

SECURITIES LAWS ENFORCEMENT AND DEFENSE CONTRACTORS

JOINT HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE COMMITTEE ON ENERGY AND COMMERCE AND THE SUBCOMMITTEE ON CRIMINAL JUSTICE OF THE COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES ONE HUNDREDTH CONGRESS FIRST SESSION

JULY 30, 1987—JUSTICE DEPARTMENT'S INABILITY TO PROSECUTE
DEFENSE CONTRACTORS
OCTOBER 28, 1987—INTEGRITY OF NORTHROP CORP.

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**SECURITIES LAWS ENFORCEMENT AND
DEFENSE CONTRACTORS**
**Justice Department's Inability to Prosecute Defense
Contractors**

THURSDAY, JULY 30, 1987

HOUSE OF REPRESENTATIVES, COMMITTEE ON ENERGY AND
COMMERCE, SUBCOMMITTEE ON OVERSIGHT AND INVESTI-
GATIONS, AND COMMITTEE ON THE JUDICIARY, SUBCOM-
MITTEE ON CRIMINAL JUSTICE,

Washington, DC.

The subcommittees met, pursuant to notice, at 10:30 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell, chairman, Subcommittee on Oversight and Investigations, and John Conyers, Jr., chairman, Subcommittee on Criminal Justice, presiding.

Mr. DINGELL. The two subcommittees will come to order.

The Chair is delighted to announce that this is a joint hearing between this subcommittee and the subcommittee of the Judiciary Committee chaired by my distinguished colleague from Michigan, the Honorable John Conyers. These two subcommittees have had the opportunity of working together in earlier times, and I'm happy to recall that their effective work on oil overcharges and matters of that kind back in 1979 has accomplished much in terms of the broad overall public interest.

The Subcommittee on Oversight and Investigations is particularly pleased to go into this because of the broad jurisdiction of our sister subcommittee, and the fact that the two subcommittees in sharing the effort can move forward on matters that relate to concerns of the Oversight Subcommittee with regard to the integrity of corporate management.

In the course of the investigations the subcommittee has examined acquisition of major weapon systems, the MX, the B-1, C-5B, 688 attack submarines, Trident ballistic submarines and a number of other systems. The committee has reviewed the roles of the Defense Contract Audit Agency, the Defense Criminal Investigative Service, the Department of Defense Inspector General, the Defense Investigative Service, and the Defense Logistics Agency. The subcommittee has become familiar with the management of major weapons acquisitions, and the fashion in which these matters are conducted.

In this joint hearing today the two subcommittees, and our sister subcommittee is the Subcommittee on Criminal Justice of the

House of Judiciary Committee, will examine the ability of the Department of Justice to prosecute fraud in the defense industry. I believe the subcommittees have real questions about the ability of the Department of Justice to manage major fraud cases against the unlimited resources of defense contractors.

For example, in an internal memorandum a top Department of Justice prosecutor 18 months into a major Grand Jury investigation complained that he could not get adequate office space, a secretary and three clerks to help him set up a document retrieval system. At the same time, General Dynamics spent over \$21 million defending the corporation and officials in the same case. Ironically, that amount will be charged to the taxpayers plus a profit. One must ask, how the cause of justice is being served in that matter.

The subcommittees will focus on three Grand Jury investigations that were terminated with no prosecutions in a recent date. Two involving General Dynamics and one involving Pratt & Whitney. The FBI and the Department of Justice have a continuing investigation of four matters in the Connecticut/General Dynamic Grand Jury investigation; and the Securities and Exchange Commission is about to conclude its investigation of General Dynamics on a number of similar issues.

The evidence developed by these three Grand Juries indicates clearly the commonality of interest between the contractors and top officials of the military services. The hearing today is important because we believe, as does the Department of Justice, that a common problem involved in these three Grand Jury cases significantly reduce the chances of successful prosecution.

The Justice Department also learned this sad lesson in its earlier Grand Jury investigation of General Dynamics/Electric Boat Division. The common problem is the acquiescence or knowledge of the military in alleged criminal activity. The subcommittee observed this problem in virtually each and every one of the investigations over the past 3½ years in which we have been engaged in this activity. There appears to be a symbiotic relationship between the military and their contractors. This is, of course, something warned of by President Eisenhower in his famous and well remembered industrial military complex speech.

One of the clearest examples of this situation was the Pratt & Whitney investigation, when the FBI concluded that the key Air Force officials at Pratt & Whitney were grossly negligent in allowing millions of dollars of lavish entertainment by Pratt & Whitney executives and other improper activities to be charged to the Government year after year without putting an end to the practice.

There were discussions during these Grand Jury investigations by the FBI and the Department of Justice about the possibility of bringing conspiracy charges against military employees and contractor officials for their participation in this matter.

In our General Dynamics hearings of February 1985 the subcommittee played a tape of a phone conversation in which a senior vice president and member of the board of directors of General Dynamics was heard telling another top General Dynamics official, he knew the chairman of the board of General Dynamics was putting

out a false press release involving delivery schedules on the Trident submarine, but had to do it to stop the slide in the stock.

The Justice Department claimed it could not prosecute General Dynamics because the Navy knew the press release was false and was aware of the schedule slippages. The Department also found that the Navy was not anxious to correct the statement because Congress might cut their funding if they knew that the Trident in question would be delayed by 2 years.

The question then, is this a conspiracy? The Justice Department agrees that the Navy people who may have withheld the truth from Congress did not benefit personally. They withheld the truth because they felt it was in the best interest of the national defense. This national defense argument is, of course, the same rationalization that has been rationalized and advanced by individuals in other committee hearings now going on before the Congress.

Indeed, it appears that in order to see to it that our defense policies are concerned and properly handled, that we must establish a proper arms-length relationship between the military, which spends \$150 billion of taxpayers' money annually to acquire weapons systems from defense contractors.

If the Justice Department cannot prosecute cases of fraud the possibilities of ever stemming endless waste in that agency appear to be small. Fraud will stand triumphant and the taxpaying public can only look forward to seemingly ceaseless hemorrhaging of ill-spent dollars extracted from the taxpayers.

Together with our good friends on the Judiciary Committee the subcommittees will jointly examine the adequacy of our laws. However, the acquisition system itself appears to be fatally flawed and appears to be in strong need of radical surgery.

The Chair recognizes my co-chairman and dear friend, the Honorable John Conyers.

Mr. CONYERS. Thank you, Mr. Chairman, and my colleague from Michigan with whom I have had a great association for many years.

Chairman Rodino of the Judiciary Committee sends his regards and his deep concern for the issue before our joint hearing. These subcommittees, as you have pointed out, have worked together before.

These hearings on the Department of Justice's management of several major defense procurement fraud cases are very important. It's a matter that you have been in over the years. We deeply appreciate the work that you and your committee have invested in a very, very important area to the American people.

Now, it appears that no accurate figures exist on the exact cost to the taxpayer on defense procurement fraud, but be noted it's quite a bit. It is safe to say that the defense contractors illegally charge hundreds of millions of dollars annually to the Federal Government, making this fraud the most serious white collar crime issue confronting the Nation.

At last count, the Inspector General of the Department of Defense had 60 of the 100 major defense contractors under criminal investigation. Over the past 2 years 200 individuals and 55 corporations have been convicted of defense contracting fraud for a wide range of charges from kickbacks, overcharging and false claims.

These shocking statistics demonstrate that we have not done as an effective job in deterring defense procurement crime. I'm pleased to hear that the Assistant Attorney General Weld comment that combating defense procurement fraud is the number one white collar crime priority of his department.

However, these prosecutions have often not been successful in altering the behavior of defense contractors. It almost seems that this fraud appears to be the rule rather than the exception.

Recently, of course, the Department of Justice has declined for prosecution or dismissed several major defense procurement fraud cases with an enormous expenditure of time and resources used to investigate these cases. And that, of course, is what brings us here this morning. Those cases not prosecuted could have been a major blow in the Department's fight against defense procurement fraud.

So, I'm here to continue this inquiry with all of my colleagues on the subcommittee, some of whom serve on both of our committees. I'm also pleased to note, and hope that this will be the beginning of a series of fruitful and important hearings on this subject. I thank you very much.

Mr. DINGELL. The Chair thanks the gentleman.

The Chair recognizes now Mr. Bliley, the gentleman from the State of Virginia.

Mr. BLILEY. Thank you, Mr. Chairman.

This hearing is prompted by the recent Justice Department announcement that it would not prosecute three alleged major defense contractor fraud cases. Those cases involved actions by Pratt & Whitney and General Dynamics which as the public outcry over waste, fraud and abuse and defense procurement has demonstrated, were offensive to most people.

We are all aware of massive cost overruns on Trident submarines, the legendary, but all too real costs of boarding Firsten the General Dynamics dog; cost overruns on the now defunct Divad anti-aircraft gun; and Pratt & Whitney expense charges for leased luxury automobiles. We all share the view in hindsight that contractors take advantage of the Pentagon when they pursue this kind of practice; and it is the taxpayer who ultimately suffers.

But the issue today is not whether these practices are objectionable, offensive, or even wrong. The question today is, are they legal? Did anyone commit a civil or criminal violation that could be proven in a court of law? The Justice Department has decided they did not.

Today we will explore why Justice concluded that it could not win in a trial of these seemingly clear cases of abuse. We will also ask how personal lives and reputations could be gambled on hasty and ill-founded indictments that were ultimately dismissed.

One of the issues appears to be why and how the Pentagon may have let itself be overcharged, in some cases knowingly. How could Pentagon rules and negotiations on expenses be so loose, so vague, and so passive, that General Dynamics and Pratt & Whitney could seek to charge the expenses or recover the cost overruns year after year without anyone simply saying, no?

While we all want to know how the FBI and Grand Jury investigations were conducted, it seems to me the key questions are the

ones many of the members of this subcommittee have been asking since these investigations began.

Can the Pentagon effectively police contractor abuse? Is it doing that now? If not, what must Congress do to be sure that the system requires contractor honesty rather than encouraging contractors to squeeze the last penny from the Government?

I look forward to our witnesses' testimony. Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman.

Mr. Gekas.

Mr. GEKAS. I thank the Chair.

Is the Justice Department on trial here today, I ask? And will it remain on trial throughout the balance of these hearings? If so, I'm going to do everything I can to make sure that it is not relegated to such a kind of a circus.

Too often it has happened that, when the Justice Department makes decisions—some to prosecute, some not to prosecute—that immediately has implications for many who want to learn what is the mystique, what is the rationale behind such a decision?

And too often, I restate, it turns out that then the Justice Department becomes the target of an inquiry which makes it seem as if the Justice Department itself is a defendant before the Congressional committees.

I am, however, inspired by the fact that both the chairman and the subcommittee chairman of which I am a member have depicted these hearings as looking at the adequacy of the laws, at the status of the resources, and the responsibilities of these committees as to oversight, generally, in this problem area.

I repeat, I for one am going to watch very carefully to see that this does not fall in to the category of a case against the Justice Department because it happens to be a part of an administration which in itself is the target so often in these Congressional committees, more often than not, in a political vein. I have great hopes that it's not going to be that in these sessions. And I bank on the opening statements that have been made thus far to put it in the proper posture. I'm going to work very hard with these colleagues on this Joint Committee.

Thank you, Mr. Chairman.

Mr. DINGELL. The gentleman from Oregon.

Mr. WYDEN. Thank you, Mr. Chairman. I want to commend you, Mr. Chairman, and also, Chairman Conyers for going forward with this important inquiry. And really pick up on the thoughtful statement of Mr. Gekas of Pennsylvania, because I don't think there's anything political that is a central issue here.

My concern is that an examination of defense fraud cases indicates to me, that increasingly the taxpayer is a victim of a perfect crime. Again and again it appears that contractors inform the services about the fraudulent activity. But because of mutual self-interest there aren't any further disclosure by either the contractors or the Pentagon. And then the Justice Department simply is unable to prosecute because of Pentagon acquiescence creates the situation where there isn't a victim.

So what I would hope is, as we look in to this area, and particularly in to the conspiracy statutes, that we recast the victim, be-

cause the victim is the taxpayer and I'm concerned right now that they really are the victim of what seems to be a perfect crime and something that results in the waste of tax dollars and the frittering away of our resources.

And I thank the chairman.

Mr. DINGELL. The Chair thanks the gentleman.

The gentleman from Florida, Mr. Bilirakis.

Mr. BILIRAKIS. Thank you, Mr. Chairman.

I am not concerned about the politics of hearings such as this, sir, because I know you to be a fair man, but I am concerned that as long as the American people have doubts in their minds as to why certain things maybe should have been done and weren't and vice-versa, then it is up to this committee and the Congress, if you will, to look into the matter. But to look into the matter, obviously, we have got to have open minds, and I am concerned that we will have objectivity in these hearings and not have predecided. If we have predecided, then we are merely wasting taxpayers' dollars in holding these hearings in the first place.

So with that in mind, and I have confidence that we will be open minded, Mr. Chairman, because of your leadership, I too commend you for holding these hearings. Thank you, sir.

Mr. DINGELL. The Chair thanks the gentleman.

The gentleman from Virginia, Mr. Boucher.

Mr. BOUCHER. Thank you, Mr. Chairman.

During the course of today's hearings, we will hear from both staff and from Department of Justice witnesses a disturbing story of Defense Department acquiescence in what generously could be called strategic accounting, accounting that is costing the American taxpayer untold millions of dollars. These revelations are coming to the Congress at a time when we are struggling to cope with the Federal budget deficit and point, I would suggest, again to the need for new efficiencies in the Pentagon spending practices and new vigilance here in the Congress over the use of Defense Department funds.

As a member of both the Subcommittee on Investigations and Oversight and the Judiciary Committee Subcommittee on Criminal Justice, I am looking forward to working with you and with Chairman Conyers to fashion appropriate remedies for these problems.

Thank you.

Mr. DINGELL. The Chair thanks the gentleman.

The gentleman from Pennsylvania.

Mr. WALGREN. No statement, Mr. Chairman.

Mr. DINGELL. The Chair announces that our first witness this morning is Mr. Bruce Chafin, Special Assistant to the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce.

Mr. Chafin, the Chair has certain preparatory matters before we hear your testimony. First, do you object to appearing under oath?

Mr. CHAFIN. No.

Mr. DINGELL. Second, do you desire to be advised by counsel?

Mr. CHAFIN. No, thank you.

Mr. DINGELL. Third, for your benefit, to inform you of the limits on the powers of the committee and also upon the scope and sweep of your rights, copies of the rules of the committee, rules of the

subcommittee and rules of the House are there on the committee table before you.

If you have no objection, then, to being sworn, if you will please rise and raise your right hand.

[Witness sworn.]

Mr. DINGELL. Mr. Chafin, you may consider yourself under oath. The Chair recognizes you for your statement.

**TESTIMONY OF BRUCE F. CHAFIN, SPECIAL ASSISTANT,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**

Mr. CHAFIN. Mr. Chairman and members of the subcommittees. For more than 3 years now, the subcommittee has been investigating whether our major defense contractors are operating in a manner that accords with Federal securities laws and regulations. During the same time the subcommittee has been proceeding, the Department of Justice has conducted dozens of Grand Jury investigations into alleged criminal acts by these same defense contractors.

At last report, the Defense Department's Inspector General had 60 of the top 100 major defense contractors under criminal investigation involving some 240 cases. We are now finding that Pentagon involvement, approval or acquiescence is greatly hampering the Government's effort to prosecute offenders and recover money, in many instances.

The Army's procurement of the DIVAD air defense system is a classic case in point. The price tag associated with each effort is estimated by the Army to be \$60 million. According to Justice Department officials, the Congress rejected that proposal because the price was too high. Not to be deterred, the Army went back to the Pentagon and arbitrarily cut the price to a more acceptable \$39 million.

However, as George Nicholas, a contract specialist at Rock Island Arsenal, told the Justice Department, the contract price of \$39 million was not enough and everyone knew it. In fact, George Dowsman, the chairman of the Army's procurement committee reviewing the proposal, stated that the contractor would be unable to complete the job for \$39 million.

This initial deception triggered a chain reaction of events that ultimately led to a 3-year investigation and the indictment of four officials at the General Dynamics Corporation for alleged mischarging of cost overruns of two overhead accounts, Independent Research and Development, called IRAD, and Bid and Proposal, called B&P.

Mr. Nicholas explained that in reality the Government condones using IRAD to help offset overruns. He stated the Government "closes its eyes" when the contractor uses other moneys on contracts.

In November 1977, the Army selected General Dynamics and Ford Aerospace to design and develop two prototypes within a 28-month period. It allotted them \$39 million for each of their efforts, knowing all along the prototypes could not be developed for anything close to that figure. It is unclear whether anyone in the Army specifically gave the approval to these contractors to charge

overhead accounts such as IRAD and B&P to cover the overruns. However, it is clear from a number of post-indictment interviews that such charges were not unexpected.

Enter the Defense Contracting Audit Agency, the DCAA. The Army's deception was not widely advertised, and therefore the DCAA was not aware of the DIVAD funding game plan. As a result, in June 1983 the DCAA referred allegations of suspected labor and material mischarging by General Dynamics on the DIVAD prototype to the Defense Procurement Fraud Unit of the Department of Justice.

On December 2, 1985, a seven-count indictment was returned by a Los Angeles Grand Jury charging General Dynamics and four of its executives with conspiring to defraud the United States.

The Justice Department conducted a number of post-indictment interviews with various key Army officials involved in the procurement. The information they received was devastating to the prosecution. It revealed that there was common knowledge that the contract had been deliberately underfunded and that the contractors would far exceed the \$39 million if they delivered a competitive prototype.

The future potential of this contract was so great most felt the contractors would use "their own money" beyond the \$39 million. Numerous Army officials in the post-indictment interview included IRAD and B&P as part of the contractor's own money. John Blanchard, Deputy to the Commanding General, stated that he believed the Government expected the contractors to use discretionary funds such as profit to supplement the underfunded contract.

Further he stated it was not illogical to assume they would use other types of discretionary funds such as IRAD and B&P. Arthur Thomas, Deputy to the Assistant Secretary of the Army for Research and Development, stated everyone involved with the program knew that the contract funds were not enough for General Dynamics to complete the prototype. Thomas himself believed that General Dynamics would use profits, IRAD and B&P funds to supplement the contract.

But the most illustrative quote comes from George Nicholas, who stated about IRAD and B&P charges, "Why not?" In addition, there was a conscious effort by the Army not to discuss what to do beyond \$39 million with the contractors. George Dowsman stated that the Government personnel consciously avoided addressing the issue, internally and with the contractors, so as not to upset an undefined delicate balance.

The Justice Department has stated they did not believe they could convince a jury that the Army had been victimized by the charges of IRAD and B&P. The testimony of Thomas, Dowsman, Nicholas and others before a jury would be devastating to the Government's case. As a result, last month the Justice Department senior prosecutors unanimously recommended that the prosecution of the indictment against General Dynamics and its officials be dismissed. Further, it has initiated an intense internal review to determine whether the investigation against Ford Aerospace should be similarly dismissed.

The cost of the Army's deception cannot be understated. The reputations of the indictment individuals at General Dynamics have

been greatly maligned. General Dynamics spent approximately \$21 million in its defense of the indictment, much of which will now be billed to the taxpayers. The Justice Department spent untold resources in staff time and moneys developing and attempting to prosecute the case.

The subcommittee staff recently talked with officials within the General Counsel's Office of the Army to determine what action, if any, the Army had taken against those involved in the DIVAD game plan. The Army told us that nothing was ongoing. It is significantly disturbing that none of the Army officials involved in this overall game plan came forward to tell their story to the Justice Department either before or after the indictment.

The actions of the Air Force in the case of Pratt and Whitney are similar. The Government Products Division of Pratt and Whitney Group in West Palm Beach, Florida submitted a claim to the Government seeking reimbursement of its overhead costs for calendar year 1981 operations. The Government attempted to prosecute Pratt and Whitney based on what were alleged to be false claims.

The questionable costs Pratt and Whitney claimed included the costs associated with company-sponsored employee rebate programs whereby employees of Pratt and Whitney could purchase Carrier air conditioners, receive a rebate for their purchase and that rebate was included in the overhead accounts and billed to the Government on defense contracts; various advertising costs incurred by the contractor, such as souvenir-type items; entertainment costs incurred by the contractor in connection with local business discussions, company-sponsored parties and banquets for employees; and the costs associated with an executive automobile leasing program.

In addition, the company allegedly gave illegal gratuities to Government personnel and made a donation of \$65,500 at the repeated request of Major General Jay Edwards to the Oklahoma Art Center because the general and his wife felt the quality of art at the Oklahoma center was not what it should have been. General Edwards was the commander at Tinker Air Force Base in Oklahoma City, which bought hundreds of millions of dollars of parts from Pratt and Whitney. This donation was included in Pratt and Whitney's overhead submission to the Government.

In July 1986, Leon Kelner, United States Attorney for the Southern District of Florida, wrote: "The chief or principal contractor officer dealing with the defense contractor for all practical purposes was the United States. Such an officer has the power to decide what costs to pay and to interpret regulations in reaching that decision."

In his memorandum declining prosecution, Mr. Kelner wrote that while some of the specific items in the Pratt and Whitney claim for 1981 may have been a surprise, Government personnel had to know that Pratt and Whitney generally included costs of a similar nature year after year. Therefore, the Government was cognizant that the costs had been included and that Pratt and Whitney could not be prosecuted for its actions because, once again, the victim, in this case the Air Force, had given outright or tacit approval for the submissions of the questionable claims.

The FBI's special agent in charge of Miami had a different view of the circumstances. His actions indicate he examined the possibility that Colonel Roberts, the Air Force plant representative, may be culpable in some kind of overall conspiracy theory to defraud the Government. Although he concluded that the culpability of the AFPRO cannot be shown through an existing evidence of a specific quid pro quo, historically military personnel retiring from the plant have obtained positions within the corporate umbrella leading those who follow to foresee the opportunities for themselves upon retirement.

If this was a bank fraud matter, evidence of gross negligence could be introduced as proof of misconduct. As it exists, the AFPRO and the ACO's inability to confront Pratt and Whitney must be seen as gross negligence.

The Navy has had its own problems with acquiescence in defense contracting matters. In 1984 the Justice Department convened a Grand Jury in Connecticut to investigate whether General Dynamics conspired to defraud the Government and its agencies of moneys and other things of value through schemes to manipulate cost, delivery, financial and other data with the purpose of covering up its poor management and deteriorating financial position.

Ultimately the Justice Department declined prosecution of these charges. In a memorandum to the Assistant Attorney General, Criminal Division, Robert Ogren, Chief of the Fraud Section, Criminal Division, explained that the major problem with the case is the lack of a victim.

Regarding the schedule delays, Mr. Ogren concluded that the delivery dates and costs were only estimates and, more importantly, the Navy was fully aware of the delays. Mr. Ogren concluded that there was no way to prove the Navy was an unwilling victim. He stated, and I quote, "It had substantial knowledge of most of the falsifications, yet it settles on favorable terms with General Dynamics."

There seems to be a fundamental commonality of interests between General Dynamics and the Navy that led to the non-disclosure and the favorable settlement. General Dynamics was concerned about the impact of its schedule delays on future contracts, the value of its stock price, et cetera. The Navy was concerned that schedule delays, if disclosed, could affect the appropriations from the Congress.

As a result, the apparent victim in this case, the Navy, was no more interested in announcing the schedule delays than was the contractor. As you will hear in testimony today from the Justice Department, the Navy's knowledge and acquiescence in not disclosing the schedule delays greatly undermined the Department's ability to prosecute.

In December 1976, General Dynamics submitted a \$544 million claim to cover overruns on the 688 program. General Dynamics blamed Navy plans and delays as the cause of the cost overrun. The Navy, upon analyzing the claim, found unsupported assumptions and calculations had been used to develop the \$544 million figure. An independent review group within the Navy determined that only \$125 million was justified.

When General Dynamics learned that the Navy was going to make this finding, it threatened to shut down its yard unless the Navy agreed to delay its finding. The Justice Department concluded the primary reason for the overruns was deliberate underbidding and low productivity by General Dynamics but that these factors were known to the Navy. In fact, Mr. Ogren's memo states: "It is our belief that Electric Boat's mismanagement and low bid caused the overrun and not any problem with the design plans and change orders. However, the Navy was in a position to know and did know of Electric Boat's problems.

"Without the ability to establish that the claim was per se false, all other elements, particularly the Navy's knowledge and acquiescence, substantially undercut our ability to support our circumstantial theory of a claim as a device to cover up."

Regarding the subsequent lucrative contracts the Navy awarded General Dynamics, the Justice Department concluded that General Dynamics did not conceal data in the negotiating process which resulted in General Dynamics being able to inflate the price by using estimates of millions of more man hours than were actually needed.

The Justice Department concluded the bid was clearly inflated; however, the method of inflation was disclosed to the Navy and subject to the negotiation process. The Justice Department concluded that without some evidence that General Dynamics concealed data in the negotiating process, there is insufficient proof of intent to defraud.

A final case involves an ongoing grand jury process at Bell Helicopter. The Justice Department has had an active grand jury investigation under way for approximately 2 years to review alleged fraud and mischarging by Bell Helicopter. Estimates of the fraud run as high as \$108 million. Concurrently, the subcommittee has an ongoing investigation into this matter. Based on our review, Army acquiescence is creating a problem once again.

For example, the DCAA reviews a contractor's accounting system prior to the award of any major contract. In the case of Bell, DCAA reviewed and commented on the eight major aspects of Bell's accounting system. Although Bell failed all eight areas, that did not deter the Army from awarding the contract to Bell anyway. As a result, it may be more difficult for the Justice Department to portray the Army as an innocent victim of Bell's accounting procedures when Bell may be able to prove the Army was fully aware of these problems before awarding the contract, once again potentially undermining the Justice Department's ability to indict and convict Bell for fraud against the Government.

There are numerous other examples of Army acquiescence or tacit approval in the Bell situation. However, the Grand Jury is still ongoing and a decision is expected in September. As a result, the Justice Department has been unable to discuss the impact of Army acquiescence in this open case.

In total, we have examined the Justice Department's inability to prosecute five different cases involving all three services of the Department of Defense. There is a clear common denominator. The Army's, Navy's and Air Force's common objective with the contrac-

tors often lead to acquiescence or approval of what would otherwise be criminal matters.

According to the Department of Justice, the law views the military services as the victims of such practices. Therefore, service acquiescence undermines any prosecution. Most people view the real victims as the American taxpayers, and often the Congress, in the sense that the military industrial complex conspires to hide the facts and condone incredible charges.

The individuals involved in the procurement process serve two masters. Their first master is the American taxpayer and the responsibility to the public interest. The second master is the Pentagon bureaucracy, which puts a high value on keeping programs on schedule, sustaining funding levels and maintaining good working relationships with the contractor. Oftentimes these duties are mutually exclusive, and when a conflict occurs, too often it will serve the Pentagon bureaucracy for career enhancement.

History is replete with examples of individuals like Colonel Jim Burton, who attempted to point out problems with the Bradley Fighting Vehicle and was rewarded with a transfer to Alaska. It is similarly replete with examples of individuals misleading the Congress and the American people as to the true state of various programs and suffering no consequences.

Throughout these 3 years of our investigations, we have rhetorically asked the question most everywhere we go: Name one individual who was promoted for killing a program because it had problems or was promoted for extracting major monetary concessions from a contractor. We have heard of no such person.

The revolving door situation exhibited in the Pratt and Whitney case is only a symptom of the problem. The fundamental problem lies with the attitude of those Pentagon officials involved in the selection, justification and procurement of our weapons system. Their current and future careers are too often predicated on acquiescence or approval of otherwise questionable practices for the sake of what they perceive as in our national interest or in their own career interest.

They do, as Mr. Nicholas explained, close their eyes when it comes to the operating practices of our defense contractors, and now it is becoming abundantly clear that not only do these individuals not suffer for their actions, but their actions undermine the Justice Department's ability to bring criminal charges and thereby deter such future activity.

[The prepared statement of Mr. Chafin follows:]

STATEMENT
OF
BRUCE F. CHAFIN
SPECIAL ASSISTANT
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
THURSDAY, JULY 30, 1987

Mr. Chairman and Members of the Subcommittee:

For more than three years now, the Subcommittee has been investigating whether our major defense contractors are in compliance with the Federal securities laws and regulations. In a June 18, 1987 report to you, the Securities and Exchange Commission pointed out:

"Public companies, including defense contractors, must disclose material risks affecting each line of business in financial reports filed with the Commission... Under existing Commission regulations, public companies cannot use national defense classification to conceal materials risks or to misstate profits on losses arising from projects that are subject to classification."

This position is consistent with the Commission's long-standing requirement that companies engaged in defense contracts make "prompt and accurate disclosure of material information concerning such activities." (See Securities Act Release No. 5263, June 22, 1972).

During the same time the Subcommittee has been proceeding, the Department of Justice has conducted dozens of Grand Jury investigations into alleged criminal acts by these same defense contractors. At last report, the Defense Department's Inspector General had 60 of the top 100 major defense contractors under criminal investigation -- involving some 240 cases. We are now finding that Pentagon involvement, approval, or acquiescence is greatly hampering the Government's efforts to prosecute offenders and recover monies in many instances.

The Army's procurement of the DIVAD Air Defense System is a classic case in point. According to the Chief of the Fraud Section of the Criminal Division of the Department of Justice, the Army presented Congress with a proposal to have two contractors build a prototype of the DIVAD. The price tag associated with each effort was estimated by the Army to be \$60 million. According to Justice Department officials, the Congress rejected that proposal because the price was too high. Not to be deterred, the Army went back to the Pentagon and arbitrarily cut the price to a more acceptable \$39 million. However, as George Nicholas, a contract specialist at Rock Island Arsenal, told the Justice Department "the contract price of \$39 million was not enough and everyone knew it." In fact, George Dowsman, the Chairman of the Army Procurement Committee reviewing the proposal, stated that the contractors would be unable to complete the job for \$39 million.

This initial deception triggered a chain reaction that ultimately led to a three-year investigation and the indictment of four officials at the General Dynamics Corporation for alleged mischarging of cost overruns to two overhead accounts -- Independent Research and Development (IRAD) and Bid and Proposal (B&P). Mr. Nicholas explained that in reality the government condones using IRAD to help offset overruns. He stated that the government "closes its eyes" when the contractor uses other money on contracts.

In November 1977, the Army selected General Dynamics and Ford Aerospace to design and develop two prototypes within a 28-month period. It allotted them \$39 million each for their efforts, knowing all along that the prototypes could not be developed for anything close to that figure. It is unclear whether anyone in the Army specifically gave the approval to these contractors to charge overhead accounts such as IRAD and B&P to cover the overrun. However, it is clear from a number of post-indictment interviews that such charges were not unexpected.

Enter the Defense Contracting Audit Agency (DCAA). The Army's deception was not widely advertised and, therefore, the DCAA was not aware of the DIVAD funding game plan. As a result, in June 1983, DCAA referred allegations of suspected labor and material mischarging by General Dynamics on the DIVAD prototype contract to the Defense Procurement Fraud Unit of the Department of Justice. On February 24, 1984, the DCAA completed the audit of General Dynamics' charges to the contract and to IRAD, B&P, and other indirect accounts and concluded that approximately \$3 million of contract costs had been mischarged in calendar

years 1979 and 1980. On December 2, 1985, a seven-count indictment was returned by a Los Angeles Grand Jury charging General Dynamics and four of its executives with conspiring to defraud the United States and making false statements to the Department of Defense in connection with the DIVAD contract.

As concerns about the Justice Department's ability to prosecute this case grew, the Justice Department conducted a number of post-indictment interviews with key Army officials involved in the procurement. The information they received was devastating to the prosecution. It was revealed that there was common knowledge that the contract had been deliberately underfunded and the contractors would far exceed the \$39 million if they delivered a competitive prototype. The contract itself contained a "best efforts" clause which would have excused the contractor from delivering any prototypes had they put forth their best efforts and spent the \$39 million. However, the future potential of this contract was so great that most felt the contractors would spend "their own money beyond the \$39 million."

Numerous Army officials, in their post-indictment interviews, included IRAD and B&P as part of the contractors "own money." John Blanchard, Deputy to the Commanding General, stated that he believed that the government expected the contractors to use discretionary funds such as profit to supplement the underfunded contract. Further, he stated it was not illogical to assume they would use other types of discretionary funds such as IRAD and B&P. Arthur Thomas, Deputy to the Assistant Secretary of the Army for Research and Development, stated that everyone involved in the program knew that contract funds were not enough for General Dynamics to complete the prototypes. Thomas himself believed that General Dynamics would use profits, IRAD, and B&P funds to supplement the contract. The most illustrative quote came from George Nicholas, who stated about the IRAD and B&P charges, "Why not?" In addition, there was a conscious effort by the Army not to discuss what to do beyond \$39 million with the contractors. George Dowsman stated that the government personnel "consciously avoided" addressing the issue internally and with the contractors so as not to upset an undefined "delicate balance."

Justice Department officials have stated that they did not believe they could convince a jury that the Army had been victimized by the charges to IRAD and B&P. The testimony of Thomas, Dowsman, Nicholas and others before a jury would have been devastating to the government's case. As a result, last month, Justice Department senior prosecutors unanimously

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recommended that the prosecution of the indictment against General Dynamics and its officials be dismissed. Further, it has initiated an intense internal review to determine whether the investigation against Ford Aerospace should be similarly dismissed. The cost associated with the Army's deception cannot be understated. The reputations of the indicted General Dynamics officials have been greatly maligned.

General Dynamics spent approximately \$21 million in its defense of the indictment, much of which will now be billed to the taxpayers because General Dynamics was not successfully prosecuted; and finally, the Justice Department spent untold resources in staff time and monies developing and attempting to prosecute this case. The staff recently talked to officials within the Army General Counsel's office to determine what, if any, actions the Army was taking against the Army personnel involved in this matter and was told that nothing was ongoing. It is significant and disturbing that none of the Army officials involved in the overall game plan came forward to tell their story to the Justice Department either before or after the indictment. Their story was only told when the Justice Department sought them out, more than a year after the indictments. According to the Chief of the Fraud Section of the Criminal Division of Justice, at least one Army official was reluctant to cooperate even when contacted by Justice.

The actions of the Air Force in the case of Pratt and Whitney are similar. The Government Products Division of Pratt and Whitney Group in West Palm Beach, Florida, submitted a claim to the government seeking reimbursement of its overhead cost for its calendar year 1981 operations. The government attempted to prosecute Pratt and Whitney based on what were alleged to be false claims. The questionable costs Pratt and Whitney claimed included:

- ° the cost associated with a company-sponsored employee rebate program whereby employees of Pratt and Whitney could purchase Carrier air conditioners, receive a rebate for their purchase, and that rebate was included in the overhead account and billed to the government on defense contracts;
- ° various advertising costs incurred by the contractor, such as the cost of souvenir-type items;
- ° various entertainment costs incurred by the contractor in connection with local business discussions and company-sponsored parties and banquets for employees; and

- ° costs associated with an executive automobile leasing program.

In addition, the company allegedly gave illegal gratuities to government personnel, and made a donation of \$67,500 at the repeated request of Major General Jay Edwards to the Oklahoma Art Center because the General and his wife felt the quality of art at the Oklaholma Art Center was not what it should have been. General Edwards was the Commander of Tinker Air Force Base, in Oklahoma City, which bought hundreds of millions of dollars worth of parts from Pratt and Whitney. This "donation" was included in Pratt and Whitney's overhead submission to the government.

In July 1986, Leon Kelner, the United States Attorney for the Southern District of Florida, wrote "the chief or principal administrative officer dealing with the defense contractor for all practical purposes was the United States." Such an officer had the power to decide which costs to pay and to interpret the regulations in reaching that decision. In his memorandum declining prosecution, Mr. Kelner wrote that while some of the specific items included in Pratt and Whitney's claim for 1981 may have been a surprise, government personnel had to know that Pratt and Whitney generally included costs of a similar nature year after year. Therefore, the government was cognizant that these costs had been included and that Pratt and Whitney could not be prosecuted for its actions because once again the victim, in this case the Air Force, had given outright or tacit approval for submission of these questionable claims.

The FBI's Special Agent in Charge in Miami had a different view of these circumstances. He examined the possibility that Colonel Roberts, the AFPRO, and Jay Moyes, the ACO, may be culpable in some kind of overall conspiracy theory to defraud the taxpayers. He concluded that "the culpability of the AFPRO cannot be shown through existing evidence of a specific quid pro quo. Historically, military personnel retiring from the plant have obtained positions within the corporate umbrella leading those that follow to foresee such opportunities for themselves upon retirement. If this was a bank fraud matter, evidence of gross negligence could be introduced as proof of misconduct. As it exists, the AFPRO and the ACO's inability to confront Pratt and Whitney must be seen as gross negligence." According to the Air Force, rather than being sanctioned, the ACO has subsequently been promoted, working for the Government in General Dynamics' Fort Worth plant. Unlike the past three AFPRO's, it appears adverse publicity prevented the last AFPRO from working at Pratt upon retirement.

The Navy has had its own problems with acquiescence in defense contracting fraud matters. In 1984, the Justice Department convened a grand jury in Connecticut to investigate charges by General Dynamics' Electric Boat Division on the 688 Attack Submarine and the Trident Ballistic Submarine programs. At issue was whether General Dynamics conspired to defraud the government and its agencies of monies and other things of value through a scheme to manipulate cost, delivery, financial and other data with the purpose of covering up its poor management and deteriorating financial position. Ultimately, the Justice Department declined prosecution of these charges. In a memorandum to the Assistant Attorney General, Criminal Division, Robert Ogren, Chief of the Fraud Section, Criminal Division, explained that the major problem with the case is the lack of a victim.

Regarding the schedule delays, Mr. Ogren concluded that the delivery dates and costs were only estimates and, more importantly, the Navy was fully aware of the delays. Mr. Ogren concluded there was no way to prove the Navy was an unwilling victim. He stated "it had substantial knowledge of most of the falsification and yet settled on favorable terms to General Dynamics."

There seems to be a fundamental commonality of interest between General Dynamics and the Navy that led to the non-disclosure and the favorable settlement. General Dynamics was concerned about the impact of its schedule delays on future contracts and on the price of its stock. The Navy was concerned that schedule delays, if disclosed, could have affected the appropriations from the Congress. The Justice Department has received information from the Appropriations Committee that had the schedule delays been known, the appropriations for the submarine program might have been eliminated that year and put into other programs. This clearly would not have been consistent with the Navy's demands for more money. As a result, the apparent victim in this case, the Navy, was no more interested in announcing the schedule delays than was the contractor. As you will hear in testimony from the Department of Justice, the Navy's knowledge and acquiescence in not disclosing the schedule delays greatly undermined the Department's ability to prosecute.

In December 1976 General Dynamics submitted a \$544 million claim to cover overruns in the 688 program. General Dynamics blamed defective Navy plans and delays as the cause of the cost overruns. The Navy, upon analyzing the claim, found unsupported assumptions and calculations had been used to develop the \$544 million figure. An independent review group within the Navy

determined that only \$125 million was justified. When General Dynamics learned that the Navy was going to make this finding, it threatened to shut down the yard unless the Navy agreed to delay its finding. The Justice Department concluded that the primary reason for the overruns was deliberate underbidding and low productivity by General Dynamics, but that these factors were known to the Navy. In fact, Mr. Ogren's memo states:

" . . . it is our belief that Electric Boat's mismanagement and low bid caused the overrun, and not any problem with design plans and change orders. However, the Navy was in the position to know and did know of Electric Boat's problems. In light of this, the Navy elected to settle with Electric Boat in June of 1978 and then, when the problem surfaced again in 1981, settled again with the award of generous contracts. An important element of the 1978 settlement is a \$300 million cash payment which allowed Electric Boat to solve its severe cash flow problems and substantially reduced its after-tax loss."

"Without the ability to establish that the claim was, per se, false, all other elements, particularly the Navy's knowledge and acquiescence, substantially undercut our ability to support our circumstantial theory of a claim as a device to cover up." [Emphasis Added]

Regarding the subsequent lucrative contracts the Navy awarded General Dynamics, the Justice Department concluded that General Dynamics did not conceal data in the negotiating process which resulted in General Dynamics being able to inflate the price by using estimates of millions of more man hours than were actually needed. The Justice Department concluded "the bid was clearly inflated." However, the method of inflation was disclosed to the Navy and was subject to the negotiation process. The Justice Department concluded that, without some evidence that General Dynamics concealed data in the negotiating process, there is insufficient proof of intent to defraud. The Justice Department was similarly unable to prove that Navy Secretary Lehman and Assistant Secretary Sawyer had crossed over the line of impropriety in this deal with General Dynamics. But again, the Department of Justice claims Navy knowledge and acquiescence greatly undermined its ability to prosecute this matter.

A final case involves the ongoing grand jury process at Bell Helicopter. The Justice Department has had an active grand jury investigation underway for approximately three years to review alleged fraud and mischarging by Bell Helicopter. Estimates of

the fraud run as high as \$108 million. Concurrently, the Subcommittee has an ongoing investigation into this matter. Based on our review, Army acquiescence is creating a problem once again. For example, the DCAA reviews a contractor's accounting systems prior to the award of any major contract. In the case of Bell, the DCAA reviewed and commented on the eight major aspects of Bell's accounting system. Although Bell failed in all eight areas, that did not deter the Army from awarding the contract to Bell. As a result, it may be more difficult for the Justice Department to portray the Army as an innocent victim of Bell's accounting procedures when Bell may be able to prove the Army was fully aware of these problems before awarding the contract, once again potentially undermining the Justice Department's ability to indict and convict Bell for fraud against the Government. There are numerous other examples of Army acquiescence or tacit approval or knowledge in the Bell situation. However, the grand jury is still deliberating and a decision is expected in September. As a result, the Justice Department has been unable to discuss the impact of Army acquiescence on this open case.

In total, we have examined the Justice Department's inability to prosecute in five different cases involving all three services in the Department of Defense. There is a clear common denominator. The Army, Navy, and Air Force share common objectives with the contractors, which often lead to acquiescence or approval in what otherwise would be criminal matters. According to the Department of Justice, the law views the military services as the victims of such practices. Therefore, service acquiescence undermines any prosecution. Most people view the real victims as the American taxpayers, and often the Congress, in the sense that the military industrial complex conspires to hide the facts and condone incredible charges.

