count of false statements, was fined \$10,000 and ordered to pay

\$7,138 in restitution. The corporation was fined \$10,000 and ordered to pay \$3,484.00 in restitution.

U.S. ATTORNEY: Requested confinement.

DIVERSIFIED AMERICAN DEFENSE (DAD): U.S. District Court, Alabama, Northern District, 1986. The defendants engaged in a conspiracy to deliver to DoD M-27 fins for 60mm mortar rounds which were not in accordance with contract specifications, attempted to alter Defense inspections, and obstruct justice regarding examinations performed on the fins by Defense Department inspectors. The faulty fins could have caused the rounds to miss their intended targets and to cause injury to unintended victims.

LOSS TO THE GOVERNMENT: In excess of \$500,000.

SENTENCE: Joel D. Helms, Jr., Vice President, was sentenced to 1 year and 1 day imprisonment, fines totaling \$2,500, and 4 years probation. The company was fined \$750,000 and ordered to pay restitution in the amount of \$150,000. Nickey Ashley, a company employee, received suspended imposition of sentence because of cooperation with the Government.

U.S. ATTORNEY: Requested confinement for the Vice President, Joel Helms.

ERIE RUBBER WORKS: U.S. District Court, Pennsylvania, Western District, 1987. Erie Rubber Works altered laboratory reports to show that rubber dust and moisture seals for master cylinders on military 5-ton trucks met specifications. The seals in question were of inferior quality and would have resulted in the malfunction of the break systems.

LOSS TO THE GOVERNMENT: \$5,000.

SENTENCE: Henry Joseph Tomko, President of Erie Rubber, was sentenced to 2 years confinement suspended in lieu of 20 days confinement, 3 years probation, a fine of \$3,000 and ordered to make restitution in the full amount of \$5,000, which was determined to be the cost of refitting new seals. Mr. Tomko pled not guilty, and was found guilty of providing false statements.

U.S. ATTORNEY: Requested confinement and restitution.

FAUCONNIERE MANUFACTURING COMPANY, INCORPORATED: U.S. District Court, Iowa, Northern District, 1986. During the past several years Fauconniere has had numerous Government contracts. Among the items it falsely certified as meeting specifications were land mine pressure plates. The case on which it was indicted involved failing to rustproof canteen cups as required, and issuing false certifications that the rustproofing was completed. The items usability was significantly shortened.

LOSS TO THE GOVERNMENT: \$900,000.

SENTENCE: William Ham, President, pled guilty to a misdemeanor false statement charge, received a \$500.00 fine, and a 9 month sentence suspended for a period of 2 years. The corporation was fined \$10,000, and the amount of money to be paid to the Government in restitution is pending.

U.S. ATTORNEY: Part of the plea arrangement was that the U.S. Attorney would not argue during sentencing.

GENII RESEARCH INCORPORATED: U.S. District Court, New York, Eastern District, 1986. Genii was awarded several DoD contracts from 1977 to 1983 for the production of .45 caliber pistol barrels, breach bolts for the M-60 and M-85 machine guns, and guidance fins for the Sidewinder missile, the primary air-to-air missile used by U.S. fighter planes.

Under the terms of the DoD contracts, Genii was supposed to test fire the parts with Government supplied equipment, and perform magnetic particle inspections of each part following the test fire to ensure that the parts were free of defects. The contracts also called for the parts to be heat treated.

Examination of parts supplied by Genii disclosed that the company did not perform the required test fire and magnetic particle inspections and did not properly heat treat the parts. In spite of that, under the direction of Luigino L. Castorini, Corporate Officer, Genii, provided the DoD with test certifications which falsely reported that the tests had been conducted and that the test results conformed to contract specifications. Defective parts could have malfunctioned, missing the intended targets and causing serious injury or death to unintended victims.

LOSS TO THE GOVERNMENT: In excess of \$500,000.

SENTENCE: Luigino L. Castorini pled to conspiracy to defraud the Government and was sentenced to 6 months active sentence and 4 years 6 months probation. Louis De Vincentis, a former Defense Contract Administration Service Management representative and presently a Genii consultant, was found guilty of 1 count of obstruction of justice and 2 counts of perjury and was sentenced to 3 months probation and a \$10,000 fine. The company was ordered to pay restitution in the amount of \$890,000.

U.S. ATTORNEY: Due to a plea agreement, there was limited argument on sentencing by the Government.

INLAND MARINE INDUSTRIES: U.S. District Court, California Northern District, 1985. Inland Marine Industries installed nonfire rated laminates on-board naval ships and falsely certified that the laminates were fire rated as required by the

contract. Excessive damage and death could have resulted in the event of a fire, due to the substitution of the inferior product.

LOSS TO GOVERNMENT: \$67,300.

SENTENCE: Ruben Sutton, owner of Inland Marine Industries, pled guilty to false statements and was sentenced to a fine of \$20,000, 1 year probation, and was ordered to make restitution on the amount of \$14,365. Dirk Sutton, son of Ruben Sutton, also an employee of Inland Marine Industries, was sentenced to 2 years probation and fined \$1,000. Further recovery is being pursued by the Civil Division.

U.S. ATTORNEY: Confinement was requested, however, the judge at sentencing indicated he felt it was not a sufficiently serious case and should have been handled as a civil matter.

MKB MANUFACTURING CORPORATION: U.S. District Court, New York, Eastern District, 1986. The MKB Manufacturing Corporation (MKB) provided false certifications regarding parts for M-16 and M-60 machine guns. The faulty parts manufactured by MKB could have resulted in malfunction of the weapons and injury to the users. The M-16 and M-60 are the basic infantry weapons of the Army and Marine Corps.

LOSS TO THE GOVERNMENT: \$118,300.

SENTENCE: Martin K. Burstein, President, MKB, pled guilty to making false statements and was sentenced to 200 hours community service. Gerry Burstein, his son and manager, pled to one count of conspiracy to defraud the Government and received 18 months in prison.

U.S. ATTORNEY: Requested confinement.

NEWPORT MACHINE TOOL COMPANY: U.S. District Court, Virginia, Eastern District, 1985. Newport Machine submitted bogus documentation to trick DoD inspectors regarding a lathe that was to be rebuilt. The lathe was to be used in the Newport News Shipyard to test numerous items for the Navy. No determination made as to the sensitivity of the items to be worked on.

LOSS TO THE GOVERNMENT: \$12,000.

SENTENCE: Alan Morrell, President, Newport Machine Tool Company, was given 3 years suspended sentence, placed on 5 years probation, and ordered to perform 20 hours per week community service for 3 years. He was also fined \$10,000 and ordered to pay restitution of \$12,609.45. He pled guilty to submitting false claims to the Government.

U.S. ATTORNEY: Did not request confinement.



**PENROD CORPORATION:** U.S. District Court, Ohio, Southern District, 1986. Penrod Corporation supplied false certifications regarding numerous items supplied to the Government to include automotive parts, gaskets and hydraulic bearings. The Defense Logistics Agency indicated that the hydraulic devices, if they had been placed in helicopters, could have resulted in crashes. Also, commercial grade bearings were supplied in lieu of military grade bearings to be used in navigational speed and distance computers for surface ships and submarines. The lower quality product did not measure up to the higher standards and could have resulted in severe navigational problems.

**LOSS TO THE GOVERNMENT:** Approximately \$247,000.

**SENTENCE:** Wayne R. Penrod, Chairman and Chief Executive Officer, was sentenced 1 year and 1 day, plus a fine of \$10,000 and restitution to be determined. Craig M. Penrod, former Vice President, was sentenced to three years imprisonment, all suspended except for five weekends. Both defendants pled to one count of submitting false statements on a criminal information. Restitution of approximately \$30,000 was to be paid by the defendants and apportioned at a later date. The restitution was based on the offenses that the defendants pled to.

**U.S. ATTORNEY:** No request for confinement was made.

**RAUSCH MANUFACTURING COMPANY:** U.S. District Court, Minnesota, 1986. Rausch Manufacturing Company, Incorporated (RMC), John Rausch, and Randall Rausch, while acting as a subcontractor that produced separate aluminum castings intended for use in the Navy's Phoenix air-to-air missile, an Air Force mobile radio tower, and a cockpit display unit for the F-16 fighter aircraft conspired to defraud the DoD by falsely and fraudulently representing that the produced parts had been properly manufactured and tested when, in fact, the manufacturing and testing had been fraudulently altered. Additionally, Rausch Manufacturing, John Rausch, and Randall Rausch were charged with submitting specific false claims for payment in respect to parts not manufactured or tested in accordance with contract requirements.

**LOSS TO THE GOVERNMENT:** The Navy has yet to assess accurately the monetary loss required to re-inspect questioned items.

**SENTENCE:** John E. Rausch, President of Rausch, was sentenced to 2 years confinement. Randall P. Rausch was sentenced to 18 months confinement, both defendants pled to 1 count of conspiracy to defraud.

**U.S. ATTORNEY:** Requested confinement.

**SPRING WORKS, INCORPORATED:** U.S. District Court, California Central District, 1987. Spring Works, Incorporated, manufactured and provided substandard springs that were to be used in the CH-47 helicopter, cruise missiles, F-18 fighters, B-1 bombers and the space shuttle. The failure of the parts could have caused loss of life and seriously impacted on the mission readiness of the Department of Defense.

**LOSS TO THE GOVERNMENT:** In excess of \$1.5 million.

**SENTENCE:** Mr. William McCullough, President of Spring Works, Incorporated, pled to 1 count of conspiracy and 3 counts of false statements. He was sentenced to 7 months confinement, 5 years probation, a \$10,000 fine, and ordered to perform 400 hours community service. Mr. Stewart Baron, Vice President of Spring Works, Incorporated, pled to 1 count of conspiracy, and 2 counts of false statements. He was sentenced to 5 months confinement, and 5 years probation, a \$7,500 fine, and ordered to perform 300 hours community service.

**U.S. ATTORNEY:** Requested Confinement.

**ST. CHARLES WELDING AND MACHINE COMPANY:** U.S. District Court, Minnesota, 1985. False statements were submitted regarding tests that should have been performed on welds for lockgates which were installed at the U.S. Corps of Engineers Winfield Lock and Dam Project. Had the faulty product not been discovered, loss of life and property could have resulted because the locks would have not held when ships were in the canal.

**LOSS TO THE GOVERNMENT:** Estimated at \$580,000. The old lockgates had to be reinstalled since the St. Charles gates were so defective that they would not hold even temporarily.

**SENTENCE:** David Allen Bishop, owner and President of St. Charles, was sentenced to 2 years confinement, all but 30 days to be suspended during 2 year period of probation.

**U.S. ATTORNEY:** Pursuant to an agreement to plead guilty, the U.S. Attorney did not argue for imprisonment.

**T.J. ENTERPRISES:** U.S. District Court, Ohio Southern District 1986. Stephen T. Hisle, the sole representative of T. J. Enterprises, submitted a vendor's quote from his place of business to the Defense Industrial Supply Center (DISC) certifying that he would provide Detroit Diesel Allison springs of a particular description identified on the DoD contract. Instead, Mr. Hisle supplied a spring that was manufactured at a local coil spring manufacturing facility. The springs were not subjected to the normal testing process, but were submitted to DISC as having been produced and tested by Detroit Diesel Allison, an approved supplier of the springs. One of the springs was ultimately placed in the engine of a Navy Torpedo Retriever.

LOSS TO THE GOVERNMENT: \$44,000.

SENTENCE: Stephen T. Hisle was sentenced to 5 years imprisonment, 4 years and 9 months suspended. Mr. Hisle was ordered to serve 90 days and placed on probation the remainder of the sentence. He also was ordered to pay a fine of \$2,500, provide 100 hours community service, and make restitution in an amount yet to be determined. He pled to a criminal information.

U.S. ATTORNEY: Stephen T. Hisle cooperated in identifying other misconduct and, as such, the U.S. Attorney did not argue for confinement.

**APPENDIX C**  
**MODEL SENTENCING MEMORANDUM**

**Filed in a recent product substitution case in California**

1 ROBERT C. BONNER  
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7 Attorneys for Plaintiff  
8 United States of America

9 UNITED STATES DISTRICT COURT

10 FOR THE CENTRAL DISTRICT OF CALIFORNIA

11 UNITED STATES OF AMERICA,	)	NO. CR 86-1112-WMB
	)	
12 Plaintiff,	)	<u>SENTENCING MEMORANDUM</u>
	)	
13 v.	)	
	)	
14 THE SPRING WORKS, INC.,	)	
WILLIAM MCCULLOUGH,	)	
15 STUART BARON,	)	
	)	Hearing Date: April 8, 1986
16 Defendants.	)	Hearing Time: 11:15 a.m.

17 I

18 INTRODUCTION

19 The government submits this Sentencing Memorandum in order to  
20 advise the court of the government's recommendation regarding the  
21 sentencing of the three defendants, and to present the basis for  
22 that recommendation. In the government's view, the crimes  
23 committed by the defendants were very serious and therefore call  
24 for substantial penalties. The Spring Works' long-standing  
25 practice of fraudulently supplying substandard, unprocessed,  
26 and/or untested springs for use in military projects was  
27 potentially life-threatening and has had dramatic financial

28 MWE:map

1 repercussions in the defense industry. The principals of the  
2 Spring Works--William McCullough and Stuart Baron--callously  
3 disregarded those potentially-disastrous consequences solely to  
4 reduce their costs and to comply with their delivery schedules.

5 In the government's view, such conduct calls for a sentence  
6 that will serve as a deterrent to others who might contemplate  
7 similar "cost-cutting" measures without regard for the obvious  
8 attendant risks. More specifically, the government recommends a  
9 custodial sentence for both McCullough and Baron, with McCullough  
10 receiving the longer period of incarceration. In addition, the  
11 defendants should be required to pay restitution to the  
12 victim-companies who were injured by the Spring Works fraud.

## 13 II

### 14 THE GUILTY PLEA AND MAXIMUM SENTENCES

15 On February 9, 1987, pursuant to a pre-indictment plea  
16 agreement, defendants The Spring Works, Inc., William McCullough  
17 and Stuart Baron pleaded guilty to a four-count indictment  
18 charging them with conspiracy, 18 U.S.C. § 371, and causing false  
19 and fraudulent statements to be made in a matter within the  
20 jurisdiction of the Department of Defense, 18 U.S.C. §§ 1001, 2

21 Count one charged all three defendants with conspiring to  
22 commit mail fraud and to make false statements in connection with  
23 Department of Defense contracts. The indictment alleged that,  
24 since its inception in 1978, The Spring Works has engaged in a  
25 systematic practice of supplying substandard parts for use in  
26 military contracts, and then providing fraudulent certificates  
27 falsely indicating that the parts complied with contract specifications.  
28 /

1 cations. The parts supplied by The Spring Works were substandard  
2 in a number of respects: The quality of the raw material was  
3 inferior; the required processing was not done, or was done by  
4 unapproved vendors; and the required testing was not done. The  
5 false certifications were supplied principally at the direction  
6 McCullough and employees acting under his control.

7 Counts two, three, and four charged the defendants with  
8 making, or causing to be made, specific false statements in  
9 connection with specific Department of Defense contracts,  
10 including the Navy F-18 Fighter project and the Air Force B1  
11 Bomber project. The specific false statements involved the  
12 substitution of inferior raw materials, the failure to perform  
13 plating processing, and the failure to conduct penetrant and  
14 magnetic particle inspection.

15 As a result of the guilty pleas, McCullough faces a maximum  
16 sentence of 15 years incarceration and a \$750,000 fine. Baron  
17 faces a maximum sentence of 10 years incarceration and a \$500,000  
18 fine. The corporate entity, The Spring Works, Inc., faces a  
19 maximum sentence of \$1.5 million in fines.

### 20 III

#### 21 THE DEFENDANTS COMMITTED VERY SERIOUS CRIMES, 22 AND THEY DESERVE SUBSTANTIAL SENTENCES

23 The crimes committed by the defendants were aggravated in  
24 number of respects. First, the Spring Works' practice of  
25 supplying substandard parts was long-standing. Since the founding  
26 of the company in 1978, William McCullough has routinely directed  
27 his employees to disregard the contract specifications on mil  
28 /

1 and other contracts, and to falsify documents to conceal that  
2 fraud. This practice continued until late 1985, when the  
3 government's investigation forced the company to curtail its  
4 illegal activities.

5 Second, the nature of the fraud posed substantial risks to  
6 safety of American servicemen, and to the readiness of the  
7 American military generally. For example, the use of inferior  
8 materials in the manufacture of springs can cause the springs to  
9 fail under stress prematurely, or at particularly inopportune  
10 moments. Similar risks are posed by the failure to test the  
11 springs by penetrant and magnetic particle inspection, which  
12 would reveal microscopic cracks in springs that commonly result  
13 from their manufacture. Where, as here, inferior metals are used  
14 or the required tests are not conducted, an inferior or cracked  
15 spring may unknowingly be installed in an airplane's hydraulic  
16 landing gear or flaps. If the spring fails under stress, the  
17 landing gear or flaps may malfunction with potentially  
18 life-threatening consequences.

19 A third aggravating fact is the relatively insignificant  
20 economic advantage gained by Spring Works' fraud. For example  
21 the difference in cost between two qualities of stainless steel  
22 often quite small, and the cost of performing penetrant or  
23 magnetic particle inspection is usually less than \$50. The  
24 defendants chose to disregard those contract requirements because  
25 they could reduce their costs and improve their delivery time,  
26 ultimately improving their competitive position within the spring  
27 industry. Since the additional cost of complying with the  
28 /



1 contract requirements was so insignificant, the defendants were,  
2 in effect, risking the lives of American airmen and the combat  
3 readiness of the American military in order to save only a few  
4 dollars.

5 Fourth, the defendants persisted in the fraud despite the  
6 complaints and protests of Spring Works' employees, salesmen, an  
7 customers alike. In the course of the government's investigatio  
8 several witnesses stated that they initially refused to obey  
9 McCullough's instructions that the substandard parts be supplied  
10 and falsely certified. McCullough, however, would threaten to  
11 fire them, and would intimidate and bully them into obeying his  
12 instructions.

13 Similarly, in approximately 1982, one of Spring Works'  
14 customers came upon some substandard parts and some apparently  
15 falsified product certifications. The customer complained to th  
16 Spring Works' salesman, who relayed the complaint to McCullough.  
17 McCullough assured the customer and the salesman that there had  
18 simply been a mistake, and that it would not happen again.  
19 However, as the evidence indicates, the fraudulent practice  
20 continued unabated.

21 Finally, the Spring Works fraud has dramatically impacted t  
22 customers of the Spring Works and as the defense industry at  
23 large. The impact on Spring Works' customers has been quite  
24 direct. Those customers incurred enormous costs attempting to  
25 rectify and determine the scope of Spring Works' fraud. Where  
26 springs were still in stock, the companies were forced to test  
27 springs, using outside and/or in-house testing facilities. Whe  
28 /

1 the springs had already been assembled into a project, the proje  
2 sometimes had to be disassembled in order to test or replace the  
3 springs. Where the customers had shipped the springs to another  
4 contractor, that second contractor had to be notified of the  
5 fraud, meetings had to be arranged to discuss the problem, the  
6 springs had to be traced into particular portions of particular  
7 projects, and the projects then had to be partially disassembled  
8 to gain access to the spring and conduct any tests or make any  
9 replacements.

10 The Spring Works' customers have responded to the fraud in a  
11 reasonable and responsible manner, but the cost--especially the  
12 man-power cost--has been enormous. Perhaps the best example of  
13 this is Rockwell's use of Spring Works parts on the Space  
14 Shuttle. Rockwell's estimate of its cost of tracing, accessing,  
15 and replacing the Spring Works products is 200 man months, or  
16 roughly \$1.5 million. Moreover, Rockwell has indicated that  
17 another Spring Works product may still have to be replaced on the  
18 Shuttle, and it is possible that the replacement will cause some  
19 delay in the next scheduled Shuttle launch. (Other similar costs  
20 are described more fully in the government's memorandum regarding  
21 restitution.)

22 There are less tangible but equally important consequences  
23 public, government, and contractor confidence in the spring  
24 industry and in the defense subcontractor community generally.  
25 For example, some contractors have given their business to spring  
26 manufacturers outside of the district because of the cloud cast  
27 the Spring Works fraud. Other subcontractors who purchased and  
28 /

1 used Spring Works products have been forced to rehabilitate their  
 2 own reputations, explaining to their customers that Spring Works  
 3 was the culprit, not them.

4 The Spring Works fraud has struck at the heart of the defense  
 5 industry, because it calls into question the reliability of the  
 6 only practicable means of verifying the quality of military  
 7 products. Contractors cannot be required to test or retest the  
 8 parts supplied by subcontractors because the resulting cost would  
 9 be astronomical. Thus, quality assurance depends on the  
 10 established system of product certification: Parts supplied by  
 11 contractors must be accompanied by certificates that indicate that  
 12 proper materials were used, required processing was performed,  
 13 approved vendors were used, and the necessary testing was done.  
 14 The certification system, then, depends upon the authenticity of  
 15 the certificates. The central question that arises from the  
 16 Spring Works fraud is: If subcontractor certificates cannot be  
 17 relied upon, then what confidence can the contractor, or the Air  
 18 Force, or the American people have in the reliability of American  
 19 military products?

20 IV

21 McCULLOUGH DESERVES A MORE SEVERE

22 SENTENCE THAN BARON

23 As between McCullough and Baron, McCullough clearly deserves  
 24 more severe sentence. McCullough was the dominant personality at  
 25 Spring Works, and he was responsible for the lion's share of the  
 26 fraud.

27 /

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1       It is true, of course, that McCullough and Baron had a  
2 comparable interest in the Spring Works: McCullough owned 51%  
3 the company. Baron owned 49% of the company. However, McCullo  
4 was the founder, President, and driving force of Spring Works.  
5 Although Baron was vice-president and ran the manufacturing end  
6 of Spring Works, McCullough was the person who was responsible  
7 receiving the work orders and directing the employees to deviat  
8 from contract specifications. To do so, he altered the work  
9 orders to require, for example, the substitution of inferior ra  
10 material. McCullough also had the responsibility for sending t  
11 parts out for processing and testing, and for gathering the  
12 necessary certifications to be supplied to the customers. Thus  
13 it was McCullough who directed Spring Works employees to use  
14 unapproved vendors, or to refrain from having plating, testing,  
15 heat treatment performed. And it was McCullough who wrote on t  
16 work orders that employees should "dupe" the certificates, or s  
17 out "dummy" batches of springs in order to obtain misleading  
18 certifications. And it was McCullough who signed the overall  
19 certificates of compliance falsely indicating that the springs  
20 complied with contract specifications.

21       Baron's role, on the other hand, was limited to carrying ou  
22 McCullough's directions in the shop area, along with assuming m  
23 complete control over the fraud whenever McCullough was absent.  
24 Furthermore, Baron appears to be easily dominated by McCullough  
25 For these reasons, Baron should receive a more lenient sentence

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v

1  
2 McCULLOUGH HAS SHOWN LITTLE REMORSE, AND HE HAS NOT ACCEPTED  
3 FULL RESPONSIBILITY FOR HIS MISCONDUCT

4 McCullough also appears to show little remorse, and he  
5 exhibits a disturbing inclination to shift the blame to others.  
6 McCullough's attitude seems to be that he has been unfairly  
7 singled out for technical crimes that are committed by everyone  
8 the industry.

9 For example, McCullough claims he learned his fraudulent  
10 practices from Bob DeLong, a spring manufacturer who employed  
11 McCullough and Baron until 1977. However, the facts are  
12 otherwise: The government understands and believes that DeLong  
13 has an excellent reputation in the industry, and that practices  
14 such as Spring Works' are not universally practiced in the  
15 industry.

16 Similarly, the defendants have tried to blame a former  
17 employee, Quality Assurance Manager David Rupp, for much of the  
18 fraud. Yet Rupp worked for the Spring Works for less than a year  
19 and left because he could no longer tolerate McCullough's  
20 fraudulent practices. In fact, Rupp is the person who ultimately  
21 blew the whistle on the Spring Works, under circumstances that  
22 are instructive: According to Rupp, he had been struggling with his  
23 conscience about whether to tell someone about the Spring Works  
24 fraud, when he saw a news report about the crash of a Japan  
25 Airlines flight. That crash reminded Rupp of how dangerous the  
26 Spring Works' practices were, and he therefore contacted DeLong  
27 and Parker Hannifin (Spring Works' major customer), who contacted  
28 the Defense Criminal Investigative Service. Furthermore, several

1 former employees of Spring Works who preceded Rupp, stated that  
2 McCullough had been perpetrating this fraud since the founding o  
3 the company.

4 These facts stand in stark contrast to defendants' suggestio  
5 that the fraud slowly evolved after several years of legitimate  
6 business dealings, and only because the company over extended  
7 itself in entering into military contracts.

8 Finally, McCullough's attitude that "every one does it" and  
9 that Spring Works is a "small fish" or a "sub-sub-sub-Contractor"  
10 simply serves to highlight McCullough's failure to appreciate the  
11 seriousness of his misconduct, his unwillingness to take full  
12 responsibility for his crimes, and the need to impose a sentence  
13 that will deter similar misconduct throughout the industry.

14 VI

15 SENTENCES FOR COMPARABLE CRIMES HAVE  
16 RANGED FROM 18 MONTHS TO 15 YEARS INCARCERATION

17 The court may be interested to know the range of sentences  
18 imposed upon major defendants in comparable cases in this distri  
19 and elsewhere.

20 The most analogous case from this district is United States  
21 District International Supply Co. Inc., No. CR 85-503-RG. In  
22 District International, a steel manufacturer and its two  
23 principals pleaded guilty to five counts of mail fraud. The  
24 indictment alleged that the company sold inferior grade steel to  
25 the Department of Defense and then provided fraudulent  
26 certificates that the steel met contract requirements. The sche  
27 lasted for two years, from 1982 to 1984. District Judge Gadbois  
28 sentenced the individual defendants to 18 months and 6 months

1 custody respectively, and required each to pay \$118,000 in  
2 restitution.

3 The government is aware of four comparable cases outside of  
4 this district. In a 1986 case from the District of Colorado, the  
5 president of a defense contractor, Beta Corp., was charged with  
6 knowingly supplying defective parts for use in military aircraft.  
7 The president was sentenced to 3 years incarceration, a \$30,000  
8 fine, and full restitution.

9 In a 1986 case from the Eastern District of Virginia, the  
10 president of an ordnance company, Nordac Manufacturing, was  
11 charged with knowingly supplying defective M-16 ammunition, and  
12 with making false statements in connection with the Department of  
13 Defense contracts. The president was sentenced to two years  
14 incarceration.

15 In a 1985 case from the Eastern District of Pennsylvania, the  
16 president of Alchemy, Inc. was charged with supplying defective  
17 valves in the F-4 fighter ejection system, and with supplying  
18 substandard material used in water nozzles. False certification  
19 of compliance were also supplied in connection with those sales.  
20 The president was sentenced to 15 years incarceration and was  
21 required to pay \$412,000 in restitution.

22 Finally, in a 1984 case from the District of Georgia, the  
23 sales manager and quality control manager of Metal Services  
24 Center were charged with supplying inferior grade steel for use  
25 military ships. One defendant was sentenced to 10 years  
26 incarceration; the other was sentenced to 3 years incarceration.

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## VII

CONCLUSION

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3 The safety of American servicemen, the reliability of American  
4 defense products, and the readiness of the American military  
5 generally, depends upon the willingness of defense subcontractors  
6 to supply dependable parts and materials for use in Department of  
7 Defense products.

8 Subcontractors cannot be permitted to supply substandard parts  
9 because "everyone does it" or because they are too far down the  
10 contracting chain to be concerned about the consequences. Nor can  
11 the defense industry tolerate subcontractor fraud that  
12 threatens the very basis of verifying product quality: reliance  
13 on the authenticity of subcontractors' certifications.

14 William McCullough has perpetrated a long-standing and serious  
15 fraud on the government. The customers of the Spring Works have  
16 suffered millions of dollars of damage. The lives of American  
17 servicemen have been placed in jeopardy, and we can only give  
18 thanks that no serious accidents have occurred.

19 This case therefore serves as an appropriate vehicle to send  
20 message to the subcontracting community that the federal  
21 government will not tolerate substandard products or falsified  
22 certifications, especially when those products are assembled in  
23 sophisticated military projects where the failure of a spring can  
24 jeopardize lives and property.

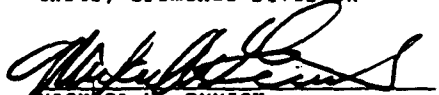
25 DATED: This \_\_\_\_\_ day of April, 1987.

26 Respectfully submitted,

27 ROBERT C. BONNER  
28 United States Attorney



ROBERT L. BROSIO  
Assistant United States Attorney  
Chief, Criminal Division



MICHAEL W. EMMICK  
Assistant United States Attorney  
Public Corruption &  
Government Fraud Unit

Attorneys for Plaintiff  
United States of America

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CERTIFICATE OF SERVICE BY MAIL

1  
2 I, MARTHA A. PADGETT, declare:

3 That I am a citizen of the United States and resident or  
4 employed in Los Angeles, California; that my business address is  
5 Office of United States Attorney, United States Courthouse, 312  
6 North Spring Street, Los Angeles, California 90012; that I am over  
7 the age of eighteen years, and am not a party to the above-  
8 entitled action;

9 That I am employed by the United States Attorney for the  
10 Central District of California who is a member of the Bar of the  
11 United States District Court for the Central District of  
12 California, at whose direction the service by mail described in  
13 this Certificate was made; that on April 3, 1987, I  
14 deposited in the United States mails in the United States  
15 Courthouse at 312 North Spring Street, Los Angeles, California, in  
16 the above-entitled action, in an envelope bearing the requisite  
17 postage, a copy of

## SENTENCING MEMORANDUM

18  
19  
20 addressed to Michael D. Nasatir, Esq. & Fred Friedman, Esq.  
21 2115 Main Street  
22 Santa Monica, CA 90405

23 at their last known address, at which place there is a delivery  
24 service by United States mail.

25 This Certificate is executed on April 3, 1987 at Los  
26 Angeles, California.

27 I certify under penalty of perjury that the foregoing is true  
28 and correct.

*Martha A. Padgett*

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**APPENDIX D**

**MODEL SENTENCING MEMORANDUM**

**Guidance issued to United States attorneys regarding  
sentencing on product substitution cases**

## TELEGRAPHIC MESSAGE

NAME OF AGENCY Department of Justice Criminal Division	PRECEDENCE ACTION INFO	SECURITY CLASSIFICATION  Unclassified
ACCOUNTING CLASSIFICATION 7B1311	DATE PREPARED 8/17/87	TYPE OF MESSAGE <input type="checkbox"/> SINGLE <input type="checkbox"/> BOOK <input checked="" type="checkbox"/> MULTIPLE-ADDRESS
FOR INFORMATION CALL		
NAME William C. Hendricks III	PHONE NUMBER (202) 786-4377	
THIS SPACE FOR USE OF COMMUNICATION UNIT		

MESSAGE TO BE TRANSMITTED (Use double spacing and all capital letters)

TO: All United States Attorneys

The Departments of Defense and Justice have agreed to attach the highest investigative and prosecutive priority to product substitution cases -- where the Department of Defense has been provided with substandard, defective or untested products. It is important that all United States Attorneys seek incarceration for those individuals who have been convicted of providing substandard products to the military services. To assist further in this joint effort, referred to in a July 10, 1987 letter sent by the Deputy Inspector General, Department of Defense, to all United States Attorneys, you are requested to consider the following:

SECURITY CLASSIFICATION

PAGE NO.	NO. OF PGS.
1	2

Unclassified

## TELEGRAPHIC MESSAGE

NAME OF AGENCY Department of Justice Criminal Division	PRECEDENCE ACTION: INFO:	SECURITY CLASSIFICATION  Unclassified
ACCOUNTING CLASSIFICATION 7B1311	DATE PREPARED 8/5/87	TYPE OF MESSAGE <input type="checkbox"/> SINGLE <input type="checkbox"/> BOOK <input checked="" type="checkbox"/> MULTIPLE-ADDRESS
FOR INFORMATION CALL		
NAME William C. Hendricks III	PHONE NUMBER (202) 786-4377	
THIS SPACE FOR USE OF COMMUNICATION UNIT		

MESSAGE TO BE TRANSMITTED (Use double spacing and all capital letters)

TO:

(1) ensure that information about the mission impact of the substandard product is included in the government's sentencing memorandum (Department of Defense criminal investigators have been given the responsibility of providing this information to the assigned prosecutor);

(2) make use of Department of Defense expert witness testimony at sentencing hearings, if necessary, to establish the adverse mission impact in product substitution cases; and

(3) make no agreements to restrict the information presented to the sentencing court as part of any plea agreement or at allocution.

FROM:

*William F. Weld*  
William F. Weld  
Assistant Attorney General  
Criminal Division

AUG 18 1987

SECURITY CLASSIFICATION

PAGE NO.	NO. OF PGS.
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Unclassified



Mr. HUGHES. Based upon this and all the other cumulative information, the subcommittee fashioned H.R. 3911 from our earlier bill, H.R. 3500. H.R. 3911 creates a new Federal procurement fraud offense involving contracts of \$1 million or more and is patterned after the Bank Fraud Act. This, I am told, would cover some 9,900 prime contracts under current conditions. The bill contains an enhanced penalty of up to seven years imprisonment for individuals upon conviction and would provide an extension of the statute of limitations in which prosecutions for procurement fraud could be initiated to within seven years rather than the normal five years.

There is an increase in discretionary fines that could be leveled upon conviction in egregious cases in an amount up to a maximum of double the value of the contract. The bill also has a system of rewards under which up to \$250,000 can be paid from the criminal fine to individuals who provide information leading to a conviction as well as private whistleblower protection for these informants based upon provisions included in the False Claims Act Amendments of 1986.

I recognize that these provisions appear stringent to some, but I would emphasize that they only come into play after a conviction for criminal fraud involving a major contract. We are here today to analyze the bill, perfect it if we can, and resolve a number of issues so that we can develop a balanced and effective tool that will protect the taxpayers, the honest businessman and woman, and our procurement process. I am looking forward to the comments which our witnesses will provide for us today.

Mr. HUGHES. The gentleman from Florida?

Mr. McCOLLUM. Thank you, Mr. Chairman. I think that what we are doing in this legislation is a very significant change to the criminal deterrent laws regarding fraud in the procurement area, and I believe that the business community appropriately should be heard. Those most effected, we need to know what their fears, what their concerns are, what way we may craft so we do not unduly hamper the world of business.

But at the same time, I share with the chairman the concern that fraud is very difficult for us to reach. Many times—it is always after the fact. We read about it in the newspapers. Our constituents come to our town meetings and say, why did you not do something about it? We are not able to directly do something about it. We are only able to provide tools to those involved. And when they are interested and request those tools, I think it is our obligation to respond in some responsible manner.

So we are looking forward to hearing from you today how we can balance the interests involved. Thank you.

Mr. HUGHES. Our witnesses today will serve on a panel in order that we can receive a maximum response to each of our questions and enough time for a meaningful dialogue.

The first panelist is Clarence Kipps who is representing the United States Chamber of Commerce. Mr. Kipps is presently a senior member of the firm of Miller and Chevalier, and is a graduate of George Washington University Law School where he was on their law review. Mr. Kipps was a law clerk for the United States Court of Claims and has had an extensive and distinguished career in the private practice of law.

Our second panelist is Alan Yuspeh who is representing the Electronic Industries Association and the American Electronics Association. Mr. Yuspeh is a partner in the Washington, DC. office of the law firm of Preston, Thorgrimson, Ellis and Holman. Mr. Yuspeh graduated from Georgetown University School of Law where he was an editor of the Law and Policy and International Business Review. Since law school Mr. Yuspeh has had a distinguished career both in private practice and as a Senate staffer, most recently as the general counsel to the Committee on Armed Services of the United States Senate.

Our last panelist is Christopher Cross who is representing the Professional Services Council. Mr. Cross is president and chief operating officer for University Research Corporation and is a graduate of Whittier College. He also received a master's degree from California State College. Mr. Cross' prior experience has been with Westinghouse Information Systems, ABT Associates, minority staff director for the House Committee on Education and Labor, and as a deputy assistant for legislation, and special assistant for student affairs at the Department of Health, Education and Welfare.

Gentlemen, we welcome you here this morning. We have your prepared statements which we have all read. And we hope that you can summarize for us. They will be made a part of the record in full. Why do we not begin with you, Mr. Kipps?

**TESTIMONY OF CLARENCE T. KIPPS, JR., ESQUIRE, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE; ALAN R. YUSPEH, ESQUIRE, ON BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION AND THE AMERICAN ELECTRONICS ASSOCIATION; AND CHRISTOPHER CROSS, ON BEHALF OF THE PROFESSIONAL SERVICES COUNCIL**

Mr. KIPPS. Mr. Chairman and members of the subcommittee, I am pleased to testify here today on behalf of the Chamber of Commerce. The Chamber has approximately 188,000 businesses, State and local chambers of commerce, and trade and professional associations as its membership.

Most certainly the Chamber and all of this in this room want to deter fraud and to discover and prosecute those Government contractors who are guilty of fraud. At the same time we all know that notwithstanding how carefully crafted and implemented contractors procedures are, there is no way the contractor can guarantee that none of his employees is going to commit a fraud. So regardless of whether the contractor is small or large, there is some vulnerability to the contractor of his employee committing a fraud.

Our concern is that this bill goes too far and is more harmful than it will be beneficial. Our concern starts with the heart of the bill, which is a fine double the value of the contract. As this committee well knows, some Government contracts exceed \$1 billion. The C-5B contract was \$7 billion. The C-17 contract is \$35-plus billion. The air tactical fighter contract is estimated to be \$30-some billion.

The most prevalent Government contract fraud is mischarging of labor costs. Some labor costs are indirect costs and are thus charged to all contractor's contracts. A fine double the value of the

contract could bankrupt the largest defense contractor for a single occurrence. By the same token, small business contractors have contracts exceeding \$1 million. A single occurrence could bankrupt a small business contractor.

I guess the bottom line on our position is that we really at this stage of the game do not see a need for a bill as stringent and as harsh and with the potential downside that this bill has. Criminal and civil penalties have been dramatically increased by Congress over the last three or four years.

For example, the fines on the False Claims Act, false statements and other felonies have been increased from \$10,000 per count to \$500,000 per count for corporations and \$250,000 per count for individuals. The other recent changes in the fines and deterrents are detailed in our prepared statement.

Existing fines and penalties provide more than adequate deterrence and punishment. Frauds are committed by individuals. And if the existing \$250,000 fine per count will not deter a person, no fine will do so. Also the existing law enables the Government to recover considerably more than its damages. Existing laws provide for double and treble damages plus recovery of costs connected with the investigation and prosecution.

The unfair leverage provided bureaucrats and the prosecutor under this kind of a law is enormous. A company threatened with penalties provided by H.R. 3911 may have to plead guilty to some other felony and agree to some other fine in order to avoid the risk involved in H.R. 3911. We see this now where suspension and debarment are misused to compel a contractor to agree to an unwarranted plea and to an excessive amount of recovery in order to avoid suspension and debarment.

What do you think would happen to the value of the company's stock when the media publishes the potential fines that could bankrupt the company. That is what they publish, they publish the maximum fines. There are too many hanging judges around for us to think that some judge would not impose what we consider to be ridiculously high fines.

H.R. 3911 has the highly undesirable feature of reducing the standard for this crime to a civil standard and imposing the largest fine of all time. The standard for most criminal fraud is knowing and willful standard. This is the standard in 18 USC 1001, which is the most frequently used procurement fraud allegation by the Government, and it has not been a problem in sustaining prosecution and guilty verdicts under that section.

A major problem not addressed by this bill and not heretofore addressed by Congress, is the resources needed by the Department of Justice to review and act on, and in the appropriate cases, prosecute the cases now pending before the Department of Justice. The Department of Justice has done a remarkably good job with inadequate resources. This day and for some time in the past, the Department has been severely understaffed, both in the criminal and the civil divisions.

Mr. Chairman, the Chamber is hopeful the committee will consider carefully the recent changes in the law and the extraordinary efforts that industry is making in this area to prevent procurement fraud. We believe that the committee should reexamine 3911 in

light of the current circumstances. The committee should support the efforts to bring out industry self-governance and give the Department of Justice the resources it needs to enforce the laws already on the books. Thank you.

[The statement of Mr. Kipps follows:]

Mr. Chairman and Members of the Subcommittee, my name is Clarence T. Kipps, Jr. I am a senior member of the law firm of Miller and Chevalier, Chartered. I am testifying today as a member and representative of the U.S. Chamber of Commerce. I am appearing today on behalf of the nearly 180,000 businesses, state and local chambers of commerce, and trade and professional associations represented by the Chamber.

I request that my full statement be entered into the record of this hearing. For the purposes of our discussion today, I will present a summary of its main points.

The Chamber's specific objections to H.R. 3911 include the following:

- o Existing penalties are sufficient to deter or to punish procurement fraud.
- o H.R. 3911 unfairly penalizes honest and responsible companies.
- o This bill will not increase the number of fraud prosecutions.
- o This bill would impose fines that are totally unrelated to the severity of the fraud, and the Subcommittee's amendments do not cure this deficiency.
- o H.R. 3911 would penalize small businesses in ways that are both illogical and overwhelming.
- o This bill invites bureaucratic abuse and unfair settlement pressures.
- o The statute of limitations should not be extended.
- o Criminal liability for fraud should be limited to willful conduct.
- o The "bounty hunter" provision will undermine efforts of corporate self-governance.
- o The "whistleblower" provision must provide protection from frivolous allegations.

#### CONCLUSION

Mr. Chairman, we are hopeful that the Subcommittee will consider carefully the recent changes in the law and the extraordinary efforts that industry is making to cure itself of the problems of fraud and mismanagement. We recommend that Congress ask the Department of Justice what it needs to prosecute the cases of which it becomes aware. With that answer, Congress could act to give the Department of Justice what it needs.

We believe that Congress should not pass H.R. 3911. Rather, it should make every effort to encourage industry self-governance and to give the Department of Justice the resources it needs to enforce the laws already on the books.



# Statement of the U.S. Chamber of Commerce

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ON: THE MAJOR FRAUD ACT OF 1988 (H.R. 3911)

TO: SUBCOMMITTEE ON CRIME OF THE HOUSE  
COMMITTEE ON THE JUDICIARY

BY: CLARENCE T. KIPPS, JR.

DATE: MARCH 16, 1988

---

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees, 59 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 10,000 members. Yet no one group constitutes as much as 31 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT  
ON  
THE MAJOR FRAUD ACT OF 1988 (H.R. 3911)  
before the  
SUBCOMMITTEE ON CRIME  
of the  
HOUSE COMMITTEE ON THE JUDICIARY  
for the  
U.S. CHAMBER OF COMMERCE  
by  
CLARENCE T. KIPPS, JR.  
March 16, 1988

Mr. Chairman and Members of the Subcommittee, my name is Clarence T. Kipps, Jr. I am a senior member of the law firm of Miller and Chevalier, Chartered. I am testifying today as a member and representative of the U.S. Chamber of Commerce.

The Chamber is the world's largest federation of business companies, chambers of commerce, and trade and professional associations. More than 92 percent of the Chamber's members are small firms with fewer than 100 employees, 59 percent with fewer than 10 employees. Moreover, virtually all of the nation's largest companies are active members. The Chamber is cognizant of the problems facing small businesses, as well as the problems facing the business community-at-large.

Many of the Chamber's members, both large and small businesses, provide a variety of goods and services to the federal government. However, many have been deterred from doing business with the government due to the overregulated and burdensome system of government contracting.



The Chamber's members are very concerned about H.R. 3911. While we all support the government's efforts to deter and punish frauds against it, we question both the rationale for and the approach taken in this bill. This bill provides neither a deterrent nor an appropriate punishment for fraud against the government. Further, we are concerned about the impact this bill would have on honest businesses of all sizes attempting to do business with the United States. The approach taken in the bill will serve only to drive small businesses from the government market and expand the potential for bureaucratic abuse of the government contracting system.

The Chamber's specific objections to H.R. 3911 include the following:

I. Existing penalties are sufficient to deter and punish procurement fraud.

No evidence whatsoever suggests that existing criminal and civil statutes are inadequate to deter, prosecute, and punish procurement fraud. The Subcommittee's work was based upon a review of past procurement fraud prosecutions but did not take into account the many new statutes and penalties that have been enacted since 1984. These new laws provide substantially increased penalties.

Among the new penalties are the following:

- \* Fines for false claims, false statements, and other felonies were increased from \$10,000 per count to \$500,000 for corporations and \$250,000 for individuals, effective December 31, 1984.
- \* The Fiscal Year 1986 Department of Defense (DOD) Authorization Act permanently increased the maximum fines for false claims relating to contracts with DOD to \$1 million.
- \* The Criminal Fines Improvements Act of 1987 (P.L. 100-185) permits a fine of up to twice the gross pecuniary gain to the defendant or twice the gross pecuniary loss to the United States for crimes including false claims against the government.
- \* 18 U.S.C. Section 3663 permits a court to order restitution to the United States for losses suffered as a result of false claims and other crimes. Restitution can be ordered as part of sentences for crimes committed after January 1, 1983.
- \* The False Claims Amendments Acts of 1986 permits the government to recover treble damages, plus up to \$10,000 per false claim, in a civil action. This recovery is virtually automatic after a criminal conviction.

- \* On false claims of up to \$150,000, the government may recover double damages, plus up to \$5,000 per false claim, in an administrative proceeding under the Program Fraud Civil Remedies Act of 1986. The government also may recover administratively a penalty of \$5,000 for any false statement not related to a claim.
  
- \* The Anti-Kickback Enforcement Act of 1986 provides a fine of \$500,000 for a corporation and \$250,000 plus 10 years imprisonment for an individual who offers or solicits kickbacks in connection with government contracts.

Because these laws are relatively new, their impact will not be entirely felt for several years. There does not appear to be a need for new legislation, and certainly there is no need to act now without evidence that existing law is inadequate.

Many of these new laws create significant new penalties that were not available to the courts in the cases studied by the Subcommittee. For example, in 1983, one contractor pleaded guilty to 100 counts of false statements and false claims in connection with the failure to test electronic components properly. The contractor paid \$1 million, the maximum fine at that time. Today, a conviction on 100 counts would subject the same contractor to a fine of up to \$100 million if the fraud were committed on a DOD contract; or \$50 million if on a civilian contract or up to double the government's loss or the defendant's gain, whichever is greater.

In addition, the court could order restitution of any damages suffered by the government, and the government could recover in a civil suit under the False Claims Act civil penalties up to \$1 million for the 100 false claims, plus three times any damages suffered as a result of the fraud. In addition, the contractor may be debarred from doing business with the United States for up to three years.

These penalties are obviously substantial and are more than sufficient to punish offenders, to deter violations, and to repay the United States for any losses suffered by reason of fraud in government contracts.

II. H.R. 3911 unfairly penalizes honest and responsible companies.

The question of effective deterrent involves several considerations. One question is who is to be deterred? Another is what conduct does the deterrence seek to encourage or discourage?

H.R. 3911 is aimed clearly not at the individuals who commit fraud but at the businesses that employ them. Individuals are subject today to fines of up to \$250,000 per count plus treble damages under the False Claims Act. This amount exceeds most people's ability to pay, and the multimillion or even multibillion dollar fines that could result from H.R. 3911 are consequently meaningless with respect to most individuals.

If the bill is aimed at corporations, how are corporations expected to respond? An increased awareness of the problem of procurement fraud has prompted industry in recent years to undertake extraordinary steps to police itself. Ethics programs, education, disciplinary actions, ombudsmen, "hot lines," independent internal auditors, and many other practices have been created to assist management in preventing corporate fraud and detecting infractions when they do occur. The prospect of debarment from future contracts and of large civil damages under the False Claims Act provide more than enough incentives to companies to further expand and to strengthen these programs.

No business can guarantee the actions of each of its employees. Almost without exception, the publicized cases of procurement fraud have been committed by low-level employees without the knowledge or participation of corporate management.

Under H.R. 3911, a corporation which implements and vigorously enforces a corporate ethics and audit program will remain subject to ruinous fines if a group of renegade employees evades these protective systems. This result is unfair and unproductive.

III. This legislation will not increase the number of fraud prosecutions.

A fundamental premise offered in support of the legislation is that it will increase the number of prosecutions for procurement fraud. This premise is incorrect. Enactment of H.R. 3911 will not result in prosecutions that would not occur under current law.

Evidence presented at a variety of Congressional hearings demonstrates that DOD and civilian agency investigations and referrals for "fraud" are increasing. We are unaware of evidence indicating that the investigative agencies lack the authority to undertake their responsibilities.

