

GAO

Report to the Ranking Minority Member,
Committee on Commerce, House of
Representatives

July 1995

DEFENSE CONTRACTING

Contractor Claims for Legal Costs Associated With Stockholder Lawsuits





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

National Security and
International Affairs Division

B-258172

July 17, 1995

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

This report responds to your inquiry concerning the allowability of legal costs resulting from stockholder derivative lawsuits associated with defense contractor wrongdoing. As your letter indicates, the wrongdoing involves fraudulent activities engaged in by the defense contractor named in the stockholder lawsuit. Specifically, you requested current information on the (1) defense procurement fraud cases, as previously reported on by us;¹ (2) Defense Contract Audit Agency's (DCAA) policy on the allowability of legal fees associated with stockholder derivative lawsuits; and (3) number of stockholder lawsuits associated with defense contractor wrongdoing. You also asked whether reimbursement for these costs has been a common practice.

Background

The Major Fraud Act of 1988 (P.L. 100-700) and the Federal Acquisition Regulation (FAR) addresses the allowability of defense contractors' legal fees and other proceeding costs related to litigation with the federal government. However, neither the act nor the FAR expressly addresses the allowability of legal costs associated with stockholder derivative lawsuits based on prior corporate wrongdoing.

DCAA performs contract audit functions for the Department of Defense (DOD) and provides accounting and financial advisory services to DOD components responsible for procurement and contract administration. In addition, DCAA audits costs and makes recommendations regarding the allowability of costs claimed or proposed by contractors. We asked DCAA for its views on the legal costs you questioned.

Results in Brief

DCAA responded that, according to its research, the FAR contains no cost principle dealing specifically with the allowability of legal fees associated

¹Defense Procurement Fraud: Information on Plea Agreements and Settlements (GAO/GGD-92-135FS, Sept. 17, 1992). This fact sheet contained information on cases the Department of Justice brought against the companies that received large DOD contracts in 1991 that resulted in criminal convictions or civil settlements or judgments.

with defending against stockholder derivative lawsuits. However, its research concluded that such costs are unallowable under the FAR cost principle on reasonableness of costs (FAR 31.201-3) when the lawsuit is based on contractor wrongdoing. As a result, DCAA addressed this situation by issuing audit guidance, on April 13, 1995, that now specifically deals with these costs. The guidance requires auditors to question costs incurred to defend against stockholder lawsuits related to contractor wrongdoing. (See app. I.)

From October 1988 through December 1994, there were 72 cases involving procurement fraud—30 criminal and 42 civil—associated with firms on DOD's Top 100 Contractor list.² Criminal fines, awards, and restitution amounts approximated \$1.03 billion. (See app. II.)

It is not apparent that claiming reimbursement for stockholder derivative legal costs is a common practice. Of these 72 procurement fraud cases, only 13 associated with 8 companies involved stockholder lawsuits. The legal costs of the stockholder lawsuits for the eight companies totaled approximately \$15 million; \$6,232,150 was being claimed under defense contracts by four of these contractors. (See app. III.)

Agency Comments

DOD reviewed a draft of this report and concurred with its findings. (See app. IV.)

Scope and Methodology

We updated the list of defense procurement fraud cases through information provided by (1) the DOD Inspector General's Criminal Division, the Department of Justice, the Securities and Exchange Commission, and DCAA and (2) a literature search. This information covered cases from October 1988 through December 1994.

To develop a list of stockholder derivative lawsuits, we reviewed those contractors on DOD's list of top 100 contractors that had criminal procurement fraud convictions or had agreed to settlements in civil actions for procurement fraud. We established which of the 100 contractors had stockholder lawsuits and reviewed the legal costs associated with these suits.


²DOD maintains a list of the top 100 contractors with the largest defense contracts based on dollar amount of their contracts. DOD's Office of the Inspector General, Criminal Division, semiannually compiles a list of contractors, based on DOD's top 100 contractors list, that were convicted of procurement fraud.

Securities and Exchange Commission officials provided us with quarterly and annual disclosure reports that corporations are required to file.³ These reports contained information pertinent to stockholder litigation, if any, against the subject corporation. We also reviewed DCAA audit reports for the 10 contractors on our list with the highest penalties to determine if DCAA had questioned the allowability of costs associated with any related stockholder lawsuits.

Once our list was developed, we sent confirmation letters to 39 corporations in our universe to verify the stockholder lawsuits, legal costs incurred, and amounts claimed for reimbursement. We received 31 responses that confirmed the number of stockholder lawsuits already obtained from the other sources. We did not independently verify the information obtained from the contractors or other sources. We conducted our review from July 1994 through May 1995 in accordance with generally accepted government auditing standards.