The individuals involved in the procurement process serve two masters. The first master is the American taxpayer and a responsibility to the public interest. The second master is the Pentagon bureaucracy, which puts a high value on keeping programs on schedule, sustaining funding levels, and maintaining good working relationships with the contractor. Often times, these two duties are mutually exclusive and when a conflict occurs, too often they will serve the Pentagon bureaucracy for career enhancement.

History is replete with examples of individuals like Colonel James Burton who attempted to point out problems with the Bradley Fighting Vehicle and was rewarded with a transfer to Alaska. It is similarly replete with examples of individuals misleading the

Congress and the American people about the true state of various programs and suffering no consequences. Throughout these three years of investigation, we have rhetorically asked, "Name one individual who was promoted for killing a program because of problems or for extracting major monetary concessions from a contractor." We have heard of no such person. In fact, since 1960, the Pentagon has only killed five programs with procurement costs in excess of \$1 billion dollars.

The revolving door situation exhibited in the Pratt and Whitney case is only a symptom of the problem. The fundamental problem lies within the attitude of those Pentagon officials involved in the selection, justification, and procurement of our weapons systems. Their current and future careers are too often predicated on the acquiescence or approval of otherwise questionable practices for the sake of what they perceive as in our national interest or in their own career interest. They do, as Mr. Nicholas explained, "close their eyes" when it comes to the operating practices of our defense contractors. Now it is becoming abundantly clear that not only do these individuals not suffer for their actions but their actions undermine the Justice Department's ability to bring criminal charges and thereby deter such future activity.

Finally, all this makes the task of the SEC in requiring prompt and full disclosure next to impossible. So long as defense contractors can find an ally in the Defense Department to support delaying or avoiding announcement of bad news or can be bailed out after the fact, the SEC is in a most difficult position to enforce the Federal securities laws. The quality of the securities disclosures becomes less meaningful and market integrity and public confidence suffers.

Mr. CONYERS [presiding]. You have made a statement that I think appropriately begins these hearings. I would like to just ask you how long it took you to conduct your investigation and put these comments together, sir.

Mr. CHAFIN. Days.

Mr. CONYERS. It is an incredibly powerful statement. You must have had some of the material already available because this sums up the whole hearing, as far as I am concerned. It puts the basis for what we are going to do in a very particular frame of reference, and I want to compliment you on it.

Mr. CHAFIN. Mr. Chairman, I would like to acknowledge the Justice Department, behind us, who has given us access to a lot of documents and records and analysis of cases and the like, and it has made our job a lot easier.

Mr. CONYERS. Thank you very much.

Chairman Dingell.

Mr. DINGELL. Thank you, Mr. Chairman.

We are very proud of our staff, and Mr. Chafin, you have done a fine job.

Mr. CONYERS. Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman.

Mr. Chafin, as far as you know, is the best efforts contract of the DIVAD unique or is it common Pentagon practice?

Mr. CHAFIN. According to the Justice Department, they hadn't run into the best efforts clause that often. We do know of level of efforts types contract are fairly common. A lot has been made of best efforts. Best efforts has to do with deliverables. You tell somebody I'm giving you \$39 million, firm fixed price, best efforts. Firm fixed price is the method of payment. It puts a constraint around how much money you can spend.

Best efforts relieves the contractors from not delivering a prototype. If they give you no deliverable but have put forward the engineering hours and made a best effort, they have performed under the contract. We have seen a lot of confusion in terms of what best efforts actually did or didn't do. It is our opinion that the problem that would absolutely undermine this case were the statements of the various individuals that would have been obviously heard by a jury showing the Army knowingly underfunded and expected the contractors to charge IRAD and B&P.

Mr. BLILEY. When the \$39 million was exhausted on the DIVAD, didn't the best efforts allow General Dynamics to claim legally that any additional expenses were no longer related to the contract and could be charged to overhead accounts?

Mr. CHAFIN. I don't believe so. I believe that when the \$39 million was exhausted, best efforts relieved General Dynamics and Ford Aerospace from any further effort. The future potential, though, was so great in terms of a multibillion dollar program that people would expect the contractors to dip into profits and the like.

Now, what kills the case, though, in terms of prosecution is when those same individuals talk about they will dip into profits and they will also dip into IRAD and dip into B&P. Once you have got Army people acknowledging that we expected them to do that, you have lost your case.

Mr. BLILEY. Thank you, Mr. Chafin.

Thank you, Mr. Chairman.

Mr. CONYERS. Thank you very much.

The Chair recognizes the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. Thank you very much, Mr. Chairman.

I have just two brief questions. Mr. Chafin, the common denominator in the cases that you have described has essentially been Government acquiescence in the fraud by military contracting officers. My question to you is: What seems to be the motivation for this kind of acquiescence? My perception is that there is a lot of heat on those Government contracting officers. They have got to get the weapon out, they have got to get it out on schedule, at cost, and it seems the whole environment is to kind of minimize problems and sort of send these optimistic "get well" cards that everything is going to come out fine.

Could you tell us what your perception is based on your investigation about why there is this Government acquiescence in these frauds?

Mr. CHAFIN. I believe your next witness hit it on the head, Mr. Weld, when he told us that pressures can be brought to bear on military contracting officers by supervisors who see the need to get the ship out, the engine built and the task accomplished, even at the expense of protecting the Government's financial interest.

I share his view. Careers are too often made in terms of staying on schedule and minimizing problems. We have seen more money is always a solution. You mentioned the overly optimistic get well plans.

Another one is waivers and deviations. The subcommittee currently has an investigation into the MX missile system, and you know as well as I do that the MX missile system has been somewhat political and there were some real problems with getting the guidance systems produced and delivered on time. At one point in time—and they still are way behind in the guidance systems—but they were identifying the fact that the guidance systems were out of spec, and the Air Force went to get a waiver. I will just quote you what the waiver says. It says, the justification. "The repair of the unit at this time would have significant impact on IMU delivery schedule and could jeopardize initial operating capability."

The AFPRO reviewed this, and the AFPRO said, "AFPRO considers the figures of merit a very effective means for screening IMU's, and an IMU displaying a higher than normal figure of merit indicates performance uncertainties. Therefore, the AFPRO recommends disapproval of the subject request for a waiver." The recommendation of the AFPRO was overridden by the Air Force, and again the overriding factor was in not correcting the problem. You had performance uncertainties. You know and I know what an MX missile can do, and yet the concern was the schedule. The concern was the initial operating capability date.

Mr. WYDEN. The only other question I wanted to ask, Mr. Chafin, was I said as I looked over these cases in preparing for the hearing that it seems that so often the taxpayer is a victim of the perfect crime. You have got the contractors informing the services about the activity, but there are no disclosures because of self-interest, and then the Justice Department can't prosecute because the Pentagon's acquiescence results in the lack of a victim.

Is that a sensible analysis, in your view, having gone through some of these cases?

Mr. CHAFIN. Yes. If you were going to do a conspiracy theory, you need a quid pro quo, and oftentimes the military officials that know don't personally gain. There is no evil intent in what they are doing. Basically they are doing what they perceive is important. The Army officials that wanted the DIVAD saw the DIVAD as a very important contract, a very important program, and if Congress won't fund it for \$60 million, then we will say whatever, do whatever so that Congress will approve it. In this case, we cut the price down to \$39 million and got Congress to approve it, but because they don't personally gain, you don't have the quid pro quo relationship necessary to do your conspiracy theories, and I think Mr. Weld may be able to help us on that.

Mr. WYDEN. Mr. Chairman, I thank you for the questions, and Mr. Chafin, I commend you for an excellent job in preparing the two subcommittees.

Mr. CONYERS. Thank you. The Chair is pleased to recognize the gentleman from Pennsylvania, Mr. Gekas, who is the ranking member on the Criminal Justice Subcommittee.

Mr. GEKAS. I thank the Chair.

The content of your long statement, Mr. Chafin, seems to me to conclude with and actually does conclude with a lamentation about the fact that the SEC is in a quandary in being able to seek and to obtain the proper disclosures in order to do its job with respect to all these individual cases. If we were by a magic wand able to give the SEC the power to get all of these disclosures before it, how would that help us in examining the relationship between the Navy and General Dynamics, for instance, in one of these sweetheart matters?

What I am seeing is that your inquiry seems to cry out for added weaponry for the SEC, and if that were obtained, it seems to me, it says you seem to feel that the quality of these disclosures would become meaningful. You end up by saying the quality of the securities disclosures becomes less meaningful and market integrity and public confidence suffers.

If the SEC were given what you feel it should be given in information, the problem is solved, it seems to me. I am wondering if that is the line of inquiry.

Mr. CHAFIN. No. Let me clarify it a little bit. What we are talking about in terms of these relationships and what is going on cut many ways. We are not only talking about victimizing the taxpayers, hurting national security, those types of things. We also have these contractors. General Dynamics was one. At the time they were experiencing the massive overruns and the massive schedule delays, there were internal estimates showing that the company was down close to \$1 billion. Similar estimates were \$1.2 billion would make General Dynamics financially insolvent.

Our Energy and Commerce Committee and the subcommittee is not only interested in the protection of the taxpayers and protection of other things that are going on, but we have also got a charter regarding protection of investors. I think what you are seeing regarding that portion of my statement is an attempt to address

the aspect of the investors in those corporations as well. They are another potential victim in these deceptions.

Mr. GEKAS. You may be correct that that is one of the lines of inquiry, but I—

Mr. CHAFIN. I don't think it is a line of inquiry in terms of the Justice Department; it is a line of concern of Chairman Dingell and our subcommittee.

Mr. GEKAS. That is what I wanted to know, in what balance the SEC portion of this had.

I thank the Chair.

Mr. CONYERS. Thank you.

Mr. Bilirakis.

Mr. BILIRAKIS. Thank you, Mr. Chairman.

Mr. Chafin, you obviously spent an awful lot of time on this chore and you appear to have done a pretty darn thorough job. I don't know what your background is in terms of technical defense contracting, but I am sure it must be there; otherwise the chairman would not have assigned you to this job.

But in the process, for instance, the question of why did the Defense Department not clearly establish that certain Pratt and Whitney expenses were expressly disallowed so that Pratt could not legally attempt to charge them to the Government, et cetera. We go to the overcharges. I'm sure in the process of all of your digging and your research and your work here, questions must have arisen in your mind about defense contract agency, procurement questions, things of that nature.

Did you formulate recommendations to this committee, to others, to the Congress in general? We can talk about the Justice Department, but I think our procurement practices and the entire defense contract picture needs to be really looked at. To me that is the bottom line.

Mr. CHAFIN. Right.

Mr. BILIRAKIS. So in the process, did you come to conclusions where, if I were a king or if I were in Congress or if I were John Dingell, which is synonymous with "king" sometimes, I would do this as far as legislation is concerned? If you did, are you going to make those recommendations available to the committee or have you already done so?

Mr. CHAFIN. I have not done so. As you know, we have been involved in legislation in the past dealing with certain matters affecting defense contracting, but I wouldn't presume to put myself in Chairman Dingell's shoes.

Mr. BILIRAKIS. Well, so what you are saying is that you had blinders on and concentrated in the area that was mandated to you and you did not go into anything in terms of—

Mr. CHAFIN. In terms of this effort, the \$64,000 question that we were asked to deal with was in these cases was why the Justice Department is unable to bring prosecutions; what is the problem? Is it a management problem within the Justice Department or is there something wrong with the merits of the case? I think based on our analysis and work, it is clear that the merits of the cases aren't there. The acquiescence issue is undermining our ability to detect, protect, and deter.

Mr. BILIRAKIS. So the conclusion may come out of these hearings that the Justice Department is wrong or the Justice Department is right, but we still would not have addressed the nuts and bolts of it all, and that is the need for corrections and improvements as far as the legislation is concerned; is that right?

Mr. CHAFIN. Yes. I think what we are seeing is the paramount need for improvement lies across the Potomac at the Pentagon.

Mr. BILIRAKIS. But we are the Congress, and if we think improvement lies there, then we ought to be addressing that, don't you think?

Mr. CHAFIN. Yes, exactly.

Mr. BILIRAKIS. And we aren't addressing it.

Mr. CHAFIN. One of the things we have talked about internally, and maybe you would support us in trying to study it or examine it further, is looking at separating out the people who are determining the requirements and working with the contractors to design and develop, and separating from that the people actually involved in the procurement and the financial aspects of it, getting two people, because right now you have got one person trying to serve two masters.

Mr. BILIRAKIS. I would suggest that we aren't doing our job adequately if we just continue in one vein and don't look at the overall picture.

Mr. CHAFIN. Right.

Mr. BILIRAKIS. Thank you.

Thank you, Mr. Chairman.

Mr. CONYERS. Are there any other questions from any members of the committee?

[No response.]

Mr. CONYERS. We thank you very much for an excellent work product, Mr. Chafin.

Mr. CHAFIN. Thank you, Mr. Chairman.

Mr. CONYERS. Our second panel consists of the Assistant Attorney General of the Criminal Division, William F. Weld; old friend Victoria Toensing, Deputy Assistant Attorney General of the same division. From the FBI we have Stan Klein, Special agent in charge from New Haven; Joe Corless, special agent from Baltimore; William Neumann, Supervisor, Miami; Steve Kennedy, Supervisor, New Haven; William Emfeld from the FBI Headquarters.

If you will all stand and let me give you the oath.

[Witnesses sworn.]

Mr. CONYERS. Welcome to this joint hearing. We are used to seeing you more over in the Judiciary hearing rooms but we are pleased you are here. All of your statements that you have carefully put together will be without objection, accepted into the record and re-printed in their entirety, which will allow you to proceed in your own way.

Mr. Weld, you may begin when you choose.

TESTIMONY OF WILLIAM F. WELD, ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, U.S. DEPARTMENT OF JUSTICE, ACCOMPANIED BY VICTORIA TOENSING, DEPUTY ASSISTANT ATTORNEY GENERAL; STANLEY KLEIN, SPECIAL AGENT IN CHARGE, NEW HAVEN; AND ROBERT NEUMANN, SUPERVISOR, MIAMI

Mr. WELD. Thank you very much, Mr. Chairman. I'd like to summarize briefly what I think are the major reasons for declining to proceed in the three cases that are the subject of today's hearings, and then along the lines that Mr. Bilirakis was just mentioning, I'd like to offer a set of suggestions or lessons or wise thoughts, if you will, that have occurred to us as a result of this set of three cases.

First, with respect to the General Dynamics' Pomona/DIVAD case out in California, I do believe that the principal reasons why there was a change there in the Justice Department's view of the case are two in number.

First, prior to indictment, the Justice Department did rely on some Government witnesses who in good faith viewed this contract as a fixed price and unambiguous contract. Second, the circumstance that there were a large number of documents, as Mr. Chafin's statement recited, that between the years 1977 and 1985, were disbursed around the country, relocated, perhaps given to elements of the Defense Department which were renamed, so that by the time the document request came along in 1985, not all the relevant documents were retrieved. This circumstance was an important reason for the prosecution's failure to appreciate as fully as it should have the full import of the course of dealing between the parties to this contract during the negotiation phase.

With respect to the General Dynamics matter in Connecticut, the so-called Electric Boat case, in my mind, the fundamental problem with that potential prosecution was that the data that were allegedly falsified were essentially estimates as to future dates and costs. They were not historical or clearly measurable facts which were capable of definite ascertainment and knowledge.

When you deal in estimates, you deal in ranges. The figures supplied by Electric Boat in that case were within a range. Their estimates did have support. The result of this is that you couldn't say, couldn't prove beyond a reasonable doubt, that you were dealing with a false statement of fact or a claim that was false in the sense of being based on false information.

That to me was the real problem with the Electric Boat case. The fact that the Navy knew the subsidiary facts relating to these estimates certainly would not have helped the jury appeal of the case if an indictment had been sought and brought to trial, but that fact in my mind at least would not necessarily have been legally fatal.

If a company submitted a claim to the military based on statements as to objective fact, that the company absolutely knew, and I'm saying "company" in a hypothetical sense, if any company did this, submitted a claim based on a statement as to objective facts that the company knew were outright lies, it wouldn't matter if the Navy or the Army or the Air Force knew those statements were lies. It would still be technically a false statement within the meaning of the false statement statute, 18 U.S. Code 1001.

I also think, and this is really getting to the nub of the question as to how pessimistic we should be about our ability to bring prosecutions in the future, I also think that hypothetically, if military personnel expressly agreed with personnel of a contractor, send in your false statements, your lies, and we will pay you anyway in service of the greater good and glory in getting this tank or ship or plane delivered, I think that situation could be prosecuted under 18 U.S. Code Section 371 as a conspiracy to defraud the United States, take money that belongs to the United States or perhaps even as a mail fraud under the mail fraud statute, Section 1341.

I don't think it would be necessary to such a prosecution to have any money change hands. In other words, in my view, that case would be prosecutable even in the absence of a bribe, kick back or gratuity.

To use Representative Wyden's words from earlier, if there was that kind of under-the-table collusion between military personnel and personnel of a contractor, it would be a perfect crime against the taxpayer only if nobody found out about it. If the Government could prove that is exactly what happened, then I think that would be a prosecutable case. In that sense, I'm not quite so pessimistic, I think, as Mr. Chafin, about our ability to bring prosecutions in this priority area in the future.

The third case, I'm going to leave most of the discussion to my colleague, Ms. Toensing, as to the Pratt & Whitney case in Florida. It may sound similar to the situation I just outlined, where the military agrees with the company, send in your claim. That did happen on one level in Pratt & Whitney, send in all your costs, we will negotiate with you, we will negotiate them out.

The problem in the Pratt & Whitney case is it was not wrong under the regulations to present all these so-called unallowable costs for negotiation. In fact, it was expressly permitted to submit them for negotiation. Even if the company and the military had gotten together and agreed that was going to happen, they would not be agreeing to have a lie submitted to the military. That in my view is why that case wasn't there.

It would be different if the company and the military had gotten together and agreed to conceal the nature of what was being submitted. You may recall in the Pratt & Whitney case, there were costs that were allowable and then unallowable. They could both be submitted. Then there were expressly unallowable costs which could not be submitted even for negotiations.

Suppose candy was an unallowable cost, category B, and whiskey was an expressly unallowable cost, category C, and the military fellow and the contracting officer from the company got together and said, well, we have a problem here, we have \$1 million of whiskey that we want to get paid for, we know we can't, and if the military officer said, that's OK, send it in and call it candy and I'll approve it, that to me would implicate the elements of deception and false statements sufficiently to support a prosecution.

As to our suggestions and reflections and lessons learned, if I may recite them very briefly, number one, coming out of the Pomona case, if a military contract contains non-standard language or is even arguably ambiguous, it is obviously of the highest importance for the Justice Department prior to indictment to consider

including as part of its Grand Jury investigation, going into all the conversations and actions of those involved in the negotiation process. Under those circumstances, the course of dealing or historical practice will possibly constitute a gloss on the meaning of the contract which won't be apparent from the face of the contract itself. That is what happened in the Pomona case.

A corollary of this is that in such a situation where you have an arguably ambiguous provision, it is all the more important to vacuum the military services for all documents that might possibly lead you to some witness who was involved in the negotiation process.

Another corollary learned from the Pomona case is an absence of evidence of concealment such as back dating or altering documents, two sets of books, perjury in the Grand Jury, coaching of witnesses by corporate counsel, that sort of thing, while it may not necessarily be fatal, an absence of evidence of concealment is a red flag to the Justice Department to inquire further as to what was the duty of the company, what did the company conceive its duty to be.

Point two that we learned, I think, is it is important for the Justice Department to understand that the DCAA auditors are just that, they are auditors. They are not necessarily going to conduct a full street investigation. It is essential before the Justice Department seeks an indictment from the Grand Jury that we conduct in effect not only a de novo evaluation of the evidence, but also in cooperation with the investigative agency, whether it is FBI, DCIS, whoever, a street investigation as well.

Point three: if overruns are to come out of profit and sometimes they do, it is important that be stated clearly in the contract. I understand this has been addressed since the time of the DIVAD contract by amendments to the Federal Acquisition regulations.

Point four: similarly, it is important for both contracts and even requests for proposals to address with clarity the extent to which overhead accounts such as bid and proposal or research and development can be invaded. This is especially important when you have a two stage production process as was the case in the Pomona prosecution.

Point five: a suggestion, the possibility of including a so-called merger clause in major defense procurement contracts to deal with the so-called acquiescence problem. This is standard boilerplate in insurance contracts, real estate contracts in the private sector. It prevents your agent, for example, the insurance broker, from negotiating away provisions in the contract.

Point six: the so-called bottom line procedure of negotiation can cause problems for the Government if the Government wishes to track back through the negotiation process to hold the contractor to a line item. For example, for overhead costs. To that extent, it is unfriendly to later prosecution.

Point seven; again, with respect to the acquiescence problem, possibly perhaps consideration could appropriately be given to rotation of contract officers more frequently to promote arm's length dealing, consideration could be given to the reporting relationships of contracting officers to their superior personnel.

Point eight: the revolving door of employment, I understand has been addressed by legislation already and others are on the table.

Point nine: acquiescence can happen at the initial stage as well as during the course of execution of a contract. If a project is unrealistically underfunded up front, that will lead to difficulties later down the line.

Point ten and last concerning the acquiescence problem, again, I would reiterate that I do not think that acquiescence or knowledge will always defeat prosecution. If there is a deliberate violation of a clear duty, statutory or regulatory, whether it is by an individual or two individuals acting in concert, my view is that case can be prosecuted even without a loss to the Government, although that helps, and even without a venal motive or personal gain by parties to the transaction in question, although that of course would help with prosecution enormously.

I think what the Justice Department and the Defense Department and Congress can all work on together is making sure that duty is as clear as it possibly can be.

Thank you.

[Testimony resumes on p. 60.]

[The prepared statement and attachments of Mr. Weld follow:]

TESTIMONY OF

WILLIAM F. WELD
ASSISTANT ATTORNEY GENERAL
CRIMINAL DIVISION
U.S. DEPARTMENT OF JUSTICE

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to discuss the Justice Department's recent experiences in connection with three defense procurement fraud cases which were either declined for prosecution or dismissed on motion of the government.

As the Members of this Subcommittee are aware, the decision to prosecute or decline a particular case is not the only standard by which to measure our progress in the area of defense procurement fraud. In every major investigation the Department undertakes there is a great deal to be learned about the contracting process which can improve our ability to prevent fraud, waste and abuse. We welcome the opportunity to share that experience with the Congress because only through an enlightened appreciation of the problems and difficulties involved can all the interested parties (Justice Department, DOD, and the Congress) fulfill their respective responsibilities under the law. Before discussing the specifics of the three cases of particular interest to the Subcommittee, I would like to take a moment to put those cases into the context of the Department's defense procurement fraud effort as a whole.

As you know, combatting defense procurement fraud is the number one white collar crime priority of the Department. This effort focuses not only on the vigorous prosecution of procurement frauds but also on efforts to prevent future frauds by altering the behavior of defense contractors in their dealings with the government.

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The Department's efforts, both in the Criminal Division's Defense Procurement Fraud Unit and the United States Attorneys' offices around the country, have resulted in convictions of approximately 200 individuals and 35 corporations in the past two years. Included among those prosecuted and convicted are seven of the top 50 defense contractors. ^{1/} These cases have yielded criminal fines of approximately \$11 million and related civil recoveries of \$56 million from May 1, 1985 through June 30, 1987. ^{2/}

These figures do not reflect the full impact of enormous administrative recoveries and voluntary adjustments by defense contractors after the criminal investigations had commenced. ^{3/}

We also believe that our efforts to modify the behavior of contractors have begun to see some success in causing them to institute internal controls to ensure compliance with laws, regulations, and high standards of ethical business conduct. On June 9, 1986, 35 defense contractors signed the Defense

^{1/} Attached is a list of the 35 corporations convicted during this time period specifically noting those seven in the top 50. (Appendix A).

^{2/} These statistics were compiled from reports generated by the United States Attorneys' offices and submitted to the U.S. Department of Justice Criminal Division, as well as the Criminal Division's own statistics of cases prosecuted by the Defense Procurement Fraud Unit.

^{3/} In one investigation now closed, the initial allegation concerned \$1.2 million in overhead overcharges. DOD has advised us that after the investigation commenced, the contractor gave DOD credits and payments of \$28.3 million with additional projected savings of \$12.7 million from reduced overhead charges. In another closed investigation, \$16 million was removed from costs on open proposals involving the issue under investigation.

Industry Initiatives on Business Ethics and Conduct (copy attached as Appendix B). By signing this document, the signatory companies adopted a set of principles of business ethics and conduct that acknowledge and address corporate responsibilities under federal procurement laws. Each company pledged to implement policies and programs to create an environment in which compliance with federal procurement laws and free, open and timely reporting of violations would become the felt responsibility of every employee in the defense industry. In addition, a number of major defense contractors have adopted a policy of voluntarily disclosing problems affecting their corporate contractual relationship with the Department of Defense. ^{4/}

I now turn to a discussion of the three cases of special interest to the Subcommittee.

A. GENERAL DYNAMICS - ELECTRIC BOAT DIVISION

The Department of Justice began investigating General Dynamics Corporation and its Electric Boat Division in 1978 after Admiral Hyman G. Rickover asserted that Electric Boat's multi-million dollar 1976 claim against the Navy for certain cost overruns on a submarine contract was fraudulent. The Fraud Section of the Criminal Division and the Federal Bureau of Investigation, with other governmental support, launched an extensive grand jury investigation into the nature of Electric

^{4/} As of July 24, 1987, there had been 24 voluntary disclosures by 17 contractors. Most of these cases are under active criminal investigation.

Boat's claim. The investigation sought to obtain evidence to determine whether Electric Boat had violated 18 U.S.C. § 1001 by enlarging the scope of the claim to cover items for which recovery was not allowable and/or claiming more recovery than that to which it was legitimately entitled on allowable items. After four years of investigation including the examination of 82 witnesses and analysis of 80,000 pages of documents, insufficient evidence to prove commission of a crime was discovered and prosecution was declined in 1981.

The original investigation was reopened and refocused beginning in mid-1984 when the Department of Justice received a set of tape recordings from P. Takis Veliotis, a former executive vice president of General Dynamics and general manager of the Electric Boat Division. The tapes contained recordings of telephone conversations in 1977 and 1981 between Veliotis and David Lewis, chairman and chief executive officer of General Dynamics, Gordon MacDonald, vice president for finance, and others. The recorded conversations suggested that in two instances, General Dynamics might have falsified data between 1977 and 1981 concerning delivery dates and costs affecting submarine construction contracts. A task force consisting of Justice Department attorneys, agents of the Federal Bureau of Investigation and the Naval Investigative Service, auditors from the Defense Contract Audit Agency, contract administration experts and computer support personnel was assembled. The task force conducted a grand jury investigation from June 1984 to

March 1987 to determine whether General Dynamics had provided false data to the Navy, the Securities and Exchange Commission, other governmental agencies, or the Congress, and whether any illegal conduct attended the Navy's award of new submarine construction contracts to General Dynamics in 1982. During the course of this second investigation, the task force examined 120 witnesses and analyzed hundreds of thousands of pages of documents.

In early 1987, the evidence assembled was analyzed to determine if it was sufficient to obtain a conviction for violating federal statutes prohibiting false statements to the government, conspiracy, and securities fraud, among others. After thorough review and upon the unanimous recommendation of the career prosecutors on the case, the Department concluded that there was insufficient evidence to support criminal prosecution on the issues raised by the Veliotis tapes as well as on numerous other issues either raised by Veliotis during interviews or brought to the attention of the task force during the investigation.

During the course of both of these investigations of General Dynamics, Electric Boat Division, two recurring themes emerged which contributed substantially to the decisions not to prosecute. First, the data provided and the claims theories advanced by General Dynamics could not be shown to be literally or technically "false." The evidence indicated that the data and information submitted by General Dynamics to the Navy in

connection with the disputed claims could properly be characterized as estimates or forecasts of future performance and therefore as subject to the vagaries of the estimating process and the application of subjective judgment. The data was not totally without arguably rational support or foundation and was always subject to modification by unknown and unforeseeable future events. In some instances, the data in question was examined and signed off on by independent certified public accounting firms; and in those circumstances where General Dynamics advanced a novel legal theory in support of a particular claim, it had an outside law firm's opinion that the theory was supportable. While in every case the data submitted to the Navy and the legal theory advanced inured to the benefit of General Dynamics, that fact alone does not support a criminal prosecution, and investigation failed to reveal evidence to prove that the company's actions were done with criminal intent, that is, not only knowingly, but also with an unlawful purpose.

The investigations looked for evidence of alteration, back-dating or destruction of documents, creation of false documents, multiple sets of books or records or inconsistencies between them (other than the existence of a spectrum of estimates) as well as instructions or suggestions to employees to falsify or withhold information from government employees or auditors. No such evidence was found.

Second, in most instances the Navy apparently did not rely on the data that General Dynamics submitted to it, but did its own independent analysis and reached its own conclusions. That the Navy did not rely on the data submitted does not, of course, foreclose prosecution, reliance on false data not being required under the law. But, the prosecutive potential of the case was clearly undercut by the fact that on each occasion where the Navy and General Dynamics reached an impasse, the Navy's solution was negotiation, compromise, and settlement (with Congressional authority in the case of the 1978 Public Law 85-804 claim resolution). The Justice Department investigation did not develop any evidence that Navy personnel, in the course of their relationship with General Dynamics, were motivated by any criminal purpose, nor any evidence that any military personnel profited personally from those dealings.

Finally, the theory that Congress or the taxpayers may have been victimized by the course of events investigated was considered. Under certain circumstances, I believe such a prosecutive theory to be tenable. However, without evidence to prove that the data submitted by General Dynamics was literally or technically false, and absent evidence of an intent to defraud or illegal collusion on the part of the Navy, there was insufficient evidence to show that a crime had been committed. Under that circumstance, the question of the identity of the victim was academic.

B. GENERAL DYNAMICS - POMONA

In April 1977, the Army issued a Request For Proposal (RFP) for the Divisional Air Defense (DIVAD) weapons system. This new weapons system was intended to protect troops from attack helicopters and small fixed-wing aircraft. A prototype phase was to be followed by a multi-billion dollar production phase. Interested contractors were informed by the Department of Defense that the Army would issue an RFP for the production contract during the prototype phase. Five contractors submitted prototype proposals, including General Dynamics/Pomona Division and Ford Aerospace (Ford). In November 1977, the Army selected these two contractors to design and develop two prototypes within a 28 month period. Selection of one contractor from the two competitors was to be based upon performance during a test phase and upon an evaluation of the production proposal.

In January 1978, the Army executed identical \$39 million contracts with General Dynamics and Ford for the prototype phase, and performance by both contractors began. The contracts incorporated the contractors' prototype proposal provided in response to the government's prototype RFP. In April 1981, the Army awarded the production contract to Ford.

In June 1983, the Defense Contract Audit Agency (DCAA) referred to the Justice Department allegations of suspected labor and materials mischarging by General Dynamics in connection with the prototype contract. In February 1984, the DCAA completed a full audit of General Dynamics's charges to the contract and to

independent research and development, bid and proposal and other indirect accounts. The DCAA concluded that approximately \$3 million of contract costs had been mischarged to indirect expense accounts, including IRAD and B&P accounts, for calendar years 1979 and 1980.

Consequently, an investigative task force was established at the Defense Criminal Investigative Service (DCIS) Los Angeles Regional Headquarters (Laguna Niguel, California) to conduct an inquiry into the allegations of illegal activities by both DIVAD prototype contractors. An Assistant United States Attorney from the Central District of California was assigned to the investigations to assist the Departmental attorney from Washington.

The audit of General Dynamics was predicated upon the DCAA's belief that the DIVAD contract was a firm fixed price contract which had specific, mandatory requirements. The audit report and the advice of DCAA personnel in connection therewith were critical to the prosecution's early understanding of the contract as a firm fixed price type, with specific and mandatory requirements which would have precluded any charges to indirect accounts. This understanding formed the premise upon which the entire investigation was conducted and the indictment presented to the grand jury.

Although there was not unanimity of opinion among the individuals reviewing the prosecution as to the wisdom of returning the indictment as proposed, on December 2, 1985, a seven count indictment alleging labor and materials mischarging was returned.

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Count One alleged a conspiracy (18 U.S.C. §371) to defraud the United States of money and to hamper, hinder, impair and impede the Department of Defense in its administration of the DIVAD prototype contract and its advance agreements with General Dynamics concerning reimbursement for IRAD and B&P efforts. The purpose of the conspiracy was alleged to have been that General Dynamics, when faced with substantial cost overruns beyond \$39 million, attempted to minimize its loss by fraudulently allocating certain costs to IRAD and B&P accounts rather than to corporate profit. Counts Two through Seven were false statement counts (18 U.S.C. §1001) which alleged the making of material misstatements or the concealment of material facts in connection with financial records maintained or submitted by General Dynamics to the Department of Defense.

The indictment alleged that the contract involved was a "firm fixed price" contract. The contract is a 52 page document with seven attachments and 22 modifications. It contains certain language which evidences the existence of firm requirements, e.g., "[t]he ... design requirements are considered firm in regard to the DIVAD Gun System, no deviation will be allowed or granted in their regard"; and "[t]he contractor's efforts will be directed toward meeting the FIRM REQUIREMENTS"

This language is in contrast to "best efforts" language in the contract which, apparently, modifies the requirements of the contract, e.g., the description of the contract type as

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"firm fixed price (best efforts)", and the statement that [t]he contractor ... will provide his best efforts ... to design, develop and deliver the DIVAD gun system" The contract does not define "best efforts."

Prior to return of the indictment, in order to determine the meaning of various provisions of the contract and what was required by it, the government looked to certain DOD personnel who were responsible for the management of the execution of the contract. Specifically, the opinions of the Army's DIVAD Project Managers on this issue were considered. None of the government witnesses interviewed prior to indictment raised any issue with respect to the best efforts language or the apparent inconsistency between firm requirements and best efforts. The witnesses believed that the government had given the contractor \$39 million to perform the work set out in the contract and that any work after the \$39 million ceiling was reached could not be properly charged to IRAD and B&P accounts. According to one important government witness, costs above \$39 million were required to be allocated to corporate profit. Statements in certain General Dynamics internal cost accounting documents and memoranda, examined prior to indictment, were consistent with a firm fixed price construction of the contract that required certain deliverables.

Although counsel for the defendants raised the issue of the apparent inconsistency between firm requirements and best efforts during meetings with the government prior to indictment, there did not appear to be any government witnesses to support the

defendant's theory. The theory was accordingly discounted by the prosecutors as an "after-the-fact" rationale, and the effect of the best efforts language in the contract was considered to be minimal. The prosecution believed, at the time, that the provision merely made explicit that which is implicit in every contract -- a duty of the contractor to operate in good faith and to use his best efforts to comply with the contract.

Prior to indictment, Justice Department attorneys were also aware of potential issues concerning the applicability of IRAD and B&P regulations to certain costs incurred by General Dynamics in connection with the DIVAD project. The Justice Department attorneys turned to DCAA and the Defense Logistics Agency (DLA) for their advice regarding the IRAD and B&P charges in question. As a result of these discussions, it appeared that the potential issues concerning the alleged IRAD and B&P mischarges would not significantly affect the case. Accordingly, a decision was made to proceed with the presentation of the indictment.

Following return of the indictment, the prosecutors continued interviews in order to identify other persons within DOD responsible for the formulation and implementation of the acquisition strategy and familiar with related regulations, and to secure experts for trial. Also, in January 1986, FOIA requests by General Dynamics and Ford were submitted to various DOD components. These requests and a FOIA lawsuit resulted in the Army locating thousands of documents that had not been

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furnished to the prosecutors despite a written request for all relevant documents in August 1985. The discovery of these documents, which were contained in 114 boxes, led to the discovery of additional relevant documents and witnesses. ^{5/}

These documents assisted the prosecutors in gaining a better understanding of the circumstances surrounding the approval and execution of the contract. In light of this new evidence, interviews were conducted with other former and present DOD personnel involved in the DIVAD acquisition strategy and the negotiation of the contract. An analysis of this evidence took place over several months and revealed that our pre-indictment understanding of the contract was incomplete or based upon misinformation.

The analysis by Department prosecutors revealed that the contract which was the subject of the indictment was highly unusual in that it required General Dynamics only to use its

^{5/} The failure to locate and produce all relevant documents prior to indictment was reportedly due, in large measure, to their having been segregated from the main body of prototype documents because of a lack of storage space. The additional documents were found in various and disparate DOD elements which, because of the significance of the DIVAD acquisition, had been involved in the program. The process of locating these additional documents was complicated because many of these original DOD elements had been renamed or placed within other DOD components. The fact that these documents were not discovered until after indictment was one of the most significant factors leading to the prosecution's failure to fully appreciate the import of the entire course of dealing between General Dynamics and Army negotiators on the contract.

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best efforts to produce the prototype gun for the fixed price of \$39 million. The contract as designed by the Army enabled the contractor to quit work without complete performance if it had used its best efforts while expending the contract price of \$39 million. A number of government witnesses, identified from the documents produced by the Army after indictment, would have testified that \$39 million was inadequate funding to produce the DIVAD prototype and that significant cost overruns were anticipated. Moreover, there would have been testimony that, in discussions between certain lower level General Dynamics and Army contracting personnel, an understanding was reached that at least part of these cost overruns could be charged by General Dynamics to IRAD and B&P accounts.

Further, it became apparent after opinions of government experts were obtained, that the effort alleged in the indictment to be "otherwise not legitimate bid and proposal and independent research and development" was, in fact, effort that would have qualified as legitimate B&P or IRAD costs if there had been no contract. Thus, both theories upon which the indictment was based proved to be no longer viable, and the government moved to dismiss.

C. Pratt & Whitney Aircraft Group
(Government Products Division)

In March of 1982, the Government Products Division (GPD) of the Pratt & Whitney Aircraft Group (a part of United Technologies Corporation) submitted a claim to the government seeking reimbursement for its overhead costs incurred during Calendar Year

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(CY) 1981 operations. This claim, known as a final overhead rate proposal, was predicated upon GPD's actual cost experience, i.e., costs that the contractor had actually incurred.

According to the United States Attorney's office for the Southern District of Florida (the office which conducted the Pratt & Whitney investigation), GPD's CY 1981 final overhead rate proposal (hereafter "claim") was alleged to be false not because it included any fictitious costs but rather because it included actual costs incurred by the company which, by government regulations, should have been excluded from the claim as costs not allowable for reimbursement on government defense contracts.

The controverted costs in GPD's claim included: (1) various "advertising" costs incurred by the contractor, e.g., the cost of souvenir or souvenir-type items such as tie tacks, coffee mugs, baseball caps, t-shirts, pen and pencil sets, quartz calendar watches, etc., which bore the logo of the company and which were distributed primarily to non-employees, as well as the costs associated with various air shows and exhibitions in which GPD participated; (2) various "entertainment" costs incurred by the contractor in connection with local business discussions and company-sponsored parties and banquets for employees of the company; (3) the costs associated with a company-sponsored employee rebate program; and (4) the costs associated with a company-sponsored executive automobile leasing program. Except for the executive automobile leasing program, the bulk of these costs were charged to the company's "Sundry" account.

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The company also allegedly gave illegal gratuities to government personnel (i.e., civilian and military Department of Defense personnel, as well as Members of Congress, their spouses, and staff), primarily in the form of meals, transportation and lodging.

Finally, the company was investigated for double-billing various intracorporate accounts from CY 1977 forward.

The 131-page declination memorandum prepared by the United States Attorney's office for the Southern District of Florida states, in summary, that the relevant regulatory principles were vague, conflicting and overlapping in crucial respects. Open-ended concepts such as "public relations" and "employee morale" blurred the line between reimbursable and nonreimbursable costs, not to mention the line between negotiable and nonnegotiable (or expressly unallowable) costs. According to the United States Attorney, these difficulties were magnified by an apparent reluctance on the part of the Air Force to effectuate the goal of the Cost Accounting Standards Board to "foster earlier and more precise identification of unallowable costs, and thereby narrow the areas of cost search, disagreement and negotiations of differences." Instead, the evidence showed that the U.S. Air Force pursued a final settlement of costs on an equitable basis without adequate concern for resolving cost disputes or ensuring that the contractor excluded unallowable costs from its claim. This "bottom line" negotiation technique, in which no specific agreement was reached on the allowability or unallowability of particular items or types of costs, resulted in repetitive consideration of the same cost items every year.

There was also evidence that the contractor was implicitly or explicitly authorized by the Air Force to include these questionable items in their overhead expense claim for purposes of negotiation.

As a result, the United States Attorney reached the conclusion that no prosecution could be brought despite the fact that some of the charges to the government seemed highly questionable.

Since March 31, 1982, and especially after the Federal Bureau of Investigation commenced its Pratt & Whitney investigation, extensive changes have been made in military procurement practices in an attempt to overcome the deficiencies which hampered this potential prosecution. As a result, the distinction between "allowable" and "unallowable" costs is much clearer today and the contractor's initial obligation to identify and exclude unallowable costs from its claim is a matter which is required to be dealt with in the procurement process.

Moreover, by statute, regulation, and agency directive, significant changes have been made in military procurement procedures generally. As a result, many of the costs examined in this investigation which were shrouded in uncertainty could now be identified with a reasonable degree of confidence as whether they were "allowable" or "expressly unallowable" if a contractor were to submit them today. In addition, GPD has, in compliance with applicable Cost Accounting Standards, entered into a formal written "Memorandum of Understanding" with the

military, setting forth costs "mutually agreed to be unallowable" which GPD thereafter would exclude from all future claims and proposals, together with directly associated costs. The June 25, 1985 agreement further delineates disputed cost items which GPD agreed to identify and segregate into separate accounts as the costs were incurred. The agreement covers attendance at award ceremonies, trade shows and exhibits, attendance at functions of organizations such as the Air Force Association and Navy League, air show souvenirs, sporting events, banquets and parties, theatrical performances and concerts, country club dues, cruises, employee meals, and other items. Had such an agreement been entered into prior to 1981, it is unlikely that GPD would have included such costs in its 1981 claim and if such costs had been included, the wrongfulness of GPD's conduct would have been obvious.

SUGGESTIONS FOR THE FUTURE

From our point of view as prosecutors, several lessons can be derived from these three experiences.

1. When we are confronted with an allegation of fraud in connection with a defense contract and that contract is in any way unusual or ambiguous (as was the DIVAD Prototype contract), consideration should be given to expanding the scope of the investigation to include contact with all of those involved in the negotiation process. While it is appropriate and proper to rely on the understanding of Generals, Admirals and other senior military officials concerning contracts whose terms are clear and

unambiguous or which have familiar provisions with established meanings, such reliance is inappropriate where the contract terms are unusual or arguably ambiguous. When there is an ambiguity or novel feature to a contract, the conversations of those involved in the contracting process may become relevant to the Court in interpreting or defining the expectations of the parties.

