Costs of
Mandatory Ethics and Compliance Programs

by

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21 January 2009

I. Introduction.

Many large aerospace and defense contractors have a robust compliance program, including published standards of conduct, a system of internal controls, ethics officials, a hotline, employee and manager training, and policies and procedures to assist in compliantly running their business. They do so because compliantly performing their contracts and running their business is the right thing to do and because it saves them money.

The typical aerospace and defense contractors' corporate ethics program existed long before the promulgation of Federal Acquisition Regulation ("FAR") 52.203-13, Contractor Code of Business Ethics and Conduct. The currently robust compliance programs of many contractors date back to the mid 1980s when they faced considerable legal challenges, often including corporate indictments, suspension and debarment from government contracting, fraud investigations and extensive litigation. For example, one unnamed corporation, including all subsidiaries, was suspended from government contracting for a period of time. Although, the indictments were ultimately voluntarily dismissed by the U.S. Attorney, a new Chief Executive Office ("CEO") took a series of actions and implemented business practices that had the practical result of significantly reducing the number and seriousness of allegations against that particular corporation. Such experiences were not unique. From the mid 1980's to the early 1990's, many large aerospace and defense companies found themselves facing criminal and civil false claims allegations. However, after a rapid increase in such claims in the late 1980's, the U.S. Department of Justice ("DOJ") has seen a general decrease in the number of new matters for aerospace and defense companies.

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[1] The opinions expressed in the paper are those of the authors alone. They should not be attributed to the General Dynamics Corporation or any of its subsidiary companies or the Kenrich Group LLC.
[2] Ibid.

This paper will discuss mandatory ethics and compliance programs and the costs a large company confronts in operating an ethics and compliance program. It will compare the costs of a compliance program to the costs that can be incurred when a company encounters serious compliance problems.[3]

II. Mandatory Ethics and Compliance Programs.

Over the past few years, Congress and the Executive Branch of the U.S. Government have implemented requirements for mandatory ethics and compliance programs, as opposed to the voluntary programs initiated previously. The first set of requirements are those included in FAR 52.203-13. The second set of requirements are those that were recently enacted as part of the FY 2009 Defense Authorization Act.

A. FAR 52.203-13, Contractor Code of Business Ethics and Conduct

The FAR requirements for a mandatory ethics compliance program were initiated by the FAR Council's publication of a proposed rule in February 2007, which resulted in a mandatory FAR clause in December 2007. The addition of a disclosure program originated in a request from the DOJ in May 2007.[4] The DOJ recommended including a mandatory disclosure requirement because it believed that government contractors, as a group, were not providing notice to the government of suspected fraud. The DOJ cited with approval a similar clause used on National Reconnaissance Organization contracts. Although not stated, DOJ may have been concerned with the decrease in the number of civil and criminal fraud cases involving large government contractors. The DOJ also cited mandatory disclosure requirements applicable to other industries.

The FAR Council promulgated a draft clause and, after extensive public comments, a revised FAR 52.203-13 was effective on the December 12, 2008. Some of the requirements of FAR 52.203-13 apply to all contractors with prime or subcontracts over a dollar amount; some apply to large, non-commercial businesses. Most of the requirements for a business ethics and compliance program overlap with those required by the Sarbanes-Oxley Act of 2002, or are recommended in the U.S. Sentencing Guidelines.

1. Who Is Covered? The new requirements do not apply to all contractors. FAR 52.203-13 applies to prime contracts expected to exceed $5,000,000, and that have an expected period of performance of over 120 days. The requirement does not apply to short term contracts, or to

[3] The focus of this paper is compliance with government contract regulations such as the FAR and agency supplements and not Generally Accepted Accounting Principles, Sarbanes-Oxley, Environmental laws and regulation or other laws and regulations.

[4] See Attachment A for DOJ comments on FAR Case 2006-007, dated May 23, 2007.

contracts that are below the $5,000,000 threshold. All of the largest Department of Defense ("DOD") prime contractors will fall within this threshold. It should also cover many small businesses and many commercial companies with substantial volumes of federal sales. FAR 52.203-13 also contains a requirement to flow down the clause to subcontracts exceeding $5,000,000, and with an expected period of performance exceeding 120 days.

2. What Does FAR 52.203-13 require? The new version of the clause requires several things. If the contractor does not already do so, it must do the following within 30 days:

- Implement a written code of conduct,
- Provide the code of conduct to each employee performing the contract or subcontract,
- Exercise due diligence to detect and prevent criminal conduct, and
- Begin timely, mandatory disclosure of certain conduct.

Additionally, within 90 days of award, a contractor, unless exempt as described below, must:

- Implement a training program in ethics and compliance, and
- Implement a system of internal controls.

3. Who Is Excluded? FAR 52.203-13(c) exempts certain contractors, otherwise covered by the FAR clause from having to implement a business ethics and compliance program, and an internal control system. The exempt contractors are:

- Small Businesses, and
- Vendors supplying commercial items.

This exemption applies only to those programs likely to prevent ethics and compliance problems. It does not exempt small businesses from having to prevent such conduct, or from reporting it to the government when they find it. The wisdom of taking advantage of this exemption is further discussed below.

B. Personal Conflicts of Interest by Contractor Employees.

A new set of ethics and compliance requirements are on the horizon for government contractor employees. The Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Public Law No. 110-417, Section 841, directs the executive branch to implement regulations requiring some government contractors to monitor financial conflicts of interest of contractor employees

supporting the Government.[5] Over the next few months, we can expect publication of draft and final regulations implementing this statute.