If you or your staff have any questions about this report, please contact me on (202) 512-4587. The major contributors were Charles Rey, Assistant Director; Don Watson, Evaluator-in-Charge; and Jimmy Palmer, Jr., Evaluator.

Sincerely yours,

A handwritten signature in black ink, reading "David E. Cooper". The signature is fluid and cursive, with the first name "David" being the most prominent.

David E. Cooper
Director, Acquisition Policy, Technology,
and Competitiveness Issues

³These reports are known as 10Q Quarterly Report pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934 and 10K Annual Report pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934.

Contents

Letter	1
Appendix I Defense Contract Audit Agency’s Policy on the Allowability of Contractor Claims for Legal Costs Associated With Stockholder Lawsuits	6
Appendix II Criminal and Civil Procurement Fraud Cases Involving Top 100 DOD Contractors, October 1988 Through December 1994	10
Appendix III Contractors With Stockholder Derivative Lawsuits and Associated Costs	14
Appendix IV Comments From the Department of Defense	15
Tables	
Table II.1: Criminal Procurement Fraud Dispositions	10
Table II.2: Civil Procurement Fraud Settlements	12

Contents

Abbreviations

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
FAR	Federal Acquisition Regulation

Defense Contract Audit Agency's Policy on the Allowability of Contractor Claims for Legal Costs Associated With Stockholder Lawsuits

On April 13, 1995, the Defense Contract Audit Agency (DCAA) responded to our request for information on its policy regarding the allowability of legal costs associated with stockholder derivative lawsuits based on prior litigation with the government. DCAA researched the allowability of these costs and determined that there was no Federal Acquisition Regulation (FAR) cost principle dealing specifically with them. However, because DCAA determined that they are unallowable under the FAR cost principle for determining reasonableness, DCAA issued the enclosed audit guidance memorandum.

**Appendix I
Defense Contract Audit Agency's Policy on
the Allowability of Contractor Claims for
Legal Costs Associated With Stockholder
Lawsuits**



IN REPLY REFER TO

**DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VA 22304-6178**

**13 April 1995
95-PAD-062(R)**

PAD 730.31/95-14

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Allowability of Costs Incurred in
Defense of Stockholder Suits

SUMMARY

Auditors should question costs incurred to defend against stockholder suits that are related to contractor wrongdoing. The costs should be questioned as directly related to an unreasonable action (the wrongdoing).

BACKGROUND

There are two types of stockholder suits, direct actions and derivative actions. A direct action is a suit brought by stockholders of a corporation against the corporation and/or its officers/directors to protect an interest specific to the stockholder. Examples of these types of actions are suits alleging wrongful denial of the stockholder's right to exercise a stock option or wrongful exclusion of the stockholder from voting his/her shares of stock.

A derivative action is suit brought by stockholders to enforce a right of the corporation. Example of derivative actions are suits to recover damages from officers/directors that were allegedly sustained as a result of actions taken by the officers/directors. Depending upon the nature of the suit, state law may obligate the corporation to defend the officers/directors.

The costs of a legal proceeding to defend against stockholder suits are not expressly unallowable under FAR 31.205-47, "Costs related to legal and other proceedings." This cost principle applies to proceedings brought by a Federal, state, local or foreign government. However, stockholder suits may follow after a contractor has lost or settled a legal proceeding which is covered by FAR 31.205-47(b) or (f)(4). In losing or settling such a proceeding, the contractor may become vulnerable to an allegation that it was guilty of wrongdoing and that the wrongdoing ultimately caused damages to the stockholders by the lowered value of the corporation's stock or dividends. Stockholders may sue the corporation and/or its officers/directors to recover those real or perceived reductions in value.

Appendix I
Defense Contract Audit Agency's Policy on
the Allowability of Contractor Claims for
Legal Costs Associated With Stockholder
Lawsuits

PAD 730.31/95-14

SUBJECT: Audit Guidance on Allowability of Costs Incurred in
Defense of Stockholder Suits

Costs of defending against stockholder suits are normally composed of internal and external legal service costs. If the contractor and/or its officers/directors lose the suit, the contractor may be required to pay damages as well as the legal costs of the stockholders.

GUIDANCE

Wrongdoing

We believe that wrongdoing includes actions such as those described in FAR 31.205-47(b) & (f)(4), intentional harm to other persons, and instances where there has been a reckless disregard for the harmful consequences of an action. Wrongdoing is demonstrated when a court or a board has found that the contractor and/or its officers/directors have engaged in any of the aforementioned actions. In addition, we consider that wrongdoing also is demonstrated when there is a settlement without a finding of a court or board, if the facts underlying the settlement indicate that the contractor and/or its officers/directors have engaged in any of the aforementioned actions.