In this connection, obviously it can be vitally important to pursue document requests with every component of the military which may possibly have been involved in the contract negotiation in order to ensure that the Justice Department comes into possession of all existing documents and records relating to a particular contract. This is not always a simple matter given the multitude of individuals and entities involved in complex military procurement processes, and the changing cast of characters.

2. There are limitations on the audit functions which the Defense Contract Audit Agency (DCAA) performs. ^{6/} A significant number of cases referred to the Department by DCAA based on apparent financial or accounting disparities do not, in fact, turn out to be prosecutable frauds. In some cases, the referrals would have been unwarranted if the auditor had pursued the financial "investigation" one step further and talked to the government representatives involved in the case -- a step which DCAA auditors sometimes may be reluctant to undertake because of

^{6/} DCAA has a wide range of responsibilities including performance of pre-and post-award audits of defense procurement contracts and the on-going monitoring of contractor compliance with the Cost Accounting Standards.

concern about auditors performing "investigative" tasks. If the auditor relies solely on the reports generated by the procuring agency, then the investigating agency at the outset must interview the government employees involved in the process to determine whether some government employee or agency has taken an action that could undercut the prosecutive merit of the matter.

More significantly, because of the relatively limited function performed by DCAA, it is all the more important for the Justice Department to conduct, in essence, a de novo investigation and evaluation of the evidence.

3. When DOD decides that excess costs should come out of the contractor's profit, a clear statement to this effect can be included in the contract, and the contractor can be advised that excess costs cannot be recovered through overhead accounts. (I understand this has been addressed through amendments to the Federal Acquisition Regulations since the time of the DIVAD prototype contract.)

4. When a contract is part of a larger program which includes follow-on contracts, the contracting officials can appropriately address, during the planning stage, the potential use of B&P or IRAD funds for tasks which may satisfy the contractual requirements and the contractor's proposal. This is especially important when a contractor is performing a contract, such as a development-type contract, and at the same time preparing a proposal for a related production contract. While this matter has also been addressed through regulations, compliance with those regulations remains an issue in some cases.

With respect to the IRAD and B&P costs, contracts can be drafted so as to specify what, if any, work can be properly charged to these indirect accounts (including funds used to perform work related to contractual effort or so-called "parallel development"). In certain circumstances, it may be appropriate for the government to address, in its request or invitation for proposals, the availability of B&P accounts.

5. Another possibility would be to include a so-called "merger" clause in all defense procurement contracts, stating that all the terms of the agreement are in the writing - the contract - itself and that they cannot be modified except via a writing executed by both parties. That would leave little room for debate about what various DOD officials did informally or said orally to amend the terms of the contract, authorize change orders or add-ons, or the like. Such merger clauses are standard boilerplate in real estate, insurance, and other private commercial contracts.

6. The practice of "bottom line" negotiation which we understand to have been utilized in 1981 in the Pratt & Whitney case (reaching a bottom line agreement with the contractor on price without addressing the amounts agreed to by the parties as being allocable to the individual components of the price) can create problems. While the Truth in Negotiations Act requires the contractor to certify the currency, accuracy, and completeness of its cost or pricing data used to support its bid or

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proposal, both the contractor and the procuring entity may believe that the next step in all likelihood will be a downward negotiation in the proposed price. If so, then to assume the only component of price with "flexibility" is profit is to ignore reality. The contractor will make assumptions and projections which increase the bid price, and the procuring agency will make those which reduce the bid price. It is the difference between the estimates and assumptions of the parties wherein the negotiation occurs. The process, while clearly capable of abuse, is not one likely to generate sufficient evidence of criminal conduct to prove a crime, particularly one based on fraudulent intent or literal falsity. As a result, a "bottom line" negotiation can undercut the government's ability to track back from the contract, through negotiations, to the bid or proposal, to analyze what exactly (and how much) the government agreed to pay for any component of the price. In the overhead area, the "bottom line" negotiation also allows the contractor plausibly to deny notice that a particular cost in overhead is unallowable, so that the contractor may keep claiming the cost year after year. (This can create an impediment not only to criminal prosecution but to civil recovery as well.) Similarly, if government officials know about unallowable costs that are lumped into a "bottomlined" negotiation, that can adversely affect the ability to make a case that the government was defrauded or deceived.

7. Defense contractor personnel and military procurement and contracting officials may work together for years, negotiating various massive contracts. In order to make the procurement process more arms-length, one possible step might be to rotate contracting officers more frequently. This would help to reduce the impact of the close relationships that can develop when officers and contractors work together for too long a period of time.

8. Another possibly relevant circumstance is the so-called "revolving door." Some military procurement and contracting officials take positions with the defense contractors they work with when they retire from the military. This arguably creates an incentive for them to be accommodating when they negotiate and supervise defense contracts. I believe various legislative responses to the "revolving door" situation have been proposed, and some have been enacted.

9. Finally, let me offer the view that in many investigations, we have found, rather than venal or improper acquiescence on the part of government officials, a merging and mutual reinforcement of interests -- profit motive on the part of defense contractors, and a desire to accomplish the mission on the part of the military. Military officials may overlook or ignore infractions by the defense contractor, not because of an evil intent or for personal gain, but because of a belief in the importance that the project or the new technology has to national security. In the absence of fraudulent intent, the resulting overcharges may not be prosecutable or even recoverable.

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However, that is not to say that there are no circumstances where the collusion or connivance of public and private contracting personnel would rise to the level of criminal fraud. For example, if a defense contractor notifies a military contracting officer that the contractor is experiencing massive cost overruns and the two individuals thereafter engage in a scheme to cover up the overruns by backdating or falsifying material documents, that would, in all likelihood, constitute a prosecutable criminal case -- one which we would pursue with vigor.

Mr. Chairman, this concludes my prepared statement and I would be happy to answer your questions at this time.

APPENDIX A

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|-------|--|-------|---|
| 1. | Acudata | | |
| * 2. | AVCO (#14 DOD Contractor) | | |
| 3. | Brownwood Woolen Mills | | |
| 4. | CACI | | |
| 5. | C3 | | |
| 6. | Delsea Fasteners, Inc. | | |
| 7. | Diversified American Defense | | |
| 8. | Diversified Products Intl. | | |
| 9. | Duroyd Mfg. Co. | | |
| * 10. | GTE Govt Systems Corp.
(#23 DOD Contractor) | | |
| * 11. | General Electric
(#2 DOD Contractor) | | |
| 12. | Genii Research, Inc. | | |
| 13. | Gould Defense Systems, Inc. | | |
| 14. | Greer Fasteners | | |
| * 15. | Harris Corp.
(#35 DOD Contractor) | | |
| 16. | Hayes International Corp. | | |
| 17. | LDL Precision, Inc. | | |
| * 18. | Litton Systems, Inc.
(#15 DOD Contractor) | | |
| | | 19. | Marine Boiler Repair |
| | | * 20. | Martin Marietta
(#11 DOD Contractor) |
| | | 21. | Moor-Fite Corp. |
| | | 22. | National Roofing |
| | | 23. | Nu-Way Trash Removal
(Atlantic Disposal) |
| | | 24. | Ostelic Enterprises, Inc. |
| | | 25. | P.S. Precision Screw & Tool Co. |
| | | 26. | Parkhill-Goodloe Company |
| | | 27. | Pennsy Wholesale, Inc. |
| | | * 28. | Rockwell International
(#4 DOD Contractor) |
| | | 29. | Rausch Mfg. Co. |
| | | 30. | River City Supply |
| | | 31. | Specific Metals Corp. |
| | | 32. | Spring Works |
| | | 33. | Waltham Screw Co. |
| | | 34. | Vion Corp. |
| | | 35. | Zelco Magnetic Corp. |

*One of the top 50 defense contractors.

DEFENSE INDUSTRY INITIATIVESIGNATORY COMPANIESApril 3, 1987

AT&T

Aeronca, Inc.
Allied-Signal, Inc.
The Boeing Company
E-Systems, Inc.
Eaton Corporation
FMC Corporation
Ford Aerospace and Communications Corporation
Gates-Learjet Corporation
General Dynamics Corporation
General Electric Company
Goodyear Aerospace Corporation
Grumman Corporation
Hercules, Inc.
Hewlett-Packard Company
Honeywell, Inc.
Hughes Aircraft Company
IBM Corporation
ITT Defense Technology Group
Lockheed Corporation
Martin Marietta Corporation
McDonnell Douglas Corporation
Northrop Corporation
Parkin Hannifin Corporation
Pneumo-Abex Corporation
Raytheon Company
Rockwell International
Science Applications International
The Singer Company
TRW
Textron, Inc.
UNISYS
United Technologies Corporation
Varian Associates
Westinghouse Electric Corporation

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?

Mr. CONYERS. We really appreciate your recommendations. We are going to come back to them. Let's recognize Ms. Toensing at this point.

TESTIMONY OF VICTORIA TOENSING

Ms. TOENSING. Good morning, Mr. Chairman.

I would like to touch briefly on the facts or at least our theory of how we viewed Pratt & Whitney because I know the subcommittees have been looking at this for a very long time, at least for the last year.

Pratt & Whitney was an investigation concerning how the Government decided to pay the costs of overhead to the contractor.

Mr. CONYERS. Pardon me, Ms. Toensing. Are you going to summarize that? I think we have questions that are going to lead into that.

Ms. TOENSING. I am going to summarize it as far as the theory. I think it will take me 2.5 minutes.

Mr. CONYERS. Please proceed.

Ms. TOENSING. The allegation which began the investigation was that Pratt & Whitney had made a false statement on its proposal to be reimbursed for overhead in 1981. The problem, and this is the core of the Pratt & Whitney case, is that is exactly what it was, a proposal, and not really a bill as you would get as if you had your car repaired and they put in brakes and a clutch and a muffler, as I had yesterday.

Under the process that was in effect in 1981, that's exactly what it was considered, as a proposal, like the sticker price on a car. Neither party, neither side of the table expected that to be the price to be paid. In looking at whether Pratt & Whitney committed a criminal act, the test was not whether the objects submitted were outrageous, as many of us considered them to be, or whether they were in the end ultimately paid for but rather whether there was anything that absolutely should not have been submitted to the Government to be paid. In other words, was anything expressly unallowable.

I will be glad to answer questions about that later. I do want to add right now that I don't think that our lengthy investigation was for naught. During the process of the investigation, the Assistant U.S. Attorney Walter Kozar, who did a commendable job, talked at great length with the contracting officers for Pratt & Whitney and for UTC. I think there was a raising of awareness during that time as to what things were causing the problem and there was a raising of an awareness with the Air Force and here on the Hill.

In 1985, there was legislation passed that now severely restricts the ability of a contractor to put these unallowable costs into their proposal for reimbursement for overhead costs.

I would like us to look at that because we shouldn't be talking on the record as it was in place in 1981, but go from where we have raised ourselves to at least another plateau, that there are things now that are expressly unallowable that were not in place at the time this case was investigated.

Mr. CONYERS. Thank you very much.

I would like to recognize the fact that Mr. Slattery of Kansas has joined us at the hearing.

And I would like to now recognize the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. Thank you very much, Mr. Chairman.

Mr. Klein, if you could, could you summarize the pattern of fraud investigations involving the 1978 and 1981 overruns, schedule delays, and bail outs on the 688 submarine program?

TESTIMONY OF STANLEY KLEIN

Mr. KLEIN. Yes, I'd like to. As a matter of fact, in my opening statement I do discuss both those cases.

The first investigation began in May of 1978 and was conducted by a task force of FBI Special Agents and support personnel. Included in this task force also were members of the Naval Investigative Service, the Naval Supervisor of Shipbuilding Engineers, and attorneys from the Department of Justice and others.

This case involved a \$544 million cost overrun claim submitted by the Navy by Electric Boat. The claim was reviewed by Admiral Rickover's staff and was ultimately referred to the Department of Justice for investigation.

Working within a framework and parameters established by the investigators in the Department, two major areas of the claim was selected for review.

The first area was the delay portion of the claim, representing approximately \$220 million, wherein the Electric Boat Division claimed that 100 percent of all delays in submarine construction was caused by the Government.

The second area was referred to as unsuitable data; this represented \$90 million. The Electric Boat Division contended that at that time the bid was made on the second contract for 688 class submarines, they were unaware of certain design complexities and should accordingly be compensated by the Navy.

The task force aggressively and continuously reviewed, analyzed, and reported on many thousands of subpoenaed documents received from Electric Boat.

[The prepared statements of Mr. Klein and Mr. Joseph Corless follow:]

OPENING STATEMENT BY
SPECIAL AGENT IN CHARGE
STANLEY KLEIN
NEW HAVEN DIVISION
FEDERAL BUREAU OF INVESTIGATION

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the Federal Bureau of Investigation's (FBI's) participation in the recent investigations of the General Dynamics Corporation, Electric Boat Division, Groton, Connecticut.

I am the Special Agent in Charge of the FBI's New Haven Division which encompasses the State of Connecticut. For most of the past nine years, the FBI in Connecticut has conducted investigations into allegations of criminal fraud at the Electric Boat Division involving the construction of the SSN 688 Class Fast Attack Submarine.

The first investigation began in May, 1978, and was conducted by a task force of FBI Special Agents and support personnel, Naval Investigative Service Agents, Naval Supervisor of Shipbuilding Engineers, Civilian Nuclear Submarine Technical Experts, and attorneys from the Department of Justice and the Navy. This case involved a \$544 million cost overrun claim submitted to the Navy by Electric Boat Division. The claim was reviewed by Admiral Hyman Rickover's staff and was ultimately referred to the Department of Justice for investigation.

Working within a framework and parameters established jointly by the investigators and the Department of Justice attorneys, two major areas of the claim were selected for review.

The first area was the DELAY portion of the claim, representing approximately \$220 million, wherein the Electric

BOAT DIVISION CLAIMED THAT 100% OF ALL DELAY IN SUBMARINE CONSTRUCTION WAS GOVERNMENT CAUSED.

THE SECOND AREA WAS REFERRED TO AS UNSUITABLE DATA, REPRESENTING APPROXIMATELY \$90 MILLION. THE ELECTRIC BOAT DIVISION CONTENDED THAT AT THE TIME THEY BID ON A SECOND CONTRACT FOR 688 CLASS SUBMARINE CONSTRUCTION, THEY WERE UNAWARE OF CERTAIN DESIGN COMPLEXITIES AND SHOULD ACCORDINGLY BE COMPENSATED. FURTHER, THEY CLAIMED NOT TO BE SEEKING REIMBURSEMENT FOR ANY ITEMS IDENTIFIED AS COMPLEXITIES WHILE WORK WAS PERFORMED ON SUBMARINES FROM THE FIRST CONTRACT (PRIOR TO THE AWARD OF THE SECOND CONTRACT).

THE TASK FORCE AGGRESSIVELY AND CONTINUOUSLY REVIEWED, ANALYZED, AND REPORTED UPON OVER 100,000 SUBPOENAED DOCUMENTS RECEIVED FROM THE ELECTRIC BOAT DIVISION. NEARLY 100 INTERVIEWS WERE CONDUCTED NATIONWIDE. ADDITIONALLY, SCORES OF WITNESSES AND SEVERAL HUNDRED EXHIBITS WERE PRESENTED TO TWO FEDERAL GRAND JURIES.

THE INVESTIGATION DISCLOSED THAT CERTAIN ITEMS CONTAINED IN ELECTRIC BOAT'S CLAIM WERE HIGHLY QUESTIONABLE. AT THE CONCLUSION OF THIS INVESTIGATION, THE FBI REFERRED THE CASE TO THE DEPARTMENT OF JUSTICE FOR A PROSECUTIVE OPINION. ON DECEMBER 18, 1981, THE DEPARTMENT OF JUSTICE DECLINED TO PROSECUTE THE CASE CITING COMPLICATIONS CREATED BY THE PUBLIC LAW 85-804 SETTLEMENT OF THE CLAIM AND AN INABILITY TO LINK RESPONSIBILITY FOR INCORRECT CLAIM ITEMS TO CRIMINAL INTENT. CONSEQUENTLY, THE FBI CLOSED THIS CASE.

THE SECOND INVESTIGATION OF THE ELECTRIC BOAT DIVISION WAS INSTITUTED ON DECEMBER 3, 1984, BASED ON A REQUEST FROM THE DEPARTMENT OF JUSTICE. THIS CASE INVOLVED ALLEGATIONS OF A VARIETY OF FRAUDULENT ACTIVITIES ON THE PART OF THE ELECTRIC BOAT DIVISION. THE ALLEGATIONS WERE MADE BY FORMER GENFPAI DYNAMICS CORPORATION VICE PRESIDENT, PANAGIOTIS TAKIS VELIOTIS, WHOM YOU ARE AWARE, IS A FEDERAL FUGITIVE, INDICTED ON AN UNRELATED MATTER, CURRENTLY RESIDING IN GREECE. THE THRUST OF THE INFORMATION PROVIDED BY VELIOTIS WAS THAT THE ELECTRIC BOAT DIVISION HAD IN FACT SUBMITTED FALSE SHIPBUILDING CLAIMS TO THE U.S. NAVY, WHICH WAS THE CRUX OF THE PRIOR INVESTIGATION. VELIOTIS ALSO PROVIDED INFORMATION TO THE EFFECT THAT THE ELECTRIC BOAT DIVISION HAD ROUTINELY AND SYSTEMATICALLY MADE FALSE STATEMENTS TO THE NAVY AND OTHER PARTIES IN CONNECTION WITH THE NUCLEAR SUBMARINE CONSTRUCTION PROGRAM. SPECIFICALLY, THE ELECTRIC BOAT DIVISION CONCEALED COST OVERRUN AND DELIVERY SCHEDULE DELAY DATA THEREBY DEFRAUDING THE GOVERNMENT, SECURITIES AND EXCHANGE COMMISSION AND COMPANY SHAREHOLDERS.

IN JANUARY, 1985, A MULTI-AGENCY TASK FORCE WAS ASSEMBLED TO INVESTIGATE THESE ALLEGATIONS. THE FBI MADE A MAJOR COMMITMENT OF MANPOWER AND LOGISTICAL RESOURCES TO SUPPORT THE TASK FORCE. DURING THE INVESTIGATION IN EXCESS OF 100 PEOPLE WERE INTERVIEWED, MORE THAN 90 PEOPLE TESTIFIED BEFORE THE FEDERAL GRAND JURY AND OVER 500,000 PAGES OF DOCUMENTATION WERE REVIEWED.

DURING THE SECOND INVESTIGATION, THE FBI LEARNED THAT

ELECTRIC BOAT'S SUBMARINE DELIVERY SCHEDULES AND COST-TO-COMPLETE DATA WERE REGULARLY REVIEWED BY THE NAVY. ELECTRIC BOAT ROUTINELY DEVELOPED MANY INTERNAL DELIVERY SCHEDULES AND COST-TO-COMPLETE REPORTS ON THESE LONG-TERM CONSTRUCTION PROJECTS. THESE FIGURES WERE ONLY ESTIMATES, AND THE MOST OPTIMISTIC OF THESE SOMETIMES CONFLICTING ESTIMATES WERE GENERALLY PROVIDED TO THE NAVY. THE NAVY KNEW AT VARIOUS TIMES THAT ELECTRIC BOAT WAS NOT FURNISHING THEM WITH REALISTIC SCHEDULES AND COST DATA.

ON JUNE 22, 1987, THE DEPARTMENT OF JUSTICE OFFICIALLY NOTIFIED THE FBI THAT THE DEPARTMENT WAS CLOSING THE CASE. ACCORDINGLY, THE FBI DISCONTINUED THE INVESTIGATION.

THIS CONCLUDES MY PREPARED REMARKS. I AM PREPARED TO ANSWER YOUR QUESTIONS.

OPENING STATEMENT OF
SPECIAL AGENT IN CHARGE
JOSEPH CORLESS
BALTIMORE DIVISION
FEDERAL BUREAU OF INVESTIGATION

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISCUSS THE FEDERAL BUREAU OF INVESTIGATION'S (FBI'S) PROGRAM TO ADDRESS DEFENSE PROCUREMENT FRAUD AND SPECIFICALLY A RECENTLY COMPLETED INVESTIGATION INVOLVING PRATT & WHITNEY. I AM CURRENTLY ASSIGNED AS THE SPECIAL AGENT IN CHARGE OF THE FBI'S BALTIMORE DIVISION. PRIOR TO THAT, I WAS ASSIGNED AS SPECIAL AGENT IN CHARGE OF THE MIAMI DIVISION WHERE THE PRATT & WHITNEY INVESTIGATION WAS CONDUCTED.

SPECIAL AGENT IN CHARGE STANLEY KLEIN, OF THE FBI'S NEW HAVEN, CONNECTICUT DIVISION IS ALSO HERE TODAY AND HE WILL PROVIDE TESTIMONY RELATING TO THE FBI'S INVESTIGATION OF GENERAL DYNAMICS CORPORATION.

I'D LIKE TO BEGIN MY COMMENTS BY GIVING YOU A GENERAL OVERVIEW OF DEFENSE FRAUD AND OUR COMMITMENT TO INVESTIGATING IT. AS YOU ARE AWARE, THE DEPARTMENT OF DEFENSE SPENDS 600 MILLION DOLLARS EVERY DAY, OPERATES 5,500 INSTALLATIONS, AND DIRECTLY OR INDIRECTLY EMPLOYS 6.3 MILLION PEOPLE INCLUDING MILITARY, CIVILIAN, AND INDUSTRIAL WORKERS. IN THE PROCUREMENT AREA, 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 WEAPONS SYSTEMS. THE SIZE OF THE DEFENSE BUDGET MAKES THE POTENTIAL DOLLAR IMPACT OF CONTRACTOR FRAUD ENORMOUS. IN ADDITION TO THE SUBSTANTIAL COST TO THE GOVERNMENT, MANY FRAUDS IMPERIL THE SAFETY AND CAPABILITIES OF OUR ARMED FORCES.

RECOGNIZING THE IMPORTANCE OF A STRONG ENFORCEMENT

PROGRAM IN THE AREA OF DEFENSE PROCUREMENT FRAUD, THE FBI HAS UNDERTAKEN A NUMBER OF INITIATIVES. AMONG THESE ARE AN OVERALL INCREASED COMMITMENT OF INVESTIGATIVE RESOURCES, INVOLVEMENT IN HIGHLY COMPLEX INVESTIGATIONS, PARTICIPATION IN AND SPONSORSHIP OF PROCUREMENT FRAUD TRAINING PROGRAMS, RECOMMENDATIONS FOR LEGISLATIVE CHANGES, EMPHASIS ON JOINT INVESTIGATIONS, PARTICIPATION AND SUPPORT OF THE DEFENSE PROCUREMENT FRAUD UNIT AND DEVELOPMENT AND UTILIZATION OF INNOVATIVE INVESTIGATIVE TECHNIQUES. THESE INITIATIVES HAVE CONTRIBUTED SIGNIFICANTLY TOWARD A COORDINATED, INTER-AGENCY ENFORCEMENT PROGRAM.

IN UNDERSCORING ITS IMPORTANCE, THE INVESTIGATION OF DEPARTMENT OF DEFENSE PROCUREMENT FRAUD IS THE NUMBER ONE PRIORITY OF THE FBI'S WHITE COLLAR CRIME PROGRAM. IN FISCAL YEAR 1986, OVER ONE-FOURTH OF THE FBI'S EFFORT EXPENDED IN ALL GOVERNMENTAL FRAUD INVESTIGATIONS WAS DEVOTED TO DEFENSE FRAUD MATTERS. THIS COMMITMENT OF RESOURCES IS CONSISTENT WITH A TREND STARTED IN THE EARLY 1980S AS THE PROBLEM OF PROCUREMENT FRAUD CAME INTO SHARPENED FOCUS. BY THE END OF FISCAL YEAR 1986, THE FBI HAD 758 DEFENSE FRAUD CASES UNDER INVESTIGATION, A 37 PERCENT INCREASE FROM FISCAL YEAR 1984. LIKEWISE, INVESTIGATIVE EFFORTS EXPENDED IN FISCAL YEAR 1986 REPRESENTS NEARLY A 50 PERCENT INCREASE OVER FISCAL YEAR 1984.

THIS INCREASED COMMITMENT OF SPECIAL AGENT WORK EFFORT IS NECESSARY TO COMBAT THE CORE ELEMENTS OF FRAUD AND CORRUPTION WHICH SYSTEMATICALLY AND ROUTINELY PLAGUE THE DEPARTMENT OF DEFENSE. NOT ONLY HAS WORK EFFORT INCREASED, BUT SO HAS OUR

UTILIZATION OF SOPHISTICATED INVESTIGATIVE TECHNIQUES, SUCH AS COURT AUTHORIZED TITLE III ELECTRONIC SURVEILLANCE, CONSENSUAL MONITORINGS, AND UNDERCOVER OPERATIONS. THESE TECHNIQUES HAVE BEEN PARTICULARLY SUCCESSFUL IN THE INVESTIGATION OF BRIBERY, CORRUPTION, AND PRODUCT SUBSTITUTION CASES.

IN ORDER TO FORMALLY DEFINE OUR ROLE IN THESE MATTERS, THE DEPARTMENTS OF JUSTICE AND DEFENSE SIGNED A MEMORANDUM OF UNDERSTANDING IN AUGUST, 1984. THIS MEMORANDUM ESTABLISHES INVESTIGATIVE AND PROSECUTIVE JURISDICTION BETWEEN THE TWO DEPARTMENTS. IT ALSO ESTABLISHES NOTIFICATION REQUIREMENTS AIMED AT AVOIDING DUPLICATIVE INVESTIGATIVE EFFORTS AND IS WRITTEN IN A SPIRIT PROMOTING, TO THE EXTENT AUTHORIZED, JOINT INVESTIGATIONS BY THE DEPARTMENT OF DEFENSE AND THE FBI.

ORDERLY IMPLEMENTATION OF THIS MEMORANDUM OF UNDERSTANDING WAS FACILITATED THROUGH A NOVEMBER, 1984, MEETING OF EXECUTIVES FROM THE FBI, THE DEPARTMENT OF DEFENSE INSPECTOR GENERAL'S OFFICE, AND COGNIZANT MILITARY INVESTIGATIVE COMMANDS. AS A RESULT NEARLY EVERY DEFENSE FRAUD CASE CURRENTLY BEING INVESTIGATED BY THE FBI IS BEING WORKED JOINTLY WITH A DEPARTMENT OF DEFENSE INVESTIGATIVE AGENCY.

ALSO SINCE 1984, THE FBI HAS BEEN COMMITTED TO FULL PARTICIPATION IN THE JOINT DEPARTMENTS OF JUSTICE AND DEFENSE PROCUREMENT FRAUD UNIT IN ORDER TO INSURE THAT DEFENSE PROCUREMENT FRAUDS ARE MORE FULLY ADDRESSED. MILITARY INVESTIGATIVE AGENCY CASE INITIATION REPORTS RECEIVED THROUGH THE PROCUREMENT FRAUD UNIT ALONG WITH DEFENSE CONTRACT AUDIT AGENCY

"EARLY ALERTS" HAVE ENABLED MORE TIMELY ATTENTION TO AREAS OF SUSPECTED FRAUD, RESULTING IN OVER 200 NEW PROCUREMENT FRAUD INVESTIGATIONS NATIONWIDE SINCE 1984.

THE VERY NATURE OF DEFENSE PROCUREMENT FRAUDS ALSO REQUIRES THAT INVESTIGATORS RECEIVE SPECIALIZED TRAINING. PROVIDING THIS TRAINING HAS BEEN A JOINT EFFORT WITH COMPONENTS OF THE DEPARTMENT OF DEFENSE, INCLUDING FBI PARTICIPATION IN THE INSPECTOR GENERAL'S AND NAVAL INVESTIGATIVE SERVICE'S PROCUREMENT FRAUD COURSES AS WELL AS FBI SPONSORED IN-SERVICE TRAINING WHICH SPECIFICALLY ADDRESSES THE INVESTIGATION OF DEFENSE PROCUREMENT FRAUD. IN ADDITION REGIONAL SEMINARS TO ADDRESS SPECIFIC CRIME PROBLEMS ARE CONDUCTED ON AN AS REQUIRED BASIS, SUCH AS THE RECENT SERIES OF SEMINARS CONCERNING SUBCONTRACTOR KICKBACK SCHEMES CONDUCTED JOINTLY WITH THE DEFENSE CRIMINAL INVESTIGATIVE SERVICE IN SOUTHERN CALIFORNIA.

ALTHOUGH THE TYPES OF FRAUD ARE VARIED, THE FBI HAS FOUND THAT THE MOST DIFFICULT DEFENSE FRAUDS TO INVESTIGATE ARE THOSE THAT INVOLVE COST MISCHARGING AND DEFECTIVE PRICING INFORMATION. THE MAZE OF DEPARTMENT OF DEFENSE PROCUREMENT REGULATIONS, AMBIGUOUS CONTRACT LANGUAGE, POORLY DEFINED DELIVERABLE PRODUCTS, COMPETING INTEREST WITHIN THE DEPARTMENT OF DEFENSE, AND GOVERNMENT FUNDING OF CONTRACTOR LEGAL FEES ARE JUST A FEW OF THE PROBLEMS ENCOUNTERED IN INVESTIGATING THESE CASES. THOUSANDS, SOMETIMES MILLIONS, OF DOCUMENTS MUST BE REVIEWED DURING THE INVESTIGATION. OFTEN THIS REVIEW REVEALS CONFLICTING

INTERPRETATIONS OF CONTRACT LANGUAGE, ACCOUNTING PRINCIPALS, AND ALLOWABILITY OF CONTRACTOR CLAIMS. TYPICALLY, A CASE CAN BE MADE FOR EACH INTERPRETATION AND THE BURDEN OF PROVING INTENT TO DEFRAUD THE GOVERNMENT CANNOT BE SUPPORTED. THE INVESTIGATION OF UNITED TECHNOLOGIES, PRATT & WHITNEY AIRCRAFT GROUP IS A GOOD EXAMPLE.

THAT INVESTIGATION WAS INITIATED IN OCTOBER, 1982, UPON RECEIPT OF INFORMATION FROM THE DEFENSE CONTRACT AUDIT AGENCY WHICH HAD CONDUCTED AUDITS AT THE PRATT & WHITNEY GOVERNMENT PRODUCTS DIVISION, WEST PALM BEACH, FLORIDA. THE INITIAL ALLEGATIONS WERE THAT COSTS HAD BEEN INCLUDED IN BILLINGS TO THE GOVERNMENT WHICH WERE, "UNALLOWABLE" AND SEEMED, "OUTRAGEOUS." AMONG THESE BILLINGS WERE COSTS FOR FLOWERS, PARTIES, LIQUOR, BABY SITTERS, TICKETS TO THE RODEO, FOOTBALL GAMES AND SPORT FISHING CRUISES. THE INVESTIGATION CENTERED AROUND THE THREE ACCOUNTS TO WHICH THESE ITEMS WERE CHARGED: MISCELLANEOUS SUNDRIES, BUSINESS GUESTS, AND INDIRECT TRAVEL ACCOUNTS.

THE UNITED STATES ATTORNEY FOR THE SOUTHERN DISTRICT OF FLORIDA, UTILIZED THE FEDERAL GRAND JURY TO ASSIST IN THE INVESTIGATION. AS A RESULT, THE DETAILS OF THE INVESTIGATION ARE RESTRICTED IN ACCORDANCE WITH RULE 6 (E) OF THE FEDERAL RULES OF CRIMINAL PROCEDURE. IN GENERAL, HOWEVER, THE INVESTIGATION INVOLVED A REVIEW OF DEFENSE PROCUREMENT REGULATIONS AND INTERVIEWS OF DEFENSE CONTRACT AUDIT AGENCY TEAM MEMBERS, AIR FORCE PLANT REPRESENTATIVE OFFICERS AND INDIVIDUALS IDENTIFIED AS BENEFICIARIES OF THE "UNALLOWABLE" EXPENSES. THE INVESTIGATION

WAS CONDUCTED IN COORDINATION WITH THE DEFENSE CRIMINAL INVESTIGATIVE SERVICE AND THE AIR FORCE OFFICE OF SPECIAL INVESTIGATIONS.

THE INVESTIGATION WAS ESSENTIALLY COMPLETED DURING THE SUMMER OF 1984. ADDITIONAL INVESTIGATION WAS CONDUCTED IN 1985, TO ASSIST THE UNITED STATES ATTORNEY IN MAKING A FINAL PROSECUTIVE DECISION. IN JULY, 1986, UNITED STATES ATTORNEY LEON B. KELLER, SOUTHERN DISTRICT OF FLORIDA, FORMALLY DECLINED PROSECUTION CITING IN PRINCIPAL PART THAT, "THE RELEVANT REGULATORY PRINCIPLES WERE VAGUE, CONFLICTING, AND OVERLAPPING IN CRUCIAL RESPECTS"

A SUMMARY OF THE JULY, 1986, DECISION TO DECLINE PROSECUTION WAS PROVIDED TO FBI HEADQUARTERS FOR ITS REVIEW. THIS INFORMATION WAS DISCUSSED WITH THE DEFENSE PROCUREMENT FRAUD UNIT, U.S. DEPARTMENT OF JUSTICE, AND A DEPUTY ASSISTANT ATTORNEY GENERAL RESULTING IN A CONCURRENCE WITH THE DECISION TO DECLINE PROSECUTION. ACCORDINGLY, OUR INVESTIGATION WAS CLOSED.

THIS WILL CONCLUDE MY OPENING COMMENTS. I AM HAPPY TO ADDRESS ANY QUESTIONS AT THIS TIME REGARDING THIS MATTER.

Mr. WYDEN. Mr. Klein.

Mr. KLEIN. Yes.

Mr. WYDEN. If I might, the question the subcommittee is interested in is the 1984 investigation. The second investigation you did when you went back and looked at the 1978 and 1981 overruns, and what we're interested in, in particular, is what you found in the way of Navy knowledge and acquiescence in this area; that's what the subcommittee wants.

Mr. KLEIN. OK. Can I briefly then summarize what that investigation was. The second investigation was based on a request from the Department of Justice. Allegations were received from a former General Dynamics Corporation Vice President who was general manager of the Electric Boat Division in Groton. P. Takis Veliotis, whom you are aware I believe, is a Federal fugitive who was indicted on unrelated charges and is currently residing in Greece.

The thrust of the information provided by Veliotis was that the Electric Boat Division had in fact submitted false shipbuilding claims to the Navy. Electric Boat Division had, according to Mr. Veliotis, routinely and systematically made false statements to the Navy and other parties in connection with the Nuclear Submarine Construction program.

In January 1985 a multi-agency task force was assembled to investigate these allegations. 100 people were interviewed; 500,000 pages of documents were reviewed, mostly based upon a subpoena issued by the Department of Justice to General Dynamics.

During the second investigation the FBI determined that Electric Boat submarine delivery schedules and cost to complete data were regularly reviewed by the Navy. Electric Boat routinely developed many internal delivery schedules and cost-to-complete reports on these long term construction projects. These figures were only estimates. And the most optimistic of these were provided to the Navy. The Navy knew, at various times, that Electric Boat was not furnishing them with realistic schedules and cost data.

Looking over Mr. Weld's opening statement I have to say that the FBI agrees totally. We looked for altered documents. We looked for back dated documents. We looked for missing documents. We looked for documents that could have been destroyed. We looked for multiple sets of books. We found none.

The investigation failed to reveal evidence to prove that the company's actions were done with criminal intent.

Second, we found that the Navy was not motivated by criminal purposes or that military personnel profited personally from the decisions they made. It was, on the other hand, I believe a conflict of interest. Those interests were profits for the company, for the contractors, and the desire to accomplish the mission on the part of the military.

All these facts were presented to the Department of Justice, and the Department of Justice in June of this year declined prosecution.

Regarding the Navy's knowledge of these cost figures, during the course of the interviews—outside the Grand Jury we did interview a number of high ranking Navy personnel, I do have some quotes I

can give you from those Navy personnel on their knowledge of these cost overruns and delay schedules.

Mr. WYDEN. Why don't you give us those quotes with respect to the knowledge issue.

Mr. KLEIN. I'll give you a sampling, if I may. On August 5th, 1986 retired U.S. Navy Vice Admiral Earl B. Fowler was interviewed by the FBI and by the Naval Investigative Service. Admiral Fowler served as Commander of NAVSEA, and NAVSEA as you are aware let out the contracts and supervised the building of the submarines in Groton. Admiral Fowler was asked if he believed that the Electric Boat Division systematically and deliberately withheld cost overrun data and delivery schedules from the Navy. Fowler replied that if that was the basis of the current investigation, then the Justice Department is, quote, "Sure as hell going to flat out lose."

Fowler stated that the Navy was fully aware that Electric Boat management was not providing good data, because Fowler and his staff had spent time in the shipyard.

Management of Electric Boat, Fowler believed, through his staff and through visits to the yard and sources developed in the yard, was incapable of producing the submarines on those time schedules.

On July 15, 1986 Donald Matteo, Executive Director of Submarine Directorate U.S. Naval Sea Systems, was interviewed. Interviewing agents asked Matteo whether the Navy withheld bad news about the fast attack sub 688 construction program including schedule deliveries from the public and the U.S. Congress during the 1970's. Matteo responded, "If I have to answer this question, yes or no, I would have to respond, yes."

Retired U.S. Navy Admiral Edward Peebles was interviewed by FBI and NIS. His statement is this, "Everyone knew that Admiral Rickover did not want a realistic Trident program delivery schedule published." Peebles was told by his superiors not to put out Trident schedules which differed from which Rickover had represented Congress.

There are some Congressional staff comments that I think are also—

Mr. WYDEN. Let's hear those as well.

Mr. KLEIN. I'll get to the staff comments. On July 18, 1986 Robert Schafer was interviewed by agents of the FBI and Naval Investigative Service. Since 1981 Mr. Schafer has been employed as professional staff member with the U.S. House of Representatives Committee on Armed Services.

Mr. Schafer said, when the Trident I contract was awarded to Electric Boat during 1977 he was working with the Office of the Secretary of Defense. "The Government was aware at that time that this contract was awarded, at the time the contract was awarded, that the contract delivery date was unattainable. The Government awarded the Trident I contract to EB, knowing that the contract delivery date was unattainable because of political reasons. The Government signed the Trident I contract to EB with a big wink."

Mr. WYDEN. Can I just ask again about that big wink, and you made some mention of the Armed Services Committee or staff person there?

Mr. KLEIN. Yes. Since 1981 he has been employed as professional staff member of the House of Representatives Committee on Armed Services.

George Norris was interviewed by Special Agents of the FBI. He served as counsel to the U.S. House of Representatives Committee on Armed Services, Sea Power Subcommittee during the period 1966 through 1979.

Mr. Norris said, "If EB was experiencing a 2 to 3-year slip in their Nuclear Submarine program delivery schedules, the Sea Power Subcommittee would have continued to push for additional Congressional funding of these programs. The number of ships in the Navy's fleet had dropped from 1,100 to 500. The Sea Power Subcommittee was the first to cause the Navy to realize that they needed a 600 ship fleet. The construction of nuclear submarines requires a long lead time. Although a submarine builder may be experiencing schedule delays, there are still many things a shipbuilder can do in furtherance of building additional submarines."

Norris believed that the Congressman he worked for also shared these opinions.

Mr. WYDEN. Well, that's helpful, Mr. Klein. The essence that I have gotten out of that is that there was general knowledge both within the Navy and also on the Hill then about cost and scheduling problems with the submarines.

Mr. KLEIN. That's correct.

Mr. WYDEN. Mr. Chairman, I would ask that we could have those materials submitted for the record and would ask unanimous consent.

Mr. CONYERS. Agent Klein, do you have any objection to making those materials from which you quoted available to the record?

Mr. KLEIN. We have—the original documents. We have procedures within the Bureau to send those through the Department of Justice for forwarding to the committee.

Mr. CONYERS. All right. I take that's acquiescence.

Mr. KLEIN. I have no problem with that.

Mr. CONYERS. Good. When we get them we'll receive them into the record. They are material and very important to your statement.

Mr. WYDEN. Thank you, Mr. Chairman.

Mr. Klein, if you might, could you briefly describe your investigation to what was called the Veliotis 1977 tape involving the false press release which related to the Trident schedule delay?

Mr. KLEIN. Yes. Mr. Veliotis supplied the FBI and the Department of Justice with a number of tape recordings that he said he made while he was general manager for General Dynamics in Groton. The reasons he made the tape recordings, he said, was because he was hard of hearing in one ear, and he did tape record some telephone conversations so that he could play them back to hear them.

When he made these tape recordings available to us they were analyzed by both the FBI and the Departmental attorney assigned to the case, and two issues were developed. One was the 1977 issue,

wherein a tape recording that was recorded on November 29, 1977 was a conversation between Mr. Veliotis and Executive Vice President of General Dynamics Corporation, Gordon MacDonald. In these conversations MacDonald and Veliotis discussed the delivery date of Trident submarine 726. I believe that was the first Trident submarine. That conversation indicated that there was an intention to report the delivery dates of that submarine in a fictitious manner.

An investigation then was opened to determine whether General Dynamics routinely and systematically withheld submarine delivery scheduled data from the beginning of the 688 and Trident submarine programs, which extended back into 1971. That was the 1977 issue.

The 1981 issue, which was the second issue was a conversation between the Chairman of the Board, at that time David Lewis, and Mr. Veliotis which occurred on October 7, 1981, in which Veliotis and Lewis discussed cost-to-complete data regarding the attack—fast attack submarine 688 flight II program. Based on this conversation, which involved cost overruns and non-reporting of these cost overruns, the Department of Justice decided to try to determine whether this was a systematic and continuing and routine matter of operation for General Dynamics in their nuclear submarine construction program.

Mr. WYDEN. Mr. Klein, the key, though, is that you found substantial Navy knowledge and acquiescence in the area with respect to the Veliotis 1977 tape involving the false press release and the Trident schedule.

Mr. KLEIN. There was a press conference held and the Navy at that time noted that the delivery date of the first Trident would be months after General Dynamics had stated that that submarine would be available.

And during this tape conversation—

Mr. WYDEN. That was 2 years later, wasn't it?

Mr. KLEIN. Right. Well, the submarine was supposed to be completed, I believe in 1979. And the Navy had this press conference to advertise that the delay—that the submarine would be completed in 1980.