This new requirement will apply to government support contractors performing acquisition functions closely associated with inherently governmental functions (including the development, award, and administration of Government contracts). The new system must include the following:

- identification and prevention of personal conflicts of interest for employees of the contractors who are performing such functions;
- prohibiting contractor employees who have access to non-public government information obtained while performing such functions from using such information for personal gain;
- reporting any personal conflict-of-interest violation by such an employee to the applicable contracting officer or contracting officer's representative as soon as it is identified;
- maintaining effective oversight to verify compliance with personal conflict-of-interest safeguards;
- procedures to screen for potential conflicts of interest for all employees performing such functions; and
- procedures for appropriate disciplinary action in the case of employees who fail to comply with the above policies.

Currently, there is no widespread practice for detailed monitoring of personal conflicts of interest for contractor employees. Some agencies have implemented a requirement for such monitoring by their support contractors. Some contractors have implemented such controls to a greater or lesser degree as corporate policy, or as part of Organization Conflict of Interest ("OCI") mitigation plans. This new requirement should expand these practices and increase their uniformity.

It is difficult to estimate the impact of complying with these new requirements in advance of the implementing regulations.

III. Costs of Compliance Programs.

A corporate compliance and ethics program conforming to the requirements of FAR 52.203-13 contains a number of elements:

- A code of business ethics and conduct,
- A process for exercising due diligence to prevent and detect criminal conduct,
- A process to promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law,

[5] See Attachment B for the Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Public Law No. 110-417, Section 841.

- A process for timely reporting many crimes and false claims to the Inspectors General ("IG") and contracting officer,
- An ongoing business ethics awareness and compliance program, including employee training and internal communications, and
- An internal control system.

Most, if not all, large defense contractors today would say they already have an ethics program substantially conforming to the requirements of FAR 52.203-13. Indeed, given: 1) the considerable enforcement effort devoted to white collar crime during the past few years, 2) the U.S. Sentencing Guidelines, and 3) the Department of Justice's position on the conduct it expects from law abiding businesses, a robust ethics and compliance program is more than prudent, it is essential to survive as a corporation. Such programs, however, do not come cheaply.

A. Affected Contractor Functions and Activities

Although virtually all departments or functions within a government contractor are affected by its compliance efforts, shown below is a listing of the groups within a typical government contractor that are most affected by compliance efforts. For a commercial company, this listing indicates those functions or departments that a typical commercial company may have to add in order to effectively comply with government contract regulations.[6]

1. Proposal Preparation and Contract Administration including cost and pricing data, estimating manual, review and approvals, proposal updates, certifications, "sweeps", billing and status reports, contract modifications and subcontractor management.

2. Government Systems Assessments including estimating, purchasing / procurement, accounting, timekeeping and billing.

3. Regulatory Requirements including cost accounting standards, FAR, agency supplements, contract terms and conditions and wage determinations.

4. Audit Issues (e.g., Defense Contract Audit Agency) including audit preparation, forward pricing rates, incurred cost submissions, project accounting, floorchecks and audit resolution.

5. Indirect Rate Structure including allocation methodology, pool and base composition, intermediate / usage charges, direct and indirect classification and unallowable costs.

[6] Attachment C includes a more extensive and detailed listing of compliance areas for a government contractor.

B. Workforce Training Costs.

Probably the largest single compliance cost a corporation incurs is training costs. The largest aerospace and defense companies have nearly 100,000 employees. While the ethics and compliance training each employee receives varies from employee to employee, and from company to company, the costs of providing that training are substantial. A rough order of magnitude of the labor cost of providing one hour of training to every corporate employee at the largest aerospace and defense companies can exceed $5 million. A typical aerospace and defense employee receives several hours of training each year on ethics and compliance with government contract requirements. The time devoted to training significantly exceeds the minimum required ethics training for U.S. Government employees. Typical topics include ethics, import/export, foreign corrupt practices, security and conflicts of interest, as well as other topics.

New employees receive significantly more training at the beginning of their employment to familiarize them with the systems and processes of the business. Typically large aerospace and defense contractors provide, training on topics such as time charging and corporate standards of conduct are a part of new employee orientation programs. Assuming a one day orientation program for new hires, and a turnover rated of 5%, a large corporation can incur several million dollars in labor costs for the training of new employees each year.

Thus, for a large business, the labor costs for ethics and compliance training of employees can easily run into the tens of millions of dollars annually. This fact is not encouraging to many commercial entities who view government contracting as an expensive and risky customer with which to do business.

C. Compliance Organizations.

A second major cost for government contractors is operating their compliance and internal controls organization. These organizations serve two different functions although they may be combined into a single organization. The internal controls organization, whether staffed by in-house employees, outside auditors, or some combination thereof, performs internal audits and reviews for Sarbanes-Oxley disclosures, effectiveness of internal controls, areas of management interest, and compliance with external and internal policies. Ethics and Compliance Organizations provide employee training, investigate reports from employees and third parties, and support implementation of new policies and procedures. There is no uniform industry practice for organizing the ethics / compliance, and the internal controls functions. These functions may be consolidated in a single organization, or may be allocated between multiple organizations, such as the Law Department, Finance, Internal Controls, or Ethics and Compliance.

The internal control framework of many publically-traded government contractors will include the following:

1. Accounting Controls including controls over financial reporting, revenue recognition, procurement, payroll, treasury, fixed assets, inventory and information technology;

2. Control Environment including Corporate Compliance Programs (e.g., code of conduct, hotline, oversight, disciplinary actions), monitoring (e.g., policies, procedures and work instructions, self audits and reviews), information and communications (e.g., disclosure controls, training, reporting to management and Board); and

3. Government Contracting controls including estimating and pricing system, government systems assessments, compliance with cost accounting standards and the FAR, government accounting controls, cost limitations and unallowable costs and indirect rate development.

