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Operation Defcon

A Multiagency Approach to Defense Fraud Investigations

". . . Operation Defcon . . . represents one of the first approaches directed primarily at kickbacks in the aerospace/ defense industry."

By
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Over $55 billion of the Federal defense budget is spent annually in the greater Los Angeles area, which is home to 1,900 Government contractors and subcontractors.[1] According to the Federal Procurement Data Center, the State of California receives approximately 20 percent of Pentagon expenditures.[2] In fiscal year 1986, 10 Los Angeles-based companies[3] each received more than 200 prime defense contracts.[4] Thus, the opportunities for massive fraud, waste, and abuse exist within Southern California, as well as in many other areas of the country.

During 1984 and 1985, instances of defense procurement fraud became increasingly known to the FBI. Information was received from a number of aerospace and defense employees who were dissatisfied with a procurement system wherein buyers from prime and first-tier defense contractors frequently solicited kickbacks from vendors and suppliers in return for favorable consideration in issuing subcontracts and purchase orders. In October 1985, the FBI, the Department of Defense, Office of the Inspector General-Defense Criminal Investigative Service (DCIS), and the Internal Revenue Service (IRS) joined forces in Los Angeles to conduct an investigation, called "Operation Defcon," into kickback schemes related to defense contracts and subcontracts.

While the concept of a task force approach to address a particular Government fraud problem is not unique, the Los Angeles effort represents one of the first approaches directed primarily at kickbacks in the aerospace/defense industry. With the cooperation of defense contractors and executives, and the information provided by many long-term participants in kickback arrangements, the task force was able to complete the first phase of its investigation by July 1986. Defendants have pled guilty to a variety of Federal offenses, including violations of the Anti-Kickback Act,[5] Mail Fraud,[6] and Tax Evasion.[7] The subjects had received kickbacks on such projects as the U.S. Air Force F-16 fighter aircraft and the U.S. Navy F-18 fighter attack aircraft, the Air Force B-52 bomber, the Navy CH-53 helicopter, the Airborne Optical Adjunct Program for Army research relating to the U.S. Strategic Defense Initiative, the Army Black Hawk helicopter, and the NASA space shuttle solid fuel rocket booster. Most of the individuals charged had no criminal record and had been successful members of the aerospace community for many years.

Special Agent McChesney

Kickback Schemes

A typical kickback scheme begins after a military agency awards a contract to a prime contractor. The prime contractor may subcontract certain portions of the contract to "first-tier" contractors who perform a particular portion of the work needed to complete the contract. Both the first-tier and prime contractors generally require services, supplies, or other products to complete the contract. These items and services are generally obtained from local vendors or machine/fabrication shops.

In each level of contracting, the Government requires that qualified, interested parties be allowed to bid for work to be performed on Government contracts. An initial Government contract may be valued at several million dollars, and the value of the corresponding subcontracts or purchase orders may range from a few dollars to hundreds of thousands of dollars.

In order to obtain lucrative subcontracts or orders for goods or services that relate to the prime Government contract, vendors and suppliers will often aggressively "market" their business with buyers from the prime or first-tier subcontractors. Some vendors and suppliers may also use the services of "manufacturer's representatives."

Manufacturer's representatives represent several vendors or suppliers dealing in similar products and are occasionally middlemen in kickback schemes. The investigation uncovered such aggressive "marketing" techniques by vendors and suppliers as the provision of free meals, trips, automobiles, tickets, or personal loans. Similarly, buyers for prime or first-tier contractors may solicit gratuities or cash in return for subcontracts and purchase orders.

Buyers may operate the schemes on their own or work with other company employees (i.e., quality control, engineering, production, management). By working with production or engineering personnel, buyers are able to write requests for bids which are so specific that only one vendor is likely to be able to obtain the contract.

Vendors or suppliers attempting to obtain defense contract business are often willing to pay up to 10 percent of the face value of a purchase order or subcontract to a buyer if the work is awarded to them. Despite Federal legislation prohibiting kickbacks related to Government contracts and company ethics programs, the expectation of a 10-percent personal profit in the awarding of a subcontract or purchase order is a strong motivating factor for participating in a kickback arrangement. Because the kickbacks are generally in cash, few are reported as "income" to the Internal Revenue Service.