There's indications that General Dynamics, at that time, believed that it would take much longer than even that date for the submarine to be completed. So they issued a press release sticking with the original date of completion of the submarine which would be 1979, which was 2 years after the press conference was held.

Mr. WYDEN. Well, the tape indicated he knew it was false.

Mr. KLEIN. Those tapes—I have to mention this—I believe the committee did have hearings on those tapes and whether those tapes were complete. And I don't know if the people that were taped agreed that those were complete conversations or conversations out of context. I don't know if those tapes would be allowable as evidence in law.

Mr. WYDEN. It did admit to the substance.

Mr. KLEIN. That's what the recording said.

Mr. WYDEN. Let me move on to one other area, with respect to the missile tube investigation and the knowledge of Navy officials in that matter, Mr. Klein.

Mr. KLEIN. Yes. Would you like me to speak on that matter?

Mr. WYDEN. Pardon me?

Mr. KLEIN. Would you like me to—

Mr. WYDEN. Please.

Mr. KLEIN. Well, during the course of our investigation of Electric Boat, there was not just one investigation there were 13 investigations in total. Nine of those investigations have been completed; and four of them are still pending.

One of those investigations involved 72 Trident submarine missile tubes. The case was opened in June of 1984, and was closed on instructions of the Department on May 15, 1987.

What you had here was Electric Boat negotiating with the Navy regarding the price of 72 submarine missile tubes, which is critical, obviously, to our submarine program.

What the Navy does when they negotiate with Electric Boat on something like this, is talk about a best and final price for an item based upon what they have received from a subcontractor. Electric Boat doesn't necessarily make the missile tubes, they subcontract that out, and then they install the tubes when they're making the submarines.

In this situation Electric Boat and the Navy agreed on a price for those submarine tubes as the best and final offer. Information was received that Electric Boat knew that they could obtain a reduction of approximately \$12 million on the missile tube subcontract. And that was after the Navy agreed that the original price was a fair and equitable price for the missile tubes.

Now, when we talked to the Navy negotiator who had advised that this was the best and final offer, and whether that was the case, and therefore Electric Boat knew they could get it for \$12 million but didn't report it to the Navy, the negotiator said that he might have incorrectly documented this as the best and final offer.

So, based upon that statement by the Navy negotiator we couldn't prove that it was a best and final offer, and therefore the case was not prosecutable.

Mr. WYDEN. So, we had a situation there, Mr. Klein, it seems to me, that these are the kinds of cases that concern me, and just based on what you've said we had a situation where there was a \$12 million rip-off, but the Navy knew about it and so you all couldn't do anything; is that correct?

Mr. KLEIN. The facts of the matter are that the Navy negotiator stated that he probably didn't say that the initial costs were best and final. The Electric Boat Division was able to get those missile tubes for \$12 million less than what the Navy negotiated for.

Mr. WYDEN. There wasn't anything you could do about it?

Mr. KLEIN. Nothing we could do about it.

Mr. WYDEN. Mr. Klein, to what extent were high ranking officials in NAVSUP, Chief of Naval Operations, the Secretary's Office, aware of the goings on and common knowledge between the Navy and General Dynamics?

Mr. KLEIN. On July 24, 1986, retired U.S. Navy Rear Admiral Walter Cantrell, was interviewed by the FBI and NIS. He succeeded Rear Admiral Peebles as the Program Manager of the Trident Acquisition Program. In July, 1980, the Navy realized that delivery dates for the Trident submarines were going to be later than the

dates published by General Dynamics. A red stripe or high priority memorandum concerning the late delivery dates was prepared.

The Secretary of the Navy at the time, Edward Hidalgo, according to Rear Admiral Cantrell, would not accept the memorandum and Hidalgo told Cantrell, according to Cantrell, that he should accept whatever General Dynamics' Electric Boat Division told him as being the gospel.

Mr. WYDEN. Just about every Admiral in NAVSUP was in on what was going on.

Mr. KLEIN. I just have these interviews.

Mr. WYDEN. Mr. Weld, it is apparent from Mr. Klein's statement that the Navy was very much aware of General Dynamics' problems. In your opening statement, you said the prosecuting potential of each case was clearly undercut by the fact that on each occasion that the Navy and General Dynamics reached an impasse, the Navy's solution was negotiate, compromise and settle.

It appears that Navy acquiescence is the key problem in the prosecution in many matters with respect to General Dynamics' Electric Boat. Isn't that correct?

Mr. WELD. As I said in my oral opening statement, Congressman, I think the most fundamental flaw with the Connecticut case was the data allegedly being misrepresented were estimates rather than hard statements of fact.

To me, the important point or the summary of what Mr. Klein has just said—you characterized it as being that the Navy knew—another way of looking at it is you have a Navy officer who is making a decision within the scope of the discretion entrusted to him by the system of regulations, that for example, something is the best and final price or in Pratt & Whitney, we are going to entertain these costs and put them on the table for negotiation.

When you have a matter entrusted to the discretion of an officer and he makes a decision within that range, it is terribly hard to go behind that in the forum of a criminal prosecution. That is how I would formulate the most fundamental problem, not in terms of merely knowledge, but of legal action being taken by the military as contemplated by the regs.

Mr. CONYERS. Would the gentleman yield to me on this question?

Mr. WYDEN. I'd be happy to.

Mr. CONYERS. We are aware there are always estimates involved. I think Mr. Wyden was worried about whether these were the best estimates that we had reason to expect to come forward.

Mr. WELD. It's true, with respect to both the cost to complete and delivery date issues in the Connecticut case, there was a range of estimates. The estimates that were put forward by General Dynamics, as I said in my written statement, always inured to the benefit of the company. If the estimates that are put forward are within a range of reasonableness and are supported by people in the company, outside auditors, indeed, Navy estimators, indeed, Mr. Veliotis himself with respect to one of these two classes of information, then it is going to be more than difficult to bring a case based on the use of that estimate. It is going to be impossible.

Mr. CONYERS. The Navy went from about \$544 million to about \$50 million. Is the Navy's determination of what was reasonable?

That really puts into pretty sharp focus whether these were just estimates or the best estimates. Most of these—

Mr. WELD. The range is still broad, you mean?

Mr. CONYERS. I mean it wasn't a very good estimate that we started off with. It seems to me there is room for a pretty wide discrepancy between whether or not this was an estimate or the best estimate. It seemed like it was pretty far off. I won't say it was fraudulent flat out.

Mr. WELD. We looked at this case pretty hard, long and hard. That is why I say in conclusion, that I think what we should all be striving to do here is to make that duty of the procurement officers, the people in the military and the people in the company, as clear as possible so you don't get these enormous stretches of latitude in which people can move freely.

As I understand it, and I'm not an expert in the military procurement process, but you have to have some flexibility so you can bring the project in. You just have a tradeoff between the amount of flexibility that is necessary in a complex project like that and holding people's feet to the fire to make sure they don't have too much running room. That is the tradeoff as I see it.

Mr. WYDEN. Just one other question. My only concern is, and of course, you have to have a range with respect to these estimates, but certainly if the estimate process is abused, we are going to have a great deal of defense waste and fraud in a number of instances.

Mr. WELD. I would agree with that. I'm not saying no case could ever be brought that involved an estimate rather than a historical statement of fact, simply that in this case there was just enough support for the estimates that were used so that the criminal potential was seriously eroded.

Mr. WYDEN. Thank you, Mr. Chairman.

Mr. CONYERS. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Mr. Klein, if I could, I would like to focus on what has been affectionately referred to as the puppy dog tape. I'd like to chat about that for a few minutes if we can.

Can you tell me what you know about this tape?

Mr. KLEIN. I can refer to an aspect of our investigation that we refer to as the Lehman deal, as we progressed through this case.

The Lehman deal centered on negotiations for the contracts on Trident submarines 724 and 734. Apparently what had happened in the building of these submarines, General Dynamics came up with many problems in their production process. They had faulty welds. They had paint that was inappropriate. They had steel that couldn't be utilized to effectively build certain parts of the submarine. Because of this, they wished to utilize the insurance claim law that the Navy has with its defense contractors, that dates back all the way to World War II. When defense contractors found themselves in a bind to continue working on defense contracts, they could file an insurance claim with the Navy and get reimbursed for problems, particularly those that the Navy had caused themselves, either by design errors, et cetera.

In this particular case, those problems were Electric Boat problems. In other words, it was because of the management and the

acquisition of supplies by Electric Boat that these faulty welds and poor steel were utilized.

Because of that, they filed a \$100 million insurance claim against the Navy.

Mr. SLATTERY. Let me make sure I understand this. The insurance claim concept which originated in World War II was designed to enable the contractor to recover from the Navy, from the taxpayers, in other words, in those instances where the Navy changed design or did something that would cause the contractor—

Mr. KLEIN. Apparently, and I'm not a student of the law. I think there was an interpretative part of that statute that was made by Electric Boat Division and General Dynamics' attorneys as possibly making the Navy liable for any problems that come out of a defense contract that is let.

What was utilized in the past when the Navy caused the problems, here, a precedent was being set, a suit was going to be filed asking the taxpayers to pay Electric Boat \$100 million for errors they caused.

Mr. SLATTERY. Mr. Weld, are you familiar with this concept, this insurance claim concept?

Mr. WELD. Generally, Congressman.

Mr. SLATTERY. Let me make sure I understand this. Historically, this concept was used to enable the contractor to recover in those instances where the contractor incurred costs that they did not anticipate because of changes or actions on the part of the Government.

Mr. KLEIN. I think it was mainly geared toward catastrophes, fires in the Navy yard, problems beyond the control of the contractor, problems that the Navy—

Mr. SLATTERY. Historically, this was not available for the contractor in those instances where the contractor had taken action or done things that were improper or negligent and incurred costs as a result of their own actions, their own negligence, in effect.

Mr. KLEIN. That's correct.

In this instance, Electric Boat asked the Navy or wanted to sue the Navy for \$100 million. Admiral Lehman became very upset with this insurance claim because if that precedent was set, then you would have all defense contractors submitting insurance claims and he was very upset. Apparently, it was a culmination of Admiral Lehman's dealings with Electric Boat over the years and the problems that they had.

Mr. SLATTERY. Secretary Lehman.

Mr. KLEIN. I'm sorry. Secretary Lehman.

Mr. SLATTERY. Secretary Lehman got concerned that Electric Boat was submitting this claim.

Mr. KLEIN. That's correct.

Mr. SLATTERY. Called in the officials from Electric Boat; isn't that correct?

Mr. KLEIN. What he did was say, OK, that's it, I've had it, no more contracts to Electric Boat, I'm going to cancel Electric Boat's option for the next Trident submarine, that's it, we have had it.

Mr. SLATTERY. If I remember correctly, there were some significant public statements made at that time, where Secretary Lehman was basically going public, letting the world know that he

was not going to continue doing business with Electric Boat; isn't that correct?

Mr. KLEIN. That's correct. It was a very public issue at the time.

Relations between the Navy and Electric Boat continued to deteriorate until I would say the summer and early fall of 1981, when the Chief Executive Officer of General Dynamics, Mr. Lewis, decided he would have to have personal meetings with Secretary Lehman, which he did. A series of meetings took place with Secretary Lehman.

In September of 1981, an agreement was reached between the Navy and General Dynamics in which General Dynamics agreed to drop its \$100 million insurance claim in exchange for Navy contracts for at least one fast attack submarine and others and one Trident submarine and an option for two more, at increased profits. When I say "increased profits," what the Navy and General Dynamics agreed to was a figure between 14.2 and 14.5 million manhours to build the submarine. I think that figure might have been backed into. That was the award for those figures.

Because this number was higher than the cost of the Trident submarines in the past, it caused great questions.

Mr. SLATTERY. They had a very lucrative contract being signed by the Navy with Electric Boat that significantly increased the cost of previous Tridents, and in return for that, basically, Electric Boat dropped its \$100 million claim on the Navy.

Mr. KLEIN. I think there is one point missing from your statement, Congressman. I think that the Navy honestly believed—Electric Boat, in the fast attack submarine program, the 688 program, had lost money from its inception. Millions and millions of dollars were lost in that program. The profitable part of the company was the Trident submarine project. I think based on statements we have recorded and interviews we have done, that Secretary Lehman believed that for the first time, we had a realistic cost estimate of the Trident submarine program. That was the gist of that matter.

There are certain aspects of the case that we are still looking at. The case is not closed right now and there are certain parts that are still under investigation.

Mr. SLATTERY. We are going to have to go vote in a few minutes. I would like to focus on what really happened here. If I remember correctly, was there not a meeting involving Secretary Lehman and Mr. David Lewis, Chairman and CEO of General Dynamics at the time, and basically Secretary Lehman expressed to Mr. Lewis his great displeasure with what was going on. After that meeting, Mr. Sawyer basically discussed this whole meeting that they had just had with Mr. Lewis and then Mr. Lewis subsequently described that conversation with Mr. Sawyer and Mr. Lewis that occurred in a car and Mr. Lewis described this conversation to Mr. Veliotis. Mr. Veliotis taped that conversation with Mr. Lewis.

Mr. KLEIN. That's correct.

Mr. SLATTERY. In that conversation with Mr. Lewis, Mr. Lewis described to Mr. Veliotis how this Mr. Sawyer came out of the meeting and in effect said, don't worry about what Secretary Lehman just told you, we are going to take care of you and all is going to be well. That was the description of the conversation that

Mr. Lewis had with Mr. Sawyer following the meeting with Secretary Lehman and Mr. Lewis described that in a conversation with Mr. Veliotis that was taped by Mr. Veliotis.

Mr. KLEIN. That's correct.

Mr. SLATTERY. That's the puppy dog tape that we referred to.

Mr. KLEIN. Yes, sir.

Mr. SLATTERY. Mr. Klein, are you aware that during testimony before this subcommittee, that Mr. Lewis confirmed the substance of that tape?

Mr. KLEIN. I am aware of that.

Mr. SLATTERY. Mr. Weld, I'm just curious, barring any other measures, why couldn't the Justice Department immunize one of the key players in the puppy dog tape incident and go after the rest involved in the deal?

Mr. WELD. I'm going to have to speak hypothetically, Congressman. I really can't speak directly to this line of questions, but as to procedures, I'm a great believer that if you come up against a stone wall in examining the whole cast of characters, you move straight up the line from the bottom with immunity to try to shake the story loose, but I really cannot address myself to the specific factual question that you raised, properly.

Mr. SLATTERY. I guess my concern is this; you had basically the substance of the quid pro quo, you might say, described in this tape. I am just curious why that was never followed up on.

Mr. WELD. I am really running into a problem with Grand Jury material, and as Mr. Klein says, not all of his matters have been closed out yet, so for a variety of reasons, I just don't think that I can properly discuss this factually.

Mr. CONYERS. Would the gentleman suspend now until we repair to the Floor for a recorded vote? Well, we will excuse ourselves and we will ask our colleague, Mr. Wyden, to take the chair and continue the questioning so that we can move.

Mr. SLATTERY. Mr. Chairman, could I ask one last question just to wrap this up?

Mr. CONYERS. Absolutely.

Mr. SLATTERY. Mr. Weld, I am just curious if you would share with me your view of the law in this regard, and Mr. Klein might be willing to help. Is it not improper, if not illegal for a contractor to be able to basically confront the Government and say we are filing this claim, basically an unjustified claim, because the claim is based on their own negligence, not the Government's action or negligence on the part of the Government or changes on the part of the Government, and then to get into a deal, in effect, where the Government says we will drop this claim, we are not going to honor your really phony \$100 million claim, and what we are going to do to take care of you is basically renegotiate the contract and give you maybe more than the \$100 million in the renegotiation of the contract?

Isn't there something fundamentally wrong about that going on?

Mr. WELD. One relevant consideration here, Congressman, is that, at least according to my understanding, every time that General Dynamics came forward with a somewhat novel legal theory or a somewhat novel accounting theory, they had it supported by the opinion of an independent and reputable law firm or account-

ing firm. So it may not be quite so clear-cut as might otherwise appear that the claim was utterly without foundation. Obviously, if there is a claim utterly without foundation so that it gets to what I am calling false statements of fact, that is a free-standing problem for a company.

Mr. SLATTERY. I am going to have to go vote, but I yield back the time that I have to the chairman so he can follow up on this line of questioning. I will be back briefly.

Mr. WYDEN [presiding]. We thank the gentleman from Kansas and we apologize to our witnesses. We have Floor votes and it is a busy day.

Mr. Weld, in your prepared statement you listed a number of suggestions for the future. I was somewhat concerned at your suggestion number 11 regarding the acquiescence issue, which, as you have heard me say this morning, I think is fundamental. You state, and I quote here, "Military officials may overlook or ignore infractions by the defense contractor not because of an evil intent or for personal gain but because of a belief in the importance that the project or the new technology has to national security."

Mr. Weld, it seems to me that is a concern that is somewhat troubling. We now are facing a very, very serious scandal. The Iran-Contra affair, it seems to me, grew out of virtually the same kind of principle. Those involved felt that what they were doing was in the overall good of the national interest and that the actions they took were therefore justifiable.

My concern is that the statement you have made with respect to suggestions regarding acquiescence open up a window for the same kind of situation. Mr. Weld, you don't intend to condone military officials overlooking or ignoring infractions by the contractors if they believe in their own mind it is in the overall national interest?

Mr. WELD. Quite to the contrary, Mr. Congressman. As I attempted to make clear in my oral statement, I do not mean to suggest that the absence of a bribe would be a bar to prosecution if the military and the contractor got together and agreed to do an end run around a clear requirement of law. If you read the next sentence of my statement, I say the military officer may overlook an infraction not for personal gain but because he thinks it is important to bring in the ship or the tank or the plane. The next sentence is, "However, that is not to say there are no circumstances where the collusion or connivance of public and private contracting personnel would rise to the level of criminal fraud." For example, if a defense contractor notifies a military contracting officer that the contractor is experiencing massive cost overruns and the two individuals thereafter engage in a scheme to cover up the overruns by backdating or falsifying material documents, even if they are doing it because they think it is in the national interest, that would, in my opinion, at least, in all likelihood constitute a prosecutable criminal case which I personally would pursue with vigor.

So you and I are on the same wave length.

Mr. WYDEN. I want to hear that "however" become the general rule, I guess. What concerned me was that you all were opening up that window that somehow if somebody had a belief in the importance of a project or a national security concern about a new tech-

nology, that somehow you could overlook infractions. Of course, that is the situation up in Electric Boat. That really, in a nutshell, is the subcommittee's concern about Electric Boat.

Mr. WELD. That is not intended, Mr. Congressman.

Mr. WYDEN. Mr. Weld, you also stated that in the absence of fraudulent intent, the resulting overcharges may not be prosecutable or possibly not even recoverable. Mr. Weld, examining the cases before us, in two or three of them we had situations in which the Congress was lied to or misled about schedules and costs on three of the major weapons systems. So the Congress was denied its constitutional role in the decision and appropriations process.

How, in your view, do we stop military officials from ignoring what is the Constitution and the laws of the land because they in their own view think they know what is best for the country?

Mr. WELD. Again, in my view, if you have a lie you are probably going to have a prosecutable case under Section 1001, False Claim or False Statement. If you have an estimate that some people agree with and other people don't agree with as to what is going to happen 2 to 4 years down the line, that may not be sufficiently factual to qualify as a lie for those who think the estimate is off the mark.

The other point I would make is that a problem we run into is that if the military officer is exercising a degree of discretion which is committed to him by the system of regulations, as in the Pratt and Whitney case, you can't go behind that. So the obvious suggestion is to tighten up the amount of latitude of discretion that the procurement officer has. That would be my answer to the "how" question.

Mr. WYDEN. But wasn't, say, in the DIVAD case that knowingly there was a statement with respect to underfunding? That, to me, is the kind of thing that is as clear a statement of misrepresentation and painting a picture that doesn't resemble reality.

Mr. WELD. This is really what I was getting at when I say acquiescence can happen in two stages. It can happen during the contract or it can happen much earlier on at the process even of formulation of the strategy or the Congress' plans for the weapons system. It has been mentioned that when the military first went up on the Hill for the DIVAD system, the price tag was \$60 million and that was viewed as steep, and people came back with a \$39 million system.

Now, DIVAD may not be the best example in the world of the improper carrot, if you will, because there you did have the production contract down the line, which was expected to be very lucrative; but to the extent that you do, as a result of competing pressures between, if you will, the Sea Power view of the world on the one hand and the Appropriations Committee view of the world on the other hand, to the extent that you do get contracts signed with a nod and a wink, that is strewing the field with land mines for the future.

To the extent that it is generally accepted, even if not overtly stated, that contractors are simply going to "have to" invade either profit or other discretionary accounts such as IRAD and B&P, that is going to be trouble down the line.

Mr. WYDEN. How can we prosecute, then, when contracts, in effect, are signed with a nod and a wink?

Mr. WELD. That was the subject of one of my earlier suggestions, that to the extent possible, if both the contract and request for proposal can make it as clear as words can be to what extent profit is going to have to eat cost overruns, to what extent IRAD and B&P can be tapped by the contractor if there are overruns from the contract price, if those things are made as clear as they can possibly be, that problem will be kept to the lowest level.

Mr. WYDEN. We just look at the documents that the subcommittee has obtained, one dated February 8, 1987 from Robert Ogren to you, and it states here with respect to Electric Boat that the NAVY and General Dynamics recognize that postponing delivery dates can mean reductions in appropriations for the submarine program. Finally, delivery of those boats were 2 to 4 years away, and thus the dates were estimates based on various assumptions. Eventually EB corrected the schedule as delays became more obvious. The Navy's knowledge of the circumstances and flexibility of the date makes it hard to prove that any date 2 to 4 years away is fraudulently conceived or forecast. In the Trident schedule, McDonnell can say there was no agreement when the staff of Veliotis responsibility in November of 1987 was to review and put out a new schedule. In November 1987, General Dynamics didn't know enough to announce the date. In addition, when General Dynamics announced the delays in February of 1978, we can't prove the market responded.

The guts of this is that the Navy and General Dynamics recognized that postponing delivery dates can mean reductions in appropriations, and the Congress is then being deceived, and I think we need to have tools that are going to allow us to deal with these deceptions. If this is a memo from Mr. Ogren to you, I would like to know what is it you can do, what is it that your office is willing to do when we have memos making it clear that the Congress is being deceived with respect to the appropriations process.

Mr. WELD. As I say, if Congress, if any segment of the Government is being lied to as a matter of fact, I think what we can do is to prosecute under 18 U.S. Code Section 1001. In case I haven't made it clear, I place more emphasis than Mr. Ogren's memo does on the fact that these data were estimates. I place less emphasis on the "there was no victim" theory.

Mr. WYDEN. Why couldn't the prosecution then come about on the basis of what I just read? The Navy and General Dynamics clearly got together, and it looks to me like a conspiracy to deceive the Congress with respect to appropriations. Keep the funding up and deceive the Congress with respect to appropriations.

Mr. WELD. As I said earlier, if I can prove—and let me state this in the hypothetical, if I may—if I could prove that a military officer and an official from the company got together, for however laudable a general motive, and decided that they would both put their imprimatur on false information being submitted, then I think you are going to have a prosecutable case.

Now, to the extent that there may be sentences in memoranda suggesting that people were acting in cahoots with some purpose in mind, that is not the same thing as direct evidence.

Mr. WYDEN. There is more in this memo that strikes me as being grounds for a prosecution. It says the initial schedules of both the 688 and the Trident were unrealistic and the Navy knew it. The Navy didn't favor changes in the schedule. What did you do to examine the possibility of prosecution in this area where the Navy and General Dynamics got together and recognized that postponing the delivery dates could bring about a reduction in the appropriation?

Mr. WELD. Without violating Rule 6(e) of the Federal Rules of Criminal Procedure, I would refer back to my previous answer, I believe to Chairman Conyers, or perhaps it was the gentleman from Kansas, that I am a great believer in exploring every conceivable investigative avenue before the Grand Jury to make sure that every possible combination of witnesses has been heard from so that there is no shortfall in the information which is available to the Government.

Mr. WYDEN. Mr. Klein, wasn't there a memo that was squashed that dealt with these schedule problems, something I think I remember you referred to as a red line memo?

Mr. KLEIN. That was a memorandum that was prepared in the Department of Defense. It wasn't a memo between the Bureau and the Department of Justice.

Mr. WYDEN. But that memo did point out the schedule delay, did it not?

Mr. KLEIN. I would have to look that up.

Yes, it did.

Mr. WYDEN. Yes, it what?

Mr. KLEIN. As I said before, this was a statement made by Rear Admiral Walter Cantrell in July of 1986 regarding the Trident. He said that in July of 1980, the Navy realized that delivery dates for the Trident submarines were going to be later than the dates published by the General Dynamics Electric Boat Division. Admiral Bryan, the Commander of NAVSEA at the time, wrote a red stripe, or high priority, memorandum concerning the late delivery dates. The Secretary of the Navy at the time, Edward Hidalgo—again, this is according to Rear Admiral Cantrell—would not accept the memo. The memo contained enclosures for dissemination to Congress and the press. Hidalgo told Cantrell that he should accept whatever General Dynamics's Electric Boat Division told him as being the gospel. This is a statement, again, by him.

Mr. WYDEN. Mr. Weld, why were Mr. Hidalgo's actions not improper?

Mr. WELD. Again, the memo uses the word "realize." This one of ficer "realizes" that this estimate as to something that is going to happen in 2 to 4 years or maybe it's a dollar figure, I can't recall, is off base. All kinds of people had all kinds of different opinions as to what these figures were going to be. Each author of each memo may state his or her view with certainty but that doesn't make it a fact.

Mr. WYDEN. Again, through the whole authorization, the whole appropriations process, it is all built around estimates. Somehow, you all seem to have fashioned a theory with respect to these estimates that I don't think is going to get us any prosecutions in areas of defense fraud, except in very rare instances. I just feel you

have so convoluted this theory of estimates by what you have told us today, that we are going to lose our deterrent against defense fraud. I am greatly concerned about it.

Mr. WELD. If I could refer to the statute, Section 1001. It requires that the defendant make a false, fictitious or fraudulent statement or representation, that he know it to be false at the time, that it be material and that the defendant do this knowingly and willfully.

I guess all I'm really saying to you is that in the area of estimates, these elements are very much more difficult to prove. When you do have support for the estimates, as you did in this case, no support, possibly a different approach, but when you do have support for the estimates, the prosecutive potential approaches the "x" axis.

Mr. WYDEN. I want to make sure I understand exactly why you dismissed that memo. That memo, it seems to me——

Mr. WELD. I'm not dismissing any memos. I am just saying they may all be part of a mosaic of opinion.

Mr. WYDEN. Mr. Weld, in your opening statement, you said there was a merging and a mutual reinforcement of interest between the contractors and the military. To what extent do you believe that this commonality of interest, and I would call it mutual self interest, encourages acquiescence in these frauds?

Mr. WELD. To the extent that people work together over a long period of time on major projects, I suppose psychologically, that could be a factor leading someone on the military side to not want to have a confrontation on every issue. To the extent, as I have said previously, that there may be this convergence in service of some supposed higher good, I don't think it would be a defense to a criminal prosecution, if the contractor and the military personnel agreed to put forward a false statement.

Mr. CONYERS. Would the gentleman yield?

Mr. WYDEN. I'd be happy to yield to the chairman.

Mr. CONYERS. I keep feeling that this may be the heart of the problem. Mr. Assistant Attorney General, let's be candid. In this kind of military procurement situation for the big ticket items, there have been longstanding relationships between the military and the contractors. We know that many of the military come out and just change sides of the desk, put on civilian clothes and they are back looking the same way that they were looking at people that were on the other side when they were military.

In some ways, I feel this may be the bigger problem that goes to some of your recommendations. I thought you were kind of passing over this one. If we could get to the bottom of these relationships without passing on whether they are incestuous or illegal or improper but just the fact they exist, that to me is a huge consideration in what has brought us to the heart of this matter.

There have been hearings and it looks like there are going to be a fair amount more.

Mr. WELD. That is the subject of one of our suggestions, Mr. Chairman. Suggestion eight on page 23, I say another relevant circumstance is the so-called revolving door. Some military procurement and contracting officials take positions with the contractors after they leave the military. This arguably creates an incentive

for them to be accommodating when they negotiate and supervise defense contracts.

I believe a measure went through recently to limit the revolving door phenomenon with respect to at least senior military officials of 1 year waiting or a cooling off period. The problem or the phenomenon is not limited to the senior echelon. I think it is worthy of congressional and maybe even Defense Department consideration.

Here, I begin to feel I am a little bit out of my depth.

Mr. CONYERS. It is a deep and difficult problem. You have touched on it in your recommendations. Let me say also that it may not be subject appropriately to legislation either. It is hard to get at. It is not all the people at the top of the service, as much of these hearings show. It seems that some way we can begin to tighten up the contractual relationships and the policy considerations which the Department of Justice may be in a very important position where they can begin to influence some of the environment around these contractual relationships that get us into all of the problems.

Mr. WELD. There are some thoughts that occur to me, Mr. Chairman. One is the possibility, as I say, of more frequent rotation of procurement officers. Another is under the personnel system, building in incentives to bring projects in at or below budget. There, obviously you have a countervailing consideration in terms of efficiency and maybe even safety of delivery of the systems.

I would yield to the Defense Department as to the extent to which those incentives should be built in.

Mr. CONYERS. Nowhere are any of us suggesting that the safety and national security should be endangered at the cost of just having some good honest bargaining in the building of our military equipment.

Mr. WELD. The other slightly more radical feature that could be considered is the reporting relationships of people in the procurement business. One thought that has occurred to me is having someone like a Clerk of the Works for a big construction project, who might report outside the normal chain of command, get a measure of arm's length or independence in there.

Again, I'm over my head here. I don't know the minutiae of how these big projects work. Those are just analogous solutions that are adopted in the private sector in my legal experience.

Mr. CONYERS. I am not calling on you to be an expert in all of this area any more than any of us who are charged with creating the law and policies are claiming to be experts just by virtue of being brought here today.

What about another idea, couldn't there be some agreement struck between the Department of Justice and the Armed Services, in which certain of these practices get cleaned up by agreement rather than us trying to debate it out in a House Resolution on the Floor?

There are certain things that bring on the problem. It seems to me that sitting around a table saying, let's stop doing this, that and the other thing, and let's agree to it, would be a lot more efficacious in the long run than us trying to pass a bill going through both bodies, Conference, signed by the President, and then figure out what this really means years later.

Mr. WELD. I'm in agreement with that. I'm in regular contact with Mr. Vander Schaff and Mr. Eberhardt in the Inspector General's Office of the Defense Department and the General Counsel's Office as well.

I think the changes that were made as a result of the Pratt & Whitney experience in Florida, tightening up the regulations there, is one salutary product of that kind of interaction.

As I mentioned, I think procurement regulations have already addressed our thoughts about clearing up the extent to which overruns have to be taken out of profit, clearing up the extent to which bid and proposal and research and development accounts can be used.

I think the people over at the Defense Department are alert to these problems. We also have a major joint project underway, announced by Deputy Secretary Taft last summer, the so-called voluntary disclosure program, in which we have about 20 cases now under review as a result of contractors stepping forward. I looked over the list last night. They are household names. It is obviously going to save the Government a lot of time and money if that program can be made to be a success as a result of joint handling of it by the Defense Department and the Justice Department.

There are those initiatives underway. I have found myself almost bargaining with Mr. Vander Schaff, well, you know, why don't we put such and such number of prosecutors in the Defense Procurement Fraud Unit and in return, maybe the mix of cases that the Inspector General's Office is referring, maybe the stream ought to be directed to such and such recipients.

We have these matters very much in mind and there is a constant dialogue between the two departments.

Mr. CONYERS. Thank you. That is helpful to know.

Mr. WYDEN. Thank you, Mr. Chairman. I am just going to ask two additional questions of Mr. Weld at this time.

Mr. Weld, to finish up on this question of the estimates, which really concerns me greatly, because you know the way a weapon system is conceived. There is a debate. There is an authorization. There is an appropriation. Weapons are killed. A variety of things happen in the course of a weapon system.

What concerns me is that even when high ranking military people up and down the line are talking about over charges or other kinds of frauds and abuses, by the theory that you have given us, if somehow there is an estimate by somebody in the file, which argues that it is reasonable, and I gather even by law firms or accounting firms, based on what I have heard you say, somehow that is going to deter prosecution.

Could you give me some further elaboration on this notion of how these estimates thereby create a situation where we can't prosecute what seems like serious fraud?

Mr. WELD. I see the basis for your alarm, I think, Congressman.

Mr. WYDEN. Is it justified?

Mr. WELD. I think not. What I can say by way of giving you comfort is that my emphasis on estimates versus facts, in the Connecticut case, is fact bound, limited to the facts of that case. We had P. Takis Veliotis, if he had come back, if we had given him his great deal and he came back and would have been a witness at the trial,

he would have been leading the band for the defense saying that this 688 schedule was absolutely doable, it was a correct estimate.

It wasn't that there were 99 estimates supported by generally accepted accounting principles and generally accepted auditing standards and then some two person law firm somewhere that said, well, our estimate is it will take 1 million hours instead of 200,000 hours.

It is a matter of degree. The estimates in this case were sufficiently close to the range of reasonableness and indeed, supported by some of the better opinion, so that the prosecutive potential suffered greatly as a result.

Again, I emphasize that I am not saying there is no case in which a false statement prosecution could be based on an estimate.

Mr. WYDEN. In this case of Mr. Hidalgo, we had top ranking military people saying it was very, very serious. Yet, somehow that's not what counts when evaluating for prosecution, instead what counts is some official in the Pentagon saying it is not warranted when you have top ranking military people say it is.

You made the key point, talking about the preponderance of the evidence. When I look at these cases, I see up and down the line, the preponderance of evidence is with top ranking military people and authoritative people who have been involved in these weapon systems saying there are serious frauds and over charges and the like, and then on the other side of the ledger, I see somebody who has not been very involved, some little memo to the file, and then we no longer have a prosecution.

Mr. WELD. Mr. Veliotis, whatever else he may have been, was certainly very much involved with respect to the schedule on the 688. It is a matter of degree.

Mr. WYDEN. Let me ask you just one other question. Chairman Conyers has been very gracious.

We have a situation where we know the Pentagon and defense contractor officials had given less than complete or misleading statements with respect to schedule slippages, cost estimates, quality problems, production, a variety of different kinds of concerns. Of course, the bottom line can be affected by these disclosures.

We have stated and you have stated Pentagon officials do not personally or financially gain by disclosing this kind of situation but what happens is all too often, where the defense contractors of course tell the Pentagon officials, the contractors can get off the hook because the victim knows and acquiesces, as we were talking about today.

I said it looked to me like it was a question of the taxpayers being the victim of a perfect crime. You had some questions about whether that was the appropriate analogy. Even if it is not, it is the ultimate Catch 22. We are not getting the prosecutions.

I would like to ask you, what is going to be needed to turn these situations into something that is prosecutable? Is it going to be legislation? Is it going to be other steps? Somewhere along the way, whether you call it a Catch 22 or the taxpayers are the victim of the perfect crime, something is going astray.

I would like to hear your thoughts about how we turn this into something that can be prosecuted.

Mr. WELD. What I was saying earlier about it's only a perfect crime if no one finds out about it.

Mr. WYDEN. It is a perfect crime if you can get away with it. That's what is going on, Mr. Weld.

Mr. WELD. It is not a perfect crime in the sense that it is not a crime. Nobody has a license to lie to the Hill and indeed, if someone comes before any committee with phony information, they are looking not merely at 1001 possibilities but 18 U.S.C. 1505 for getting in the way of Congress.

Mr. CONYERS. If the gentleman would yield, I used to think that up until recently.

Mr. WYDEN. We have read from memos where the Hill is being deceived on appropriation matters which I think further corroborates what Chairman Conyers has said in that regard.

Mr. WELD. I think the best answer I can give to your question is to suggest again that everyone, the Justice Department, the Defense Department, and Congress should strive for clarity in creating and defining the legal duties of the parties to the procurement process at every stage of the way.

If submissions to the military, if submissions to Congress were required to be certified in some form, to have backup documentation, to get away from bottom-lining and certify the constituent component elements of whatever claim that was being pressed, whether it was a claim for appropriations or a claim for reimbursement under a contract, that promotes clarity of legal duty. And when you have a clear legal duty it's a lot easier to prosecute its violation in a criminal forum.

Mr. WYDEN. Well, I can just tell you that there are many on the Hill that are increasingly concerned about this. Chairman Aspin on the Armed Services Committee wrote to the Air Force on March 19 of this year, and I quote here, "The Services have got to learn that having a problem is no crime, but hiding a problem is. You have the opportunity in your present position to set right much that Congress finds irritating. Candor has been in short supply in the Air Force. Patience is now in short supply in the Congress."

I just think we have got to look, either through new tools or through new kinds of arrangements between your office and the Pentagon at a way to convert these kinds of frauds, which I think are frauds, and certainly our constituents see them as tremendous waste of the taxpayers' money, into something that can be prosecuted and can serve as a deterrent of future abuse.

And I want to thank Chairman Conyers for the opportunity to ask these questions.

Mr. CONYERS. Do any of the members seek recognition at this point?

Mr. Slattery.

Mr. SLATTERY. Mr. Chairman, if I could, I have some additional questions for several of the panelists. But before I start those questions, I'm just curious, do any of the members of the panel have any knowledge of how the Pentagon dealt with military officials who were responsible for monitoring either the problems with Pratt & Whitney or with Electric Boat Company or any other defense contractor? I'm just curious, how has the Pentagon internally dealt with these people that were responsible for monitoring these contracts on behalf of the Pentagon? Have they been promoted? Have they been, in any way, reprimanded for being rather lax or

negligent in supervising these billings? I'm just curious, does anyone have any knowledge of how they've been internally handled?

Ms. TOENSING. In Pratt & Whitney I don't believe anybody was disciplined. What the Air Force did was change their procedure so that this would not occur again. I believe it was a realization that the whole system was a bit out of whack, and that if people had to deal more directly and more specifically that had to be written down, because the rules were that the contracting officer had a lot of discretion, and the corporation had a lot of discretion as to what they could put into the pile, into the proposal to be reimbursed.

And so what they did after the investigation, rather than casting any stones at a particular person, is they changed their procedures. I'm not sure that it's perfect yet, but it sure seems that a lot of gaps are closed now expressly in writing what is an allowable.

Mr. SLATTERY. It seems to this member that clearly military officials involved in monitoring these various contracts need broad discretion. But with that discretion must come enormous responsibility. And with that responsibility, accountability.

And it seems to me that's where this system breaks down. And it's a little bit like our budget process debate around the Hill with the President and with the Congress. We can talk process until we're blue in the face, but until you have people that are willing to make decisions and accept responsibility, you know, process doesn't really matter all that much. And that's sort of a ducking of responsibility.

Somebody is responsible for these things. Somebody has to sign off and say, I accept this, I'm going to pay the bills. And whoever it is that has to sign off is responsible, it seems to me.

And I'm just asking for those people that are signing off, saying, "We're going to accept this or we're going to reject this," what happens to those people?

I've been advised that the ACO, who was involved with the Pratt & Whitney problems that we've talked about, has in fact been promoted to another big job, and in so doing—I mean, that's the system's way of saying I suppose, "Job well done."

Mr. WELD. What you're talking about as accountability, Congressman, is what I'm calling clarity of legal duty. And I think the problem is that, when we try to promote the twin objectives of accountability and discretion they aren't really mutually reinforcing, they are to some degree in conflict with each other.

Mr. SLATTERY. I appreciate your concern as a lawyer and as a prosecutor involved in this case. I guess I'm talking more in terms of just the institution of the Pentagon. I mean, there are people over there that are accountable, and they should be accountable. Start out with the Secretary of Defense and move down the chain of command. And all I'm saying is that the system is not holding people accountable, as evidenced by the fact that when people are involved in these kind of poor performance from the standpoint of this member in terms of monitoring taxpayers' money, they're not in any way chastised. They're not in any way punished within the system. In fact, in many instances they're rewarded by promotions and given new jobs, bigger responsibilities.

The point in fact would be, with the Pratt & Whitney incident and what happened to the ACO in that case. I should take those matters up with the Pentagon, I suppose.

Let's get back to the line of questioning that I wanted to pursue.

Mr. Weld, in your testimony you stated, and I'll just quote from your testimony, "That subtle pressures can be brought to bear on military contracting officers by supervisors who seek the need to get the ship out, the engine built, or the task accomplished even at the expense of protecting the Government's financial interest," end quote.

And you further stated, and I quote, "The military employee knows that his or her career advancement depends on the evaluations of those same supervisors," end quote.

Now that statement is particularly alarming because these officials are entrusted, obviously, with great fiduciary responsibility.

Mr. Weld, what are our current abilities to prosecute Government officials who are either negligent or grossly negligent in carrying out these fiduciary responsibilities? And I know this is sort of a follow-up of what we have been talking about here today. But, what I hear you saying is that there is just a real void here. It's like trying to get your hands on jello, it's just pretty slippery. It's very difficult from the standpoint of a prosecutor.

Mr. WELD. The standard of, you know, mental—state of mind is pretty high for prosecuting an individual and gross negligence won't do it. In demonstrating willfulness which is the most common statement of the mental element required, the Government is entitled to an instruction that willfulness can be inferred from the defendant's having willfully blinded himself to facts going on under his nose or consciously avoiding knowledge or the means of acquiring knowledge that would be tantamount to giving him that requisite state of mind. But aside from that, gross negligence is not going to do it for individuals.

In the law of corporate criminal responsibility there's a theory under which a corporation can be held criminally liable, not merely under the traditional doctrine of respondeat superior being liable for the willful acts of its officer, but also, if it's flagrantly indifferent to its responsibilities under the law, on a kind of theory that, if they're flagrantly indifferent, then, we're not going to worry about actual knowledge. But that standard doesn't apply to individuals.

Mr. SLATTERY. Do you have any ideas, after your experience in dealing with this, that would help us deal with this problem where obviously there's enormous institutional pressure on the part of Colonels and Generals and Admirals to get the job done; and at the same time there's a lot of pressure coming from contractors, perhaps, to accept changes, to accept additional payments to enable them to keep the program on schedule? So, you've got this built-in sort of conflict going on out there all the time, and it's extremely difficult, obviously, for you from the outside to look in to that military officer's mind and say, "Well, is he doing this to accommodate the contractor and enrich the contractor or is he doing this to achieve the goal of getting the ship built?"

That's the conflict that I hear you describe. Do you have any ideas in terms of what can be done institutionally to change this?