For a large, publicly traded company, a robust internal controls organization has been a requirement for doing business, as well as a prudent management practice. The recent additions to our contractual requirements for ethics and internal controls embodied in FAR 52.203-13(c) have only a modest cost impact given the pre-existing legal and management requirements. The incremental cost is associated with implementing the new reporting requirements.

Interestingly, FAR 52.203-13(c) excludes vendors selling commercial items, and small businesses from the requirement for an internal controls systems. A review of the public releases of the Department of Justice's National Procurement Fraud Task Force suggests that the reason for excluding these two groups is something other than their record for problematic conduct[7]. Given the widespread adoption of ethics, compliance and internal controls by large businesses, one wonders why a small business or commercial company large enough to perform a $5,000,000 contract would not equally benefit from a similar capability.

The number of employees devoted to ethics and compliance is difficult to estimate because every company employee is typically charged with conducting its business in an ethical and compliant manner. Also, it is difficult to distinguish between a finance department employee who works on indirect cost rate proposals, and one who monitors unallowable costs. However, some employees are assigned to compliance and internal control functions full time. For example, at a typical aerospace and defense business of approximately 10,000 employees, it would not be unusual to find 10-20 employees devoted full time to ethics, compliance, and internal controls. The direct and allocated costs of maintaining compliance and ethics organizations are significant, and range in the millions of dollars.

[7] Information on the DOJ's National Procurement Fraud Task Force can be found at http://www.usdoj.gov/criminal/npftf/

D. Training Development Costs.

A third category of significant costs are those for development of the training materials for ethics and compliance. Some defense businesses acquire some or all of their materials from commercial sources. Others develop materials in house in order to tailor the presentations to the contractor's business, and to address specific issues. Many use some combination of the two. Whether outsourced, or internally developed, training can present a significant non-recurring cost to develop or acquire a complete training program. Maintaining the training modules imposes a recurring cost that fluctuates with the volume of changes in the relevant laws and regulations. Fortunately, the rate of change in the substantive requirements has slowed significantly from the late 1980's and early 1990's. Thus the recurring maintenance costs have come down.

While the costs vary significantly, acquiring, developing, and maintaining a comprehensive training program can require tens of thousands of dollars a year.

E. Reporting and Disclosure Systems.

Another area where a large aerospace and defense contractor may incur additional compliance related costs are in the implementation of a system to comply with the new disclosure requirements. All contractors which receive contracts over $5,000,000, and all contractors desiring to avoid suspension and debarment from government contracting, must implement a system to identify and report certain conduct to the contracting officer and the agency IG. This includes both future conduct and past conduct. Because not all conduct must be reported, and because the threshold for what must be reported hinges on the existence of "credible evidence", the reporting system should include a review mechanism for all issues raised by employees to see if the issue triggers a mandatory reporting requirement.

The foreseeable additional costs for a large defense contractor caused by the new mandatory reporting requirements have two causes. First, are the additional costs of reviewing incidents to see if such incidents are reportable? This means that if a party raises a concern, the contractor must investigate the concern, evaluate the facts discovered to determine whether the facts represent "credible evidence" of criminal fraud, conflicts of interest, civil false claims, overpayments, or other allegation of a reportable offence. The amount of additional internal investigations these new rules will trigger remains to be seen.

Second, if the contractor reports credible evidence of a covered event to the IG, then it must cooperate in the government's own investigation. Government investigations are often long and drawn out, are marked by requests for large numbers of documents and witness interviews. In fact, some believe that the costs of an investigation into non-culpable conduct far outweigh the costs of cooperating with an investigation of actual wrongdoing (e.g., attempts to prove the absence of illegal activity can be much more time-consuming than investigating known illegal activity with more limited boundaries).

Absent actual experience with the new reporting regime, the costs anticipated for the new reporting requirement are speculative. If you believe that the industry has largely "cleaned up its act" since the 1980s, then you will probably conclude the cost of complying with these regulations will be low, as will the reports accompanied by "credible evidence". If you instead believe that industry is ripe with undetected fraud, then you will probably also conclude that the costs incurred by company's supporting the new reporting requirement will be considerable. A middle approach is that the costs incurred by industry will increase since incidents that previously may have been resolved with the contracting officer, with relatively low transactional costs, will now be much more costly with the involvement of the IG.

IV. Costs of Compliance Problems.

As we have discussed in the previous section, the costs of maintaining a comprehensive program of ethics, compliance and internal audit are not trivial. Why then did many companies set up comprehensive programs long before such measures were required, and why did they maintain them for so long once they were set up?

The answer is simple. The costs of compliance problems far outweigh the costs of an effective compliance program. In a case arising in the 1980's, an unnamed contractor unsuccessfully tried to recover more than $20,000,000 in attorney's fees that were incurred in defending against Government proceedings. Those were the costs incurred where the contractor was not culpable. Accounting for inflation, a large aerospace and defense contractor could easily exceed that amount on a similar, significant matter. Where the contractor concludes it may have some risk of liability and settles, the cost of the settlement, considering damages multipliers and statutory penalties, is added to the costs of defense. For example, a small defense contractor recently settled a civil false claims case of over charging the government for slightly under $1,000,000, after considering the multiplier. It is reasonable to estimate that the defense costs incurred by the contractor prior to the settlement were of equivalent size, or greater, for a rough order of magnitude of $2,000,000. If a small contractor is able to avoid one such incident per year by implementing a $2,000,000 ethics, training, and internal controls program, then the company will be better off financially.