The number of successful criminal prosecutions have been limited for several reasons. In many cases, there is simply insufficient evidence to support a criminal prosecution. In some cases, the government prefers to use its civil remedies under the False Claims Act or its administrative and contractual remedies, such as debarment.

If there is a problem with prosecutions, it is a lack of adequate resources in the Department of Justice. In fact, this resource problem was one of the motivations for Congress' enactment of the Program Fraud Civil Remedies Act--an alternative mechanism for punishing fraud without the need to use scarce prosecutorial resources.

Nothing in this legislation will address the real limitations that affect the number of criminal prosecutions for fraud by the Department of Justice.

IV. H.R. 3911 would impose fines that are totally unrelated to the severity of the fraud.

We believe that H.R. 3911 would impose such large fines as to violate the spirit and perhaps the letter of the Constitution's prohibition of "excessive fines."

Congress in considering the appropriate fine to be imposed for crimes against the government is required by the Constitution to ensure that the punishment fits the crime. Most recently, in the Program Fraud Civil Remedies Act, the False Claims Amendments Act, and the Criminal Fine Improvements Act, Congress has chosen to relate the amount of the fine to multiples of the amount of the fraud. It is difficult to imagine that a more severe fine would pass Constitutional muster.

H.R. 3911 totally divorces the penalty from the severity of the offense. A \$1 million fraud in connection with a \$100 million contract can subject the defendant to a \$200 million fine. A \$1 million fraud on a \$1 million contract will result in a penalty of only \$2 million. A \$900,000 fraud on a \$900,000 contract will not be covered by the bill at all and will result in only a \$500,000 fine. This illogical disparity results from divorcing the penalty from the seriousness of the offense and is Constitutionally suspect.

V. The Subcommittee's amendments do not cure these deficiencies.

During the Subcommittee's markup of H.R. 3911, an effort was made to alleviate these problems by providing that the fines would not ". . . exceed twice the value of the contract or services and the amount of the fraud is substantial in relation to the value of such contract or services." (emphasis added). The difficulty, nevertheless, remains because the term "substantial" is left undefined. Is a \$1,000 fraud substantial in relation to a \$10,000 subcontract? Is a \$1,000 fraud

substantial in relation to a \$100,000 contract? Is a \$1 million fraud "substantial" regardless of the value of the contract? The "clarification" unfortunately raises as many questions as it resolves.

We believe that the appropriate solution is to link specifically the amount of the fine to the amount of the fraud or to establish fines of fixed amounts.

VI. H.R. 3911 would penalize small businesses in ways that are both illogical and overwhelming.

Small businesses have both prime contracts with federal government agencies and subcontracts with many larger companies. Regardless of the size of their subcontract, their liability under H.R. 3911 could be double the value of the much larger prime contract. Even small businesses making routine minor sales to government contractors could be held liable where those sales were made part of a government contract valued at \$1 million dollars or more.

Aside from the Constitutional problem, the results can be truly illogical. Consider the exposure of small businesses acting as suppliers or subcontractors on major government projects. For example, a small construction firm could be paving a driveway for a large government office building. The subcontract could be less than \$10,000 out of a \$20 million contract for the building. If it is guilty of mischarging \$1,000 on its work, it could be liable for a \$40 million fine.



The bill also would permit government prosecutors to multiply the small business's liability by alleging a fraud for each part delivered. The mere exposure to such overwhelming liability inevitably will drive many small businesses out of the government market.

In sum, the liability created and the manner in which it may arise are so broad that small businesses will not be able to determine the range of their potential liabilities.

VIII. The bill invites bureaucratic abuse and unfair settlement pressures.

Those who argue for tying the amount of a fine to the value of a contract ignore the bureaucratic abuses that such disproportionate fines can create.

Government prosecutors easily could threaten a company with prosecution under H.R. 3911, raising the specter of multimillion or multibillion dollar fines. A company threatened with such penalties could be blackmailed into a settlement because of fear of bankruptcy--an action that would not be supported by the facts of the case if decided by a court. The threat of such immense fines deprives the defendant of the ability to mount a defense. Confronted with a threatened indictment under H.R. 3911, with the massive attendant penalties, a company may be forced to plead guilty under other statutes, such as the false claims or false statement laws, despite having valid defenses. The risks of a jury

trial simply would be too high when the very existence of the company is at stake. No company can risk a fine that equals or exceeds the value of all of the company's assets.

For many companies, government contracts are the major source of business. Companies indicted for fraud against the government are likely to lose their eligibility for doing business with the federal government through the suspension and debarment process. The preparation and trial of criminal cases frequently take years to accomplish. To avoid suspension or debarment, companies have sought, for years, to settle these cases. Under such settlement agreements, companies often pay heavy fines, admit responsibility, and accept further government supervision of their daily operations.

Anyone familiar with the court decisions of the Texaco-Pennzoil dispute knows how the possibility of such liability can readily push an industry giant into bankruptcy. Many government contractors perform functions unique and essential to national defense. Guilty parties must be punished with a severity proportionate to their crimes. But public policy is not well served by disproportionate fines that can drive companies out of business.

VIII. The statute of limitations should not be extended.

Section 2(a) of the bill unfairly and unnecessarily extends from five to seven years the statute of limitations for prosecution of covered contract fraud. The provision would create, without justification, a new and different class of fraud under federal law.

Why should government contract fraud be a special class unto itself? The statute of limitations for other federal felonies, including bank fraud, securities fraud, and racketeering, is five years. No evidence has been presented to suggest that prosecution of procurement fraud requires more time than these other equally severe offenses.

No case has been made that extending the statute of limitations would result in more prosecutions. Executive branch witnesses at the December of 1987 Subcommittee hearings spoke of a need for additional investigative and prosecutorial officials within the executive branch. It has not been demonstrated that the current statute of limitations is in any way detracting from the Department of Justice's ability to prosecute fraud cases. The problem is more one of bureaucratic inefficiency and budgetary limitations.

For a defendant, lengthening the statute of limitations would create serious problems in preparing a defense. It would extend a defendant's liability for two years, without preserving the trail of evidence, which would grow colder as memories fade and witnesses become more difficult to locate.

For these reasons, the statute of limitation should remain at five years.

IX. Criminal liability for fraud should be limited to willful conduct.

Currently, Section 1031 of H.R. 3911 reads:

"(a) Whoever knowingly executes, or attempts to execute any scheme or artifice--

"(1) to defraud the United States; or

"(2) to obtain money or property from the United States by means of false or fraudulent pretenses, representations, or promises . . . ."

This standard of intent is essentially a civil standard and is unreasonably low considering the magnitude of the penalties.

This section should require the defendant to be found to have acted ". . . knowingly and willfully." The "knowing and willful" standard is included in over 30 criminal statutes, including the "False Statements" statute, 18 U.S.C. 1001, the government's most frequently used statute in procurement fraud cases. This standard has not prevented prosecutions of fraud but does prevent innocent mistakes from being treated as criminal offenses.

H.R. 3911 would impose liability in cases where the defendant did not have an intent to defraud the government. In criminal cases, specific intent to defraud always should be required for a conviction.

X. The "bounty hunter" provision will undermine efforts of corporate self-governance.

Proponents state that the intent of H.R. 3911 is to deter fraud by encouraging whistleblowing and increasing potential penalties. Yet, these same provisions could undermine the self-governance and voluntary disclosure programs currently in place at many defense contractors in accordance with the recommendations of the Packard Commission.

For example, suppose a corporation assigns an internal auditor to investigate an alleged fraud. The auditor discovers indications of \$1,000 of intentional mischarging on a \$5 million contract. Prior to the corporation's confirmation and disclosure of the mischarging, the auditor could file a qui tam action under the Civil False Claims Act. He then could claim both the \$250,000 "bounty" under H.R. 3911 and 35 percent of any recovery in the civil suit against his own corporation.

Stated bluntly, the provisions of H.R. 3911, especially when coupled with previously enacted qui tam provisions, would create financial incentives for employees to act in contravention of company self-policing and ethics programs.

The viability of these corporate self-governance initiatives only can be assured by encouraging allegations of wrongdoing to be made, in the first instance, to the corporation's own ombudsman or auditors. Only in this way will the corporation be able to discover and to correct any problems on its own.

The "bounty" provision raises many other problems. As currently stated, this provision does not include any limitations or guidance as to who may furnish information and from what source. The bill may encourage persons to swamp government agencies with publicly available information such as information gathered from civil or administrative hearings; Congressional or General Accounting Office reports; government audits or investigations; or the news media.

Furthermore, there is no requirement that data be provided voluntarily. The provision currently would enable individuals to claim a reward for information provided in response to a subpoena or threat of prosecution. Even a participant in the fraud could claim an award!

Increased reports of alleged fraud do not ensure increased prosecutions. There has been no definitive demonstration of a correlation between the two. Without the appropriate safeguards to separate valid allegations from frivolous claims, the Department of Justice may find increased strain on its already limited resources without increased productivity and success. The bill explicitly should make it a federal crime to provide false information for the purpose of obtaining a bounty.

XI. The "whistleblower" provision must provide protection from frivolous allegations.

The whistleblower protection provision does not prevent frivolous claims or accusations against honest companies and individuals. There is no deterrent to prevent disgruntled employees from providing false claims against employers.

H.R. 3911 shifts all burdens and risks to the defendant. A small business, in particular, is vulnerable to disgruntled employees who by complaining of a fraud, grant themselves "tenure" and complete protection from being fired. Further, the company and accused individuals will incur substantial expenses and damage to their reputations in defending against these charges. At a minimum, the legislation should provide recovery of costs and attorneys' fees incurred by the wrongfully accused.

CONCLUSION

Mr. Chairman, we are hopeful that the Subcommittee will consider carefully the recent changes in the law and the extraordinary efforts industry is making to cure itself of the problems of fraud and mismanagement. We recommend that Congress ask the Department of Justice what it needs to prosecute the cases of which it becomes aware. With that answer, Congress could act to give the Department of Justice what it needs.

We believe that Congress should not pass H.R. 3911. Rather, it should make every effort to encourage industry self-governance, and to give the Department of Justice the resources it needs to enforce the laws already on the books.

Thank you, Mr. Chairman, for this opportunity to testify. I would be pleased to answer any questions.



Mr. HUGHES. Thank you very much. Is it Mr. Yuspeh?

Mr. YUSPEH. Mr. Yuspeh, Mr. Chairman.

Mr. HUGHES. Mr. Yuspeh, welcome.

Mr. YUSPEH. Mr. Chairman, members of the subcommittee, as the Chairman indicated earlier, I am appearing today on behalf of the Electronic Industries Association and the American Electronics Association, which as many of you know, represent the spectrum of electronic manufacturers in the country. Membership includes a very large number of major suppliers to the Federal Government. I very much appreciate the opportunity to be heard this morning, and we appreciate, Mr. Chairman, your convening this hearing today.

At the outset, I think that most of us probably can agree on what the reasonable objectives for public policy in the area of procurement fraud ought to be. And in my mind there are three of those. It would seem that the reasonable public policy objectives would be first, to deter any type of procurement fraud. Second, to punish such fraud equitably when it might occur. And finally, to make certain that prosecutors have all the tools that they require in order to effectively deal with such cases.

Mr. Chairman, with that in mind, the associations which I represent today believe that H.R. 3911 should not be enacted. And we believe that primarily for two reasons. We believe it first because all of these public policy goals which I have just listed are achieved through existing provisions of law. We believe it, second, because, as I will discuss later, certain aspects of H.R. 3911 actually appear contrary to sound public policy.

On the first issue, my prepared testimony reviews in some detail the existing provisions of law used to deter, to investigate, to prosecute, and to punish procurement fraud. There are few areas to which the Congress has given more attention in the last five years than that of procurement fraud. In 1982 an Inspector General was established in the Department of Defense. That office now has a thousands of individuals working in the area of procurement fraud. Similar offices were established in the civilian agencies in 1978.

Senator Grassley appeared before your committee last December to discuss the Civil False Claims improvements which he authored last year. And those now appear in statute together with their *qui tam* provisions. Landmark legislation was passed last year creating administrative false claims remedies in each and every agency of the Federal Government.

Procurement fraud penalties, as Mr. Kipps mentioned, for Defense Department frauds were increased from \$10,000 to \$1 million for fines, a 10,000 percent increase in the penalties that are available.

Senator Levin was instrumental last year in authoring legislation to strengthen substantially the Anti-kickback law. And finally, even in very narrow specific areas such as that of the submission of unallowable costs, Congress has provided for specific penalties where certain unallowable costs are submitted.

Moreover, Mr. Chairman, I know that you are aware of the fact that prosecutors have available to them a very large number of tools today that appear in Title 18, including provisions on false statements, false claims, conspiracy, mail fraud, tax fraud, bribery,

illegal gratuities, conflicts of interest, foreign corrupt practices, and criminal racketeer influenced and corrupt organizations, or RICO provisions.

In our view, if you look at the body of law which I have just outlined, what you will find is that it meets the public policy goals which I mentioned at the beginning of my statement. It provides adequate deterrence, especially in light of the fact that Government contractors are also subject to being suspended or debarred, denied the right to do business with the Government completely in the event that they are convicted of a crime.

These laws provide ample punishment in that the aggregate of all these penalties amounts to what could be a recovery of five times the ill-gotten gain in addition to jail sentences of five years. These laws provide adequate prosecutorial tools. I am unaware of any prosecutor who believes that illegal conduct has gone unprosecuted because it has fallen between cracks that exist in coverage of statute.

Even if H.R. 3911 were merely unnecessary, we could understand your giving attention to it and the subcommittee giving attention to it because Congress often legitimately wants to reinforce its concern about an area of public policy. Unfortunately, we believe that the bill actually will do affirmative harm, and I would like to explain why.

The most important harm we think is created by the reward provisions which we believe are fundamentally unsound for a number of reasons. We would urge you and the members of the subcommittee to consider the reward provisions in light of current developments in the defense contracting community.

When the Packard Commission made its report in the summer of 1986, one of its most important recommendations was that there should be greater emphasis on contractor self-governance. And as a direct outgrowth of that, 46 defense contractors, including all of the major defense contractors and a number of EIA and AEA members, have developed a program called the Defense Industry Initiative on Business Ethics and Conduct.

What each of these companies has agreed to do and has followed through on, is to develop written codes of conduct for their employees, to distribute the codes to each and every employee in the company involved with Government contracts, to orient new employees with respect to the codes, to conduct ethics training programs, and to maintain hotlines and ombudsmen so that confidential reports of problems that arise can be received within the company.

They have systems in place to make voluntary disclosures to the Federal Government as problems are discovered. They meet in best practices forums, to share lessons learned and ideas with one another. And finally, they have a system of public accountability.

The public accountability process requires that each company complete a questionnaire on its efforts. The questionnaire is audited by the company's accountants, and these are compiled by an external independent body. That process has just been completed, Mr. Chairman, and with your permission I would like to make a copy of the public accountability report from last year on this effort a part of the record of today's hearing.

Mr. HUGHES. Without objection, it will be so received.

[The information of Mr. Yuspeh follows:]

**DEFENSE INDUSTRY INITIATIVES  
ON BUSINESS ETHICS AND CONDUCT**

**PUBLIC ACCOUNTABILITY**

**1987 ANNUAL REPORT  
TO THE PUBLIC  
AND THE DEFENSE INDUSTRY**

**PREPARED BY  
ETHICS RESOURCE CENTER, INC.  
WASHINGTON, DC**

**JANUARY 1988**

*"Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception — a loss of confidence in its integrity — that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established."*

**Defense Industry Initiatives  
on Business Ethics and Conduct  
June 1986**

**DEFENSE INDUSTRY INITIATIVES  
ON BUSINESS ETHICS AND CONDUCT  
1987 ANNUAL REPORT**

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## I. BACKGROUND OF THE DEFENSE INDUSTRY INITIATIVES

During the 1980s, public concern about malfeasance in the defense industry grew as investigations of major defense contractors increased and reports of procurement irregularities proliferated. In July of 1985, President Reagan asked David Packard, the Chairman of Hewlett-Packard and a former Deputy Secretary of Defense, to chair a specially appointed, independent Blue Ribbon Commission on Defense Management, which came to be known as the Packard Commission. The commission was directed to conduct a broad study of defense management, including the budget process, procurement, organization and operation, and legislative oversight, and to make recommendations for streamlining and improving defense management. In its Interim Report, dated February 28, 1986, the Packard Commission recognized the limits of federal regulation and suggested that effective self-governance might help to curb industry misconduct. The Interim Report stated:

To assure that their houses are in order, defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance.

A number of companies in the defense industry responded to the Commission's preliminary recommendations with concrete action of their own. In the late spring of 1986, representatives of 18 defense contractors met and drafted six principles that became known as the Defense Industry Initiatives on Business Ethics and Conduct, or "DII" (for the text of the Initiatives, see Exhibit 1). These principles, which appeared in the Appendix to the Packard Commission's June 1986 final report to the President, "A Quest for Excellence," pledged the signatory companies to promote ethical business conduct through the implementation of policies, procedures and programs in the following six areas:

- Codes of ethics;
- Ethics training;
- Internal reporting of alleged misconduct;
- Self-governance through the implementation of systems to monitor compliance with federal procurement laws and the adoption of procedures for voluntary disclosure of violations to the appropriate authorities;
- Responsibility to the industry; and
- Accountability to the public.

The Initiatives were intended to promote sound management practices, to ensure that companies were in compliance with complex regulations, and to restore public confidence in the defense industry. At the time the Packard Commission's final report appeared in June 1986, there were 32 signatory companies to the Defense Industry Initiatives. That number had grown to 36 by June 1, 1987, and as of this writing stands at 45 (see Appendix A). Although the number of signatory companies is small compared to the total number of firms doing business with the Department of Defense, these 45 companies represent roughly one-half of the fiscal 1986 DoD contract awards.

The signatory companies established a Steering Committee of corporate executives to be the policy-setting body for the DII and a Working Group to analyze policy issues and present recommendations to the Steering Committee. Both the Steering Committee and the Working Group are composed of representatives of the same seven signatory companies (for a list of members, see Exhibit 2).

In addition, the position of DII Coordinator was created to handle administrative details, arrange meetings, and conduct the day-to-day business associated with the DII. The position was originally to have a term of three months, but it has since become an open-ended appointment. The first DII Coordinator was Rhett Dawson, who had been the Executive Director of the Packard Commission. He acted as DII Coordinator from July - December 1986. Upon his return to government service, the Steering Committee appointed Alan Yuspeh, the former General Counsel of the Senate Armed Services Committee and currently a partner with Preston, Thorgrimson, Ellis and Holman, as the new DII Coordinator. He has served in that capacity from the beginning of 1987 to the present.

In order to promote industrywide cooperation, to share experience, and to discuss matters of business conduct and compliance with laws and regulations, the signatories of the Initiatives agreed to convene periodic Best Practices Forums, the first of which was held October 30-31, 1986, in Washington, DC. The Forum was attended by several hundred individuals from 50 signatory and non-signatory companies. Participants discussed codes of ethics, ethics training programs, and compliance monitoring efforts that were being undertaken by signatory firms. These issues correspond to Principles 1,2,3 and 4 of the DII. The second Best Practices Forum was held June 29-30, 1987, in Chicago and was devoted to the issue of public accountability, addressed in Principle 6 of the DII. This meeting was attended by representatives of the signatory companies and their outside accounting or law firms, and a number of non-signatory companies.

As part of principle six of the Defense Industry Initiatives, the signatory companies have committed themselves to public accountability. The mechanism for public accountability requires that each company submit to an examination or review of its ethics policies, procedures and programs annually for the next three years to demonstrate the company's compliance with the DII principles. Each company is required to complete an 18-point questionnaire (see Exhibit 1) and submit it to an independent public accounting firm or a similar independent organization, which is to conduct an examination or review of the company's

responses to the questions and issue an opinion on the appropriateness of the answers. The examiners and reviewers are to submit their opinion letters along with the companies' responses to an external independent body, which is to prepare a public report that summarizes the responses of the signatory companies as a group.

The companies participating in the process intend that the three years of examinations and reviews will give added force to the initiatives and demonstrate that the defense industry is serious about its commitment to act in accordance with the highest standards of business conduct.



## II. INTRODUCTION

As the first year under the Initiatives drew to a close, the Steering Committee determined that the 36 companies that had signed the DII prior to June 1, 1987 should participate in the public accountability process for 1987. Reviews and examinations from 33 of those 36 are covered in this report. Of the three remaining companies, one has merged with a company that is not a signatory and hence did not participate in the examination/review process. The other two companies had not submitted responses in time to be included in this report.

An additional company, which had signed the DII after June 1, 1987, also chose to undergo an examination in 1987. It asked the Steering Committee to be included in this report, bringing the total number of respondents to 34 (see list, Exhibit 3).

The responding companies range in size from about 5,000 employees to more than 400,000 employees, with revenues from \$500 million to more than \$50 billion. Defense contracts account for less than 10% of revenues in some signatory companies, while others rely almost completely on DoD business. In some of the companies, defense-related business is organizationally separated from commercial operations. In other companies, the same operating units may perform both defense and commercial work.

The Steering Committee decided that the examinations or reviews would cover programs in place during the minimum period of July 1 through September 30, 1987, in order to give companies adequate time from the signing of the Initiatives to implement their commitments under the DII, and to allow completion of the examination/review process by the end of 1987. In 1988 and 1989, the reporting period will again end September 30 each year. The reporting period in the remaining two years will be the 12 months prior to September 30, or a period of at least 90 days prior to that date in the case of new signatories.

Three companies modified the reporting period in their 1987 questionnaire responses. One company reported on its policies, procedures and programs in place as of September 30, 1987; another as of October 23, 1987; and a third as of October 30, 1987.

Each of the 34 participating signatory companies completed a questionnaire concerning certain policies, procedures, and programs that were to have been in place during the reporting period of July 1 through September 30, 1987. The original language of Principle Six of the DII had indicated that each company's independent public accountants or similar independent organization should complete the questionnaire. However, the Steering Committee, in consultation with an Auditing Standards Board Task Force, determined that the best way to execute the questionnaire process would be to conduct an attestation engagement. In order for the independent public accountants to conduct an attestation

engagement, the companies themselves had to complete the questionnaires and submit their responses to the accountants for an examination or review.

Accordingly, all but one of the participating companies completed the questionnaire and submitted its responses to its independent public accountants or a similar independent organization. In 32 cases, companies submitted their questionnaires to accounting firms; in one instance, the company chose a law firm. The remaining company had its independent body, a law firm, complete the questionnaire as originally envisioned by Principle 6.

The Auditing Standards Division of the American Institute of Certified Public Accountants and representatives of the DII signatory companies agreed to a framework for the examinations and reviews. That framework is embodied in the "Interpretation of Statement on Standards for Attestation Engagement, Attestation Standards: Defense Industry Questionnaire on Business Ethics and Conduct," henceforth referred to as "Interpretation" (see Exhibit 4). All of the accounting firms and one of the law firms followed the guidelines set forth in the "Interpretation." The other law firm, which completed the DII questionnaire on behalf of its client company, conducted its review "as a lawyer," not as an accountant, in accordance with methods and procedures used in the legal profession.

The "Interpretation" obliged each company to submit with its questionnaire responses an assertion letter stating that the company's responses were based on policies and programs in operation during the reporting period and were appropriately presented in conformity with the criteria set forth in the DII. Three companies did not submit an assertion letter, including the company that instructed its independent body to complete its questionnaire.

Consistent with the "Interpretation," signatory companies had the option of asking their independent body to perform either an examination or a review of their questionnaire responses. The "Interpretation" specifies that "a review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the affirmative responses in the Questionnaire." Examiners were required to attest that a company's responses were appropriately presented in conformity with the criteria set forth in the DII, including the questionnaire. Reviewers, on the other hand, were required only to attest that nothing had come to their attention during their review that caused them to believe that the company's responses to the questionnaire were not appropriately presented.

Examiners were required to obtain more evidence than reviewers by possibly talking to a broader sampling of the company's employees or examining more documentation. For example, Question 15 on the DII questionnaire asks, "Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?" The procedures for both examinations and reviews instruct the independent bodies to "determine by inquiry of company officials and/or by reading relevant documentation how the company monitors, on a continuing basis, adherence to the code and compliance

with federal procurement laws." The procedures for examinations, however, further instruct examiners to "obtain additional evidential matter, for example by reading internal audit reports, of the company's monitoring of compliance with the code and federal procurement laws." Thus, for example, a review would determine *how* monitoring is done, while an examination would also ascertain *that it is done*. (For a question-by-question comparison of the procedures for examinations and reviews, see Appendices A and E to the "Interpretation": Exhibit 4.)

The independent bodies conducted their examinations and reviews by visiting plant sites; by interviewing key managers; by looking over codes of ethics, corporate policies and procedures, attendance sheets for ethics training workshops, company newsletters, logs of hotline calls, minutes of meetings of the Board of Directors, and other documentation; and, in the case of examinations, by talking to random samples of employees. In many cases, internal audit staff assisted in this process.

Consistent with the "Interpretation," each examiner or reviewer was obliged to issue an opinion on the appropriateness of the company's answers for the reporting period of July 1 - September 30, 1987. Appendix B to the "Interpretation" gives illustrations of five types of possible opinions (see Exhibit 4). Twenty-nine independent bodies gave an unqualified opinion; four others gave an unqualified opinion/report modified for negative responses. The law firm that completed the DII questionnaire on behalf of its client did not issue an opinion letter, since to do so would have been to issue an opinion on answers it had prepared.

The opinions do not entail an assessment of the quality or effectiveness of a company's policies, procedures and programs, nor do they express any judgment on the part of the examiner or reviewer as to whether a company was fully in compliance with federal acquisition laws and regulations. However, as Question 18 makes clear, each company's public accountants or a similar independent organization is required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct.

The examiners and reviewers were instructed to send their opinion letters along with the companies' DII questionnaire responses to the external independent body, whose role is to collect all the responses, analyze them, and issue a report simultaneously to the participating companies and to the general public, summarizing the collective responses of the companies and describing generally what signatory companies are doing to comply with the Initiatives (see Exhibit 5, "Description of the Role of the External Independent Body for the Defense Industry Initiatives"). The external independent body may contact examiners and reviewers to ascertain the methods used to conduct the examinations or reviews and to seek clarification of responses. The Ethics Resource Center, an independent, non-profit, educational organization, was chosen as the external independent body for 1987 (see Exhibit 6, "Ethics Resource Center, Inc.").

The companies submitting DII questionnaire responses were invited to submit, through their examiners or reviewers, relevant documentation and illustrative company materials to the external independent organization. Fifteen of the responding companies did so. The materials included codes of ethics, policies, procedures, descriptions of training programs, and copies of articles on business conduct that appeared in internal company publications.

### III. SUMMARY OF RESULTS

Several points should be noted with regard to the summary of results which follows. First, each of the companies is organized differently. Various titles may be given to individuals or groups that perform essentially the same function. Similarly, individuals or groups with the same title may have slightly different functions, follow different procedures, or have different reporting relationships. For purposes of analyzing and reporting in aggregate the responses of the 34 participating companies, the Center has chosen to ignore minor distinctions in titles, functions, and procedures. For instance, one company's "Corporate Office of Business Practices," another's "Ethics Program Office," and yet another's "Corporate Committee on Defense Industry Ethics" have all been categorized as "Ethics Offices/Committees."

Second, some of the signatory companies are highly decentralized and do not have a unitary ethics program for all of their operations. The programs may differ significantly among different divisions or subsidiaries. Where appropriate, the Center has noted where these differences exist.

Third, because 32 of the 34 companies chose to have their independent bodies conduct an examination rather than a review, the Center has aggregated the company responses to the eighteen questions without distinction as to whether those responses were examined or whether they were reviewed by the companies' independent bodies.

Fourth, respondents were invited, but not required, to elaborate on their "yes" or "no" answers and to provide the external independent body with relevant details about their policies, procedures and programs. The Center's analysis is based on the questionnaire responses, such other information as was provided by the respondents through their examiners or reviewers, and the Center's discussions with examiners and reviewers.

Fifth, although the 18 questions were essentially derived from the six DII principles, the correspondence between principles and questions is not exact. The following table shows the correlation between the principles and the questions drawn from them:

<u>Principle</u>	<u>Question(s)</u>
1	1, 4, 6, 14
2	2, 3, 5, 11, 12
3	7, 8, 9, 10
4	13, 15

<u>Principle</u>	<u>Question(s)</u>
5	16, 17
6	18

In some cases, the questions ask for more than the principles require. For example, Question 14, which asks if implementation of the code's provisions is a standard for evaluation of supervisory performance, usefully goes beyond the requirement of Principle 1 for a "clear assignment of responsibility to operating management and others for monitoring and enforcing the standards throughout the company." The question advances the principle a logical step forward by providing a mechanism for assessing how well supervisors are fulfilling their obligations under the DII. Similarly, Question 18 goes beyond Principle 6's requirement that an independent organization conduct an annual examination or review to also require that the independent organization "comment to the Board of Directors . . . on the efficacy of the company's internal procedures for implementing the company's code of conduct."

In other cases, the questions require less than the principles seem to intend. Whereas Principle 2 seems to indicate that training programs should cover all employees ("each company will train its employees concerning their personal responsibilities under the code," "adherence to the code becomes a responsibility of each employee," "codes of business ethics and conduct are effective only if they are fully understood by every employee"), the language of Questions 3 and 5 permits a broader reading. A company could (and some respondents did) give an affirmative answer to these questions, when orientation and training about the code were provided only to some employees in the organization.

Principle 5 states "Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors." The corresponding question, number 17, makes no mention of outside directors.

The following is a question-by-question breakdown of the company responses to the questionnaire and an analysis of those responses (Chart 1 shows the percentage of companies that responded "yes" to each question):

**Question 1: Does the company have a written code of business ethics and conduct?**

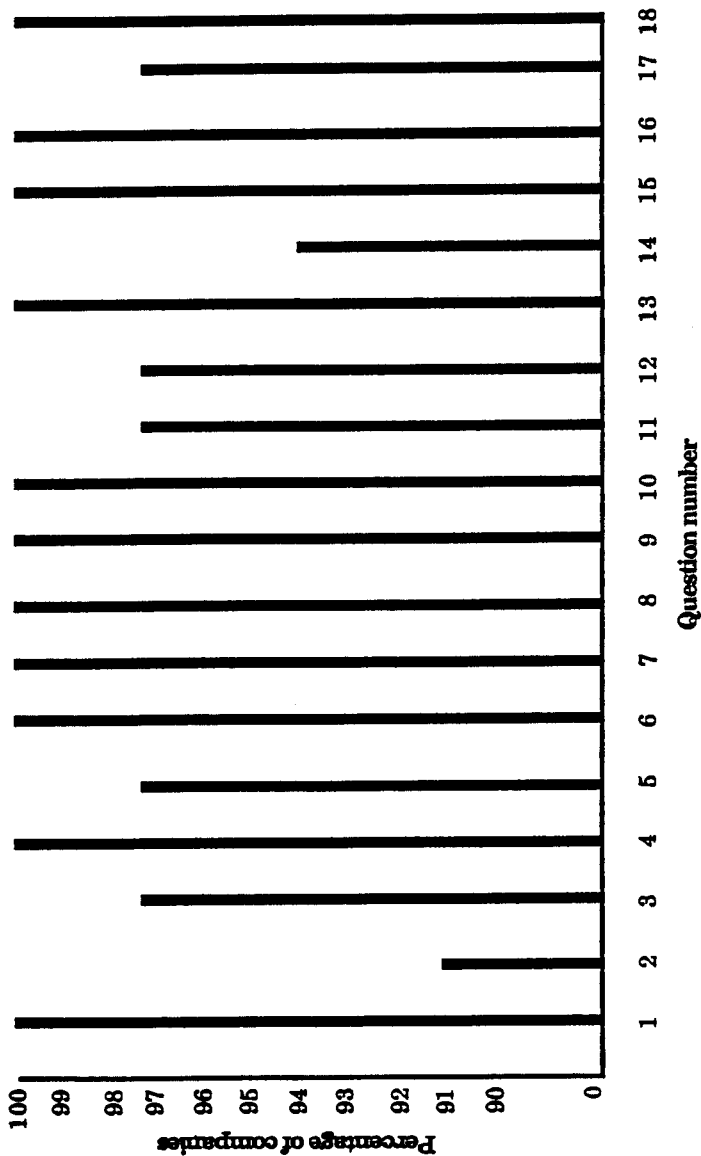
**Yes: 34      No: 0**

A code of ethics articulates the values, principles and standards intended to govern employee conduct. All of the participating companies have codes of ethics. In almost all cases, the code is a separate document entitled "Code of Ethics,"

CHART NUMBER ONE

DEFENSE INDUSTRY INITIATIVES  
REPORT OF EXTERNAL INDEPENDENT BODY  
JULY 1 - SEPTEMBER 30, 1987

PERCENTAGE OF YES RESPONSES TO EACH QUESTION



"Standards of Business Conduct," "Business Conduct Guidelines," or something similar. In two cases, the company's code consists of separate company policies that have not been systematized or collected into a single document. Ten of the respondents noted that they have had their codes for many years. Six companies stated that they have updated their codes recently, five specifically to address issues related to the Defense Industry Initiatives and contracting with the federal government.

**Question 2: Is the code distributed to all employees principally involved in defense work?**

**Yes: 31      No: 3**

Of the 31 companies that answered "yes," four specified that they distribute their codes to all employees worldwide. Eighteen companies added, either under Question 2 or in their answers to other questions, that they require employees to execute written acknowledgements that the employees have received the code, have read and understood it, or agree to abide by its provisions.

One of the companies that answered "yes" noted that it had a sizeable group of new employees who were scheduled to receive their copies of the code in October 1987, just after the end of the reporting period.

One of the three respondents that answered "no" is a decentralized company that has left the manner of code distribution up to the individual operating units. Although some units have distributed the code to all personnel, others have so far given it only to managers and certain other key employees. Distribution to hourly employees has not yet taken place. The other respondents that answered in the negative have distributed their codes to all salaried personnel, but not yet to hourly workers. All three of these companies plan to distribute their codes to all employees during 1988.

**Question 3: Are new employees provided any orientation to the code?**

**Yes: 33      No: 1**

While all but one of the respondents have some sort of orientation to the code for new employees, there are wide variations in form and content. Two companies stated that new employees simply receive the company's code and sign an acknowledgement. Three others distribute the code to new employees and sign them up for the next available ethics training session (see the commentary on Question 5 below). The remaining 28 distribute the code and provide some sort of formal orientation to it.

Three of the 28 stated they did not provide orientation for all new employees during the reporting period of July 1 - September 30, 1987. In one case, a formal, systematic orientation to the code for new employees was only instituted toward



the end of the reporting period; since that time, however, all new employees have received an orientation to the code. In another case, some operating units had not yet established procedures for conducting an orientation to the code in a few particular functional areas. In the final case, the company provided an orientation for new salaried employees but not for hourly workers.

Respondents use a variety of orientation methods and procedures, which may differ by operating unit or employee level even within the same company. The following list shows how many companies use a given form of orientation. The number in parentheses indicates how many companies use these methods only in particular operating units or among certain levels of employees, usually managers.

• Lectures/explanations/briefings/discussions	16 (4)
• Videos	14 (6)
• Acknowledgment cards	8 (1)
• Distribution of other ethics materials	7 (5)
• Orientation regarding reporting mechanisms (see Commentary to Question 7, below)	5 (1)
• Question-and-answer sessions	3 (1)
• Opportunity to discuss code with supervisor or representative from human resources department	1
• Assignment of an ethics counselor to each new employee	1 (1)
• Viewgraph presentations	1 (1)
• Format not specified	3

Six companies noted that they plan to upgrade or expand their new-employee orientation programs. Four are working on new video presentations, three are developing training modules, and one is planning to begin distributing its code to new hourly employees.

The respondent that answered "no" to Question 3 stated that it currently distributes its code to new salaried employees and requires them to sign an acknowledgement. The company intends to expand this practice to new hourly workers as well.

***Question 4: Does the code assign responsibility to operating management and others for compliance with the code?***

**Yes: 34**

**No: 0**

All of the respondents' codes mention the role assigned management to ensure compliance. Many of the codes also clearly state the individual responsibility of each employee to abide by the code's principles.

**Question 5: Does the company conduct employee training programs regarding the code?**

**Yes: 33**

**No: 1**

There are almost as many varieties of ethics training programs as there are responding companies. Among the respondents that answered "yes," 22 companies stated that they have already trained, are in the process of training, or plan to train all of their employees principally involved in defense work. At five companies, ethics training is provided only to managers and certain other key personnel. One company has a "voluntary, comprehensive" ethics training program. The remaining five companies did not specify whether or not they provide or intend to provide training to all employees with regard to the code. Several of these companies are decentralized, and although they require all operating units with employees principally involved in defense work to conduct ethics training programs, they have left it to the individual operating units to decide which employees should attend.

The different companies use a wide variety of training formats. Several companies have comprehensive training programs with workshops tailored to employees at different levels or in different functions in the corporation. Other companies use a workshop format, but gear the workshops just to particularly sensitive functional areas, such as purchasing, accounting, contracts, or quality assurance. Still others use a presentation/briefing format for their ethics training. A number of companies do not segregate ethics from the rest of employee training, but integrate ethics modules into general or functional training courses.

Based upon analysis of companies' responses and accompanying documentation, the Center has grouped the ethics training programs into three categories with different training objectives. These categories are not necessarily mutually exclusive, but may rather indicate differences in emphasis.

- 1) *Compliance training* familiarizes employees with the provisions of federal laws and regulations in such areas as timecharging, truth in negotiation, unallowable costs, and expense reporting. It also indicates the consequences to firms and individuals if laws or regulations are breached.
- 2) *Code awareness training* elaborates on standards contained in the company's code of ethics and illustrates how these standards apply to employees' day-to-day jobs.
- 3) *Ethical decision-making training* strives to help managers recognize the ethical content and ramifications of business decisions and to give managers a framework for coping with complex issues and "grey areas."

The following figures show how many companies provide training of each type. Some companies provide more than one type of training; others did not specify the objectives of their training programs.

- Compliance with federal laws and regulations 13
- Code awareness 7
- Ethical decision making 3
- Objectives not specified 16

In addition, eight companies provide ethics training in functional areas. This training focuses on the special rules or the unique ethical issues that arise or vulnerabilities that exist in functional areas like purchasing, engineering, finance, or quality assurance.

Most respondents did not specifically identify the materials used in their ethics training programs. Among those that did, 12 specified that they utilize videotapes. A few companies mentioned that they use case studies, group discussions or speakers.

The one company that responded in the negative to Question 5 stated that it intends to develop an employee training program regarding the code.

***Question 6: Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?***

**Yes: 34**

**No: 0**

Codes of ethics can provide employees guidance in dealing with groups that are external to the company, but deeply involved in its day-to-day business. For example, codes may address the need to deal honestly with suppliers and customers, forbidding bribery and kickbacks and restricting the giving and receiving of gifts and gratuities. They may require that the company contract only with consultants and suppliers who agree to abide by the same standards as the company's own employees.

All of the respondents' codes specifically address standards of conduct in relationships with suppliers and customers. Twenty-six of the codes specifically mention consultants. Six companies include consultants under the category "suppliers of services," which their codes specifically address. The remaining two companies consider consultants to fall into the more general category of "suppliers."

**Question 7: Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?**

**Yes: 34**

**No: 0**

Many companies noted that they prefer that employees report suspected violations to their supervisor whenever possible. However, employees may be reluctant in some cases to report allegations to their direct supervisors, particularly when the employee suspects his or her supervisor of wrongdoing. Accordingly, each of the respondents has some alternative reporting mechanism as well, and many have more than one. The following list shows the types of reporting mechanisms identified by the signatories:

• Hotline	17
• Ombudsman	16
• Ethics office or committee	13
• Post office box or other procedure for written allegations	7
• "Open door" policy	3
• Corporate review board	2
• Other	3

One company stated that its employees can contact the regional offices of corporate security. Another company indicated that employees can report allegations directly to corporate or internal audit staff. Another company responded that its employees can report allegations to the company's law department or controller, or to a special advisor to the Chief Executive Officer. Moreover, in some of its operating units, employees can report alternatively to a steering committee, ethics office, or other independent individual or organization.

Of the three companies that have an "open door" policy, two also have other procedures for reporting allegations. The remaining company relies solely on its "open door" policy as an alternative reporting mechanism.

**Question 8: Does the mechanism employed protect the confidentiality of reports?**

**Yes: 34**

**No: 0**

Respondents use a variety of methods to protect the confidentiality of reports. It is important to note that, these safeguards notwithstanding, a company may be compelled to reveal the identity of a "whistleblower" under certain circumstances. Respondents frequently have two or three, and sometimes more, of the following policies and procedures:

• Provision for anonymous reporting	22
• Company pledge, policy, or instruction to handle all calls and reports in confidence to the extent possible	17
• Limited access to reports and records	15
• Names of reporting employees are removed from reports	5
• Reports identified by control numbers rather than by names of individuals involved	5
• Company pledge/policy that retribution against "whistleblowers" will not be tolerated	4
• Use of hotline telephones that have no trace feature	2
• Communication with the reporting employee done away from his or her work station	2
• Calls to hotlines not included in lists of calls made from company phones	1
• Reporting employee may request strict confidentiality	1
• Reporting employee's name not revealed without his or her permission, unless disclosure is unavoidable during an investigation	1
• External communication about reports controlled by the Corporate General Counsel	1

***Question 9: Is there an appropriate mechanism to follow up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other action?***

**Yes: 34**

**No: 0**

Methods of investigating and adjudicating allegations of wrongdoing vary widely among the responding companies, making categorization difficult. Generally, an individual or office, such as an ombudsman, ethics director, ethics office, or law, audit or security department, has the principal responsibility for conducting investigations. Depending on the nature of the allegation, the individual or office may seek assistance from other areas within the company, such as operating management, human resources, corporate security, the law department, internal audit or contracts.

***Question 10: Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?***

**Yes: 34**

**No: 0**

Each of the companies has a procedure for apprising employees of the results of the investigations into the allegations that they have reported (see Chart 2). In 15 of the companies, an ombudsman, ethics director or manager is obliged to advise reporting employees concerning the results of the consequent investigations. At one of these companies, ombudsmen are required to document that they have followed-up with employees who reported allegations. Nine additional companies specified that their procedures provide for a response only if the identity of the reporting employee is known. Six other companies stated that they give feedback even to employees who remain anonymous. Their methods of responding to employees who report anonymously include requesting the employee to call back for a report or publicizing the results of investigations through meetings, public statements by senior executives, or articles in employee newsletters. The remaining four companies notify employees only if the employees so request or call back.

**Question 11: Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?**

Yes: 33

No: 1

**Question 12: What are the specifics of such a program? a) Written communication? b) One-on-one communication? c) Group meetings? d) Visual aids? e) Others?**

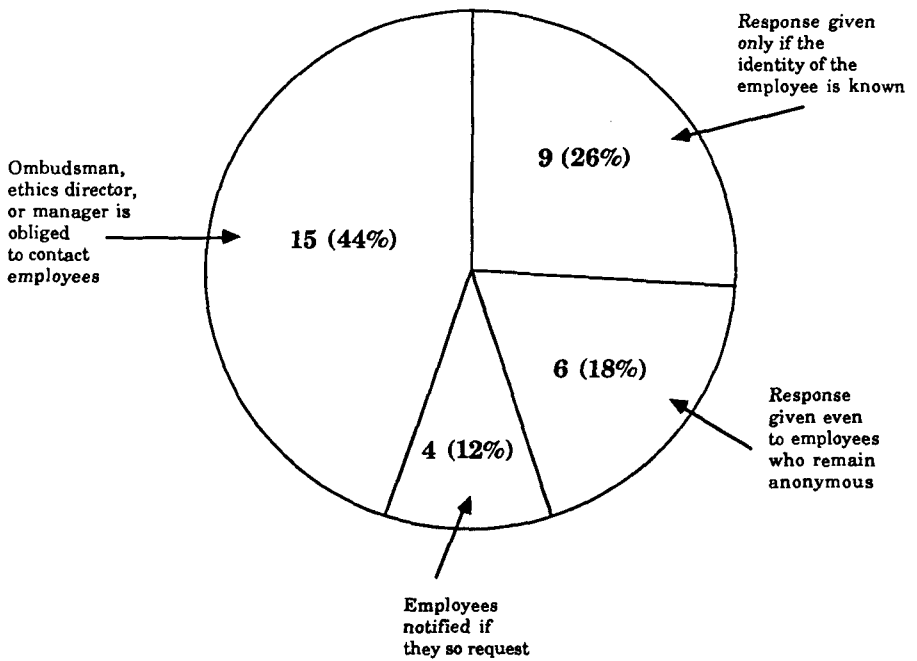
All but one of the companies have ongoing measures to increase awareness of the code and its provisions. The following breakdown indicates which methods are used most widely.

**a) Written communication**

• Articles in company newspapers, newsletters and magazines	30
• Letters and memos to employees from senior management	11
• Bulletins and notices addressing ethics or compliance matters	8
• Messages in pay envelopes or on pay stubs	4
• Periodic redistribution of the code of ethics	4
• Distribution of ethics-related books and pamphlets other than the code	4
• Periodic certifications that the employee has no conflicts of interest	2
• Inclusion of ethics-related material in annual reports or other reports	2
• Direct communications to suppliers	2
• Warnings about falsification printed on timecards	1

CHART NUMBER TWO

**QUESTION 10:** Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?



- Distribution of a copy of the code of ethics to many sales representatives along with their annual quotas 1
- Ethics communication resource kit 1
- Policies and procedures on business ethics and conduct 1
- Articles printed in external publications 1
- Internal circulation of externally published articles 1

***b) One-on-one communication***

- Communication from supervisors 5
- Employee conversations with ethics office staff and corporate counsel 2
- Nature of communication unspecified 5

***c) Group meetings***

- Departmental, divisional or staff meetings 9
- Mass meetings 3
- Briefing sessions 3
- Speeches 3
- Counseling sessions 1
- Question-and-answer sessions 1
- Nature of meeting unspecified 5

***d) Visual aids***

- Videotapes 22
- Posters 21
- Badge extenders 2
- Viewgraphs and slides 1
- Unspecified 1

***e) Other***

- Use of employee opinion surveys as a means of communication about standards of business conduct 2
- Reviews of potential customers' ethics rules 1
- Telephone newslines including items about ethics 1
- Audio newsletter for employees 1
- Electronic access to code of ethics 1
- Electronic mail 1



- Employee input into biannual reviews of the corporate credo 1
- Easy accessibility of forms for reporting violations 1
- Opportunity for employees to attend outside programs dealing with government contract matters 1

One company noted that it plans to implement a procedure to ensure that all employees receive regular updates of the corporation's requirements concerning ethical conduct and compliance with federal procurement regulations.

The one company that responded "no" nevertheless noted that its Chief Executive Officer distributes annual written communications to notify and remind salaried employees of their obligations under the code. These written communications are supplemented by discussions at group meetings and normal supervisory exchanges. The company intends to extend these communication practices to all employees principally involved in defense work.

***Question 13: Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?***

**Yes: 34**

**No: 0**

Procedures for voluntary disclosure to the government vary greatly depending on the company. To a lesser degree, they may also vary within a company depending on the particular case or the manner in which the violation came to light. Typically, a review board, an ethics committee, a compliance officer or the law department examines the results of investigations and makes its recommendation to the Chief Executive Officer, or another senior executive, who has the final decision about whether, when and how to disclose the alleged incident. Some companies mentioned in their responses the parties to whom violations might be disclosed. Those which did so indicated that violations may appropriately be disclosed to the DoD Office of the Inspector General or other government agencies such as the resident Defense Contract Audit Agency (DCAA) auditing staff, the Procurement Contracting Officer, or the Department of Justice.

At one company, operating management is obliged to ensure disclosure of matters that do not involve potential criminal issues. If the matter entails potential criminal issues or civil fraud, it receives an additional review by internal audit, with the possible assistance of the law and human resources departments.

At another company, responsibility for disclosure to the contracting officer or other local representatives of governmental agencies lies with the operating unit from which the allegation was reported. The corporate law department

assumes primary responsibility for all reports to the DoD Office of the Inspector General.

The procedures of another company include a comprehensive list of factors to weigh in making decisions about disclosure. Among these factors are the weight of the evidence, the clarity of the law, whether the violation was deliberate or unintentional, whether there was any actual or intended pecuniary gain to any party as a result of the action, and whether there was a single act or a pattern of violations.

A number of companies stated that they have a long-standing practice of making voluntary disclosures to the government or that they have already made disclosures in accordance with the procedures that they have established. Two of the companies noted that they have a practice of reimbursing the government if the company has profited from violations of procurement laws.