Mr. WELD. Well, in the personnel area, and again I'd like to issue a disclaimer here that I'm over my head and this is really the Defense Department's business, but I was discussing briefly with Chairman Conyers three possibilities, rotation of personnel to promote a more arms-length stance with respect to each other.

Another would be incentives in the personnel system for coming in at or under budget. And another would be consideration to the reporting relationships in the personnel area. Maybe you have some portion of the procurement people reporting independently rather than up through their command. But that's really beyond the scope of my responsibilities.

Ms. TOENSING. Congressman Slattery, I would just like to explain something about Pratt & Whitney and the contracting officer.

What we were really looking at as far as the behavior of the contracting officer was, what did he negotiate for the bottom-line price? And so, the fact that he was promoted is neither here nor there, really. If he negotiated a good bottom-line price, then he was considered to have done a good job.

We were looking criminally at what Pratt & Whitney submitted, whether that was illegal or improper. And most of us turned our stomachs as what was submitted by them.

But the way that business was being done then, if he said, "You're only going to get \$100,000 and nothing more, it doesn't matter what you put in here, even if you want to put in \$20,000 for the retirement party." It didn't matter. The test of his ability was whether he negotiated what was considered a fair bottom-line price.

I just didn't want the point of how that process worked to be missed.

Mr. SLATTERY. In that instance, then who is responsible for approving the \$20,000 retirement party, to use your example?

Ms. TOENSING. It doesn't matter. It's as if you contract to have your car fixed and you've got several things wrong and you get an estimate.

Mr. SLATTERY. We agree on a price.

Ms. TOENSING. The car guy says \$500. You say, I don't want to pay more than \$250 to get it done. And they say \$300, and you agree on that price of \$300. The fact that they're going to put down that they charged you \$199 to put on a new gas cap, and \$50 to fix the brakes doesn't matter how it's delineated, it's only the bottom-line price that's important. That's the problem with the bottom-line price, because it's very difficult for the auditors to go in and really see if there's a problem in the system.

And that's why after Pratt & Whitney, the Air force changed the system so that many of these expenses were not even allowed to be submitted.

Mr. SLATTERY. This is where I need some help to further understand this. This was basically a cost plus contract; right?

Ms. TOENSING. Yes. In the overhead.

Mr. SLATTERY. Pardon me?

Ms. TOENSING. Yes.

Mr. SLATTERY. In the overhead?

Ms. TOENSING. Yes.

Mr. SLATTERY. Well, the whole contract was cost plus.

Ms. TOENSING. What we were looking at was the proposal for the overhead for the whole year from Pratt & Whitney. In other words, Pratt & Whitney in 1982 submitted what was their overhead for the whole year.

Mr. SLATTERY. But the whole contract was a cost plus contract; is that correct?

Ms. TOENSING. We're not talking about one contract, we are talking about Pratt & Whitney dealing with the Government for the year of 1981.

Mr. SLATTERY. Mr. Weld, I'm just curious, in any of the cases that we have discussed today, have any of the services contacted you or your people to determine if there are any personnel problems that they should be aware of?

Mr. WELD. I'm not aware of all the discussions that may have happened between the prosecutors reviewing the cases and people in the services. I know there have been a lot of discussions. It's also not unheard of, after we've reviewed a case for prosecution, for us to make a comment to the services, although it's not common.

Mr. SLATTERY. In this case have there been any inquiries from the services to determine if you have evidence or information that they should be aware of that may not justify criminal prosecution, but may justify personnel decisions?

Mr. WELD. There are no such inquiries that I'm aware of, Congressman, but I'm not sure that I necessarily would be aware of them if they had been made.

Mr. DINGELL. Would the gentleman yield?

Mr. SLATTERY. Yes.

Mr. Klein, if I could get this—I'm just curious.

Mr. KLEIN. I'm not aware of any either.

Mr. SLATTERY. I would be happy to yield to the chairman.

Ms. TOENSING. I've been in contact with the Air Force General Counsel's office regarding Pratt & Whitney, regarding changing procedures. Again, we couldn't blame the contracting officer per se; but they wanted to have their procedures changed so that this wouldn't happen again. And they were very diligent about doing so.

Mr. SLATTERY. Very good.

Mr. DINGELL. Would the gentleman yield?

Mr. SLATTERY. I would be happy to yield.

Mr. DINGELL. Why would not an appropriate consideration of this matter involve more than just a criminal prosecution? We should apparently here be having a change in procurement procedures, or we should be having a review of behavior of the individuals involved. A review of the personnel practices of the Agency in general. A review specifically of the personnel performances of the individuals involved. A review of the questions associated with the contracting processes and officers and procedures, to deal with all aspects of the events that attend these several examples that the committee is inquiring into today.

First, have such actions taken place or any of them? And second, if they have not, why not? And third, why should they not occur with considerable vigor? Massive amounts of the taxpayers' money have been dissipated, I think, and under the most questionable circumstances.

Mr. WELD. Speaking for the Justice Department, Mr. Chairman, with respect to the Pomona case, which is the one where we really had a problem, I would regard the review that went on during the months of April, May and June of 1987 as being that review, and it produced the very lengthy and detailed memoranda which we have transmitted to the committee.

Mr. DINGELL. That was the Justice Department's problem, but there is no evidence here that any corrective actions have taken place inside the Pentagon, with regard to any of the points that I raised in my question.

Ms. TOENSING. I would just like to point out our unit, the Defense Procurement Fraud Unit, is in constant contact with the various military agencies regarding anything that they deem improper.

Mr. DINGELL. I am intruding on the time of my good friend from Kansas, to whom I apologize. But you observed, in the course of your statement, Mr. Weld, that there was no evidence here of falsification of papers, false statements made by the Pentagon people, and that sort of things.

But the harsh fact of the matter is that there was no need for that to occur. From the very beginning, judgments had been made by the Pentagon which sanctified behavior which comes very close to fraud. Isn't that correct?

Mr. WELD. In the California case?

Mr. DINGELL. Yes. In every one of these cases.

Mr. WELD. I view the Connecticut case as closer to the line.

Mr. DINGELL. It is totally unnecessary for there to be any falsification of books, records, documents, any false statements under oath, because the whole matter was premised on clear and obvious agreement, in advance, by the Department of Defense with regard to what is clearly misbehavior.

Mr. WELD. I think the members and both chairmen have raised a number of interesting questions this morning. They are questions that we attempted to address in a prospective fashion in the statement that was submitted, and I am sure, as a result of these hearings, that there will be a public airing of these issues.

Mr. DINGELL. The ability of the Justice Department, in each of these cases, was compromised before the matter even arrived at the desk of the Department of Justice, because of the prior behavior of the Department of Defense.

Is that not so?

Mr. WELD. Yes, but again, there is a little bit of a temptation, in retrospect, to look on these cases as the Electric Boat prosecution, the Pratt and Whitney prosecution, which went sour. They never were prosecutions. Those two are two investigations out of a couple of hundred that did not proceed to the indictment stage.

Mr. DINGELL. They either died shortly before conception, or shortly thereafter. And it appears that if an abortion occurred, it occurred at the hand of the Department of Defense. Isn't that right?

Mr. WELD. Can I take five on that, Mr. Chairman?

Mr. DINGELL. I thank the gentleman for yielding.

Mr. SLATTERY. Mr. Chairman, I just have one last question that I would like to ask. Mr. Weld, I am aware that there are some grand

jury investigations under way that affect TRW. As you know, this committee has held several hearings on the whole question of the self-disclosure process that TRW has utilized.

I do not want to get into a lot of specifics about this, in light of the grand jury situation, but I am just curious: is it your view that the self-disclosure procedures that are being used by TRW, are they adequate? Are they working? What is your view?

Mr. WELD. We have very recently, Congressman, developed a set of guidelines to assess when the Justice Department will view as truly voluntary an allegedly voluntary disclosure under Secretary Taft's program.

Among those factors is whether the Government was already nipping at the heels of the contractor before they came forward; how pervasive the wrong-doing was; what level of management or non-management was involved. So that we will apply the same matrix of eight or nine factors to every purported voluntary disclosure in assessing—

Mr. SLATTERY. Mr. Weld, if you do not want to answer this question, just indicate that. Do you view TRW's disclosures as an effort to get to the full truth? Or, in your judgment, do you think this is more an attempt to control damage within the company?

Mr. WELD. I do not think I could comment on that. That really goes to the guts of a pending matter.

Mr. SLATTERY. Thank you. I have no further questions, Mr. Chairman.

Mr. CONYERS. Thank you very much. Let me turn to Supervisor Neumann, if I can, to discuss with him an FBI document with reference to Pratt and Whitney that may continue this discussion about our concern.

This was a response to the declination letter that was sent up from SAC in Miami on August of 1986. Have you had an opportunity to examine this document at all?

Mr. NEUMANN. Yes, I have.

Mr. CONYERS. There were about four reasons advanced as the underlying premises for the declination. The first, of course, was that the Air Force failed to issue a final determination of non-compliance with reference to the cost, and thereby did not require Pratt and Whitney to halt its practice.

Then, in the response from the FBI, which sounds pretty persuasive to me, to rely on the testimony of ACO J. Moyes at Pratt and Whitney as to what constitutes an expressly unallowable cost defies logic. Being the principle person who is responsible for overseeing the conduct of Pratt and Whitney and its billing practices, Moyes' conduct in failing to halt Pratt and Whitney in its claims, is at the heart of the matter.

His actions personify the relationship existing between the contractor and the AFPRO. The bottom line, of course, is that the overcharge was more than \$3.5 million in 1981 alone, and \$22 million in total.

Do you have a view about this that supports the thoughtful argument that discontinuing this matter was probably not, perhaps, the best way to proceed?

Mr. NEUMANN. I believe that the statement there, Mr. Chairman, indicates that the individual responsible for the final determi-

nation, Mr. Moyes, did not indicate to the contractor that these expenses were expressly unallowable.

Therefore, he invited the contractor to present them for bottom line determination. Once that was done, the contractor obviously availed themselves of that; and, even though some of the charges were alarming, the ACO invited the contractor to participate in the bottom line negotiation, and that was done.

Mr. CONYERS. Here we have a situation where we have evidence of gross negligence. The defense, actually, for moving forward here is that the victim's actions were somehow a part of the problem, a part of the crime. What I am reading here in this FBI report that went back up was that there was a quid pro quo existing; that there had been found that regularly military personnel from the plant go under the corporate umbrella, and that everybody expected that that would happen; and that, in a way, there was a quid pro quo.

There was evidence of gross negligence. Just sharing the FBI point of view, it seemed to me that this kind of line of argument would carry the day, Mr. Neumann. What do you think?

Mr. NEUMANN. There may have been gross negligence. Certainly, gross negligence, I don't feel, is a reason to prosecute an individual. The statutory base that we were looking at—the fraud, the withholding of or the falsification of documents—was never in the Pratt and Whitney case.

The documents were forwarded to the AFPRO. They were on the table. And yes, gross negligence was used; but was that a basis for an indictment? I do not believe a review of that would indicate that.

Mr. CONYERS. But gross negligence can be introduced as proof of misconduct.

Mr. NEUMANN. It can in certain cases, yes.

Mr. CONYERS. I am not familiar with any line of cases where it could not be introduced. It can if the prosecutor wants to do it. But what about Moyes? What happened to him?

Mr. NEUMANN. Mr. Chairman, I really don't know. I have heard today that he was promoted.

Mr. CONYERS. I do, yes. What you heard was absolutely correct. He was promoted, which goes to the whole point of the matter. It does not seem that we are looking real hard to put a case together, to be honest with you.

We have the quid pro quo. You say that there is some line of cases in criminal law where gross negligence may not be introduced as proof of misconduct. Moyes gets promoted. What are we to draw from that?

Just from this point one. This is point one of four reasons that the FBI sent back, arguing within their own shop to Judge Webster why we might want to continue on with this matter. To decline to prosecute would be—it makes no sense, under the circumstances.

Mr. NEUMANN. If I may? The general tenor, as I perceive the memorandum when it went up to our headquarters, was to give an overview of the four reasons that the United States Attorney's Office used to decline on the case. We indicated in this particular document that we felt that there was a possibility that prosecution still could be pursued.

That was stated in the closing paragraph of the memorandum. We did not indicate, nor did we mean to imply, that it should be pursued under the theory we were operating under: fraud, deceit, withholding. But what we attempted to do was address the four points, sending the back to our headquarters, to see if, through discussions with the Department, we may have overlooked any possibility that charges could have been brought, based on our investigation.

Mr. CONYERS. What happened? This is where I came in on this document. What was the subsequent exchange of letters and conversation?

Mr. NEUMANN. We received back from the Department, through our headquarters, a reply based on our request that recontact had been made with the Department, and that the decision had been reaffirmed that there was no way to prosecute this matter criminally. At which point, as we do in many instances with the Department, we said fine; we discussed our concerns; they have rendered a decision; and we closed our case.

Mr. CONYERS. Right. There is not that much you could have done. This seems like the kind of case that would have made a great, classic prosecution to set an object lesson, to me. Apparently, someone else thought so, because it seems to me they argued vigorously in this memorandum for reconsideration.

Mr. WELD. Mr. Chairman, I have some knowledge with respect to the future course of that memorandum. It was reviewed at Bureau headquarters, and I am authorized to say, as a result of a discussion yesterday between Mr. Trott, the Associate Attorney General, and Mr. Revell, the Executive Assistant Director, that it was reviewed at the level of Mr. Revell, who concurred with the logic in the 131-page declination memorandum.

So there was a divergence of view within the Bureau on the matter, which is not all that uncommon.

Mr. CONYERS. It happens, sure. Here, on page 7, to acquiesce on this matter is to imply that the FBI—further actions of Pratt and Whitney are not unique to the defense industrial complex, and a failure to follow through with prosecution could send an errant signal to all contractors that are engaged in these kinds of activities.

This document, alone, leads me to ask you how that was treated within the Department? Here, from the FBI, we have a respectful but yet very vigorously advanced set of rebuttals to a declination. You concede there was a split decision, but still we agreed to scrap it.

That is what brings us here, really, isn't it, Mr. Assistant Attorney General? What tipped the scale, as it were?

Mr. WELD. If I may, Mr. Chairman, with respect to the suggestion in the AIRTEL that the contracting officer was simply wrong in permitting consideration of these unallowable expenses, the problem with that line of analysis is that the then-regulations in 1981 entrust that decision, not to the DCAA, who did not like what he did, or to the FBI; but to the contracting officer.

As Ms. Toensing has said, that problem was addressed by tightening up the regulations; but in terms of that theory of prosecution, it really made it not a viable one.

Mr. CONYERS. To prosecute for failure for fiduciary duty is not new in the law. That has been laying around for quite a while. Wasn't there a fiduciary relationship, which could be the basis for a criminal prosecution?

Mr. WELD. I read that memorandum, and I am not sure that the legal analysis was as crisp as it might have been. A lot of fiduciary duty failures, gross negligence; a lot of stuff that didn't really add up to a violation of a specific statute. My heart was with the author of the memorandum. But I think there were legal answers to the points advanced there.

Mr. CONYERS. I have not read this document as much as you have, and certainly have given it not nearly the study that you and your team have. But you must understand how this could be disturbing here in the legislature.

With these kinds of things flying around, it could make a committee chaired by Congressman Dingell very, very alert to a continuing problem and practice. Actually, I am not sure how much the Defense Department's activity actually released Pratt and Whitney from prosecution. You would have to line all of these factors up.

Apparently, it gets pretty complex. But I can tell you that this document, generated by the FBI, would have really weighed in with me, as apparently it did with you, in a pretty impressive fashion.

May I recognize the chairman of the committee, Mr. Dingell.

Mr. DINGELL. Thank you, Mr. Conyers, and I thank you for the fine job you have done in presiding over our joint hearing today.

Mr. Weld, with regard to General Edwards, here is an individual who sat as an important customer of Pratt & Whitney, either in his own right or in his official capacity. He used that relationship to solicit on a number of occasions, finally successfully, a \$67,500 donation to the Oklahoma Arts Center. Did this violate the arms length role that we should expect of our military officials?

Mr. WELD. Mr. Chairman, I asked about that yesterday, having been perturbed by it, and was informed, and I hope this is accurate, that when that \$67,500 item was called to the attention of the company, they said, oh, this is a mistake, we didn't mean to put in for this. I hope that is accurate.

Mr. DINGELL. They found many mistakes of that kind in their billing, very few of which were caught until this committee interested itself in these matters. I'm sure a case was made that this was innocent, but obviously, I have a little difficulty in accepting it as such.

Mr. TOENSING. Mr. Chairman, it was never submitted. Mr. Chafin, I am sure, misspoke earlier. It was never submitted to the corporation. It got put into the wrong pot within the corporation, and when it was discovered, it was said to be a mistake. But it is my understanding of the facts that it was never, in fact, ever submitted to the Government to be reimbursed.

Mr. DINGELL. Didn't the Government, at least initially, pay for this item of \$67,500?

Ms. TOENSING. No, it never did.

Mr. DINGELL. It did not show up in the progress payments made by the Federal Government?

Ms. TOENSING. No, it did not.

Mr. DINGELL. It did not?

Ms. TOENSING. That's correct. Progress payments are not based on any costs incurred; they are just payments every so often, and nothing is delineated in that.

Mr. DINGELL. Did this fall in those categories, it just was stuck away in the payments?

Ms. TOENSING. It was never submitted. He misspoke earlier. It was just never submitted to the corporation.

Mr. DINGELL. You don't mind if there is a certain skepticism up here. Our information is that it was received, that it was, in fact, billed and then paid back.

Ms. TOENSING. It was put into the wrong pot within the corporation.

Mr. DINGELL. It was put in the wrong pot and the Government paid it, and then it was returned. Isn't that the fact?

Ms. TOENSING. Those are not the facts as the U.S. Attorney on the case has submitted them.

Mr. DINGELL. Does this action violate the Code of Ethics for military personnel on the part of General Edwards?

Ms. TOENSING. I believe that it is technically a violation.

Mr. DINGELL. Technically?

Ms. TOENSING. It is a technical violation, yes.

Mr. DINGELL. It is \$67,500 worth of a technical violation?

Ms. TOENSING. Well, Mr. Chairman, it is not for him. He is asking for a contribution to an art show, so when you look at this situation and you think about taking it before the Jury, I could see the argument there: "Ladies and gentlemen of the Jury, this man is indicted for asking for a contribution to an art show and we would like you to convict him of this."

Mr. DINGELL. I can see a couple hundred or maybe a couple thousand, but \$67,500?

Ms. TOENSING. But he received nothing.

Mr. DINGELL. No, excepting a growth in stature in the community. Here is General Edwards going to a defense contractor and he can produce a \$67,500 contribution. Could you produce a \$67,500 contribution to this arts center? Could Mr. Weld or Mr. Klein or Mr. Kennedy or Mr. Emfield or perhaps Mr. Corless or Mr. Neumann do so? Or would any of you proceed to approach a contractor about a contribution of that sort?

Ms. TOENSING. No.

Mr. DINGELL. Why would you not, and why could you not procure a contribution of this magnitude?

Ms. TOENSING. As I understand it, it can be argued or construed as a violation of, I believe it is, 207. The attorney working on the case said that it was not considered to be even a criminal violation; it was a violation of some regulations within the Department of Defense.

Mr. DINGELL. It is not a criminal violation?

Ms. TOENSING. There are some internal regulations in the Department of Defense that do not allow a person to solicit funds for any kind—

Mr. DINGELL. What is the penalty for those internal regulations with regard to soliciting funds? Promotion, or what?

Ms. TOENSING. I'm sorry, I couldn't hear the first part of your question.

Mr. DINGELL. I am curious what the penalty is for violating these regulations.

Ms. TOENSING. I don't think there is a criminal sanction.

Mr. DINGELL. I beg your pardon?

Ms. TOENSING. I do not believe that there is a criminal sanction.

Mr. DINGELL. What are the sanctions? Discipline? Letter of reprimand?

Ms. TOENSING. Usually something like that. If they are similar to the Department of Justice, you could be fired for them or you could get a letter or reprimand or some kind of lowering of your evaluation at the end of the year.

Mr. DINGELL. Is there any record of any disciplinary action on the part of General Edwards?

Ms. TOENSING. I am told that he retired soon thereafter.

Mr. DINGELL. I beg your pardon?

Ms. TOENSING. He retired soon thereafter.

Mr. DINGELL. He retired.

Ms. TOENSING. Yes.

Mr. DINGELL. I assume he had a retreat parade and reception at the officer's club?

Ms. TOENSING. I am not familiar with those things.

Mr. DINGELL. He probably got the Distinguished Service Order or something of that kind. Who is he working for now?

Ms. TOENSING. I don't know the history of General Edwards after he left the Department of Defense.

Mr. DINGELL. He wouldn't be employed by the Arts Center, would he?

Mr. Chairman, I thank you. There is a certain distinct odor here that I don't like.

Mr. CONYERS. I think your line of questioning is probably going to close us down, Mr. Chairman, unless there are any further questions from our panel, and I want to say I have enjoyed working with you on this matter.

Let me just ask the last question to the Assistant Attorney General. At some point it has been said that there was no alteration of records dealing with Pratt and Whitney. Excuse me. This is the Beggs case. What we have here is indication that there were plenty of time cards, travel records to bill contract work, all of which were altered. Has that come to your attention recently?

Mr. WELD. I think there were changes made, if that is what the reference is to, matters being billed to the contract and then being shifted to overhead accounts, but if you accept the theory of the contract as a firm fixed price contract modified by best efforts, and you accept the import of the fact that the company was told it could do that by the negotiating officials, then that would be OK. That wouldn't be the kind of surreptitiously altered records.

Mr. CONYERS. But there were alterations of records.

Mr. WELD. Well, there were changes made in the accounting. With the exception of a single memorandum where the situation appears to have been based on a misunderstanding, I don't think we came up with the kind of alteration of records that would sup-

port the consciousness of guilt type analysis that I think is the touchstone.

Mr. CONYERS. Well, I am looking at a statement that suggests that prosecutors had uncovered hundreds of documents indicating that the company had altered time cards and travel records to bill contract work to overhead, and that the company was trying to hide projected overruns.

Mr. WELD. You know, in the early going, in December 1985 and shortly thereafter, there were some members of the prosecution team who were of the view that some changes that had been made to the company's internal records had been made with a view to deceiving the Government. In fact, that was, I think, much of the basis for counts 2 through 7 of the indictment. But as the post-indictment investigation proceeded, our view of the facts did change on that.

Mr. CONYERS. My thanks on behalf of Chairman Dingell to all of you, lady and gentlemen, for a long and, I think, very fruitful morning.

I yield to the chairman for any concluding remarks.

Mr. DINGELL. Mr. Chairman, I thank you.

Mr. Weld, Ms. Toensing, ladies and gentlemen, we thank you for your assistance. You have been here a long time and you have been very patient and very helpful, and we thank you for your assistance. Thank you all.

Mr. CONYERS. The subcommittee is adjourned.

[Whereupon, at 1:42 p.m. the hearing was adjourned, to reconvene at the call of the Chair.]

SECURITIES LAWS ENFORCEMENT AND DEFENSE CONTRACTORS Integrity of Northrop Corp.

WEDNESDAY, OCTOBER 28, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 11 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. DINGELL. The subcommittee will come to order.

The subcommittee is proceeding under its authorities with regard to registered securities, the Securities and Exchange Commission, and corporations conducting business under regulation of that body.

The Northrop Corporation is registered with the Securities and Exchange Commission. It, therefore, falls under the securities laws of the United States. Its duty, then, is to comply with reporting and disclosure requirements of Federal securities laws.

The securities issued by that corporation are listed and traded on the New York Stock Exchange. Because this corporation is a major defense contractor, dependent upon the Defense Department for 98 percent of its annual revenues, the corporation must disclose to both its stockholders and to the SEC any events that may have a material impact upon the corporation, on the value of the stock and on the interests of the shareholders. This includes possible recovery by the Government of overcharges, cost overruns, failure to meet contract specifications, delivery dates, and other requirements.

In May, 1987, the subcommittee initiated an investigation into a series of quality assurance, quality control problems and possible fraud involved in Northrop's production of the Inertial Measurement Unit (IMU), which is the brains of the MX guidance system.

The President claims that the MX missile, the so-called Peacekeeper, is the most critical part of this Nation's land-based nuclear deterrent.

However, because of the corporation's failure to produce IMU's on schedule and in compliance with specifications of the Air Force, only 17 of the 27, or 63 percent of the deployed MX's are on alert in silos at Warren Air Force Base in Wyoming because of the lack of operational IMU's. That means 90 to 100 deployed warheads are not targeted because of Northrop's failures.

Moreover, the accuracy of the MX is declining as Northrop has moved from the research and development phase of the contract to full scale production. Because three of the last eight MX flight tests have failed to hit within acceptable distances of the targets, the Air Force has postponed further test flights of the MX.

Based in part on information provided by the subcommittee, the Department of Justice currently has seven separate criminal investigations underway involving Northrop's role in the MX programs. These investigations include the following:

Alleged labor and cost mischarging on the MX program; false certification of Peacekeeper parts affecting 77 units; cost mischarging of the MX harness rework; the operation of at least 11 dummy companies or concerns to get around problems with Northrop's procurement system; inadequate controls of Government property leading to theft or improper sales; false certification regarding testing on certain electronic components of the MX; and false certification of gyros on the MX program.

In addition, in a soon to be released report, the Air Force's Scientific Advisory Board has concluded that because of Northrop's practices, there is general uncertainty about the reliability of the circuitry that forms the brains of the MX guidance system.

Because of the subcommittee's concern over adequate internal controls, we always ask: Where were the auditors? In this case, internal, external and Air Force auditors identified the weaknesses in the management systems which have consistently plagued Northrop's MX efforts since 1982. The utility of these audits is best summed up in a memorandum from one internal auditor to his boss: "Our audit reports end up being buried indefinitely with no solution to the problems."

It is important to understand that throughout this period, Northrop management was handsomely rewarded with large salaries, large bonuses, stock options, and other substantial benefits. Ninety-eight percent of this compensation is paid for by the U.S. taxpayers. The subcommittee would have less concern over this level of compensation if the Nation were getting a well-managed and highly efficient company that produced weapons systems on schedule, at a reasonable price, and which performed their missions. Sadly, it appears that the relationship between compensation and performance rarely coincides.

In addition to the MX problems, there is a Grand Jury investigation of Northrop's Air Launched Cruise Missile, (ALCM) program at Pomona, California. Clear evidence shows that Northrop systematically falsified test results leading to the installation of defective guidance systems in the ALCM. Because of the falsifications, the Air Force is now uncertain about the reliability of 1,900 cruise missiles.

Another Northrop program currently under scrutiny is the Stealth Bomber Program. The GAO recently reported to this subcommittee that Northrop had lost approximately 1,000 secret and top secret documents dealing with the Stealth Bomber Program. Northrop has recently disclosed cost overruns, and subsequent tax write-offs, well in excess of \$100 million on the Stealth Bomber Program. And the Justice Department has investigated and con-

victed at least one Northrop employee for taking kickbacks on the Stealth Bomber Program.

Our witness today, Mr. Frank Lynch, is standing in for the Chairman and Chief Executive Officer, whom the subcommittee has excused for personal reasons.

It is the hope of the subcommittee that we can explore with Mr. Lynch issues of the accuracy and completeness of Northrop's compliance with Federal securities laws and whether the taxpayer is receiving fair value for billions of dollars spent.

Mr. Lynch, we thank you for being with us.

Mr. Lynch, there are certain preliminaries to conducting business of the subcommittee with which I think you are familiar.

Mr. BLILEY. Mr. Chairman.

Mr. DINGELL. Oh, I am sorry. The Chair apologizes. The Chair recognizes my friend from Virginia for an opening statement.

Mr. BLILEY. I thank the chairman.

Mr. Chairman, I had originally planned to raise a point of order on this hearing because of the violation of the committee rules in that adequate notice was not given.

However, upon assurances from you this morning in a conversation that it was necessary to move forward and because of the nature and the importance that this hearing will have, and the further assurance that we will not have hearings in the future without proper notice to all parties involved, I shall not do so.

This hearing should be a valuable review of a very unfortunate record.

On June 10, 1987 the Air Force Office of Special Investigations testified before the Armed Services Committee about ten investigations of Northrop Electronics Division in connection with the production of the MX Inertial Measurement Unit, IMU.

Seven of those investigations are still open, and in each case a possible criminal prosecution is pending. I have a summary of those investigations and would like to ask unanimous consent that they be inserted in the record at this point.

Mr. DINGELL. Without objection, so ordered.

[The information referred to follows:]

Attachment

The Air Force Office of Special Investigations (AFOSI) provided the following information regarding the status of AFOSI investigations mentioned in 10 June 1987 testimony before the House Armed Services Committee.

1. File 8618058-1874. STATUS: Closed.

Northrop Electronics Division (NED) experienced problems concerning mischarging of government furnished property from the Peacekeeper fixed-price contracts, resulting in increased costs to the government of \$49,767.66. NED stated this was due to an administrative error and will transfer the entire amount from government cost-plus contracts to fixed-price contracts. To date, \$7,461.17 has been transferred. The Assistant U.S. Attorney declined prosecution due to the remedial action being taken.

2. File 8718058-0/905. STATUS: Closed.

This allegation involving "Red Line" drawings was investigated and determined to be unfounded. The status is closed and no further action is warranted.

3. File 8718058-0/910. STATUS: Closed.

This allegation involved alleged "fix it" tapes. With the "fix it" tape inserted in automatic test equipment, it would allegedly inspect a defective item, but results would indicate a successful test. The allegation was disproved and no further action is warranted.

4. File 8618058-1849. STATUS: Open.

Based on an anonymous letter, Defense Contract Audit Agency (DCAA) audit assistance was requested to determine whether labor cost overruns from a fixed-price contract were being charged to a cost-plus contract. Several million dollars in questionable charges are under review by the DCAA. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

5. File 8618058-1859. STATUS: Civil Suit Filed.

Air Force Plant Representative Office (AFPRO) employee alleged NED falsified test results of heat exchanger units being built for the inertial measurement unit. Civil suit has been filed. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

6. File 8718058-1895. STATUS: Open.

A DCAA audit indicated mischarging direct labor rework charges to the government. Parts received at NED were not within specifications; NED reworked parts, provided technical advice to the subcontractor and billed the government for these costs. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

7. File 8718058-1902. STATUS: Open.

It was alleged NED established "Doing Business As" companies in an effort to circumvent authorized procurement accounting and material control procedures. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

8. File 8718058-1903. STATUS: Open.

It was alleged government property was being sold by NED without authority and other government property was being improperly disposed of by company employees. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

9. File 8718058-1904. STATUS: Open.

Allegations of improper repairs were received and disproven. AFPRO and AFOSI personnel developed indications, however, that Peacekeeper missile components were being falsely certified as meeting contract specifications. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action.

10. File 8718058-1908. STATUS: Open.

Relates to the alleged improper testing of hybrids. Case is pending a decision by the Assistant U.S. Attorney, Los Angeles, CA, regarding possible prosecutive action. This file was opened after the 10 Jun 87 House Armed Services Committee hearing.

Mr. BLILEY. The allegations of possible fraud, mischarging, circumvention of Pentagon rules, improper repairs, sale of Government property, and improper certifying are a sorry record.

I can only hope that the reports we have received that Northrop has taken decisive actions to remedy these and other IMU problems are true.

We should have a hearing to explore how and why the Government and Northrop could be involved in a so disorganized and wasteful situation. But we should have a proper hearing where everyone gets adequate notice and opportunity to research and prepare, and where the issues are covered in depth.

I thank the chairman.

Mr. DINGELL. The Chair thanks the gentleman.

The gentleman from Oregon.

Mr. WYDEN. Thank you very much, Mr. Chairman. I will be very brief. I want to commend you, Mr. Chairman, for initiating this inquiry, because I think it is an extremely important one.

The one thing that absolutely amazes me about this matter, Mr. Chairman, is that there were internal audits that spotlighted the problems that the subcommittee has turned up, that indicated that these problems were clear quite some time ago. They were extremely serious, and yet management, even though these audits dated years back, took no effective action.

That just strikes me as incredible incompetence, Mr. Chairman, and I think it is worth contrasting that conduct of top management to the level of bonuses that were paid during that same period, the period between 1982 and 1986.

Mr. Chairman, I have evaluated the compensation materials that the subcommittee has gotten. It is clear now that the top ten executives in 1986 got several millions of dollars of bonuses during that year, when they were literally running this program into the ground. And I think that is unacceptable conduct.

The only other point that I would make at this time, Mr. Chairman, deals with the Air Force. It seems to me that their conduct shows that they simply are not able to control their contractors.

The message that the Air Force sends through in this case to the contractors is that no matter how irresponsible the conduct of a contractor may be, the Federal Government will still let that contractor keep bumbling along, wasting the money of the taxpayers of this country. I also think that is unacceptable.

Mr. Chairman, I look forward to our witnesses and commend you again for the important inquiry.

Mr. DINGELL. The Chair thanks the gentleman.

The gentleman from Tennessee.

Mr. COOPER. I have no opening statement, Mr. Chairman.

Mr. DINGELL. Mr. Lynch, copies of the rules of the committee, subcommittee and the House sit there before you at the table. It is your right, as defined by the rules to be advised by counsel. Do you desire to be represented or advised by counsel today?

Mr. LYNCH. Yes. Counsel is with me at the table.

Mr. DINGELL. OK. Mr. Sauber, that will be your task?

Mr. SAUBER. Yes, sir.

Mr. DINGELL. You are going to serve as counsel, then, to Mr. Lynch?

Mr. SAUBER. Yes, sir.

Mr. DINGELL. Very well.

Do you have objection, Mr. Lynch, to appearing under oath?

Mr. LYNCH. I have no such objection.

Mr. DINGELL. OK. It is the practice of the subcommittee that all witnesses shall testify under oath, and so we will continue that practice today.

If you will, please rise and raise your right hand.

[Witness sworn.]

Mr. DINGELL. You may consider yourself to be under oath.

The Chair will recognize you for your opening statement.

STATEMENT OF FRANK W. LYNCH, VICE CHAIRMAN, NORTHROP CORP., ACCOMPANIED BY RICHARD SAUBER, COUNSEL

Mr. LYNCH. Mr. Chairman and members of the subcommittee, I am Frank Lynch, the Vice Chairman of the Board of the Northrop Corporation.

Prior to operating in this position, I also served as President and Chief Operating Officer of the company. I am also presently acting as the Group Vice President of the Electronics Systems Group, which includes the Electronics Division.

Now, for myself and for Thomas V. Jones, the Chairman and Chief Executive Officer, I want to assure you of our decision to cooperate with the subcommittee in this inquiry into Northrop and the defense industry in general. It is our view that companies that do significant business with the Federal Government have a special obligation to cooperate with Congress. All we seek is a fair and reasonable opportunity to explain ourselves and our activities.

We have a hard-earned and well-established reputation for integrity in our products and in their performance, and we are very upset and concerned by any departures from the high corporate standards which have produced that reputation.

I am here today voluntarily and, at your request, we are providing the subcommittee with a significant number of documents. We are mindful that the subcommittee seeks additional documents, which we are prepared to produce upon the receipt of a subpoena. This is because we are advised by counsel that such a subpoena is necessary in order to protect the documents covered by legal privilege.

Now, the precise subject of the hearing is something that we have been discussing with subcommittee staff since we were first notified of the hearing last Wednesday, and I will certainly do the best I can in answering all of your questions today. However, because the parameters of the hearing are likely to go beyond some of the subjects we may have anticipated, I feel constrained to tell you that there may be some answers that I will have to provide for the record. But I do reiterate the intention of the company to cooperate and my personal commitment to do the most I can do to be responsive.

I do, Mr. Chairman, want to take a moment at this time to discuss the activities on the Inertial Measurement Unit of the MX missile, since we know that this is one subject, from your opening remarks, that is of particular interest to the committee.

There has been a lot of speculation about the system and questions raised about whether it will work. And I want to repeat, Mr. Chairman, it has worked 17 times in test flights without a failure, and it is working today in the silos in Wyoming with a reliability record that is 10 to 20 percent better than expected for this system at this point in its lifetime.

These are not our statistics, Mr. Chairman. We do not grade our own papers. These are the statistics compiled and analyzed by the Air Force, which has been operating the Peacekeeper missiles for over 100,000 hours.

The accuracy of the system has been consistently better than predicted, and again, according to the Air Force, better than the Minuteman itself. The production configurations alone that have been tested, on the average, are 10 percent better than the specification.

However, as we concentrated our attention on the schedule problems in the Electronics Division, we have also recognized that major changes were required in the division's management and in its procedures. We have made changes and we will be making changes.

As we reported some time ago, there had been management lapses and errors of judgment in the division. And these were simply not acceptable.

We wanted and need better practices and procedures, and better discipline in making sure that those procedures are adhered to. About 30 key people have been moved out of their management responsibilities.

We changed the vice president and general manager of the division. We put in a new head of finance, a new head of manufacturing, and a new head of quality control. We have changed the program manager and the deputy program manager for the Peacekeeper work.

Building high quality, high precision instruments does not lend itself to easy or quick fixes. It takes time to see the effect of these changes. But those steps we took in 1985, 1986 and throughout this year are now beginning to produce results.

For some time the division had been falling farther and farther behind schedule, delivering units at one-half to one-third the required rate, and failing to develop a reliable schedule for the repair and recycling of the IMU's from the field.

By June of this year, our Electronics Division was some 23 units behind its contract delivery schedule. In the last 4 months, we have seen that cut by half.

We met the Air Force's IOC requirements at the end of 1986. I would be surprised if we still did not see delays from 1 month to the next month, and problems further, as we go through this process. With the standards we and the Air Force demand of this system, it will always be difficult to get the precision components in sufficient quantities built either in our own plant or delivered from suppliers. But we are working with the Air Force on all elements of this program, and we expect to be back on contract schedule in the early months of next year.

Now, this is not a production line in the way most people think of one. There aren't enough systems required to have a mass pro-

duction system or a high level of automation. the human, hands-on factor is always going to be present.

We cannot eliminate all of these human imperfections, but we can't accept them either. So, we and the Air Force, and the other contractors in the chain that produce this guidance system for the Peacekeeper missile, have developed an intricate and redundant and repetitive process of testing procedures to overcome to the greatest extent possible the realities we face with human beings.

There are those who complain about tests that produce failures in the factory, or about audits that find weaknesses that should be corrected. That, Mr. Chairman, is what we have testing for and what we have audits for.

To point to the existence of test reports and audit reports as damaging evidence of weaknesses is to turn the argument on its head. Testing and audits are management tools for the continuous improvement of the product and the process.

In the past 5 years, we have almost tripled the number of corporate auditors at Northrop, to nearly 100. This is due in part to our growth, and in part to the increased requirements for audits imposed upon the defense industry by the Government. In addition, we have 26 auditors in our Electronic Divisions alone.

But not all auditors are perfect, either, and all audits are not always accurate or complete. And some, by being incomplete, raise questions but do not present answers that are also available.

The question is, what do you do with all of these reports, these suggestions? How do you sort the facts out from the findings, the valid ideas from the frustrated complaints, the technical innovations that sound plausible but are impossible or impractical, or simply technically unsound?

In our case, we look at each one thoroughly. We consider every allegation, every finding as if it ought to be or might be true, every idea as if it might be valid, every test failure as a step toward a higher quality. Through our testing, our failures and our analyses of the failures, we have achieved a better accuracy and a better reliability than predicted. Through our audits we have and are continuing to improve the procedures and practices. That, in part, is how we are going to get back on schedule.

Through our willingness to sort out the technical suggestions and make technical judgments, we have steadily raised the quality and improved the way things are done. Sometimes not as fast as others would like, not as fast as I would like, but the results are there, in the silos in Wyoming.

Mr. Chairman, I would like to reiterate in advance of the specific questioning our realization that the performance standards have not been met by some of our people at the Northrop Electronics Division. We do not hide from that fact, nor do we seek to make light of the problems that require our attention and corrective action. They are being corrected, and with all deliberate speed.

However, I must again stress to the subcommittee that we are a company of people as well as machines, and are therefore subject to human error on occasion, despite our best efforts to prevent it.

I am ready to take your questions and to try to satisfy, to the best of my ability, your interests and needs.

Mr. DINGELL. Mr. Lynch, the subcommittee thanks you for your statement.

The Chair recognizes first the gentleman from Virginia, Mr. Bliley, for questions.

Mr. BLILEY. Thank you, Mr. Chairman.

Mr. Lynch, Northrop's management of the IMU Program has been plagued with all sorts of problems, some of which have—are the subject of this hearing. Given these problems, it is important to determine what effect they have had on the ultimate issue, the ability to field a sufficient number of reliable MX missiles to meet the national defense requirements.

My question is, first: Has the Air Force been able to meet the program demands for fielding the missiles?

Mr. LYNCH. I think that, sir, is a question best answered by the Air Force. We are behind schedule, our contract schedule, and to that end it poses a real problem for them.

We are approaching and are making a recovery schedule. But the issues that go beyond that, the contract schedule and the recovery schedule, as to how the Air Force finds that to satisfy their deployment needs, is a question I am not really in a position to answer.

Mr. BLILEY. The second question. The Air Force claims the performance of the IMU's and the MX's has been better than was expected. But here we have this list of so-called IMU failures.

Exactly what is the problem with the IMU, if any, with regard to the accuracy and reliability of the MX?

Mr. LYNCH. Sir, I think as I tried to imply in my opening statement, I don't believe there is a problem with the accuracy or the reliability of the IMU as it is delivered to the Air Force.

Now, we have, as we proceed in the process of construction and delivery of these, successive steps of testing, and that is really the secret or the problem where—how should we put this—the real way to get that kind of an accuracy in an imperfect world and that kind of reliability is through a series of redundant testing—not only redundant testing but very conservative design margins. And those have all been applied to the system.

For example, I know there has been a question raised on hybrids and hybrid testing. Each hybrid, before it finally leaves the plant, goes through eight levels of testing. If one is missed, if one is inaccurate, if there is a problem, it is caught again and again.

It has been through this process—this doesn't mean that we should not be concerned or disturbed if any element of that is not right. But it is this process of essentially overlapping and redundant testing that gives us the assurance and provides the product, that we have actually seen the final results in the field.

Mr. BLILEY. Are the finished IMU's tested before they leave Northrop Electronics Development?

Mr. LYNCH. Yes, sir, they are.

Mr. BLILEY. Are they tested anywhere else before they are put in the missiles?