Investigations of government contractors typically must mirror the very complex business operations of the company being investigated. A listing of examples of false claims alleged and issues sometimes investigated is included at Attachment D. A review of this attachment will reinforce the highly complex nature of many issues investigated. It is not uncommon for investigations of government contractors to include subpoenas or other orders not to discard documents or electronic information covering large portions of the company's business over long periods of time. These requests often specify that any and all documents (electronic or otherwise) that relate to relatively broad topics or types of document (e.g., any and all accounting documents covering 2000 to 2008) be retained, copied and provided. If on paper, this can often constitute literally truckloads of documents. It is often necessary for the company being investigated to organize a team of company personnel, outside counsel and consultants with special accounting, electronic retrieval or subject matter expertise to investigate finance, accounting and other regulatory issues. The complexity of issues investigated can be multiplied by when attempting to ascertain the truth or falsity of allegations relating to a recently acquired company or a company located in another country with different public accounting laws and regulations and, sometimes more importantly, different customs.

The cost-saving benefits of a robust ethics, compliance and training program are even more obvious for a large contractor. Last year, the largest defense contractor false claims settlement was over $50,000,000[8]. A contractor could run a very effective program for years for less money than was paid to the government and the company's own attorneys and consultants.

V. Conclusion.

Ethics and compliance programs that are robust enough to prevent violations of those laws and regulations unique to government contracts are costly. The annual costs can run to the tens of millions for a large company. For a contractor that has significant cost type contracts, the fact that the costs are allowable reduces the burden. For commercial companies, and companies with competitively awarded fixed price contracts, the burdens are real. The financial burden and the corporate culture necessary to comply with these requirements are two of the factors that have prompted commercial companies to shy away from government business. They also account for the relative lack of success of traditional government contractors in commercial markets.

As burdensome as they are, the costs to a government contractor of not implementing a robust ethics and compliance program are significantly greater. The costs of internal investigations, cooperating with external investigators,

[8] Attachment E includes the DOJ press release dated 10 November 2008 – "More Than $1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008, More Than $21 Billion Recovered Since 1986".

defending litigation, and settling cases are often much more costly than preventing ethics and compliance problems through training, process, and culture.

Weighing the two sets of costs, a manager, whether of a large business, a small business, or a commercial company would be extremely short sighted to avoid implementing a robust ethics and compliance program when selling to the government. Not only is it the right thing to do, it is a smart thing to do.

List of Attachments

Attachment A -- U.S. Department of Justice comments on FAR Case 2006-007, dated May 23, 2007

Attachment B -- Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Public Law No. 110-417, Section 841

Attachment C -- Checklist of Compliance Areas for a Government Contractor

Attachment D -- Examples of False Claims Alleged

Attachment E -- U.S. Department of Justice press release dated 10 November 2008 – "More Than $1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008, More Than $21 Billion Recovered Since 1986"

Attachment A

U.S. Department of Justice comments on FAR Case 2006-007, dated May 23, 2007

U.S. Department of Justice

Criminal Division

Assistant Attorney General *Washington, D.C. 20530*

May 23, 2007

General Services Administration
Regulatory Secretariat
1800 F Street, NW, Room 4035
Attn: Ms. Laurieann Duarte
Washington, DC 20405

Re: Comments on FAR Case 2006-007

Dear Ms. Duarte:

Thank you for the opportunity to comment on FAR Case 2006-007, Contractor Code of Ethics and Business Conduct. First, I wanted to commend your agency for proposing a rule intended to establish a clear and consistent policy regarding "contractor code of ethics and business conduct." Since October 2006, I have chaired the Department's National Procurement Fraud Task Force, which includes many Inspectors General and U.S. Attorneys, and the Deputy Administrator of OMB, among others. One of our objectives is to enlist the support of the contracting community to reform its practices, and this proposed rule advances that discussion.

The only specific comment the Department of Justice has is that the proposed rule could provide more detail on what is required in the "written code of ethics and business conduct" by specifically referencing the U.S. Sentencing Guidelines ("Sentencing Guidelines"). Since 1991, the Sentencing Guidelines, in one form or another, have prescribed what the Sentencing Commission believes represents an "Effective Compliance and Ethics Program," currently found in Section 8B2.1.

There are several advantages to referencing the Sentencing Guidelines formula in this proposed rule. First, in this area of corporate compliance, it could be confusing if it appeared that the FAR was setting a different standard than the Sentencing Commission and the federal courts, which implement the Guidelines. Second, the Sentencing Guidelines are subject to routine reexamination and revision by both the Sentencing Commission after substantial study and public comment, and the federal courts in specific cases, allowing for adjustments to this proposed rule without having to open a new FAR case. Therefore, we believe that the Guidelines should serve as the baseline standard for a contractor's code of ethics and business conduct. By referencing the Guidelines, we would be able to ensure that the federal government speaks with one voice on corporate compliance.

Thank you for this opportunity to comment. If you have any questions, please contact

Steve Linick at (202) 353-1630, who serves as the Director of the National Procurement Fraud Task Force.

Sincerely,

Alice S. Fisher
Assistant Attorney General
Criminal Division, Department of Justice

cc: Robert Burton
Deputy Administrator, OMB

Attachment B

Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Public Law No. 110-417, Section 841

SEC. 841. PERFORMANCE BY PRIVATE SECURITY CONTRACTORS OF INHERENTLY GOVERNMENTAL FUNCTIONS IN AN AREA OF COMBAT OPERATIONS.

(a) Modification of Regulations- Not later than 60 days after the date of the enactment of this Act, the regulations issued by the Secretary of Defense pursuant to section 862(a) of the National Defense Authorization Act for Fiscal Year 2008 (Public Law 110-181; 122 Stat. 254; 10 U.S.C. 2302 note) shall be modified to ensure that private security contractors are not authorized to perform inherently governmental functions in an area of combat operations.