***Question 14: Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?***

**Yes: 32**

**No: 2**

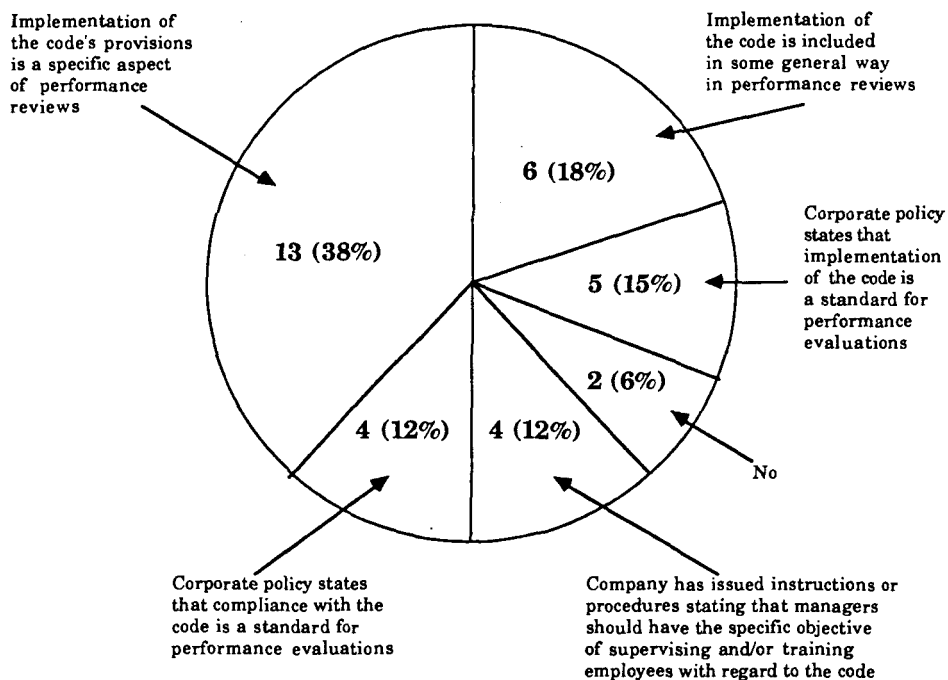
Most of the respondents indicated that implementation of their code's provisions is one measure of supervisory performance (see Chart 3). Some companies incorporate specific language about ethics or compliance into performance evaluation forms. Other companies factor implementation of the code's standards into supervisors' performance reviews in some general way. The following is a breakdown of the responses:

- Implementation of the code's provisions is a specific aspect of performance reviews 13
- Implementation of the code is included in some general way in performance evaluations 6
- Corporate policy states that implementation of the code is a standard for performance evaluation 5
- Company has issued procedures or instructions stating that managers should have the specific objective of supervising and/or training employees with regard to the code 4
- Corporate policy states that compliance with the code is a standard for performance evaluation 4

Of the two companies that gave a "no" response to Question 14, one holds management responsible for ensuring adherence to the code as a matter of company policy. However, the company felt obliged to give a "no" answer because its current performance evaluations do not specifically address the effectiveness

## CHART NUMBER THREE

**QUESTION 14:** Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?



with which individuals have implemented the code. The company intends to make implementation of the code's provisions a specific standard for performance reviews after all employees have had the opportunity to attend one of the company's training workshops. The other company answered "no" because some of its operating units, accounting for substantially less than half of the company's defense-related business, "do not specifically address the question of personal integrity and ethics" in their performance evaluations.

Five respondents noted that they are revising their performance review forms to incorporate language addressing implementation of the code, and two additional companies are revising position descriptions along the same lines.

***Question 15: Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?***

**Yes: 34**

**No: 0**

Many of the mechanisms listed by companies in their answers to Question 7 are also used to monitor compliance. The following is a breakdown of the responses:

• Reviews by internal audit	29
• Monitoring by ethics office/committee	9
• Monitoring by review board/contract compliance committee	8
• Oversight by law department	7
• Review systems in functional areas	6
• Oversight by management and supervisors	5
• Self-audits by employees in functional areas	3
• Certification with regard to conflict of interest	3
• Audits by independent public accountants	3
• Audits by accounting department	2
• Compliance certification by key employees	2
• Reviews by an operations oversight group	1
• Company policies and procedures	1
• Communications audits	1
• Reviews of the numbers and categories of hotline calls	1
• Quarterly reports from the ethics committee chairman of each operating unit to the corporate ethics committee chairman regarding efforts to foster ethics awareness and compliance	1
• Review of the company's policies, practices, and procedures by an outside law firm	1
• Annual reviews by general managers of operating units	1

- Analysis of policy violations to identify opportunities to improve compliance routines and training 1
- Reviews by the Executive Committee of the Board of Directors 1
- Monitoring by corporate security 1
- Periodic audits by the parent company 1
- Program to ensure compliance with Federal Acquisition Regulations and Cost Accounting Standards 1
- Compliance review program 1
- Oversight by contracts department 1

**Question 16: Does the company participate in the industry's 'Best Practices Forum?'**

**Yes: 34**

**No: 0**

All but one of the companies indicated that they had sent representatives to each of the "Best Practices Forums" held to date. The remaining company became a signatory to the Defense Industry Initiatives after the first forum had been held, so it attended only the second one.

**Question 17: Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?**

**Yes: 33**

**No: 1**

As with many other procedures, methods of reporting to the Board of Directors about adherence to the code vary widely. In some companies, reports are made on a regular basis: monthly, quarterly, semi-annually, or annually. In other companies, reporting is done occasionally, or regular reports are supplemented by ad hoc reports as needed. Most respondents stated that a few specific individuals or groups present reports on ethics and compliance to the Board or its committees, as the following list indicates:

- Ethics director or ethics committee 12
- Internal audit or finance 9
- General Counsel 8
- Company's independent accountants 5
- Corporate executives 4
- External, independent ombudsmen 1
- Unspecified 6

Reports are usually made either to an audit committee or an ethics committee of the Board of Directors. The following summary indicates the parties to whom these reports are presented:

• Audit Committee	26
• Ethics/Corporate Responsibility Committee	8
• Full Board of Directors	4
• Legal Affairs Committee	1
• Executive Committee	1
• Chairman of the Board	1
• Unspecified	1

Reports most frequently address the structure and activities of the company's ethics program and/or provide information about investigations of reported violations.

The respondent that answered negatively stated that its internal audit department does report to the Audit Committee of the Board of Directors on matters relating to the company's code, but no reports have yet been made regarding the DII principles. In the future, the company intends to have reports made to the Board of Directors on matters relating to the DII.

***Question 18: Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct?***

**Yes: 34**

**No: 0**

Question 18 was subject to the most diverse interpretation of any question on the DII questionnaire. Sixteen companies indicated in their written responses that they were having their independent organizations comment on the efficacy of the company's internal procedures. Seven other companies stated that their independent organizations would be commenting to the Board of Directors on the results of the examination/review of the company's DII questionnaire. The remaining 11 companies did not make clear the nature of their independent organizations' comments.

Follow-up calls to the examiners and reviewers clarified the companies' answers and produced the following breakdown of the responses:

• Company has asked an independent organization to conduct a separate engagement to evaluate and report on the efficacy of the company's internal procedures	3
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- Independent organization has rendered or intends to render orally some opinion about the efficacy of the program or suggestions for minor improvements 24
- Independent organization has submitted or intends to submit a management letter or similar document 11
- Independent organization's comments limited to certification process of DII questionnaire; no rendering of or intent to render any evaluative comments concerning efficacy of policies, procedures and programs 3

One of the companies that requested a separate engagement stated that it intends to request such a report on an annual basis.

Six of the Examiners and Reviewers indicated that they intended to both make oral comments before the Board of Directors and draft a management letter.

#### IV. CONCLUSION

The responses to this questionnaire document the efforts of the DII signatory companies to ensure ethical business conduct and compliance with federal procurement laws and regulations. Since the drafting of the Defense Industry Initiatives on Business Ethics and Conduct, signatory companies have taken positive steps to implement or expand ethics programs. Codes of ethics, training and communication programs, and procedures for monitoring compliance cannot guarantee that all employees will observe the rules of proper business conduct; however, these measures can give business ethics a high profile within the companies that implement them. At the very least, ethics programs should help reduce the number of inadvertent violations of company policies and of procurement laws and regulations.

It is noteworthy that where respondent companies did not have particular policies, procedures or programs in place during the reporting period, in most cases they had plans to remedy the situation during 1988. The Center hopes to see the DII self-governance process continue and expand, embracing more companies, encouraging defense contractors to learn from one another, and instilling an on-going commitment to operate in accordance with the highest standards of business conduct.



**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT****SUMMARY OF EXHIBITS**

- |           |  |
|-----------|--|
| EXHIBIT 1 | Defense Industry Initiatives on<br>Business Ethics and Conduct   |
| EXHIBIT 2 | Defense Industry Initiatives Steering Committee<br>and Working Group Members   |
| EXHIBIT 3 | Signatory Companies and<br>Independent Organizations   |
| EXHIBIT 4 | Interpretation of Statement on Standards<br>for Attestation Engagements, Attestation<br>Standards: "Defense Industry Questionnaire<br>on Business Ethics and Conduct." |
| EXHIBIT 5 | Description of the Role of the External<br>Independent Body for the Defense Industry<br>Initiatives  |
| EXHIBIT 6 | Ethics Resource Center, Inc.   |

## DEFENSE INDUSTRY INITIATIVES 1987 ANNUAL REPORT

### EXHIBIT 1

## BUSINESS ETHICS AND CONDUCT

The defense industry companies who sign this document already have, or commit to adopt and implement, a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public. Further, they accept the responsibility to create an environment in which compliance with federal procurement laws and free, open, and timely reporting of violations become the felt responsibility of every employee in the defense industry.

In addition to adopting and adhering to this set of six principles of business ethics and conduct, we will take the leadership in making the principles a standard for the entire defense industry.

### I. Principles

1. Each company will have and adhere to a written code of business ethics and conduct.
2. The company's code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.
3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting.
4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of

violations of federal procurement laws and corrective actions taken.

5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.
6. Each company must have public accountability for its commitment to these principles.

### II. Implementation: Supporting Programs

While all companies pledge to abide by the six principles, each company agrees that it has implemented or will implement policies and programs to meet its management needs.

#### *Principle 1: Written Code of Business Ethics and Conduct*

A company's code of business ethics and conduct should embody the values that it and its employees hold most important; it is the highest expression of a corporation's culture. For a defense contractor, the code represents the commitment of the company and its employees to work for its customers, shareholders, and the nation.

It is important, therefore, that a defense contractor's written code explicitly address that higher commitment. It must also include a statement of the standards that govern the conduct of all employees in their relationships to the company, as well as in their dealings with customers, suppliers, and consultants. The statement also must include an explanation of the consequences of violating those standards, and a clear assignment of responsibility to

operating management and others for monitoring and enforcing the standards throughout the company.

***Principle 2: Employees' Ethical Responsibilities***

A company's code of business ethics and conduct should embody the basic values and culture of a company and should become a way of life, a form of honor system, for every employee. Only if the code is embodied in some form of honor system does it become more than mere words or abstract ideals. Adherence to the code becomes a responsibility of each employee both to the company and to fellow employees. Failure to live by the code, or to report infractions, erodes the trust essential to personal accountability and an effective corporate business ethics system.

Codes of business ethics and conduct are effective only if they are fully understood by every employee. Communication and training are critical to preparing employees to meet their ethical responsibilities. Companies can use a wide variety of methods to communicate their codes and policies and to educate their employees as to how to fulfill their obligations. Whatever methods are used—broad distribution of written codes, personnel orientation programs, group meetings, videotapes, and articles—it is critical that they ensure total coverage.

***Principle 3: Corporate Responsibility to Employees***

Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting.

To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.

It is critical that companies create and

maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.

To receive and investigate employee allegations of violations of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office or other similar mechanism.

In general, the companies accept the broadest responsibility to create an environment in which free, open and timely reporting of any suspected violations becomes the felt responsibility of every employee.

***Principle 4: Corporate Responsibility to the Government***

It is the responsibility of each company to aggressively self-govern and monitor adherence to its code and to federal procurement laws. Procedures will be established by each company for voluntarily reporting to appropriate government authorities violations of federal procurement laws and corrective actions.

In the past, major importance has been placed on whether internal company monitoring has uncovered deficiencies before discovery by governmental audit. The process will be more effective if all monitoring efforts are viewed as mutually reinforcing and the measure of performance is a timely and constructive surfacing of issues.

Corporate and government audit and control mechanisms should be used to identify and correct problems. Government and industry share this responsibility and must work together cooperatively and constructively to ensure compliance with federal procurement laws and to clarify any ambiguities that exist.

### ***Principle 5: Corporate Responsibility to the Defense Industry***

Each company must understand that rigorous self-governance is the foundation of these principles of business ethics and conduct and of the public's perception of the integrity of the defense industry.

Since methods of accountability can be improved through shared experience and adaptation, companies will participate in an annual intercompany "Best Practices Forum" that will bring together operating and staff managers from across the industry to discuss ways to implement the industry's principles of accountability.

Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors.

### ***Principle 6: Public Accountability***

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

### **Questionnaire**

1. Does the company have a written code of business ethics and conduct?
2. Is the code distributed to all employees principally involved in defense work?
3. Are new employees provided any orientation to the code?
4. Does the code assign responsibility to operating management and others for compliance with the code?
5. Does the company conduct employee training programs regarding the code?
6. Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?
7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
8. Does the mechanism employed protect the confidentiality of employee reports?
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?
12. What are the specifics of such a program?
  - a. Written communication?
  - b. One-on-one communication?
  - c. Group meetings?
  - d. Visual aids?
  - e. Others?

- 
13. Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?
  14. Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
  15. Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?
  16. Does the company participate in the industry's "Best Practices Forum"?
  17. Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?
  18. Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct?

**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT****EXHIBIT 2****MEMBERS OF DII STEERING COMMITTEE  
AND WORKING GROUP***Steering Committee*

**Mr. Donald R. Beall**  
President and Chief Operating Officer  
Rockwell International

**Dr. J. R. Burnett**  
Executive Vice President  
TRW Space and Defense

**Mr. Robert F. Daniell**  
President and Chief Executive Officer  
United Technologies Corporation

**Mr. Edward E. Hood, Jr.**  
Vice Chairman of the Board  
General Electric Company

**Mr. Caleb Hurtt**  
President and Chief Operating Officer  
Aerospace Division  
Martin Marietta Corporation

**Mr. Thomas V. Jones**  
Chairman and Chief Executive Officer  
Northrop Corporation

**Mr. Malcolm T. Stamper**  
Vice Chairman of the Board  
The Boeing Company

**Mr. Alan R. Yuspeh, Esq.**  
Coordinator, Defense Industry Initiatives  
Preston, Thorgrimson, Ellis and Holman

**EXHIBIT 2 (CONTINUED)*****Working Group*****Ms. Zoe Baird, Esq.**

General Electric Company

**Mr. Ted Collins, Esq.**

Vice President and General Counsel

The Boeing Company

**Mr. William M. Elliott, Esq.**

Senior Vice President and General Counsel

Northrop Corporation

**Mr. Charles H. Harff, Esq.**

Senior Vice President, General Counsel and Secretary

Rockwell International

**Mr. Frank W. McAbee, Jr.**

Vice President, Government Contracts and Compliance

United Technologies Corporation

**Mr. Frank Menaker, Esq.**

Vice President and General Counsel

Martin Marietta Corporation

**Mr. Paul Schwegler**

Vice President, Business Ethics and Conduct

TRW Space and Defense

**Mr. Alan Yuspeh, Esq.**

Coordinator, Defense Industry Initiatives

Preston, Thorgrimson, Ellis and Holman

**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT**

**EXHIBIT 3**

**SIGNATORY COMPANIES  
AND INDEPENDENT ORGANIZATIONS**

- |   |                                       |
|---|---------------------------------------|
| 1. Allied-Signal                                      | Price Waterhouse                      |
| 2. AT&T   | Coopers & Lybrand                     |
| 3. The Boeing Company                                 | Touche Ross & Company                 |
| 4. Eaton Corporation                                  | Ernst & Whinney                       |
| 5. E-Systems, Inc.                                    | Ernst & Whinney                       |
| 6. FMC  | Peat Marwick Main & Company           |
| 7. Ford Aerospace &<br>Communications Corporation     | Coopers & Lybrand                     |
| 8. General Dynamics                                   | Arthur Andersen & Company             |
| 9. General Electric Company                           | Peat Marwick Main & Company           |
| 10. Grumman Corporation                               | Arthur Andersen & Company             |
| 11. Harris Corporation                                | Ernst & Whinney                       |
| 12. Hercules Aerospace Company                        | Coopers & Lybrand                     |
| 13. Hewlett-Packard Company                           | Price Waterhouse                      |
| 14. Honeywell Inc.                                    | Deloitte, Haskins & Sells             |
| 15. Hughes Aircraft Corporation                       | Latham & Watkins,<br>Attorneys at Law |
| 16. International Business<br>Machines Corporation    | Price Waterhouse                      |
| 17. ITT Defense Technology<br>Corporation             | Arthur Andersen & Company             |
| 18. Lockheed Corporation                              | Arthur Young & Company                |
| 19. Martin Marietta Corporation                       | Ernst & Whinney                       |
| 20. McDonnell Douglas Corporation                     | Ernst & Whinney                       |
| 21. Northrop Corporation                              | Touche Ross & Company                 |
| 22. Parker Hannifin Corporation                       | Coopers & Lybrand                     |
| 23. Pneumo Abex                                       | Crowell & Moring                      |
| 24. Raytheon Corporation                              | Coopers & Lybrand                     |
| 25. Rockwell International<br>Corporation             | Deloitte, Haskins & Sells             |
| 26. Science Applications<br>International Corporation | Price Waterhouse                      |
| 27. The Singer Company                                | Peat Marwick Main & Company           |
| 28. Textron Inc.                                      | Arthur Young & Company                |
| 29. TRW Inc.  | Ernst & Whinney                       |
| 30. Unisys Corporation                                | Arthur Young & Company                |
| 31. United Technologies Corporation                   | Price Waterhouse                      |
| 32. Varian Associates                                 | Coopers & Lybrand                     |
| 33. Westinghouse Electric Corporation                 | Price Waterhouse                      |
| 34. Zenith Electronics Corporation                    | Arthur Andersen & Company             |



# OFFICIAL RELEASES

public accountability for their commitment to the Initiatives. That principle requires completion of a *Questionnaire on Business Ethics and Conduct (Questionnaire)*, which is appended to the six principles.

The public accountability principle also requires the defense contractor's independent public accountant or similar independent organization to express a conclusion about the responses to the *Questionnaire* and issue a report thereon for submission to the External Independent Organization of the Defense Industry (EIODI). (Appendices C and D to this Interpretation provide background information about the *Initiatives*, the six principles, and the required *Questionnaire*.)

A defense contractor may request its independent public accountant (practitioner) to examine or review its responses to the *Questionnaire* for the purpose of expressing a conclusion about the appropriateness of those responses in a report prepared for general distribution. Would such an engagement be an attest engagement as defined in *Statement on Standards for Attestation Engagements, Attestation Standards (SSAE)*?

*Interpretation*—SSAE defines an attest engagement as one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The questions in the *Questionnaire* and the accompanying responses are written assertions of the defense contractor. When a practitioner is engaged by a defense contractor to express a written conclusion about the appropriateness of those responses, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the defense contractor. Consequently, SSAE applies to such engagements.

*Question*—Paragraph 11 of SSAE specifies that a practitioner shall perform an attest engagement only if there are reasons to believe that "the assertion is capable of evaluation against reasonable criteria that either have been estab-

## ATTESTATION INTERPRETATION

*The staff of the Auditing Standards Division has been authorized to issue interpretations to provide timely guidance on the application of pronouncements of the Auditing Standards Board. Interpretations are reviewed by members of that Board. An interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.*

*Interpretation of Statement on Standards for Attestation Engagements, Attestation Standards: "Defense Industry Questionnaire on Business Ethics and Conduct"*

*Question*—Certain defense contractors have made a commitment to adopt and implement six principles of business ethics and conduct contained in the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)*. One of those principles concerns defense contractors'

lished by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them." What are the criteria against which such assertions are to be evaluated and do such criteria provide a reasonable basis for the general distribution of the presentation of the assertions and a practitioner's report thereon?

**Interpretation**—The criteria for evaluating the defense contractor's assertions are set forth in the *Initiatives and Questionnaire*. The reasonableness of those criteria must be evaluated by assessing whether the assertions they generate (the questions and responses in the *Questionnaire*) have an appropriate balance of the relevance and reliability characteristics discussed in paragraph 15 of SSAE.

The criteria set forth in the *Initiatives and Questionnaire* will, when properly applied, generate assertions that have an appropriate balance of relevance and reliability. Consequently, such criteria provide a reasonable basis for the general distribution of the *Questionnaire* and responses and the practitioner's report thereon. Although the criteria provide a reasonable basis for general distribution of the practitioner's report, they have not been established by the type of recognized body contemplated in paragraph 13 of SSAE. Consequently, as required by paragraph 14 of SSAE, the criteria must be stated in the presentation of assertions in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand them. This requirement will be satisfied if the defense contractor attaches the *Initiatives and Questionnaire* to the presentation of the assertions.

**Question**—What is the nature of the procedures that should be applied to the *Questionnaire* responses?

**Interpretation**—The objective of the procedures performed in either an examination or review engagement is to obtain evidential matter that the defense contractor has designed and placed in operation policies and programs that conform with the criteria in the *Initiatives and Questionnaire* in a manner that supports the responses to the questions in the *Questionnaire* and that the policies and programs operated during the period covered by the defense contractor's assertion. The objective does not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employ-

ees or about whether the defense contractor and its employees have complied with federal procurement laws. In an examination, the evidential matter should be sufficient to limit the attestation risk for the assertions to a level that is appropriately low for the high degree of assurance imparted by an examination report. In a review, this evidential matter should be sufficient to limit the attestation risk to a moderate level.

Examination procedures include obtaining evidential matter by reading relevant policies and programs, making inquiries of appropriate defense contractor personnel, inspecting documents and records, confirming defense contractor assertions with its employees or others, and observing activities. Illustrative examination procedures are presented in Appendix A. Review procedures are generally limited to reading relevant policies and procedures and making inquiries of appropriate defense contractor personnel. Illustrative review procedures are presented in Appendix E. When applying examination or review procedures, the practitioner should assess the appropriateness (including the comprehensiveness) of the policies and programs in meeting the criteria in the *Initiatives and Questionnaire*.

A particular defense contractor's policies and programs may vary from those of other defense contractors. As a result, evidential matter obtained from the procedures performed cannot be evaluated solely on a quantitative basis. Consequently, it is not practicable to establish only quantitative guidelines for determining the nature or extent of the evidential matter that is necessary to provide the assurance required in either an examination or review. The qualitative aspects should also be considered.

In an examination it will be necessary for a practitioner's procedures to go beyond reading relevant policies and programs and making inquiries of appropriate defense contractor personnel to determine whether the policies and programs that support a defense contractor's answers to specific questions in the *Questionnaire* operated during the period.

In determining the nature, timing, and extent of examination or review procedures, the practitioner should consider information obtained in the performance of other services for the defense contractor, for example, the audit of the defense contractor's financial statements. For multi-location defense contractors, whether policies and programs operated during the period should be evaluated for both the defense contractor's headquarters and for selected defense contracting locations. The practi-

tioner may consider using the work of the defense contractor's internal auditors. The guidance in AU Section 322 may be useful in that consideration.

Examination procedures, and in some instances review procedures, may require access to information involving specific instances of actual or alleged noncompliance with laws. An inability to obtain access to such information because of restrictions imposed by a defense contractor (for example, to protect attorney-client privilege) may constitute a scope limitation. Paragraphs 63 through 66 of SSAE provide guidance in such situations. The practitioner should assess the effect of the inability to obtain access to such information on his or her ability to form a conclusion about whether the related policy or program operated during the period. If the defense contractor's reasons for not permitting access to the information are reasonable (for example, the information is the subject of litigation or a governmental investigation) and have been approved by an executive officer of the defense contractor, the occurrences of restricted access to information are few in number, and the practitioner has access to other information about that specific instance or about other instances that is sufficient to permit a conclusion to be formed about whether the related policy or program operated during the period, the practitioner ordinarily would conclude that it is not necessary to disclaim assurance.

If the practitioner's scope of work has been restricted with respect to one or more questions, the practitioner should consider the implications of that restriction on the practitioner's ability to form a conclusion about other questions. In addition, as the nature or number of questions on which the defense contractor has imposed scope limitations increases in significance, the practitioner should consider whether to withdraw from the engagement.

**Question**—What is the form of report that should be issued to meet the requirements of SSAE?

**Interpretation**—The standards of reporting in SSAE (paragraphs 45 through 70) provide guidance about report content and wording and the circumstances that may require report modification. Appendix B and Appendix F provide illustrative reports appropriate for various circumstances. Paragraph 46 states that the practitioner's report should refer to a separate presentation of assertions that is the responsibility of the asserter. The completed *Questionnaire* constitutes the presentation of assertions that should be referred

to in the practitioner's report. The defense contractor should prepare a statement to accompany the presentation of the completed *Questionnaire* that asserts that the responses to the *Questionnaire* are appropriately presented in conformity with the criteria. An illustrative defense contractor statement is also presented in Appendix B and Appendix F.

The engagements addressed in this Interpretation do not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. The practitioner's report should explicitly disclaim an opinion on the extent of such compliance.

Because variations in individual performance and interpretation will affect the operation of the defense contractor's policies and programs during the period, adherence to all such policies and programs in every case may not be possible. In determining whether a reservation about a response in the *Questionnaire* is sufficiently significant to result in an opinion modified for an exception to that response, the practitioner should consider the nature, causes, patterns, and pervasiveness of the instances in which the policies and programs did not operate as designed and their implications for that response in the *Questionnaire*.

When scope limitations have precluded the practitioner from forming an opinion on the responses to one or more questions, the practitioner's report should describe all such scope restrictions. If such a scope limitation was imposed by the defense contractor after the practitioner had begun performing procedures, that fact should be stated in the report.

A defense contractor may request the practitioner to communicate to management, the board of directors, or one of its committees, either orally or in writing, conditions noted that do not constitute significant reservations about the answers to the *Questionnaire* but that might nevertheless be of value to management. Agreed-upon arrangements between the practitioner and the defense contractor to communicate conditions noted may include, for example, the reporting of matters of less significance than those contemplated by the criteria stated in the *Initiatives* and *Questionnaire*, the existence of conditions specified by the defense contractor, the results of further investigation of matters noted to identify underlying

causes, or suggestions for improvements in various policies or programs. Under these arrangements, the practitioner may be requested to visit specific locations, assess the effectiveness of specific policies or programs, or undertake specific attestation procedures not otherwise planned. In addition, the practitioner is not precluded from communicating matters believed to be of value, even if no specific request has been made.

#### APPENDIX A

##### ILLUSTRATIVE PROCEDURES FOR EXAMINATION OF ANSWERS TO QUESTIONNAIRE

##### DEFENSE INDUSTRY QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT

Before performing procedures, the practitioner should read the *Defense Industry Initiatives on Business Ethics and Conduct*.

##### 1. DOES THE COMPANY HAVE A WRITTEN CODE OF BUSINESS ETHICS AND CONDUCT?

Determine whether the Company has a written Code of Business Ethics and Conduct.

##### 2. IS THE CODE DISTRIBUTED TO ALL EMPLOYEES PRINCIPALLY INVOLVED IN DEFENSE WORK?

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.

**b.** Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Code was distributed to employees principally involved in defense work.

##### 3. ARE NEW EMPLOYEES PROVIDED ANY ORIENTATION TO THE CODE?

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.

**b.** Obtain additional evidential matter, by positive confirmation of a selected number of employees hired during the reporting period or by other means, that an orientation to the Code was provided at time of employment.

##### 4. DOES THE CODE ASSIGN RESPONSIBILITY TO OPERATING MANAGEMENT AND OTHERS FOR COMPLIANCE WITH THE CODE?

Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and

(b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.

##### 5. DOES THE COMPANY CONDUCT EMPLOYEE TRAINING PROGRAMS REGARDING THE CODE?

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.

**b.** Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Company conducted employee training programs regarding the Code for employees principally involved in defense work.

##### 6. DOES THE CODE ADDRESS STANDARDS THAT GOVERN THE CONDUCT OF EMPLOYEES IN THEIR DEALINGS WITH SUPPLIERS, CONSULTANTS AND CUSTOMERS?

Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.

##### 7. IS THERE A CORPORATE REVIEW BOARD, OMBUDSMAN, CORPORATE COMPLIANCE OR ETHICS OFFICE OR SIMILAR MECHANISM FOR EMPLOYEES TO REPORT SUSPECTED VIOLATIONS TO SOMEONE OTHER THAN THEIR DIRECT SUPERVISOR, IF NECESSARY?

Determine by inquiry of Company officials, observation, and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.

##### 8. DOES THE MECHANISM EMPLOYED PROTECT THE CONFIDENTIALITY OF EMPLOYEE REPORTS?

**a.** Determine by inquiry of members of the corporate reviewboard, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.

**b.** Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.

##### 9. IS THERE AN APPROPRIATE MECHANISM TO FOLLOW-UP ON REPORTS OF SUSPECTED VIOLATIONS TO DETERMINE WHAT OCCURRED, WHO WAS RESPONSIBLE, AND RECOMMENDED CORRECTIVE AND OTHER ACTIONS?

**a.** Determine by inquiry of Company

officials and/or by reading relevant documentation how the follow-up procedure established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.

**h.** Determine by inquiry of those responsible for performing such follow-up procedures how they document that the procedures were carried out.

**e.** Obtain additional evidential matter that the follow-up mechanism was employed by examining a selected number of reports of suspected violations from the log or other record of reports used by the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism.

**10. IS THERE AN APPROPRIATE MECHANISM FOR LETTING EMPLOYEES KNOW THE RESULT OF ANY FOLLOW-UP INTO THEIR REPORTED CHARGES?**

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.

**b.** For those items selected at Question 9 above, determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism and by examining other evidential matter whether the results of the Company's follow-up of reported charges have been communicated to employees.

**11. IS THERE AN ONGOING PROGRAM OF COMMUNICATION TO EMPLOYEES, SPELLING OUT AND RE-EMPHASIZING THEIR OBLIGATIONS UNDER THE CODE OF CONDUCT?**

and

**12. WHAT ARE THE SPECIFICS OF SUCH A PROGRAM?**

**A. WRITTEN COMMUNICATION?**

**B. ONE-ON-ONE COMMUNICATION?**

**C. GROUP MEETINGS?**

**D. VISUAL AIDS?**

**E. OTHERS?**

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the Questionnaire.

**b.** Read announcements and other evidential matter in support of the actual program of re-emphasis.

**13. DOES THE COMPANY HAVE A PROCEDURE FOR VOLUNTARILY REPORTING VIOLATIONS OF FEDERAL PROCUREMENT LAWS TO APPROPRIATE GOVERNMENTAL AGENCIES?**

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies and examine evidential matter to determine whether such procedures are being implemented.

**14. IS IMPLEMENTATION OF THE CODE'S PROVISIONS ONE OF THE STANDARDS BY WHICH ALL LEVELS OF SUPERVISION ARE EXPECTED TO BE MEASURED IN THEIR PERFORMANCE?**

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.

**b.** Obtain additional evidential matter to determine that supervisors are responsible for implementation of the Code's provisions.

**15. IS THERE A PROGRAM TO MONITOR ON A CONTINUING BASIS ADHERENCE TO THE CODE OF CONDUCT AND COMPLIANCE WITH FEDERAL PROCUREMENT LAWS?**

**a.** Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on a continuing basis, adherence to the Code and compliance with federal procurement laws.

**b.** Obtain additional evidential matter, for example by reading internal audit reports, of the Company's monitoring of compliance with the Code and federal procurement laws.

**16. DOES THE COMPANY PARTICIPATE IN THE INDUSTRY'S "BEST PRACTICES FORUM"?**

Examine evidence of the Company's participation in the "Best Practices Forum."

**17. ARE PERIODIC REPORTS ON ADHERENCE TO THE PRINCIPLES MADE TO THE COMPANY'S BOARD OF DIRECTORS OR TO ITS AUDIT OR OTHER APPROPRIATE COMMITTEE?**

Determine by inquiry of Company officials and/or by reading minutes of the

board of directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.

**18. ARE THE COMPANY'S INDEPENDENT PUBLIC ACCOUNTANTS OR A SIMILAR INDEPENDENT ORGANIZATION REQUIRED TO COMMENT TO THE BOARD OF DIRECTORS OR A COMMITTEE THEREOF ON THE EFFICACY OF THE COMPANY'S INTERNAL PROCEDURES FOR IMPLEMENTING THE COMPANY'S CODE OF CONDUCT?**

Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

## APPENDIX B

### ILLUSTRATIVE DEFENSE CONTRACTOR ASSERTIONS AND EXAMINATION REPORTS

#### DEFENSE INDUSTRY QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT

##### Illustration 1: Unqualified Opinion

#### DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_.

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

#### Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_.

## EXAMINATION REPORT

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon. In our opinion, the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_ referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

**Illustration 2: Unqualified Opinion; Report Modified for Negative Responses**

## DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives

on Business Ethics and Conduct, including the Questionnaire.

## Attachments

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_

(The responses could include an explanation of negative responses if the defense contractor so desired.)

## EXAMINATION REPORT

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_ referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire. The negative responses to Questions \_\_\_\_\_ and \_\_\_\_\_ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

**Illustration 3: Opinion Modified for Exception on Certain Response**

## DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

## Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_

## EXAMINATION REPORT

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon. In our opinion, except for the response to Question 10 as discussed in the follow-

ing paragraph, the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_ referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

**Illustration 4: Opinion Modified for Exception on Certain Response; Report also Modified for Negative Responses**

#### DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

#### Attachments

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_

(The responses could include an explanation of negative responses if the defense contractor so desired.)

#### EXAMINATION REPORT

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, except for the response to Question 10 as discussed in the following paragraph, the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_ referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire. The negative responses to Questions \_\_\_\_\_ and \_\_\_\_\_ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the

Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

**Illustration 5: Opinion Disclaimed on Certain Responses Because of Scope Restrictions Imposed by Client**

#### DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

#### Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_

#### EXAMINATION REPORT

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Except as explained in the fol-

lowing paragraph, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

We were not permitted to read relevant documents and files or interview appropriate employees to determine that the affirmative answers to Questions 8, 9, and 10 are appropriate. The nature of those questions precluded us from satisfying ourselves as to the appropriateness of those answers by means of other examination procedures.

In our opinion, the affirmative responses to Questions 1 through 7 and 11 through 18 in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_

referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire. Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to express, and we do not express, an opinion on the appropriateness of the affirmative responses to Questions 8, 9, and 10 in the Questionnaire.

#### APPENDIX C

##### BACKGROUND

##### DEFENSE INDUSTRY QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT

The June 1986 final report to the President of the United States, *A Quest for Excellence*, by the President's Blue Ribbon Commission on Defense Management (the "Packard Commission") included as an appendix the Defense In-

dustry Initiatives on Business Ethics and Conduct (Initiatives) written by leaders in the defense industry and signed by many of the country's major defense contractors. The Initiatives, which were endorsed by the Packard Commission, set forth six principles of business ethics and conduct, which signatories to the Initiatives are committed to adopt and implement.

The sixth principle of business ethics and conduct specifies that "Each company must have public accountability for its commitment to these principles." The section of the Initiatives on implementation contains the following discussion of the sixth principle:

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Appendix D to this Interpretation reproduces in full the Initiatives, including the Questionnaire on Business Ethics and Conduct (Questionnaire).

Representatives of the signatories to the Initiatives have agreed that the defense contractor assertion illustrated in Appendix B and Appendix F, with the attachments thereto, is the appropriate vehicle for meeting the sixth principle referred to above. They also have agreed that each signatory should adopt and implement a code of business ethics and conduct that, in a self-contained document, addresses all of the required provisions of the six principles. In 1987, representatives of the signatories to the

Initiatives created the External Independent Organization of the Defense Industry (EIODI) as the body to receive responses to the Questionnaire, report the results for the defense industry as a whole, and release the data to the companies and the public. The Auditing Standards Division of the American Institute of Certified Public Accountants, the EIODI, and representatives of the signatories to the Initiatives have agreed to a framework, which is embodied in this Interpretation, in which practitioners can accept engagements to attest to the answers to the Questionnaire and issue reports on the results of those engagements.

#### APPENDIX D

##### DEFENSE INDUSTRY INITIATIVES ON BUSINESS ETHICS AND CONDUCT AND QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT\*

##### BUSINESS ETHICS AND CONDUCT

The defense industry companies who sign this document already have, or commit to adopt and implement, a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public. Further, they accept the responsibility to create an environment in which compliance with federal procurement laws and free, open, and timely reporting of violations become the felt responsibility of every employee in the defense industry.

In addition to adopting and adhering to this set of six principles of business ethics and conduct, we will take the leadership in making the principles a standard for the entire defense industry.

##### 1. Principles

1. Each company will have and adhere to a written code of business ethics and conduct.

2. The company's code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.

3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting.

\*From *A Quest for Excellence*, appendix, final report by the President's Blue Ribbon Commission on Defense Management, June 1986.

4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.

5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.

6. Each company must have public accountability for its commitment to these principles.

#### **II. Implementation: Supporting Programs**

While all companies pledge to abide by the six principles, each company agrees that it has implemented or will implement policies and programs to meet its management needs.

##### **Principle 1: Written Code of Business Ethics and Conduct**

A company's code of business ethics and conduct should embody the values that it and its employees hold most important; it is the highest expression of a corporation's culture. For a defense contractor, the code represents the commitment of the company and its employees to work for its customers, shareholders, and the nation.

It is important, therefore, that a defense contractor's written code explicitly address that higher commitment. It must also include a statement of the standards that govern the conduct of all employees in their relationships to the company, as well as in their dealings with customers, suppliers, and consultants. The statement also must include an explanation of the consequences of violating those standards, and a clear assignment of responsibility to operating management and others for monitoring and enforcing the standards throughout the company.

##### **Principle 2: Employees' Ethical Responsibilities**

A company's code of business ethics and conduct should embody the basic values and culture of a company and should become a way of life, a form of honor system, for every employee. Only if the code is embodied in some form of honor system does it become more than mere words or abstract ideals. Adherence to the code becomes a responsibility of each employee both to the company and to fellow employees. Failure to live by the code, or to report infractions, erodes the trust essential to personal accountability and an effective corporate business ethics system.

Codes of business ethics and conduct

are effective only if they are fully understood by every employee. Communications and training are critical to preparing employees to meet their ethical responsibilities. Companies can use a wide variety of methods to communicate their codes and policies and to educate their employees as to how to fulfill their obligations. Whatever methods are used—broad distribution of written codes, personnel orientation programs, group meetings, videotapes, and articles—it is critical that they ensure total coverage.

##### **Principle 3: Corporate Responsibility to Employees**

Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting.

To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.

It is critical that companies create and maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.

To receive and investigate employee allegations of violations of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office or other similar mechanism.

In general, the companies accept the broadest responsibility to create an environment in which free, open and timely reporting of any suspected violations becomes the felt responsibility of every employee.

##### **Principle 4: Corporate Responsibility to the Government**

It is the responsibility of each company to aggressively self-govern and monitor adherence to its code and to federal procurement laws. Procedures will be established by each company for voluntarily reporting to appropriate government authorities violations of federal procurement laws and corrective actions.

In the past, major importance has been placed on whether internal company monitoring has uncovered deficien-

cies before discovery by governmental audit. The process will be more effective if all monitoring efforts are viewed as mutually reinforcing and the measure of performance is a timely and constructive surfacing of issues.

Corporate and government audit and control mechanisms should be used to identify and correct problems. Government and industry share this responsibility and must work together cooperatively and constructively to ensure compliance with federal procurement laws and to clarify any ambiguities that exist.

##### **Principle 5: Corporate Responsibility to the Defense Industry**

Each company must understand that rigorous self-governance is the foundation of these principles of business ethics and conduct and of the public's perception of the integrity of the defense industry.

Since methods of accountability can be improved through shared experience and adaptation, companies will participate in an annual intercompany "Best Practices Forum" that will bring together operating and staff managers from across the industry to discuss ways to implement the industry's principles of accountability.

Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors.

##### **Principle 6: Public Accountability**

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

#### **Questionnaire**

1. Does the company have a written



- code of business ethics and conduct?
2. Is the code distributed to all employees principally involved in defense work?
  3. Are new employees provided any orientation to the code?
  4. Does the code assign responsibility to operating management and others for compliance with the code?
  5. Does the company conduct employee training programs regarding the code?
  6. Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?
  7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
  8. Does the mechanism employed protect the confidentiality of employee reports?
  9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
  10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
  11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?
  12. What are the specifics of such a program?
    - a. Written communication?
    - b. One-on-one communication?
    - c. Group meetings?
    - d. Visual aids?
    - e. Others?
  13. Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?
  14. Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
  15. Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?
  16. Does the company participate in the industry's "Best Practices Forum"?
  17. Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?
  18. Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing

the company's code of conduct?

#### APPENDIX E

#### ILLUSTRATIVE PROCEDURES FOR REVIEW OF ANSWERS TO QUESTIONNAIRE

##### DEFENSE INDUSTRY QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT

Before performing procedures, the practitioner should read the Defense Industry Initiatives on Business Ethics and Conduct.

##### 1. DOES THE COMPANY HAVE A WRITTEN CODE OF BUSINESS ETHICS AND CONDUCT?

Determine whether the Company has a written Code of Business Ethics and Conduct.

##### 2. IS THE CODE DISTRIBUTED TO ALL EMPLOYEES PRINCIPALLY INVOLVED IN DEFENSE WORK?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.

##### 3. ARE NEW EMPLOYEES PROVIDED ANY ORIENTATION TO THE CODE?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.

##### 4. DOES THE CODE ASSIGN RESPONSIBILITY TO OPERATING MANAGEMENT AND OTHERS FOR COMPLIANCE WITH THE CODE?

Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and (b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.

##### 5. DOES THE COMPANY CONDUCT EMPLOYEE TRAINING PROGRAMS REGARDING THE CODE?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.

##### 6. DOES THE CODE ADDRESS STANDARDS THAT GOVERN THE CONDUCT OF EMPLOYEES IN THEIR DEALINGS WITH SUPPLIERS, CONSULTANTS AND CUSTOMERS?

Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.

##### 7. IS THERE A CORPORATE REVIEW BOARD, OMBUDSMAN, CORPORATE COMPLIANCE OR ETHICS OFFICE OR SIMILAR MECHANISM FOR EMPLOYEES TO REPORT SUSPECTED VIOLATIONS TO SOMEONE OTHER THAN THEIR DIRECT SUPERVISOR, IF NECESSARY?

Determine by inquiry of Company officials and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.

##### 8. DOES THE MECHANISM EMPLOYED PROTECT THE CONFIDENTIALITY OF EMPLOYEE REPORTS?

a. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.

b. Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.

##### 9. IS THERE AN APPROPRIATE MECHANISM TO FOLLOW-UP ON REPORTS OF SUSPECTED VIOLATIONS TO DETERMINE WHAT OCCURRED, WHO WAS RESPONSIBLE, AND RECOMMENDED CORRECTIVE AND OTHER ACTIONS?

Determine by inquiry of Company officials and/or by reading relevant documentation how the follow-up procedures established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.

##### 10. IS THERE AN APPROPRIATE MECHANISM FOR LETTING EMPLOYEES KNOW THE RESULT OF ANY FOLLOW-UP INTO THEIR REPORTED CHARGES?

a. Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.

b. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism whether the results of the Company's follow-up of reported charges have been communi-

cated to employees.

**11. IS THERE AN ONGOING PROGRAM OF COMMUNICATION TO EMPLOYEES, SPELLING OUT AND RE-EMPHASIZING THEIR OBLIGATIONS UNDER THE CODE OF CONDUCT?**

and

**12. WHAT ARE THE SPECIFICS OF SUCH A PROGRAM?**

- A. WRITTEN COMMUNICATION?**
- B. ONE-ON-ONE COMMUNICATION?**
- C. GROUP MEETINGS?**
- D. VISUAL AIDS?**
- E. OTHERS?**

Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the Questionnaire.

**13. DOES THE COMPANY HAVE A PROCEDURE FOR VOLUNTARILY REPORTING VIOLATIONS OF FEDERAL PROCUREMENT LAWS TO APPROPRIATE GOVERNMENTAL AGENCIES?**

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies.

**14. IS IMPLEMENTATION OF THE CODE'S PROVISIONS ONE OF THE STANDARDS BY WHICH ALL LEVELS OF SUPERVISION ARE EXPECTED TO BE MEASURED IN THEIR PERFORMANCE?**

Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.

**15. IS THERE A PROGRAM TO MONITOR ON A CONTINUING BASIS ADHERENCE TO THE CODE OF CONDUCT AND COMPLIANCE WITH FEDERAL PROCUREMENT LAWS?**

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on a continuing basis, adherence to the Code and compliance with federal procurement laws.

**16. DOES THE COMPANY PARTICIPATE IN THE INDUSTRY'S "BEST PRACTICES FORUM"?**

Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company participated in the "Best Practices Forum."

**17. ARE PERIODIC REPORTS ON ADHERENCE TO THE PRINCIPLES MADE TO THE COMPANY'S BOARD OF DIRECTORS OR TO ITS AUDIT OR OTHER APPROPRIATE COMMITTEE?**

Determine by inquiry of Company officials and/or by reading minutes of the Board of Directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.

**18. ARE THE COMPANY'S INDEPENDENT PUBLIC ACCOUNTANTS OR A SIMILAR INDEPENDENT ORGANIZATION REQUIRED TO COMMENT TO THE BOARD OF DIRECTORS OR A COMMITTEE THEREOF ON THE EFFICACY OF THE COMPANY'S INTERNAL PROCEDURES FOR IMPLEMENTING THE COMPANY'S CODE OF CONDUCT?**

Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

#### APPENDIX F

##### ILLUSTRATIVE DEFENSE CONTRACTOR ASSERTION AND REVIEW REPORT

###### DEFENSE INDUSTRY QUESTIONNAIRE ON BUSINESS ETHICS AND CONDUCT

###### DEFENSE CONTRACTOR ASSERTION

Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_.

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_ are based on policies and programs in operation during that period and are appropriately presented in conformity with the criteria set forth in the Defense Industry Initia-

tives on Business Ethics and Conduct, including the Questionnaire.

###### Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from \_\_\_\_\_ to \_\_\_\_\_.

###### REVIEW REPORT

To the Board of Directors of the XYZ Company

We have reviewed the XYZ Company's Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_, and the Questionnaire and responses attached thereto. Our review was made in accordance with standards established by the American Institute of Certified Public Accountants. Our review was designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. Our review was not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the affirmative responses in the Questionnaire accompanying the Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from \_\_\_\_\_ to \_\_\_\_\_ referred to above are not appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire. ■

**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT****EXHIBIT 5****DESCRIPTION OF THE ROLE  
OF THE DEFENSE INDUSTRY INITIATIVES  
EXTERNAL INDEPENDENT BODY**

The function of the external independent body will be to report the results of the commitment to the Defense Industry Initiatives by compiling the audited questionnaires of the signatory companies to the Initiatives and to release a report of the data simultaneously to the companies and the general public. The report should explain the background of the Initiatives, the manner in which the questionnaires were completed, and the manner in which the questionnaires were reviewed by independent organizations for each company.

In preparing its report, the external independent body is to rely on the audited questionnaires submitted by the signatory companies and on interviews with representatives of the independent organizations as to the procedures followed by them in examining or reviewing the responses to the questionnaires. The report of the external independent body should be a self-contained document generally comprehensible to the general public and should serve in and of itself as an explanation of the activities undertaken by the signatory companies to achieve the goals of the Initiatives.

**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT****EXHIBIT 6****ETHICS RESOURCE CENTER, INC.**

The Ethics Resource Center, Inc. is a private, non-profit organization working to strengthen public trust in business, government and other institutions of our society. The Center is non-partisan and non-sectarian. It was established in 1977 in response to growing concern among the public, elected officials, business executives and others about ethical standards and conduct in business and government.

The Center serves as both catalyst and resource for the development and implementation of ethics programs. The Center collects information on ethics issues and policies from all levels of business, government, education and the professions; provides analyses of the most critical and common problems; and develops programs to address these concerns. The Center advises corporations, trade associations, professional societies, municipal governments and federal agencies on the development and implementation of standards of ethical conduct.

At the request of the Packard Commission, the Center submitted recommendations regarding voluntary corporate measures to enhance ethical business conduct in the defense industry.