When a stockholder suit relates to the type of wrongdoing described in FAR 31.205-47(b) or (f)(4), the auditor will need to document that (i) contractor wrongdoing exists, and (ii) the stockholders' suit cites a legal proceeding of the type covered by FAR 31.205-47(b) or (f)(4) as the cause of the damages.

When a stockholder suit relates to wrongdoing against private persons (intentional harm to other persons or a reckless disregard for the consequences of the actions taken), the auditor must document that (i) wrongdoing exists, and (ii) the stockholder suit is related to the harm that the wrongdoing caused to the private party. An allegation of wrongdoing, in itself, is not sufficient evidence to establish unallowability of costs. Nor should an auditor presume that such an allegation establishes wrongdoing merely because the charges result in a settlement. The auditor must determine that an allegation, not resulting in a judgement, is supported by independent evidence which convinces an impartial fact finder that wrongdoing, within the meaning of this guidance paper, occurred. The basis for the auditor's determination must be explained in the workpapers with citations to the supporting documentation.

Direct Actions

When there is a direct action stockholder suit related to contractor wrongdoing, the costs should be questioned as

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Legal Costs Associated With Stockholder
Lawsuits

PAD 730.31/95-14

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Defense of Stockholder Suits

unreasonable. The contractor would not have found itself in the position of being sued for damages to stockholders but for the wrongdoing. The costs incurred to defend against the wrongdoing are unallowable under FAR 31.201-3, Determining reasonableness, since the wrongdoing is not the type of action that would be undertaken by a reasonably prudent business person. Similarly, payment of damages or the stockholders' legal costs in pursuing these cases are also unallowable.

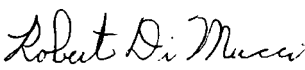
Derivative Actions

The guidance regarding direct actions also applies to derivative actions. In the case of derivative actions, the contractor may argue that state law obligates the contractor to defend the officer/director against the suit, because the officer/director was acting in his/her official capacity as a representative of the corporation. For example, under Delaware law, a corporation must defend the actions of its directors if they are challenged in court.

However, if the auditor is able to demonstrate that wrongdoing exists and that the wrongdoing relates to the stockholder suit, the fact that state law requires the contractor to defend against the suit is not determinative. The actions of the officer/director were not the type of action that would be undertaken by a reasonably prudent business person. Since the imprudent actions were taken by an officer/director who was acting in their official capacity as a representative of the corporation, the costs to defend against the suit are unreasonable, even though state law obligates the contractor to defend against the suit.

CONCLUDING REMARKS

Field office personnel should direct any questions regarding this memorandum to appropriate regional personnel. Regional personnel should direct questions to Mr. H. Clyde Wray, Program Manager, Accounting Policy Division, at (703) 274-6343.


FOR Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

DISTRIBUTION: C

Criminal and Civil Procurement Fraud Cases Involving Top 100 DOD Contractors, October 1988 Through December 1994

Table II.1: Criminal Procurement Fraud Dispositions

Case number	Contractor	Case type	Case disposition	Date of conviction	Criminal fine	Restitution
1	Bicoastal Corporation	Procurement and mail fraud	Pled guilty	11/04/93	\$1,000,000	\$55,600,000
2	Boeing Company	Procurement fraud	Pled guilty	11/13/89	20,000	4,000,000
3	E Systems	Procurement fraud	Pled guilty	10/02/90	2,000,000	1,800,000
4	Emerson Electric Company	Procurement fraud	Pled guilty	5/11/90	40,000	9,000,000
5	Exxon Chemical Company	Procurement fraud	Pled guilty	11/10/93	3,801,875	None
6	Fairchild Industries Incorporated	Procurement fraud	Pled guilty	5/11/90	2,950,000	None
7	General Electric Company	Procurement fraud	Pled guilty	7/22/92	69,000,000	None
8	General Electric Company	Procurement and mail fraud	Found guilty	2/02/90	10,000,000	2,200,000
9	General Electric Aircraft Engines	Procurement and mail fraud	Found guilty	3/07/94	9,500,000	69,500,000
10	Grumman Corporation	Procurement fraud	Pled guilty	3/16/90	20,000	None
11	GTE Government Systems Corporation	Procurement fraud	Pled guilty	2/03/89	20,000	None
12	Harris Corporation	Kickback	Pled no contest	7/02/89	200,000	None
13	Hazeltine Corporation (subsidiary of Emerson Electric Company)	Procurement fraud	Pled guilty	1/06/89	1,000,000	None
14	Hughes Aircraft Company (subsidiary of General Motors Corporation)	Procurement fraud	Found guilty	6/15/92	3,500,000	None
15	Hughes Aircraft Company (subsidiary of General Motors Corporation)	Procurement fraud	Pled guilty	3/09/90	20,000	None
16	Ladish Company	Procurement fraud	Pled guilty	11/09/92	751,600	None
17	Litton Systems, Incorporated	Procurement fraud	Pled guilty	1/14/94	3,900,000	None
18	Loral Corporation	Procurement fraud	Pled guilty	12/08/89	1,500,000	None