(b) Elements- The modification of regulations pursuant to subsection (a) shall provide, at a minimum, each of the following:

(1) That security operations for the protection of resources (including people, information, equipment, and supplies) in uncontrolled or unpredictable high threat environments are inherently governmental functions if such security operations--

(A) will be performed in highly hazardous public areas where the risks are uncertain and could reasonably be expected to require deadly force that is more likely to be initiated by personnel performing such security operations than by others; or

(B) could reasonably be expected to require immediate discretionary decisions on the appropriate course of action or the acceptable level of risk (such as judgments on the appropriate level of force, acceptable level of collateral damage, and whether the target is friend or foe), the outcome of which could significantly affect the life, liberty, or property of private persons or the international relations of the United States.

(2) That the agency awarding the contract has appropriate mechanisms in place to ensure that private security contractors operate in a manner consistent with the regulations issued by the Secretary of Defense pursuant to such section 862(a), as modified pursuant to this section.

(c) Periodic Review of Performance of Functions-

(1) IN GENERAL- The Secretary of Defense shall, in coordination with the heads of other appropriate agencies, periodically review the performance of private security functions in areas of combat operations to ensure that such functions are authorized and performed in a manner consistent with the requirements of this section.

(2) REPORTS- Not later than June 1 of each of 2009, 2010, and 2011, the Secretary shall submit to the congressional defense committees a report on the results of the most recent review conducted under paragraph (1).

Attachment C

Checklist of Compliance Areas for a Government Contractor

Attachment C -- Checklist of Compliance Areas for a Government Contractor

1. CORPORATE CODE OF ETHICS/PROCEDURES & POLICIES.
    a. Gift Giving Restrictions.
    b. Conflicts of Interest.
        (1) Organizational.
        (2) Personal.
2. COST & ACCOUNTING REQUIREMENTS.
    a. Cost Allowability.
        (1) Truth in Negotiations Act.
        (2) FAR Cost Principles.
        (3) Overtime Authorization.
        (4) Limits on Executive Compensation.
    b. Cost Accounting Standards.
        (1) CAS Disclosure Statement (Modified/Full).
        (2) CAS Compliant Accounting Procedures.
    c. Time Charging.
    d. Billing System/Progress Payments.
    e. Indirect & Other Direct Cost Allocations.
    f. Estimating System.

Attachment C -- Checklist of Compliance Areas for a Government Contractor (Continued)

3. MATERIAL MANAGEMENT & ACCOUNTING SYSTEM.
    a. System Description.
    b. Material Requirements/Product Substitution.
    c. System Monitoring.
    d. Audit Trail.
    e. Physical Inventories.
    f. Material Transfers.
    g. Costing of Material Transactions.
    h. Inventory Allocations.
    i. Commingled Inventories.
    j. Internal Audits.
4. GENERAL ELECTRONIC DATA PROCESSING SYSTEM.
5. BUDGET & PLANNING SYSTEM.
6. QUALITY ASSURANCE REQUIREMENTS.
    a. Types of Quality Assurance.
    b. Reliance on Contractor's Inspection.
    c. Higher-level Quality Assurance (e.g., ISO 9001, 9002, 9003).
    d. Record-keeping.
    e. Audits.
7. SOCIO-ECONOMIC OBLIGATIONS & REPORTING REQUIREMENTS.
    a. Equal Opportunity.
    b. Affirmative Action Requirements/Written Affirmative Action Program.
    c. Anti-Kickback Program/Policy.

Attachment C -- Checklist of Compliance Areas for a Government Contractor (Continued)

8. DRUG FREE WORKPLACE OBLIGATIONS, TESTING & REPORTING REQUIREMENTS.

9. COMPLIANCE WITH LABOR LAWS & REPORTING REQUIREMENTS.

    a. Walsh-Healey Act.

    b. Service Contract Act.

10. ENVIRONMENTAL COMPLIANCE.*

11. OCCUPATIONAL SAFETY & HEALTH COMPLIANCE.*

12. PURCHASING SYSTEM POLICIES & PROCEDURES.

    a. Small Business Subcontracting Plan.

    b. Major Subcontractors.

    c. Suppliers.

13. PROTECTION OF PROPRIETARY DATA.

    a. Bid and Proposal Information.

    b. Intellectual Property.

    c. Confidentiality Agreement Procedure.

14. DOMESTIC AND FOREIGN PRODUCT PREFERENCES.

    a. Buy American Act.

    b. Trade Agreements Act.

    c. Export Restrictions.

    d. Foreign Corrupt Practices Act.

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* Facilities are presumed to be in compliance with applicable Environmental and Occupational Safety & Health laws and regulations. There are no significant additional requirements that arise from doing Government Contracts work.

Attachment C -- Checklist of Compliance Areas for a Government Contractor (Continued)

15. ISSUES CONCERNING OFFENSES AND PENALTIES.

    a. Contract Remedies.

    b. Administrative Remedies.

        (1) Suspension

        (2) Debarment

    c. Civil Penalties (Civil False Claims Act and Qui Tam Actions).

    d. Criminal Penalties (Criminal False Claims, Criminal Fraud).