Mr. LYNCH. Yes, sir, they are. They go from our plant to Rockwell, who is the guidance integrating contractor. There they are integrated with the MECA, which is the guidance computer. They are tested there. They are tested there not on equipment produced

by Northrop or by Northrop people, but by Rockwell people and supervised by the Air Force.

I believe, again, as it leaves the Rockwell plant it is tested again before it gets to the missile and into the silos.

Mr. BLILEY. How complex is the IMU and how reliable is it in relation to the complexity? How many parts are there that could actually fail? And how many actual failures of those parts have been found by the Air Force, or Northrop, for that matter? And how many times has the missile failed to reach its target within the required range of accuracy because of IMU failure?

Mr. LYNCH. Well, you have given me a set of questions there, sir, that I am going to have to maybe sort of take them back one by one.

I think in answer to your last one, how many times has it failed to be within the target—and I would hope we understand that the target is as the Air Force defines it, the CEP.

To my knowledge, all 17 out of 17 test flights have been within the CEP requirements. So, the answer to that one, I would say there have been no cases of that sort.

Can you sort of walk me back through the questions?

Mr. BLILEY. How many parts are there that could fail?

Mr. LYNCH. Well, there are 19,401 parts, and since I am under oath, let me say that is approximately, because, you know, that is the number I have been given of different parts in the IMU.

Now, when you ask the question, how many of those parts can fail, some of those parts are mechanical—any part can fail in the strictest sense. So, that gives you a sense of the complexity.

There are some parts that are more likely to fail than others, if you will. I would say probably, you know, the more sensitive number that you would be concerned about is probably, you know, in the hundreds to the thousand level that you would say are more sensitive parts that could fail.

Mr. BLILEY. I thank you.

With respect to the hybrids, the Air Force convened a Scientific Advisory Board to look at all the IMU problems and they particularly analyzed the problems with paperwork, with so-called hybrid failures of the IMU.

Can you describe their findings?

Mr. LYNCH. No, sir, I can't. That report, as I understand, is being reviewed currently by the Scientific Advisory Board and has not been released as a final formal report. I understand that it will be very shortly.

We have had discussions in the process of the review with various members of the Scientific Advisory Board as we have furnished information for that. But I am not in a position to know what their final report or findings will turn out to be.

Mr. BLILEY. Finally, Mr. Lynch, it is my understanding that the Air Force has withheld some money from Northrop. How much actually have they withheld? And if they have withheld funds, how much longer will it be before the Air Force can be satisfied that this program is under control?

Mr. LYNCH. I think the Air Force has made a statement that they are withholding payments amounting to more than \$108 mil-

lion so far. I think the last figure I had from our Accounting Department was \$108 million.

I can't really say how long they are going to withhold it. I personally am not able to answer that. I would say I would anticipate until they feel satisfied themselves that we are back on track and they are satisfied with all the actions that we have taken to correct the situation.

Mr. BLILEY. Thank you, Mr. Lynch.

Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman.

The Chair recognizes the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. Thank you very much, Mr. Chairman.

Mr. Lynch, at the end of your statement you said that the company realizes that performance standards have not been met on the MX weapon.

Mr. Lynch, could you tell the subcommittee what went wrong on the MX missile?

Mr. LYNCH. Let me try, Mr. Wyden, to describe it as best I can say it.

We were transitioning in that particular division from a developmental program to a production program. And frankly, in my mind, in a program like this—and there is a sense—maybe I should try to correct, there is sort of a sense that you are producing these over here at development, you know, by hand, by individuals completely separately. That is really not the case.

We are building both full scale engineering development and “production models.” We are evolving the process of building these all together and at the same time.

The big difference between development and production, in a sense, is the degree of documentation and control and precision in the following of procedures that you must have in a production program.

You asked me what went wrong. Well, frankly, I think it is a mind set or a mental attitude in the management that does not completely understand the significance of that particular change. And that has been the biggest difficulty and that is the thing that has caused us to finally, after much effort, make the necessary changes in the top management of the division to get that mind set changed.

Mr. WYDEN. In June of 1982, Mr. Lynch, the Air Force conducted a contractor operations review of Northrop Corporation regarding the weapon. The report states:

“The review team concluded that the noncompliances were due to an unorganized transition from a research and development environment to production mode of operation. Top management must assure that all understand and accept the responsibility for product quality.”

Now, that was 5 years ago. That wasn't yesterday. That was 5 years ago.

Were you aware of this report? And why wasn't action taken in 1982, years ago, to deal with this problem of moving from development to production?

Mr. LYNCH. Mr. Wyden, let me say first, I was not aware of that particular report. However, I think we were familiar with and con-

cerned about division management in that. It is not as if things weren't—I would have to say, Mr. Wyden, unfortunately, the response of the division management to the pressures involved were just inadequate. And I can really go no—go ahead, sir.

Mr. WYDEN. You weren't aware of this report in 1982, which describes this problem. Does top management not get these internal audits, Air Force audits?

Mr. LYNCH. Air Force audits for a division generally go to the division and the division management themselves at that point. That particular division worked as an element of a group, and that would go to the group.

At that particular point in time—it was 1982—I had just been made President of the Company. I don't think that I was given that particular report.

Mr. WYDEN. Well, the same Air Force warning, the 1982 Air Force warning, was repeated in February of 1983 in an internal Northrop audit. This audit stated, and I quote:

“Current systems, concepts and operational structure for implementing contract requirements were assessed. Audit findings indicated unsatisfactory condition.”

It further states, again quoting:

“Northrop Electronics Division is challenged with the transition from research and development to a production mode. This transition must be orchestrated with a firm statement of policy and implementing procedures.”

Now, what our subcommittee has been told is that rather than heeding this warning, a decision was made to limit distribution of this audit to the vice president and department managers.

Now, again, why weren't the corrections made in 1982? The Air Force had designated the problem. Then in 1983, when your own internal audits showed the problem, still nothing was done.

Mr. LYNCH. Mr. Wyden, let me make clear, the problem of knowledge that there were difficulties in the transition from development to production in the Electronics Division was known. I was aware of that.

We go through different ways of understanding and knowledge in the company, beyond just the audit reports.

Pressures have been brought on the division and the division management. They submit plans and corrective actions to that. Those have been done.

I will frankly admit that they were not successful. But the issue—so, in that sense, I would say I would not characterize it as nothing has been done or there was no awareness or no concern. I will frankly admit, we didn't do enough, we didn't do it fast enough.

There was a judgment made that the people could accomplish. They failed to do that.

Mr. WYDEN. Well, during an evaluation conducted by the Air Force plant representative in July, 1983, it was observed that functional management was not responding to systems related audit reports and recommendations. As a result, the company formed an ad hoc committee with members appointed by respective department managers.

The committee consisted of individuals from engineering, and a variety of other different operations, including internal audit.

On December 21, 1983, the ad hoc committee reported that management generally is not responding to system related audits. They concluded that audit findings and recommendations are not being formally reviewed.

Mr. Lynch, were you aware of the ad hoc committee's findings?

Mr. LYNCH. If you are referring to a particular document or a thing, I will have to say I cannot remember that specific thing.

I would not, however, Mr. Wyden—I would have to rather say, I have been aware of the problems in the Electronics Division for that 5 year period. I have been concerned about those problems. And whether I was aware of a particular finding of an audit, that, you know, in my judgment, is not really the issue.

We worked with the division management through that time period to try to get them to achieve the requirements and the responsibilities, and we believed that progress was being made.

Mr. WYDEN. I just must tell you, I can't see why it took Northrop 5 years to get out of the soup, and I don't see any evidence that the company provided support when these internal audit problems were raised in 1983.

I know my time has just about expired, but my last question would be: What actions were taken by the company to provide support to the internal audit function as a result of what was said in December, 1983?

Mr. LYNCH. I think I tried to say in our statement—when you use the word "support," you mean—maybe I should ask—

Mr. WYDEN. They were identifying the problems, Mr. Lynch, and management was sitting on its hands for 5 years, no evidence of effective action, one internal audit after another designating the problems, and I don't see any evidence that management was responding. Why don't you show me some?

Mr. LYNCH. Well, Mr. Wyden, perhaps I can and will submit for the record, back on each audit—if you would like, and perhaps the data we are submitting will show that—what actions have been taken on the various internal audits that were constructed in that time.

[The following information was received:]

Relative to questions posed on management actions taken in response to past internal audit reports, Northrop submits the following background information and specific results:

The internal audit function within Northrop has traditionally been performed by a centralized organization reporting directly to the Corporate Office. This reporting structure provides independence from the operating divisions being audited and has enabled the company to maintain a high degree of professionalism in staffing and audit methodology. As the corporation grew, the larger divisions augmented the centralized internal audit resources with dedicated staffs of their own to retain an acceptable level of oversight at the division management level.

In the case of the Electronics Division, which experienced its most significant growth in the past five years, the creation of self-contained audit occurred in 1982. The first three columns of data in Table 1 present a breakdown by performing organization of the 173 reports submitted to the subcommittee and reveal the number of audit findings closed or resolved. The facts clearly show that there has been a high aggregate level of management response in terms of findings closed. This condition applies in particular to the formal audits performed by Corporate Internal Audit organization.

We have also verified that a substantial number of audit findings which were shown as open or unresolved were, indeed, closed but lacked documentation to evidence the closure. The right column of Table 1 provides our assessment of current status and reflects an even higher degree of management response - slightly over 90%. It is expected that all findings will be acted upon as expeditiously as possible.

With respect to the Subcommittee's questions about the existence of repeat audit findings over the last five years with no apparent management response, we have conducted an intensive analysis of all 173 internal audit reports to identify and classify the repeat findings therein. Twenty such instances were uncovered in the overall findings count of approximately 2,300. It should be noted that repeat audit findings are not uncommon where matters of adherence to procedures and discipline are involved. This class of problem is not amenable to one-time permanent solution but requires, instead, constant refresher training and surveillance to maintain adequate control.

Audits conducted since, or (later) determined to have been omitted from 10/28/87 submittal: Since documents were submitted to the committee, it has been determined that four additional internal audits had been conducted during the 1982-1987 period of interest. These are summarized in Table 2. In addition, two additional audits have been conducted, or formally reported, since the "end of Summer 1987" cut-off for submittal. These are summarized in Table 3.

Table 1
SUMMARY OF INTERNAL AUDIT REPORTS
RELATING TO NORTROP ELECTRONICS DIVISION
(1982-87)

PERFORMING AUDIT ORGANIZATION	QTY OF AUDITS	QTY OF FINDINGS OF	QTY OF FINDINGS KNOWN TO BE CLOSED/RESOLVED AS OF 10/28/87	QTY OF FINDINGS KNOWN TO BE CLOSED/RESOLVED AS OF 12/18/87
CORPORATE INTERNAL AUDIT	36	64	58	60
NED ORGANIZATION	132	2,231	1,590	2,016
	173	2,295	1,448	2,075

Table 2

**NED AUDITS CONDUCTED OR FORMALLY REPORTED
1982 - LATE SUMMER 1987**

*NOT INCLUDED IN 10/28/87 SUBMITTAL
DUE TO OMISSION*

<u>AUDITED BY</u>	<u>AUDIT SUBJECT</u>	<u>AUDIT DATE</u>	<u>STATUS</u>
PROGRAM MANAGEMENT • ILS	• ILS SELF AUDIT	11/85	• 10 SIGNIFICANT FINDINGS + 12 MINOR FINDINGS + 12 OBSERVATIONS ALL NOW CLOSED. CLOSURE NOT FORMALLY DOCUMENTED.
	• ILS SELF AUDIT	12/86	• 20 FINDINGS; NO MAJOR PROBLEMS; LARGELY, SUGGESTED, DESIREABLE IMPROVEMENTS TO OPERATIONS. ALL NOW CLOSED. CLOSURE NOT FORMALLY DOCUMENTED.
• PROGRAM MGMT. OFFICES OTHER THAN PEACEKEEPER	• PROGRAM MGMT DEPT. SELF AUDITS (OF EACH P.M. OFFICE)	6/86 - 10/87 & ON-GOING	• AUDIT CONDUCTED CONTINUALLY, ONE OFFICE AT A TIME, RECYCLING WHEN FINISHED. • ONLY MINOR, RECENT FINDINGS REMAIN OPEN/BEING CLOSED.
HUMAN RESOURCES AND ADMINISTRATION	DEPT. SELF AUDITS • COMPENSATION • EMPLOYEE RELATIONS	1/87	• VERY INFORMAL REVIEWS • NEEDED CORRECTIVE ACTIONS TAKEN AT THE TIME OF THE REVIEW • REPORTS NOT PREPARED • DETAIL DATA NOT RETAINED

Table 3

NED AUDITS CONDUCTED OR FORMALLY REPORTED, FALL 1987
 AFTER COMPILATION CUTOFF FOR 10/28/87
 SUBMITTAL TO COMMITTEE

AUDITED BY	AUDIT SUBJECT	AUDIT REPORT DATE	STATUS
CORPORATE AUDIT	REVIEW OF PAYROLL FUNCTION	10/8/87	11/15/87 CONDITIONS FOUND SATISFACTORY
ENGINEERING DEPT.	ENGINEERING DEPT. SELF-AUDITS	9/18/87 AND LATER - (ON-GOING)	1 OF 10 FINDINGS REMAIN "OPEN" AS OF 11/16/87; (MINOR PROBLEM). BEING FIXED

Mr. WYDEN. The ad hoc committee concluded in 1983 that audit findings and recommendations were not being formally reviewed. And it seems to me that if your people down the line, are designating problems and you all aren't willing to respond with solutions, then the heart of the problem is management.

Thank you, Mr. Chairman.

Mr. DINGELL. The time of the gentleman has expired.

The Chair recognizes the gentleman from Tennessee, Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

I would like to continue on the internal audit theme, Mr. Lynch, and ask this question.

It is my understanding that since the subcommittee staff visited Northrop in May and identified a number of problems with the MX Program that Northrop has conducted a number of audits to determine what is, in fact, going on.

The subcommittee has a copy of the audit schedule as of September 23, 1987 and notes that there are approximately ten so-called "Dingell" audits into such things as spare parts pricing, facilities management, and these procurement entities set up by Northrop.

I would like to know, why are these audits called "Dingell audits?"

Mr. LYNCH. I would like to know that one, too. No, I am afraid you catch me at a disadvantage. I am not familiar with whatever you are reading from that identifies those in that fashion. Could you help me out there, sir?

Mr. COOPER. You are not aware of any audits conducted by Northrop that are informally called "Dingell audits" that are in response to—

Mr. LYNCH. Well, they haven't been called that in my presence.

Mr. COOPER. Mr. Chairman, I ask unanimous consent that the so-called "Dingell audit" papers be submitted for the record.

Mr. LYNCH. As I said, frankly, I have not seen this paper before and I am not able to answer your question. I will certainly get back and get an answer to that and, if it is acceptable to you, provide it to the record.

[The following response was received:]

By letter dated August 10, 1987, the chairman asked Northrop to provide various documents, including audit reports. The company began a process of searching its records for such reports. The requested reports came to be referred to as "Dingell audits," a shorthand way of referring to them during the search.

Mr. COOPER. I would personally be very interested in that, and I think we should probably ask unanimous consent that this audit paper be submitted for the record.

Mr. DINGELL. If the gentleman would yield.

Mr. Lynch, the copy of the list of the audit schedule has been made available to you just now by counsel. I notice your attorney is handling it. So, it is available. Without objection, that will also be inserted in the record.

[The information referred to follows:]

GENERAL AMBII SCHEDULE (Cont.)
AS OF SEPTEMBER 23, 1987

9/4	9/11	9/18	9/25	10/2	10/9	10/16	10/23	10/30	11/6	11/13	11/20	11/27	12/4	12/11	12/18
CU	PPP-LTR	COMP-ELEC PAYROLL	MEB-CASH INC	IMP-ICS											
FRIED	COMP-SAVINGS PLAN	IMP-SPECIAL-941-CURTEL													
LANE	PPP-COST ACCTS STIM	IMP-SPECIAL-942-PETERSON TIME CHARGING													
SECYAR	IMP-SPECIAL	IMP-SPECIAL-940-BINGELL-MEB-SPECIAL-943-STI													
PLACENCIA	MEM-LIFE MERTS	IMP-SECURITY													
BILLIETTE	COMP-PROCUREMENT STIM	IMP-SECURITY													
MEY	9/4	9/11	9/18	9/25	10/2	10/9	10/16	10/23	10/30	11/6	11/13	11/20	11/27	12/4	12/11
ONE	9/4	9/11	9/18	9/25	10/2	10/9	10/16	10/23	10/30	11/6	11/13	11/20	11/27	12/4	12/11

10940 - Potential Data Processing Support. See Attached Memo to Staff.
 ICS - Internal Control Survey.
 EPS - Ethical Practices Survey.
 SKC - Standards of Ethical Business Conduct.
 LFA - Limited Financial Review.

- Manager Designations
- (A) Bezie Aquirre
 - (J) Jerry Jordan
 - (L) Ken Levinson
 - (M) Steve Nelson
 - (R) Steve Root

Mr. DINGELL. The Chair would recognize the gentleman again.

Mr. COOPER. I thank the Chair.

Mr. Lynch, it is my understanding that currently the Justice Department has seven separate investigations going on into the MX Program. I am curious as to which of these investigations were initiated as a result of Northrop following its stated policy of self governance?

Did Northrop disclose to the Government instances of alleged labor and cost mischarging on the MX Program?

Mr. LYNCH. Yes, sir. We have had number of areas in which, as a result of internal information, we have disclosed to the Government issues of this sort. I am not familiar with which ones—is there a particular one you are referring to? I have some list of some 21 events here or disclosures that we made to elements of the Government where there were problems that had arisen.

Mr. COOPER. I was interested in Northrop's self disclosure, voluntary self disclosure regarding instances of alleged labor and cost mischarging on the MX Program.

Mr. LYNCH. If you will give me just a second, I am going to have to run through this and see if we have it.

Here is one. We have a number here, but I have one listed here to AFPRO on the 29th of June, 1987—I am sorry, that is not on the MX.

I am not able to say, frankly, at this point whether there had been a specific one on labor mischarging. We have had a large number—we have had a number of disclosures to the Government on the MX, primarily with regard to technical issues and production issues.

We have also had some disclosures to the Government of potential labor mischarging on some other programs. I am not able, though, right now to identify whether or not that specific one was a matter of disclosure.

Mr. COOPER. Were these disclosures made to the Pentagon IG, Inspector General?

Mr. LYNCH. Well, in some cases they were made to OSI agents, in some cases they were made to the AFPRO, in some cases to DCAA. It seems that they have been made to whichever was the appropriate agency concerned with the issue at that point.

Mr. COOPER. Mr. Chairman, I see that my time has expired. I would like to ask that the paper that the gentleman is reading from, revealing the 21 instances, apparently, that Northrop has voluntarily disclosed certain practices, should be submitted to the committee for the record, if it has not already been submitted.

Mr. DINGELL. Without objection, so ordered.

[The information follows:]

The specific information referred to in your letter of January 13 is material to the document requested by Congressman Cooper at the hearing on October 28, 1987. As previously explained this document has not been submitted for the record since it falls within that group of documents protected by legal privilege referred to in Mr. Lynch's opening statement. However, the following general summary regarding Northrop voluntary disclosures can be provided:

Over the past two years, Northrop has made twenty-one voluntary disclosures in the following areas to appropriate Government agencies including among others, the AFPRO, DCAA, OSI and the United States Attorney:

- (1) *Cost Charging*

Northrop has disclosed labor and other cost charging matters on eight occasions.

(2) *Testing Procedures*

Northrop has disclosed matters involving testing procedures on thirteen occasions.

In many of the referenced disclosures, Northrop's disclosures have been continuous during the course of an ongoing Government inquiry.

Mr. DINGELL. The time of the gentleman has expired.

The gentleman from Minnesota, Mr. Sikorski, is recognized.

Mr. SIKORSKI. Thank you, Mr. Chairman.

Let me backtrack just a little bit, if I need to. Did you disclose cost mischarging on MX harness rework?

Mr. LYNCH. I don't believe that one was listed in here.

Mr. SIKORSKI. I am sorry?

Mr. LYNCH. Just a second, sir.

I think, Mr. Sikorski, you are referring to a specific instance in which there was a labor mischarging issue regarding some cables that were received by Northrop from a company called CERTEL that were inadequately done, and those cables were reworked at Northrop.

Mr. SIKORSKI. MX harnesses.

Mr. LYNCH. MX harnesses, is that the one?

Mr. SIKORSKI. Yes.

Mr. LYNCH. I can't answer your question as to the extent or the degree and how that was disclosed. I know that is a matter of knowledge and information to elements of the Government ourselves and that there have been discussions and findings with regard to that. I am not in a position to tell you how that has been resolved.

Mr. SIKORSKI. Did Northrop disclose that it was operating at least 11 companies or concerns to get around problems with its procurement system, the approved procurement system? Did you disclose that?

Mr. LYNCH. You are referring to what has been otherwise, I think, in another committee talked about as the d/b/a's or "doing business as" companies.

Mr. SIKORSKI. Yes, the 11 little entities.

Mr. LYNCH. To my knowledge, through the investigation, that turned out to be three, not 11. And again, I can't say just at the point that was disclosed and through that investigation. But that, again, is a matter with which the Air Force is fully familiar.

Mr. SIKORSKI. Didn't the subcommittee bring it to your attention and to the Air Force's attention?

Mr. LYNCH. It could have. I am not absolutely sure how that all—

Mr. SIKORSKI. Well, this is the self governance policy that we are talking about that requires your disclosure of these things, and thus far we have batted zero for three on these.

Did you disclose that because of inadequate controls Government property may have been improperly sold?

Mr. LYNCH. Mr. Sikorski, I can't say. It usually determines where these things are found first. When we find them, we disclose them. If they are found elsewhere—

Mr. SIKORSKI. I understand. But did you disclose these things?

Mr. LYNCH. I can't answer that. I will have to go back and look at that.

Mr. SIKORSKI. You can't answer thus far any of these, and your boss, Mr. Jones, is on the self governance committee.

Did you disclose false certification regarding testing on certain electronic components of the MX?

Mr. LYNCH. Could I get the list of the things and get back as specific answer to each question and tell you which way or how we found that?

Mr. SIKORSKI. Sure. And I would be very interested in receiving that.

Would you describe for the subcommittee your current problem with the falsified test results on the Cruise Missile Project at your Pomona Plant?

Mr. LYNCH. Would I describe—please say that again?

Mr. SIKORSKI. Would you describe Northrop's current problem with the falsified test results on the Cruise Missile Project at the Pomona Plant?

Mr. LYNCH. Could you give me a second?

We discovered a problem at our Pomona Plant with regard to practices there which involved a number of programs, in which test results were not being properly presented, where—I think you used the word—falsified test results. There is no other way to use that, yes, sir.

That was done and I think the initial investigations arose, to the best of my belief, out of an OSI or an outside investigation, which we then followed.

It was discovered that the plant manager and the quality assurance and engineering, all with knowledge, had been shipping products that had not been fully or completely tested, and in some cases, with regard to environmental testing, at levels that were inappropriate.

We have taken steps in that situation to disclose the problems with each of those programs to the procuring agency. In some cases, it is directly to the Air Force, in other cases it has been to the Navy and others, in all of those.

Mr. SIKORSKI. Before you get too far, Mr. Lynch, you had not only cases of tests that weren't performed but failures, testing results showing failures that were then falsified.

But I guess my question is: How did the Government become aware of this situation?

Mr. LYNCH. As soon as we were aware of it and did an investigation to—

Mr. SIKORSKI. How did you become aware of it?

Mr. LYNCH. I became aware of it by a call from the general manager of the division, who advised me of the problems that he had there.

Mr. SIKORSKI. And how did he become aware of it?

Mr. LYNCH. To the best of my recollection on that one, there had been allegations from employees in that case, which had then gotten to the Government, and then back to us with regard to that issue.

Now, again, I have to be careful of that statement because—

Mr. SIKORSKI. Well, the reason I am asking is that I asked you how did the Government become aware, and you started talking about as soon as you became aware of it. And then you became aware of it from your general manager, who got it from employees, who got it from the Government.

Mr. LYNCH, the Pomona Plant produces gyros for the MX missiles, as well.

Mr. LYNCH. Yes.

Mr. SIKORSKI. The subcommittee has evidence that the same practices that plague the cruise missile test also affect the gyros for the MX. What has your investigation shown?

Mr. LYNCH. Let's separate, the Pomona Plant has nothing to do with the gyros for the MX. They build small rate packages and they are not involved in any way with the MX Program.

Mr. SIKORSKI. They don't produce anything for the MX Program at the Pomona Plant?

Mr. LYNCH. At the Pomona Plant?

Mr. SIKORSKI. Behind you, you have one person going like this and another person going like this and this.

Mr. LYNCH. Well, you have really got me at a disadvantage.

Mr. SIKORSKI. I am looking at you and seeing three different heads going in different directions, either that or the aerobics have come to the committee room.

What other defense related products are produced at that Pomona Plant?

Mr. LYNCH. They have produced, I think, for the ALCM missile. They are producing some packages for the Harrier, the 88-B. I believe they produced some parts or they produced rate gyro packages. I can't give you a whole list of all of the places that they go. But again, I would be willing to give you such a list.

Mr. SIKORSKI. We would like that list provided.

[The document follows:]

<u>PROGRAM</u>	<u>CUSTOMER</u>	<u>PRODUCT</u>	<u>APPLICATION</u>
Tecit Rainbow	Venture/Northrop	3 Axis Gyro Package DC/DC	Stabilization
BQM-74 Drone	Venture/Northrop	1 Axis Gyro Package DC/DC	Heading Hold
USC-6 Satcom Antenna System	Electro Spec, Inc.	3 Axis Gyro Package DC/DC	Stabilization
International Defense Fighter	Bendix	4 Axis Gyro Package DC/DC	Heads Up Display
AV-8B Harrier	Honeywell/Sperry	3 Axis Gyro Package AC/AC	Flight Control
Fiber Optic Guided Missile - Medium	Colea	1 Axis Gyro Package DC/DC	Stabilization
Air Launched Cruise Missile	Boeing/Tinker AFB	4 Axis Gyro Package AC/AC	Flight Control
Air Launched Cruise Missile	Boeing/Tinker AFB	Circuit Boards	Flight Control Spares
Instrumentation	Westinghouse	2 Axis Gyro Package DC/DC	Minisweper Instrumentation
UH-1 Helicopter	Aviation Supply Office, Phil.	3 Axis Gyro Package AC/AC	Helicopter Stabilization
F-16 Aircraft	Hill AFB/USAF	4 Gyro Package	Flight Control
Stand-Off Land Attack Missile	McDonnell Douglas Astronautic	3 Axis Gyro Package DC/DC	Instrumentation
Peacekeeper	G.E./Phil.	3 Axis Gyro Package DC/DC	Instrumentation/Re-entry
Instrumentation	Edwards AFB	3 Axis Gyro Package DC/DC	Instrumentation
Instrumentation	Sandis Labs	3 Axis Gyro Package DC/DC	Instrumentation
UH-1 Helicopter	Bell Helicopter	Circuit Boards	Helicopter Spares
HK IV Platform	Naval Ships Parts Control Center	Drawer Assembly	Precision Carrier Landing System

Mr. SIKORSKI. Aren't these programs suspect, too?

Mr. LYNCH. Every program right now at Pomona, in that sense, was suspect. And as a result, once we discovered it on one program, we have gone through a complete investigation as to all of the programs.

To my knowledge, each program in which there has been any suspect parts has been gone—that advice has been given.

Now, we initially found the problems at Pomona, I am told, as a result of a Government investigation to us. The extent of that, which then involved other programs which were not alleged there, have been investigated and have been disclosed externally.

Mr. SIKORSKI. How many falsified tests were there originally?

Mr. LYNCH. I beg your pardon?

Mr. SIKORSKI. How many falsified tests have you discovered?

Mr. LYNCH. I am not in a position to give you a specific number, but I will be glad to get it.

Mr. SIKORSKI. Why aren't you in a position to give it? You came here to impart your information. This is clearly one of the issues that you were noticed about to come here. Are we talking tens, hundreds, thousands?

Mr. LYNCH. First, let me make a comment for the record. Unfortunately, I was not noticed that we were going to come here to talk about the Pomona and the ALCM missile. I found out about that a day or so ago.

Now, I regret and I apologize that I am not able to get to the point of giving you or brought with me a briefing to be able to give you the level of detail that you appear and feel necessary for the committee. I will be able to provide that to you for the record. So, I do apologize for not being prepared at that level of detail.

[The following information was received:]

ALCM FTD

(1) How many ALCM tests were not done at all?

From the company's internal investigation it is reasonably certain that 20 PRVT retests were not done, and that circuit board humidity testing, which was required to be performed on a sampling basis only, was not done from May 1984 to the end of production. There is uncertainty as to the number of boards not tested (possibly as few as 5 or 6). Although not performed, no evidence was found that the tests were falsified. Northrop is unaware of any adverse effect on ALCM operations.

(2) How many ALCM FTD tests where units failed but were documented as having passed?

From the company's internal investigation, it appears that 5 to 10 units failed the frequency response test and passing graphs were substituted. Northrop is unaware of any adverse effect on ALCM operations.

(3) How many ALCM FTD tests were conducted to parameters that were less than specified in the formal procedures?

We explored the possibility that random vibration test levels were less than required due to adjustment of the equipment for another program test. It has proven to be impossible to affirm or deny this possibility.

Mr. LYNCH. When you are talking in terms of those, there was a product verification and reliability testing, and if you are talking the numbers of test results, as far as I understand there were probably on the order of around 20 areas or situations where the tests were not done in accord with the specifications.

Mr. SIKORSKI. Mr. Lynch, what is bothersome here, one of the things that is bothersome here, is the failure of top management to

appreciate what is going on and coming in only at the end, and then not being fully briefed except right before testimony here.

My understanding of how management should operate—and I am not a management specialist—is that management has to be informed of what is going on, especially in issues as serious as falsified tests.

And we are talking about, as you said, several items. Every program is suspect because of the problems that have surfaced on the falsified tests.

Beyond that, the bothersome aspects are exacerbated by the fact that the process by which you people get to learn about this is after people come forward to the Government at the risk of their own careers and then the Government comes in, and that is not the way it is supposed to work.

Mr. WYDEN. Would the gentleman yield on this one point?

Mr. SIKORSKI. Sure, whatever time I have.

Mr. WYDEN. I just want to make one thing clear from what I know. These tests weren't done at all. The Government was billed, there was paperwork that was done, but the tests weren't done at all. Isn't that correct, Mr. Lynch?

It is not a question of somebody not really doing the tests properly or less than perfectly. There was paperwork done, the Government was billed, but the tests were not done at all. Isn't that correct?

Mr. LYNCH. I am not sure. We would have to speak about a particular or a specific test. One of the issues at Pomona on the ALCM were tests that were done on a vibration table to a G level that was substantially less than the specification level. The tests were done, but they were not done to the proper level.

Mr. WYDEN. So, in that instance, you are passing failed tests?

Mr. LYNCH. No, we are not passing to the requirement. Now, the issue on that is whether or not the failure to test the full requirement has prejudiced the reliability or the potential reliability of the part.

The solution to that is being worked currently with the Air Force, as to whether or not we should recall and retest, how many we should recall and retest, or what answer we should get to get that assurance back.

Mr. WYDEN. But there was paperwork done and the Government was billed when no tests were done at all, isn't that correct?

Mr. LYNCH. A test was done. It wasn't to the required specification, sir.

Mr. WYDEN. There were no instances, then, when no tests were done and yet paperwork—

Mr. LYNCH. I am not about to say that. I can't say that there were no instances of that sort. I am not in a position, with the information available to me.

If you have got some information—

Mr. WYDEN. Were there instances where you passed items that failed the tests?

Mr. LYNCH. Mr. Wyden, I wish I was in a position to answer specifically the question you are asking, but I am not. I can go back, again, and get these materials for the record, to see if there are any instances, and we will be specific on the program and the par-

ticular—I am sure you must have some particular issue in mind here.

Mr. WYDEN. We have information that indicates that, as well as the other point, that tests weren't performed and yet the paperwork was done.

I thank my friend from Minnesota for yielding.

Mr. LYNCH. I would appreciate, sir, if we could have that information, I would be in a position to say whether we would agree or not. Without that information, you catch me at a loss. I just don't know how I can answer your question.

Mr. DINGELL. The Chair will see to it that information is made available to you, Mr. Lynch.

Mr. LYNCH. I would appreciate that, Mr. Chairman.

Mr. DINGELL. The Chair is going to recognize himself now.

Mr. Lynch, why was it that the people at the Pomona Plant didn't go to the manager with the complaints on these matters?

Mr. LYNCH. The people at the Pomona Plant go to the manager of the Pomona Plant?

Mr. DINGELL. Yes, to complain about falsified tests and things of that kind, why did they not go to the manager himself?

Mr. LYNCH. Well, unfortunately, sir, the manager of the plant was involved in the decisions to falsify or alter or not perform the tests. So, this was being done with the knowledge of and the direction of the manager.

Mr. DINGELL. You are telling me, then, that they were afraid to go to him?

Mr. LYNCH. Please don't ask me to deal with someone else's motivations.

Mr. DINGELL. I want your best advice here.

Mr. LYNCH. I don't think I would—if I were in that situation, I don't think I would go to that individual, if I was aware that—nor, I think, would you.

Mr. DINGELL. So, you are telling us that there was generally common knowledge that the manager was falsifying test documents and changing test parameters in order to achieve passing results at the Pomona Plant. Is that what you are saying to us?

Mr. LYNCH. I would have to say that, yes, sir. Those were conditions that were found.

Mr. DINGELL. It would then appear that his determination was to stay on the delivery schedule, regardless of how he had to do it.

Mr. LYNCH. Well, you are asking me to again, I would hope, explain something that I find inexplicable in a manager at that level. I mean, I can't understand, frankly, what the motivation was.

Mr. DINGELL. The subcommittee has received reports that this individual would threaten employees of the company who came to him with complaints about these matters with firing and things of that kind.

Mr. LYNCH. That he did that?

Mr. DINGELL. Do you have evidence of that?

Mr. LYNCH. I am not aware that he had done that. I was aware that he had, as I said, what I feel was inadequate or totally unsatisfactory and unacceptable management performance.

Mr. DINGELL. Who was the quality assurance person at this plant required to see to it that the quality of products leaving the plant met Government contract standards?

Mr. LYNCH. I am sorry, I didn't quite understand the question.

Mr. DINGELL. Who was the quality assurance person at the Pomona Plant charged with the responsibility of seeing to it that the products leaving the plant for delivery to the Government met Government standards?

Mr. LYNCH. The quality assurance person at the plant was also involved, and I think I stated, along with the engineering individual at that plant, in this process.

Mr. DINGELL. So, the quality assurance person was involved in these matters also?

Mr. LYNCH. Unfortunately, that is correct. And where we have normally relied upon a separation of function, that turned out to be inadequate. And that is one of the things now we have corrected in that plant.

Mr. DINGELL. That quality assurance person had undergone a rather startling rise in grade inside the company, isn't that so?

Mr. LYNCH. Well, I can't, again, speak to that. I think I have tried to say that we had a totally unsatisfactory situation in the management locally. We have taken steps to discharge the employees that were involved where we felt that was the case. We are taking steps to close that plant out, bring the work back into our Boston operations, where it could be maintained under better control.

I am in no way, Mr. Chairman, in a position to defend any of that. The systems that we relied upon there turned out to be inadequate.

Mr. DINGELL. The committee has received information that the quality assurance person started on the assembly line and in a matter of months wound up as being chief of quality control at the plant. Is there any truth in that statement?

Mr. LYNCH. Let's sort of try to keep the plant in size. This is a relatively small operation of about 30 to 40 people, and so I don't want to get the feeling that we have got a situation here in which we are dealing with a large, big production facility.

It did fairly simple work. It took gyros that had been produced in Boston, added some small elements of electronics to them, and shipped them as an assembly.

Again, I don't want to minimize—

Mr. DINGELL. Of course, it is fair to say that these parts were extraordinarily critical and of very high quality. The size of the work force is relatively less important than the employee skills necessary to produce the parts.

Mr. LYNCH. The reason I brought that up was not so much the number of the people as the level of technology of the work in that particular plant was not high technology work. It was relatively straightforward work in which you assembled parts that had been checked elsewhere, assembly of these. So, it was not what you would consider high—it is an important—and again, I don't want to diminish the importance of it, and there is absolutely—you know, any piece we produce is part of a system. It has got to work,

it has got to be of integrity. There is absolutely no question of that. And that is totally intolerable.

Mr. DINGELL. Mr. Lynch, the Chair notes that my time has expired. The Chair also notes that we have a vote going on on the floor.

Why don't we recess until 12:30 and then return to finish up. Would that be acceptable, sir?

Mr. LYNCH. Fine.

Mr. DINGELL. Very well. The committee will stand in recess until 12:30, when we will return.

[Brief recess.]

Mr. DINGELL. The subcommittee will come to order.

The Chair recognizes the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. One second, Mr. Chairman.

Mr. DINGELL. Does the gentleman want me to defer recognizing him?

Mr. WYDEN. No, one brief second. Mr. Chairman, this is a first.

Mr. DINGELL. It is the first time the Chair has ever found the gentleman from Oregon to be speechless.

Mr. WYDEN. Thank you, Mr. Chairman.

Mr. Lynch, I did want to discuss the accuracy issue with you. And I am particularly concerned, because the MX is currently experiencing a drop-off in accuracy performance.

Now, the early test flights using research and development hardware and software, of course, appeared to be good. However, as Northrop attempted to move from the R&D phase into the production phase, there has been a significant drop-off in accuracy.

Now, three of the last eight test shots have failed. In fact, the only test shot approximating the configuration in the silos not only failed, but every warhead—every warhead, Mr. Lynch—missed its target.

As a result, the Air Force went back to using either R&D hardware or software with its last two successful test shots.

Why has accuracy dropped off so dramatically in Northrop's production units?

Mr. LYNCH. Mr. Wyden, I have got to have you help me out again with some of the figures and the numbers you are using. Would you please go back across those again?

Mr. WYDEN. The only test shot—in fact, let me go back even further. Three of the last eight test shots failed.

Mr. LYNCH. Could you help me out with what you mean by failed? You are getting me into something there—

Mr. WYDEN. They didn't fall within the required circle that is used as a standard.

Mr. LYNCH. Well, let's go back, if we are talking about the definition of a Circular Error Probable, a CEP.

Mr. WYDEN. Well, no. We don't want to get into a bunch of these technical, legal lingo, Air Force definitions.

Mr. LYNCH. Well, I am afraid, you see, when we talk about—

Mr. WYDEN. Because they throw out the worst half. What we are interested in is why three of the last eight test shots failed because they didn't fall within that circle.

Mr. LYNCH. I am afraid, sir, I can't avoid the necessity to go into what you might call technical lingo. The whole way that the Air

Force measures and the requirements are set with regard to the accuracy of any system of that sort is the CEP. And when they put a number down, that is a circle within which $\frac{1}{2}$ or 50 percent will fall. And that is the definition of accuracy.

There is a second circle which is an outer circle that all must fall within.

Now, this is a definition that goes all the way back to how you interpret or deal with bombing accuracies in World War II or earlier. That is the basis of success or failure.

Now, you are choosing to characterize failure as the half that fell outside of the circle that half were supposed to fall into. It is not the same thing.

Mr. WYDEN. Have you seen, Mr. Lynch, the raw data that were compiled by the Air Force regarding the accuracy of each of the MX test flights?

Mr. LYNCH. No, sir, I haven't.

Mr. WYDEN. The subcommittee has those raw data. We have seen them. And they are irrefutable. Moreover, the Air Force freely admits that the accuracy of the MX has experienced a significant decline.

So, I think what we are interested in knowing, from a purely production standpoint, what has happened out there at Northrop that has contributed to the sharp decline in accuracy?

Mr. LYNCH. You see, I can't deal, unfortunately, sir, with the entire MX missile or the whole—the guidance system consists of more than the IMU. This is an Air Force issue and I am afraid that I am not in a position to answer your questions on that.

With regard to the IMU and the portion that Northrop produces in this, as far as I understand, it is still within the contractual requirements. And we are not dealing with a statistically significant sample here, sir.

Mr. WYDEN. But it is getting worse, is it not?

Mr. LYNCH. I can't accept that as a fair characterization.

Mr. WYDEN. Well, yes or no? You don't think the accuracy problem is getting worse?

Mr. LYNCH. I don't know that it is getting better or worse.

Mr. WYDEN. Well, we have the raw data and they make it clear that it is getting worse. And the Air Force has admitted that the accuracy of the weapon has experienced a *significant decline*. So, everybody seems to think that there is an accuracy problem out there except you.

Mr. LYNCH. We are in a situation of delivering units within our contract and with our specifications. As far as I know, we are doing that, sir.

Mr. WYDEN. In addition to the current accuracy problems that we found, and that the Air Force agrees with the subcommittee on, Northrop has been unable to produce the required number of IMU guidance components for the Air Force. In fact, Northrop was 6 months late in the delivery of its first IMU and you are approximately 15 IMU's behind schedule now.

As a result, although the Air Force has 27 MX missiles otherwise ready to go, only 17, or 63 percent, have the guidance systems that are necessary to work. Now, here we are talking about affecting about 100 warheads.

Why has the company been unable to fulfill its contractual obligations to deliver the agreed upon number of IMU's?

Mr. LYNCH. I think we have admitted, as I understand it, that we have a schedule problem of delivery here. There is no question about that. We got behind early in the program. There have been a number of reasons for that. They have included, amongst other things, delivery of components from vendors, a whole different set of problems in initial production.

We are now improving upon that. I think I said in my opening statement, earlier this year we were 23 behind. We are now down at this point, as of the end of last month, to 12. It may vary between 12 and 15 behind, depending on where you measure at a point.

The problems that have occurred are being corrected. We will hope and expect to get back on schedule in early next year. I really don't know how I can say much more than that.

Mr. WYDEN. Well, I just want to make one thing clear for the record. The Air Force, according to what you said in response to one of my questions earlier, has never told you that there is a problem of declining accuracy with the weapon?

Mr. LYNCH. Has told me personally?

Mr. WYDEN. The company. Remember, you work for the company.

Mr. LYNCH. That is correct, sir.

Mr. WYDEN. Has the Air Force told the company about declining rates of accuracy with this weapon? Yes or no?