**DEFENSE INDUSTRY INITIATIVES  
1987 ANNUAL REPORT****APPENDIX A****SIGNATORY COMPANIES  
JANUARY 1988**

1. Aeronca, Inc.
2. Allied-Signal
3. AT&T
4. BDM International
5. The Boeing Company
6. CFM International
7. Computer Sciences Corporation
8. Dyncorp
9. Eaton Corporation
10. E-Systems, Inc.
11. FMC
12. Ford Aerospace & Communications Corporation
13. Gates-Learjet Corporation
14. General Dynamics
15. General Electric Company
16. Grumman Corporation
17. Harris Corporation
18. Harsco Corporation
19. Hercules Aerospace Company
20. Hewlett-Packard Company
21. Honeywell Inc.
22. Hughes Aircraft Corporation
23. International Business Machines Corporation
24. ITT Defense Technology Corporation
25. Lockheed Corporation
26. Martin Marietta Corporation
27. McDonnell Douglas Corporation
28. Morton Thiokol, Inc.
29. Northrop Corporation
30. Pan Am World Services
31. Parker Hannifin Corporation
32. Pneumo Abex
33. Raytheon Corporation
34. Rockwell International Corporation
35. Science Applications International Corporation
36. Sundstrand Corporation
37. The Singer Company
38. Teledyne, Inc.
39. Textron Inc.
40. TRW Inc.
41. Unisys Corporation

**APPENDIX A (CONTINUED)**

42. United Technologies Corporation
43. Varian Associates
44. Westinghouse Electric Corporation
45. Zenith Electronics Corporation

**Mr. YUSPEH.** The program is working superbly. Most defense procurement compliance problems are handled today through voluntary disclosures, and the voluntary disclosures result from internal processes in companies. Frankly, we believe that creating monetary incentives for employees to bypass these internal systems is a mistake, and we should be working to incentivize employees to work within these systems.

There is one other point that I would like to make, and that is that contractors are called upon every day to make numerous technical decisions about applying procurement laws and regulations which are exceedingly complex. They have to decide which information must be disclosed to the Government in negotiations, which costs are allowable and which are unallowable, how to allocate indirect expenses to a large number of contracts, and how to account for material which is moved back and forth among contracts. And frankly, people will disagree about how to apply these complex rules. In today's environment, each disagreement can become a potential fraud against the Government.

I am genuinely concerned that if H.R. 3911 is enacted, you may simply be inviting any disgruntled employee of a Government contractor to seek a financial windfall by disclosing to the Government some technical disagreement with his management.

I would ask, Mr. Chairman, if such a person has such important information, why would he not share it with the Government without financial reward if his earlier attempts to resolve the matter internally have been unsuccessful? If we are going to have a system which relies on whistleblowers, then I think we should do everything we can to make certain that the whistleblower himself has no conflict of interest in his own action.

There are other concerns which EIA and AEA have with this bill. Mr. Kipps has summarized some of those related to the level of fines and the standard of culpability, and I would like to associate myself with his remarks. These issues are discussed in our prepared testimony as well.

I would like to make one final point. If one studies the testimony which the subcommittee received on December 3rd, you will find that it consists largely of reviews of the work being done by the Department of Defense, Inspectors General, DCAA, Department of Justice, and Project on Military Procurement. The only conclusion that I could draw from this testimony, given the outstanding work that each of these groups described for you, is that they have all the tools they need to do their job. That testimony taken as a whole provides no cogent rationale or public policy justification for the enactment of H.R. 3911.

Again, Mr. Chairman, we appreciate the opportunity to be heard today, and we would urge the subcommittee to reconsider the bill in light of today's testimony.

[The statement of Mr. Yuspeh follows:]

TESTIMONY OF ALAN R. YUSPEH PRESENTED ON BEHALF OF THE  
ELECTRONIC INDUSTRIES ASSOCIATION  
&  
AMERICAN ELECTRONICS ASSOCIATION  
HOUSE SUBCOMMITTEE ON CRIME - MARCH 16, 1988

The Electronic Industries Association (EIA) and American Electronics Association (AEA), as representatives of several thousand companies engaged in every aspect of the electronics industry strongly oppose the enactment of H.R. 3911, the Major Fraud Act of 1988. We believe that H.R. 3911 substantially duplicates the intent and purpose of existing laws, many of which have been enacted or substantially strengthened by Congress within the past five years including the Civil and Criminal False Claims Acts, the Anti-Kickback Act, and the Unallowable Costs provisions as well as numerous other existing laws including False Statements, Conspiracy, and Mail and Wire Fraud. We are aware of no additional public policy purpose that will be achieved by the passage of H.R. 3911 that is not already well-served by these existing statutes.

In addition to the existing criminal and civil statutory deterrents, the threat of suspension and debarment from receiving further government contracts is actually the largest deterrent against fraudulent activity by government contractors. That threat, coupled with the loss of commercial business that results from the negative publicity associated with allegations of fraud, serve to encourage contractors to engage in the type of self-governance that results in ethical business practices and provides early warning of potential and existing improper conduct.

There is simply no demonstrable need for the increased penalties established in the legislation, nor for the increase in the statute of limitations. In addition, the cash reward system for individuals providing information to the government will become, in effect, a "bounty" system that will subject companies to the possibility of numerous false or questionable accusations. These provisions encourage employees to ignore existing internal control procedures designed to encourage ethical conduct and act as early warning systems for improper action. Finally, the absence of a knowing and willful standard for culpability is inappropriate in a technical area such as government procurement where difficult decisions are made each day concerning the interpretation of a plethora of complex rules, regulations and procedures.

H.R. 3911 greatly increases the risk of doing business with the government without equivalent benefit accruing to the taxpayer, government, or business.



TESTIMONY OF THE  
ELECTRONIC INDUSTRIES ASSOCIATION  
AND  
AMERICAN ELECTRONICS ASSOCIATION  
PRESENTED TO  
THE SUBCOMMITTEE ON CRIME OF THE  
JUDICIARY COMMITTEE OF THE U.S. HOUSE OF REPRESENTATIVES

PRESENTED BY

ALAN R. YUSPEH

MARCH 16, 1988

My name is Alan Yuspeh. I am a partner in the law firm of Preston, Thorgrimson, Ellis & Holman and am appearing today on behalf of the Electronic Industries Association (EIA) and the American Electronics Association (AEA). EIA and AEA appreciate the opportunity to present their views on H.R. 3911, the Major Fraud Act of 1988. EIA represents the entire spectrum of electronic manufacturers in the United States. Its members range from manufacturers of the smallest electronic part to corporations that design and produce the most complex systems used in defense, space and industry. AEA represents nearly 3,700 companies engaged in every aspect of the electronics industry, from manufacturing to software and systems. At any one time, a significant number of AEA members do business directly with the government or as subcontractors and suppliers to those who do contract with the government.

EIA and AEA member companies pursue new business each day in the highly competitive government market and in worldwide commercial markets. They compete based upon the price and on the quality and reputation of their products and services. EIA and AEA members are very concerned with the growing number of federal statutes and regulations that have been imposed in recent years that have increasingly criminalized the process of doing business with the government. The extent of the growth of civil and criminal fraud law is evidenced by the fact that two-day continuing legal education programs are now taught on fraud and on how to deal with the plethora of certifications that must be signed by corporate personnel in order to do business with the government.

EIA and AEA strongly oppose the enactment of H.R. 3911 for a number of reasons. First, H.R. 3911 substantially duplicates the intent and purpose of existing laws. Second, there is no demonstrable need for the increased penalties incorporated in H.R. 3911 nor the increase in the statute of limitations. Third, the cash reward system for individuals providing information to the government would become in effect a bounty system that will only subject companies to the possibility of numerous false or questionable accusations and encourage employees to ignore existing internal control procedures designed to encourage ethical conduct and act as early warning systems for improper actions. Fourth, the absence of a knowing and willful standard for culpability is inappropriate.

We are aware of no public policy purpose that would be achieved by the passage of H.R. 3911. In fact, some important existing public policies would be undermined if the bill were to be enacted. What purpose is served by stiffer penalties? Is there any evidence that the existing laws are an insufficient deterrent? In particular, don't the suspension and debarment procedures in fact provide the greatest deterrent for companies that rely on government business?

### RECENT CONGRESSIONAL ACTION

In order to place H.R. 3911 in context, we should review the legislation enacted by Congress in just the past 5 years that has substantially strengthened the federal tools used both to deter and prosecute fraud against the government in general and procurement fraud in particular.

#### Inspectors General

In 1982, Congress created a statutory Office of Inspector General at the Department of Defense. The creation of this office essentially completed an effort begun in 1978 to coordinate better the investigatory tools used by each major and many minor departments and agencies in the federal government. Statutory inspectors general have the mandate to ferret out waste, fraud, and abuse. They have at their disposal an estimated 7500 investigators, auditors, and other staff that have been provided the power of the subpoena and virtually unrestricted access to contract data and other relevant information.

The Inspectors General offices work closely with the Department of Justice, the Federal Bureau of Investigation, and each of the 94 U.S. Attorneys in making decisions to investigate and prosecute fraudulent activity involving government contractors. At the Department of Defense, the Defense Contract Audit Agency is frequently used by the Inspector General to provide the necessary technical expertise in assuring that improper contract activity is uncovered. Congress, in responding to a perceived gap in the DCAA's power to gain access to certain documents, recently enacted legislation that provides the DCAA with its own independent subpoena authority.

#### Unallowable Costs

As part of the Defense Procurement Improvement Act of 1985, Congress enacted Section 2324 of Title 10 of the U.S. Code, "Allowable costs under defense contracts" which provides that for any contract, other than a fixed-price contract without cost incentives, valued at more than \$100,000, a cost that is submitted and determined by clear and convincing evidence to be unallowable will result in a penalty of up to twice the amount of such unallowable cost plus \$10,000 per proposal. In addition, the statute specifically provides for certification by a corporate official concerning the allowability of all submitted costs. A false certification subjects the corporate official to prosecution under the False Statements Act, 18 U.S.C. § 1001. Any cost submitted with knowledge that such cost is unallowable is also subject to the penalties of both the criminal and civil false claims statutes, 18 U.S.C. § 287 and 31 U.S.C. § 3729. The penalty for the second submission of an unallowable cost is now three times the amount of the cost submitted.

Civil False Claims

In specific response to allegations of procurement fraud activity, Congress, in 1986, enacted the False Claims Act Amendments Act of 1986, Public Law 99-562. This major piece of legislation, enacted after numerous days of hearings and intense debate by all parties concerned, substantially rewrote the False Claims Act. This comprehensive statute now provides the prosecutorial tool needed by the government in fighting procurement fraud. The False Claims Act amendments:

- o increased the statutory penalty for submitting a false claim from \$2,000 to \$10,000;
- o increased recoverable damages from double to treble the amount;
- o extended the scope of the Act to include acts of members of the armed forces;
- o expanded the scope of the Act to include as a violation the making of a material misrepresentation to avoid paying money owed the Government;
- o permits the Government to obtain consequential damages from the submission of a false claim;
- o establishes liability for those persons who have actual knowledge, or act in deliberate ignorance or in reckless disregard of the truth or falsity of the information;
- o substantially strengthened the provisions relating to qui tam suits and permits up to 30 percent of the recovery to be provided to the qui tam party;
- o tolls the statute of limitations until 6 years after the date on which the violation occurred or 3 years after the date when facts material to the right of action are known or reasonably should have been known by the official of the United States charged with responsibility to act in the circumstances;
- o provides that a nolo contendere plea in a criminal fraud case shall have collateral estoppel effect in a subsequent civil fraud action;
- o establishes a new Civil Investigative Demand tool to be used by the Department of Justice when investigating possible fraud; and

o provides for "whistleblower" protection for anyone who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against by his employer due to his involvement with a false claim disclosure.

We note that many of the provisions in H.R. 3911 merely attempt to duplicate the provisions of the False Claims Act Amendments enacted by Congress less than two years ago, including whistleblower protection, encouragement of private party involvement in fraud cases, establishment of statute of limitations, and clear responsibility for improper conduct. To our knowledge there is simply no evidence that these provisions and standards need to be altered once again.

#### Criminal False Claims

In addition to the significant changes outlined above, Congress, as part of the False Claims Act of 1986 raised criminal penalties for criminal violations involving false claims. The penalty for conviction of making a false claim to the government was raised from \$10,000 to \$250,000 for individuals and to \$500,000 for corporations. It should be noted that as part of the Defense Procurement Improvement Act of 1985, Congress raised the penalty for making a false claim to the government related to a Department of Defense contract to \$1,000,000.

Again, there has been no demonstrable need to increase once again these penalties or any evidence that these existing penalties are inadequate.

#### Anti-Kickback

As part of the Anti-Kickback Enforcement Act of 1986, Congress extended and expanded the coverage of the Anti-Kickback Act of 1946, 41 U.S.C. § 51-54, applicable to kickbacks made in connection with contracts of the federal government. The legislation prohibits attempted as well as completed kickbacks and now applies to all federal contracts not just negotiated contracts. In addition, the Act requires government contractors to use internal procedures to detect and prevent kickbacks.

Criminal penalties were increased from a maximum two year prison term and a \$10,000 fine to a maximum 10 year prison term and a \$250,000 fine with a maximum fine of \$500,000 for business entities. Civil penalties were increased, in cases of knowing violations, from the amount of the kickback to twice that amount plus up to \$10,000. A six year statute of limitations provision was also established.

### Criminal Fines

As part of the Criminal Fines Improvements Act of 1987, Public Law 100-185, Congress enacted legislation that permits the imposition of a fine after conviction of a crime, including false claims against the government, of up to twice the gross gain to the defendant or twice the gross loss to the United States.

The totality of these new and revised statutes means that where evidence surfaces that a contractor may have engaged in any type of fraudulent activity, the federal government is well-equipped both to investigate and prosecute such fraud. The breadth and scope of this most recent legislation is a clear indication that Congress has, in just the past 5 years, dealt forcefully with the perceived procurement fraud problems.

### Other Existing Laws

In addition to the above cited statutes, there are numerous existing criminal statutes that provide federal prosecutors with the tools they need both to deter and prosecute fraudulent activity. Currently available criminal code sections for use in fraud prosecution include:

o 18 U.S.C. § 201, Bribery of Public Officials and Witnesses

This section provides for a penalty of \$20,000 or three times the monetary equivalent of the thing of value or imprisonment for not more than 15 years or both.

o 18 U.S.C. § 218, Voiding Transactions in Violation of Bribery, Graft, and Conflicts of Interest Laws

This section provides that for any violation of the bribery, graft and conflicts of interests laws, any contract involved may be declared void and the amount expended on the contract may be recovered as a penalty.

o 18 U.S.C. § 371, Conspiracy to Commit Offense or to Defraud the United States

This section provides for a penalty of \$10,000 or 5 years of imprisonment or both for conspiring to commit any offense or to defraud the United States.

o 18 U.S.C. § 1001, False Statements

This section provides a penalty of \$10,000 or 5 years of imprisonment or both for knowingly and willfully falsifying a material fact or making a false, fictitious or fraudulent statement. This section has become increasingly important as the number of certifications required in government contracting has increased.

o 18 U.S.C. §§ 1341 - 1343, Mail Fraud

These sections provide for penalties of \$1,000 or 5 years of imprisonment or both for engaging in mail or wire fraud.

EXISTING DETERRENTS

As an intended deterrent, H.R. 3911 ignores what is, and what will remain, as the largest deterrent against fraudulent activity by government contractors -- the possibility of being suspended and debarred from receiving further government contracts. For businesses, suspension and debarment, the total prohibition against doing business with the government, is equivalent to capital punishment. For those small companies whose marketplace is primarily the government, suspension and debarment simply puts them out of business, permanently. For larger companies doing significant business with the government, suspension and debarment results in an enormous financial penalty as entire production lines are shut down and a significant source of revenue and profits is eliminated. The intended deterrent effect of H.R. 3911 is simply unnecessary as long as the government continues to pursue actively suspension and debarment procedures against companies which are found to engage in irresponsible conduct.

There is another deterrent in the present system which is the fact that many government contractors also have substantial amounts of commercial business. Those companies know that there is nothing worse for business than having your name on the front page of the paper as being prosecuted for procurement fraud. This is viewed by some as having the effect of being proven guilty before the matter has been heard. I have spoken with a number of contractors with large commercial businesses which have had irregularities in their government business publicized. They tell me that the loss to their commercial business has been substantial. Much like suspension and debarment, the resulting financial penalties, including the need to shut down production and lost markets, are, in fact, a significant consideration for any business and encourages those businesses to maintain proper internal controls to try and prevent fraudulent activity. H.R. 3911 becomes yet another unnecessary deterrent in an area where the functioning of our marketplace actually provides the best of deterrents.

SELF-GOVERNANCE

The two provisions in H.R. 3911 that are intended to provide for whistleblower protection and payment for information leading to a fraud conviction are of particular concern. The provisions create a clear disincentive for contractor employees to cooperate with recent efforts by major contractors at increased self-governance. Further, they lack clear guidance on their applicability and penalties for misuse.

In response to the findings of the President's Blue Ribbon Commission on Defense Management (the Packard Commission) that contractors needed to improve and strengthen their efforts involving self-governance, the Defense Industry Initiative on Business Ethics and Conduct was formulated. As a result of those efforts, new and rewritten contractor codes of conduct have been produced and distributed to employees; orientation programs on proper business conduct have been presented; ethics training programs initiated; and ombudsmen offices and hotlines created. In addition, the now 46 signatories to the Defense Industry Initiative have agreed to have a public accountability process, the first year of which has just been completed.

The Ethics Resource Center, an independent, non-profit organization, has compiled audited questionnaires from each company about the development and implementation of these ethics and contract compliance programs, and has issued a report which indicates the energetic industry effort in this area. I request that this report be made part of the record of this hearing. These new efforts are all designed to encourage as company policy proper and ethical business practices and to provide an early warning for government contractors of potential and existing improper conduct.

With all these systems in place, what should happen if an employee becomes aware of something that he believes constitutes fraudulent conduct? The implication of the bounty provisions in H.R. 3911, as well as the qui tam provisions in the False Claim Act Amendments, is that the individual, much like the apocryphal person who slips on the banana peel in a grocery store, should be smiling with joy because his financial windfall has arrived. He should race out and hire a lawyer to bring an action against his employer for fraud. He should call the appropriate criminal authorities, already counting the money in the bank that he will receive as a reward for his perceived patriotic gesture. Is this the type of incentive that should be created?

In the view of the members of the associations whom I represent, let me suggest another scenario. In our view, when this employee sees something that is awry, he should first discuss it with people with whom he works, because things are often not what they appear. If he thinks that avenue will be unavailing, he should call a corporate ombudsman or hotline and explain the matter. Under the principles of the Defense Industry Initiative, he is entitled to feedback, even if the report is anonymous. In such cases, incidentally, the report is usually assigned a case number and the feedback can be provided by inquiring under the case numbers as to what has happened. If the matter, as investigated by the ombudsman, raised questions of possible fraudulent conduct, it would typically be referred to the General Counsel's office for the conduct of an internal investigation.



It is my belief that there is a universal acceptance in industry today that if the contractor involved became convinced through the internal investigation that individuals in the company were guilty of criminal conduct, that conduct would be voluntarily disclosed to the appropriate authorities. For those cases where this procedure simply does not work, the individual can call the Department of Defense hotline, the General Accounting Office hotline, or the hotline established by most agencies and report the matter. My question to the Committee is why should we have to pay the individual to do that?

Why are these bounty and qui tam provisions as a matter of public policy a bad idea? In part, they are a bad idea because there is so much judgment involved in the application of complex government regulations, that any two people can reasonably disagree on numerous actions that any company will elect to take. There are requirements that contractors submit the data which underlies their pricing of proposals, and that it be current, accurate and complete. However, data which is judgmental or of an estimating nature need not be submitted. There has always been disagreement about what constitutes cost and pricing data, and what needs to be submitted. Reasonable people will disagree.

There are categories of unallowable costs where certain costs may have several purposes and fall in multiple categories. The categorization of the costs as allowable or unallowable is not necessarily a black or white matter. There are 19 cost accounting standards, most of which are highly technical from an accounting standpoint and discuss the allocation of indirect costs to various contracts. There is endless litigation about the interpretation of these various standards and the proper application. There will continue to be differences of opinion, which alone should not give rise to allegations of criminal conduct.

I am concerned about the pernicious influence of these various incentives. Individuals who become aware of these disagreements could try to use them as allegations of fraud in the hope that the government one day will recover some money and that the individual will share in a recovery. I can assure you that where there is a case of clear fraud, contractors today are going to disclose that to the government. What you are, therefore, going to pick up through these new reporting incentives are tips by disgruntled employees with respect to interpretation on various issues.

Government contracting is subject today to numerous technical disputes. Many of the companies involved in this market employ tens of thousands of individuals. The aggregate number of total employees and former employees is a number in the tens of millions. H.R. 3911 sends every one of those individuals a message that some small bit of information that he may have about a questionable matter in the company's administration of its government contracts could be his pot of gold at the end of the rainbow. In no time, we may well have every major defense

contractor in this country with so many ongoing investigations that the amount of time devoted to responding to investigators' requests will exceed the time available for managing the company. And these expenses are typically allowable costs, which means the taxpayer will ultimately be paying for it.

The success of these ethics and contract compliance programs is dependent to a large degree on the cooperation of contractor employees and their willingness to report and eliminate improper or fraudulent conduct at the earliest possible stage. The provisions of H.R. 3911, however, will actually encourage contractor employees to ignore potential problems and internal management controls because of the possibility of being rewarded at a later date for "reporting" such information to the government.

#### SPECIFIC PROVISIONS

In addition to the concerns about H.R. 3911 outlined above, EIA and AEA are concerned about several specific provisions of the proposed legislation. In particular, we are concerned that H.R. 3911 establishes a new and different "knowingly" standard for fraud without providing any guidance on its implementation. The standard of culpability with respect to criminal activity has generally been recognized to be knowing and willful action. Someone ought to have specific intent to violate the law in order to be subject to criminal penalties. In an environment where corporate officials must deal with an enormous number of complicated federal acquisition regulations, procedures, and accounting methods, specific intent to commit fraud must be proven before a crime can be shown.

We are also concerned about the increase in the statute of limitations. Once a company or individual is subjected to criminal prosecution, enormous amounts of time and attention are focused on that single activity. Tremendous uncertainty is created in the lives of any individuals who are implicated. The government ought to be under an obligation to investigate and act expeditiously on suspected criminal activity. To permit the government to leave such matters open for a period as long as seven years is unnecessary. Such a lengthy period of time also destroys a primary value of a reasonably expeditious statute of limitations, which is to guard against evidence becoming lost or unreliable. To our knowledge, there has been no demonstrated need for such an extension of the statute of limitations.

Finally, the size of the financial penalty incorporated in H.R. 3911, up to twice the value of the contract or services, is totally inappropriate. Existing statutes already provide for penalties of up to \$1,000,000. In almost every case of procurement fraud, there are numerous counts, because the submission of a single false time card represents a false statement and the submission represents a false claim. There is seldom any procurement fraud matter that arises where the

government is limited in the number of counts that it can bring against the contractor. Thus, the courts have almost unlimited discretion to accumulate sentences. Does equity demand steeper fines? Any fine or civil penalty must bear some relationship to the amount of the alleged fraud involved. There is simply no demonstrable need to increase the amount of fines which are found in present law.

The Electronic Industries Association and the American Electronics Association are strongly opposed to H.R. 3911. As indicated, we do not believe it establishes any additional tools necessary to protect against and prosecute fraud against the government. It does, however, greatly increase the risk of doing business with the government without equivalent benefit accruing to the taxpayer, government, or businesses.

I would like to conclude by recognizing the sincere attempts of the Committee to review this body of law. I also very much appreciate the opportunity for the Electronic Industries Association and the American Electronics Association to be heard this morning, and I would be pleased to answer any questions which you may have about my testimony.

Mr. HUGHES. Thank you, Mr. Yuspeh.

Mr. Cross, welcome.

Mr. CROSS. Thank you, Mr. Chairman, members of the committee. My name is Christopher Cross and I am president of University Research Corporation. I appear here today on behalf of the Professional Services Council, which is a trade association representing the rapidly expanding professional and technical services industry. We very much appreciate this opportunity.

I would also like to bring a bit of a different perspective to this. The conversations this morning which have taken place before me, and the hearing which took place back in December, focused on Defense Department issues. My company and many of the companies that are in the Professional Services Council are not DOD contractors. What we are concerned about as a group, and what I am personally concerned about, is being swept up in some issues that relate to the Defense Department, and essentially using a sledgehammer to solve some issues that may go far and beyond what is effective in terms of some other areas.

The kind of business we do, for example, is with the child support enforcement programs, AID health programs and substance abuse programs in HHS and in the Department of Education. Let me give you an example of what one of my concerns would be.

We have a major contract with AID, (about \$8 million), to support family planning programs in Asia. Under that contract, one of the things that we do is give subcontracts to indigenous organizations in countries like Thailand, Bangladesh, Nepal, and Indonesia.

Under the provisions of this act, if one of those indigenous organizations (most of whom, of course, have never heard of H.R. 3911 or any of the other bills and provisions which have been enacted into law) if any of them committed a fraud—and it could be done in a number of ways, I am sure—it would subject not only that company, but our company as well to the maximum provisions of this bill. We would be there carrying out the mission of AID, for example, in providing services to do better family planning in Bangladesh, a country which is in enormous need of some help in this area.

My point in mentioning this, is that the provisions which are talked about here go far beyond what one thinks of in terms of the normal Defense Department contractor who, for example, makes a widget that gets used in some sort of device which is used in the defense establishment. The kinds of provisions here are very complex to administer, very complex to handle when you get into the professional services area, and particularly when you get into some of the human service areas which are represented by companies like my own.

I would also like to add that we believe that H.R. 3911 would serve as a deterrent not to fraud, but to entrepreneurship of small businesses. You just cannot have the threat of legislation like this hanging over small businesses and expect them to continue to want to do business with the Federal Government. We believe that is contrary to the thrust that has been taken by Congress in the last several years of indeed expanding opportunities for small businesses to do work with the Federal Government. The provisions here

are very complex. They are very onerous. And they are, in our view, Machiavellian.

I am also concerned about where the evidence is that the 1986 and 1987 acts have not done the job which you believe needs to be done. I think it is fair to say that given the bureaucracy of the executive and legislative system, it is probably only now that the effects of those laws are beginning to be seen. I would urge that action on legislation like this be deferred until and unless there is some evidence that those earlier laws were, in fact, not effective.

I would also like to associate myself with the earlier remarks, particularly the remarks from Mr. Kipps relative to the publicity that would surround something like this. A small business could not continue to get financial support from lending institutions if it were accused of perhaps having a several million dollar fraud investigation pending against it. The company would probably have a hard time meeting its payroll the next time it went to the bank to get a loan to float itself until the Government got around to paying on its contracts. Even with things like the Prompt Payment Act, the Government is not always the fastest in paying its bills.

I would, in this regard, like to mention to you that it is not many months ago that a case occurred affecting a former administrator of NASA, James Beggs, who was falsely accused of having committed fraud relative to his work with a defense contractor. With a great deal of embarrassment, the Justice Department ended up cancelling that case, and apologizing to Mr. Beggs.

This man and his career have been ruined. He had to give up his position at NASA, and, I think his whole life from here on out was gravely affected, because the complexity of the law under which he was prosecuted was so great that the U.S. Attorneys in charge of that case did not understand the subtleties between fixed price and a cost reimbursement contract.

I do not know of any small business, my own included, that would be able to stay in business if it was subject to the kind of fines that are proposed here.

I am also concerned, as Mr. Yuspeh mentioned, about the bounty hunter provisions. It is certainly not effective to be running a business in which people have the potential to gain tremendous economic advantage by continually being on the lookout for potential fraud in a company, and thinking that they can benefit to the tune of a quarter of \$1 million and more, because of the impact of this and other legislation.

Finally, I would like to say that I think that this provision, this law, sets up an adversarial relationship between the Government and between contractors. The Federal Government, in a number of areas, has moved to make the relationship between the Government and contractors more collegial. In my view, this makes it more adversarial.

Again, I think you will find that the competition will not be enhanced by this. The Government will end up paying more because fewer companies will participate in the Federal market. The result will be higher costs, and probably lower quality goods and services, to the Federal Government.

I appreciate the chance to be here. PSC, as well as my own company, is certainly against any implication that fraud takes place

with respect to the work that we and our colleagues do. We do not want to see that occur, but we want to have legislation that is workable from the viewpoint of the business people who are running the companies that do business with the Government. Thank you very much.

[The statement of Mr. Cross follows:]

STATEMENT OF CHRISTOPHER CROSS  
on H.R. 3911, the "MAJOR FRAUD ACT OF 1988"  
on Behalf of the  
PROFESSIONAL SERVICES COUNCIL

Before the House Judiciary Committee  
Subcommittee on Crime

March 16, 1988

My name is Christopher Cross and I am President of University Research Corporation. I appear today on behalf of the Professional Services Council, a national trade association representing the rapidly growing professional and technical services industry. PSC appreciates the opportunity to testify before this subcommittee to express our views on H. R. 3911, the "Major Fraud Act of 1988."

At the outset, I should note that the PSC fully supports Government and industry efforts to deter and punish fraud in the procurement of goods and services. We believe, however-- and in this regard we fully support the views of the U. S. Chamber of Commerce, that passage of H. R. 3911 would be a mistake. In short, we believe that the proposed legislation would be unduly harsh on small businesses and subcontractors involved in larger government contracts. H. R. 3911 is overbroad in its applicability. Its penalty provisions are stilted, confusing and unnecessary within the current scheme of federal law. Indeed, H. R. 3911 would serve as a deterrent, not to fraud, but to the entrepreneurship of small business.

Congress has, of course, already taken dramatic steps to improve the enforcement and deterrence of procurement fraud. In 1986 alone, the False Claims Amendments Act, the Program Fraud Civil Remedies Act, and the Anti-Kickback Enforcement Act were passed into law. Just last year, the Criminal Fines Improvements Act was enacted. Where is the evidence that this recent legislation has not done the job? In light of all of this recent

legislation, we believe further activity in this area to be unnecessary, redundant and--in fact--counterproductive.

Under H. R. 3911, even a small subcontractor faces fines of up to twice the value of the prime contract, if the subcontractor's fraud is judged to be substantial in relation to the value of the contract. In specific terms, judges would be permitted to impose fines of up to twice the value of prime contracts over \$1 million, provided that the amount of the fraud is substantial in relation to the value of the contract. Thus, a subcontractor providing \$50,000 in services under a \$5 million prime contract could be ordered to pay as much as \$10 million on a timesheet overcharge of \$1,000.

Proposed section 1031 of Title 18 is unfair because it fails to require a sufficient nexus between the severity of the fraud and the degree of the harm caused thereby. Under the bill, judges would be guided only by the "substantial" nature of the fraud. PSC believes that fraudulent activity should be punished with a penalty that corresponds to the severity of the harm, and not to the whim of the courts. In failing to define the bounds and scope of "substantial" fraud, the bill unduly expands court discretion in the execution of justice.

A significant percentage of PSC member companies--including my firm--are small businesses and subcontractors serving the federal government. Many concerns have only one or two government contracts. H. R. 3911 would have a dramatically negative impact on such firms, because a fraud committed by one dishonest employee could result in the imposition of huge fines, even though the harm may be relatively insignificant. I know of no small businesses that would be capable of staying in business after paying a fine twice the value of one of its major contracts.



The fine must fit the crime. Yet, the Major Fraud Act of 1988 would permit judges to impose \$1 million dollar and greater fines to even the smallest of subcontractors, for commission of undefined, "substantial" frauds. Indeed, a small firm's liability could double, triple or quadruple depending on the whim of prosecutor and judge, without any true relationship to the severity of the alleged fraud. That is manifestly unfair, and should not stand the test of reasonable review.

In providing disincentives to small businesses exploring the possibilities of government contracts opportunities, H. R. 3911 would contravene current federal policy in this regard. Indeed, it is a fundamental element of federal procurement policy that contracts with small businesses be encouraged. The breadth of this policy is reflected in the Small Business Administration's Section 8(a) program, wide-ranging small business subcontracting requirements, and an increasing number of small business set asides.

Finally, PSC is also concerned about the "bounty hunter" and whistleblower protection provisions. These provisions provide no guidance as to who may furnish information and from what source it may be derived. There is virtually no protection for the employer to ensure that the data came from the original source and not from a disgruntled employee. Further, employee productivity, morale, and efficiency would be decreased by a "bounty" of as much as \$250,000. Without such protection, a disgruntled employee could obtain lifetime tenure by simply making baseless charges of fraud against the company. In addition, it is absolutely essential that a person who participated in a fraud be prohibited from obtaining a monetary reward.

As you are no doubt aware, there is growing concern about the increasingly adversarial relationship between private industry and the federal government. In fact, Defense Secretary Carlucci and Under Secretary Costello have made improving the

government/industry partnership one of their major priorities. They recognize--as does PSC--that a continuing adversarial relationship will result in fewer companies--large and small--that are willing to do business with the federal government. Less competition will result in higher costs and lower quality goods and services. The inequitable provisions of H. R. 3911 can only have a chilling effect on this already strained relationship.

PSC supports high standards of ethics and measures to prevent and deter fraud against the federal government. However, those mechanisms already in place--self-governance, internal audits, and recently enacted legislation--are sufficient to prevent and punish fraud. H. R. 3911 is counterproductive, unnecessary and in direct conflict with congressional initiatives to promote small business entrepreneurship.

On behalf of PSC, thank you for the opportunity to submit our views.

TESTIMONY OF ALAN R. YUSPEH PRESENTED ON BEHALF OF THE  
ELECTRONIC INDUSTRIES ASSOCIATION  
&  
AMERICAN ELECTRONICS ASSOCIATION  
HOUSE SUBCOMMITTEE ON CRIME - MARCH 16, 1988

The Electronic Industries Association (EIA) and American Electronics Association (AEA), as representatives of several thousand companies engaged in every aspect of the electronics industry strongly oppose the enactment of H.R. 3911, the Major Fraud Act of 1988. We believe that H.R. 3911 substantially duplicates the intent and purpose of existing laws, many of which have been enacted or substantially strengthened by Congress within the past five years including the Civil and Criminal False Claims Acts, the Anti-Kickback Act, and the Unallowable Costs provisions as well as numerous other existing laws including False Statements, Conspiracy, and Mail and Wire Fraud. We are aware of no additional public policy purpose that will be achieved by the passage of H.R. 3911 that is not already well-served by these existing statutes.

In addition to the existing criminal and civil statutory deterrents, the threat of suspension and debarment from receiving further government contracts is actually the largest deterrent against fraudulent activity by government contractors. That threat, coupled with the loss of commercial business that results from the negative publicity associated with allegations of fraud, serve to encourage contractors to engage in the type of self-governance that results in ethical business practices and provides early warning of potential and existing improper conduct.

There is simply no demonstrable need for the increased penalties established in the legislation, nor for the increase in the statute of limitations. In addition, the cash reward system for individuals providing information to the government will become, in effect, a "bounty" system that will subject companies to the possibility of numerous false or questionable accusations. These provisions encourage employees to ignore existing internal control procedures designed to encourage ethical conduct and act as early warning systems for improper action. Finally, the absence of a knowing and willful standard for culpability is inappropriate in a technical area such as government procurement where difficult decisions are made each day concerning the interpretation of a plethora of complex rules, regulations and procedures.

H.R. 3911 greatly increases the risk of doing business with the government without equivalent benefit accruing to the taxpayer, government, or business.

Mr. HUGHES. Thank you, gentlemen. I get the impression there is not very much you like about the bill. Let me just begin with you, Mr. Cross, since you were the last witness.

You argue that any businessman attempting to secure a loan would have a very difficult time if he picked up the newspapers one day and read that he was under investigation for criminal fraud. Your argument would seem to be that we ought to repeal all of the statutes that would have any application, because that is always a risk, is it not?

Mr. CROSS. Certainly it is always a risk. This bill though, by expanding the size of those penalties so greatly, would certainly highlight in the news media the fact that the potential obligation on the part of the contractor is quite substantial.

Mr. HUGHES. Mr. Cross, you are a very able attorney. Today the Government has a number of tools. You have said that and other witnesses have said the same thing. Isn't it possible that any one of the frauds that could be committed now could be charged under the mail wire fraud statute and combined with the RICO statute, would subject all of the assets of the corporation to forfeiture? Is that not so, under existing law?

Mr. CROSS. I believe that is so.

Mr. HUGHES. Do you know of any instances where that process has been abused?

Mr. CROSS. I am not an expert on that. I would defer to my colleagues who certainly follow that. I am not an attorney. I am not in the business of tracking——

Mr. HUGHES. No, I am just taking your argument to the absurd conclusion that you would have us follow it. I mean, you would argue for us to repeal all the statutes.

Mr. CROSS. No, not at all.

Mr. HUGHES. Mr. Kipps, I could not believe some of your testimony last night when I read it. You suggest that the knowing standard is a civil standard. Is that a misprint?

Mr. KIPPS. No, what I am saying is that for serious frauds, serious felonies, the standard has been knowingly and willfully.

Mr. HUGHES. Mr. Kipps, what is the standard in the mail and wire fraud statutes?

Mr. KIPPS. It is knowing.

Mr. HUGHES. Is that a civil standard, Mr. Kipps?

Mr. KIPPS. No, that is a criminal standard. Mr. Chairman, I did not say the exclusive standard. I said the standard normally used and the one that does appear in most statutes for felonies is knowingly and willfully.

Mr. HUGHES. No, that is not what you said. Do you want me to read your statement to you? Page 13, "Criminal liability for fraud should be limited to willful conduct. This standard of intent"—and you have cited H.R. 3911—"is essentially a civil standard and is unreasonably low considering the magnitude of the penalties."

Now that is not so, and you know it is not so.

Mr. KIPPS. The knowingly is essentially a civil standard. It is not the only standard that is used.

Mr. HUGHES. It is not a civil standard. It is a standard——

Mr. KIPPS. For civil fraud.

Mr. HUGHES. It is a standard we use in the bank fraud statute. It is a standard we use in many fraud statutes. It is a standard we use—that this committee used in the false identification statute that we passed a few years ago, 18 U.S.C. 1028. It is a standard that we use in the credit card statute that this committee wrote a few years ago, 18 U.S.C. 1029. It is a standard in the computer crimes statute which this committee wrote a number of years ago, 18 U.S.C. 1030. It is a criminal standard. It is not a civil standard.

Mr. KIPPS. Mr. Chairman, I accept your criticism. I think you are right. The point that we were trying to make is that for a serious felony such as we are talking about here, for a large fine we should maintain the willful standard along with the knowing.

Mr. HUGHES. I understand that.

Mr. KIPPS. That is the point.

Mr. HUGHES. I understand that point, but that is not the point you made. The Chamber's initial point, and the one the other panelists subscribe to is that existing penalties are sufficient to deter and punish procurement fraud. I mean, that is the point that all three of you have made.

That was not the consensus of the witnesses last December, nor even that of the casual observer of any morning paper for the last month. For instance, I have a March 1, 1988 article right here claiming that the Department of Justice has charged Goodyear Aerospace Corporation with fraudulently overbilling the Pentagon by more than \$7 million; a February 26, 1988 article claiming Northrop destroyed internal evidence documenting at least \$400 million in overbilling; a March 10, 1988 article in this packet stating that Bell Helicopter Textron Inc. has agreed to return \$90 million to resolve allegations of fraudulently overcharging the Army on helicopter spare parts; and an article about Alchemy, Inc., a case noted in the DOD Inspector General report, stating that 52 defective firehose nozzles were still in use aboard aircraft carriers, destroyers and other combat vessels, and on and on and on I could go.

Does that indicate to you that we have achieved sufficient deterrence? I am not minimizing the defense industry initiative which is commendable. I am not trying to minimize that. But do these current reports suggest to you that we have adequate deterrence?

Mr. KIPPS. What you have just referred to does not. But neither does H.R. 3911. Increasing the fine will not do it. What will do it is education. What will do it is better quality control. And what will do it is providing quick and vigorous prosecutions where these things are discovered. And that was not taking place during the time frame that the problems that you have alluded to arose.

Mr. HUGHES. We have the same arguments you raise from time to time on a whole host of matters before this committee. Education is an extremely important part, Mr. Kipps, of any strategy. But we are developing additional criminal penalties in many areas; in the area of substance abuse, drugs, where education has an extremely important part.

The fact of the matter, for example, is that one of our problems with drugs is that while we are attempting to do more in the area of education and treatment, there is not sufficient deterrence for traffickers. We have people today engaging in drug trafficking be-

cause the risk is so low and the rewards as so high. We have got to find a way to put them more at risk.

If I had any complaint to make about our criminal justice system—and I do not want to get too philosophical today—is that we have lost that element of certainty in the system. The certainty that people are going to get caught. And second of all, that when they are caught they are going to go to jail or suffer the consequences of their act. We have lost that unfortunately in many aspects of our criminal justice system.

Mr. KIPPS. I agree with you. I agree with you and I think something needs to be done.

Mr. HUGHES. And we do not have a freestanding procurement fraud statute. This is not targeted at the defense industry. This is a freestanding fraud statute which basically endeavors to mold the punishment to fit the crime. And the suggestion that we have too many hanging judges out there—I am the first to concede that we do have disparity of sentences—is no reason not to try to craft a statute that is going to meet the threat.

We have lost much of the consensus in this country, speaking of defense, for defense procurement because of all the scandals that have evolved in the last few years from that particular industry. We have lost much of that consensus today.

Mr. KIPPS. I agree with much of what you say, Mr. Chairman. I have been in this business for 30 years, and we have been working to try to improve the system. And some of us are surprised, as this committee is, the extent to which the system has gotten lax and that the employees of contractors have taken actions which are inimical to the company's interest and to this Government's interest and the national security. It is shocking to many of us that it is as widespread as it is, and something needs to be done about it. That something has started with the industry itself.

That is not the complete answer because it has to be followed up. It has to be implemented. The employees have to know that what heretofore has been an audit problem, something you can simply solve by paying some money back, has now become a criminal problem. They know that now, and they need to be keep reminded of that. But a \$250,000 fine is more than any employee can possibly afford to pay.

Mr. HUGHES. Mr. Kipps, you have more problems than with the fine. You do not like extending the statute of limitations, although the Justice Department tells us that they have had serious problems because the cases are very complex. You do not support that. You do not support the whistleblower provisions. You do not support the provisions providing rewards for information. You do not support any provisions of the bill.

Basically I find it appalling that the business community would be attempting to apologize in some way, or to defend unscrupulous contractors doing business with the Government. No innocent businessman is going to be taken before the bar under this bill. This bill applies to persons who knowingly commit a fraud against the United States Government, just like to bank fraud statute, or the wire fraud statute, or the false claims statute, or the false statements statute. Nobody has anything to fear if they do not commit a knowing act of fraud.

My time has expired. The gentleman from Florida?

Mr. McCOLLUM. Thank you, Mr. Chairman. I am curious if any of you gentlemen know the answer to the question I have been kind of curious about since we began this process on H.R. 3911 and its predecessor. This bill applies to contracts, procurement contracts of \$1 million or more. Do any of you know how many or what percentage of the contracts with the Government are of that nature or that size?

Mr. YUSPEH. I do not know the exact number, Mr. McCollum, but I can tell you that typically there are about 15 million contractual actions a year in the Department of Defense, and that a relatively very, very small percentage of them are over \$1 million. Now you can take a relatively small percentage of 15 million and you still get a very big number, but percentage-wise, it is a small percentage of 15 million.

Mr. McCOLLUM. In other words, if we increased it to \$5 million or \$2 million or something else, it probably would not make much difference because you are talking about a really small number of contracts, but those are very big contracts. Is that basically the bottom line of this?

Mr. YUSPEH. There are various kinds of cuts you can make. If you were to take it up to \$25 million, then I think you would have a major exclusion of a whole set of contracts that are in that \$1 million to \$25 million range. But I am virtually certain that the percentage of contracts that are higher than \$1 million, given a 15 million contract action base, is—small.

Mr. McCOLLUM. Nobody here today is arguing the point, and I was curious about it, that we have too low a threshold or anything of that nature from the standpoint of that issue. Everybody is arguing the bill is not right for other reasons.

Let me ask you about another area. Some of you are aware that we tried to amend this bill in subcommittee to clarify a few things, to at least restrict the amount of the penalty and when it becomes double. I know the language, the word substantial is rather vague, and there is no question we discussed it in subcommittee. So probably by full committee that will become changed in some way. Whether or not we change it the way exactly you all envision, I am not sure. But there are no specific suggestions in any of your testimony.

I am wondering if we need to put a maximum ceiling on here, even if that is practical. Some of us have discussed whether it is or not; \$2 million, \$5 million, something like that. That certainly would keep you from getting \$1 billion in a \$1 billion contract setting. I do not think any of us here expect a fine of \$1 billion for a \$1 billion contract. Nobody wants to see something like that.

Would a maximum limit involved in this somewhere, on the fine, be something you think would be a vast improvement, or no improvement, or it really does not make any difference?

Mr. KIPPS. I think it would be a vast improvement. I do not think it takes care of all the problems, but I think it would take care of what I envision as being a very, very serious problem, that there is no limit in many situations, and what that leads to from the standpoint of leverage. These cases do not go to trial. Most of these cases do not go to trial, they are negotiated.

And when you are talking about giving the Government and the bureaucrats starting right down at the first investigator right up to the prosecutor and the grand jury, you are giving him the leverage to put you out of business. That is a very wide spread within which to negotiate. So if you put a limit, if you reduced it and put a max on it, it would help, but it would not get rid of a lot of the problems we see.

Mr. CROSS. Mr. McCollum, I would just add and ask you, if the subcommittee does choose to pursue that, to keep in mind that it is just not the major defense contractors that this bill applies to.

Mr. McCOLLUM. Of course.

Mr. CROSS. Companies like my own—and I would urge that the maximum be related in some way not to a theoretical amount like \$10 million or something like that, but to something to do with the size of the fraud.

Mr. McCOLLUM. I think that is what we intended in the amendment that I put to limit it to; got to be substantially related. We had a hard time coming up with language which would get more specific because there is such a wide variance and such a large difference in some of these contracts that it did not seem practical to come up with a figure. But I was trying to put some kind of a lid on it, some kind of a cap on it. And I am sure by full committee we will put some kind of a cap.

So while you all have not testified today to any of those ideas or brought us any suggestions, I would welcome them. I am sure the chairman would too, if you have any creativity in that area. We are not the repositories of all wisdom, as you well know, and you have been critical of us today. So I am asking you to submit something to us if you do.

Mr. CROSS. We would be glad to.

Mr. McCOLLUM. Secondly, or another area I would like to ask about, individual human beings commit the fraud, and I think, Mr. Kipps, you pointed that out to us pretty strongly in your testimony. We have an increase in the jail time, seven years from the five years that otherwise might be what somebody could get here as a maximum sentence.

What would you think about our more or less throwing the book at individuals on the jail time end of it; like maybe a minimum sentence of no less than one year and a maximum sentence of 20 years? Something that would have a chilling effect for individuals but would not involve the corporation, would not involve going to the bank, but certainly would be something that could be read into this as a real deterrent if somebody frankly was aware of it and might be a little afraid they would really go to jail. Would that be something you would consider appropriate or inappropriate? Mr. Kipps, Mr. Cross, Mr. Yuspeh, any of you?

Mr. KIPPS. I think further consideration needs to be given to that question because it has the potential of really being a deterrent. I think under the existing administration of the laws, the tendency has been to impose a sentence of maybe three or four years and suspend all of it except maybe six months or a year. I do not know. I have handled a number of these fraud cases, and they are all different, and they are very difficult.



But I have found the biggest deterrent is the realization by the employee that what he is doing really is a criminal act and that he is going to be prosecuted. Not only is he going to lose his job, but he is going to be prosecuted. And I can tell you, and what has been going on in the last 10 years or so, most employees did not really quite look at what they were doing that way.

Mr. McCOLLUM. That is one reason we are interested in this piece of legislation. We want to get the message out. This is a message piece of legislation. If it fails to get the message out, it fails in the purpose, at least as I see it. So that is why I am exploring this penalty question with you because individuals commit the crimes. It is great to go after the corporation to try to get them to tighten up. I mean, that is the only real reason to do that.

But if you can get at the individual and get his attention, that is even better. So I would appreciate it if you all would look at it and consider that. Mr. Yuspeh, do you—

Mr. YUSPEH. I was just going to say, Mr. McCollum, that though I do not have any authorization from the association I represent to tell you whether your specific proposal is a reasonable one, my personal view is that if we were to prioritize the various concerns we have with the bill, the length of incarceration goes to the bottom of the list of concerns as compared with the other things we have talked about today.