16. FACILITY SECURITY CLEARANCE SYSTEM.

17. FOREIGN MILITARY SALES ISSUES.

Attachment D

Examples of False Claims Alleged

Attachment D -- Examples of False Claims Alleged

- Mischarging Labor
- Defective Pricing and Providing False Estimates
- Charging Commercial Costs to Government Contracts
- Overstating Claims and Requests for Equitable Adjustment
- Billing for Expressly Unallowable Costs
- Failing to Perform in Accordance with Contract Requirements
- Premature Progress Billings or Advance Billings
- Misstating Progress Reporting (e.g., Estimates at Completion)
- Failure to Follow Disclosed Accounting Practices
- Performing and Charging for Unauthorized Work
- Performing Deficient Work
- Use of Residual Inventory without Providing Credit to the Agency
- Understating Credits for Deleted Work
- Overstating Equipment Charges and Rental Rates
- Double Billing for the Same Work
- Submitting Invoices for Work not Performed
- Falsifying of Timecard Hours
- Overstating of Labor Hours
- Overstating of Labor Wage Rates
- Mischarging Fixed Price Work to Cost-Type Contracts
- Substitution of Cheaper/Substandard Materials or Equipment
- Overstating Overhead Rates
- Forging or Altering Third Party Invoices
- Advance Billing of Travel Expenses
- Environmental Non-Compliance
- Falsifying Original Bid Information
- Intentional Underbidding
- Falsely Representing Planned Performance of Work or Planned Rates

Attachment D -- Examples of False Claims Alleged (Continued)

- Claiming Crews and Equipment that were not Delayed
- Front Loading of Bids or Schedule of Values
- Improperly Claiming Feasibility of Design and Construction
- Falsely Disclosing Accounting Practices
- Charging Sale Leaseback Rental Costs
- Falsely Classifying Workers
- Prevailing Wage Rate Violations
- Building Uninhabitable Military Housing
- Falsifying Quality Control or Inspection Reports
- Misrepresenting Small Business Status
- Advance Billing of Subcontractor Costs
- Violating Minority Business Enterprise (MBE) and Disadvantaged Business Enterprise (DBE) Participation Requirements
- Inflating Disadvantaged Business Participation Figures
- Violating Subcontractor Listing or Licensing Requirements
- Improperly Substituting Subcontractors
- Passing Through Fraudulent Costs of Subcontractors
- Violating Buy America Requirements
- Falsifying Safety Reports
- Proposing “A” Team, but Using “B” Team

Note: The Purpose of this list is not to conclude that these items are or are not false claims, rather the list is intended to demonstrate the broad nature of false claims allegations.

Attachment E

U.S. Department of Justice press release dated 10 November 2008 – "More Than $1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008, More Than $21 Billion Recovered Since 1986"

Department of Justice

FOR IMMEDIATE RELEASE
Monday, November 10, 2008
WWW.USDOJ.GOV

CIV
(202) 514-2007
TDD (202) 514-1888

More Than $1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008

More Than $21 Billion Recovered Since 1986

WASHINGTON – The United States secured $1.34 billion in settlements and judgments in the fiscal year ending Sept. 30, 2008, pursuing allegations of fraud against the federal government, the Justice Department announced today. This brings total recoveries since 1986, when Congress substantially strengthened the civil False Claims Act, to more than $21 billion.

"Now, more than ever, it is crucial that taxpayer dollars aren't lost to fraud," said Gregory G. Katsas, Assistant Attorney General for the Department's Civil Division. "The billion dollars collected this year is only part of the story. By rooting out fraud and vigorously pursuing it, the Department, with the help of concerned citizens who report fraud in hotline calls and in *qui tam* complaints, undoubtedly saves the country many times that amount in aborted schemes and misconduct."

Assistant Attorney General Katsas also paid tribute to Senator Charles Grassley of Iowa and Representative Howard L. Berman of California who sponsored the 1986 amendments to the False Claims Act, the government's primary weapon to fight government fraud. "Without this important legislation strengthening the Act and, in particular, the *qui tam* provisions which encourage private citizens to uncover government fraud, such recoveries would not have been possible."

Almost 78 percent of this year's recoveries are associated with suits initiated by private citizens (known as "relators") under the False Claims Act's *qui tam* provisions. These provisions authorize relators to file suit on behalf of the United States against those who have falsely or fraudulently claimed federal funds. Such cases run the gamut of federally funded programs from Medicare and Medicaid to defense procurement contracts, disaster assistance loans and agricultural subsidies. Persons who knowingly make false claims for federal funds are liable for three times the government's loss plus a civil penalty of $5,500 to $11,000 for each claim.

Relators recover 15 to 25 percent of the proceeds of a successful suit if the United States intervenes in the *qui tam* action, and up to 30 percent if the government declines and the relator pursues the action alone. In fiscal year 2008, relators were awarded $198 million. (This figure does not include relator shares awarded after Sept. 30, 2008.)

As in the last several years, health care accounted for the lion's share of fraud settlements and judgments–$1.12 billion. This number includes both *qui tam* claims and those initiated by the United States. The Department of Health and Human Services reaped the biggest recoveries, largely attributable to its Medicare program and the federal/state Medicaid program which funds health care for the needy. Recoveries were also made by the Office of Personnel Management which administers the Federal Employees Health Benefits Program, the Department of Defense for its TRICARE insurance program, the Department of Veterans Affairs and others.

The largest health care recoveries came from pharmaceutical companies and related entities. Settlements with Cephalon Inc., Merck & Co. and CVS Caremark Corp. accounted for more than $640 million. In addition to federal recoveries, these pharmaceutical fraud cases returned $430 million to state

Medicaid programs.

The Civil Division's investigation of the pharmaceutical industry is part of a Department-wide effort. Typical allegations include "off-label" marketing, which is the illegal promotion of drugs or devices that are billed to Medicare and other federal health care programs, for uses that were neither found safe and effective by the Food and Drug Administration nor supported by the medical literature; paying kickbacks to physicians, wholesalers and pharmacies to induce drug or device purchases; establishing inflated drug prices knowing that federal health care programs use these prices to reimburse providers, then marketing the "spread" between the federal reimbursement and the provider's lower cost to induce drug purchases; and knowingly failing to report the company's true "best price" for a drug to reduce rebates owed to the Medicaid program.