Mr. LYNCH. I can't answer that. They may or may not have. I am not sure. If you have documents, an Air Force letter, or something of this sort—the Air Force has written us a number of letters expressing serious concerns with the program. I am not in a position to say all of the things that are in each of those letters. So, you have me at a disadvantage here in being able to say have they or haven't they. I don't know.

Mr. WYDEN. Mr. Chairman, the last point that I would want to mention is, again, the audits. The internal audits showed throughout the years, from 1982 and 1983 on, that there were serious problems that Mr. Lynch describes today.

On October 28 of 1985 George Vidal, an auditor within the company production assurance, wrote to Mr. Colombano, Vice President and Manager, that the quality function didn't have the necessary independence to be effective. He stated, and I quote:

To have quality management under the direction of only manufacturing minded and experienced personnel is not going to lead us anywhere. At present, what we have is schedule control in place of quality assurance. I suggest that quality assurance be completely independent from manufacturing as an organization and in its decision-making actions. To be not so tight and more flexible in the schedule, having the tolerance in the schedule times that will allow us to produce improved quality products in schedule would be less expensive than to have numerous kickbacks, as we are experiencing at the present time. The slogan, "Do it right the first time" should not just be in writing only, mainly it should be practiced as well.

Mr. Chairman, it just seems to me to be clear, and it is a sad, sad pattern to see it go on year after year from 1982 through 1986, that there simply was no independence of the audit function and the good work done by the internal audit groups was continually ig-

nored by the production line personnel, and particularly the management.

We still haven't gotten an explanation why that is, and I think that leads to my next question to you, Mr. Lynch. Why did production line personnel continue to ignore the findings of the internal audit groups?

Mr. LYNCH. There is no excuse for the ignoring of a recommendation of that sort. I think I have tried to say, we have made the necessary changes in production management personnel as well as in quality assurance and other areas, and it is our anticipation that type of a problem will not reoccur.

Mr. WYDEN. But who in corporate management took responsibility, actually took the responsibility, for the lack of power and independence of the internal auditor function? I mean, I can just keep reading these. I have already gone through 1982, 1983, 1985. There was another one in 1987. Who took responsibility in management for the lack of independence of the internal audit function?

Mr. LYNCH. I think the reference that you are referring to had to do with a perceived lack of independence of the quality assurance function, as compared to the internal audit function.

Mr. WYDEN. Well, there were both.

Mr. LYNCH. There is a difference. I believe our audit function is independent.

Mr. WYDEN. Well, let me read you, then, what was stated in 1987. In 1987, Mr. Vidal wrote once again to Mr. Colombano stating, and I quote here:

"Our audit reports end up getting buried indefinitely with no solution to the problems."

That doesn't strike me as a very independent approach to the important function of internal audits. And now I have gone through 1982, 1983, 1985, all the way up to a few months ago. And you are telling me—your last response to me was that you said that you had an independent audit program. This fellow writes on August 28 that those audits are getting buried.

Mr. LYNCH. Well, I am afraid I will have to look at the particular one here. Audits do come in, they are reviewed, and they are acted upon. We have already discussed with the committee and will continue to furnish the results of those audits. I believe a lot of that will be in the documentation you have.

Mr. WYDEN. Your own people are refuting the statement that you are making today. You are saying those audits are reviewed. On August 28 of this year your own people said that the internal audits, and I quote here, "get buried indefinitely with no solution to the problems."

Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman.

The Chair recognizes the gentleman from Minnesota, Mr. Sikorski.

Mr. SIKORSKI. Thank you, Mr. Chairman.

Mr. Lynch, did you get a chance to read the Los Angeles Times article yesterday titled "Memos Appear to Support Allegations of Flaws in MX?" Today, I am sorry.

Mr. LYNCH. I got a chance to look at that very quickly just before we came to this meeting.

Mr. SIKORSKI. Would you look at the last paragraph in that article? It reads:

"Among the many other disclosures contained in the Shielke documents"—he, I understand, was a Northrop auditor and project leader that investigated the MX Program, wrote some of the audit reports—"is the allegation that Northrop attempted to preempt Dingell hearing by seeking a hearing before the Armed Services Committee. Shielke said that Brigadier General Charles A. May, Jr. even flew out to Northrop prior to the Armed Services Committee hearings in June to 'coordinate' testimony on the MX issue. May declined a request for an interview last week."

What do you know about this?

Mr. LYNCH. Well, nothing, as a matter of fact. But let me make a comment or two, if it is appropriate.

With regard to the view of seeking a hearing, I would say that, you know, I don't know that Northrop has ever sought a hearing before the Armed Services Committee or this committee. We are here. I don't think it is a pleasant experience. I don't think seeking a hearing would be a proper way to characterize that.

Mr. SIKORSKI. I am not interested in your hypothesizing on your comfort levels before various committees. But the allegation is that Northrop, in fact, did attempt to preempt this subcommittee by going to Armed Services. And I want to know what you know about that at Northrop?

Mr. LYNCH. I know nothing about that.

Mr. SIKORSKI. Didn't you ask anyone about that?

Mr. LYNCH. I was not aware of any such.

Mr. SIKORSKI. You weren't ever aware of this accusation made by Mr. Shielke?

Mr. LYNCH. This is the first I have seen of it, when I read this.

Mr. SIKORSKI. And when you read it, what did you say to the group that you have with you?

Mr. LYNCH. Well, frankly, we didn't have much chance to discuss it.

Mr. SIKORSKI. Did you discuss it at all?

Mr. LYNCH. Yes, I looked at and made a comment. I had no—

Mr. SIKORSKI. What was your comment?

Mr. LYNCH. I got no one who would support—that I know of that would support that. There was a comment made with regard to General May's visit, that he did come out to the plant as an orientation visit sometime in June. I was told—by the way, I have not met General May and had any contacts with him—that that was a briefing and a review to bring him up to date with regard to the nature of the program and the problems in the program, since he had been recently assigned responsibilities. Nothing more.

Mr. SIKORSKI. Purely coincidental in that trip with the Armed Services activities?

Mr. LYNCH. We respond to the Air Force—we have Air Force visitors with us all the time.

Mr. SIKORSKI. General May, I am talking about General May.

Mr. LYNCH. His coming to the plant is at his request, not ours. And we accommodate General May or anyone else from the Air Force.

Mr. SIKORSKI. Were the hearings discussed at that visit?

Mr. LYNCH. I have no idea.

Mr. SIKORSKI. Who does?

Mr. LYNCH. Well, I would imagine the people that attended or gave him the briefings and the orientation.

Mr. SIKORSKI. Who did?

Mr. LYNCH. I don't know.

Mr. SIKORSKI. You will find out and less us know?

Mr. LYNCH. We will certainly find out for the committee and respond to you on that.

[The information follows:]

Gen. May was at NED on June 8, at his own request, to receive a briefing on the Peacekeeper IMU program. According to those present, the hearings were not discussed.

Mr. SIKORSKI. Would you find out the basis for this allegation and let the subcommittee know?

Mr. LYNCH. Well, I am afraid you have to get Mr. Shielke, because he is the one that has apparently made it. And according to the remainder of the article—

Mr. SIKORSKI. Well, let me just say, you are here representing Northrop.

Mr. LYNCH. Yes, sir.

Mr. SIKORSKI. This allegation has been made. I find it, if it is true, to be offensive. I think that judge-shopping if it was done by Northrop, may serve Northrop's purposes but not the taxpayers. This subcommittee, as the chairman will tell you in more eloquent terms, has a long and very important tradition of congressional oversight, and that tradition won't be foreclosed by any actions by any potential witnesses here.

I want to know Northrop's position on this allegation. I see what Mr. Shielke has said and we will hear more from that. But I want to know your position on that.

Mr. LYNCH. My position, sir, is that we do not judge-shop, as you would put it, on any of these matters.

Mr. SIKORSKI. Mr. Lynch, you have told me you don't know anything about it and the discussions consisted of a very brief one or two sentences. I want you and I am asking you to go back and do a little investigation on your own, and then present the position of Northrop on that to the subcommittee. And I think that is reasonable.

Mr. LYNCH. That certainly is, sir.

Mr. SIKORSKI. Good.

Mr. LYNCH. I thought you were asking for my position now, and that is, I would hope, clear. It is not a policy or a practice or something that I would support or condone or initiate or otherwise approve.

Mr. SIKORSKI. Good.

Mr. LYNCH. But we will certainly investigate the issue and make a determination to the best of our ability, whether any such thing went on within Northrop.

Mr. SIKORSKI. Good. Thank you.

Mr. LYNCH. I will say at any responsible level.

Mr. SIKORSKI. Well, I want to hear any level.

Mr. LYNCH. All right, to the best of our ability.

Mr. SIKORSKI. Let me be the judge of what is responsible.

Mr. LYNCH. I view this as a management level. There may be people that discuss—

Mr. SIKORSKI. Well, I think you had a good answer and I think you should pursue it. But you are asking me to start talking about my opinion on management.

Mr. LYNCH. We will do it.

Mr. SIKORSKI. Thank you.

Thank you, Mr. Chairman.

Mr. DINGELL. The time of the gentleman has expired.

Mr. Lynch, the committee has been concerned about various accounts Northrop used to procure parts for a number of programs. These procurement accounts come under a number of names and titles, such as d/b/a's, petty cash funds, revolving funds, cash funds, and so forth.

In May of this year, Northrop told the subcommittee staff that there were five such activities ongoing within Northrop.

The Justice Department now claims they have an investigation going on into 11 such activities.

The subcommittee understands that in the wake of the visit of the subcommittee staff, Northrop has conducted audits into these various accounts.

Can you tell the subcommittee how many such funds existed or exist and the amounts channeled through these activities since their inception?

Mr. LYNCH. Mr. Chairman, I have been advised at various points in time of differing numbers of these types of activities.

Mr. DINGELL. Give us your best estimate as of today, please.

Mr. LYNCH. I was advised that we discovered within the Electronics Division that there were actually three.

Mr. DINGELL. Three?

Mr. LYNCH. That was what I was told.

Mr. DINGELL. Justice advises us of 11, and your people told our staff when they were out there that there were five.

Mr. LYNCH. I will need to have the information that they have or in some way reconcile the differentials between what our internal information and what these outside things are. So, if there is anyway that I could understand what those specific ones are, it would be helpful to me.

Mr. DINGELL. We will try and get you the information we have on this.

Mr. LYNCH. I would appreciate that.

Mr. DINGELL. Let me ask you, would such procurement activities operate in other divisions of the company as well as in the Electronics Division?

Mr. LYNCH. Well, we have petty cash funds throughout the entire corporation, and we have revolving funds throughout the entire corporation. And those continue.

With regard to the d/b/a's, which is this use of a fictitious business name, the instructions were given to eliminate all of those. And to my knowledge, they have been, or at least I have been advised that they have been.

Mr. DINGELL. Prior to the elimination of these funds, can you give us the number and the amount?

Mr. LYNCH. Well, I think I should get back to you on that for accuracy on the whole issue as to the exact numbers at a point in time.

[The following information was received:]

There were three dba accounts in the Electronics Division that were created at various dates subsequent to April 1985, and were halted at various dates beginning in December, 1986, and ending in July, 1987. Pertinent details are:

Date opened	Custodian	DBA name	Largest imprest balance	Cumulative activity
May 1985.....	Dave Peterson	Liaison Engineering Services.....	\$15,000	\$238,114
October 1985.....	Linda Allison (Doran).....	South Coast Engineering Accounts Payable.....	\$1,000	\$36,902
June 1985.....	Robert K. Stein.....	Laser Systems	\$1,000	\$93,114
				\$368,130

Mr. DINGELL. We will try and share with you the information that the committee has.

Mr. LYNCH. It will be helpful to us, because often times discrepancies in this information occur because we take them at different snapshots in time and over different scopes of activities.

Mr. DINGELL. Our subcommittee staff informs us that the amount of these funds was as high as \$4 million, from our own internal audits.

Mr. LYNCH. Well, if that is from our own internal audits, then the number is probably at or near correct, if you are just dealing with all revolving and petty cash funds. I don't, as I said, have those figures, but those are regularly audited in our Finance Department and should be made available, and we will be glad to try to get those reconciled as far as the specifics between your staff numbers and what we have in our company financial records.

Mr. DINGELL. Was it a regular practice to use funds of this kind for the purpose of procuring parts or procuring spare parts?

Mr. LYNCH. No, sir, that is not what ought to be done.

Mr. DINGELL. How did it happen that these funds were used, then?

Mr. LYNCH. Well, they were used——

Mr. DINGELL. Were they used with authorization of the management of the company, or plant managers? Just who in the company was it that authorized the use of these funds?

Mr. LYNCH. These funds were authorized, in that case, at the division financial management level. And frankly, that was one of the issues of a lapse in judgment or an incorrect judgment, to use funds for that purpose.

The important thing and the thing that should have been done at that division was, with procurement delays and the need to make schedule, to get fast parts into the test equipment organization, which was where these occurred as the initial thing, what we should have was improve the procurement system and that flow time. And that has been done.

I ran a division for 13 years and I had these same problems and we did it in accord with those approaches and systems. That was a judgmental problem that was wrong at that division. We needed to

correct the system of procuring parts, not bypass the system. And I can't excuse or condone that.

Mr. DINGELL. You said this was done at the division financial management level.

Mr. LYNCH. That was the level that I found that the d/b/a's had been discussed and approved.

Mr. DINGELL. Did the division manager know of this use of funds?

Mr. LYNCH. I am not sure that the division manager knew of them. He would not necessarily, because that is usually a detailed financial and it is typically within the delegated authority of the chief financial officer of a division.

Mr. DINGELL. Was the Air Force informed of these matters?

Mr. LYNCH. At the time that it was done?

Mr. DINGELL. Yes.

Mr. LYNCH. Not likely. But let me put it this way, it was not a secret. As a matter of fact, they were so proud of it they published it in our Northrop News, that they had this expedited procurement system. So, there was no effort to hide what was being done. It was a flaw in judgment as to how they ought to do it.

Mr. DINGELL. What has happened to the people who approved the use of these funds?

Mr. LYNCH. The financial manager—this is part of the reason for it—has been relieved and demoted.

Mr. DINGELL. Relieved and demoted?

Mr. LYNCH. Yes, of that position.

Mr. DINGELL. Were the other people involved who were relieved, demoted or otherwise disciplined?

Mr. LYNCH. Well, the general manager was, as well, as a part of the overall problems in the division. There were others elsewhere in the division that were. The people that were directly involved in certain of the funds are no longer with the company. Some of them have been the ones that have made allegations with regard to the conduct of the funds that they were supervising.

Mr. DINGELL. Now, Mr. Lynch, the subcommittee has been given to understand that these funds were used to buy parts for the MX missile and for the Stealth Bomber. Can you tell us, based on the audits of the company, what other programs were affected by the use of these funds to procure spare parts?

Mr. LYNCH. This particular fund that I believe we are referencing here was set up to be used to buy expedited parts for the support equipment for the MX missile.

Mr. DINGELL. I said spare parts? Then I misspoke myself.

Mr. LYNCH. Yes. But whichever way it is, sir, it is bad. It is not right. So, it was for support equipment. And of the total number of parts, it amounted to a small, a very small percentage where things needed to be expedited. It was also used for expedited handling of processing and plating and other processes that were involved.

Let me see if I have some summary here.

No, unfortunately, the summary that I was provided is not helpful in the answering of your question as to what contracts—unfortunately, it doesn't tell me what contracts these are.

To my memory, the majority of the fund was used on MX parts.

Mr. DINGELL. On MX?

Mr. LYNCH. MX support equipment parts.

Mr. DINGELL. Can you make the statement it was not used on other programs?

Mr. LYNCH. I can't make a categorical statement because the traceability of these is not adequate, and that is one of the problems that we have with it.

It is one of the weaknesses of doing things this way, is that your traceability of what you buy is lost. And it is terribly critical in programs of this sort to have traceability.

Mr. DINGELL. That is true. When you say traceability, are you referring to the origin of the parts and the character of the parts, as opposed to questions related to funds?

Mr. LYNCH. Well, we have both, frankly. I mean, from an operational point of view, reliability point of view, quality of the parts, we have to have the traceability of the part.

Mr. DINGELL. But here you are referring to the question of tracing the parts.

Mr. LYNCH. Absolutely. From the financial point of view, we have to have a traceability of the funds and the charging, and both are equally important.

Mr. DINGELL. What I am trying to figure out is how you are using the word, traceability. I believe you are using it in connection with the quality, reliability, standardization and identity of the parts.

Mr. LYNCH. I say traceability in that sense. There is also a traceability, another situation, which relates to the financial charging.

If parts are bought under one contract, used under another, you have to transfer the charges. And so, you have got to have an identity of financial records that go with that, just as much as you have to know whether or not the quality of those parts is suitable for the intended purpose.

Mr. DINGELL. Well, the financial records tell you some of both. In addition to the financial, they also tell you about where the parts came from, so you can identify what the parts are.

Mr. LYNCH. Unfortunately, the financial records won't tell you whether or not the part was inspected or how it was inspected.

Mr. DINGELL. Or even where it originated?

Mr. LYNCH. Well, it could, to the extent that you could find the vendor of that. But that may not give you the traceability you need there.

So, there is no question in my mind that the use of that type of a fund, without the proper controls, is improper and inadequate.

Mr. DINGELL. All right. Have your audits revealed whether all of the parts procured through these funds were procured from authorized vendors?

Mr. LYNCH. Most were.

Mr. DINGELL. Most?

Mr. LYNCH. Most were. But I believe the audit reports—and again, we are dealing with the limits of my memory—about 10 percent of them may have been or were procured from non-authorized vendors.

Mr. DINGELL. Can you tell us what the impact of procurements from these unauthorized vendors would have been on the program?

Mr. LYNCH. Well, it makes it difficult, then, to have an assurance of the quality of the part, and you don't know.

Now, it doesn't mean—the part, not knowing whether it is authorized or unauthorized, is whatever it is.

The problem we have is that we don't know the degree of control that was put into it. The only way we can determine that is ultimately by later tests. And in some cases, that may be adequate. In other cases, it may not be.

And it again depends on whether or not, for example, a controlled process is required in which a test wouldn't detect.

Those things, then, demand a careful review and a determination, if such a part has been used in an improper place, whether or not that part ought to be removed and purged, or whether it would be OK to use as is.

And that would take it through what was called a material review process, in which the quality and the company people and then the Government people must determine what disposition should be made.

Mr. DINGELL. Thank you.

The time of the Chair has expired.

The Chair is going to recognize the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. Thank you very much, Mr. Chairman.

Mr. Lynch, do we know where these parts are today? And if so, what aspects of the programs did they go into? Were they parts procured for flight hardware for the MX, or test equipment for the MX, or flight aspects of the Stealth Bomber?

I would like to know where these parts went. You have said that there were parts that were being provided by unauthorized suppliers. Do we know where they went?

Mr. LYNCH. Unfortunately, Mr. Wyden, not completely. Reviews have been made and the problems—and it is for the very reason I said, the traceability is not practiced in that fashion, and that is why it is not good.

At the same time, there have been inferences, or we can infer some—by virtue of the type of part and the part numbers, we can safely say, I believe, that most of the parts were used for the purpose intended in support equipment, where that part was probably adequate.

But we cannot say for sure and precisely and definitively where the parts all turn out to be, because unfortunately that traceability does not exist.

Mr. WYDEN. But then we may have some of these suspect parts being used in critical areas of our defense base?

Mr. LYNCH. That is within the realm of possibility. But the other side of that, which is the point I tried to make, again, in my initial remarks—and I am glad you used the word, suspect, because the issue is it is not whether they are good or bad, it is that we don't know. And that is a terribly important—

Mr. WYDEN. What concerns the subcommittee is that we think we ought to have a system where you do know, where there is some quality assurance.

What I am concerned about is that the procurement system is out of control because you don't know where these parts are, and they could be anywhere.

Mr. LYNCH. You are absolutely right, Mr. Wyden. We have put it back under control.

Mr. WYDEN. Mr. Lynch, did your investigation reveal that a number of these parts did not receive the proper level of inspection, as required by the Air Force?

Mr. LYNCH. It did.

Mr. WYDEN. Weren't most of the parts purchased through these funds not inspected to the proper level?

Mr. LYNCH. It could be. I know that the code inspections were not on the parts the way they should be, and it is quite possible. I can't say most, but the answer is, again, yes, sir, it is inadequate. It is not acceptable.

Mr. WYDEN. What are the national security implications, then, of parts not being inspected to the proper level and now we don't know where they are?

Mr. LYNCH. Well, I tried to cover that a bit, Mr. Wyden, that this failing—ultimately, parts do get tested. They may not get tested at the receiving dock, where they ought to have been tested. But as they are assembled into the equipment, they will be tested again, and they will be tested again and again.

So, ultimately, we don't have untested parts, we have tested parts. And when you get to the issue, then, of the implications, it is the redundancy of the testing process that gives us protection against this kind of a problem.

That doesn't excuse, believe me, what has occurred, and that has been fixed.

Mr. WYDEN. You are basically saying that what we ought to do is put our faith in other corporations. I am not sure they are doing any better testing than you are. But I do want to move on.

The subcommittee staff viewed 83 boxes—

Mr. DINGELL. Would the gentleman yield?

Mr. WYDEN. I would be happy to yield to the chairman.

Mr. DINGELL. We have a little problem. Some of these parts, I gather, were purchased in places like Radio Shack.

Mr. LYNCH. The Radio Shack issue has come up. I have been told that based on the audits of the records, that Radio Shack was not involved. They have not been, frankly, sir, and I again have said, the parts were not all purchased from authorized vendors. And whether it is Radio Shack or anyplace else, again, it is not a satisfactory situation.

Mr. DINGELL. Well, when you get down to the point, though, where they are not purchased from authorized vendors, your ability to be sure of the character of the vendor, the character of the manufacturer, the character and quality of the part diminishes rather startlingly, doesn't it?

Mr. LYNCH. Absolutely, sir.

Mr. DINGELL. So, again, once you get these kinds of parts involved in a sensitive place in military hardware, you have some real difficulties, do you not?

Mr. LYNCH. You could. And let me make another comment, that when there is a part that in any way—for example, we get back to

the question of unidentified parts. Computations, when those are in that situation, the reliability computations for the system take that into consideration, and a determination would be made as to whether or not we felt—and they are degraded in the analysis.

Now, this is done in the process of review, if you have what you would consider a suspect situation. And in this suspect situation, if that degradation—let's us say it might be not as good as, we think—is taken into account at that point.

But fundamentally—

Mr. DINGELL. Well, can you really do that? Let's look at this. I have never fired an intercontinental missile. The biggest gun I ever shot was a 90 millimeter gun back in the Army 40 years ago. But I knew everything had to be done the same way and everything had to be standard, or you weren't going to hit what you were shooting at.

Now, I shoot at little paper squares at 100 yards and I try and get it down under an inch, and I know that if I shoot well but I don't prepare my ammunition right, I am not going to shoot a nice, tight little group on the paper and I am not going to hit a woodchuck at 300 yards.

Now, if you have got a missile that has got a sensitive part in it that comes from some unidentified source where you really can't trace where it comes from, how can you be sure that you are going to be able to put it in a pickle barrel at five, six, eight thousand miles?

Mr. LYNCH. Well, the whole process—and it gets into the process in a program of this sort that is called material review. And this is a case, then, in which the company, the company's quality, the Air Force and the experts involved—in this case, we have not only the Air Force, but TRW, which for the Air Force gives oversight—review those conditions and make a determination.

They make a determination, again, as to whether whatever the discrepant condition is, whether it is satisfactory to use as is, or whether or not it needs to be replaced and altered.

So, that judgment will be made in the individual cases.

Now, I certainly share what you have said.

Mr. DINGELL. Well, if you have got an oddball part in it, that judgment is going to be harder to make.

Mr. LYNCH. Well, I would say if there is a concern to that part, then that part most likely would be removed, replaced, and the part would be made—you know, as you used the word, the oddball part becomes an even, it is known, if that is determined to be the appropriate disposition for that.

Mr. DINGELL. But if they don't know that curious part is there, then they have a problem.

Mr. LYNCH. When we deliver the guidance system, you know, it goes through a configuration management review of all the documentation as well as the hardware and the test results.

It is at that point, if there is non-traceability—and there have been evidences of that in certain areas—that non-traceability is reviewed and established. And it is at that juncture where the dispositions are made as to what ought to be done about it in those cases.

Waivers are granted if it is considered to be acceptable, or they are not granted and rework is done if they are not. And that means that the traceability has got to match the hardware.

If it doesn't, if that identity cannot be established in the paper trail, that is the point that that matter is resolved.

Mr. DINGELL. Don't you have a problem, though, if you are an inspector or an official of the Air Force, in being sure that you have all the papers that will identify potential problems or will demonstrate clearly that the particular unit is or is not one on which full reliability can be placed by the procuring service, in this case the Air Force?

Mr. LYNCH. Well, the paper trail is—maybe I am missing something. The paper trail is put together and has to match in that time of final acceptance or sell-off between the two.

Now, if that paper trail is discrepant, that is the point where review board action takes place. That is a judgment that is made in accord with a procedure by people who are considered to be qualified to make those judgments.

Mr. DINGELL. Aren't these systems that have parts procured from unauthorized vendors, subject to deviations? Aren't they subject to waivers and deviations?

Mr. LYNCH. Well, first, let's maybe continue. I want to be careful we don't get into another point, which says most of these parts that we are talking about from the d/b/a's or from this source were not even of the part numbers or common to IMU's. There is a very small fraction that you could sit down and say, I really don't know.

So that just by virtue of the fact they are not parts that are used in the IMU's, I want to sort of set at least some clarity, that we are not talking about there are a few parts that you could say that are common to an IMU, which then said there is a possibility, if you will, since these are there, that in the plant that they might get into the IMU.

Now we go back to the protection of the IMU, and the protection of the IMU is the traceability issue. And the traceability and the paperwork that goes with IMU, which then identifies everything that goes—you know, the things that go into it, has got to be perfect and match.

If it isn't perfect and match—and unfortunately, they aren't always perfect—that is, the paper trail will have its errors in it.

That is the area where we then get to the review process to determine how we solve that traceability problem, and that will lead to either a major waiver, a minor waiver, if it is to be accepted, or a rejection and a necessity to clean the situation up. And that is the process.

Now, there are waivers that are issued against each IMU as it goes. Those are done by, let's say, qualified people.

Those waivers, as an amount, are steadily decreasing. There were typically four to five major, four to five minor per system. They are down at the present time to about two per system.

Now, that sets a level of imperfection. I don't find that that level of imperfection is still a standard, that we ought to be better than that. But those judgments are made there. The system is evaluated as to whether it is acceptable or not at that point.

Mr. DINGELL. Thank you. I won't pursue this further. I apologize for using your time.

Mr. WYDEN. No, no, Mr. Chairman.

I want to follow up with a concrete case involving the inspection process that you've singled out as so critical.

Now there have been a number of allegations concerning the quality and reliability of the hybrids produced by Northrop, Mr. Lynch, very simply, that hybrids can result in launched missile straying off course.

Now the Scientific Advisory Board has been established by the Air Force to look into this matter, and in its soon to be released report, this advisory board found that a hybrid may fail on one test machine at Northrop but pass on another, and the Scientific Advisory Board found that Northrop shopped hybrids from one test station to another until the hybrids passed.

The Scientific Advisory Board then concluded that this practice has led to a general uncertainty about the reliability of the hybrids.

Mr. Lynch, are you aware of this finding of the Scientific Advisory Board?

Mr. LYNCH. First of all, I have not seen their report, but I am aware of the condition. And that condition is not an acceptable practice and is one that can't be continually continued.

Now the issue is a matter of review at this time as to how—I don't know how to put this—that problem has got to be a resolved problem. It's a known problem. It's been reviewed with the Air Force as to how we deal with that in terms of the quality.

I would go back again—

Mr. WYDEN. But it appears to us in their findings that there is general uncertainty now about the reliability of the hybrids, that this is a very grave situation, and that we may not know the quality of the guidance systems currently in our MX missiles on alert.

Now what assurance can you give us that allay those concerns? I mean, the Scientific Advisory Board has made these findings about the unreliability of the hybrids. That's not this subcommittee. And I'd like to know something that you could tell the subcommittee that would allay these concerns.

Mr. LYNCH. Well, I'm also advised that in that Scientific Advisory Board report that there was a position taken, although I have not seen it, but I've been told that it's there, that there was also a concern that we were probably overtesting and that in some cases more likely to be rejecting good hybrids than passing bad ones.

But I think we have to wait until the report comes out to have the whole picture of the hybrid testing.

Mr. WYDEN. They did find that Northrop was shopping hybrids from one test station to another until the hybrids passed.

What do you think of that situation specifically, Mr. Lynch?

Mr. LYNCH. It's an unsatisfactory situation in a production program of this sort, sir.

Mr. WYDEN. Unsatisfactory.

Mr. LYNCH. That's unsatisfactory. That's not an acceptable way to manage the testing program.

Now you asked for the other question—and let me try to respond to that—is what assurance can I give. The assurance I can give is

that hybrids are tested not only at the hybrid acceptance level, but at four other acceptance levels following that point, so that the performance of the system is assured by the redundancy of the testing process.

Mr. WYDEN. Thank you very much, Mr. Chairman.

Mr. DINGELL. The gentleman from Minnesota, Mr. Sikorski?

Mr. SIKORSKI. No questions, Mr. Chairman.

Mr. DINGELL. The gentleman from Tennessee, Mr. Cooper?

Mr. COOPER. Thank you, Mr. Chairman.

Just to put things in perspective from my standpoint—I apologize for having been absent a little bit—if an MX missile does have a defective guidance system, wouldn't that then mean that if that missile were launched, that we would not know where that missile would land?

Mr. LYNCH. Well, phrasing the question as you have, if you launched a missile with a defective guidance system, there is a problem. But you also must remember that the missile is under a continuous monitoring in the whole process, and whether or not, you know, the guidance system is good is a test that's being done continuously, and the guidance system monitor runs continuously in the silo, and so no—you're asking me to deal with—we build the guidance unit, so I'm moving into an area that's beyond—but I'm doubtful that the Air Force would launch a missile with a known defective guidance system.

Mr. COOPER. But if their testing procedures are as unsatisfactory as yours apparently are, that leaves open the possibility that there could be an MX missile with a defective guidance system.

Mr. LYNCH. Sir, that's why testing procedures are redundant, overlapping, and intended to be sure that any inadequacy in any one procedure is caught in others.

Mr. COOPER. I can understand how overlapping test procedures would catch a part that showed its defect at the time, but I do not understand how test procedures could catch a part that, say, was prone to fail earlier than another part, a part that was not as durable or as lasting as a legitimate part.

If the mean time between failures was considerably shorter than for a regular part, how would a test procedure catch that, a part that worked great for 3 months instead of the required 6 months?

Mr. LYNCH. Well, durability, we have really two things we're dealing with here in testing. One of them, as you make the point, is the performance of the article itself. The other one you've now entered into, which is durability, what the failure rate of the article would be.

Now that is handled by a different kind of testing, and that's usually handled to get any single unit down to its basic or random failure rate through the process of time in operation. In some cases, that's known as burn-in, in which parts are operated over a period of time and under stresses to eliminate or reduce the probability that those parts will fail. And that type of test procedure is carefully calculated and developed for every class of part. In some cases, these are done under temperature; in some cases, they're done under temperature and environment; in some cases, they're done at room temperature over time periods.

That tends to permit the part—and you have to do these things both at a level that will give some stress, but at a level that will not overstress the part and induce a failure or cause it to be potentially less reliable. These procedures are a separate class of test procedures that are done.

The IMU gets hundreds of hours of testing. It goes through both in our plants and at Autonetics before it gets to the silo. In that sense, the probability of early failure or incipient—or durability is minimized. From that point on, it operates continuously, and the longer it operates in that sense, the risk of failure as a result of something inherent or, as you used the word, durability, which is quite an appropriate concept, is reduced. It's a different kind of testing.

Mr. COOPER. Still, it worries me when you use phrases like the probability of such-and-such is minimized, because to me what we're really talking about is the probability of launching a nuclear attack perhaps against ourselves is minimized. Any degree of risk in that situation, I think we would all agree, is unacceptable, and you seem to be relying on the Air Force to backstop whatever mistakes there might be in your testing system.

Mr. LYNCH. We're not relying on the Air Force to backstop mistakes. We have enough backing in our own internal one for these. That other backup exists there, too. We're not relying on it. It's unacceptable to not do each of the steps. I tried to make that point clear.

Mr. COOPER. But there are so many things that you've admitted were unacceptable in your own organization, so many failures and breakdowns, an entire plant that was run by a manager and a quality assurance officer whom you couldn't trust and whom, I believe you indicated, it was general knowledge couldn't be trusted. And whether it was a plant of 30 or 40 people or not, to me, that seems to show a significant breakdown in quality control in your operation regarding an extremely sensitive instrument atop one of the most deadly weapons ever devised by mankind.

Mr. LYNCH. Sir, we're mixing two things, I'm afraid, here in some fashion. We're talking—you're putting the General Manager and the quality assurance man of one plant, as if they were the members of the other, and I don't think that's a pretty correct characterization.

Mr. COOPER. Well, can you guarantee me that there aren't breakdowns in your other plants similar to those found in Pomona?

Mr. LYNCH. I couldn't guarantee anything of that sort, and you know, as well as—this is proving a negative. We try to develop our systems to give us assurance that these things are—but things do happen, and when they do happen, we have to fix them.

I wish I could.

Mr. COOPER. I wish you could, too.

Earlier I had mentioned the Dingell audits subject, and you seemed to have very little, if any, knowledge about the so-called Dingell audits. The subcommittee has obtained copies of a number of these reports including a draft report on traceability systems controls and testing of controls and traceability of parts.

The draft report states that at least seven production IMU's have been determined to contain hybrids which have not been manufac-

tured and tested to required specifications. In addition, from information obtained from the Air Force, the subcommittee has determined that some of these IMU's went into MX missiles and were put on alert by the Air Force.

Were you aware of these audit findings, and what is the current status of these IMU's?

Mr. LYNCH. I was made aware of these audit—this particular audit, which was a draft audit and not yet released, about, I think it's about 1 week or so ago. I have some comments. The audit is in some cases incomplete in the sense that it doesn't answer all of the questions with regard to that.

The first issue, I think, that you are finding was that at least 11 production IMU's have been determined to contain certain unidentified hybrids, and the answer on that one is, yes, that is a correct finding. It should go further, however, and establish that those unidentified hybrids, which is a traceability issue that is being dealt with, were made known to the Government at the time of the sell-off of each of those systems, were processed through the material review process, and waivers granted for the use as-is.

Further, there's an action request out on those, to my knowledge, that when the units do come back and to the extent that they are torn down—this is a matter, by the way, of identifying the serial number on the hybrid, in which case the paperwork accompanying the system was not correct, was not complete.

Mr. WYDEN. Would the gentleman yield?

Mr. COOPER. Yes, I'd be happy to yield to the gentleman from Oregon.

Mr. WYDEN. Thank you.

And very briefly, didn't you say earlier that traceability was one of the most important aspects of the system?

Mr. LYNCH. It is in a long-term reliability sense. In other words, you need to be able, as you go through later versions of test, analyze, fix, know what you have in the system. It doesn't mean you can't correct, but it is important in the overall maintenance of a reliability program for the life of the project.

Now these particular matters are likely to be corrected; that is, the traceability numbers discovered as these units normally come back through the process. And there is an action request to do that. When that's done, the traceability will be complete with regard to those unidentified hybrids.

Mr. COOPER. What worries me is, earlier you said you were not relying on the Air Force to backstop your operation. And granted, that's a plain English summary for something that I feel you're really trying to quibble with when you say you admit that 11 defective units or hybridized units had to be granted waivers by the Air Force, and to me that means that even though American taxpayers pay for real equipment the Air Force had to grant a waiver in order for the acceptability of the hybrids to be allowed.

Mr. LYNCH. Please, sir, you're mischaracterizing it. You characterize those as defective or failed. It was identification of the serial numbers.

Mr. COOPER. I believe I called them hybridized, didn't I?

Mr. LYNCH. All that was missing—that particular finding related to the fact that in the documentation that went with those systems,

the serial numbers of those particular hybrids were not identified, not that the hybrids had failed, not that the hybrids didn't work.

Mr. COOPER. But the American taxpayer pays for real, traceable, identifiable parts. The American taxpayer was not given traceable, identifiable parts. The Air Force had to grant a waiver before you were legally allowed to sell those parts to the Air Force. Without that waiver, the transaction would not have been a legal, acceptable transaction.

Is that right?

Mr. LYNCH. Yes. And the Air Force, as those parts come back, those numbers will be recorded and that matter will be cleared.

Mr. COOPER. But were these 11 hybridized units placed inside MX missiles that were put on alert?

Mr. LYNCH. In dealing with the question, we are delivering a set of production IMU's. There are a set of serial numbers of those production IMU's that have been delivered to the Air Force which have 11 cases, about one for each of those per unit, where there was one out of some 260 hybrids that didn't have a serial number on the documentation that could be relied upon.

Now, the next question you asked me is, were those units put into alert status? I'm personally not in a position to know which units are in alert status. I can speculate only and say, they probably are in some sense, some of those serial numbers in alert status. But I have no direct knowledge.

Mr. COOPER. But doesn't that deeply concern you that when American taxpayers pay for parts that should be traceable, and you said how important traceability is, you deliver parts that are untraceable or at least haven't been traced yet to the Air Force, those parts are put in an MX missile, which the subcommittee has learned, was put on alert; and to me you don't show a proper level of concern for the level of mistake involved.

Mr. LYNCH. I'm sorry. I don't know quite how—I have tried to express to the committee my concern with all of these discrepancies. I take them seriously. They're important. They need to be resolved. We can't, you know, a program cannot continue on that kind of a basis.

I don't know quite what more I can say to you that would cause you to believe that I am concerned. I'm concerned about all of this. I wish I had the personal capability to communicate better. I don't know what more I can say.

Mr. COOPER. Maybe you're just such an even tempered person that your blood pressure does not rise discernibly when you are upset with something.

Mr. LYNCH. Well, to put it this way, you know, as a survivor in this world you learn—I'm an Irishman, I used to have a very flaming temper. My neck would get red and I would blow up. If I was to live and survive I had to learn to control it, and over the time I have. Sometimes I still do lose it. But, you know, it doesn't mean that I'm not concerned because at this stage in life I don't flush and get red. Perhaps I've seen too much. But I am concerned; I would like to assure you of that.

Mr. COOPER. The committee has learned that at least seven production IMU's have been determined to contain hybrids which have not been manufactured and tested to required specifications.

Some of these IMU have gone on deployed MX missiles on alert. You might be happy that you're a survivor, I would like to make sure that the constituents in my district and the folks across the country are survivors should one of these unguided missiles go off in the wrong direction.

And to me, you are still relying on the Air Force to backstop your work. The quality assurance controls sound to me like a very poor sieve; and to me the American taxpayers are paying for more than that and they're paying for better than that. And I wish that you could guarantee this subcommittee here today that mistakes, such as we've seen, would not happen again.

Mr. LYNCH. Sir, we're doing everything we can to try to prevent that.

Mr. COOPER. Mr. Chairman, I have no further questions at this time. Thank you.

Mr. DINGELL. The time of the gentleman has expired. The gentleman from Oregon.

Mr. WYDEN. Thank you, Mr. Chairman.

Mr. Lynch, Chairman Dingell had the staff visit the company in May of this year, and the staff viewed 83 boxes of Northrop parts at that time including parts for the MX missile. In fact, they brought back one box of parts as an example. This is what they brought back. These parts are examples of what were contained in the 83 boxes.

Now, they subsequently showed all these parts to company officials for purposes of the company's own investigation.

Mr. Lynch, can you tell us what that investigation showed?

Mr. LYNCH. Well, as I understand, we were shown or some of our people shown some particular parts.

Mr. WYDEN. You were shown this kind of part. I can, in fact, turn it around and it's even clearer. You've got all kinds of parts in this box. This is a circuit board.

Mr. LYNCH. Yes, I understand. I'm trying to see if I—I know that the ones that were seen, and I'm not sure about that particular part, whether that was one that was seen, were reviewed, and some identifications made of those. To my knowledge none of those appeared as parts that would have been in IMU's, which is clearly I think our matter of major concern. I don't have in my notes specifically the identification of the parts you showed us, but I could provide those for the record as to what that was.

Mr. WYDEN. Well, we showed your people one out of 83 boxes, and I gather that what your investigation showed is that some parts were supposed to have been thrown away and that they simply don't know how they got there?

Mr. LYNCH. Well, you have asked me two questions, I think, or perhaps I misunderstood you. One question that you asked, what did your investigation show that were the source of those parts? Where did they come from and what were they?

Mr. WYDEN. Right.

Mr. LYNCH. And I'll be glad to submit that for the record.

Mr. WYDEN. They came out of the Dumpster, didn't they?

Mr. LYNCH. Well, it has been alleged they came out of the Dumpster.

[The information follows:]

The items identified were:

- (1) Bag of 250 adapters, P/N 39598-6. Brass adapters with very thin nickel plating covered by another very thin layer of 18-karat gold, used to improve conductivity. (Valued at 82 cents each, for a total value of \$205).
- (2) Three microcircuits, \$23.04 each.
- (3) Six resistors, 8 cents each.
- (4) One circuit card, \$1,998 each (cost to customer for this part to be made at Northrop, since it is a "make assembly," not a purchased part).
- (5) One cable assembly, \$55 each.
- (6) One performance board, \$7,538 each (another Northrop "make assembly").
- (7) One connector, \$117.23 each.
- (8) Ten integrated circuits, 71 cents each.
- (9) One connector, \$90 each.
- (10) One pump, \$885 each.

All the parts are found in Northrop-built ground support or test equipment. None of the parts are used in the Peacekeeper Inertial Measurement Unit (IMU).

Three of the items (microcircuit, item #2; resistor, item #3; and integrated circuit, item #8 were shown with incomplete "credit requisitions," indicating that, at some time before the parts left Northrop, someone was attempting to work properly within the system by crediting these excess items back to stock.

Mr. WYDEN. What does your investigation show?

Mr. LYNCH. We haven't been able to get—in our investigations we have not been able to validate this alleged Dumpster situation. We would still be appreciative if you had names of any witnesses other than the ones that made the initial allegation that would corroborate that, but we haven't been able to identify or validate the so-called Dumpster story.

Mr. WYDEN. You haven't been able to either refute or validate it, and that's been 5 or 6 months, hasn't it?

Mr. LYNCH. You can go so far—we have found nobody that will confirm or witnesses who will say they did or did not see that. If you've got corroborating witnesses that you know, that I don't know about, it would be very helpful for me to know.