(continued)

Appendix II
Criminal and Civil Procurement Fraud Cases
Involving Top 100 DOD Contractors,
October 1988 Through December 1994

Case number	Contractor	Case type	Case disposition	Date of conviction	Criminal fine	Restitution
19	LTV Aerospace and Defense Company	Procurement fraud	Pled guilty	8/14/90	10,000	None
20	Magnavox Government and Industrial Electronics Company	Procurement fraud	Pled guilty	9/17/90	150,000	None
21	Northrop Corporation	Procurement fraud	Pled guilty	2/27/90	17,000,000	None
22	Raytheon Corporation	Procurement fraud	Pled guilty	3/20/90	10,000	None
23	RCA Corporation (subsidiary of General Electric)	Procurement fraud	Pled guilty	2/05/90	20,000	None
24	Rockwell International Corporation	Procurement fraud	Pled guilty	1/19/89	5,500,000	446,000
25	Science Applications International	Procurement fraud	Pled guilty	8/26/91	550,000	None
26	Sundstrand Corporation	Procurement fraud	Pled guilty	10/19/88	500,000	None
27	Sundstrand Corporation	Procurement fraud	Pled guilty	10/21/88	115,000,000	None
28	Teledyne Incorporated	Procurement fraud	Pled guilty	10/02/92	17,500,000	None
29	Teledyne Incorporated	Procurement fraud	Pled guilty	3/23/89	1,500,000	None
30	Unisys Corporation	Procurement fraud	Pled guilty	9/06/91	4,000,000	None
Total					\$270,963,475	\$142,546,000

Sources: This listing is derived from data provided by the DOD Inspector General and the Department of Justice. Additionally, information addressing this subject was contained in our September 1992 report..

Appendix II
Criminal and Civil Procurement Fraud Cases
Involving Top 100 DOD Contractors,
October 1988 Through December 1994

Table II.2: Civil Procurement Fraud Settlements

Case number	Contractor	Type case	Case disposition	Date of disposition	Award to the government
1	Argosystem Incorporated (subsidiary of Boeing Company)	Voluntary disclosure fraud	^a	^a	\$3,000,000
2	Argosystem Incorporated (subsidiary of Boeing Company)	False Claims Act	Settled without litigation	12/23/92	868,000
3	AT&T Company	Procurement fraud	Settled without litigation	9/12/90	625,000
4	Avondale Industries, Incorporated	Procurement fraud	Settled without litigation	10/10/89	2,500,000
5	Boeing Company	False Claims Act	Settled without litigation	4/29/94	75,000,000
6	Boeing Company	False Claims Act	Settled without litigation	4/15/94	250,000
7	CAE Link & Singer Company	False Claims Act	Settled without litigation	9/92	55,500,000
8	Computer Sciences Corporation	Procurement fraud	Settled without litigation	10/09/90	1,750,000
9	Ex Cell O Corporation (subsidiary of Textron)	Procurement fraud	Settled without litigation	8/20/90	91,000
10	Ex Cell O Corporation (subsidiary of Textron)	Procurement fraud	Settled without litigation	9/20/90	3,650,000
11	Federal Express	False Claims Act	Settled without litigation	8/21/92	950,000
12	Ford Aerospace & Communications Corporation	Procurement fraud	Settled without litigation	10/06/89	200,000
13	Ford Aerospace & Communications Corporation	Procurement fraud	Settled without litigation	8/10/90	119,250
14	Ford Aerospace & Communications Corporation	Voluntary disclosure fraud	Settled without litigation	8/10/90	111,300
15	Ford Motor Company	Procurement fraud	Multiple disposition	8/10/90	2,606,063
16	General Dynamics Corporation	Procurement fraud	Settled without litigation	11/21/88	2,600,000
17	General Dynamics Corporation	Procurement fraud	Postfiling settlement	12/20/91	8,000,000
18	Honeywell, Incorporated	Voluntary disclosure fraud	Settled without litigation	1/03/91	700,000
19	Litton Systems, Incorporated	False Claims Act	Settled without litigation	7/14/94	82,000,000
20	Litton Systems, Incorporated	Procurement fraud	Settled without litigation	5/06/91	2,400,000