The Department also collected $133 million in defense procurement fraud. Defense contract recoveries included a $53 million settlement with Pratt & Whitney, a division of United Technologies Corporation, and PCC Airfoils LLC, a subsidiary of Precision Castparts Corporation. The settlement resolved allegations that Pratt & Whitney and PCC Airfoils knowingly submitted false claims to the Air Force for defective turbine blades sold to the government to retrofit the F100-PW-220 engines in F-16 and F-15 aircraft. This case was pursued as part of a National Procurement Fraud initiative, launched in October 2006, to promote the early detection, identification, prevention and prosecution of procurement fraud.

FACT SHEET: SIGNIFICANT RECOVERIES IN FISCAL YEAR 2008

Among the Department's most significant settlements and judgments in fiscal year 2008 were:

- $361.5 million from Merck & Company to resolve allegations that the pharmaceutical manufacturer knowingly failed to pay proper rebates to Medicaid and other government health care programs, and paid kickbacks to health care providers to induce them to prescribe the company's products. The settlement resulted from two lawsuits brought under the *qui tam* provisions of the False Claims Act. In the first, which accounted for $221.9 million of the $361.5 settlement, a former Merck employee alleged that the company violated the Medicaid Rebate Statute by providing deep discounts to hospitals that used its drugs Zocor and Vioxx in place of competitors' brands, without reporting those discounts and other cost information to reflect its "best price," as required by the statute to ensure that Medicaid obtains the benefit of the same price concessions other purchasers enjoy. This suit also alleged that Merck paid kickbacks to physicians, disguised as fees for training, consultation, and market research, to induce them to prescribe its drugs, also contrary to law. The United States paid the relator $46.6 million as his share of the settlement under the False Claims Act's *qui tam* provisions. In addition to the federal recovery, Merck paid $162 million to state Medicaid programs.

  In the second lawsuit, which accounted for the remaining $139.6 million of the settlement, a physician alleged that Merck provided deep discounts to hospitals to induce them to administer its antacid, Pepcid, as a means to boost sales through continued use after the patient's discharge. The suit went on to allege, similar to the first suit, that Merck knowingly failed to report these discounts as required by the Medicaid Rebate Statute, which resulted in illegal and inflated claims to federal and state Medicaid programs. In addition to paying the United States $139.5 million in federal claims, Merck paid $114 million to settle state Medicaid claims. The relator received $24 million as his federal share of the settlement and an additional sum for the state recoveries. Merck also entered into a Corporate Integrity Agreement with the Inspector General of the Department of Health and Human Services (HHS) to ensure compliance with federal health insurance programs in the future.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/February/08_civ_094.html

  http://www.usdoj.gov/usao/pae/News/Pr/2008/feb/steinkrelease.pdf

- $258 million from Cephalon Inc. to resolve claims that the company marketed three drugs for uses not approved by the Food and Drug Administration (FDA). By promoting the drugs for so-called "off label" uses, Cephalon caused providers to charge federal health insurance programs such as Medicare, Medicaid, TRICARE and the Federal Employees Health Benefits Program for unapproved uses of the drugs not covered by the programs. The settlement resolved four lawsuits, three of which were brought by former Cephalon sales representatives under the *qui tam* provisions of the False Claims Act. Consistent with those provisions, the relators who filed the suits will share $46.7 million as their part of the settlement. In addition to the $258 million recovered for federal programs, the United States recovered $116 million for the Medicaid programs in 14 states and the District of Columbia. Cephalon also pleaded guilty to related criminal charges, paid $50 million in fines and forfeitures and entered into a five-year Corporate Integrity Agreement with the Inspector General of HHS to ensure strict compliance in the future.
  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/September/08-civ-860.html

- $225 million from Amerigroup Corporation to settle both federal and state allegations that Amerigroup, together with its Illinois subsidiary, systematically avoided enrolling pregnant women and other high-cost patients in the company's managed care program in Illinois. The program was funded by Medicaid, which required open enrollment to all eligible beneficiaries. By excluding pregnant women and other high-cost patients, Amerigroup increased its profits in conflict with the law. The United States and Illinois jointly brought suit under the federal False Claims Act and the Illinois Whistleblower Reward and Protection Act. In October 2006, following a lengthy trial, the court entered judgment for $334 million. Amerigroup appealed and the parties entered negotiations leading to settlement. The relator received $56.25 million as his share of the federal and state recoveries. In conjunction with the settlement, Amerigroup entered into a Corporate Integrity Agreement with the Inspector General of HHS to ensure future compliance.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/August/08-civ-723.html

- $75 million to settle claims that Kyphon Inc., now Medtronic Spine LLC, violated the False Claims Act by knowingly causing the submission of false claims to Medicare for its kyphoplasty procedure–a minimally-invasive surgery used to treat compression fractures of the spine. The settlement resolved a lawsuit filed by two former Kyphon employees under the *qui tam* provisions of the False Claims Act. The suit alleged that Kyphon engaged in a seven-year marketing scheme that resulted in certain hospitals billing Medicare for kyphoplasties performed on an inpatient basis rather than for less costly and clinically appropriate outpatient kyphoplasty treatment. This conduct resulted in the Medicare program paying more for inpatient kyphoplasty procedures. The relators received a total of $14.9 million as their share of the settlement. In conjunction with the settlement, Kypon entered into a Corporate Integrity Agreement with the Inspector General of HHS to ensure future compliance.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/May/08-civ-455.html

- $74 million from Staten Island University Hospital (SIUH) to resolve two False Claims Act *qui tam* suits and two other matters. In the first action, a physician and former SIUH Director of Chemical