In most kickback schemes, a portion of the kickback is paid "up front" as the contract or purchase order is awarded. The remainder is paid when the contract performance has been completed. These schemes have the effect of falsely increasing the costs to the Government for goods and services. Some of the methods used in kickback arrangements include "bid rigging," "courtesy bidding," "sole source contracts," and "bid-bumping/overage."

Bid Rigging—In a bid rigging scheme, buyers or other procurement officials make discrete arrangements with a particular bidder from whom they accept some type of personal payment or gratuity. The selected company is provided proprietary information, including critical pricing data, which en-

"A cooperative relationship between the Government and defense contractors is paramount to kickback prevention."

ables the company to submit a bid that is either the lowest or contains enough specific information to make the company appear best suited for the contract. Bid rigging destroys competition and eliminates the opportunity for legitimate businesses to compete equally for Government contract work.

Courtesy Bids—A buyer or procurement official may conduct business regularly with several vendors or suppliers who participate in this scheme by submitting bids on all potential contracts. In each instance, the amount of the lowest acceptable bid is provided by the buyer to one selected vendor or supplier on a rotating basis. The selected vendor is awarded the subcontract or purchase order, while the other participating vendors provide higher, unacceptable bids as directed by the buyer. The vendor who receives the bid or purchase order is responsible for paying the kickback to the buyer. Vendors "take turns" at being the designated awardee. This scheme differs from bid rigging in that courtesy bidding requires the participation of several vendors or suppliers, whereas bid rigging occurs between the buyer and the contract awardee only.

Sole-source Contracts—While only a few "sole-source" contracts are involved in fraudulent schemes, this arrangement is an easy way to award contracts and purchase orders to a favored vendor. In this scheme, a vendor or supplier is designated by the buyer as a "sole source" for a particular part, product, or service. A sole-source designation infers that one particular vendor or supplier is the only acceptable, approved source of the product or service. Sole-source items are generally unique and rare and are likely to be very expensive. The sole-source nature of the items or service is often inaccurate or exaggerated. As in other schemes, the designated vendor or supplier pays a specified percentage of each contract awarded to the buyer.

Bid-bumping/Overage—Prior to issuing subcontracts or purchase orders, buyers are aware of the maximum amount a company is willing to spend on the subcontract. In this scheme, the buyer advises a vendor or supplier how much his proposed bid can be raised ("bumped up") and his company still win the subcontract. A portion of amount of the "bump" (usually 50 percent) is kicked back to the buyer. The "bump" or "overage" portion is in addition to the original kickback paid by the vendor to the buyer for the receipt of the subcontract or purchase order.

New Legislation

The Anti-Kickback Act of 1986 stagnated in Congress in mid-1986. However, following the massive publicity generated by the indictments of Operation Defcon defendants, congressional interest in the bill was renewed, helping to ensure the bill's passage in October 1986. The passage of the act amended and strengthened the original Anti-Kickback Act of 1946 to include solicitation for kickbacks and attempts to provide or offer kickbacks as criminal acts. The act increased the criminal penalty to a maximum of 10 years' imprisonment and a $10,000 fine per violation. A unique part of the act requires that prime contractors have procedures in place to prevent and detect violations of the act. Prime contractors or subcontractors must report possible violations in writing to the inspector general of the contracting agency.

The False Claims Amendments Act of 1986 provides that any individual who knows of false claims made by a contractor to the Government may file a Federal lawsuit against a contractor on behalf of the Government and himself.[8] The complaining party is entitled to receive from 15-30 percent of any recovery obtained in the case. The strength of the act is the provision for triple damages and its 10-year statute of limitations. The act, often referred to as "whistle-blower" legislation, also contains strong protection against the harrassment or firing of complaining witnesses.