(continued)

**Appendix II
Criminal and Civil Procurement Fraud Cases
Involving Top 100 DOD Contractors,
October 1988 Through December 1994**

Case number	Contractor	Type case	Case disposition	Date of disposition	Award to the government
21	Litton Systems, Incorporated	False Claims Act	Settled without litigation	1/14/94	2,400,000
22	Lockheed Corporation	False Claims Act	Settled without litigation	8/04/92	1,042,144
23	Lockheed Corporation	False Claims Act	Settled without litigation	4/30/93	639,641
24	Martin Marietta Corporation	Procurement fraud	Settled without litigation	4/22/92	752,000
25	McDonnell Douglas Corporation	Qui tam ^b	Postfiling settlement	8/29/89	28,000
26	McDonnell Aircraft Company	Procurement fraud	Settled without litigation	3/13/91	1,100,000
27	Olin Corporation	Voluntary disclosure fraud	Settled without litigation	5/17/91	694,586
28	Olin Corporation	False Claims Act	Settled without litigation	9/13/93	325,000
29	Texas Instruments, Incorporated	Voluntary disclosure fraud	^a	^a	230,750
30	Texas Instruments, Incorporated	False Claims Act	Settled without litigation	8/05/94	5,000,000
31	Texas Instruments, Incorporated	False Claims Act	Settled without litigation	8/26/92	36,526
32	Texas Instruments, Incorporated	False Claims Act	Settled without litigation	8/25/92	550,000
33	Tracor Corporation	Defective pricing	Settled without litigation	8/15/91	450,000
34	TRW, Incorporated	False Claims Act	Settled without litigation	6/28/93	2,500,000
35	TRW, Incorporated	False Claims Act	Settled without litigation	4/15/94	29,000,000
36	Unisys Corporation	Qui tam ^b	Postfiling settlement	9/06/91	8,200,000
37	Unisys Corporation	Qui tam ^b	Postfiling settlement	9/06/91	3,200,000
38	Unisys Corporation	Bribery, conflict of interest and kickback	Settled without litigation	9/06/91	159,000,000
39	United Technologies	False Claims Act	Settled without litigation	3/30/94	150,502,931
40	United Technologies	False Claims Act	Settled without litigation	8/28/92	4,000,000
41	Varian Associates, Incorporated	Procurement fraud	Settled without litigation	12/13/88	2,430,000
42	Westinghouse Electric Corporation	Procurement fraud	Settled without litigation	7/07/91	665,000
Total					\$615,667,191

^aThe Department of Justice has won one or more awards and is pursuing further relief in the case.

^bA qui tam action is one in which a private party brings suit in the name of the United States and is entitled to a portion of the proceeds if the prosecution is successful.

Sources: Data obtained from the DOD Inspector General and the Department of Justice. Other information addressing this subject was contained in our September 1992 report.

Contractors With Stockholder Derivative Lawsuits and Associated Costs

Data in this appendix were obtained from contractor confirmation letters, DCAA responses to our requests for information, and Securities and Exchange Commission reports. To protect the potentially proprietary nature of the data, we have replaced the names of affected companies with alphabetic labels (A-H).

Contractor	Number of suits	Total legal costs incurred	Amount claimed ^a
A	1 ^b	Not given ^b	None will be claimed ^b
B	1 ^b	\$500,000 ^b	\$18,000 ^b
C	4 ^d	1,400,000 ^c	1,400,000 ^c
D	1 ^b	Not given ^b	None will be claimed ^b
E	1 ^b	180,493 ^b	54,150 ^b
F	2 ^d	5,020,000 ^c	None claimed ^c
G	1 ^b	3,020,000 ^c	None claimed ^b
H	2 ^d	4,760,000 ^c	4,760,000 ^c
Total	13	\$14,880,493	\$6,232,150

^aAccording to DCAA, the amount claimed by the contractor in its submission and the amount reimbursed by the government may vary.

^bReplies from contractor confirmation letters.

^cResponse from DCAA to our request for information and reports.

^dResponse from Securities and Exchange Commission to our request for information.

Comments From the Department of Defense



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OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

JUN 19 1995



Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Hinton:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "DEFENSE CONTRACTING: Contractor Claims for Legal Costs Associated With Shareholder Lawsuits," dated June 8, 1995 (GAO Code 705068/OSD Case 9959).

The DoD has reviewed the draft report and concurs without further comment. Suggested technical changes have been provided separately. The Department appreciates the opportunity to review the report in draft form.

Sincerely,

Eleanor R. Spector
Director, Defense Procurement



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