Mr. McCOLLUM. One last thing and I will yield back my time. The criticism that you have, Mr. Kipps, in the whistleblower area, in part contains a suggestion that I would like to ask Mr. Cross and Mr. Yuspeh if they agree with. You suggest that the bill should explicitly make it a Federal crime to provide false information for the purpose of obtaining a bounty. That is an interesting restriction. Would both of you gentlemen agree with that suggestion? Mr. Cross?

Mr. CROSS. Yes, I would.

Mr. McCOLLUM. What about you, Mr. Yuspeh?

Mr. YUSPEH. I would agree with it, Mr. McCollum. But one ought to keep something else in mind, which is that part of the problem in this whole area of bounties, whistleblowers, and the like is that what I envision is that many people may be incentivized to surface things which would never rise to the level of being frivolous. They may be simply disputes with management, differences of opinion about how regulations and the like should be interpreted.

And frankly, I am genuinely concerned that what is going to happen if these provisions are enacted are, first of all, you are going to destroy the very constructive environment that now exists among larger defense contractors and a number of small ones as they adopt similar for voluntary disclosures and for people to have a sense of felt responsibility to enforce ethical standards.

The other thing that I think is going to happen is that if there is enough benefit from *qui tam* civil cases plus bounties on the criminal side, what you are going to do is have many disgruntled employees who are surfacing problems which do not rise to the level of being frivolous or will ever subject them to prosecution themselves, but nevertheless, cause tremendous amounts of both governmental resources and corporate resources to be involved in further investigations of their allegations. We are going to have a whole

subculture of people doing this. That is going to be far more negative in its consequences than it is going to be positive.

Mr. McCOLLUM. That is all part of the balance we have to decide on. I mean, there are trade-offs in every one of these areas. So we are very happy to have heard what you have had to say today and now we have got to go back and sort of be the judges and the legislators. Thank you. Thank you, Mr. Chairman.

Mr. HUGHES. I just might say, in reference to the whistleblower provisions, if in fact any individual misrepresents material facts to an investigator, he already violates the law. It is a violation of Title 18, Section 1001, the false statement provision.

The gentleman from Florida?

Mr. SMITH. Thank you, Mr. Chairman. Gentlemen, I am sorry that you cannot be sitting where we are in a way so that you could have heard yourselves. It is disheartening to hear testimony like this from three very capable individuals, to sit here and then try and reconcile what we heard against the facts as they were recited by the chairman in his opening statement. Defense criminal investigative services have obtained 85 indictments since January of 1986 and they are currently carrying over 225 open investigations.

There is an enormous amount of cheating going on. Not one of you in your statement has recognized the reality of the situation, which is the basis on which we are having to deal with the problem and why this legislation is necessary. I do not say you should really agree with every part of it. Far from it. There are plenty of things that come through here we do not agree with individually, one piece or another or even on the whole.

But this Government is being plucked to death by people out there who think this is a golden goose. We spend \$300 billion in the DOD alone and so much of it is fraudulently wasted. These cases are not isolated. They are only the tip of an iceberg that we have gotten around to finding. The chairman is basically correct, a deterrent still does not exist. There are still more people who believe that they can get away with it than there should be.

We are not talking about insubstantial things. We are not talking about a small professional service contract where somebody tried to cheat the Government on a case where it is \$1 million or \$2 million—\$88 million, \$400 million. These are telephone numbers—unbelievable. Of course, in the context of some of these contracts they may not be, but the reality is the total volume, when you add it up, it just means gross amounts of fraudulent, illegal conduct.

And to hear you talk, for instance, Mr. Yuspeh, there should be equitable penalties, equitable treatment. How do you fashion a law which treats a lawbreaker equitably? I am curious. What is equity in terms of having cheated people out of hundreds of millions of dollars? That he should only be fined up to \$10,000 or \$15,000 or \$20,000, or \$4 or \$5 million because it might threaten his very corporate existence?

As far as I am concerned, he should be run out of town on a rail. You know why? Because he gives everybody you all represent a big, black eye and makes this kind of legislation necessary.

Corporations that are doing millions of dollars worth of business right now do not need education. What they need is fear that en-

gaging in this conduct will in fact result in the very thing the chairman said—certainty of being caught, prosecuted, and if convicted, punished and punished in the most equitable of manners. When I talk about equity, I mean equity as it relates to the taxpayers of this country that were cheated.

Now Mr. Yuspeh, how do you talk in terms of equitable penalties, self-governance, when so far all you see is a litany of disgraceful conduct by some of the most important corporations in the United States?

Mr. YUSPEH. Mr. Smith, I think it is a very fair question. First of all, let me tell you that I think, at least today, March 16th, 1988, that amongst companies that are part of this Initiative, among that set of contractors for the Defense Department who have large contracts, I would be personally amazed if in this environment today there are systematic frauds that are presently underway. I think that if there have been problems in the past, those companies have gotten the message that the risk to the company, to the long term viability of the company in terms of the suspension and debarment from doing business with the Government, is simply too great.

And moreover, I frankly think that where we have seen very reputable and highly regarded companies plead guilty over the last year or two to various types of criminal allegations, there are several comments I would make. One is—

Mr. SMITH. Before you make that comment, and I am interested in what you just said and what you are going to say. But let me just say this. There was a significant case a few months ago and they were debarred for three months. They defrauded the Government out of millions and millions of dollars and they were debarred for three months. You know, that is disgraceful. That sends the most atrocious signal to the business community.

If you have a couple of billion dollar contracts and you have to suffer the outrage of paying a few million dollars in fines and being debarred for three months—remember, debarment means you do not lose what you have. You only cannot bid on new ones. You can go right back to the same course of conduct and if you get found out again, it happens again, because there is no repetitive conviction statute. There is no provision that, if you are cited two or three times, you are out forever. You can go through the administrative revolving door 20 times under the existing law.

Mr. YUSPEH. At some point in time, presumably you would no longer be able to prove you were ever going to be presently responsible and you will never be reinstated.

Mr. SMITH. We are not sure about that. We are trying to give all these tools to the departments who are involved in contracting, to some degree because it does not appear that they themselves have gotten the message inside the departments, let alone outside in the contracting community.

Mr. YUSPEH. I would like to tell you though and make part of the record why I think we continue to see some of these large numbers of large plea bargains. There are several reasons. First of all, many of them arise now from voluntary disclosures. So the companies should get some credit for having surfaced many of the things that we are reading about in the newspapers.

Second, most of them relate—

Mr. SMITH. What is that, the mea culpa reward?

Mr. YUSPEH. It does not excuse it, Mr. Smith. But I think that the general environment which promotes voluntary disclosure is, on balance, a positive kind of thing. It certainly does not excuse improper conduct in the past.

The second thing is is that, frankly I think in many of these cases what you are seeing are complex disputes where companies are choosing, in order to avoid suspension or debarment, to reach some agreement with the Government. And the Government has a great deal of coercive ability in doing that.

Mr. SMITH. Ninety million dollars, Mr. Yuspeh? Ninety million dollars voluntarily returned because it is too difficult to fight? You want to bet? You want to bet that they did not do it for that reason? That is a lot of legal fees, \$90 million.

Mr. YUSPEH. I have no doubt that the company obviously felt it must have had a substantial potential liability if it returned that amount of money to the Government; obviously, it did.

I think that there have been guilty pleas where companies felt that if they had had the flexibility to contest the matter in court and to remain suspended for a long period of time, they had a meritorious defense to the charges. In many of these cases also, Mr. Smith, where smaller amounts of money are involved, the fraudulent actions are a frolic of a relatively small number of lower level employees and there has been no evidence that senior management has been involved with it.

Mr. SMITH. Let me stop you there because by that standard, none of the senior management or the company would, in fact, be ultimately responsible. The knowing standard means that the company would have had to know, not the lower level employees, unless they can be proven to be acting with the authority, which at that point means there was knowing conduct on the part of the people who are involved.

Mr. YUSPEH. I appreciate what you are saying and it is a helpful part of the legislative history. But, of course, in most cases, the corporations have been held to have some criminal liability even in situations I have described.

The last thing is that most of these cases are what I would describe as "old cases," meaning that they are arising out of contracts and activities three, four, five, or six years ago.

I genuinely think that in light, both of this voluntary initiative I have described, as well regulations that the Department of Defense has issued, the message is getting across. Companies which have cheated the Defense Department have done a vast disservice to the Federal Government. They have done a vast disservice to themselves, and they have dishonored themselves and dishonored the industry. And I think the situation has improved.

Mr. SMITH. So you think we have turned a corner?

Mr. YUSPEH. I think we have turned a corner.

Mr. SMITH. Mr. Cross, you made a contention that there will be all these corporations that are currently doing business with the Government who will not want to do business with it and the Government will therefore suffer higher prices because of a lack of competition, and will suffer basically lower quality goods and services, also because of lack of competition.

Mr. Cross. Right.

Mr. SMITH. Are you willing to place your professional reputation on the line that there will not be thousands of people to fill the contract that right now all of your members in fact are filling? There is a line out there, Mr. Cross, that goes around the block 17 times to do business with the Federal Government. It is the deepest pocket in the country. And they will continue to line up to do business with this Government.

Mr. Cross. I have seen, in terms of the companies that we have normally competed with, a number of them in fact get out of the business in the last three years.

Mr. SMITH. One of the problems is, of course, that there has not been the kind of capability on the part of Government to make more people aware of what is available at the Federal Government level. And there are a lot of small businesses out there, I think, who would probably be very, very well suited to doing business with the Government.

But I want to ask you a specific question. You gave the example of James Beggs. Where is Mr. Beggs now?

Mr. Cross. I have no idea.

Mr. SMITH. I do, the head of a large corporation in this country, doing a tremendous amount of business with the U.S. Government. I would not be rushing out to do any charity benefits for Mr. Beggs, because the problem—I do not excuse, at all, what the Justice Department did. But let us not get too hasty to beat our breast and start shedding tears over people that are charged.

For the most part, they are not the James Beggs, and they do not have the indictments or the investigations withdrawn. They are truly, at least on paper, victims because they have provided their own probable cause. And generally, if they do not go to trial, they settle with the Government.

It seems to me that the case of Mr. Beggs is a very rare exception. This statute would not do anything to promote any more *Beggs* cases.

Mr. Cross. I suspect, though, that although Mr. Beggs may be doing just fine today, that the majority of people in this country remember that he was accused and not that he was cleared, number one.

Secondly, I should have thought to have brought today the volume of regulations which any company, small or large, has to deal with in ferreting out how to do business with the Federal Government. It is overwhelming.

Mr. SMITH. That I agree with you, but that is no reason not to have a criminal statute. That is not one of the ways you do business with the Government. That is sort of a sign post on what paths you stay within.

Mr. Cross. But I think what happened with Mr. Beggs was the complexity of the law was so great that neither the Justice Department nor the prosecutors involved with the case could understand the intricacies of what was going on there. And as we get more and more complexity, it becomes more and more difficult to operate as a Government contractor. I would also like to—

Mr. SMITH. Knowingly, willingly, willfully and all those standards are fairly clear cut in large corporations and experienced gen-

tleman and ladies, with good educational backgrounds, and those are, for the most part, the people that run the businesses that do business with the Federal Government.

Thank you.

Mr. HUGHES. The gentleman's time has expired. The gentleman from Pennsylvania.

Mr. GEKAS. I thank the Chair.

First, I wonder if the Chair is empowered to issue sunglasses to the members of this subcommittee. Notwithstanding that, I will try to talk with the members of the committee.

I would, tomorrow, remove my name as a cosponsor of this legislation if I could be convinced of the answers to two large questions. One, it seems to me that the statistics of the gentleman from Florida repeated, that the Chairman uttered at the beginning, seemed to indicate in a large sense that the present laws are working. That is, the high number of convictions which they alluded, the high number of investigations that are underway, are both underway and the convictions were secured under the present system of laws.

One reason that I became a cosponsor of this bill was because I felt, too, emotionally from the rash of newspaper headlines and discoveries that were made of vast frauds, that perhaps we ought to be doing something more. But the Chairman's statistics, buttressed by the gentleman from Florida's revelations here show a high degree of activity on the part of the Justice Department with convictions gained under the present system of laws.

If I were convinced, and I think the burden is on you and on us in a different way to be sure that the time given for the exercise of the present laws is sufficient to be able to test them. That is something that makes me hesitate to continue full speed on this legislation, as it now exists.

The second part in this preface to some questions, if I were convinced that—I am convinced that the most positive goal that we can seek here is deterrence. And that portion of this bill which has to do with increased criminal penalties, that is with jail time, I would concur. I am a hard-liner on increased jail time.

And for that purpose, if that were the only thing that remained in this bill, I would be the first cosponsor and chief advocate of this legislation.

I want to see debarment or threat of debarment as the chief deterrent in this whole, complex business. If I were convinced that there was a real crackdown and an almost foolproof system of debarment where a company could not, by the side door, come right back in the next day and resume doing business as usual, I would again, as I say, remove my name from this legislation.

I need to know, and I do not think our committee has enough evidence on this, on this subject, who has been debarred, for how long, and whether that system is working before I come to a final conclusion on this bill. Does anybody have a feel for an idea of severe debarments and ones that have been in the best interest of the taxpayers in the recent past?

Mr. HUGHES. Would the gentleman yield to me?

Mr. GEKAS. Yes.

Mr. HUGHES. The panel can respond, but I think I can respond to some personal experiences. I find the record will show that the

small companies are often unduly and harshly treated and debarred and it puts them out of business, in many instances. And I find that some of the large concerns, such as General Dynamics, are back in business within three months.

We have a serious problem. Many of the firms that do specialized type of work, the Government has very few alternatives.

Mr. GEKAS. Reclaiming my time, that is exactly my point. If we focus on perfecting the debarment procedure and making sure that that works, I am saying that we will have struck a major blow, even if we did not pass this legislation as it now stands.

Mr. HUGHES. Would the gentleman yield?

Mr. GEKAS. Yes.

Mr. HUGHES. We do not have jurisdiction over debarment. That is not within this committee's jurisdiction. We are dealing with a free-standing statute. We have no statute now.

Mr. GEKAS. I understand that.

Mr. HUGHES. We have no statute in Title 18 that deals with fraud. At the present time, we have to find a piece that fits a particular crime. We have to shop around. Can we put it within mail fraud? Can we put it within wire fraud? Does it fit within the false statements provisions of the law?

We have no free-standing fraud statute as such.

Mr. GEKAS. I understand and I am not even questioning that. I am saying, as far as this member is concerned, if I were satisfied that we could crack down—and I do not mean this subcommittee or whatever committee is going to have jurisdiction over it. Whatever is done to ensure proper and accurate debarment proceedings, I would be more than satisfied that an element of deterrence has been put into the law.

What can you tell me about the debarment and how that is generally viewed, and so forth?

One other comment I want to make, the gentleman from Florida also added a little evidence to the fact that the present laws are working. If he, indeed feels—I wish he were here so he could respond—that this \$90 million give back from that company was forced upon them because of the threat of conviction or investigation or prosecution or whatever, then the present law is working again and the \$90 million were returned because of the threat of prosecution under the existing law.

Whether that is adequate or not, if he is correct that it was the fear of that that did it. Again, the present system has a little bit more active adherence.

Mr. YUSPEH. I would like to address your question about debarment, Mr. Gekas. Debarment is not intended to be a supplemental penalty. Under the pertinent provisions of the Federal acquisition regulation, debarment is intended to be a method for the Government to ensure that it does not do business with contractors who are not responsible to do business with it, that is contractors who cannot comply with Federal law and with Government procurement regulations.

Consequently, what you find—and this is relevant to what the Chairman was saying a moment ago—is if you have a small contractor, who has perhaps one major contract with the Government and who has had a systematic program of fraud with respect to

that contract, it probably indicates that that contractor is not responsible and shows little promise of becoming responsible. And therefore, you may well have a debarment which will generally go to the maximum period of three years.

On the other hand, if you have a major diversified corporation, perhaps one of the top 20 suppliers to the Department of Defense, which—as was the case with Litton Industries—has a series of problems with one, very small division where there is no evidence of senior management condoning the action, then you have a situation where what that contractor is required to do is to demonstrate that throughout the company it continues to be presently responsible to do Government business.

That is what happened with General Dynamics, Mr. Chairman. They had a very difficult period, where they were forced to put into place very elaborate and very expensive control systems to demonstrate to the Government that they were presently responsible and that they could comply with Government regulations.

But it is more likely, in a very large company, that the matter giving rise to the debarment is small and isolated in one part of the company, and that the company will have some ability to demonstrate that it can, once again, be presently responsible and receive Government contracts.

Mr. GEKAS. Your answer implies to me that debarment should be looked at case by case, which it should be, and even isolated case by case within the fabric of a corporation, to determine what number of contract applies, and it should not affect other divisions, and so forth.

You are not giving me much satisfaction or hope that if indeed we can veer away from this bill and go into strict debarment procedures, where the taxpayers could be and the armed forces could be protected in the ultimate. If you cannot give me such satisfaction, we may have no alternative but to go full force with such a far ranging bill.

Mr. YUSPEH. I do not want to mislead you. The policy of the Government is that if there is any problem in a company giving rise to debarment, the entire company is debarred and the entire company is debarred Government-wide. The Government has generally resisted any more limited debarments than that.

However, I also want to tell you that I think the idea of using debarment, which is intended to protect the Government from doing business with irresponsible contractors, as a supplemental penalty is not a good idea. I think the use of debarment to make certain that there is present responsibility is the right and appropriate use of debarment.

Mr. KIPPS. I agree with that. I do not think you would want to combine those two. They serve totally different functions. The United States Government wants to have the ability to look out for its best interest in its procurement. If it can achieve that through ridding the company, the bad contractor, of the people who perpetrated the fraud and have good people put in, there is no reason why the United States Government should not be able to do business with that company. It saves them all kinds of money and all kinds of technical know-how. It just makes good sense, from the standpoint of the United States, to do that.



That is the reason for suspension and debarment being kept separate from the criminal side of the picture. It is not always done that way, but it is designed to be done that way.

Mr. GEKAS. The only other comment I would have to make, then, is it seems the only common ground which it seems we have all reached throughout this hearing, at least, we all seem to be in agreement that lifting the jail possibilities is an appropriate way to go, at least for portions of this legislation.

I have no further questions.

Mr. HUGHES. Thank you.

I just might say that the industry has serious concerns about the suspension and debarment proceedings of the Government, serious concerns.

Mr. KIPPS. Absolutely.

Mr. HUGHES. In fact, the industry—I do not know about your associations or the Chamber, but I do believe—I should not say that about the Chamber. I think the Chamber has had some major concerns over the use of debarment as a form of supplemental punishment.

Mr. KIPPS. Absolutely and we oppose that.

Mr. HUGHES. So while you are using the argument that you have debarment, I think what you have done is a little misleading to members because it is your position that it should never be considered as a supplement to criminal prosecution.

Mr. KIPPS. Mr. Chairman, you are right and I certainly want to state, on behalf of the Chamber, that we are all seeking to do the same thing. Our approach would be different. We do not tolerate fraud. Our companies do not want fraud. They have rules that are being violated.

When an employee goes out, a program manager or someone else goes out and substitutes the product or has costs mischarged, he is violating company policy and he is doing the company a tremendous disservice.

Now no one has dealt with this problem until the last five or six years. The enforcement aspect of it has been lax. There is tremendous pressure by the Government on the contractor and the contractor, in turn, on his employees to do the job for less.

Obviously, he is telling them to do it for less honestly. But the employees, not all of them, use honest means for doing so. And when they do not use honest means, they should be punished and something should be done about it. We all agree with that.

The question is that our approach to it is really and truly—like I say, I have been in this business a long time and I see the inadequacy on the part of the Department of Justice, to carry out their job. You need to move swiftly and you need to move effectively.

Mr. HUGHES. Let me just be more pointed. My colleague from Pennsylvania, who has likewise just departed the scene here, suggested however that perhaps what Congress should do is look at strengthening the debarment and suspension proceedings. You would not support that, would you?

Mr. KIPPS. No, sir.

Mr. HUGHES. The gentleman from West Virginia.

Mr. STAGGERS. Thank you, Mr. Chairman.

Listening to some of the comments that other people would not be doing business, and seeing that West Virginia is last in procurement business with Government in the first place, I am also aware that the Small Business Administration does assist small businesses with rules and regulations. I think that if, in fact, this does become law, I might characterize this as a full employment bill for West Virginia.

Going over the sections, I have to agree with the Chairman, that you look at section one and we talk about knowingly to fraud or use false or fraudulent pretenses. It appears that that is fairly good language. I mean, objectively looking at it. And then going further down the page into subsection A, looking at the fact that the fines may be imposed, letting the court decide case by case, once again it does not appear to be that bad of language, objectively looking at it from a legislative standpoint.

I do know that my colleague from Florida, Mr. McCollum, asked you for your input into subsection A. I think that you may have limited yourselves, and I hope that you did not interpreting that as a limiting type of request. Hopefully, you would look at subsection A completely and, if you have suggestions, bring them to the subcommittee's purview.

I do think that—he mentioned that the amount of fraud is substantial. We may be able to make some amendments that might strengthen this. So hopefully, you will look at each one of these subsections, not just subsection A, subsection B, and subsection C.

On subsection A, again, I would like to ask this question. Actually, two questions. If there is anything else that you know of, in any of these sections, that you think would make this bill a better bill, I would like to hear it.

But also, aside from the cap and the maximum, is there anything else in Subsection A? The other part of that question would be with the statute of limitations, we are not going from five to 20 or five to 15. We are going from five to seven. We are talking about two years. And once again, looking at it from an objective standpoint, it does not appear that that is such a large number that is going to put a lot of people out of business with the Government.

Is there anything in subsection A that we could change that would make it better, in your opinions?

Mr. YUSPEH. I think, as other witnesses have mentioned, Mr. Stagers, that the addition of the words "and willfully" in line two on page two would be an improvement. The treatises do not exactly say what they think willful adds. I think that what that will get you is a little more insistence of specific intent. Especially in this era where we are criminalizing a lot of conduct which previously was in the realm of being a contract dispute, the more specific intent that the Government has to prove, the fairer the situation would be.

The other thing, and I do not want to repeat what has been said here, is that the problem with the fine is that the punishment seems not to fit the crime because we move from thinking about the amount of fraud to thinking about the amount of the contract. And, of course, the amount of the fraud may have no relationship whatsoever to the amount of the contract.

So I think the feeling would be that if we looked at what other laws had done, which is typically to tie maximum fines or maximum civil remedies to the amount of the fraud and to use the amount of fraud as some type of index in setting a maximum fine, we would be on much sounder footing than starting to think about this concept of the amount or value of the contract.

Mr. STAGGERS. Aside from the maximum, about which you have already commented with Mr. McCollum and other members, and you did mention the willingly, are there any other provisions? The other two?

Subsection B, once again, trying to be objective, it is on application by the attorney general. This is not the individual. The court may, once again it is left to the discretion of the court, so there are two hurdles that you would have to jump over before you have any type of monetary reward if you are the individual, and it comes from the criminal fine and you had to furnish the information leading to the conviction.

It appears that there are at least four safeguards there so that you are not going to have this bounty hunting, as you mentioned.

Mr. KIPPS. I am not as concerned about the bounty hunter getting paid, whatever he gets. I am more concerned about what it does to the system in the real world. In the real world, the companies are trying to do—most of the companies—are trying to do exactly what this committee is doing and that is get rid of fraud.

The question is how do you best do that. The companies have started these enormous initiatives and have all these safeguards out there and they have got to continue that sort of thing and they have got to educate their people.

Mr. STAGGERS. Let me interrupt you just a minute; I heard your answer and I know your position. But you also mentioned earlier that you thought that education was the most important part. And I think that you meant education to the individual employee?

Mr. KIPPS. Absolutely, training programs, et cetera.

Mr. STAGGERS. But would this not be the best possible education tool, is that if you are going to know that you will get some sort of financial reward? Not only, as Mr. McCollum points out, another educational tool will be to make the penalty substantial for the individual, would it not be just as good to include that carrot in this type of legislation, also?

Especially if you have the safeguards built into it?

Mr. KIPPS. I do not think so. I think it is counterproductive to where the job has to be done. The job has to be done by the company. The company has got to clean up its act. It is trying to do that and you cannot have the company obligated to do that, and at the same time having someone coming along and saying call us and tell us about what your company is doing wrong. Tell us about all these things that you found out about.

Those two things are inconsistent. You want the company to go investigate, find out where their people are violating their own rules, and violating the procurement rules, and report it to you, the Government. Then you ought to let them do that. You ought to let them set up a system that permits that to be done in a fair manner, in a fair manner to the employee, and in an effective manner.

I am suggesting that the bounty hunter approach is not the way to do it because it is counterproductive in trying to get the employees to do it. You just do not generate the kind of data and you have these people working in the company who are not there looking out for the best interest of Uncle Sam or the company. They are in there looking out for how can I make a buck out of this thing, and jumping the gun.

The two systems just do not work well together.

Mr. YUSPEH. Mr. Staggers, I would like to add to that, too, that the Department of Defense has taken an action which is directly consistent with the philosophy in Mr. Kipps' comment, and that is that there was a large dispute last fall about whether or not contractors had to post a poster in their facilities advertising the DOD hotline telephone number.

Finally, on September 11, a Federal Register notice was published, which I would like to make part of the record, if you would, Mr. Chairman.

Mr. HUGHES. Without objection.

[The information of Mr. Yuspeh follows:]

**DEPARTMENT OF DEFENSE****48 CFR Parts 203, 209 and 252****Department of Defense Federal Acquisition Regulation Supplement; Implementation of Recommendations Made by the President's Blue Ribbon Commission on Defense Management**

**AGENCY:** Department of Defense (DoD).  
**ACTION:** Final rule.

**SUMMARY:** The Defense Acquisition Regulatory Council has amended the Defense Federal Acquisition Regulation Supplement, Subparts 203.70, 209.4, and 252.2 to implement certain recommendations made by the President's Blue Ribbon Commission on Defense Management. The final rule adopts a policy which promotes rather than mandates the establishment of contractor programs to improve compliance with law, regulations, and contract commitments and provides criteria for responsibility determinations in suspension and debarment decisions. The rule also includes a clause that, when inserted in contracts, will require contractors to display DoD Hotline posters unless the contractor has established a mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports.

**EFFECTIVE DATE:** October 1, 1987.

**FOR FURTHER INFORMATION CONTACT:** Defense Acquisition Regulatory Council, ATTN: Mr. Charles W. Lloyd, Executive Secretary, ODASD (P)/DARS, c/o OASD (P&L), Room 3D139, The Pentagon, Washington, DC 20301-3062.

**SUPPLEMENTARY INFORMATION:****A. Background**

On June 30, 1986, the President's Blue Ribbon Commission on Defense Management (the Packard Commission) rendered a Final Report to the President concerning its study of defense management and acquisition practices. The Commission's Report has been strongly endorsed by the Department of Defense (DoD). The purpose of this rule is to implement recommendations contained in sections I and III.C.2. of chapter four of the Report concerning contractor self-governance programs and debarment and suspension.

**B. Regulatory Flexibility Act**

The Department of Defense certifies that this final rule will not have a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act, 5

U.S.C. 601 et seq. Although the rule contains a requirement to display DoD Hotline posters, this requirement only applies to contractors who receive an award amounting to \$5 million or more and who do not meet the criteria for exception contained in the rule. Approximately 484 contracts exceeding \$5 million were awarded to small businesses in 1986. Small businesses receiving such awards and not meeting the exception criteria will be required on a one time basis to obtain free copies of the DoD Hotline poster from the DoD Inspector General's office in Washington, DC and to display such posters.

**C. Paperwork Reduction Act**

The rule does not contain information collection requirements which require the approval of OMB under 44 U.S.C. 3501 et seq.

**List of Subjects in 48 CFR Parts 203, 209 and 252**

Government procurement.  
Charles W. Lloyd,  
*Executive Secretary, Defense Acquisition Regulatory Council.*

**Adoption of Amendments**

Therefore the DoD FAR Supplement is amended as set forth below.

1. The authority citation for 48 CFR Parts 203, 209, and 252 continues to read as follows:

Authority: 5 U.S.C. 301, 10 U.S.C. 2202, DoD Directive 5000.35, and DoD FAR Supplement 201.301.

**PART 203—IMPROPER BUSINESS PRACTICES AND PERSONAL CONFLICTS OF INTEREST**

2. The Table of Contents of Part 203 is amended by adding at the end thereof the following new subpart and section titles, as follows:

**Subpart 203.70—Contractor Responsibility To Avoid Improper Business Practices**

203.7000 Policy.  
203.7001 Display of DoD Hotline Poster.  
203.7002 Contract Clause.

3. Subpart 203.70, consisting of sections 203.7000, 203.7001, and 203.7002, is added to read as follows:

**Subpart 203.70—Contractor Responsibility To Avoid Improper Business Practices****203.7000 Policy.**

It is essential that companies with whom the Government contracts conduct themselves only with the highest degree of integrity and honesty. Therefore, contractors should have standards of conduct and internal

control systems, suitable to the size of the company and the extent of their involvement in Government contracting, that are designed to promote such standards, to facilitate the timely discovery and disclosure of improper conduct in connection with Government contracts, and assure that corrective measures are promptly instituted and carried out. For example, a contractor's system of management controls should provide for—

(a) A written code of business ethics and conduct and an ethics training program for all employees;

(b) Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with standards of conduct and the special requirements of Government contracting;

(c) A mechanism, such as a hotline, by which employees may report suspected instances of improper conduct and instructions that encourage employees to make such reports (but see 203.7001 below);

(d) Internal and/or external audits as appropriate;

(e) Disciplinary action for improper conduct;

(f) Timely reporting to appropriate Government officials of any suspected or possible violation of law in connection with Government contracts or any other irregularities in connection with such contracts; and

(g) Full cooperation with any Government agencies responsible for either investigation or corrective actions.

**203.7001 Display of DoD Hotline Poster.**

Contractors who are awarded a DoD contract of \$5 million or more and who have not established an internal reporting mechanism and program, as described in 203.7000(c) above, shall be required to display prominently in common work areas within business segments performing work under DoD contracts, DoD Hotline posters prepared by the Office of the Inspector General, DoD.

**203.7002 Contract clause.**

The contracting officer shall insert the clause at 252.203-7003, Display of DoD Hotline Poster, in solicitations and contracts expected to exceed \$5 million.

**PART 209—CONTRACTOR QUALIFICATIONS**

4. Section 209.406-1 is amended by revising paragraph (d) and by adding paragraph (e) to read as follows:

**209.406-1 General.**

(d) If the cause for debarment as listed in FAR 9.406-2 is based on a felony conviction, the debarment period should be commensurate with the seriousness of the crime. The period of debarment should afford adequate time for the contractor to eliminate the circumstances within the contractor's organization that encouraged the belief that the acts or omissions on which the organization's conviction was based would escape accountability or be condoned. Mitigating factors should be considered in making the debarment decision. However, for any decision not to debar or to debar for one year or less, the mitigating factors must demonstrate clearly to the debarring official's complete satisfaction, that the contractor has eliminated such circumstances and has implemented or agrees to implement remedial measures. The debarring official should consider the following mitigating factors, among others, in making a debarment decision:

(1) Whether the contractor had effective standards of conduct and internal control systems, as outlined in section 203.7000, in place at the time of the activity on which the felony conviction was based or has adopted such procedures prior to any government investigation leading to the suspension or debarment proceedings;

(2) Whether the contractor made timely disclosure to the appropriate government agency;

(3) Whether the contractor cooperated fully with government agencies during the investigation and any court or administrative action;

(4) Whether the contractor has paid or has agreed to pay all criminal, civil, and administrative liability for the improper activity;

(5) Whether the contractor has made or has agreed to make full restitution, including any investigative or administrative costs incurred by the government;

(6) Whether the contractor has taken appropriate disciplinary action against the individuals responsible for the activity upon which the conviction was based, including dismissal when such action is warranted based on a consideration of all the available facts;

(7) Whether the contractor has implemented or agreed to implement remedial measures; and

(8) Whether the contractor has agreed to institute new or revised review and control procedures and ethics training programs.

(e) Whenever, following a felony conviction, the debarring official determines that debarment is not

necessary to protect the government's interests, the debarring official shall require the contractor to enter into a written agreement, which includes (i) a requirement for the contractor to establish (if the contractor has not already established such standards for conduct and internal control systems) and/or maintain effective standards of conduct and internal control systems as outlined in DFARS 203.7000, and (ii) other requirements as the debarring official deems to be appropriate.

5. Section 209.406-4 is amended by revising paragraph (a) and by adding paragraph (b) to read as follows:

**209.406-4 Period of debarment.**

(a) If a decision is based upon a felony conviction, the period shall be commensurate with the seriousness of the crime and will generally be for more than one year but not more than three years. A decision by the debarring official not to debar or to debar for one year or less than one year and the agreement required by DFARS 209.406-1(e) must be approved in writing by the Secretary concerned or, in the case of the defense agencies, by the Assistant Secretary of Defense (Production & Logistics), except where the debarring official determines that all of the enumerated mitigating factors set out in DFARS 209.406-1(d) are applicable and have been accomplished.

(b) If suspension precedes debarment, the suspension period shall be considered in determining the debarment period.

**PART 252—SOLICITATION PROVISIONS AND CONTRACT CLAUSES**

6. Section 252.203-7003 is added to read as follows:

**252.203-7003 Display of DoD Hotline Poster.**

As prescribed in 203.7002, insert the following clause.

**Display of DoD Hotline Poster (Oct 1987)**

(a) Except as provided in paragraph (c) below, the Contractor shall display prominently in common work areas within business segments performing work under DoD contracts, DoD Hotline posters prepared by the Office of the Inspector General, DoD.

(b) DoD Hotline posters may be obtained from the DoD Inspector General, ATTN: Defense Hotline, 400 Army Navy Drive, Washington, DC 22202-2884.

(c) The Contractor need not comply with paragraph (a), above, if the Contractor has established a mechanism, such as a hotline, by which

employees may report suspected instances of improper conduct, and instructions that encourages employees to make such reports (See DFARS 203.7000(c)).

(End of clause)

[FR Doc. 87-20912 Filed 9-10-87; 8:45 am]

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**GENERAL SERVICES ADMINISTRATION****48 CFR Parts 519 and 553**

[APD 2800.12 CHGE 48]

**General Services Administration Acquisition Regulation; Subcontracting Plan Reporting Requirements**

**AGENCY:** Office of Acquisition Policy, GSA.

**ACTION:** Final rule.

**SUMMARY:** The General Services Administration Acquisition Regulation (GSAR), Chapter 5, is amended to revise Part 519 to provide a checklist for use in reviewing subcontracting plans, to require the contracting officer to send appropriate reporting forms to the contractor at the time of award, to provide that small business technical advisors be notified of contract awards that contain subcontracting plans and to identify to whom the contracting officer is to send copies of notices of award or checklists, to provide information on the report forms and procedures to be used under the subcontracting assistance program, to outline the responsibilities and procedures related to subcontracting data collection; to revise section 553.173(c) to add the GSA Form 3584, Checklist for Review of Subcontracting Plan; and to add section 553.370-3584 to illustrate GSA Form 3584, Checklist for Review of Subcontracting Plan. The intended effect is to improve the regulatory coverage and to provide uniform procedures for contracting under the regulatory system.

**EFFECTIVE DATE:** September 2, 1987.

**FOR FURTHER INFORMATION CONTACT:** Ms. Ida M. Ustad, Office of GSA Acquisition Policy and Regulations on (202) 566-1224.

**SUPPLEMENTARY INFORMATION:****Background**

The General Services Administration published GSAR Notice 5-86 in the Federal Register (50 FR 14122) on April 10, 1985, inviting comments from interested parties. Comments received from the American Bar Association.

Mr. YUSPEH. This notice indicates that DOD changed its position and said that if a contractor had an internal reporting mechanism, some type of internal ombudsman, then its own posters which advertise the internal hotline would be then there was no need to post the DOD hotline.

I think, frankly, where we would like to see happening, where problems arise, is a felt responsibility on the part of employees to report it to internal channels, and then a felt responsibility on the part of the company, in the event that it evidences some type of fraud, to disclose that to the Government. I think we are getting very close to the point where that is happening.

As Mr. Kipps says, we already have the *qui tam* incentive for people to go outside. I think if you add to that a monetary incentive for people to make Government disclosures, one you are going to undermine these programs but two, I think you are going to get a lot of problems that surface which do not rise to the level of being frivolous, but rise to the level of being internal, personal kinds of disputes with company management.

I think it is going to exhaust a tremendous amount of Governmental resources and company resources in investigating and reviewing each of those kinds of things.

Mr. STAGGERS. Let me follow up with that. If, in fact, subsection B was excluded then do you have objections to subsection C?

Mr. YUSPEH. That is a very good question. I think the primary objection of EIA and AEA is with respect to the concept of paying whistle blowers and creating financial incentives. I would be glad to provide for the record what their views are generally on the question of whistle blower protection, because I have not consulted with them and could not speak from a knowledgeable standpoint. Some type of appropriate whistle blower protection, if there were no financial incentives for the whistle blower, would be far more palatable.

Mr. STAGGERS. I would point out, in subsection C, it does once again talk about lawful acts done by the employee and does leave it up to the court. It is not an automatic feature.

Mr. YUSPEH. I would also say, for the record, that I think that the companies that are EIA and AEA members have always felt that if an individual surfaces a problem in an appropriate kind of way and does it without disclosure of privileged information that individual certainly should not be the subject of any type of reprisal by the company.

Mr. STAGGERS. I am going to make a different assumption than what my friend from Pennsylvania made. It appears that, in fact, if there was some sort of maximum and that subsection B was gone, then you all might support this?

Mr. YUSPEH. I think that those two things would go a very long way toward making the bill a more acceptable piece of legislation.

Mr. STAGGERS. Is that true of the others?

Mr. KIPPS. I think it would be an improvement. I still have problems with it because I do not think it focuses on where the real problems are. I think the problems are quick enforcement and this does not touch that.

I oppose the Department of Justice every day in my practice. I know that they are understaffed on both sides and this does not

deal with that. It should not take seven years to prosecute a case. They ought to be on top of the case and working it out in two or three years, even through the administrative process.

But I do not have all that much problem with the seven years.

Mr. STAGGERS. We are only talking about two additional years.

Mr. KIPPS. That is right. That is lower down the list of our priorities. But I think it is focusing on the wrong end of it. I think we need to focus on getting quick and effective action. I think we have got all the penalties out there, as I said. I do not see how hiking the penalty over \$250,000 per count is going to do anything. We already have that.

If that does not do it, then a fine is not going to do it. You have to do something else. And I do not think that is going to do it. I think you do have to have these other things that I have already alluded to.

Mr. STAGGERS. Thank you, Mr. Chairman.

Mr. HUGHES. In the *E.F. Hutton* case, E.F. Hutton was convicted of a couple thousand counts of mail and wire fraud and fined several million dollars. No officers were convicted in that case. The Justice Department could not find anybody criminally responsible.

What do you think should be the standards for that type of a criminal prosecution? What do you think is an adequate deterrent?

Mr. KIPPS. I think that is a good question, Mr. Chairman.

Mr. HUGHES. You argue, on the one hand, that we should be putting the folks that commit that fraud in jail. How about if the circumstances are so convoluted that while the company benefitted from a mail or wire fraud, no individuals can be identified for prosecution? At least that is the position that the Justice Department took?

Mr. KIPPS. That means you have a civil case and cannot prove a criminal case. That is just the way the thing goes and increasing the penalty is not going to do it.

Mr. HUGHES. No, the corporation pleaded guilty. The corporation was convicted of 2,000 counts of mail and wire fraud.

Mr. KIPPS. As an overall settlement—I am not that familiar with the case. I have read the newspaper reports of it. As an overall settlement of the case, and that is done every day in plea-bargaining.

Each side has its own objectives and they somehow come to a common ground which neither likes but is willing to do it in order to dispose of it.

Mr. HUGHES. They argued, in that case, that they had put in place some new internal managements. They hired Griffin Bell to make some recommendations on changes of procedures. They argued, as you argued today, that the industry initiative basically was adequate. They argued that, in the final analysis, that there was adequate punishment in the fines imposed and that it should not be pursued any further.

What kind of a signal does that send to the little guy on the street, that gets caught for stealing? Does it send a signal that if you are wealthy and well-connected or can hide behind a corporate veil you walk but if you happen to be a poor slob walking around who ends up being convicted of a petty crime, he goes to jail?

Mr. KIPPS. Unfortunately, too much of that exists in the system. We looked at what can you do to improve the system. And when



the top management and down through the management is doing everything within their power to see that the laws are complied with and, notwithstanding that, some person way down the line commits a fraud, it does not seem appropriate to penalize the management people. They have done everything they can.

Mr. HUGHES. What do you think would be the proper punishment for a fraud on the Government where the contractor supplied substitute items that were defective and it resulted in the life of 50 sailors aboard a destroyer? What would be an ample fine?

Mr. KIPPS. I do not think you can determine an ample fine. That sort of thing should be a very high priority item within the Government and the contractors, to improve quality control and not permit product substitution and particularly in the areas where it has such potential dangers.

Mr. HUGHES. Is that a far-fetched hypothetical, in your judgment?

Mr. KIPPS. No, the kind of cases that are referred to—in a recent GAO report—of that nature and they have been around. That sort of problem has been around for years.

Mr. HUGHES. And yet, you are arguing that the court should not have that option, in the context of this legislation. Are you not arguing just the opposite? Are you not arguing that a court should not have that flexibility to mete out a penalty that, in fact, will adequately do justice in those individual cases?

Mr. KIPPS. I do not think we are arguing that as much as that there be some definition of what is substantial. This morning, in your opening remarks, you used the term egregious, not substantial. I do not know if egregious equals substantial and that equals something else, but I think in the legislation, if there were something finer standard.

In the case that you cited, certainly a penalty of the magnitude talked about here is not inappropriate. But when you have small instances, where they can become subject to judiciary having little guidance in what is meant in interpreting that, that is where our problem is.

Mr. HUGHES. Mr. Cross, I was under the impression that the industry wanted a cap. In fact, it has been suggested to me that a \$1 million cap would be a fairly prudent cap to be placed on our statute. That is not what you have been arguing.

You have been arguing that you do not want to give the judge any flexibility, so the judge could not deal with that type of egregious situation. You, yourself, argued that there are too many hanging judges out there? Was that not your quote?

Mr. KIPPS. No, that was mine.

Mr. HUGHES. Oh. Forgive me, Mr. Cross.

That was your statement, Mr. Kipps?

Mr. KIPPS. Yes, sir.

Mr. HUGHES. Basically, we do have a disparity in sentences and I am one of the first to admit that we have got to deal with that serious problem. But it seems to me that your arguments are basically to derail the entire legislation. You are not interested in trying to perfect it.

Unlike Mr. Stagers, I get the very distinct impression that there is nothing we could do to this legislation to make it attractive to you folks?

Mr. KIPPS. I would not say that irrevocably, Mr. Chairman. What we have looked at is what we have in front of us. We have examined—

Mr. HUGHES. I have not heard any constructive suggestions. I have only heard criticisms of each section of the bill, without fail. You have walked through each section and you have criticized each section as either being unnecessary, counterproductive, a sledgehammer approach. Mr. Cross, that was yours. It permits too many hanging judges too much flexibility.

And yet, I would invite you to point to one section of Title 18, if you can, that has a freestanding, broad statute to deal with contracts with the United States Government. I am not talking about what the Justice Department has to do in each instance, that is to find out what slot perhaps they can put conduct into.

I am talking about a freestanding fraud statute, like we have done with mail or wire fraud. Do you know of any, in Title 18?

Mr. KIPPS. That expressly addresses Government contracts, no, but Section 1001 is the one that is used extensively for Government contract fraud.

Mr. HUGHES. That deals with false statement.

Mr. KIPPS. False statements and false claims.

Mr. HUGHES. False statements, as a prosecutor, I used that often. It is a catch-all, but sometimes it does not fit. Prosecutors often have a very difficult time in trying to find where to put a scheme or artifice to defraud. You make it sound as if a lot of innocent businessmen are going to be targeted. You have read the statute.

Let me just read it to you and you tell me if this sounds like somebody who has committed some innocent conduct?

“Whoever knowingly executes or attempts to execute any scheme or artifice; 1, to defraud the United States or to obtain money or property from the United States by means of false or fraudulent pretenses, representations or promises.”

Does that sound like innocent conduct.

Mr. KIPPS. No, you are defining criminal fraud and the language reads very similar to Section 1001 and some of the other provisions.

Mr. HUGHES. It reads very similar to the bank fraud statute. We are not talking about bank fraud. We are talking about fraud perpetrated against the United States Government. But we are talking about knowledge, knowingly, with the intent to defraud.

Let me ask you a couple of other questions, if I might, because I have found the dialogue today to be interesting and I think somewhat constructive and productive.

One of the criticisms leveled by the panel of H.R. 3911 is that it will not increase the number of fraud cases. It is not the purpose, really, of this bill to do that. The purpose is to deter. And in the second place, to provide a freestanding statute that will cover acts of fraud against the United States Government in our procurement practices.

You questioned the fine provisions and I would join with my colleague that we have had some concern about the fine provisions ourselves. We had concerns in the subcommittee and I am not sure

that we have arrived at the right formula yet. I have been candid with those that have talked with me about this legislation, that we are open to suggestion. We want to make it fair and reasonable, but we want it to also act as a deterrent.

I join with my colleague in inviting you to suggest some language that you feel is fair and reasonable. We are working on language, also.

I also have some concerns about information in your statements. You indicate that there are some worst case situations that could occur with small business. Let me ask you some questions, if I might. First, let me just ask you, Mr. Kipps, do you believe the Department of Justice would prosecute a subcontractor for a \$1,000 mischarge on a \$10,000 subcontract on a \$20 million contract and ask for a \$40 million fine?

Mr. KIPPS. I do not think they would. They may negotiate some plea-bargain with them.

Mr. HUGHES. That happens now.

Mr. KIPPS. But that happens now. I think there are two reasons for that. The first is some exercise of discretion but the other is that they just do not have the resources to even think of that.

Mr. HUGHES. Do you know of many hanging judges that would accept that recommendation.

Mr. KIPPS. I have been before some judges that I would be concerned about what they would do with that.

Mr. HUGHES. I trust you try to make arrangements not to appear in those courts?

Mr. KIPPS. That is right.

Mr. HUGHES. In fact, under the existing mail and wire fraud statutes and RICO statutes, as I mentioned earlier, the Government already has tools that could wreak havoc with a corporation if they chose to use those tools. I do not know of any instances, as I said earlier, where that process has been abused. I would invite you, if you have any instances where the Justice Department has abused that process, to bring that to the committee's attention.

You also allege that the Department of Justice could use H.R. 3911 to blackmail companies into settlements. Does the Justice Department do that today?

Mr. KIPPS. Sure they do. They use the suspension, debarment. They use anything they can as an argument to try to get to what they feel is a reasonable settlement. This would provide an enormous tool because it would open up the span of money that you are talking about.

Mr. HUGHES. You are getting back to the fines here?

Mr. KIPPS. Yes.

Mr. HUGHES. You also, and I believe you, Mr. Yuspeh, were talking with my colleague Mr. Staggers about the whistle-blower provisions and also the reward provisions. Do you think the average employee, within a corporation, is going to be anxious to come forward and blow the whistle on an employer as a general rule and face all that whistle-blowers in the past have had to go through without giving a great deal of thought to it and feeling very strongly about the issue.

Mr. YUSPEH. Obviously, again, we are talking about a small percentage of people, but if you consider the vast number of people

who work, for example, in the defense industry, Mr. Chairman, as well as people who have worked in the defense industry—former employees—we are talking about numbers in the millions. And again, it does not take a large percentage of that number to get a meaningful number of potential whistle blowers.

I think there are probably many disgruntled former employees of defense contractors, just like there are disgruntled former employees of, I suspect, every large corporation in this country.

Mr. HUGHES. Do you think that they would, without giving a great deal of thought to it, make a false statement about practices within the company to Federal law enforcement?

Mr. YUSPEH. Not at all. Mr. Chairman, I want to emphasize that I am not asserting that false statements will be made. I think that there is so much "gray" area in the interpretation of these complex regulations that much judgment is applied. The best analogy that I can give you is that I am sure when you or any of us prepare our Federal income taxes, if there is any complexity in our transactions, it requires some judgment in what deductions are taken and the structure of those deductions.

An analogous situation would be that any individual who thought that perhaps you or I or someone else had taken a deduction which might, if examined by the Internal Revenue Service, be disallowed surfaced that, and if eventually it moved to the point where we had to give up that deduction, they could get some reward for it. I think you would find a lot of people who—

Mr. HUGHES. I do not see any parallel. You are talking about rewards after conviction. Rewards after conviction.