Kickback Prevention

Notwithstanding the mandate set forth in the amendments to the Anti-Kickback Act, it is extremely important for defense contractors, or any other contractor involved in business with the Government, to establish policies with respect to gratuities and kickbacks. These policies, of course, should be in conformance with Federal and State law. They must be communicated to each employee and followup conducted to ensure that the employee understands the policy. Finally, internal controls have to be established to ensure adherence to the policies.

A cooperative relationship between the Government and defense contractors is paramount to kickback prevention. The experience of Operation Defcon clearly showed the contractors' dedication to dealing with the kickback problem. Communication between the investigators and company security personnel enabled the investigation to proceed without delay.

Contractors benefit from the cooperative relationship with Government investigative agencies, especially when unscrupulous buyers or other employees are identified. These buyers reap extra personal profits and deprive vendors and suppliers from participating in fair business practices. Vendors and suppliers benefit from Government investigations by the deterrent effect of a Government prosecution. The deterrent effect of a case like Operation Defcon is difficult to quantify; however, industry sources indicate that most buyers and vendors are aware of the Government's investigation and commitment to eliminating this problem.

Conducting business with the U.S. Government is unlike business conducted between private sector corporations. It has long been a common practice for many private businesses to show signs of appreciation to their customers with gifts or other remembrances. This practice, or the appearance of this practice, is not acceptable among those companies who conduct business using taxpayer dollars. Government contractors should take every precaution to avoid even the perception that they are involved in unethical business procedures.

Summary

The major advantage of any task force approach is the complementary effect of investigative resources. By combining the unique abilities and expertise of Special Agents from the FBI, DCIS, and IRS, the Operation Defcon task force is uniquely able to investigate kickback schemes. The inclusion of the IRS in this investigation has allowed the Government to include tax avoidance or tax evasion charges, in addition to kickback counts. In those rare instances where individuals did claim money generated from kickbacks as "income," the source of the income was disguised. In addition, continued assistance from the U.S. attorney's office is particularly important. From the outset of this investigation, prosecutors were intrinsically involved with legal issues and task force goals.

The task force is located in a centralized office, allowing for the essential daily contact between the investigators from the participating agencies. Extraordinary investigative expenses are shared among the FBI, IRS, and DCIS. As the investigation progressed, additional assistance to the task force was provided by the Defense Contract Audit Agency (DCAA) and the National Aeronautics and Space Administration (NASA).

In kickback cases, as in all Government fraud cases, it is critical that the FBI work closely with the affected (victim) Government agency. These agencies have access to necessary information and documentation which might otherwise be unknown or unavailable to the FBI.

Investigations of defense procurement kickback schemes in the Los Angeles and Southern California area are continuing. A special hot-line has been instituted to accept information from the public regarding defense procurement fraud. In addition, the FBI works closely with the Air Force Office of Special Investigation (AFOSI), U.S. Army Criminal Investigative Division (USACID), and the U.S. Naval Investigative Service (USNIS) to investigate other types of defense fraud. These investigations involve contract mischarging, false certification of testing, defective pricing, and product substitution.

Operation Defcon investigators remain committed to identifying, investigating, and prosecuting subjects involved in defense fraud. During 1987, the expertise developed in investigating kickback cases was used to conduct briefings and training sessions for over 200 investigators from various defense investigative agencies throughout the country. Information regarding defense procurement fraud investigations may be obtained from Operation Defcon task force members through the FBI, Los Angeles. FBI

Footnotes

[1] "Top 25 Defense Contractors in Los Angeles County," *Los Angeles Business Journal*, August 3, 1987, p. 24; the dollar amount given includes military salaries and facility expenses.

[2] Ibid.

[3] The companies are Hughes Aircraft, McDonnell Douglas, General Dynamics, TRW, Lockheed, Northrop, Litton Industries, Garrett Corp., Todd Pacific Shipyards, and Computer Sciences Corp.

[4] Prime contracts are defined as $25,000 or larger.

[5] 41 U.S.C. 51-54.

[6] 18 U.S.C. 1341.

[7] 42 U.S.C.

[8] 31 U.S.C. 3729-3731.