Mr. WYDEN. Is this the subject of a Grand Jury investigation?

Mr. LYNCH. I don't know—I can't—is it?

Mr. WYDEN. Or a Justice Department investigation?

Mr. LYNCH. I don't know what Grand Juries are investigation or to the extent of the Justice investigating of those things.

Mr. WYDEN. Well, do you believe that's where the other 82 boxes of parts are at this time?

Mr. LYNCH. I don't see how I can be aware or our people be aware of what they haven't seen. We have been shown, as you indicated, samples of those parts. There was an investigation to identify what those were. I will be glad to furnish what we found out about that to you.

I can't really say what the other 79, if you showed us one of 80, contain.

Mr. WYDEN. On May 7th of this year, Mr. Lynch, Michael Patton of the Program Products Division of the company sent a memorandum to Mr. Sweikert and Mr. Nakugoff describing his general findings in the Northrop clean rooms. His conclusion states and I quote here, "Although strict controls have been established, in very little instances could compliance of these controls be found. The potential for contamination in all of the rooms is extreme. Large amounts of dirt, grime and dust could be found in all of the rooms."

Now, Mr. Lynch, this is a May 7, 1987 audit, it was in the wake of an October 1986 audit that found many hybrid clean room deficiencies as well. My question to you is, why did these conditions exist 6 months after the original audit report, and what is the current status of the clean room problem?

Mr. LYNCH. The current status of the clean room problem is that those conditions noted in that audit report have been corrected. I can't justify why they weren't corrected sooner.

Mr. WYDEN. How did they occur in the first place? Was it just a lack of oversight?

Mr. LYNCH. It's a lack of discipline. And a lack of discipline that leads to a lack of oversight; it comes from inadequate supervision and management.

Mr. WYDEN. I can't state it any better than that.

Thank you, Mr. Chairman. And, Mr. Chairman, I think it's worth noting, you and I have both mentioned it, that during this period, and Mr. Lynch described it as a period where there was a lack of oversight and a lack of discipline, bonuses were being paid to the top 10 executives of the company that came to millions of dollars; and I think that's what is really disgraceful about the whole situation.

Thank you, Mr. Chairman.

Mr. DINGELL. Mr. Lynch, this is one of the boards that our staff found in the Dumpsters; can you explain how parts at the plant get into Dumpsters and why they go there?

Mr. LYNCH. Well, frankly, no, sir; they're not suppose to. That's not an accepted method of disposal of material.

Mr. DINGELL. This is property that had been bought with Government funds, is it not?

Mr. LYNCH. I would assume so; yes.

Mr. DINGELL. One thing that I note as I observe this and that piques my interest is a number of the circuits here are stamped Taiwan; this means that the part is from an approved supplier or from someone who is not an approved supplier?

Mr. LYNCH. I can't answer that one. If that's an important detail, I'll get an answer for you, but I can't identify what part numbers mean.

Mr. DINGELL. One of the concerns I have, coming back to this question about hybrids and circuits that have parts not procured from approved suppliers. It is fair to say that where you have a sensitive part to equipment like this that all parts have to be very carefully calibrated to assure proper performance; that they meet standards; that they are reliable and have the necessary strength to function properly when the time comes, is that not so?

Mr. LYNCH. Yes, sir.

Mr. DINGELL. And if you have hybrids in there that have not been properly calibrated you then run into a very major problem in terms of assuring that these parts are able to perform as the individual specs or specs the entire assembly would require is that not so?

Mr. LYNCH. No, it will depend, I think each unit is going to, you know, the control of the individual elements will be dependent upon each particular hybrid or each particular unit that you have. And as a generalization, yes, sir.

Mr. DINGELL. So, what has happened here is, you have used these unauthorized suppliers and essentially shifted responsibility to the Government to check out and analyze the parts to assure that they function exactly as they should; is that not so?

Mr. LYNCH. I'm not sure I follow exactly the line we're going down here. We have in the process, when you go through your control, your traceability, all these processes, let's remember one other thing, I don't want to let ourselves—we're having a tendency to do some linking here of the d/b/a's, the uncontrolled parts or the unknown, our logic has taken us from the fact that we have that situation which we have discussed. We have now over here an IMU that has hybrids in it. The numbers of parts that exist between this is a very small number that could possibly exist between these two things is a very small number.

Mr. DINGELL. There's an ancient poem about, "For the want of a nail a shoe is lost, for the want of a shoe a horse was lost, for want of a horse the rider was lost, and for the want of the rider the battle was lost."

Mr. LYNCH. You're absolutely right. And I would not want to, again, minimize, but at the same time I want to keep a perspective because I don't want to create an impression that we have massive—

Mr. DINGELL. What I'm trying to get at is, as a result of procuring parts from unauthorized vendors, the Government has to check with far greater care to be sure of both the paper trail, and also to be certain that the part, assembly and the whole weapon system function as the contract specifications require; is that not so?

Mr. LYNCH. We and the Government together, in terms of the oversight in the program, have got to make sure that that unit is right. We go through that paper trail, they go through that paper trail. We double-check each other on the paper trail, and the paper trail needs to be perfected. It's not always perfected. And to that extent, between ourselves and the Government, we have to deal with those issues of imperfections.

The same thing occurs with regard to the equipment and that, I think, is done as a part of the total process. I'm not sure I completely understand your question, but that's the way the program is structured, to give us the confidence in the system.

Mr. DINGELL. Now were these subject to waivers and deviations?

Mr. LYNCH. All or none.

Mr. DINGELL. Were any waivers and deviations given for parts that were not from approved sources?

Mr. LYNCH. I can't—the way you are phrasing the question, I'm afraid I can't—I can tell you this, with regard to the hybrids, which seems to be, I believe, the matters of issue—I'm looking for the F-14—let me say this. I have been given a tracing in my preparation of some—in the order of about 60 units with regard to all of the hybrids which identified which ones—which systems had waivers and which didn't. I'm afraid I'm not able to locate that now, but I'd like to furnish that for the record.

[The following information was received:]

NAME
ROBERTS
H510

PEACEKEEPER IMU
CONFIGURATION MANAGEMENT



12-2-87

PRODUCTION IMU MATRICES EFFECTIVITY MATRIX

MATRICES	P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	P11	P12	P13	P14	P15	P16	P17	P18	P19	P20	P21	P22	P23	P24	P25	P26	P27	P28	P29	P30
U035 81 EXPOSED COPPER																														
U036 81 PPS EXCEEDS LIMITS																														
U037 81 ENCRUSHMENT																														
U038 81 NO PPS DATA																														
U039 81 FOR-HON																														
U036 VALVE DRIVE TORQUE ATP																														
U037 ATTITUDE EDC																														
U039 USE OF 30017 BIRD																														
U018 ATTITUDE EDC																														
U011 ATTITUDE EDC																														
U012 ATTITUDE EDC																														
U013 104 81AS TRSB																														
U016 POSSIBLE OUT-OF-LIMITS SUP. PMS																														
U015 THE CHARACTERISTICS OUT-OF-LIMITS																														
U014 81 ATTITUDE EDC																														
U018 81 INTERNAL PRESS. VALVE CORRECT																														
U019 81 USE OF 30017 BIRD																														
U018 81 USE OF 30017 BIRD																														
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U023 USE OF 30017 BIRD																														
U024 FOR																														
U025 FOR																														
U027 ATTITUDE EDC																														
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DEVIATION TITLE:	DEVIATION REQUESTED:	AIR FORCE APPROVAL CONDITION:	NORTHROP COMMENTS:
0155 R1 ALTITUDE EROC	ATTITUDE ERROR RATE OF CHANGE LIMITS EXPANDED IN ACCEPTANCE TEST PROCEDURE		SUPERCEDED BY APPROVED ENGINEERING CHANGE PROPOSAL NE 222
0156 EXTENDED CAL AT ATP	A SECOND INITIAL CALIBRATION WHEN UNIT HAS EXCESSIVE RESIDUAL FAILURES DUE TO INADEQUATE GYRO WARM-UP TIME	ENGINEERING CHANGE PROPOSAL SUBMITTAL REQUIRED	SUPERCEDED BY APPROVED ENGINEERING CHANGE PROPOSAL NE 255
0158 R1 TEST CCA AT INA	MANUAL TEST OF CIRCUIT CARD ASSEMBLIS DUE TO LACK OF AVAILABLE AUTOMATIC TEST EQUIPMENT		SUPERCEDED BY APPROVED DEVIATION D177
0160 R2 ELIMINATION OF SPHERE TEST	ELIMINATION OF THE REDUNDANT PARTS OF THE ACCEPTANCE TEST PROCEDURE WHICH CAN BE PERFORMED AT THE SYSTEM LEVEL		SUPERCEDED BY APPROVED ENGINEERING CHANGE PROPOSAL NE 255
0165 R1 CRYSTAL TRACEABILITY	USE OF CRYSTALS WHOSE TRACEABILITY IS TO AS-GROWN NOT AS LUMBERED BARS		A SEARCH OF NORTHROP AND VENDOR RECORDS CONFIRMS THAT NONE OF THESE PARTS WERE EVER SHIPPED BY THE VENDOR OR RECEIVED BY NORTHROP
0174 ATP LIMIT MOD	EXPANSION OF GYRO RELATED AND EXCESSIVELY STRINGENT TEST LIMITS		SUPERCEDED BY APPROVED ENGINEERING CHANGE PROPOSAL NE 283
0177 R3 TEST CCA AT INA	SEE D158 R1	NO TWO SUCCESSIVE LEVELS OF TESTING WILL OCCUR	
0187 HYBRID BURN-IN TEMP ERROR	USE OF HYBRIDS BURNED-IN AT LESS THAN TEST SPECIFIED TEMPERATURES	REDUCTION OF \$40,000 IN TOTAL TARGET COST	

WAIIVER: TITLE:	NON-COMFORMANCE CONDITION:	AIR FORCE APPROVAL CONDITION:	NORTHROP COMMENTS:
W285 R1 EXPOSED COPPER	CIRCUIT CARD ASSEMBLY HAS OVER ETCHED CONDITION AND SLIGHTLY MISALIGNED HOLES	NORTHROP ELECTRONICS DIVISION (NED) WILL PROVIDE A SPARE CIRCUIT CARD ASSEMBLY, PART NUMBER 106210-302 TO THE AIR FORCE GUIDANCE AND MISSILE CENTER TO BE AVAILABLE FOR INSTALLATION SHOULD UNIT BE SENT TO DEPOT AND DISASSEMBLED TO A LEVEL WHERE CARD IS ACCESSIBLE	
W286 R1 POS EXCEEDS LIMITS	USE OF HYBRIDS WITH PARAMETER DRIFT SCREEN OUT OF LIMITS CONDITION	THE HYBRIDS IDENTIFIED WILL BE TREATED AS PRIME UNITS FOR WARRANTY PURPOSES.	
W287 R1 ENCROACHMENT	USE OF FLEX WADRESSES WITH COVERLAY ENCROACHMENT ONTO SOLDER FILLETS	FAILURE OF PARTS WILL NOT BE EXCLUDED FROM WARRANTY	
W288 R1 NO POS DATA	USE OF HYBRIDS WHICH DO NOT HAVE ADEQUATE DATA TO TEST PARAMETER DRIFT	SEE W286 R1	SUBSEQUENT UNITS CONTAINING HYBRIDS WITHOUT PARAMETER DRIFT SCREEN DATA WERE DISPOSITIONED AS MINOR WAIVERS THROUGH APPRO
W291 R1 FOR-NON	SYSTEM ACCEPTANCE TEST PROCEDURE FAILURE OF FIGURE OF MERIT - MEASURE OF MISMODELING	NED WILL REPAIR THE WAIVERED CONDITION ON THE SUBSEQUENT RETURN OF THE IMU AT NO INCREASE IN TARGET COST	ENGINEERING CHANGE PROPOSAL WE 295 EXPANDED THE FIGURE OF MERIT - MEASURE OF MISMODELING LIMITS IN THE ACCEPTANCE TEST PROCEDURE WHICH MAKES THIS CONDITION CONFORMING
W306 VALVE DRIVE TORQUE ATP	PEAK TO PEAK VALVE TORQUE EXCEEDS ACCEPTANCE TEST PROCEDURE (ATP) LIMITS		ENGINEERING CHANGE PROPOSAL WE 283 ELIMINATES PEAK TO PEAK REQUIREMENT IN ACCEPTANCE TEST PROCEDURE AS TEST DOES NOT ACCURATELY ASSESS TORQUE

11/24/87

AIR FORCE APPROVED PEACEKEEPER IMU MAJOR WAIVERS

WAVYER: TITLE:	NON-COMFORMANCE CONDITION:	AIR FORCE APPROVAL CONDITION:	WORTHROP COMMENTS:
W307 R1 ATTITUDE EROC	ATTITUDE ERROR RATE OF CHANGE (EROC) LIMITS FOR ACCEPTANCE TEST PROCEDURE EXCEEDED LIMITS		APPROVED ENGINEERING CHANGE PROPOSAL NE 1011 INCREASED ERROR RATE OF CHANGE LIMITS IN ACCEPTANCE TEST PROCEDURE WHICH MAKES THIS CONDITION CONFORMING
W309 USE OF 300017 DIODE	USE OF DIODES WHICH HAVE NOT COMPLETED LIFE CYCLE TESTING		DIODES SUBSEQUENTLY PASSED LIFE CYCLE TEST
W310 ATTITUDE EROC	ATTITUDE ERROR RATE OF CHANGE (EROC) LIMITS FOR ACCEPTANCE TEST PROCEDURE EXCEEDED LIMITS	WORTHROP ELECTRONICS DIVISION (WED) SHOULD REPAIR UNITS WITH A NO COST TEST PROCEDURE EXCEEDED LIMITS	SEE W307
W311 ATTITUDE EROC	SEE W310	SEE W310	
W312 ATTITUDE EROC	SEE W310	SEE W310	
W313 TCG BIAS TREND	BIAS TREND OF THE NUMBER THREE THIRD GENERATION GYRO WAS OUT OF LIMITS		CONDITION CAUSED BY GOVERNMENT FURNISHED EQUIPMENT APPROVED ENGINEERING CHANGE PROPOSAL NE 295 EXPANDED THE GYRO TEST LIMITS IN THE ACCEPTANCE TEST PROCEDURE WHICH MAKES THIS CONDITION CONFORMING
W314 POSSIBLE OUT-OF-LIMITS SUSP. PAD	APPRO SUSPECTED SUSPENSION PADS OF BEING ASSEMBLED INCORRECTLY		BOTH UNITS PASSED THE MAXIMUM BALL RATE TEST DESIGNED TO ASSURE ADEQUATE TORQUE MARGIN
W315 TCG CHARACTERISTICS OUT-OF-LIMITS	MULTIPLE CHARACTERISTICS OF THE THIRD GENERATION GYRO WERE OUT OF LIMITS		SEE W313
W316 R1 ATTITUDE EROC	SEE W310	SEE W310	SEE W307

WAVER: TITLE:	NON-COMFORMANCE CONDITION:	AIR FORCE APPROVAL CONDITION:	NORTHROP COMMENTS:
U317	INTERNAL FREON VALVE CURRENT FREON CONTROL VALVE EXCEEDS ACCEPTANCE TEST PROCEDURE LIMITS FOR MAXIMUM CURRENT		
U318 R2	VALVE TORQUE, DRIVE, CURRENT RED RETEST PROCEDURE QUESTIONED BY AIR FORCE PLANT REPRESENTATIVE		UNIT WAS FLUSHED AND REFILLED WITH FLUID AND RETESTED WITHIN LIMITS
U319 R1	USE OF 3C0012E CAP. - LIFE CYCLE USE OF CAPACITORS WHICH HAVE NOT COMPLETED LIFE CYCLE TEST	FINANCIAL RESPONSIBILITY RESTS WITH CONTRACTOR - UNITS TO BE REPAIRED UPON RETURN FOR OTHER REPAIRS	
U323 R1	USE OF 3C0012E CAP. - DPA USE OF CAPACITORS WHICH HAVE NOT COMPLETED DESTRUCT PHYSICAL ANALYSIS	SEE U319 R1	
U324 R1	USE OF 300017 DIODE TWO DIODE LOTS COMBINED INTO SINGLE LOT TO FINISH QUALIFICATION TESTING	AUDIT OF MOTOROLA FLOOR PAPER TO ASSURE LOT TRACEABILITY	AUDIT COMPLETED AND RESULTS REPORTED TO AIR FORCE
U325	FOM SYSTEM ACCEPTANCE TEST PROCEDURE FAILURE OF FIGURE OF MERIT		SEE U329 R1
U327	ATTITUDE ERC SEE U310		SEE U307
U329	CONNECTOR DEFECTS USE OF CONNECTORS WHICH WERE FOUND TO HAVE PLATING DEFECTS	CONNECTORS TO BE REPLACED AT NO COST TO GOVERNMENT - FAILURE OF CONNECTORS TO BE REPAIRED AT NORTHROP'S EXPENSE AND WILL NOT AFFECT WARRANTY	
U330	CANNON CONNECTOR USE OF CONNECTORS WITH RECEPTICLES WHICH HAVE NOT BEEN GOLD PLATED	SEE U329	

WAIIVER: TITLE:	NON-COMFORMANCE CONDITION:	AIR FORCE APPROVAL CONDITION:	WORKSHOP COMMENTS:
W331 R1 TRN/GAM/DEUTSCH CONNECTOR	USE OF CONNECTORS WITH NON-MATING SURFACE OF THE PINS TIN-PLATED INCORRECTLY	SEE W329	
W332 HYBRID - UNIDENTIFIED	USE OF HYBRID WHICH WAS NOT IDENTIFIED ON THE KIT MANUFACTURING INVENTORY	VERIFICATION OF HYBRID PEDIGREE OR REPLACEMENT AT NO COST TO GOVERNMENT	
W333 FOM	SYSTEM ACCEPTANCE TEST PROCEDURE FAILURE OF FIGURE OF MERIT		SEE W291 R1
W334 HYBRID - NO BUILD PAPER	USE OF HYBRID WITH NO BUILD PAPER	VERIFICATION OR REPLACEMENT OF HYBRID AT NO COST TO GOVERNMENT	
W335 HIGH CIRCULATOR PUMP SPEED	CIRCULATOR PUMP SPEED WHICH EXCEEDS THE ACCEPTANCE TEST LIMITS		
W336 FOM	SYSTEM ACCEPTANCE TEST PROCEDURE FAILURE OF FIGURE OF MERIT		SEE W291 R1
W337 HYBRID - UNIDENTIFIED	USE OF HYBRID WHICH WAS NOT IDENTIFIED ON THE KIT MANUFACTURING INVENTORY		
W338 ATTITUDE EROC	SEE W310		SEE W307
W339 ATTITUDE EROC	SEE W310	UNIT TO BE BROUGHT UP TO SPECIFICATION AT FIRST RETURN TO THE FACTORY AT NO COST TO GOVERNMENT	
W340 ATTITUDE EROC/BETA	ATTITUDE ERROR RATE OF CHANGE AND BETA VALUE FOR ACCEPTANCE TEST PROCEDURE EXCEEDED LIMITS	SEE W339	SEE W307

11/24/87

AIR FORCE APPROVED PEACEMAKER IAU MAJOR WAIVERS

PAGE 3 OF 3

WAIVER: TITLE:	NON-COMFORMANCE CONDITION:	AIR FORCE APPROVAL CONDITION:	WORTHROP COMMENTS:
W350 ATTITUDE EROC	SEE W310		SEE W307
W351 ATTITUDE EROC	SEE W310		
W352 HIGH BETA	BETA VALUE FOR ACCEPTANCE TEST PROCEDURE OUT OF LIMITS		
W355 ATTITUDE EROC	SEE W310		SEE W307
W356 R1 ATTITUDE EROC	SEE W310	\$16,000 WITHHELD FROM UNIT PRICE UNTIL ENGINEERING CHANGE PROPOSAL NE 1011 APPROVED	SEE W307
W358 ATTITUDE EROC	SEE W310		SEE W307
W359 ATTITUDE EROC	SEE W310	SEE W356R1	SEE W307
W360 ATTITUDE EROC	SEE W310	SEE W356R1	SEE W307
W363 HIGH BETA	BETA VALUE FOR ACCEPTANCE TEST PROCEDURE OUT OF LIMITS	SEE W356R1	
W375 HARNESS CONNECTOR TRACEABILITY	USE OF HARNESSES WHICH HAVE CONNECTORS WITHOUT TRACEABILITY	UNIT PRICE REDUCED BY \$10,000	
W376 HARNESS CONNECTOR TRACEABILITY	USE OF HARNESSES WHICH HAVE CONNECTORS WITHOUT TRACEABILITY	UNIT PRICE REDUCED BY \$10,000	

Mr. LYNCH. My memory of that said that about half of the systems had waivers, about half passed through or had no waivers on them.

Mr. DINGELL. I have a list of IMU-approved waivers and deviations. It says—let's see here what we've got. One is an ECP [Engineering Change Proposal] title that we have here, for example, "Attitude Error Rate of Change (EROC)." Then again, "Attitude Rate of Change—Attitude Error Rate of Change."

Circuit card assembly units. Elimination of IMU-sphere level testing. Traceability on radiation-hardened parts—1P0006H crystals. Then again, circuit card assembly units, about five or six times.

Those are some of the examples of approved waivers and deviations. Traceability on radiation-hardened part. I'm not quite sure why radiation-hardened parts were needed, but apparently they thought enough to harden a part to withstand radiation, and if they can't trace it, I'm not sure they can tell whether it was hardened or performed according to specs.

Mr. LYNCH. I'm not sure of the report you're reading from, but it sounds to me that it's a listing of all of the waivers and deviations that have been granted on IMU's.

Mr. DINGELL. Approved waivers and deviations.

Mr. LYNCH. And I'm not sure what question—the fact is that units are shipped with waivers and deviations. I'm not quite sure what the question really is to me.

Mr. DINGELL. Well, apparently it's a part that was sufficiently critical, but it had to be hardened to withstand radiation.

Mr. LYNCH. The issue of radiation-hardened parts refers to another requirement of the specification, is that the MX missile be able to function and operate successfully in the event—in a nuclear event. In order for that to be accomplished by the guidance system, certain parts have to be then, as they put it, radiation-hardened.

Mr. DINGELL. I assumed this was a part that you hardened with radiation.

Mr. LYNCH. No, sir. It's a hardening against radiation, and there is a software in the overall system that permits the guidance system and the missile to function adequately in the event of a—in the event of that kind of event. That's what is meant by that.

Mr. DINGELL. I see.

Mr. LYNCH. But the fact is you have said yes, there are lists of waivers and deviations with regard to the guidance units.

Mr. DINGELL. I've got to recess the meeting for just a few minutes to vote. The bells ringing and the lights on up there say I have got to go. I will be back in about 10 to 15 minutes. If Mr. Wyden comes back before I do, he will start the committee again.

The committee will stand in recess for about 15 minutes.

[Brief recess.]

Mr. DINGELL. The committee will come to order.

Gentlemen, the Chair apologizes to you. A number of things came up, and I was not able to get back as quickly as I had hoped.

Mr. Lynch, in June of this year the General Accounting Office reported to this subcommittee that Northrop had lost control of a number of documents, records, blueprints on the Stealth bomber program. They reported as of December 1986 780 of these items

were unaccounted for. 205 additional items were under investigation, and an additional 384 may have been disposed of without proper documentation.

Can you tell us what is the status of these missing documents?

Mr. LYNCH. No, sir, unfortunately I can't. I was not aware that I was going to be—that was a matter we were going to discuss.

Mr. DINGELL. Would you inquire into it and——

Mr. LYNCH. I will certainly do that, sir.

Mr. DINGELL [continuing]. And let us know, please?

Mr. LYNCH. And provide the information as to that.

[The following information was received:]

UNCLASSIFIED

Answer 12

The figures shown in the GAO report for December 1986 are in error. The error occurred when the numbers in sub-categories of documents, which we provided to update the August 1986 totals, were inappropriately added together. That resulted in some double-counting of documents and produced a higher grand total than was actually correct. The erroneous and correct figures are the following:

	<u>GAO:DEC86</u>	<u>ACTUAL:DEC86</u>	<u>STATUS:NOV87</u>
TOTAL REPORTED	1822	1612	1612
RECOVERED	- 453	- 450	- 488
DISPOSED WITHOUT DOCUMENTATION	- 384	- 360	- 428
UNACCOUNTED FOR AND UNDER INVESTIGATION	985	802	696
UNDER INVESTIGATION	- 205	- 170	___0
UNACCOUNTED FOR	780	632	696

These unaccounted-for documents cover the period 1983 - 1986 and are a part of 500,000 documents generated and placed into accountability. Of the 500,000 documents, 250,000 have been destroyed with a remainder of 250,000 in inventory. Over the same time period, there were 800,000 transactions involving generation, transfer, reproduction, alteration, incorporation and destruction.

Mr. DINGELL. When Mr. Roy Kitchen, the CEO of Lockheed, described the situation of similar character, he said, and I quote:

“The laxness within our corporation is inexcusable.”

How would you describe the situation on this matter with regard to these papers at Northrop?

Mr. LYNCH. Well, I find the problem here, I would have to describe in a similar fashion to Mr. Kitchen. We have to have in classified documents perfection. We don't have—it's one thing to view that 780, well, then, ask the question out of how many. But any is too many in that particular case. The character of the project and the sensitivity, that's not an acceptable level of performance.

Now we have tightened our security, and that's not been warmly received, and efforts are being made to assure that the kind of conditions that could permit that would not occur.

Again, we deal with human imperfection, but that's not acceptable.

Mr. DINGELL. Now Northrop reported that the manager of your investigations unit was replaced, because the management was dissatisfied with the quality of the investigations. What has your new investigations manager done to improve the investigation and reports on which he labors?

Mr. LYNCH. I'm afraid again I'm at a disadvantage of the——

Mr. DINGELL. Would you like to submit that to the committee?

Mr. LYNCH. Again, I would appreciate that, sir.

[The information follows:]

The following actions have been taken to improve missing document investigations and resulting reports:

- (1) The investigation format has been standardized.
- (2) A training program was implemented and all missing document investigators are subjected to this training.
- (3) The missing document investigations activity was integrated into the Security Compliance and Audit department. This department is responsible for auditing the effectiveness of the document control system; therefore, is the most qualified to conduct investigations of documents reported missing. This restructuring brought current in-depth knowledge of the document control system to the investigative task.
- (4) Added emphasis was placed on determination of underlying causes, and appropriate corrective action plans are now in place.
- (5) A pre-release review of all investigation reports was established to validate the completeness and thoroughness of the investigation and resultant corrective action plans.

Mr. DINGELL. Mr. Lynch, Northrop has recently reported cost problems with regard to the Stealth bomber program. Can you tell us what is the current level of write-offs, overruns and so forth, on the Stealth program?

Mr. LYNCH. Well——

Mr. DINGELL. Would you want to submit that?

Mr. LYNCH. I'd very much appreciate that.

Mr. DINGELL. I have a notion that we ought to be cooperative with you because that——

Mr. LYNCH. All I can say is that we can certainly deal to the greatest extent we can deal with that from a financial records point of view, we will.

Mr. DINGELL. What I think I should do, I have several questions on this matter, and I will submit those to you for a response for the record. I think that would be a fair way to proceed.

Mr. LYNCH. Yes, sir, I'd appreciate that.

Mr. DINGELL. And then without objection, that will be inserted in the record at the appropriate place.

[The following information was received:]

WHO, IN CORPORATE MANAGEMENT, HAS RESPONSIBILITY TO ASSURE THAT THE INTERNAL AUDIT FUNCTION RETAINS ITS POWER AND INDEPENDENCE? WHAT ACTIONS HAVE BEEN TAKEN?

It is the policy of the Company to maintain a comprehensive program of internal auditing as an overall internal control measure to aid management at the Corporate Office and at the operating elements in achieving business goals in accordance with established policies and procedures and without undue business risk.

The Senior Vice President - Finance, who reports directly to the Executive Office, consisting of the Chairman of the Board and Chief Executive Officer, the Vice Chairman and the President and Chief Operating Officer, is responsible for creating and maintaining an effective internal audit program for implementing this policy. The Director - Auditing, who reports directly to the Senior Vice President - Finance, is responsible for devising appropriate audit plans and directing internal audit activities in a manner that will reasonably ensure objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed.

The Audit Committee of the Board of Directors, composed of outside directors, reviews with the Director - Auditing the opinions and other information developed from the audit program and requests such special reviews, follow-up reports and other internal audit activities as they deem appropriate.

The Senior Vice President - Finance maintains management oversight of the Company's internal audit activities and provides such direction as may be appropriate to assure the independence, objectivity and responsiveness of the internal audit program.

ALTHOUGH MR. LYNCH REFERS TO A HIGH LEVEL OF MANAGEMENT RESPONSE IN TERMS OF FINDINGS CLOSED, HE PROVIDES NO SPECIFIC EXAMPLES.

WHAT ACTIONS HAVE BEEN TAKEN ON THE VARIOUS INTERNAL AUDITS THAT HAVE BEEN CONDUCTED OVER THE PAST FIVE YEARS?

For use at the hearing on October 28, 1987, Northrop delivered to the Committee ten volumes of material including one hundred and seventy-three audit reports. The twenty-three hundred specific issues contained in those one hundred and seventy-three reports are the ones summarized below in response to your question about the actions taken. A copy of this summary material was included with the materials submitted with our letter of January 8, 1988.

HOW WILL NORTHROP ASSURE THAT NECESSARY AUDITS WILL BE PERFORMED AND ACTED UPON THROUGHOUT THE COMPANY ON A TIMELY BASIS?

Appropriate internal audits are conducted in accordance with an annual plan or as a result of special reviews as may be requested by the Audit Committee of the Board of Directors, the Senior Vice President - Finance, or others. The Director - Auditing develops annual plans for audit coverage of relevant business activities. In addition to independently developed areas to be covered, management throughout the Company is formally encouraged to submit recommended areas for audit, as indicated in the attached memorandum. Audit coverage is also coordinated with independent outside auditors and operating element internal audit organizations to ensure timely coverage of relevant issues and to avoid unnecessary duplication of effort.

The Corporate Audit organization subsequently provides corporate management and the Audit Committee of the Board of Directors with opinions and information derived from the program of audit coverage for the entire Company, and follows up audit recommendations to determine that they are implemented by affected management.

Attached is Corporate Functional Outline No. 155, which explains how the Company's audit policy is implemented.

No: CFO No. 155

Page 1 of 2

Date: 16 September 1985

Supersedes: CPD No. 155
dtd. 24 October 1983

DIRECTOR-AUDITING

SUMMARY

The Director-Auditing reports to the Senior Vice President-Finance and is responsible for directing a comprehensive program of internal auditing as an overall internal control measure to aid management at the Corporate Office and at operating elements in achieving business goals in accordance with established policies and procedures and without undue business risk.

SPECIFIC RESPONSIBILITIES

1. Develops and maintains the auditing standards, the approach, and the techniques by which all internal auditing at Northrop is to be performed and publishes this information in the Corporate Auditing Manual.
2. Devises annual plans of audit coverage that will result in a reasonable sampling of relevant business transactions, cycles, functions, and operations and provides a basis for forming opinions and reporting other important information with respect to:
 - the adequacy of the company's total internal accounting control systems for achieving stated objectives
 - compliance by company elements with Corporate Policy Directives, with emphasis on those pertaining to standards of business conduct
 - the efficiency and effectiveness of functions and techniques used by company elements for achieving operational objectives
 - the adequacy of security, control, and operational efficiency present in the company's various electronic data processing installations.

3. Coordinates audit coverage with independent outside auditors and operating element internal audit organizations to ensure reasonable coverage and to avoid unnecessary duplications of effort.
4. Provides advice and counsel to operating element management and chief auditors in organizing and staffing internal auditing organizations.
5. Reviews the performance of company element internal auditing functions for compliance with the requirements of the Corporate Auditing Manual.
6. Where appropriate, coordinates assignments with subsidiary and division management to facilitate efficient completion.
7. Develops the professional capability of the internal audit staff by on-the-job training, staff meetings, seminars, and other forms of professional training.
8. Ensures that evidential matter contained in work papers adequately documents work performed and supports conclusions contained in reports.
9. Reviews audit report drafts to ensure their high quality and to ensure that matters requiring management action are brought to its attention in a timely fashion.
10. Follows up audit recommendations to determine that they are implemented by affected management.
11. Directs the performance of such other special reviews as may be requested by the Audit Committee of the Board of Directors, the Senior Vice President-Finance, or others.
12. Reports to the Audit Committee of the Board of Directors the opinions and other information developed from the program of audit coverage.

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Memorandum

Northrop Corporation

In reply refer to

To Distribution From S. J. Root

Subject: 1988 Audit Plan Date November 23, 1987

Copies Ref

To assist in developing our 1988 audit plan, please advise me of all relevant topic areas which you believe require our attention.

In our normal planning process, we provide for auditing internal accounting controls, interim period financial reporting, operational efficiency and effectiveness, procedures aimed at compliance with government regulatory and contractual requirements, information systems and resource management, and standards for ethical business practices. On a rotational basis, we cover these functions by reviewing cash, procurement, payroll, program management, facilities management, inventory management, labor charging, overhead billings, expense reports, electronic data processing applications, etc., so that all major areas are reviewed every few years. These are periodically included in the annual plan for all major divisions. We also include other areas of operational interest such as quality assurance, production scheduling, human resource management, communications management, and toxic waste management.

During 1988, we also plan to initiate a program of audits designed to test compliance with procedural aspects of the Defense Industry Initiatives. These reviews will be conducted annually as surveys in a manner similar to our internal control surveys.

In addition, we perform consulting services in areas of finance, management control techniques, and aspects of information resource management. These projects may be included in the annual planning process or provided on an as needed request basis throughout the year.

If you have specific areas of interest which are not likely to be considered in our planning process, or if you would like to suggest areas where you believe our resources can best be used, please advise me by December 4, 1987. In addition, please include any comments or questions you may have regarding our audit service.

Your assistance is important.



S. J. Root
Director - Auditing

SJR:ss Distribution: All Corporate and Division Officers and Attorneys

Mr. DINGELL. Now, Mr. Lynch, there's a matter of special concern to the Chair and to this subcommittee, and that is the basic question of how one audits a program like Stealth, and how one can either expect that your company in-house can do a proper job, DOE auditors can do a proper job, GAO auditors can do a proper job of auditing these.

A former employee of yours—and to your credit, you have fired him—was convicted of taking kickbacks on the Stealth bomber program. In a taped conversation, which was recorded by the FBI, this individual boasted that no one was really looking into the programs, and that individuals could get very rich by ripping them off.

Now, as I have mentioned, the subcommittee is concerned about the ability of the company to audit and supervise these programs; about the ability of the Congress to audit and supervise these programs and about the ability of the GAO to get in and audit these things.

How can we deal with this problem of opportunists taking advantage of a situation which is surrounded with the most intense secrecy and national security implications?

Mr. LYNCH. Well, let me first comment that within our company, we have our outside auditors, and certain of those outside auditors are suitably cleared and have suitable access so they can participate in that.

Mr. DINGELL. How many auditors would be cleared properly to do this kind of work for you there at Northrop on, for example, the program I have been mentioning?

Mr. LYNCH. I'm not—you know, in this area, I don't—

Mr. DINGELL. I understand the difficulty of your responding to a question of this kind.

Mr. LYNCH. But could I, within the limits that we are permitted, through—

Mr. DINGELL. It will be fine to let you submit us an answer on that. In fact, I'll give you some questions on it that you can respond to.

Mr. LYNCH. I would very much appreciate that.

Mr. DINGELL. We will cooperate with you and with the necessary security concerns.

Mr. LYNCH. That would be most appreciated.

Mr. DINGELL. I think it's important for both of us.

[The following information was received:]

Auditors with ATB program access: Northrop internal auditors, 75; Touch Ross & Company retained external auditors, 12. In addition to the aforementioned Northrop auditors, there are Government DCAA (22) and AFPRO (67) personnel on site performing audit and contract administration functions.

Mr. DINGELL. Now, as a matter of fact, I will submit a number of other questions that will relate to this particular matter.

Mr. Lynch, in addition, I would observe that Northrop has indicated to the Defense Department that as a part of its recovery schedule, that it will deliver six IMU's per month for the rest of the year. Now I note that Northrop testified in June 1987 they were capable of meeting this delivery goal. It now appears, however, that projections of both Northrop and the Air Force indicate that we can only anticipate that three IMU's will be delivered in each of November—rather, October, November and December.

This is half the promised delivery, and falls short of your contractual delivery schedule. Can you give us some appreciation of whether that understanding by the subcommittee is correct? And if so, what are the problems?

Mr. LYNCH. Yes, sir. That basic projection is, as best I have it, correct. The—we have built up to and maintained the six a month rate through the summer of the year. That is at a recovery schedule which is in excess of the—of what we call the contract schedule.

Mr. DINGELL. Are you telling us that this will be in addition to the contract schedule?

Mr. LYNCH. Well, pardon me, sir, in addition to the contract schedule rate. Clearly we are not on contract schedule, and I think—so we are absolutely clear in our terms—we will not be until sometime next year. But the rate of contract schedule was typically 4, 3, 3, 3, 5, 4, 5, 2, 3, 2, 2, that type of a rate, averaging out slightly more than 3 a month. We have been operating, in order to recover the schedule—and as has been noted, we were 6 months late in the initial deliveries—we have to deliver at near twice that rate. That rate of six a month was our recovery schedule.

Now we have maintained that. I think the schedule was actually May, 6; June, 6; July, 4; August, 7; September, 6. So that we are close to or very close to the recovery rate. I think we fell one short behind that recovery rate through the end of September.

The projection right now for the next 3 months is that we will be behind that. We will be at about the contract rate, but not making the recoveries these next 3 months. Now that's been occasioned—

Mr. DINGELL. You're indicating that you will be delivering at the rate of about three a month?

Mr. LYNCH. It would average about three a month. Right now the present forecast is—and it will depend—is on forward bills, I think was—is 2, 3, 3 for the next 3 months, with the hope that we might be able to better that slightly, but more or less at about three a month.

Mr. DINGELL. Is there a reason why you're falling behind?

Mr. LYNCH. Yes, sir. The reason has been the shortage of—again a part shortage of fully qualified acceptable parts in that time period to maintain the recovery rate.

Mr. DINGELL. Should we give you the address of a good dumpster?

Mr. LYNCH. Well, if it would help, I'll take it. But, nonetheless, with the flow time it takes to build an IMU, you can predict where you are ahead based upon what your work-in-process is. If I don't have them done, I know I can't recover later. It's then scheduled that we will be back up to a forecast rate, recovery rate by January, and then we will complete the recovery in early next year. It means that we will not recover quite as soon as we had hoped, and that we had predicted back in June to the Air Force. That was done with our best knowledge at that time, and this is our best knowledge at this point.

Mr. DINGELL. One of the issues I raised earlier was the question of Radio Shack serving as one of your suppliers, and I think you thought I was kidding when I mentioned it. The staff did interview

a number of Northrop employees, and they indicated that parts were bought under petty cash funds, as referred to earlier in the testimony, from Radio Shack.

Mr. LYNCH. Well, I really didn't think you were kidding, because I've heard that, you know, issue before and I tried to—and if there's any ambiguity in my answers, I don't know.

Mr. DINGELL. Well, I buy from Radio Shack, they're excellent, but I'm—

Mr. LYNCH. In fact, so do I, and they have pretty good stuff, but not for what we require here. They certainly don't have the traceability that we want. But the point I tried to be—to be sure my answer was clarified, the answer is I don't know. Our records that our people have been able to find do not include invoices from Radio Shack, and so to the best of our knowledge, and the documentation that we reimbursed against, do not include that.

I understand that employees, or former employees, have said they did. I have been told by one of your staff that there are canceled checks to show that they did. Unfortunately, I have not seen those checks and I have no way of knowing whether they did or did not. All I can say is that the documentation that we have audited, against which we reimbursed, did not show that.

Mr. DINGELL. One of the concerns that the subcommittee always has relates to whistle-blowers and people like that who come forward to protest wrongful behavior with regard to the Government. We are always concerned that there are great pressures against honest men coming forward to correct the kinds of situations that you have been confronted with in the company, and matters which I really believe you, Mr. Lynch, are trying to correct. And the question that I have got to address is what could we do to assure that honest men are able to come forward and serve their Government well by seeing to it that improper practices that are going on come to a halt? How do we prevent penalties from being assessed against those people, and how do we assure that they are not be hurt or intimidated or frightened or unable to serve their Government, and to work with their employer to see to it that honest officers of companies with distinguished records, like yours, are able to correct abuses that necessarily occur? Not because they want to, but just because you can't avoid them somewhere in the chain of command of the company.

Mr. LYNCH. Well, we need that help, and we have tried to take some steps, and I have to say if people felt we were, I'll say disappointed and that if there was any feelings in our company that individuals could not come forward or would not be able to be fairly treated and have their positions objectively evaluated, but accepting the fact that apparently don't feel that they could in the company come forward, we have taken steps to try to make that a more—an easier thing. We have put hot lines now and insisted upon that in all of our operational levels, as well as our corporate office. We have set up individuals in each operation that can receive that kind of information, and either directly with attribution, or anonymously in that way if the individual is uncomfortable to give it directly, to try to be able to open those channels, and to make sure that people can feel both that they can openly discuss matters of concern to them, and that they can feel secure in them.

I am hopeful that that will improve that. We are—I will say we tend to find in asking Mr. Hays, who handles that for our corporate office, we find that we go through probably on the order of 10 allegations or findings in which then we find one that really deserves attention and substance.

But the fact that one is there——

Mr. DINGELL. Well, I realize that you get a lot of chaff with the wheat in that kind of arrangement.

Mr. LYNCH. Yes. I say the fact that one is there is reason enough. We have to look at each one of these things, and we do, to be sure that we both understand and take the action that's necessary.

I hope what we have done is going to be able to give the openness and the channel that we think is essential, not just to the Government and to you, but to us. Because we need that.

Mr. DINGELL. Mr. Lynch, the subcommittee wants to thank you. You have been here a long time, and we appreciate the assistance you have given us and the courtesy that you have shown us, and we thank you for your assistance.

The committee will be submitting a few questions to you for written answers, and we are sure you will cooperate, and without objection, those will be inserted in the record in the proper place.

The committee will stand adjourned to the call of the Chair.

[Whereupon, at 2:45 p.m., the subcommittee was adjourned.]