Mr. YUSPEH. I am talking about the fact that the potential for the reward becomes the incentive for the action.

Mr. HUGHES. I would think, as a matter of just common sense, that the average employee would think twice about making statements to the law enforcement community about petty things or matters that would be a matter of interpretation within the company, without giving a great deal of thought to it.

And if they lied about it, they would be subject to prosecution.

Mr. YUSPEH. At a minimum, we should do that. But a disgruntled former employee obviously has no disincentive whatsoever to do something.

Mr. HUGHES. But if, in fact, if the information has to do with fraud by the company and it is prosecuted and the company is found guilty, which is a pre-condition, what is wrong with a reward under those circumstances? I do not understand your argument. It is not innocent conduct we are talking about. A court has already determined that there was fraud perpetrated upon the Government. It is at that point that a reward is paid.

Mr. CROSS. I think the point is the degree to which people are incentivized to bring the kind of disputes which Mr. Yuspeh mentions which are basically interpretation issues. I would think it is not unlikely that a medium-sized company could have 10 or 20 allegations made of which zero or one are, in fact accurate. But there is a lot of time and cost in defending oneself.

Mr. HUGHES. Mr. Cross, I cannot imagine a court finding an individual or a company knowingly defrauding the Government over strictly an interpretation.

Mr. CROSS. No, and I agree with you. But what we are suggesting is the other end of that. The bringing of charges, not the settlement of a case or the litigation.

Mr. HUGHES. But the Justice Department already has that.

Mr. CROSS. Already has what?

Mr. HUGHES. Already has that responsibility for determining whether there is any basis for it.

Mr. CROSS. That is right. Let us take a scenario where a company of 10,000 employees has two or three people a year who are disgruntled, who get fired or discharged or maybe even still are there but they are angry, they feel they have been mistreated. And they bring some type of a grievance that is related to an interpretation of law.

That is a lot of time and cost on the company's part to defend themselves against what are probably, in 99.9 percent of the cases, matters of interpretation. It is complex enough for people in top management of a company to know and understand the procurement regulations and laws. If you take somebody who is at the fourth, or fifth, or sixth or seventh level down, they may sincerely believe they have a case. But the reality is they do not.

I mean, if the Justice Department can make errors of the magnitude that they make, to think that an employee is not going to possibly make errors and fully believe that they are correct and not be making a false statement under the definition of the Justice Department statute.

Mr. HUGHES. So it becomes a policy question as to whether or not it is going to encourage the disgruntled employees coming in and the inconvenience and expense and perhaps even the adverse publicity that the company had to go through, to be balanced against how much information we will get by providing rewards.

Mr. CROSS. I think that is well stated.

Mr. HUGHES. And I gather the whistle blower provisions only give you concern because you are basically opposed to the whistle blower provisions in the context of a fraud statute?

Mr. CROSS. I think if you take a small company, and I cannot speak for my colleagues, but if you have a small company—we have 250 employees—to have to keep somebody on under circumstances where a disgruntled employee may have brought a charge and under this provision, as I read it, you would have to keep that person on and protect them while something is under development and under decision or adjudication.

Mr. HUGHES. That is the law civilly.

Mr. CROSS. That is a big cost.

Mr. HUGHES. That is the law civilly today, is it not? And this statute tracks pretty much, I believe, the whistle-blower provisions of existing law.

Mr. CROSS. It applies to all Government contractors?

Mr. HUGHES. False claims. Basically did you oppose the whistle-blower provisions in the false claims?

Mr. CROSS. I was not aware of them.

Mr. KIPPS. The Bar Association did, I mean the industry did.

Mr. HUGHES. How about the Chamber of Commerce?

Mr. KIPPS. I am not sure what the Chamber did. I think they were involved in the effort.

Mr. HUGHES. It would be fair to say, however, that even if they agreed to the compromise, it was a reluctant agreement because you are basically opposed to the concept of the whistle-blower protection provision, if I understand what you just said? You have some concerns?

Mr. KIPPS. That is correct.

Mr. HUGHES. All right. I think that answers my questions. Thank you very much. Your testimony was very helpful and we appreciate your testimony.

That concludes the hearing for today. The subcommittee stands adjourned.

[Whereupon, at 11:57 a.m., the hearing was concluded.]



## ADDITIONAL MATERIAL



U.S. Department of Justice

Office of Legislative Affairs

FEB 4 1988

Office of the Assistant Attorney General

Washington, D.C. 20530

**03 FEB 1988**

The Honorable William J. Hughes  
 Chairman  
 Subcommittee on Crime  
 Committee on the Judiciary  
 House of Representatives  
 Washington, D.C. 20515

Dear Mr. Chairman:

In the course of the testimony on December 3, 1987, of Deputy Assistant Attorney General John C. Keeney before the Subcommittee, you requested him to supply a description of the Criminal Division's Defense Procurement Fraud Unit as a supplement to his testimony. By this letter, we are responding to that request.

Overview of the Defense Procurement Fraud Unit

The Defense Procurement Fraud Unit (hereinafter "the Unit or DPFU") was established on October 26, 1982, pursuant to an agreement between the Attorney General and the Secretary of Defense. It was and is designed to focus priority attention on fraud occurring in the defense procurement process by creating a central clearing house for defense fraud cases and by creating a cadre of prosecutors whose professional efforts would be entirely devoted to the investigation and prosecution of such cases.

The Unit is part of the Fraud Section of the Criminal Division. It is currently staffed by ten Fraud Section lawyers including a Chief. It is supervised by a Fraud Section Deputy Chief who spends much of his time on defense procurement fraud cases. Department of Defense (DOD) agencies supply four attorneys, four liaison persons and two secretaries to support the unit.

The functions of the Unit include investigating and prosecuting selected cases by itself or in conjunction with United States Attorneys, screening referrals from DOD, and liaison with cases investigated and prosecuted by United States Attorneys.



The cases historically involve labor mischarging, defective pricing, product substitution (including both false testing and false certification) and official corruption. Some cases have disclosed widespread patterns of fraud victimizing DOD agencies and the contracting process itself.

#### The Unit Screening Process

The vast majority of allegations of fraud come to the Unit from the Defense Contract Audit Agency (DCAA), the Defense Criminal Investigative Service (DCIS) or, to a lesser extent, from the criminal investigative components of each of the three services: the Naval Investigative Service (NIS), the Army Criminal Investigative Division (CID), and the Air Force Office of Special Investigations (OSI). Upon receipt these allegations are reviewed by Unit staff, including a DCAA auditor and DOD attorneys, and finally by Justice Department attorneys. In many instances, a request for additional information is made to the originating agency before this initial review can be completed.

When the review is completed, one of five possible screening actions is taken. Those are 1) accepting the case for investigation and prosecution by the Unit; 2) declining prosecution on behalf of the Department of Justice; 3) returning the case to the originating agency for additional investigation; 4) returning the case to the originating agency for additional investigation, followed by referral to a United States Attorney's office; and 5) directly referring the case to a United States Attorney's office.

When cases are returned to an investigative agency for further investigation (screening actions 3 and 4, above) the Unit prepares an investigative plan detailing the additional work required to complete the preliminary investigation. As screening actions are taken, notification is given to affected DOD agencies and the Justice Department Civil Division. The Unit seeks to monitor and coordinate cases which are referred to agencies and to United States Attorneys' Offices at the completion of the screening process.

In addition to accepting cases through the screening process discussed above, the Unit accepts other investigations referred from DOD agencies such as DCIS, NIS, Army CID, and Air Force OSI. Another source of referrals to the Unit is the United States Attorneys' Offices. These cases come to the Unit in different stages of maturity and are reviewed by the Unit Chief and by the Deputy Chief of the Fraud Section with responsibility for the Unit.

This pre-acceptance review process focuses upon, among other things, the type of case, the amount of the loss, the significance of the alleged fraudulent conduct, and any statute of limitations problems. If a corporation is among the subjects of the referral, the Unit considers the prevalence of the fraudulent conduct within the corporation and level of the corporate officials involved.

Screening decisions to accept, decline or refer cases to the United States Attorney are made by the Fraud Section Deputy Chief upon recommendations from DPFU.

#### The Unit Investigative Process

If, following this review, a case is accepted by the Unit, it is assigned to a DPFU attorney. All available material is then reviewed by the attorney and, where necessary, an investigator. At the same time, contact is made with the principal investigative agency. Frequently, additional material is sent to the assigned attorney from the investigative agency and an on-sight review is conducted as soon as possible.

During the on-sight review, several areas are addressed. These include additional discussion of statute of limitations issues and the discussion and review of documents and interview reports. Detailed factual analysis is also conducted in cooperation with investigative agents and auditors.

Following the on-sight review, the attorney and agents prepare an investigative plan which receives varying degrees of review dependent on the nature of the particular case. The plan is updated and the progress of the investigation is reviewed by the Unit Chief and/or the Fraud Section Deputy dependent on the nature of the particular case. Periodic reviews of the investigative plan are made. The Chief of the Unit is available for discussing the case on a daily basis if that is necessary.

During the investigation, inspector general or grand jury subpoenas are issued as dictated by the circumstances. Documents are reviewed as they are produced and interviews of both government and contractor employees as well as other witnesses are conducted. If Inspector General subpoenas are first issued, another review of the case will take place before the commencement of grand jury proceedings.

When necessary, or as the investigation nears conclusion, the Unit attorneys begin preparing a prosecutive memorandum which, when completed, will discuss several subjects. These will include 1) a statement of relevant facts; 2) a summary of relevant documents; 3) a summary of important witness interviews and testimony; 4) a statement of applicable law; 5) a discussion

which applies the law to the facts of the case, including a discussion of the available theories of prosecution and their "correctness"; 6) an enumeration of the evidence to be used in the government's case-in-chief; 7) a discussion of evidentiary and admissibility issues regarding the government's evidence; 8) a discussion of anticipated defenses; and finally, 9) a recommendation regarding prosecution.

As the prosecutive memorandum is being completed, a draft indictment is prepared. In many instances, counsel for the targets of the grand jury investigation also will have made written and oral presentations for consideration during the final decision process.

Once the investigation, prosecutive memorandum, and draft indictment are completed, the prosecutive recommendation is reviewed by an Indictment Review Committee made up of senior Fraud Section attorneys which includes the DPFU Chief. The Committee is chaired by the Deputy Chief of the Fraud Section. The Committee reviews the prosecutive memorandum, draft indictment, and any information submitted by counsel for the proposed defendants. The committee then meets with the case attorneys. In some instances, the committee directs that further investigative steps be taken before a final recommendation is made.

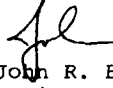
After discussion, consideration, and any necessary redrafting of the indictment or additional investigation, the committee makes its prosecution recommendation. This recommendation is forwarded to the Fraud Section Chief for review and final decision. If the Fraud Section Chief decides that an indictment should be sought from the grand jury, the staffing is reviewed for the purpose of determining whether additional staffing is necessary. Likewise, final declination decisions are made by the Chief of the Fraud Section.

#### DPFU Staffing

The number of procurement fraud matters referred to the Unit is continually growing and the need for experienced attorneys correspondingly is increasing. The adequacy of DPFU staffing also is affected by the number of attorneys who obtain other employment. Both referrals and staff turnover occur in cycles, so, at certain times, the need for experienced attorneys is greater than at other times. During the past six months, six new Department of Justice attorneys have been added to the Unit. Two additional attorneys are expected within the first quarter of 1988. At this writing, the Unit is staffed with ten DOJ attorneys, including the Unit Chief, and four DOD attorneys.

I trust this description of the Defense Procurement Fraud Unit will be of assistance to the Subcommittee.

Sincerely,

A handwritten signature in black ink, appearing to be 'J.R. Bolton', written in a cursive style.

John R. Bolton  
Assistant Attorney General

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JUSTICE DEPARTMENT INVESTIGATIONS OF  
DEFENSE PROCUREMENT FRAUD: A CASE STUDY

A Staff Report

Presented To The

Subcommittee on National Security Economics  
of the  
Joint Economic Committee

And The

Subcommittee on Administrative Practice and Procedure  
of the  
Committee on the Judiciary

March 19, 1987

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## EXECUTIVE SUMMARY

The history of the Newport News Shipbuilding investigation reveals inefficiencies, unexplained lapses, and systemic problems in the Justice Department's management of major defense fraud cases. The establishment of the Defense Procurement Fraud Unit (DPFU) within the Justice Department was intended to correct the type of deficiencies experienced in the Newport News case. While some progress is evident in the overall detection and prosecution of procurement fraud, systemic weaknesses continue to plague the Justice Department's efforts, especially with regard to complex cases involving major contractors.

The Justice Department's approach to the Newport News investigation was to assign responsibility for the investigation to the U.S. Attorney in Alexandria, Virginia, while retaining authority to make the final decision on whether to prosecute. Navy attorneys were assigned to the investigative team, but were given no role in decisions about investigative strategy and a minor role in determining recommendations to the U.S. Attorney. This system of dividing responsibility and authority was ultimately fatally flawed. It contributed to staffing problems, caused delays, and defeated the underlying purpose of a mixed investigative team. Instead of a combined force providing increased effectiveness, there was a divided force that proved ineffective.

The approach of DPFU has resulted in some of the same problems, including inadequate numbers of staff and excessive staff turnover. Defense Department attorneys and Justice Department civil attorneys assigned to DPFU play a minor role, primarily in the screening of referrals from Defense. The objective of establishing an effective prosecutive unit of identifiable resources available on a continuing basis to handle major defense fraud cases has still not been achieved.

Serious mistakes were made at every stage of the Newport News investigation and much time wasted during lengthy periods of inactivity. There was poor supervision of prosecutors and investigators, questionable decisions at the prosecutorial and managerial levels, excessive staff turnover, and inadequate coordination within the Justice Department and between Justice and the Navy. There is strong evidence that the statute of limitations on the substantive offenses of false claims and false statements was allowed to lapse before the case was closed.



These problems occurred even though it had been recognized at the highest levels within the Justice Department when the investigation began that prior experiences with Navy shipbuilding fraud cases were unsatisfactory and that a better approach was needed.

The following is a more detailed list of conclusions.

THE NEWPORT NEWS INVESTIGATION

1. The Justice Department allowed two years to lapse without conducting any investigation from the time allegations and evidence of possible fraud were first referred to it in 1976 by Senator William Proxmire.
2. After agreeing to share responsibility for the Newport News matter with the U.S. Attorney's Office in Alexandria, Virginia, the Justice Department failed to carry out its responsibility for advancing the investigation.
3. The head of the Richmond team did not properly carry out the directions of the U.S. Attorney to conduct further investigation following the submission of his initial recommendations in March 1980. A key witness, who was a high official of Newport News, was mistakenly given full immunity and questioned outside the presence of the grand jury, contrary to the instructions of the U.S. Attorney.
4. The U.S. Attorney's Office in Alexandria, Virginia, renewed the grand jury investigation in early 1981 and uncovered new evidence about the VCAS item. In the view of the Alexandria prosecutors, the new evidence established the methodology of how the false aspects of the claim were prepared. The prosecutors forwarded a report to the Justice Department in November 1981 concluding that there was evidence of fraud and a criminal conspiracy, and requesting staff assistance to complete the investigation. The report urged that the investigation be completed by the middle of 1982 to avoid statute of limitations problems. But from the date of the report until the case was closed in August 1983, there were no further grand jury proceedings or other efforts to advance the investigation.
5. In November 1981, Elsie Munsell, the new U.S. Attorney in Alexandria, abolished the Fraud Division in her office which had responsibility for the Newport News case, and reassigned the two prosecutors who had worked on it. This action was taken without consulting the previous U.S. Attorney or officials in the Justice Department, and over the objections of Joseph Fisher, the Alexandria prosecutor who had been in

- charge of the investigation. The reorganization sidetracked the investigation and reduced prospects for completing it in the U.S. Attorney's office.
6. In January 1982, U.S. Attorney Munsell asked the Justice Department to reassume responsibility for the Newport News case. Justice advised her in March that it would take back the case. The shift in responsibility for the investigation led to further discontinuity and delays.
  7. The Justice Department decided to review the case to determine whether the investigation should be continued or ended. There was an additional delay and confusion in beginning the review as Justice officials searched for an attorney to work on the case.
  8. Ed Weiner submitted a report on August 5, 1982, agreeing with the Alexandria prosecutors that there was evidence of fraud and a criminal conspiracy, and recommending that the investigation be continued. Later, Mr. Weiner was directed to search the files again for additional evidence of fraud. Mr. Weiner did, in fact, uncover what he viewed as new evidence of fraud. Nevertheless, Mr. Weiner's superiors in the Fraud Section decided in November 1982 to recommend to their superiors at the Criminal Division level that the case be closed.
  9. Robert Ogren, Chief of the Fraud Section, strongly argued in his report to Assistant Attorney General Jensen that by February 1983 the statute of limitation had expired on the substantive crimes of false claims and false statements. Mr. Jensen's letter informing the Navy that the dominant reason for closing the case was the absence of sufficient evidence to prove a criminal conspiracy is consistent with the view that the statute of limitations would have barred prosecution of the substantive offenses.
  10. The statute of limitations would not have been a bar to prosecution on charges of conspiracy.
  11. There was additional delay as the final decision by Assistant Attorney General Jensen to close the case was not made until August 1983.

THE DEFENSE PROCUREMENT FRAUD UNIT

1. The Justice Department's Defense Procurement Fraud Unit has not sufficiently corrected the numerous problems encountered with previous investigations of major shipbuilders.

2. DPFU has experienced excessive staff turnover, and effective coordination with the Defense Department still appears to be in need of improvement.
3. DPFU has produced few successful prosecutions of major contractors. As of July 1986, the Unit had participated in only three convictions of major defense contractors. In all three cases, the sentences were limited to fines.
4. DPFU appears to lack an adequate recording system for cases referred to it. According to the General Accounting Office, the Unit could not produce records showing the reasons for actions, if any, taken with regard to 58 case referrals.

## I. INTRODUCTION\*

Newport News Shipbuilding and Dry Dock Company, a division of Tenneco, submitted claims in March 1976 seeking \$894 million reimbursement for cost overruns in the construction of 14 nuclear-powered vessels. The Navy settled the claims for \$208 million and in 1978 referred the matter to the Justice Department for investigation of possible fraud. In August 1983, the Justice Department declined prosecution.

The Newport News case was controversial because it involved public allegations by high Navy officials of possible fraud by a major defense contractor, very large sums of money, and what many consider to have been an excessive amount of time to complete the investigation. The Newport News investigation also coincided with several other investigations into alleged Navy shipbuilding fraud, all of which were declined by Justice. These cases led to allegations that the Justice Department was failing to enforce the laws prohibiting fraud against major defense contractors, and that lax law enforcement was contributing to inefficiency and unnecessary cost increases in defense production.

Senator William Proxmire and Senator Charles E. Grassley conducted joint hearings of their respective Subcommittees on October 1, 1984,<sup>1/</sup> inquiring into the Justice Department's investigation of Newport News. It was revealed at the hearings that the prosecutors in the case strenuously opposed the decision to decline prosecution. The hearings and subsequent actions by the two Subcommittees produced additional information and Justice Department documents about the investigation.

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\* This report was prepared by Richard F Kaufman and Lisa Hovelson. Frank W. Dunham, Jr., served as a consultant.

<sup>1/</sup> The hearings were conducted before the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, and the Subcommittee on Administrative Practice and Procedure of the Senate Committee on the Judiciary.

The General Accounting Office (GAO) had previously been asked to review the Justice Department's management of three investigations into alleged false shipbuilding claims, including the Newport News claims. GAO issued its report on August 1, 1985 ("Information On Three Investigations By The Department Of Justice Into Navy Shipbuilding Claims," hereafter referred to as the GAO Report). The section of the report concerning Newport News, describing the dates of key Justice Department actions and decisions, and the number and experience of the staff assigned to the case, raised a number of questions about the adequacy of the management of the investigation.

Following receipt of the GAO Report, the Senators directed the staffs of the Subcommittees to conduct a detailed inquiry into the Justice Department's handling of the Newport News investigation, in particular, and of the Department's program with respect to defense procurement fraud, in general. The staff was instructed to examine the materials turned over to the Subcommittees by Justice, to obtain other materials and information, and to interview the government attorneys and officials who were involved in the Newport News investigation. The purpose of the staff effort was to provide the following:

1. An analysis of the Justice Department's investigation of Newport News
2. An assessment of the approach used by the Justice Department to investigate defense procurement fraud

In carrying out its instructions, the staff examined the available documents and records of the investigation. Unfortunately, most of the files and evidence gathered during the investigation were destroyed or returned to Newport News immediately following the decision to terminate the investigation. However, the Justice Department turned over to the Subcommittees copies of the various reports and memoranda prepared by the prosecutors and supervisors in the case. A number of documents were obtained from the Navy and additional documents were obtained from other sources including present and former government attorneys. Documents referred to as exhibits in the report are reprinted in the appendix.

The staff also conducted interviews with nearly all the prosecutors and Justice Department officials who were involved in the investigation. Most of the interviews were not recorded. However, detailed notes were taken. Summaries of the interviews were later prepared by the staff and forwarded to the persons interviewed for comment. The written summaries, comments, and letters are retained in the Subcommittee's files.

## II. THE NEWPORT NEWS CASE

A. THE REFERRALS1. Referral by Senator Proxmire to the Justice Department

In April and May 1976, Senator William Proxmire received information suggesting that the huge shipbuilding cost overrun claims filed by Newport News against the Navy were, in part, fraudulent. Senator Proxmire directed a staff inquiry and conducted hearings on the subject in June 1976 and December 1977 in the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (the hearings are entitled, Economics of Defense Procurement: Shipbuilding Claims).

Admiral H.G. Rickover testified at the June hearing that Newport News' claims were greatly exaggerated and unsupported, and he discussed examples from the claims that were described as "absurd." Rickover argued that the company was responsible for much of the cost overruns.

William R. Cardwell, a former long-time management employee at Newport News, also testified at the June hearing. Cardwell was a member of the shipyard's claim team engaged in preparation of the claim eventually submitted to the Navy. He testified that the claims he worked on contained exaggerated, unsupported, or inaccurate figures, and that this was done at the direction or with the knowledge of higher management.

Cardwell said that many of the construction delays and cost overruns in the construction of the ships were caused by inefficiencies in the shipyard. He testified about questionable practices including the maintenance of two sets of construction schedules. One, an optimistic schedule, showed the ships would be delivered on time, and was "published" and forwarded to the Navy. A second, more realistic schedule showed there would be substantial delays in completion of the ships. The second schedule was retained by company management and not shown to the Navy.

On July 29, 1976, Senator Proxmire wrote to Attorney General Edward H. Levi stating that he had received information in Committee hearings suggesting possible fraud by Newport News and requesting an investigation. On August 16, 1976, Justice advised Proxmire that a Fraud Section attorney had been assigned to evaluate the inquiry. (GAO Report.4)

In August 1976, Calvin Kurimai, a staff attorney in the Fraud Section of the Department of Justice's Criminal Division, opened a preliminary investigation into the question of whether the Newport News claims were based on fraud. (Exhibit L.3)<sup>2/</sup> Kurimai was directed to monitor the Navy's analysis and technical review of the claims and report the results back to his Fraud Section supervisor.

Kurimai kept abreast of the Navy's claim evaluation process and familiarized himself with the Newport News claims and contract procedures. (Ex. L.3) He appears to have spent an insignificant amount of time on the case. (Interview E.3)<sup>3/</sup> When interviewed by GAO in 1985, he had no idea what portion of his time had been expended on the matter. He made no written reports or analysis of his efforts, but reported orally from time to time to the Chief and Deputy Chief of the Fraud Section regarding the Navy's progress in evaluating the Newport News claims. (GAO Report.10) A Justice Department attorney reviewing the matter several years later stated in a report to the Chief of the Fraud Section that the Justice Department should have begun the investigation in earnest in the summer of 1976. (Ex. W.14)

Admiral Rickover appeared before Senator Proxmire's Subcommittee again in December 1977, and testified that he had submitted to appropriate naval authorities four reports on Newport News claim items which he believed warranted investigation for possible violation of fraud or false claim statutes. Also testifying was Admiral F.F. Manganaro, Chairman of the Navy Claims Settlement Board established to examine the Newport News claim and make a formal Navy determination. At the time of Manganaro's testimony, the board had essentially completed its examination. He testified that he had notified the Navy General Counsel's office of items in the claim which he considered to be "significantly inaccurate, potentially false, or possibly fraudulent."

<sup>2/</sup> Exhibits may be found in the appendix and are hereafter referred to as "Ex."

<sup>3/</sup> Interviews, hereinafter referred to as "Int.," are retained in the files of the Subcommittee.

## 2. Referral by the Navy to the Justice Department

On February 8, 1978, the Navy advised the Justice Department by telephone that it would be referring for investigation three shipbuilding claim matters from three different shipbuilders. Each involved claims which were so exaggerated that the Navy wanted the Justice Department to determine whether they were fraudulent. (Ex. G.1) One of the referrals was the Newport News case. Up to this time, Kurimai had done nothing substantive to advance the case referred by Senator Proxmire in 1976. (Int. E.3-4)

The Chief of the Fraud Section expressed concern because the referrals failed to specify the nature and location of the suspected fraud in the voluminous claims. (GAO Report.5) The Navy believed it had specified where the suspected fraud could be found. For example, a series of memoranda from Admiral Rickover in 1977 and 1978 analyzed the possibilities of fraud in various portions of the Newport News claim. (Ex. A, B, C, D, E, and F) These analyses by the Navy were later described as excellent by prosecutors who worked on the case. (GAO Report.5 and Int. A.7)

On February 8, 1978, the Navy notified the Justice Department that it would be referring Newport News and two other shipbuilding claims to Justice in the next several days, and indicated that it intended to advise President Carter of the referrals that day. Justice Department officials agreed, with Attorney General Griffin Bell's express approval, to begin criminal investigations.

At the time of referral, Justice officials were concerned about the demands the cases would place upon the Department. Mark M. Richard, Chief of the Fraud Section, recommended that, in light of prior experience with Navy shipbuilding cases, a specialized group of Defense and Justice officials take responsibility for them. John C. Keeney, Deputy Assistant Attorney General, passed the suggestion to his superior, Benjamin Civiletti, Assistant Attorney General, Criminal Division, adding that shipbuilding cases "require tremendous investigative and prosecutive resources...." Civiletti passed it to Attorney General Bell who in giving his assent urged his subordinates to "Hold D.D. & Navy's feet to fire. It is their case. They must help 100 %." (Ex. G.1 and H.3)

On April 18, 1978, Civiletti wrote to the Defense Department stating that the new shipbuilding cases would be handled differently than earlier ones. Civiletti explained the need for Navy legal and investigative participation in the case: "The intent is to combine multiple talents on one investigative team to conduct a more rapid and efficient investigation and, if



warranted, prosecution than has been possible previously." (Ex. I.1) Richard later told GAO that Justice agreed to accept the cases because of public concern about fraudulent shipbuilding claims and a commitment by the Navy to assist in staffing the inquiry. (GAO Report.5)

The Navy assigned two attorneys from the Navy's Office of General Counsel, Eugene Paulisch and Saundra Adkins, to act as co-counsel with the Justice Department prosecutors. (Ex. L.6 and I.1-2) Adkins and Paulisch were generally familiar with procurement law and had specific experience with Navy claims. About the time that the Navy attorneys were assigned, the Fraud Section reassigned responsibility for the case from Kurimai to Joe Covington. (Ex. L.6)

### 3. Referral by the Justice Department to the U.S. Attorney

In the summer of 1978, the Justice Department referred the Newport News matter to the U.S. Attorney for the Eastern District of Virginia, whose main office is located in Alexandria. The referral was accompanied by the services of the two Navy attorneys, Adkins and Paulisch, as well as the services of Fraud Section attorney Covington. It was the understanding of the U.S. Attorney at the time the case was referred that the responsibility for investigation and any prosecution would be shared between the U.S. Attorney and the Fraud Section. However, it was clear that ultimate decisionmaking authority on the case rested with the Justice Department. (Int. B.3, C.2, E.11, and K.3) In 1977, Attorney General Bell had personally approved the indictment of the Ingalls Shipbuilding Division of Litton Industries in Pascagoula, Mississippi, charging it with submitting a false shipbuilding claim. It was generally accepted that the Litton precedent would require Attorney General approval of any attempt to seek an indictment against Newport News. (Int. D.11)

Shortly before the assignment of Newport News to the Alexandria office, the then U.S. Attorney William B. Cummings had established a special Fraud and Corruption Division, known as the Fraud Unit. Its purpose was to concentrate resources and expertise for the handling of major defense procurement cases. Assistant U.S. Attorney Joseph Fisher was named Chief of the Fraud Unit. Elliot Norman, an Assistant U.S. Attorney, was assigned to it. (Int. B.3 and E.2)

Norman was selected by Fisher to be the prosecutor on the Newport News matter in August 1978, and the investigation was moved from Alexandria to Richmond, closer to the Newport News

shipyard. (Int. C.2 and E.2) Norman had experience in handling complex civil litigation, but had no substantial experience in running major criminal investigations.

Covington, who had been assigned to the case by the Justice Department, worked on the investigation only part time. Later, a second "part-time" attorney from the Justice Department's Fraud Section, Linda Pence, was also assigned to the case. (Int. C.2, B.4, E.12-13, and L.3-4) Fisher states he had assumed at least one of Justice's Fraud Section attorneys was to have been assigned on a full-time basis to compensate for Norman's lack of criminal experience.

## B. THE RICHMOND PHASE

### 1. The Richmond Investigation and Norman's Report

Investigative efforts began in Alexandria in August 1978 under Norman's direction. Norman states that in the fall he and Fisher developed an investigative strategy. One decision was to conduct all substantive questioning of potential witnesses in the grand jury. Another was to conduct the grand jury in Richmond because it was the most convenient and central location for the witnesses and attorneys. (Int. E.4-5) The strategy for the investigation was to build the case step by step, concentrating on individual claim items. Norman also intended to prove an overall conspiracy by showing that false statements were submitted in individual claim items. (GAO Report.14) In the fall of 1978, Norman discussed his investigative plan with the Navy attorneys, Adkins and Paulisch. A grand jury was impaneled in Richmond on October 18. (Int. L.3)

Norman states when he first started working on the case there was a morale problem with the two Navy attorneys. They had been examining the claim and had developed a list of potentially fraudulent items, but could not investigate them and were standing idle without direction. After he, Norman, took over, the investigation progressed and the morale problem largely disappeared. In late 1979, the Navy attorneys left the case to resume their Navy duties in Washington, D.C. (Int. E.10)

Norman describes the period from October 1978 to July 1979 as an intensive investigative effort. The grand jury work was led mostly by Norman and the Navy attorneys. (Int. E.9-10) Although the district court did not allow the grand jury to sit more than one week a month on the Newport News case, Norman did not believe this hampered progress. He did not request more

grand jury time because the attorneys needed the time between grand jury sessions to digest what they had learned and prepare for the next session. (Int. E.12)

Pence and Covington traveled from Washington to Richmond only for the grand jury sessions and were not there between sessions. Both had other case responsibilities. Norman recalls that they remained with the investigation until it was shifted to Alexandria, but neither was as active in it as Norman or the Navy attorneys. Norman states that ample resources were allocated to the case. His team included the two attorneys from the Fraud Section, the two Navy attorneys, and several FBI agents and Navy auditors. (Int. E.12-13)

Navy officials have a somewhat different view of the conduct of the investigation. Paulisch suggests the Justice Department attorneys did not carry their full share of the responsibility for the investigation. Each of the attorneys was assigned to a "team" and given responsibility for portions of the claim. For example, Paulisch was assigned a 688 submarine claim and the entire aircraft carrier claim. Covington was assigned to a team but was not released from his other Justice Department duties and did not "carry the ball" on any particular claim item or aspect of the case. (Int. L.3-4)

Paulisch states that Covington's and Pence's assignment to the case overlapped for a time, but as Covington "faded out" Pence became the only Justice Department attorney involved in the investigation. Pence could not always get to Richmond because of her other cases, and eventually "she kind of faded out too." She was not responsible for any specific part of the claim. She would appear at grand jury sessions and handle certain witnesses if she was interested in assisting on an individual claim item. According to Paulisch, Pence "played a utility role" during the period of her involvement. (Int. L.4)

Tim L. Foster, one of Admiral Rickover's former top assistants, believes that the investigation was conducted in a fragmented manner and that, if it had been better coordinated, the Navy could have made a greater contribution. (Int. N.12) Individual attorneys were given pieces of the investigation to look at, but no one seemed to have an overview. Members of the investigative team would come to Rickover's office from time to time for factual information and technical advice, but would not provide the context of the request, thus limiting the assistance that might have been given. According to Foster, the Richmond team lacked supervision, direction, technical expertise, and experience. He states there was an absence of vigorous and timely follow-up to leads provided by Rickover's office at various stages of the investigation. (Int. N.18-19)

Navy attorney Paulisch has a different view than Norman's regarding the limitation on grand jury time. Paulisch states that one technique used by Newport News attorneys was to prepare witnesses friendly to its position so that they could "filibuster" with lengthy statements during their testimony. Newport News attorneys knew that the amount of grand jury time available to the prosecutors was limited. The long-winded speeches of the witnesses took up so much grand jury time that the prosecutors were unable to bring some witnesses and aspects of their case to the grand jury before the session concluded. (Int. L.6-7)

In late January 1979, the Richmond attorneys concluded that the investigation was going well and that decisions about prosecution could be made in the late spring of that year. In a July 6, 1979, letter to the U.S. Attorney, Norman said the investigative strategy was moving from review of individual claims for false statements to pursuit of evidence of a conspiracy to submit a claim regardless of the claim's validity. The letter said the task force intended to compile indictments by October 1, 1979, and that one or more individuals would be indicted on about 10 items that were submitted to the Navy with knowledge that they were false or in reckless disregard of the facts. An October 4, 1979, letter to an FBI agent states that the investigative strategy remained the same. (GAO Report.14)

Norman said that he was optimistic about his chances of successfully prosecuting the case until November 1979, although he began having doubts about the case in the summer of 1979. His attitude began to change when Navy attorney Adkins told him that a major claim item she was investigating did not seem to be prosecutable. After he learned of negative developments on other items, he reread the grand jury transcripts and did a "total flip-flop" in his thinking. (Int. E.5-7)

One problem, Norman said, was that the prosecutors had obtained information from Admiral Rickover's staff about two of the items that turned out, after grand jury and other investigation, to be incorrect. In one instance, Norman was led to believe by a member of Admiral Rickover's staff that the claim for the Inner-Bottom Shielding of the aircraft carrier Eisenhower was false. The investigation showed the claim was not false and was "an arguably proper claim." These experiences, Norman said, added to his concern about proving a case, and the credibility of Admiral Rickover's staff. (Int. E.7-9)

David T. Leighton, a former official in Admiral Rickover's office, said in the staff interview that he told Norman it was not true that problems in the construction of the Inner-Bottom

Shielding led to delays in construction of the Eisenhower. He informed Norman that Newport News had been able to work around Inner-Bottom Shielding problems in construction of the previous aircraft carrier, the Nimitz, and he demonstrated with photographs taken during construction of the Eisenhower that the alleged delay did not occur. Leighton also points out that the Navy Claims Settlement Board concluded that the Inner-Bottom Shielding claim was without merit. (Int. L)

Leighton states that at one time he was scheduled to testify before the grand jury, but his appearance was postponed and not rescheduled. He was later given special permission by the district court to review grand jury testimony of a Newport News employee about the Inner-Bottom Shielding. He states that he showed the prosecutors that the employee's testimony was incorrect, and he gave a written memo on the subject to the Norman team. No one discussed the matter with him again. (Int. L)

Leighton states in a letter he sent to the Committee "to the best of my knowledge neither Admiral Rickover nor anyone on his staff were given a debriefing by Norman or anyone on his team as to the basis for concluding that the items raised in Admiral Rickover's letters to the Secretary of the Navy concerning possible fraud in the Newport News claims were considered invalid." (Int. L) Foster, another former aide to Admiral Rickover, said in reply to Norman's allegations that no one from the Richmond team, including Norman, had ever before mentioned to him that Rickover's office had provided incorrect information, or that it had misled or withheld facts from the investigators. (Int. N.13)

Norman recalls that in late 1979 he was "pushing" the Navy attorneys to finish their reports. (Int. E.14) About that time, he also communicated verbally to the U.S. Attorney that he would recommend against prosecution. A formal prosecutive report was submitted in March 1980 recommending that prosecution be declined.

Norman states he based his conclusions largely on the failure of the investigation to demonstrate criminal intent on the part of any Newport News official. He also found that there was no pattern of misstatements or evidence of a grand conspiracy. Factual misstatements were identified, but in general they were for items in the claim that were withdrawn prior to the settlement involving relatively small dollar amounts. Regarding the Bow Dome item, which was withdrawn from the claim, Norman stated, "The jury in any NNS prosecution will be dealing with a 'victimless' crime." (Ex. Q.46. This exhibit is Norman's prosecutive report for the Bow Dome, SSN 688

Submarine, claim item. The Bow Dome report and its attachments were part of Norman's first report and re-submitted as part of the second report, discussed below. Norman states that the Bow Dome report provides a general overview of the scope of the investigation and the prosecutive theories.)

Norman states in his report that two alternative approaches were pursued in an effort to establish that the entire claim was deliberately inflated to meet prearranged dollar targets. The first approach was to prove the company requested payment in the claims for millions of man-hours that were not worked or expected to be worked. Secondly, the team tried to establish a pattern of deliberate false statements in several of the small items in each of the major claims. According to Norman, both prosecution strategies failed. Newport News did not misrepresent its estimated final costs for construction of the ships, and top management did not write or rewrite the claims to fit predetermined target values. (Ex. Q.26)

Norman's report discusses the investigation of the submarine claim as an illustration of the lack of evidence of a pattern of deliberate misstatements. The report states that, of the 63 items in this part of the claim, fewer than six appeared to be factually incorrect, and these items amounted to less than 4 percent of the submarine claim. (Ex. Q.27)

However, the Richmond prosecutors had serious disagreements among themselves about important aspects of the case. For example, Navy attorney Paulisch prepared extensive written comments on Norman's prosecution report taking issue with it. Paulisch challenged Norman's conclusion that there was no pattern of deliberate misstatements in the various hardware items investigated. He argued that there was a pattern in the way the claims group behaved.

All the claims show a consistent pattern of overreaching, Paulisch said. The estimators had "fooled around" with their estimating calculations until they had covered all possible costs plus a substantial surplus of claimed cost. In one case, an estimator "submitted an estimate which claimed 10,000 more labor hours than the company actually booked on the whole job." The estimate on "Navy Recruiting" shows the same disregard for actual cost. Paulisch concluded: "The claims on their face are false and/or fictitious. It appears that the claims were deliberately designed and assembled to accomplish an illegal objective, i.e., to recover more money from the Government than NNS was legally entitled to under the contracts." (Ex. N.1-4, 13)

Navy attorney Adkins wrote a separate prosecution memorandum on the Ventilation Control Air System (VCAS), a hard item claim on one of the ships. Adkins' report is heavily censored to remove material protected by grand jury rules of secrecy. What remains indicates that the investigation established the claim item was false, and that several different drafts of the VCAS claim item were under scrutiny.

The Adkins report mentions Leonard Willis, who headed the claims preparation group for the shipyard, and states, "his attorney, off the record, advised that Mr. Willis had edited the VCAS claim. Mr. Willis refused to 'lay-out' this matter for the U.S. Attorney and will answer specific questions only if given immunity from prosecution." The report goes on to discuss the role of others who worked on the claim and notes, "It is unclear why Mr. Doyle wants immunity, since he blames either Mangus or Willis for writing each claim draft." Adkins' recommendation was that Willis be granted immunity so that he could be required to "lay out" the facts. (Ex. O.25, 28, and 33)

Justice Department attorney Pence expressed her views about the Navy recruiting part of the claim, one of the soft items, in a December 1979 memo. There she states that the investigation indicated that the shipyard claimed an amount for navy recruiting "which I believe can only be categorized as outrageous." Her assessment shows that Newport News did not properly take into account the fact, among others, that historically the company has lost employees to the Navy and the Navy has lost employees to the company. But Pence concluded that the evidence developed to date would not support an indictment because of an absence of a showing of criminal intent. (Ex. M)

Pence said in the staff interview that the Navy recruiting issue, while not prosecutable, could possibly have been used as part of a "manner and means" clause in an indictment. She said the Newport News claims revealed a pattern of gross exaggeration but that it was not a sufficient basis for prosecution without evidence of concealment, false statements, or alteration or back dating of documents. Pence stated that when she left the case the Richmond team was working on three items where there was potential for finding actual false statements. However, these items alone would not make a prosecutable case because the items were for such small amounts in comparison to the entire claim. She believes Newport News abused the claims process. She said she would not assert there was no fraud, but that "we just couldn't prove it." (Int. K.6, 9, 10, and 15)

Pence said in the staff interview that, after seven months of traveling to Richmond for grand jury sessions, from a personal standpoint, she wanted out of the case. She was convinced there

would be no indictment, that Norman no longer needed her, and she wanted to get back to other assignments where she could indict and try cases. Pence had no further involvement with the case after late 1979. (Int. K.12)

Norman was asked in the staff interview about the propriety of disregarding evidence of fraud in a claim against the government because the amount is small in comparison with the claim. He replied that it would not be proper, given the overall structure of the Newport News claims, for a prosecutor to dismiss a particular claim item as not relevant to a fraud case simply because it was small in dollar value when compared with the overall amount claimed. He explained that the smaller, hard items were essential to calculation of Newport News' claims on larger soft items. This was because the hard items were the base of a "multiplier effect" that was used to justify the soft items. Norman termed this the "ripple effect." However, Norman said, one or two questionable small hard items, out of hundreds, valued at less than \$100,000, would not establish criminal intent if major hard items worth millions and tens of millions turned out to be legitimate claims. (Int. E.10-11)

## 2. Review by the U.S. Attorney and Norman's Supplemental Report

In the early part of the Richmond investigation, Norman reported orally to Fisher about once a month. In 1979, Fisher became heavily involved in the prosecution of another case and Norman did not have much contact with him during most of that year. (Int. E.5) U.S. Attorney Williams states he also received oral briefings from Norman. Both Williams and Fisher believed the investigation was going well and it would lead to indictments. They were surprised to learn that Norman wanted to close it. Norman's recommendation at the end of 1979 that the investigation be closed was viewed as a reversal of his position and shocked the Alexandria office. (Int. B.5 and I.3) Williams asked for a written report and, after a delay and several inquiries from Williams, Norman submitted his report in March 1980. (Int. I.3)

Norman states he was surprised at the reluctance of Williams and Fisher, who had not questioned his judgment on other matters, to accept his recommendation to close the Newport News investigation. (Int. E.14) He believes Fisher felt pressure from Admiral Rickover to produce an indictment and that, while Fisher also disagreed with him about the facts in the case, "his bias colored his judgment." (Int. E.21) Fisher maintains that it was Norman's reversal of position that caused him to be skeptical of Norman's recommendation.



After Norman submitted his written report, there was a March 1980 meeting at the U.S. Attorney's Office in Alexandria attended by Norman and the two Navy attorneys, Paulisch and Adkins; U.S. Attorney Williams and several assistant attorneys including Fisher and Joseph Aronica; and Justice Department attorney Pence. (Int. A.1, B.5, and I.3-4) At the start of the meeting, Pence reminded the group that there could be no final decision regarding the case without Justice Department approval. (Int. A.1)

Williams did not believe the report reflected an adequate basis for a decision to close the investigation. He recalls that the Navy attorneys implied they did not agree with Norman's conclusion, and that, while they shared some of Norman's concerns, they did not favor closing the investigation. Williams states that he asked the Navy attorneys if they agreed with Norman's assessment and they said they did not. (Int. I.4)

Williams wanted Norman to investigate further, emphasizing the VCAS claim item. Fisher recalls that the review of Norman's investigation showed that one of the Navy attorneys had found different drafts of the VCAS claim containing inconsistent contentions. One draft, which appeared factually correct, did not support any known theory of entitlement. In another draft, the facts were altered in an apparent effort to "tailor" the facts to fit an entitlement theory. The Navy attorney reported that persons involved in preparing the drafts had announced their intention to take the Fifth Amendment if called to testify about this aspect of the claim. (Int. B.5-6)

Williams directed Norman to conduct additional investigation focusing on the VCAS claim item. Williams wanted Norman to obtain formal "use" immunity for Leonard Willis, the principal Newport News claims writer, and compel his testimony on only VCAS before the grand jury. (Int. A.2 and I.4-5) Willis had previously refused to testify before the grand jury on Fifth Amendment grounds. Indeed, no one above Willis had been questioned. John Diesel, President of Newport News, had also asserted the Fifth Amendment in refusing to testify before the grand jury. Diesel was questioned informally, in the presence of his lawyer, a procedure which the Alexandria attorneys considered highly questionable. (Int. E.16) Williams was hopeful that, by granting limited immunity to Willis and limiting the scope of Willis' interrogation to the VCAS item, significant new investigative leads would develop while preserving a degree of leverage over Willis on other claim items. (Int. I.5)

Norman returned to Richmond to conduct the additional investigation. A proffer from a witness such as Willis, usually tendered by his counsel, is ordinarily essential before granting

the witness immunity. Norman had obtained an "off-the-record" proffer from Willis prior to submitting his March 1980 report and he based his request to the District Court for authority to formally immunize Willis on that proffer. Willis was then immunized by the court and questioned outside of the grand jury, a method that was later criticized by Alexandria. (Int. E.14-15)

This second grand jury investigation was conducted in the spring of 1980 and completed in June. Norman submitted his report of the expanded investigation on October 1, 1980. The report consisted of a somewhat modified version of the earlier report, plus a supplemental section based on the work done at William's direction. Norman's recommendation, again, was that prosecution be declined. (Int. E.1 and Ex. R)

The first part of Norman's October report discusses the VCAS. Unfortunately, the discussion is so heavily censored that it is not possible to summarize or assess Norman's findings. In one of the few passages that remain in the copy submitted to the Committee, it is stated about the VCAS claim that "It is wrong and by 1978 everybody knew it. The staff also believes, however, that there was no deliberate effort to [passage censored by the Justice Department] at the time the claim was submitted." (Ex. R)

The remainder of the report deals with several hard claim items such as the Bow Dome, which was dealt with in the earlier report, soft items such as the aircraft carrier delays, and the issue of conspiracy to arrive at a prearranged dollar figure in the claims. In each case, Norman concluded there was no evidence of criminal intent, even though there were instances of incorrect figures or estimates that turned out to be too high. The report states that a handful of the claim items among the 300 submitted to the Navy showed a lack of attention to detail and sloppiness, indicating the claims writer was satisfied to present a colorable argument for compensation backed up by only a few of the necessary facts. But, the report states, "such evidence does not amount to proof of the requisite intent for criminal prosecution." Finally, the report found "only a few instances of factually false representations, and little or no evidence of factors conducive to a criminal conspiracy." (Ex. R.62, 63, and 64)

### 3. Reactions to the Supplemental Report

The second Norman report was reviewed in Alexandria by Assistant U.S. Attorney Fisher, Aronica, and Ted Greenberg. Their conclusion was that Norman had not conducted a thorough investigation of the VCAS item, as had been requested.

Eventually, when the files of the case were examined, a consensus emerged in Alexandria that the entire investigation had been mishandled in Richmond.