Dependency Services, filed suit alleging that SIUH fraudulently billed Medicare and Medicaid for substance abuse and alcohol detoxification services provided to inpatients in unlicensed beds, in violation of state law, between 1994 and 2000. SIUH paid the United States $11.8 million in settlement of this *qui tam* action, with the relator receiving $2.3 million as his share of the government's recovery. In related allegations of inflated Medicaid billings asserted under New York State's false claims statute, SIUH paid New York $14.88 million, with the relator receiving $2.97 million as his share of the state's recovery.
In the second action, the widow of an SIUH cancer patient filed suit alleging that between 1996 and 2004, SIUH submitted false claims to Medicare and TRICARE using incorrect codes for cancer treatments not covered by the programs. SIUH paid the United States $25 million, including a relator share award of $3.75 million. In the third matter, the United States alleged that SIUH deliberately inflated the number of residents it employed to fraudulently increase Medicare reimbursement between 1996 and 2003. SIUH paid the United States $35.7 million in settlement of this matter. Lastly, SIUH paid the United States $1.47 million to settle allegations that it billed Medicare and Medicaid for treating psychiatric patients in unlicensed beds from 2003-2005. In conjunction with the settlement, SIUH also entered into a Corporate Integrity Agreement with the Inspector General of HHS to ensure future compliance.

For the original press release, see:

http://www.usdoj.gov/usao/nye/pr/2008/2008sep15.html

- $60 million from Lester E. Cox Medical Centers, a health care system headquartered in Springfield, Mo., to settle claims that it violated the False Claims Act, the Anti-Kickback Statute and the Stark Statute between 1996 and 2005. The United States alleged that Cox entered into illegal financial relationships with referring physicians at a local physician group and engaged in improper billing practices with respect to Medicare. Under the Stark Statute, providers such as Cox are prohibited from billing Medicare for referrals from doctors with whom the providers have a financial relationship, unless that relationship falls within certain exceptions. The United States contended that Cox and the referring physicians ran afoul of the Stark Statute, as well as the Anti-Kickback Statute, which prohibits offering inducements to providers in return for patient referrals. The settlement also resolves claims that Cox included non-reimbursable costs on its Medicare cost reports and improperly billed for dialysis services. In conjunction with the settlement, Cox entered into a Corporate Integrity Agreement with the Inspector General of HHS to ensure future compliance.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/July/08-civ-638.html

  http://www.usdoj.gov/usao/mow/news2008/cox.settlement.htm

- $53 million from Pratt & Whitney, a division of United Technologies Corporation, and PCC Airfoils LLC, a subsidiary of Precision Castparts Corporation, to resolve allegations that the companies knowingly submitted false claims for defective turbine blades purchased by the Air Force to retrofit the F100-PW-220 engines found in F-16 and F-15 aircraft. The settlement includes corrective action to replace defective blades and inspection of potentially serviceable blades to ensure their integrity. The case was pursued as part of a National Procurement Fraud Initiative launched in October 2006, to promote the early detection, identification, prevention and prosecution of procurement fraud.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/August/08-civ-675.html

- $26 million from St. Joseph's Hospital of Atlanta to resolve allegations that the hospital falsely claimed Medicare reimbursement for inpatient admissions that were, in fact, less costly outpatient visits. A registered nurse, formerly employed by the hospital, initiated suit under the False Claims Act's *qui tam* provisions. The complaint alleged that the hospital improperly billed for short inpatient admissions, usually of one day or less, when the service should have been billed as an outpatient "observation" or emergency room visit. Medicare reimburses hospitals a higher rate for inpatient admissions than it does for observation care or emergency room visits. The nurse who triggered the investigation received $4.94 million as her share of the recovery. St. Joseph's entered into a Corporate Integrity Agreement with the Inspector General of HHS in conjunction with the settlement, to ensure future compliance.
  For the original press release, see:

  http://www.usdoj.gov/usao/gan/press/2007/12-21-07.pdf

- $23.2 million from Bechtel Infrastructure Corp. and PB Americas Inc. to settle allegations of false claims for federal highway funds in connection with the firms' failure to provide adequate management and quality assurance services during the construction of the Central Artery Tunnel, known as the Big Dig, in Boston. The recovery, part of a $458 million settlement of state and federal claims, resolved parts of a *qui tam* lawsuit, a related federal investigation and additional claims that Bechtel and PB Americas violated federal and state criminal and civil laws in connection with their services on the Big Dig. In addition to the federal recovery, the companies paid $40 million in state claims and $335 million into a state warranty fund for future repairs to the Big Dig. The private citizen who filed the suit received $54,000 and $96,000 as his share of the federal and state recoveries, respectively.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/January/08_crt_048.html

  http://boston.fbi.gov/dojpressrel/pressrel08/govtclaimsettlement012308.htm

- $21.1 million from CVS Caremark Corp. to settle claims that from 2000-2006, the company illegally switched patients from the tablet version of the drug Ranitidine (generic Zantac) to a more expensive capsule version for the sole purpose of increasing Medicaid reimbursement. For example, CVS pharmacies in Illinois would charge Medicaid $79.80 for 60 Ranitidine capsules, rather than $17.10 for the tablets prescribed, increasing reimbursement by $62.70 on a single prescription. CVS Caremark is headquartered in Rhode Island and operates more than 6,000 pharmacies nationwide. The settlement resolves *qui tam* claims under federal and state false claims statutes. In addition to the federal recovery, CVS Caremark paid $15.6 million to 23 states and the District of Columbia. The *qui tam* plaintiff received $4.3 million as his share of the federal and state settlements. CVS Caremark also entered into a Corporate Integrity Agreement with the Inspector General of HHS to ensure future compliance.

  For the original press release, see:

  http://www.usdoj.gov/opa/pr/2008/March/08_crt_214.html

Fraud Statistics 1986-2008

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