First, there was a realization that the Justice Department had done little to carry out its responsibility for the investigation, and that there had been serious staffing problems. The Richmond team, according to Fisher, "had more or less disappeared, not with a bang but with a whimper." Norman had given no explanation for the departures of Covington, Pence, Paulisch, and Adkins, none of whom had participated in Norman's efforts from March to October 1980. (Int. B.7)

Second, a major controversy developed over the way Willis was immunized and questioned. Williams, Fisher, and Aronica all state that Willis was questioned outside the grand jury in the presence of his attorney, and that instead of limiting the questioning to the VCAS item Norman allowed the questioning to range broadly over all claim issues. (Int. A.2-3, B.7, and I.5-6) Norman does not contest the assertion that at least part of the questioning was outside the grand jury. He states that he "may" have started the questioning in the grand jury but finished it outside because it was late in the day and the grand jury had to go home. Norman said he was not certain he questioned Willis in that manner, but agrees that if others say that was what happened, then he must have done it that way. He maintains that he did not allow Willis' attorney to be present when he questioned him on the record. Norman says he did not know that the questioning of Willis was supposed to be limited to the VCAS. (Int. E.15)

Williams contends that the effects of Norman's treatment of Willis were that the United States (a) had given up all leverage over Willis on other claim items and (b) because his testimony had not been given in a proceeding for which an oath was authorized, there was probably no foundation for a perjury charge if it was later determined that Willis had testified falsely. Williams concluded that Willis had been given total immunity, inadvertently or otherwise. (Int. I.6)

In a later review of the files of the investigation, Aronica learned about another aspect of the case that bothered him. Norman had sent letters to the targets of the investigation outlining the areas of inquiry he intended to pursue in questioning them before the grand jury. Aronica said this is not a good practice because it encourages witnesses to get together about their testimony and gives them an opportunity to fabricate explanations prior to their grand jury appearances. (Int. A.6)

When questioned about this in the staff interview, Norman explained that witnesses were initially brought before the grand jury without advance warning as to what they were to be questioned about. This caused delays as the grand jury "on one or two occasions" had to be adjourned to permit witnesses to review plans or other documents. Thereafter, some witnesses were given advance notice of expected areas of inquiry. Norman saw no advantage to be gained by keeping the pending topic of interrogation secret because Newport News had the "TARS" (Technical Advisory Reports of the Navy's Claim Review Board) and congressional testimony, which had identified the "hot" items that the investigators were interested in. (Int. E.11)

Williams also criticizes Norman's conduct of grand jury proceedings. He states that in reviewing the transcripts he found that Norman had not subjected the witnesses to the kind of hard, penetrating interrogation needed to open up a case such as this one. (Int. I.8)

A series of meetings was conducted on December 16, 19, and 22, 1980, in Alexandria to review the status of the investigation, at the end of which it was concluded that Norman had not done what he had been requested to do in March. (Int. A.3-4, B.7-8, and C.3) Fisher described the Norman efforts on the VCAS item as a "once over lightly." He said there was a "failure to interrogate everyone involved," that many Newport News officials who should have been questioned had not been, and that there was "a total absence of analysis." (Int. B.7-8) Aronica concluded that, in the 11 months since Norman was directed to continue the investigation, not much had been done. (Int. A.2) After meeting with Norman on the three December dates, Williams directed Fisher, Aronica, and Norman to proceed with a thorough grand jury inquiry on the VCAS claim item to see whether the investigation should go further, and to conduct the additional effort in Alexandria. (Int. A.3 and B.8)

James J. Graham, an attorney in the Fraud Section of the Justice Department, states that he learned about the December meetings from Linda Pence, and was told by her that the Justice Department was not invited to the meetings. This added to the impression that the U.S. Attorney's office was in charge of the investigation. However, Graham says, any decision to indict or not indict would have to be made at the Justice Department, and all involved in the investigation were aware of that. (Int. C.3) Williams states that no thought was given to inviting Pence to take part in the review because at the time there was no longer any meaningful participation in the case by her or any Justice Department attorneys. (Int. I.7)

In January 1981, Fisher and Williams personally presented a detailed plan for continuing the investigation to Jo Ann Harris, then Fraud Section Chief. They also discussed the matter with Acting Assistant Attorney General John C. Keeney. Harris and Keeney approved the decision to continue the investigation. (Int. B.10)

C. THE ALEXANDRIA PHASE

1. The Alexandria Investigation by Fisher and Aronica

Fisher and Aronica, with the assistance of Norman, conducted several grand jury sessions in Alexandria between January and March 1981, with emphasis on the multiple drafts of the VCAS item. (Int. A.3) According to Norman, the drafts had been available to the Richmond team and there was no question about the identity of the authors -- everyone knew who wrote them. Norman felt nothing new was learned in Alexandria about VCAS. Further, in his view, the broad immunity granted by Fisher and Aronica in pursuing the VCAS item precluded further pursuit of that item because all leverage over the individuals involved had been given away. (Int. E.18)

On the other hand, Fisher and Aronica believe that, as a result of the early 1981 grand jury sessions, they understood for the first time the "methodology" of the claim preparation, and learned the secret of how to "unravel" much of the false aspects of the claim. Aronica states that the investigation revealed how Newport News had "beat the bushes" for claim items, preparation of accounting data to support the claim, and preparation of narratives to be included in it. He says there appeared to be fraudulent statements in the narratives based on a comparison of original drafts of claim items, which had gone through a "massaging process," with the final version submitted to the Navy. (Int. A.4)

Fisher maintains that the discarded drafts contained facts which conflicted with what was submitted to the Navy, and that comments written by Newport News engineers on those drafts revealed apparent firsthand knowledge that the VCAS item was not only false, but knowingly false. He states that, while the Richmond team was aware of the drafts, they had not been analyzed for the purpose of determining whether there was a conscious effort to commit fraud. He believes this was established in the Alexandria grand jury. In addition, the authors of the drafts and most of the changes were known in Richmond, but it was not known who made a key change in the final draft. This was learned in Alexandria. (Int. B.8. For copies of the VCAS drafts, see Ex. V)

The 1981 grand jury sessions convinced the Alexandria attorneys that there was evidence upon which a jury could conclude that the VCAS item was a false claim. But to develop the facts fully and reach that conclusion, it was necessary to take 35 people before the grand jury and conduct a more detailed examination than any other claim item had been subjected to. Fisher felt that similar intensive investigation was required for other claim items to determine whether the VCAS item was part of a pattern that could justify an indictment charging conspiracy as well as substantive crimes. (Int. B.10-11)

Fisher suspected the shipyard had engaged in a conspiracy to obstruct the operations of the Navy. His theory was that Newport News wanted about \$200 million more than the Navy had agreed to pay to satisfy financial requirements caused by cost overruns in the ship programs. In view of the Navy's practice of settling shipbuilding claims for a fraction of their face value, it was decided that the claim submitted would be much larger than the amount needed.

The shipyard, according to Fisher, set up a process to produce any claims which could be conjured up, for a wide variety of ships built under different contracts, without regard to merit or truth. The claims would be so staggering in size and complexity that the Navy would have difficulty analyzing them and could be pressured into making a lump sum settlement. During the negotiations over the claim, Newport News had threatened to stop building nuclear ships for the Navy unless the shipyard was fully and promptly paid. The threat to stop building ships under construction was part of the pressure. (Int. B.11-12 and Ex. V)

In the spring of 1981, the Federal District Court in Richmond considered a motion by Newport News to quash the subpoenas issued for the grand jury on the grounds that the government was harassing the shipyard. Judge Robert Mehrige ruled against Newport News but expressed concern with the length of time the investigation was taking. He commented that the staff turnover among the prosecutors had probably helped prolong the investigation, and told the government that it should complete the case within a year. (Int. A.5 and B.9)

At the conclusion of the grand jury proceedings, Aronica began a review of the files from the Richmond investigation, while Fisher became temporarily absorbed with another criminal matter. Aronica states an examination of memoranda prepared by Navy attorneys Adkins and Paulisch indicated to him that one or both believed there was evidence of a conspiracy. He selected a group of hard items for special review where the "flavor" of the claims narratives was similar to the VCAS narrative, and planned

to give them the same intensive scrutiny when grand jury proceedings resumed. These items included Discharge Sea Chests, Reactor Shielding, OSHA and EPA, and Navy recruiting claims. (Int. A.8)

During this period of review, Aronica concluded that there had not been enough supervision of Norman's activities in Richmond. (Int. A.5) Also, while Aronica was reviewing the Newport News files in the summer of 1981, he became aware, for the first time, of the Richmond grand jury testimony of Russell Weed and William Cardwell. (Cardwell was the witness Senator Proxmire had called to the Justice Department's attention almost five years earlier.) Aronica described their testimony as firsthand accounts that superiors at Newport News had told Cardwell and Weed to inflate claims, misrepresent facts, and include everything conceivable in the claims. He believed this was consistent with what he and Fisher were finding in the claims documents; for example, ridiculous claims, such as one for violating Parkinson's law, and factually misrepresented claims, such as the VCAS item.

## 2. The Fisher-Aronica Status Report

In the summer of 1981, Fisher and Aronica decided to summarize the status of the Newport News investigation in a report to the Justice Department before attempting to go further with the investigation. They cited several reasons for preparing the report. At the time, a new U.S. Attorney for the Alexandria office was in the process of being selected. Fisher and Aronica would have to justify the resources being used in the Newport News investigation and perhaps the need for additional resources. (Int. A.8)

A second reason was to respond to a formal and voluminous brief submitted by Newport News directly to the Justice Department, arguing that the investigation should be halted. This unusual submission by the shipyard bypassed the prosecutors in the case. Finally, the new U.S. Attorney designate, Elsie Munsell, had indicated to Fisher during that summer that the Reagan Administration might redirect law enforcement priorities and that Navy shipbuilding cases might not be undertaken. Fisher wanted to document the justification for continuing the investigation. (Int. B.14-15)

The Status Report was not the usual "pros memo" frequently prepared by prosecutors to help supervisors determine whether to seek an indictment. It was intended to rebut the contention that there was no case, and show that further investigation would produce sufficient additional information to warrant an

indictment. To prepare the report, the Alexandria attorneys enlisted the assistance of David B. Smith, an attorney in the appellate section of the Justice Department's Criminal Division. The report does not recommend an indictment, but attempts to show that evidence of criminality was uncovered, and that further investigation would turn up evidence of more criminal violations. The report requests assistance from the Justice Department in the form of additional staffing, and states that with such help an indictment could be returned by the middle of 1982.

The report discusses evidence of "a massive conspiracy to defraud the United States," as well as evidence that several of the claim items were false. The VCAS item is analyzed at length, and copies of the various claim drafts are included in an appendix of relevant documents. It is stated that "the VCAS item is but one of many false claims knowingly submitted by NNS." Among the others discussed are Navy Recruiting, Bow Dome, Discharge Sea Chests, and Reactor Shielding. (Ex. U.6-10 and 29)

One section of the report is devoted to a rebuttal of the argument advanced in Newport News' legal brief that its requests for reimbursement are not claims within the meaning of the False Claims Act. The report shows the Act originated in congressional investigations of abusive military contracting practices during the Civil War, and quotes a 1958 Supreme Court decision holding that in passing the law "Congress wanted to stop this plundering of the public treasury." A 1968 Supreme Court decision is cited to demonstrate that the court has consistently refused to accept a rigid, restrictive reading of the Act. (Ex. U.95-101)

The report states that the statute of limitations on a prosecution for submitting a false claim would run on August 1, 1982, and on conspiracy to submit a false claim in October 1983. (Ex. U.102 and 105)

The Status Report concludes by stating, "It is clear beyond cavil that the individual claims analyzed above are not only false and without legal merit, but that their preparation was purposeful and criminal," and it recommends that the investigation be concluded by late spring or early summer 1982, because of statute of limitations considerations. (Ex. U.107-109)

### 3. Reorganization of the U.S. Attorney's Office

Elsie Munsell began the process of reorganizing the Alexandria U.S. Attorney's office soon after being designated U.S. Attorney in the fall of 1981. Aronica states that, in a



meeting with Munsell before she took office, he was asked to become Chief of the Criminal Division and she proposed eliminating the Fraud Unit headed by Fisher. Aronica says he thought elimination of the Fraud Unit was a good idea, but that Munsell had decided to do so before their meeting. (Int. A.9)

Fisher states he was called to Munsell's home and advised that she was going to eliminate the Fraud Unit and wanted him to be Chief of the Civil Division. Fisher told Munsell that he felt the reorganization would harm the Newport News investigation, and he asked her not to make a final decision until she assumed office and read the Status Report.

He states that he pointed out there was a statute of limitations problem and any interruption of current staffing on the case could impair the government's ability to conclude its investigation in time for the matter to be prosecuted successfully. He believed the best course for finishing the Newport News investigation was to devote the full-time efforts of himself and Aronica to the case. Fisher told Munsell the case was labor intensive and it would be impossible for them to work on it if given other duties. He emphasized to Munsell that there were two major defense procurement fraud cases pending in the office, Newport News and a case involving Litton, and he urged her to request a meeting with the Justice Department to get help in working these cases. (Int. B.14-17)

Munsell said she eliminated Fisher's unit because it was too narrow in scope to handle all the significant cases assigned to her district. She states the decision to eliminate the Fraud Unit was independent of consideration of any case pending in the district, and that she made no inquiry to determine what effect it might have on any particular case. She made the decision without consulting her superiors in the Justice Department, and without discussing it with her predecessor, Williams. (Int. D.3)

Munsell said she did not know then, and did not know at the time of the staff interview, whether Aronica and Fisher had been actively engaged in conducting the Newport News investigation before she took office. She believed their interest at the time she became U.S. Attorney was limited to the preparation of the Status Report. She said she had no reason to consider the effect of their reassignment on the investigation. (Int. D.4)

Munsell read the Status Report shortly after taking office in November 1981. Her review showed there was evidence of criminal wrongdoing and her main concern was to assure that the matter received appropriate staffing. (Int. D.5) It was the view of Munsell and Aronica, contrary to Fisher's view, that Fisher and Aronica could continue to work on Newport News even

though limited to part-time effort by their new supervisory roles. Nevertheless, all three attorneys concluded that at least two additional full-time prosecutors would be needed to complete the investigation. (Int. A.10, 16 and B.16)

Munsell states it was her impression that Aronica and Fisher wanted to keep the Newport News case in the U.S. Attorney's office and work on it. But she concluded that because of staffing problems her office could not work on both shipbuilding cases and one of them would have to be handled by the Justice Department. In response to a question during the staff interview, she gave no explanation as to why she did not consider the option of obtaining additional staff from the Justice Department instead of seeking to have one of the cases reassigned to Justice. She said her only concern was that both matters receive appropriate attention. (Int. D.5-6)

From the time Munsell's reorganization took effect until early January when she and Aronica decided to ask the Justice Department for assistance, no work was done on the case by Aronica or Fisher, both having been given new administrative duties.

#### D. THE JUSTICE DEPARTMENT PHASE

##### 1. The Justice Department Reassumes Responsibility

At Munsell's request, a meeting took place with Justice Department officials in January 1982 to discuss the two shipbuilding cases. Present at the meeting from the Alexandria office were Munsell, Fisher, and Aronica; and from Justice, Lowell Jensen, the Assistant Attorney General for the Criminal Division, his Deputy, Roger Olsen, and James J. Graham, then Acting Chief of Justice's Fraud Section. Munsell says she made it clear at the meeting that she wanted the Justice Department to take one of the cases and that she expressed no preference as to which one. She states Justice had some responsibility for the shipbuilding cases because of the way they were referred and the understanding that there would be sufficient assistance from Justice. (Int. D.6-7) Fisher and Aronica agree it was proposed at the meeting that Justice take over one of the cases. (Int. B.17 and A.10)

But Graham states he was shocked to learn at the meeting that Munsell wanted Justice to take over both cases on grounds that she was reorganizing her office. He was surprised at her proposal in view of the size and age of the two investigations. Both would be "tough nuts" to crack and it seemed inappropriate for the U.S. Attorney to be trying to hand them over to the

Justice Department. Graham says he thought at the time "if the cases were important, why should a reorganization prevent them from being properly staffed?" (Int. C.5-6)

Jensen's and Olsen's recollections of the meeting are similar to Graham's. Both agree Munsell said she did not have the resources to handle the two cases. According to Jensen, the major problem was that the attorneys who had worked on Newport News during the past year were no longer available due to the reorganization; they were in supervisory positions and unable to do further investigation. The final conclusion, Jensen said, was that Fisher and Aronica were "totally unavailable" and new people were needed for the Newport News case. (Int. M.2) Olsen recalls Munsell wanted the Justice Department to take over both shipbuilding cases, but she was stronger in her desire that Newport News be taken by Justice than that Litton be taken. He states Munsell's attitude was "we want to give Newport News back to you." Olsen states that during the meeting he and Jensen were trying to figure out exactly why Alexandria could not handle the cases. (Int. G.3-4)

After the meeting with Munsell, the Justice officials met among themselves and decided Alexandria should keep the Litton case because it was under indictment, and Justice would take over Newport News. The option of sending people from Justice to help Alexandria with Newport News was discussed. That option did not seem feasible because Fisher and Aronica would not be available to work on the case full time as a result of the reorganization. Jensen said, if Munsell had indicated Fisher and Aronica were available to work on Newport News and she needed some help for them, he would have considered that approach. (Int. C.6, G.4-6, and M.3)

Weeks went by before Alexandria heard from Justice about its decision. Munsell finally received a telephone call from Olsen on March 11 advising her the Justice Department would assume full responsibility for the Newport News matter. She confirmed the arrangement by a letter to Jensen dated March 26, 1982, stating Roger Olsen told her on March 11 that the Criminal Division accepted full responsibility for the Newport News investigation. (Int. D.6)

In the months that followed, Munsell received no progress reports from the Justice Department on the case. She states no arrangements had been made for progress reports and no one in her office had any responsibility for the matter. If she had thought her office had any responsibility, she would have inquired about the status of the case. (Int. D.8) However, in November 1982, Munsell wrote to Roger Olsen seeking information about the investigation and stating, "As far as I know, only one lawyer is

assigned to the case, and one FBI agent. All of the documents are here, but we see no concerted activity by people using them." (Ex. Z.1)

## 2. The Assignment of Ed Weiner

Olsen states Justice needed to make its own assessment as to whether it should go forward with the Newport News investigation without being bound by the Fisher-Aronica Status Report. It was decided the Fraud Section would review the entire investigation and not be constrained by the recommendation of the Alexandria prosecutors. (Int. G.7-8) Graham, Acting Chief of the Fraud Section, states he read the Status Report and thought it presented an interesting approach to the possible prosecution of Newport News. If it could be shown there were other examples like the VCAS item, with multiple drafts of the claim demonstrating fraud, there would be real progress in the investigation. (Int. C.4)

Graham and Olsen felt the case required at least two attorneys on a full-time basis, because of its complexity. Both felt an experienced, senior litigator should head up the review. Olsen said he "wouldn't assign a junior lawyer to something like this." Graham reviewed the availability of attorneys in the Fraud Section and found they were all busy with other assignments. Graham decided to assign Ed Weiner, who was in the process of winding up his responsibilities in the Economic Crime Program.

Graham also wanted William Lynch, a Justice Department senior litigator, to be assigned to the case to work with Weiner. Graham recommended to Olsen that Lynch be recruited and he directed Ed Weiner to go to Munsell's offices to review the Newport News files while awaiting the decision about Lynch. Olsen said he did talk to Lynch about working on Newport News, but could not recall Lynch's reaction or why Lynch was not assigned. In March, when it became apparent that Lynch would not be assigned, Graham directed Weiner to get going on the case himself, but he continued to hope a second attorney would be assigned. Graham acknowledges that the case was not adequately staffed from March 1982 to August 1982. (Int. C.7-9, G.8, and GAO Report.7)

Graham states that Weiner's instructions were to find out everything he could about the case and to come up with an investigative strategy, keeping in mind that he had the options of continuing the investigation, ending it, or recommending indictment. He also had authority to talk to witnesses. From

March to August 1982, Weiner came under Graham's supervision. However, Graham states he was never intensively involved in the case and did no official monitoring of Weiner's activities.

In March 1982, Robert Ogren was appointed Chief of the Fraud Section, and Graham resumed his role as Deputy Chief. Olsen recalls talking to Ogren about Newport News "shortly if not immediately upon" Ogren being hired, and says he made it clear to him that he expected to be kept advised of its progress. Olsen says he had ongoing discussions with Ogren about Newport News during the March-July 1982 period. (Int. G.11)

Weiner states his first contact with Ogren was in July 1982 when he was asked by Ogren to be brought up to date on Newport News. He advised Ogren and Graham at that time that he was going to recommend additional manpower be put on the case and additional investigative work be done. (Int. H.6)

Ogren disagrees with the recollections of Olsen and Weiner. He states he first became aware of Weiner's role in reviewing the Newport News case in about March 1982, when he assumed his position as Chief of the Fraud Section. When he learned about it he was told, probably by Graham, that Bill Lynch would be asked to work on it with Weiner. He states he learned from Graham the case was initially a Criminal Division matter. It became the responsibility of the Fraud Section when it was determined Lynch would not be assigned to it. According to Ogren, as late as August 1982, he did not understand the Newport News case and did not clearly understand the role of the Justice Department's Criminal Division or of his Fraud Section with regard to it. He states the first time he knew anything about the Newport News matter was in August 1982. Prior to that time, he had "given no thought whatsoever" to what Weiner was doing. (Int. F.2-3 and 6)

### 3. Weiner's Review and Report

Weiner began his detailed review in April 1982, and he spent the next several months going over the record of the investigation. He examined grand jury transcripts, documents, FBI reports, the reports prepared by the various prosecutors, depositions in a related civil case, and pertinent congressional hearings. He discussed the case with the Alexandria and Richmond prosecutors and the Navy attorneys, and interviewed Navy engineers and grand jury witnesses. During the review, he received a telephone call from Newport News attorney J. Clayton Undercofler, in which it was suggested that Weiner conduct off-the-record interviews with shipyard officials. Weiner said he wanted to interview the officials without such restrictions, but this request was rejected. (Int. H.7, 9, and 10)

Weiner submitted his written report on August 5, 1982, recommending that active investigation should be resumed and "should focus on the NNS claim effort as a conspiracy to obstruct, impede, and delay the lawful function of government...and the orderly claims process..." (Ex. W.18) His general impression was that the Richmond phase of the investigation had covered a lot of ground but spread itself too thinly and had not concentrated sufficiently on any particular aspect of the claim. While this permitted the Richmond team to get a good global view, there was a lack of intensive follow-up on items that appeared questionable. But he believed the case was not in bad shape because of the work done in both Richmond and Alexandria. (Int. H.4)

His report states there is sufficient evidence to prove the VCAS claim is fraudulent, and that additional investigation is indicated for two other hardware items, Discharge Sea Chests and Reactor Shielding. Concerning the soft claim items, the report concludes the Deterioration of Labor (Parkinson's Law) claim is "outrageous and fraudulent," the Navy Recruiting Practices claim "is ridiculous," and further investigation is needed with regard to several other alleged delays and disruptions. (Ex. W.3-6)

In addition to fraud in the claim items, Weiner concluded there was evidence of a conspiracy. His report states, "I believe that a sophisticated conspiracy to inflate claims regarding cost overruns was begun by Newport News late in the summer of 1974." After noting that "some work" had been done on this aspect of the case by the Richmond and Alexandria prosecutors, he observed "it may be too late at this point (eight years after the fact) to prove the conspiracy beyond a reasonable doubt." (Ex. W.7) In Weiner's view, "The Department of Justice should have begun this investigation in earnest in the summer of 1976." (Ex. W.14)

Weiner's theory is similar to what is described in the Fisher-Aronica Status Report. He believes the strategy was to recover \$200 million from the Navy by claiming four or five times that amount. A claims process was established which would lead to exorbitant claims. Employees who had no previous experience in claims came up with unbelievable estimates of delay, disruption, and deterioration of labor in order to create a massive amount of paper which the Navy might not be able to digest. Pressure tactics, such as the threat to stop construction of Navy ships, were employed to force a favorable settlement. (Ex. W.16)

In the staff interview, Weiner provided additional details about the conspiracy theory. He referred to the "moon/Swiss cheese" memo, a document obtained from Newport News by subpoena. The memo was intended to guide shipyard claims writers. It told the claims writers that it is permissible to ask for the moon if it is made clear that the writer believes it is made of Swiss cheese. The making of outrageous claims based on equally outrageous entitlement theories was encouraged and employees were advised that this would not be fraud as long as the facts were not knowingly misstated. (Int. H.17)

Weiner also discussed the testimony of William Cardwell and Russell Weed, the former shipyard employees. He states Cardwell testified he had been asked to inflate claim items by four or five times, and Weed had evidence of a plan to inflate the claims. Although Weed had left Newport News before the claims were submitted, he was working at the shipyard when the plan to submit them was "hatched." Weiner states he found evidence of conversations between Leonard Willis, the head of the claims group, and a Navy official in which Willis was reported to have said that the shipyard would ask for \$600 million but wanted only \$200 million. Weiner says he had reservations about the dependability of testimony from Cardwell and Weed because of memory lapses since the events they witnessed. (Int. H.18)

#### 4. The Fraud Section's Reaction and Weiner's Follow-up Efforts

Weiner received no reaction to the report for several weeks after it was submitted, except for a comment from Graham who thought it was interesting. (Int. H.10) Olsen believes he began discussing it with Ogren in late August or early September. Olsen states the dispute about whether to continue the investigation centered on the viability of a prosecutive theory. No one disagreed about what the evidence was. (Int. G.12)

Ogren does not recall reacting to the report until after he hired Morris Silverstein to work in the Fraud Section in late August 1982. Silverstein was made head of a litigation branch within the Fraud Section in early September. About this time, Weiner was assigned to work under Silverstein and, according to Ogren, the Newport News case "became a Fraud Section matter by default." (Int. F.4) Silverstein first discussed the report with Weiner in early September. (Int. H.11)

On September 17, Ogren and Silverstein asked Weiner to prepare a "work plan" to continue the investigation for a 60-day period. Weiner submitted his work plan on September 24. The plan was primarily directed toward investigation of conspiracy. After he submitted his work plan, Weiner was then directed to

concentrate on the hardware items, like the VCAS, to see if there was a pattern, and to ignore the soft items and the conspiracy. (Int. H.11-12, F.8 and Ex. Y.1)

Sometime during the next two weeks, Silverstein told Ogren, based on his reading of the prosecutors' and the shipyard's summaries of the case and a discussion with Fisher, that his initial impression was that "despite everything that has gone on in the investigation, we don't have anything." At about this time, Weiner was directed to look for documents concerning the statute of limitations. Silverstein states he was then focusing on the case and under one theory the statute of limitations would run in six or seven months. In the weeks that followed, Silverstein's doubts about the case increased. (Int. J.35-36 and 41-42)

In response to the directive to come up with additional hardware items, Weiner examined the claim narratives for the Discharge Sea Chests and Reactor Shielding portions of the claim. In mid-October, Weiner found a box in the basement of the U.S. Attorney's Office containing drafts of those claim items in spiral-bound notebooks. The handwritten drafts, when compared with the narratives in the claim submitted by Newport News to the Navy, showed that the facts in the claim were different than and inconsistent with those set forth in the handwritten drafts. (Int. H.12-13)

Weiner recognized that the methodology of claim preparation had been established during the investigation of the VCAS item by Fisher and Aronica. Claim items were drafted initially by production workers who had firsthand knowledge of what happened during construction but had little or no knowledge of claim entitlement theory. The items were later revised for claim purposes by the Contract Control Group who had no knowledge of what had happened except what was described by the production workers. But the Contract Control Group was well aware of what a description of facts would have to contain in order to support a legal entitlement theory. Weiner believed he had evidence that the handwritten claim drafts on Discharge Sea Chests and Reactor Shielding, like the handwritten drafts on VCAS, were accurate factually but were later altered by the Contract Control Group to fit an acceptable entitlement theory. In the process, a true statement not supporting a legal claim of entitlement was converted into a false statement supporting a false claim. (Int. H.13)

Weiner said he was excited by what he had found. Norman had told him during his first review that the VCAS item was clearly false, but it was unlikely a conviction could be obtained on that item alone. Norman stated that if he had two or three other



items like the VCAS, he would have felt there was a pattern and the case could go forward. (Int. E.19) Ogren and Silverstein had directed Weiner to examine other hardware items to see if there was a pattern. Weiner believed he found evidence of a pattern, although he realized that additional investigation was required. He pointed this out to Ogren and Silverstein on October 20, and demonstrated the similarity between these items and what had been found with regard to the VCAS item. (Int. H.13-14)

5. Ogren and Silverstein Disagree with Weiner and Weiner Dissents

Silverstein states that, although he did not spend every day on Newport News, he "focused on the case from the time that Weiner was assigned [to him]...it was a big case [and] the statue of limitations under one theory...would run in another six or seven months." (Int. J.36 and 41) Silverstein did not become skeptical about the case until after Weiner submitted his plan to revitalize the investigation on September 24, 1982. (Int. J.39) This skepticism bloomed into "real doubt" about the case during the first two weeks of October. (Int. J.42) Sometime between September 24 and the first two weeks of October 1982, Silverstein spent two afternoons at the U.S. Attorney's Office in Alexandria. (Int. J.42) Silverstein states his doubts arose in a brief conversation with Fisher during one of his visits to Alexandria. Silverstein says Fisher claimed that the creation by Newport News of the Contract Control Group was criminal. Silverstein believed the creation of this control department was a neutral act. (Int. J.36-37)

Weiner, Ogren, and Silverstein had a series of meetings about the Newport News matter on October 12 and 20, and November 3 and 9, 1982. (Int. H.14) Ogren states he and Silverstein spent about 10 hours in this review of the case with Weiner. (Ogren letter of March 6, 1986, p. 3, which is part of Exhibit U) Weiner thought Ogren and Silverstein would be impressed with the additional hard items he found. But Ogren did not agree that what Weiner found was the major evidentiary breakthrough Weiner thought it was. While Weiner felt grand jury inquiry would be necessary before any final conclusions could be reached with regard to the multiple drafts on the claim items he discovered, he believed they were truly similar in nature with what Fisher and Aronica had found on the VCAS item. (Int. H.14)

Silverstein acknowledged Weiner did find two other items with multiple drafts, but said he still saw problems with the case. (Int. J.81) He had problems with the VCAS item because he did not believe it had been established who had authored the

drafts. (Int. J.77-78 and 80). Concerning the two other items that Weiner uncovered, he said he "didn't see...the same sort of thing we found in the ventilation air control." (Int. J.81)

During the meetings, it became apparent to Weiner that Ogren was going to recommend declining further investigation of the case. (Int. H.14 and Ex. Y.1) Ogren told Weiner that central to his decision to recommend closing the case was his reluctance to commit additional manpower to the investigation. (Int. H.14) According to Weiner, Ogren justified this position by pointing out (a) he would have to pull people off other cases in order to staff the Newport News case adequately; (b) delay in reaching a conclusion on the investigation which had come to the Justice Department in 1978 and statute of limitation problems made it perhaps not fruitful to pursue the matter further; and (c) he was uncertain of Weiner's theory of the case. (Int. H.14-15) According to Weiner, Ogren further said the matter was "too old" and there was no proof of deception. (Int. H.14, 20, and Ex. Y.1)

Ogren's concern, Weiner said, about the conspiracy theory of the prosecution had to do with the case of U.S. v. Hammerschmidt, 265 U.S. 182, 188 (1924). Ogren believed, before a conspiracy to obstruct the Navy claims settlement process could be proven, the government would be required to show there had been some degree of trickery or deceit on the part of Newport News. (Int. H.15)

Weiner did not believe such an element of proof was required. (Int. H.15) Weiner felt that piling reams of material upon the Navy to bog down the process -- including placing the requirement on the Navy to wade through encyclopedia-like voluminous material to ferret out and unscramble claim narratives that left out facts, misstated facts, and created misleading innuendos -- provided ample basis for proving a case for submission of a deliberate false claim, particularly when coupled with the evidence that the shipyard went into the claims process with the intent of asking for more money than it actually had hoped to realize and then tried to force a settlement by threatening to stop building ships. (Int. H.21) In addition, Weiner did not accept Ogren's view that there was no deception. (Int. H.15) In Weiner's judgment, examination of the early drafts of the hard claim item narratives revealed them to be sufficiently deceptive to support a prosecution. (Int. H.15 and 21)

When Ogren said the matter was too old, Weiner understood him to be referring to the investigation which had been done by others prior to the time the Justice Department's Fraud Section took sole responsibility for the matter. (Int. H.20) Ogren was apparently concerned about trying to refresh the recollection of

witnesses regarding old events and going back and reinterviewing witnesses that had already given statements to the FBI or had been questioned extensively in the grand jury. Weiner states Ogren was also concerned about the number of stops and starts in the matter -- something that Ogren felt was unusual in Justice Department investigations and believed would cause problems if the Justice Department tried to start the investigation yet one more time. (Int. H.20-21) Weiner's view was the case was not too old as long as the statute of limitations had not run. (Int. H.20)

According to Weiner, Silverstein repeatedly stated "materiality" was an element of a False Claims Act case, and that Silverstein had a problem with the "materiality" of the Newport News representations Weiner viewed as fraudulent. (Int. H.18) Weiner understood Silverstein's materiality concerns to stem from the fact the individual claim items that appeared to have the most prosecutive merit were small in dollar value when compared with the overall magnitude of the Newport News claim. (Int. H.19-20) In Silverstein's view, this undercut proof of intent to defraud. (Int. H.20) Silverstein suggested during the staff interview, however, that the materiality proof problem related to the fact the Navy had already denied certain Newport News contentions before they were submitted in the claim. Silverstein said even if a claim was false it would not be material because Newport News had obviously submitted the claim knowing the Navy would not believe it. (Int. J.44-49)

Silverstein also seemed to equate "materiality" with "reliance," implying someone would have to show the Navy relied on a falsehood to its detriment in order to successfully bring a False Claims Act case. (Int. J.47) Silverstein agreed during the staff interview that, in the Fourth Circuit, where any case against Newport News would be brought, materiality was not an element the government would have to prove in a False Claims Act case. (Int. J.47) Silverstein said, even if materiality were not an element, the problems he categorized as materiality problems would make it difficult to establish intent. (Int. J.51-52)

Weiner believed the dollar amounts of the items could not be viewed as immaterial because they were at least six figure amounts, large claims against the government by almost any standard of measure.

Weiner asked permission at the November 9 meeting with Ogren and Silverstein to put his disagreement with their decision to recommend declining prosecution in writing and was advised he could do so. On November 17, Weiner wrote a "dissenting memorandum," stating his conviction that further investigation

would enable the government to prove there had been a conspiracy to obstruct, impede, impair, and overload the Navy claims evaluation process with the objective of getting paid more than Newport News was entitled to receive. (Int. G.13, H.15, and Ex. Y)

#### 6. The Ogren Report

On November 29, 1982, Weiner was asked to obtain certain files from Alexandria to be used by Ogren in preparing a report to Assistant Attorney General Lowell Jensen. Weiner delivered the files to Ogren on December 16, 1982. By that date, to Weiner's knowledge, Ogren had not yet reviewed the files or any source material in the case, and Siverstein had spent one or two days examining source material in Alexandria in late October. (Int. H.19) Ogren states in his report that he met with Weiner and Siverstein on a number of occasions to review the progress of the evaluation and reviewed a number of transcripts, documents, and other materials. (Ex. CC.2)

On February 25, 1983, Ogren sent his report to Jensen recommending prosecution be declined and the investigation be terminated. Silverstein drafted part of it and Graham was also given a copy. It had not been shown to Weiner or the prosecutors in Alexandria. In the staff interview, Ogren said he saw no reason to show it to Weiner because he had already registered his disagreement with Ogren's position. (Int. F.14) The memo was not shown to the Alexandria office until April, 1983. (Int. F)

The report analyzes the two types of offenses identified by Weiner and the Alexandria prosecutors: (1) the substantive crimes of false claims and false statements, and (2) conspiracy. It acknowledges that four of the hard claim items examined, including VCAS, the Discharge Sea Chest, and Reactor Shielding, and OSHA and EPA, "appear to contain false claims or false statements." But the memo states, none are prosecutable because there are adequate legal defenses. Concerning the conspiracy to defraud theory, Ogren concludes its use would be impossible. (Ex. CC.2)

Among the defenses against prosecution for false claims or false statements, the report cites the likelihood that the statute of limitations had already run; the fact that after five years of investigation only four items totaling a few million dollars out of a \$894 million request were shown to be arguably false, one of which was withdrawn by Newport News prior to settlement and the others subject to technical attack; and it would be difficult to prove there was specific intent to defraud the government. The amounts of the false claim items are listed

as follows: VCAS, \$930,000; Discharge Sea Chest, \$300,000; Reactor Shielding, \$384,000; and OSHA and EPA, \$5.5 million. (Ex. CC.19-29)

The intent requirement cannot be satisfied, the report states, because under the law the government must prove that the person submitting the false claim knows it is false and is aware he is violating the law. Proof of reckless indifference or disregard as to the truth or falsity of a statement is not enough. Ogren concludes no evidence had been developed pointing to a specific high level official of Newport News who had the necessary specific intent to submit false claims.

The report states an indictment for conspiracy would not hold up for a number of reasons. Two kinds of conspiracies were discussed by the prosecutors, conspiracy to file false claims, and conspiracy to submit voluminous meritless claims. Ogren's view is the government would not be able to sustain a charge of conspiracy to file false claims because "it is not possible to prove any substantial portion of the various claims to be false." The four claim items represent less than 1 percent of the total claim, and even with respect to these there is no evidence of intent or linking the falsity in those items to a conspiracy, according to the memo. (Ex. CC.12-15)

The second conspiracy theory was that Newport News submitted voluminous, meritless claims in an effort to break down the Navy's claims process. Ogren concludes the theory would not hold up because there is little evidence to support it and abundant evidence to contradict it. In addition there is no precedent for a charge of conspiracy to defraud the United States by impeding and impairing its lawful functions unless there is a component of deception or trickery. Citing the 1924 Supreme Court case of Hammerschmidt v. United States in support of the idea that the government must prove deception or trickery, the memo concludes that as to virtually all of the soft claim items the issue is not nondisclosure or deceit but entitlement. (Ex. CC.15-18)

Ogren said in the staff interview that, when deciding whether to recommend the investigation be continued, the question in his mind was "will it be productive?" There were too many problems with the case which made it, in Ogren's judgment, not worth the effort. A major factor in his decision was that it was "very late in the game." If it had been a new matter, he might have felt differently because age is definitely a factor which usually mitigated against a successful prosecution. (Int. F.11)

7. Critique of the Ogren Report

The U.S. Attorney's Office in Alexandria did not receive a copy of the Ogren report until April 1983. In response, the Alexandria attorneys prepared a "Critique of the Fraud Section Memo" which was forwarded to Assistant Attorney General Jensen on May 18, 1983. The Critique, signed by U.S. Attorney Munsell, Aronica, Fisher, and Smith, replies to the arguments against prosecution, except for those related to the statute of limitations problem with respect to the substantive offenses. It says, "We are still convinced that there is a prosecutable case against the company," and suggests that a two-count indictment charging conspiracy to defraud the government and to impede and impair its lawful functions could be quickly drafted. (Ex. DD.2)

The Critique argues that Ogren is wrong to conclude there is little, if any, evidence of actual fraud. In addition to the evidence of fraud in the VCAS and soft items found during the U.S. Attorney's investigation, it is pointed out that Weiner was able to uncover new evidence of fraud in two other hardware items in a relatively short period just by taking the time to read a few of the documents. The company's claim, the Critique states, "is like a huge field of oil lying just beneath the surface of the earth. Wherever prosecutors probed, oil (evidence of fraud) bubbled to the surface." (Ex. DD.6-9)

Ogren's assertion, the Critique states, that there is no evidence of specific intent even with respect to the four false claim items, completely misperceives the law on specific intent. The Alexandria attorneys state it is not necessary to produce a confession of company officials to satisfy the intent requirement. Ordinarily, intent is not proved directly because there is no way to fathom the operations of the human mind. Intent is usually inferred from the surrounding circumstances. If a claim is false, it may be inferred that the person who submitted it intended to submit a false claim. It may also be inferred that the claim was submitted with reckless indifference to whether it was true or false. (Ex. DD.11-14)

According to the Critique, the authors of the false claims, including the VCAS, are known to the prosecutors, contrary to the assertion in the Ogren report. More importantly, a corporation is criminally liable for the acts of its employees, and it is not necessary to establish links between high level officials and particular claim items. It would be enough for the government to prove that whoever wrote a particular claim must have known it was false. (Ex. DD.22-24)

Ogren's report states a prosecution of the Discharge Sea Chests claim would fail because the government could not satisfy the materiality requirement. It also states an indictment for the Reactor Shielding claim would fail partly because the amount of the claim is comparatively insignificant, and that the VCAS claim is at best a technical violation because it was withdrawn prior to settlement. Both Ogren and Silverstein raised the issue of materiality in the staff interviews, and indicated that obtaining a conviction in a false claim or false statement case is almost impossible unless the government can show it relied on the claim or statement, or was induced by it to spend a relatively significant sum of money. (Int. F.12 and J.44-52)

These views are disputed by the Critique which maintains it is well settled that materiality hinges on whether the false statement has a natural tendency to influence, or was capable of influencing, the determination required to be made. A false statement may be material although the government does not actually rely on it, or if it is ignored or never read. It is a crime to submit a false statement that is merely capable of impairing the functioning of a government agency. (Ex. DD.25-26)

The Critique points out that, in addition to the fact the four hardware items "recognized as false" add up to about \$7 million, the soft claim items questioned are much larger. These include the Deterioration of Labor/Parkinson's Law (\$97 million) and Navy Recruiting (\$24 million). (Ex. DD.3 and 10)

The materiality issue also was discussed in the staff interview with Roger Olsen, who at the time of the interview was Acting Assistant Attorney General for the Tax Division. Olsen was asked about the argument that a particular claim might not be material because it represents a relatively small portion of the overall claim. He replied by referring to a recent tax case in which a large firm was indicted for making a \$96,000 false statement on its tax return. The firm argued its income was so large that the error resulting from the false statement was equivalent to an average taxpayer making a \$0.38 false statement. Olsen said the firm was prosecuted successfully despite the fact that the false statement had very little effect on its overall tax liability. (Int. G.20-21)

#### 8. The Statute of Limitations Problem

The statute of limitations problem began to be discussed in 1981. Fisher and Aronica expressed deep concern about it in their 1981 Status Report. Olsen, who served as Lowell Jensen's

deputy, states that throughout the time he was involved in the case there were always discussions concerning the statute of limitations. (Int. G.9)

The application of the statute differs somewhat with respect to substantive offenses and conspiracy. Newport News filed its revised claim on March 8, 1976. Normally, criminal prosecutions for false claims are barred unless indictments are brought within five years of the submission of the claims. However, conspiracy is a continuing offense, and all government attorneys seemed to agree the statute of limitations on a conspiracy prosecution would not run until October 5, 1983, five years after the Navy and Newport News reached a settlement on the Newport News claim.

In addition, the statute may run anew on substantive crimes under certain circumstances. The Alexandria prosecutors determined that a Newport News letter of August 1, 1977, informing the Navy of changes in the projected costs of the ships for which claims had been submitted, had the effect of starting anew the running of the statute of limitations. In other words, the government had until August 1, 1982, to bring an indictment. This explains why Fisher and Aronica say in the Status Report, "Statute of limitations considerations make it advisable that the investigation be concluded by late spring or early summer 1982." (Ex. U.102-106 and 108)

The Ogren Report discusses the question of whether there is a claim or statement within the statute of limitations. By the time of the report (February 1983), the date identified by Fisher and Aronica had passed, beyond which prosecution of the substantive violations would be barred. However, several letters sent by Newport News to the Navy in 1978 concerning the settlement negotiations had been found. Ogren explored the possibility that these letters renewed the claims and are themselves false claims or false statements. Regarding the possible renewal of the claim, the report states, "we doubt that a court would allow the Government to revive an otherwise time barred claim for statute of limitations purposes each time a new letter is submitted to the Navy prior to obtaining payment."

The Ogren Report discusses whether the letters, one dated April 20, 1978, and several dated October 5, 1978, are claims or statements. It points out that one of them states that no major errors or inconsistencies had been found in the claims, and the others state that no inaccuracy had been found during the negotiations, and wherever an inaccuracy could have affected pricing, the company advised the Navy. Ogren concludes, "It is doubtful whether these assertions could be called 'claims'."



The report goes on to state that the assertions in the letters are statements which, if false, could be potentially prosecuted. But the assertions about errors, inconsistencies, and inaccuracies were general. Ogren concludes that attempting to build a prosecutable case from such general, nonspecific statements would be a formidable task, and in the context of the proof problems in the Newport News case "it appears insurmountable." (Ex. CC.19-21)

Ogren said in the staff interview that there were statute of limitations problems with regard to a prosecution for false claims, but none with regard to a prosecution for false statements. In a subsequent letter to the Committee, he states, "I believed then and now that the statute of limitations issue was totally secondary." (Int. F) Silverstein maintained during the staff interview that "the statute of limitations was never an issue in declining on Newport News." He referred specifically to October 5, 1978, letters from Newport News saying they extended the statute of limitations five years from that date. (Int. J.75)

#### 9. The Decision to Close the Investigation

In August 1983, a meeting was held by Assistant Attorney General Jensen to decide whether or not to proceed with further efforts on the Newport News matter. Jensen does not recall why the meeting was not held sooner. He states that he assumes there were schedule problems on both sides, and there may have been an earlier date set for the meeting that was canceled. Attending the meeting were Fisher, Munsell, Aronica, Silverstein, Olsen, Ogren, Jensen, and Keeney. (Int. B.21, G.16, and M.6) By the time of the meeting, Ogren had responded to the Alexandria Critique of May 18 with a memo dated August 23, 1983. In it, he repeated his recommendation that the investigation be terminated. (Ex. GG)

"We were asking," according to Attorney General Jensen, "can we file [an indictment] now or, if not, what would it take to get there." (Int. M.6) Fisher and Aronica responded that it was too late for the kind of indictment they had contemplated when the Status Report was prepared because, by the end of 1982, the statute of limitations had run on the substantive crimes that had been investigated. (Int. B.21-22) Their view was that a conspiracy indictment was still possible, but it would have to be obtained before September 1983 even under the most creative theories on how to extend the statute of limitations. (Int. B.21-22 and A.14)

Aronica advanced a plan as to how such a deadline could be met. His plan would have required a major allocation of manpower at the 11th hour, i.e., several teams of attorneys operating in several grand juries with one or two attorneys at the focal point. Aronica believed further investigation would uncover additional evidence of wrongdoing based on his own and Weiner's investigation. (Int. A.14-15)

Jensen's decision was to terminate the investigation. In his letter dated August 30, 1983, informing the Navy of his decision, Jensen said: "the dominant reason influencing our judgment is the absence of sufficient evidence to prove the existence of a criminal conspiracy to submit false claims or to defraud the United States." He said in the staff interview that in the end he "arrived at the conclusion that the matter should be closed." (Ex. HH and Int. M.5)

III. DEFENSE PROCUREMENT FRAUD AND  
THE JUSTICE DEPARTMENTA. THE VIEWS OF JENSEN AND OLSEN

Assistant Attorney General Jensen (now a U.S. District Court judge) and his former deputy, Assistant Attorney General Roger Olsen, indicated in the staff interviews that problems in the management of major defense fraud cases have been persistent.

In 1978, as Justice was considering what to do with Newport News and two other shipbuilding cases referred to it by the Navy, Mark M. Richard, Chief of the Fraud Section, urged the establishment of a specialized group to handle the cases. Under Richard's approach, which was influenced by experiences with earlier Navy shipbuilding cases, the group would be composed of Justice attorneys and Defense Department auditors. The Richmond investigative team was set up along those lines, the major difference being that control was divided between Justice and the U.S. Attorney's Office.

Jensen states that problems in the Newport News case contributed to the decision in 1982 to establish within Justice the Defense Procurement Fraud Unit (DPFU). Jensen said he had in mind a defense procurement "strike force" type of organization. While the Newport News case was not the proximate cause of the decision to create DPFU, he said, all the shipbuilding cases led to a rethinking of the Justice Department's approach to defense fraud. (Int. M.7)

Jensen said the Newport News investigation had been disjointed and driven by fortuitous decisions about staffing, depending upon what attorney might be available at the time. In light of those problems, it became evident there was a need to have identifiable resources available on a continuing basis to handle these kind of cases. The specific purpose of establishing a fraud unit, Jensen said, was to make available attorneys with procurement expertise for full-time assignment to complex procurement cases such as Newport News. If the DPFU had been in place when Justice accepted Newport News, unquestionably that case would have been assigned to it. (Int. M.7)

Jensen said that, while DPFU was an improvement over the previous system for handling defense procurement fraud cases, there is still a "developmental process" in this area that may be changed. Jensen said it would make sense to have fraud units located in other parts of the country, such as Los Angeles, where defense contractor business is concentrated. (Int. M.7-8)

In the staff interview, Olsen also addressed some of the larger questions. He said that it was his job to try to narrow the issues for Jensen when disputes arose between attorneys as occurred in the Newport News case. But he was prompted to form an opinion that was broader than the case. He came to the view that there was something wrong with the way the Justice Department was equipped to handle major Defense Department procurement fraud cases. He cited the difficulty in getting Justice attorneys "up to speed" in procurement cases. The subject matters are frequently technical and the cases difficult to learn. He said staffing is a problem because the cases are often of a long-term nature and turnover of attorneys interferes with the ability of Justice to manage long-term cases. (Int. G.14)

Olsen stated that, regardless of the final decision on Newport News, the case "was an unfortunate example of the way DOJ deals with these [defense procurement] problems." He said it was his suggestion to create DPFU as a way to improve Justice's ability to respond to procurement fraud cases in a timely and effective manner. He saw creation of this unit as an answer to the problem of the institutional inability to assign people to defense procurement fraud cases for long periods of time. Attorneys assigned to it would be expected to work in the defense procurement area exclusively and to become familiar with procurement concepts and technical matters. The location of the unit in Alexandria, Virginia, gave it a possible venue for many cases because the Pentagon and the Navy's procurement offices in Crystal City were located nearby. This would reduce the requirement for prosecutors to travel to other jurisdictions to handle cases. Olsen pointed out that keeping prosecutors "off the road" was an important ingredient in keeping them productive and in government service. (Int. G.14-15)

Olsen acknowledged that Justice could have done a better job on the Newport News case. But he was hopeful that the DPFU, which was intended to combine the expertise of Defense and Justice Department lawyers, would result in swift and certain justice for people engaging in procurement fraud. In response to a question about the adequacy of staff resources for these kind of cases, Olsen said that Justice had not obtained budget increases in the past several years. He also observed that, with certain crimes such as narcotics violations, there is an overlap with state law enforcement authorities, but there is no one other than the Justice Department to enforce the laws against defense procurement fraud. (Int. G.20)

B. THE DEFENSE PROCUREMENT FRAUD UNIT

In 1983, after lengthy investigations of possible fraud in claims filed by five major shipbuilders and after prosecution was declined in three of those cases, the Justice Department conducted an internal management review of those closed investigations concerning General Dynamics, Lockheed, and Bath. (Ex. FF) The Department's review did not examine the Newport News investigation which was still pending, nor the investigation of Litton which had led to an indictment dismissal.

The internal review found a series of institutional weaknesses which may have contributed to the lack of success in those cases. Among the problems recognized were: (1) little expertise in procurement law or voluminous document cases among assigned prosecutors; (2) frequent turnover among assigned prosecutors and investigators; (3) minimal supervision; (4) a lack of investigation plans and schedules; (5) insufficient coordination between Justice and the Defense Department, as well as between Justice's Criminal Division and U.S. Attorneys' offices; and (6) a serious underestimation of the size and complexity of the investigations.

In response to the problematic shipbuilding investigations and to complaints from the Defense Department that Justice was not providing adequate prosecutive support for Defense fraud cases, the two agencies formed the DPFU in August 1982. Defense Secretary Caspar Weinberger and Attorney General William French Smith agreed in a formal memorandum of understanding that both agencies would contribute staff resources. However, DPFU was established within the Justice Department's Criminal Division which would control management as well as all prosecutive decisions.

The stated purpose of DPFU was to "deter future fraud by conducting nationally significant procurement fraud and corruption investigations and prosecutions." (letter from Justice to Senator Grassley, March 13, 1985) More specifically, the Unit was created to prosecute the following types of cases: (1) those that are too complex or beyond the interest and resources of U.S. Attorney's offices; and (2) those that involve multiple venues and are beyond the operational jurisdiction of any single U.S. Attorney's office. Additionally, Justice indicated that the DPFU was intended to correct the "numerous problems" experienced with investigations such as Litton and General Dynamics.

However, less than three years after DPFU's inception, representatives from both Justice and Defense publicly decried the overall state of procurement fraud law enforcement. Justice

in its Economic Crime Council study of April 1985 reported that, despite some progress in detection and prosecution, the overall number of cases continue to be too few to represent an adequate level of enforcement. The Council blamed the lack of effectiveness on a "disturbingly low" number of quality referrals from the Defense Department.

Defense Department Inspector General Joseph Sherick testified before Congress with a different view about where the system is lacking. Sherick said that, while the existence of DPFU helped prosecutors focus more on procurement fraud, he was "unsatisfied" with the minimal number of cases handled by DPFU. The Inspector General went on to say that the government remains "overmatched" in its efforts against fraudulent contractors, and that taxpayers are "getting their clock cleaned." (Hearings, Defense Procurement Fraud Law Enforcement, Subcommittee on Administrative Practice and Procedure of the Senate Committee on the Judiciary, 99th Congress, 1st Session, 1985)

Following that testimony, Senator Grassley, Chairman of the Subcommittee on Administrative Practice and Procedure, asked GAO to review the operations of the DPFU since its creation in 1982. GAO examined cases referred to the DPFU from 1982 through December 1985 and found that, of 486 defense procurement fraud cases referred for Unit action, by July 1986 DPFU had participated in 34 successful convictions (7 percent). Most of the convictions involved smaller companies. (GAO, Defense Procurement Fraud, Cases Sent to the Department of Justice's Procurement Fraud Unit, September 1986)

In general, GAO found that DPFU produced few successful prosecutions of major contractors, accepted many cases involving minor or no dollar loss, and appeared to have lost track of some cases brought to the Unit. GAO's findings also show many cases pending with DPFU for two years or more, and a high staff turnover rate. Most attorneys and investigators stayed with the Unit for periods less than two years.

Under the agreement between Justice and Defense, all significant defense fraud cases are referred to DPFU for the Unit Chief to determine one of four actions: (1) accept the case for DPFU prosecution; (2) accept the case for prosecution but refer it to a U.S. Attorney's office; (3) send the matter back to Defense for more investigation; or (4) decline prosecution. The GAO study found that roughly one-quarter of all referrals were assigned to each of the four categories, resulting in just over half of those cases referred (261) being accepted for prosecution by either DPFU or U.S. Attorneys.

From the 261 cases DPFU accepted for prosecution between 1982 and 1986, there have been 42 total convictions with DPFU, as mentioned above, claiming involvement in 34. Because some investigations produced multiple convictions, the GAO report shows DPFU actually participated in 15 separate successful investigations. Of 156 referrals involving major contractors (top 100 in volume of sales to the Defense Department), nine resulted in convictions, with local U.S. Attorneys prosecuting six of those cases and DPFU participating in three.

Most of the major contractor cases referred (105 of 156) involved the Defense Department's "top 25" contractors. Four of the nine convictions of major contractors were among the "top 25." DPFU participated in just one case involving a "top 25" defense contractor.

That case, one of the first handled by DPFU prosecutors, resulted in the Sperry Corporation pleading guilty to mischarging \$325,000 of extra costs onto government contracts. Sperry agreed to pay a fine. The plea agreement worked out between DPFU and Sperry attorneys was initially labeled "unconscionable" by the presiding Federal District Court judge due to its failure to charge individuals, but he later accepted it.

Sperry's agreement with the government, known as a "global" settlement, protected Sperry from suspension or debarment from government contracts as a result of the conviction and had the effect of halting a second criminal investigation of similar practices at another Sperry facility. That investigation was halted because the agreement immunized Sperry for any illegal cost mischarging up to the date of the settlement.

Inspector General Sherick called the Sperry agreement a "disgrace" and a "travesty" in congressional testimony. (Hearings, Senate Judiciary Subcommittee on Administrative Practice, October 1985) In the wake of criticism from the Defense Department, the Justice Department announced it would no longer enter into "global" agreements.

The other two convictions of major contractors in which DPFU participated involved Gould Defense Systems and GTE Government Systems Corporation. There were plea agreements in both resulting in fines.

According to GAO, while a number of pending cases involve top 100 contractors, DPFU has not participated in a successful prosecution of a top 100 defense contractor since October 1985.

DPFU "screens" cases to determine which ones to accept for prosecution. Approximately 62 percent of DPFU's accepted cases involve estimated losses of less than \$1 million. Nearly 40 percent of DPFU's cases fall into the category of no loss or "unknown" loss.

Many of the unknown loss cases may be among the numerous referrals to DPFU for which it could not render an accounting. According to GAO, DPFU lacked any records which could show the reason for the referrals or what action, if any, had been taken on 58 cases.

In light of the staff turnover problems cited in the shipbuilding fraud investigations, GAO was also asked to examine the staffing of the DPFU. At its inception, eight full-time attorneys were assigned to DPFU; three from the Criminal Division, one from the Civil Division, one Assistant U.S. Attorney, and three from the Defense Department. GAO found that two of the original three Criminal Division prosecutors assigned to the DPFU, including the Unit Chief, left within two years to enter private practice. The third left DPFU after two and a half years. Both the Civil Division attorney and the Assistant U.S. Attorney were still assigned to DPFU as of March 1986. Two of the original three Defense Department attorneys were reassigned after two and a half years. As of July 1986, the staff's average tenure with the Unit totaled about 18 months.

The DPFU has increased its staff since 1982. In July 1986, the staff included seven criminal prosecutors, two civil attorneys, one of whom was on temporary assignment elsewhere, five investigators, and five Defense Department attorneys. In the October 1985 hearing before the Senate Judiciary Subcommittee on Administrative Practice and Procedure, Justice representatives testified that the resources devoted to DPFU were adequate and that extra resources, if needed, could always be borrowed from the Criminal Division. The Justice Department's Fiscal Year 1988 budget request includes an allowance for three additional attorneys to be assigned to DPFU.



## IV. SUMMARY AND CONCLUSIONS

The history of the Newport News Shipbuilding investigation reveals inefficiencies, unexplained lapses, and systemic problems in the Justice Department's management of major defense fraud cases. Establishment of the Defense Procurement Fraud Unit within the Justice Department was intended to correct the type of deficiencies experienced in the Newport News case. While some progress is evident in the overall detection and prosecution of procurement fraud, systemic weaknesses continue to plague the Justice Department's efforts, especially with regard to complex cases involving major contractors.

The Justice Department's approach to the Newport News investigation was to assign responsibility for the investigation to the U.S. Attorney in Alexandria, Virginia, while retaining authority to make the final decision on whether to prosecute. Navy attorneys were assigned to the investigative team, but were given no role in decisions about investigative strategy and a minor role in determining recommendations to the U.S. Attorney. This system of dividing responsibility and authority was ultimately fatally flawed. It contributed to staffing problems, caused delays, and defeated the underlying purpose of a mixed investigative team. Instead of a combined force providing increased effectiveness, there was a divided force that proved ineffective.

The approach of DPFU has resulted in some of the same problems, including inadequate numbers of staff and excessive staff turnover. Defense Department attorneys and Justice Department civil attorneys assigned to DPFU play a minor role, primarily in the screening of referrals from Defense. The objective of establishing an effective investigative and prosecutive unit of identifiable resources available on a continuing basis to handle major defense fraud cases has still not been achieved.

Serious mistakes were made at every stage of the Newport News investigation and much time wasted during lengthy periods of inactivity. There was poor supervision of prosecutors and investigators, questionable decisions at the prosecutorial and managerial levels, excessive staff turnover, and inadequate coordination within the Justice Department and between Justice and the Navy. There is strong evidence that the statute of limitations on the substantive offenses of false claims and false statements was allowed to lapse before the case was closed.

These problems occurred even though it had been recognized at the highest levels within the Justice Department when the investigation began that prior experiences with Navy shipbuilding fraud cases were unsatisfactory and that a better approach was needed.

The following is a more detailed list of conclusions.

A. THE NEWPORT NEWS INVESTIGATION

1. The Justice Department allowed two years to lapse without conducting any investigation from the time allegations and evidence of possible fraud were first referred to it in 1976 by Senator William Proxmire. The Proxmire referral was based on information provided in congressional hearings by Admiral H.G. Rickover and William R. Cardwell, a former long-time employee of Newport News. Cardwell eventually testified before the grand jury, but years later was considered no longer to be a reliable witness because of the passage of time.
2. After agreeing to share responsibility for the Newport News matter with the U.S. Attorney's Office in Alexandria, Virginia, the Justice Department failed to carry out its responsibility for advancing the investigation. The attorneys assigned to the investigation by Justice worked on it only part time, were replaced after short intervals without notifying the U.S. Attorney's Office, and made little contribution to the case.
3. The Assistant U.S. Attorney placed in charge of the Richmond phase of the investigation did not have substantial prior experience in major criminal cases. The Richmond investigative team received insufficient supervision from the U.S. Attorney's Office and was inadequately staffed.
4. The head of the Richmond team failed to give adequate consideration to the findings and views of the Navy attorneys assigned to the team, or to take full advantage of the Navy's offer to provide technical assistance. The Richmond prosecutor apparently did not understand the significance of some of the evidence obtained, and did not pursue all avenues of possible prosecution.
5. The head of the Richmond team did not properly carry out the directions of the U.S. Attorney to conduct further investigation following the submission of his initial recommendations in March 1980. A key witness, who was a high official of Newport News, was mistakenly given full immunity and questioned outside the presence of the grand

jury, contrary to the instructions of the U.S. Attorney. The purpose for which further investigation was directed -- comprehensive scrutiny of a particular part of the claim, the Ventilation Control Air System (VCAS) item -- was not achieved.

6. The U.S. Attorney's Office in Alexandria, Virginia, renewed the grand jury investigation in early 1981 and uncovered new evidence about the VCAS item. In the view of the Alexandria prosecutors, the new evidence established the methodology of how the false aspects of the claim were prepared. The prosecutors forwarded a report to the Justice Department in November 1981 concluding that there was evidence of fraud and a criminal conspiracy, and requesting staff assistance to complete the investigation. The report urged that the investigation be completed by the middle of 1982 to avoid statute of limitations problems. But from the date of the report until the case was closed in August 1983, there were no further grand jury proceedings or other efforts to advance the investigation.
7. In November 1981, Elsie Munsell, the new U.S. Attorney in Alexandria, abolished the Fraud Division in her office which had responsibility for the Newport News case, and reassigned the two prosecutors who had worked on it. This action was taken without consulting the previous U.S. Attorney or officials in the Justice Department, and over the objections of Joseph Fisher, the Alexandria prosecutor who had been in charge of the investigation. The reorganization sidetracked the investigation and reduced prospects for completing it in the U.S. Attorney's office.
8. In January 1982, U.S. Attorney Munsell asked the Justice Department to reassume responsibility for the Newport News case. Justice advised her in March that it would take back the case. The shift in responsibility for the investigation led to further discontinuity and delays.
9. The Justice Department decided to review the case to determine whether the investigation should be continued or ended. There was an additional delay and confusion in beginning the review as Justice officials searched for an attorney to work on the case. Ed Weiner, the Justice attorney selected to conduct the review, did so without supervision. Officials at the Criminal Division level assumed the Fraud Section was supervising it. The Chief of the Fraud Section assumed it was being supervised at the Criminal Division level.

10. Ed Weiner submitted a report on August 5, 1982, agreeing with the Alexandria prosecutors that there was evidence of fraud and a criminal conspiracy, and recommending that the investigation be continued. Later, Mr. Weiner was directed to search the files again for additional evidence of fraud. Mr. Weiner did, in fact, uncover what he viewed as new evidence of fraud. Nevertheless, Mr. Weiner's superiors in the Fraud Section decided in November 1982 to recommend to their superiors at the Criminal Division level that the case be closed. There was additional delay as the Fraud Section report recommending that the case be closed was not sent to Lowell Jensen, Assistant Attorney General for the Criminal Division, until February 25, 1983.
11. Robert Ogren, Chief of the Fraud Section, strongly argued in his report to Assistant Attorney General Jensen that by February 1983 the statute of limitation had expired on the substantive crimes of false claims and false statements. Mr. Jensen's letter informing the Navy that the dominant reason for closing the case was the absence of sufficient evidence to prove a criminal conspiracy is consistent with the view that the statute of limitations would have barred prosecution of the substantive offenses.
12. The statute of limitations would not have been a bar to prosecution on charges of conspiracy. The Alexandria prosecutors believed there was substantial evidence of fraud and conspiracy, that more evidence could be found, and that the investigation should have been continued. The Justice Department attorney who reviewed the case agreed with the Alexandria prosecutors. The Justice Department supervisors concluded that, although there was evidence of fraud, there was insufficient evidence on which to base a prosecution.
13. There was additional delay as the final decision by Assistant Attorney General Jensen to close the case was not made until August 1983.

B. THE DEFENSE PROCUREMENT FRAUD UNIT

1. The Justice Department's Defense Procurement Fraud Unit has not sufficiently corrected the numerous problems encountered with previous investigations of major shipbuilders.
2. DPFU has experienced excessive staff turnover, and effective coordination with the Defense Department still appears to be in need of improvement.

3. DPFU has produced few successful prosecutions of major contractors. As of July 1986, the Unit had participated in only three convictions of major defense contractors. In all three cases, the sentences were limited to fines.
4. DPFU appears to lack an adequate recording system for cases referred to it. According to the General Accounting Office, the Unit could not produce records showing the reasons for actions, if any, taken with regard to 58 case referrals.

## APPENDIX

## LIST OF EXHIBITS

- A. May 19, 1977 -- Letter from NAVSEA 08 (Rickover) to Inspector General, NAVSEA
- B. July 14, 1977 -- Letter from NAVSEA 08 (Rickover) to Inspector General, NAVSEA
- C. November 1, 1977 -- Letter from NAVSEA 08 (Rickover) to Inspector General, NAVSEA
- D. December 30, 1977 -- Letter from NAVSEA 08 (Rickover) to Secretary of the Navy
- E. January 3, 1978 -- Letter from NAVSEA 08 (Rickover) to Secretary of the Navy
- F. January 5, 1978 -- Letter from NAVSEA 08 (Rickover) to Secretary of the Navy
- G. February 8, 1978 -- Memo from Mark M. Richard to John C. Keeney, re: Shipbuilding Referrals from the Department of the Navy
- H. February 15, 1978 -- Memo from Mike Kelly to Benjamin Civiletti, re: Judge Bell's Comments to Memo
- I. April 12, 1978 -- Letter from John C. Keeney to Deanne Siemer, re: Navy Referrals
- J. June 2, 1978 -- Letter from NAVSEA 08 (Rickover) to the Secretary of the Navy
- K. July 19, 1978 -- Letter from NAVSEA 08 (Rickover) to the Secretary of the Navy
- L. 1979 -- Response of U.S. Government to Newport News Motion to Terminate Grand Jury Proceedings
- M. December 3, 1979 -- Memo from Linda Pence on Navy Recruiting Claims
- N. March 1980 -- Paulisch "Bow Dome" Memo
- O. March 5, 1980 -- Memo from Sandra Adkins on Norman Prosecution Memo
- P. April 4, 1980 -- Memo from Jo Ann Harris to Jim Graham, et. al., re: Meeting with ADM Rickover on Navy Referrals

- Q. October 1, 1980 -- Norman Prosecution Memo
- R. October 1980 -- Norman Supplemental Prosecution Memo
- S. January 23, 1981 -- Letter from Undercofler to Renfrew
- T. November 2, 1981 -- White Collar Crime Priorities, Eastern District of Virginia
- U. November 1983 -- Fisher-Aronica Status Report
- V. November 1983 -- Fisher-Aronica Status Report Appendix
- W. August 5, 1982 -- Weiner Memo
- X. September 1, 1982 -- Memo from Smith to Ogren
- Y. November 17, 1982 -- Dissenting memo from Weiner to Ogren
- Z. November 26, 1982 -- Letter from Munsell to Olson
- AA. December 16, 1982 -- Memo from Weiner to Silverstein
- BB. February 18, 1983 -- Letter from Rickover to Ogren
- CC. February 25, 1983 -- Ogren Memo
- DD. May 18, 1983 -- Critique of the Ogren Memo
- EE. July 8, 1983 -- Letter from Rickover to the Attorney General
- FF. July 22, 1983 -- Review of Navy Claims Investigations, Office of Policy and Management Analysis, Criminal Division, U.S. Department of Justice
- GG. August 23, 1983 -- Memo from Ogren to Jensen
- HH. August 30, 1983 -- Jensen Declination Letter

than 25 percent and not more than 30 percent of the proceeds of the action or settlement and shall be paid out of such proceeds. Such person shall also receive an amount for reasonable expenses which the court finds to have been necessarily incurred, plus reasonable attorneys' fees and costs. All such expenses, fees, and costs shall be awarded against the defendant.

"(3) If the Government does not proceed with the action and the person bringing the action conducts the action, the court may award to the defendant its reasonable attorneys' fees and expenses if the defendant prevails in the action and the court finds that the claim of the person bringing the actions was clearly frivolous, clearly vexatious, or brought primarily for purposes of harassment.

"(e) CERTAIN ACTIONS BARRED.—(1) No court shall have jurisdiction over an action brought by a former or present member of the armed forces under subsection (b) of this section against a member of the armed forces arising out of such person's service in the armed forces.

Armed Forces.

"(2)(A) No court shall have jurisdiction over an action brought under subsection (b) against a Member of Congress, a member of the judiciary, or a senior executive branch official if the action is based on evidence or information known to the Government when the action was brought.

"(B) For purposes of this paragraph, 'senior executive branch official' means any officer or employee listed in section 201(f) of the Ethics in Government Act of 1978 (5 U.S.C. App.).

"(3) In no event may a person bring an action under subsection (b) which is based upon allegations or transactions which are the subject of a civil suit or an administrative civil money penalty proceeding in which the Government is already a party.

"(4)(A) No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.

"(B) For purposes of this paragraph, 'original source' means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this section which is based on the information.

"(f) GOVERNMENT NOT LIABLE FOR CERTAIN EXPENSES.—The Government is not liable for expenses which a person incurs in bringing an action under this section.

"(g) FEES AND EXPENSES TO PREVAILING DEFENDANT.—In civil actions brought under this section by the United States, the provisions of section 2412(d) of title 28 shall apply."

**SEC. 4. ENTITLEMENT TO RELIEF FOR DISCRIMINATION BY EMPLOYERS AGAINST EMPLOYEES WHO REPORT VIOLATIONS.**

Section 3730 of title 31, United States Code, as amended by section 3 of this Act, is further amended by adding at the end the following new subsection:

"(h) Any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of the



employee or others in furtherance of an action under this section, including investigation for, initiation of, testimony for, or assistance in an action filed or to be filed under this section, shall be entitled to all relief necessary to make the employee whole. Such relief shall include reinstatement with the same seniority status such employee would have had but for the discrimination, 2 times the amount of back pay, interest on the back pay, and compensation for any special damages sustained as a result of the discrimination, including litigation costs and reasonable attorneys' fees. An employee may bring an action in the appropriate district court of the United States for the relief provided in this subsection."

**SEC. 5. FALSE CLAIMS PROCEDURE.**

Section 3731 of title 31, United States Code, is amended by striking subsection (b) and inserting the following:

"(b) A civil action under section 3730 may not be brought—  
 "(1) more than 6 years after the date on which the violation of section 3729 is committed, or

"(2) more than 3 years after the date when facts material to the right of action are known or reasonably should have been known by the official of the United States charged with responsibility to act in the circumstances, but in no event more than 10 years after the date on which the violation is committed, whichever occurs last.

"(c) In any action brought under section 3730, the United States shall be required to prove all essential elements of the cause of action, including damages, by a preponderance of the evidence.

28 USC app.

"(d) Notwithstanding any other provision of law, the Federal Rules of Criminal Procedure, or the Federal Rules of Evidence, a final judgment rendered in favor of the United States in any criminal proceeding charging fraud or false statements, whether upon a verdict after trial or upon a plea of guilty or nolo contendere, shall estop the defendant from denying the essential elements of the offense in any action which involves the same transaction as in the criminal proceeding and which is brought under subsection (a) or (b) of section 3730."

**SEC. 6. FALSE CLAIMS JURISDICTION; CIVIL INVESTIGATIVE DEMANDS.**

31 USC 3721

(a) **IN GENERAL.**—Subchapter III of chapter 37 of title 31, United States Code, is amended by adding at the end the following new sections:

31 USC 3732.

**"§ 3732. False claims jurisdiction**

"(a) **ACTIONS UNDER SECTION 3730.**—Any action under section 3730 may be brought in any judicial district in which the defendant or, in the case of multiple defendants, any one defendant can be found, resides, transacts business, or in which any act proscribed by section 3729 occurred. A summons as required by the Federal Rules of Civil Procedure shall be issued by the appropriate district court and served at any place within or outside the United States.

"(b) **CLAIMS UNDER STATE LAW.**—The district courts shall have jurisdiction over any action brought under the laws of any State for the recovery of funds paid by a State or local government if the action arises from the same transaction or occurrence as an action brought under section 3730.

MAR 14 1988



AMERICAN BAR ASSOCIATION Section of Public Contract Law  
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March 14, 1988

**BY HAND**

Honorable William J. Hughes  
 Chairman  
 Subcommittee on Crime of the House  
 Committee on the Judiciary  
 207 Cannon Building  
 Washington, D.C. 20515

Re: H.R. 3500, The Major Fraud  
 Act of 1988

Dear Representative Hughes:

The American Bar Association's Section of Public Contract Law ("Section") appreciates the opportunity to express these views concerning H.R. 3500, the Major Fraud Act of 1988. Unless otherwise indicated herein, the views expressed are those of the Section. They have not been approved or adopted by the Association's Board of Governors or its House of Delegates and should not be construed as representing the position of the American Bar Association.

91-712 292

1987-88

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Members of the Section include a cross-section of lawyers from the private bar, government, corporations and academia. However, the positions of the Section are developed independently as a group of public contract professionals after much study and constructive debate.

The Section has consistently supported legislation enhancing the government's ability to correct abuses of the procurement system and fraudulent actions by the contractors, while also protecting the rights of the accused. We share the concerns of the Congress for the reduction and prevention of contract fraud and seek to resolve the problems through legislation that will correct contracting abuses.

1. Need for Additional Legislation to Combat Fraud

The Act has been proposed as a way of giving new emphasis to the criminal law side of the ledger in the government's battle against fraud. Assertions have been made that the considerable statutory tools currently available to the Justice Department are inadequate when dealing with "major fraud" against the United States, which is defined as fraud "in any procurement of property or services for the Government, if the value of the contract for such property or services is \$1,000,000

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or more.<sup>1/</sup> We address these assertions below with regard to specific modifications of current law proposed in the Act. However, as an initial matter we note that the Justice Department's overall record in prosecuting procurement fraud appears to be a highly successful one, as the following figures from Defense Department Inspector General reports indicate:<sup>2/</sup>

<u>Period</u>	<u>Indictments</u>	<u>Convictions</u>	<u>Fines, Forfeitures, Restitutions &amp; Recoveries</u>
10/84 - 3/85	124	156	\$14,372,962
4/85 - 9/85	129	100	26,835,000
10/85 - 3/86	21	42	5,802,811
4/86 - 9/86	170	163	34,181,883
10/86 - 3/87	146	133	5,257,682
<u>4/86 - 9/87</u>	<u>488</u>	<u>399</u>	<u>25,218,573</u>
Total since 10/84	1078	993	\$111,668,911

1/ Fraud is defined as

knowingly execut[ing] or attempt[ing] to execute any scheme or artifice --

(1) to defraud the United States; or

(2) to obtain money or property from the United States by means of false or fraudulent pretenses, representations, or promises.

This parallels the definition of bank fraud in 18 U.S.C § 1344.

2/ Data compiled from five Semiannual Reports to the Congress, from the Department of Defense, Office of Inspector General: May 30, 1985 at 3-3; November 29, 1985 at 3-2; May 30, 1986 at 3-1; November 29, 1986 at 3-2; May 30, 1987 at 3-2.

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Moreover, if Congress' concern is that an insufficient number of prosecutions for procurement fraud have been brought due to lack of prosecutorial resources, the Act does not address that concern.

2. Extension of Statute of Limitations

The Act proposes a seven-year statute of limitations for prosecuting the offenses proscribed under the Act. Currently, criminal prosecutions for procurement fraud are generally subject to the five-year statute of limitations provided in 18 U.S.C. § 3282.<sup>3/</sup> In addition, criminal violations of equivalent seriousness and complexity to "major fraud," such as bank fraud, 18 U.S.C. § 1344; securities fraud, 15 U.S.C. § 78ff; and antitrust violations, 15 U.S.C. §§ 1-31, are all subject to the same five-year statute of limitations. We do not believe there are any factual or policy bases which warrant extending that limitations period with regard to "major fraud."

The policies underlying statutes of limitations have been summarized by the United States Supreme Court as follows:

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<sup>3/</sup> Offenses generally alleged in procurement fraud cases include: Conspiracy to Defraud the Government with respect to Claims, 18 U.S.C. § 286; False, Fictitious or Fraudulent Claims, 18 U.S.C. § 287; Conspiracy to Commit Offense or to Defraud United States, 18 U.S.C. § 371; False Statements or Entries, 18 U.S.C. § 1001; Possession of False Papers to Defraud the United States, 18 U.S.C. § 1002; and Mail Frauds and Swindles, 18 U.S.C. § 1341.

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The purpose of a statute of limitations is to limit exposure to criminal prosecution to a certain fixed period of time following the occurrence of those acts the legislature has decided to punish by criminal sanctions. Such a limitation is designed to protect individuals from having to defend themselves against charges when the basic facts may have become obscured by the passage of time and to minimize the danger of official punishment because of acts in the far-distant past. Such a time limit may also have the salutary effect of encouraging law enforcement officials promptly to investigate suspected criminal activity.

Toussie v. United States, 397 U.S. 112, 114-115 (1970) (emphasis added).

Proponents of the seven-year statute of limitations claim that such a time period is necessary because procurement fraud cases entail long and difficult investigations involving very complex facts. However, the experiences of many lawyers familiar with major criminal investigations of procurement fraud indicate that these investigations expand to fill the time allotted, meanwhile subjecting the investigated business and employees to prolonged disruption, uncertainty, expense and agony. The public would be rightly outraged if an investigation of a government official remained uncompleted five years after the alleged violation, let alone seven. Government contractors should also be promptly prosecuted or vindicated. No fact situation could be so complicated that it requires seven years to

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investigate, nor could the added expense to the government of prolonging investigations an extra two years be justified.

This concern is of particular importance in the context of government procurement, where the government has available the additional protection afforded by the debarment and suspension process. In an increasing number of cases, contractors have been suspended and even debarred based on allegations of criminal activity that has not yet been the subject of an indictment. The result can be to deprive the individuals involved of the presumption of innocence, or to force them to waive their fifth amendment privileges prior to initiation of criminal proceedings. This is because the suspensions or debarments will remain in effect unless evidence is provided to the debarring authorities either to disprove guilt, or to establish that the business has identified the violation and who was responsible, and that corrective actions necessary to prevent a recurrence, including disciplinary measures, have been implemented. Extending the statute of limitations, and thereby indirectly the length of time during which an individual may remain suspended or debarred before trial, would substantially increase the pressure on suspended/debarred persons to waive their rights to await a

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criminal trial at which the government would be required to prove its criminal allegations beyond a reasonable doubt.<sup>4/</sup>

Finally, it will be virtually impossible for most defendants and witnesses to remember accurately the relevant acts in a complex procurement fraud trial conducted seven or more years after the alleged fraud. The critical events in procurement fraud, unlike those in crimes with long statutes of limitations such as murder or kidnapping, do not emblazon themselves upon the alleged perpetrator's consciousness. Nor can every contractor with a million dollar contract be expected to expend the extra resources required to retain, file and store every relevant document for at least seven years after the contract's close, an expense that would in any event ultimately be borne by the government.

### 3. Bounty Payments to Informers

The Act would permit payments of up to \$250,000 to anyone, other than a government officer or employee, who furnishes information leading to a conviction thereunder. These

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<sup>4/</sup> While FAR § 9.407-4(b) provides that a suspension may not continue beyond eighteen months unless "legal proceedings" have been initiated, 48 C.F.R. § 9.407-4(b), the only time limit on debarment is FAR § 9.406-4(a), which states that "[g]enerally, debarment should not exceed three years." *Id.* § 9.406-4(a). Moreover, a mere notice of proposed debarment has the effect of barring further awards within the agency, *id.* § 9.406-3(b)(7), and pending amendments would expand this bar to all other federal agencies. 52 Fed. Reg. 28642 (1987).



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payments would be at the discretion of the prosecutor, subject to approval by the trial judge.

Under the ABA Code of Professional Responsibility, which is still in effect in many jurisdictions, it is an ethical violation to employ a witness whose fee depends on the outcome of the case.<sup>5/</sup> This is because "[w]itnesses should always testify truthfully and should be free from any financial inducements that might tempt them to do otherwise."<sup>6/</sup> The new Model Rules of Professional Responsibility address this issue less specifically than does the Code. However, they prohibit "offer[ing] an inducement to a witness that is prohibited by law," and the accompanying comment explains that "[t]he common law rule in most jurisdictions is that it is improper to pay an occurrence witness any fee for testifying and that it is improper to pay an expert witness a contingent fee."<sup>7/</sup> We believe that the payment of a bounty to a witness contingent upon conviction of the defendant would be unwise and prejudicial to the adversary system of justice.

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<sup>5/</sup> DR 7-109(c) states: "A lawyer shall not pay, offer to pay, or acquiesce in the payment of compensation to a witness contingent upon the content of his testimony or the outcome of the case."

<sup>6/</sup> EC 7-28 (footnote omitted).

<sup>7/</sup> Model Rule 3.4(b) and Comment.

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In the event Congress nevertheless decides to retain the bounty provision, it should at a minimum take steps to prevent its abuse, including prohibiting payment to any individual who shared culpability for the offense. Otherwise, an employee could mischarge his time, then turn in his employer and claim a bounty. Outrageous as this may seem, similar scenarios have already begun to occur under the amended qui tam provisions of the civil False Claims Act.

#### 4. Whistleblower Protection

The Act would allow employees to sue their employers in federal court for alleged discrimination because of "lawful acts done by the employee . . . in furtherance of a prosecution" under the Act. Prohibited acts of discrimination would include not only discharge and demotion but also threats and harassment. Successful plaintiffs would be entitled to double back pay plus interest, "special damages" (including attorney's fees), and reinstatement with "full seniority rights."

This section, while similar to a section of the recent civil False Claims Act amendments, runs counter to the policy of decades of federal legislation in the employment field -- a policy of discouraging litigation and encouraging voluntary resolution of employer-employee disputes, through arbitration of

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grievances under collective bargaining agreements and administrative conciliation of race, sex, national origin, age, handicap and other discrimination charges. In contrast, the Act would provide no opportunity for conciliation and would reward confrontation and aggressive litigation by requiring the finder of fact to award the damages specified in the Act, including double back pay, interest, litigation costs and attorneys' fees. This would likely have the effect of putting any employee who made fraud accusations, however baseless, in a special, untouchable position.

Mandatory imposition of penal damages, such as double back pay, is inappropriate not only because it encourages litigation but also because special factors will likely be involved which make it particularly suitable for the Court to exercise discretion in fashioning a remedy. These factors include whether the plaintiff participated in the fraud and whether he or she has made false or unfounded accusations.

Other recent federal statutes have dealt with the whistleblower protection issue in a manner far more consistent with established federal labor policy. For example, the Occupational Safety and Health Act ("OSHA"), 29 U.S.C. § 660(c), protects whistleblowers by allowing them to file complaints with the Secretary of Labor alleging retaliation. The Secretary must investigate such complaints and, if meritorious, bring a civil

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action against the retaliator for appropriate relief, including rehiring or reinstatement with back pay. A similar remedy should be substituted for that proposed in the Act.

5. Increased Maximum Fine & Prison Term

The Act would increase the maximum prison term to seven years and the maximum fine to twice the value of the contract, provided that the "amount of the fraud is substantial in relation to the value of [the] contract." The increase in maximum fines would add to the "crazy quilt" in this area, where fines already vary from \$250,000, for false statements and non-defense contract false claims by individuals; to \$500,000, for such acts by - corporations; to \$1,000,000, for defense contract false claims by either; to twice the amount of the pecuniary gain or loss, where that amount exceeds the otherwise applicable maximum. It would also contribute to the rapid unraveling of the comprehensive criminal code reform legislation which the Congress recently passed after years of effort.

Moreover, the application of these enhanced penalties would be primarily a function of the value of the contract, not the amount of the actual fraud. Thus, a \$500,000 fraud on a \$5,000,000 contract could lead to a \$10,000,000 fine and 7 years in jail, whereas an equal fraud on a \$900,000 contract would be subject to maximum penalties of \$1,000,000 dollars and 5 years.

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An indictment charging multiple counts on the same contract would exacerbate this disparity. Such potential results would pose obvious problems under the eighth amendment, which "bars not only those punishments that are 'barbaric' but also those that are 'excessive' in relation to the crime committed. . . . [A] punishment is 'excessive' and unconstitutional if it . . . is grossly out of proportion to the severity of the crime." Coker v. Georgia, 433 U.S. 584, 592 (1977) (White, J.) (plurality opinion). The penalty should either be set at an absolute cap, such as \$1,000,000, or be related to the amount of the gain or loss resulting from the "major fraud."

We hope these views will be of assistance in your consideration of this legislation. We would be happy to discuss these views with you at your convenience. In addition, we would welcome the opportunity to testify at the hearings scheduled for Wednesday, March 16.

Sincerely,

*C. Stanley Dees (by POW)*

C. Stanley Dees  
Chairman  
Section of Public Contract Law



1110 Vermont Avenue, N.W.  
Washington, D.C. 20005-3553  
202-775-9060

RECEIVED  
MAR 15 1988  
JUDICIARY COMMITTEE

March 14, 1988

MAR 16 1988

Dear Mr. Chairman:

The Shipbuilders Council of America, the national organization representing principal domestic shipbuilders, ship repairers, and the vendors of equipment and services to those industries, submits this letter for the record in opposition to H.R. 3911, the Major Fraud Act of 1988. The Council strongly favors efforts to prevent and punish fraudulent activities in the area of government procurement. However, this legislation will not, in our judgment, achieve that objective.

If enacted, H.R. 3911 would dramatically increase the criminal penalties for fraud in any procurement on government contracts where the value of the contract for goods or services is \$1 million or more. The jail term would be increased to a maximum of seven years and the "fine imposed for an offense" may be "twice the value of such contract or services, and the amount of the fraud is substantial in relation to the value of such contract or services." The key term "substantial" is undefined in the legislation. It is not uncommon for Navy shipbuilding contracts to be in excess of \$500 million. Thus, the potential liability for a fraud could be a billion dollars. Also, the statute of limitations for prosecution of an offense under the statute would be increased from five to seven years.


Furthermore, the bill contains language that would permit a court to order an award of up to \$250,000 to an individual who furnished information leading to a conviction under the statute. In addition to this "bounty hunter" provision, the legislation contains language to protect the "whistleblower." However, this latter provision lacks any limitation to prevent frivolous claims or accusations by disgruntled employees lodged against honest corporations or individuals.

The Council believes H.R. 3911 is unwarranted and unnecessary. The major problems to effective procurement fraud prosecutions are the lack of continuity of personnel in the Department of Justice and inadequate departmental resources. These are essentially management and budgetary issues that cannot be addressed in a criminal statute. They must be confronted in the authorization and appropriation process.

Finally, there have been a number of recently enacted laws in the area of procurement fraud. Illustrative are the Civil and Criminal False Claims Acts, the Program Fraud Civil Remedies Act and the Anti-Kickback Enforcement Act. All of these statutes vest the government with broad new powers and impose new penalties on those convicted in procurement fraud cases. It should be clearly established that these laws are not carrying out the intent of Congress before such a punitive measure, such as H.R. 3911, is enacted.

Accordingly, the Shipbuilders Council strongly opposes the enactment of H.R. 3911. We respectfully request that this letter be made a part of the record on this legislation.

Sincerely,



John J. Stocker  
President

The Honorable Peter W. Rodino, Jr.  
Chairman  
Committee on the Judiciary  
2462 Rayburn House Office Building  
House of Representatives  
Washington, DC 20515

# American ★ Furniture Manufacturers Association

OFFICE FOR GOVERNMENT AFFAIRS

918 16TH STREET NW SUITE 402  
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(202) 466 7362

March 14, 1988

The Honorable William J. Hughes  
Chairman  
Subcommittee on Crime  
Committee on the Judiciary  
U.S. House of Representatives  
Washington, DC 20515

Dear Mr. Chairman:

The American Furniture Manufacturers Association (AFMA) is concerned about several provisions of H.R. 3911 -- The Major Fraud Act of 1988. Many AFMA members, ranging from small to large business organizations, provide furniture products to the federal government.

We understand that proponents of H.R. 3911 believe the bill will increase the number of prosecutions for procurement fraud. There does not appear to be a lack of authority on the part of existing investigative agencies to undertake prosecutions in this area.

While, as indicated above, the furniture manufacturing industry is made up of differing sizes of organizations, of the approximately 4,000 furniture manufacturers in America, most are very small. With that in mind, AFMA is quite concerned about the lack of small business protection in H.R. 3911. At a minimum, changes should be made to remedy this problem.

H.R. 3911, while creating a new statutory crime, fails to define "knowingly," "value," and "substantial." AFMA believes definitions should be provided for these terms.

With regard to H.R. 3911's statute of limitations provision, AFMA sees no basis for creating such a 7-year period. AFMA believes that with a 5-year statute of limitations for other federal felonies, including bank fraud and racketeering, a 7-year period for contract fraud should be viewed as unusual at best.

One final disturbing provision in H.R. 3911 involves "whistleblowers." AFMA believes that the whistleblowers



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protection provision should contain language which would unquestionably deter disgruntled employees from providing false claims against employers.

AFMA would appreciate your making these comments a part of the record on H.R. 3911.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph G. Gerard". The signature is written in a cursive, flowing style.

Joseph G. Gerard  
Vice President

JGG/hw

## Contract Services Association



March 14, 1988

Mr. Edward O'Connell  
Subcommittee on Crime  
Committee on the Judiciary  
U.S. House of Representatives  
207 Cannon HOB  
Washington, D.C. 20515

Dear Mr. O'Connell:

The Contract Services Association of America (CSA) feels that it is essential to comment on H.R. 3911, the Major Fraud Act of 1988. Though CSA endorses efforts to prevent fraudulent behavior, the Association feels that certain provisions of H.R. 3911 are excessive and would negatively impact the Contract Services Industry. CSA praises the efforts of the U.S. Chamber of Commerce and supports their views to correct H.R. 3911's harmful provisions.


CSA is the major trade association exclusively representing those companies which provide technical and support services to federal, state, local and foreign governments. CSA serves as a forum and advocate for the entire range of issues of interest to the services industry.

Several provisions of H.R. 3911 could destroy the relationship between the public and private sector. Several provisions that CSA feels should be amended include: the "bounty" provision, the "whistleblower" provision, the provision imposing fines and penalties and the lack of self-governance utilization.

Enclosed is a more indepth description of CSA's concerns. Please include our comments in the official record.

CSA endorses every effort to correct fraudulent behavior. However, H.R. 3911 does not adequately address the needs of the industry. I urge you to consider these comments prior to acting on this legislation.

Sincerely,



Gary D. Engebretson  
Executive Director

## Contract Services Association



### CSA's Key Objections to H.R. 3911, the Major Fraud Act of 1988

1. The "bounty" and "whistleblower" provisions will undermine the employee/management relationship.

The "bounty" provision does not provide enough guidance as to who may furnish information and from what source. This language may actually encourage employees to disclose information that was derived from other than "original source". These sources could include the news media, legal hearings, reports by the federal government, public disclosure or audit or transaction. Provisions should exist to limit false claims against honest companies.

The "whistleblower" protection provision does not limit false claims or accusations against honest companies and individuals. No protection exists for the company from a possible past disgruntled employee. All burdens and risks are shifted to a company. The irrational fear of a disgruntled employee suddenly becomes real.

An employee, past or present, can make false claims and the company will find itself embroiled in legal and public relations' battles before the facts can be verified. H.R. 3911 should include the explicit statement "it is a crime to provide false, fictitious or fraudulent information for the purpose of obtaining payment by the government". Otherwise, false claims will overload the oversight system and diminish the objectives of the program.

2. The provision imposing fines and penalties is inconsistent with current statutes and the premise that the penalty should fit the crime.

By providing for fines for up to twice the value of the contract, the bill separates the severity of the punishment from the severity of the crime. Some small companies with a limited number of contracts would be at risk of going bankrupt if a penalty were imposed.

In the last four years several new laws have been enacted that would substantially increase penalties. There is no reason to create another layer of penalties before the new provisions have had the chance to take effect. The Subcommittee's work was based upon a review of past procurement fraud prosecutions but did not take into account the myriad of new statutes and penalties that have been enacted since 1984.

There is no existing evidence that suggests the current criminal and civil statutes are inadequate to prosecute, punish and deter procurement fraud. Further clarification and limits are required to ensure that this provision doesn't destroy private sector incentive to do business with the federal government. By no means should fraudulent behavior be condoned, but it is felt that the penalty should fit the crime.

Existing provisions such as the Civil and Criminal False Claims Acts, the Program Fraud Civil Remedies Act and the Anti-Kickback Enforcement Act of 1986 provide more than sufficient penalties to deter fraud. Therefore, these already enacted provisions should be studied to determine if further legislation is actually needed.

3. H.R. 3911 would extend the statute of limitation for procurement fraud beyond that for other types of fraud, without any demonstration of the need for a longer period. In addition, the bill does not take into consideration the benefits of self-governance.

The legislation unreasonably and unnecessarily extends from five to seven years the statute of limitations for prosecution of covered contract fraud. The provision would designate, without justification, a special class of fraud covered by federal statute.

An extension of the statute of limitations would result in poorer prosecutions. A defendant would have a harder time providing for its own defense as paper trails fade, memories grow older and witnesses become more difficult to locate.

Executive Branch witnesses at the December, 1987 Subcommittee hearing spoke of a need for additional investigative and prosecutorial officials in the executive branch. The ability to prosecute fraud cases is a budget problem not a statute of limitations problem. Lengthening the time is only a quick fix solution, backlogs will again develop and federal contractors will be left hanging for as long as seven years.

The federal government should utilize efforts to limit fraudulent behavior through the use of self-governance programs as endorsed by the Packard Commission and the Defense Contract Audit Agency. Self-governance can correct many problems and still provide the oversight and necessary incentive for contractors to act responsibly.

4. The goal of H.R. 3911 is to increase the number of prosecutions for procurement frauds. This premise is unfounded because the problems resulting from limited prosecutions has not been stated.

There is already existing evidence to show that Department of Defense and civilian agency investigations and referrals are increasing. In the past, successful criminal prosecutions have been limited, in a lot of cases, because there is simply insufficient evidence to support the burden of proof required for a criminal prosecution. Often, the federal government prefers to use its civil remedies under the False Claims Act or its administrative and contractual remedies, such as debarment.

The actual problem is not with contractor compliance but rather with the limited resources of the Department of Justice. A review of Department of Justice procedures and budget would be a more efficient solution than H.R. 3911 which is only a stopgap remedy.

MAR 14 1988

FINANCIAL EXECUTIVES  
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Washington, D.C. 20036  
(202)659-5700

March 11, 1988

The Honorable William J. Hughes  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Congressman Hughes:

The Committee on Government Business of the Financial Executives Institute would like to express its views on H.R. 3911, the Major Fraud Act of 1988. We respectfully request that these comments be submitted for the record on this issue.

The Financial Executives Institute (FEI) is a professional organization of individuals who are senior financial and administrative officers in business organizations throughout the United States. FEI has over 13,000 members, affiliated with 6,000 companies in virtually all segments of the economy, who represent a broad cross section of American business. The Committee on Government Business is authorized to formulate FEI statements and positions relative to existing or proposed legislation and regulation designed to mandate accounting principles, standards and practices, record-keeping and reporting, and other financial-related rules followed by industry in providing goods and services to the Federal Government.

In addition to the comments that have been made by the Chamber of Commerce we would like to draw your attention to the following points. As you are aware, Congress has most recently addressed the issue of procurement fraud by passing the False Claims Act, the Program Fraud Civil Penalties Act and the Anti-Kickback Enforcement Act of 1986. While we strongly believe that the presence or the appearance of fraud is detrimental to the government, to the general public and to the contractor, we believe that H.R. 3911 is unwarranted. In our view, all parties are better served by allowing time to assess the merits of the laws currently on the books rather than instituting new ones.

We also believe that H.R. 3911 as currently drafted contains major flaws. First, the language states that the "fine imposed may exceed the maximum otherwise provided by the law if such fine does not exceed twice the value of such contract or services, and the amount of the fraud is substantial in relation to the value of such contract or services." In our reading of the language, the term "substantial" is ambiguous.

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Second, we are concerned about the possibility of inequitable settlement pressures. As you know, many companies rely upon government contracts as a major source of business. To avoid suspension or debarment companies who have been indicted for fraud against the government make every effort to settle these cases. No company can risk a fine that equals or exceeds the value of all of the company's assets. We are concerned that under H.R. 3911, businesses could be adversely affected by mere allegations of fraud under contracts valued at millions, or even billions, of dollars. The threat of such large fines may in certain cases be enough to cause the defendant to forego a defense. In addition, reporting a pending judgment worth twice the amount of a large contract may provide an unnecessary risk to the company and its stockholders.

While we can appreciate the Committee's interest in creating an environment in which there are significant deterrants to committing fraud, we would urge you to review the existing laws.

We would be pleased to answer any questions you may have.

Sincerely,



Arthur H. Lowell  
Chairman, Committee on Government Business

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