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A Cost of Doing Business: Defense Contracting Fraud

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The Cost of Doing Business

In March 2001, defense contractor EOTech signed a \$7.35 million agreement with the Department of Defense to provide sights for automatic rifles. The sights were defective; they lost accuracy at extreme temperatures, despite EOTech's explicit promises. In fact, the potential for failure was so great that the Norwegian military declined to purchase the sights before EOTech attempted to sell them to the United States. Internal EOTech documents revealed that the company was aware of the flaws and still marketed them to the military without proposed fixes.

It was not until the FBI conducted an independent investigation that EOTech's sights were found to be faulty by the United States. After the FBI discovered the flaws, the US Attorney Preet Bharara's office filed a civil suit. EOTech settled within 24 hours. Instead of being disallowed to bid for contracts, EOTech continued to bid and receive contracts with the United States government.

Despite allegations of fraud substantiated by an FBI investigation and US Attorney's office that span over 10 years, defense contractor EOTech remains eligible to do business with the US. EOTech agreed to pay \$25.6 million to the US Government in November 2015 to settle allegations that the company violated the False Claims Act and defrauded the Department of Defense, the Army and the Navy over a 10-year period.

EOTech is not alone: since 2000, eight of the largest defense contractors have been found criminally or civilly liable for fraud yet continue to do business with the US government.

Suspension & Debarment

Suspension and debarment are measures that the US government can take to protect tax dollars from being wasted by fraudulent or potentially fraudulent contractors. The law makes it very clear: suspension and debarment are not considered to be punishments.

"The debarment remedy is one of the government's most powerful tools to protect taxpayers from entities who engage in dishonest, unethical or otherwise illegal conduct or are unable to satisfactorily perform their responsibilities under Federal funded awards," said David M. Sims, chair of the Interagency Suspension and Debarment in a statement before the Senate Committee on Homeland Security and Governmental Affairs. "Debarment is a discretionary decision by the Government as a consumer of goods and services, which serves the purpose of protection not punishment."

[A memo](#) from Sally Quillian Yates, the deputy Attorney General, clarifying the justice department's role in preventing or prosecuting contractor fraud and misconduct lists "exclusion,

suspension and debarment” as one of “remedies” for fraud alongside civil or criminal prosecution.

Suspension and debarment are tools that the government can use to protect itself from conscious or negligent fraud. Though both prevent contractors from making money from government contracts they are, according to experts and the governing guidelines, they are tools for the government to proactively protect itself going forward, not punishments meant to harm contractors.

[The Federal Acquisition Regulation \(FAR\)](#) is the law that governs why and the government may seek assistance from the private sector. The far-reaching legislation dictates the terms under which contracts are open for public bidding vs. more limited private bidding. It regulates how subcontractors can and cannot be used. It outlines how contracts are written and how they can be terminated. It also governs how and why contractors can be prevented from bidding or receiving contracts due to actions which impede the efficiency or integrity of the US government.

According to the FAR, suspension and debarment are tools to protect the integrity of the contracting process and to maintain accountability. The relevant section of the FAR reads: “The serious nature of debarment and suspension requires that these sanctions be imposed only in the public interest for the Government’s protection and not for purposes of punishment.”

“Without long term financial consequences, I question whether there is any incentive to change corporate culture,” said Neil Gordon, an investigator at the Project on Open Government (POGO). “Some of these companies have extensive histories and accusations of fraud but they are rarely prevented from bidding on government contracts.”

Debarment is the process by which the government prevents contractors, whether individuals or companies, from bidding on or accepting government contracts. A contractor can be debarred for fraud, back taxes, or failing to adhere to drug-free workplace guidelines. However, debarment or suspension is completely separate from the legal process. A contractor can only be debarred by a head of a government agency, like the General Services Administration or Department of Defense, or an agent acting on a head’s behalf. In order for a company to be debarred, there needs to be considerable evidence of wrongdoing: i.e. a criminal conviction. Debarments can last up to three years.

Suspension, on the other hand, is immediate and temporary: it lasts less than 12 months. A company can be suspended following a criminal indictment. Since it is temporary, it can be reversed if the indictment is dropped or there is no conviction.

However, suspension and debarment can be mitigated by a number of factors: voluntary compliance, cooperation and corporate reorganization are some examples.

This means that a civil settlement with an admission of misconduct or fraud does not always result in the suspension or debarment of a contractor. The data gathered shows that numerous government contractors committed fraud and were found criminally or civilly liable but only paid fines. Granted, these fines were often in excess of \$1 million but many of these companies received billions of dollars in government contracts each year.

Despite the potential for fraud and high-profile instances of fraud popping up in the last 15 years, outside contracting has been crucial to the US military and defense apparatuses since before the Constitution was written. Contracted support staff have provided equipment and services since the Revolutionary War. Initially the US Military attempted to directly furnish supplies by having officers purchase what their units needed. By 1781, the US had shifted to using private contractors to procure supplies. Shifting needs and the rapid increase in technological complexity caused the government to grow and more and more reliant on contractors as the weapons, vehicles and computer systems became more central to the US defense apparatus.

The government chooses to rely on contractors to speed acquisition and to allow the government to manage a system that's malleable and ready to face new challenges at a moment's notice, according to "At What Risk?," a 2011 report on the potential overreliance on outside contractors. The report notes that, in theory, private companies can provide trained personnel more quickly than the government could; instead of creating new government agencies to handle each variable in a conflict, the government chooses to hire private companies on a contingent basis.

Private companies are also able to hire and fire more quickly and on a more temporary basis than the governmental agencies that draft the contracts, said Benjamin Friedman of the Cato Institute. He added that the ability to retain only the most useful personnel was a driving factor behind the extensive use of the contracting system.

Both Friedman and "At What Risk?" said that cost was one of the major factors in using outside contractors. In theory, competition for government contracts will drive agencies to offer the best service at the lowest possible price. "At What Risk?" notes that there have been few studies to either confirm or refute whether competition for contracts is actually a cost saving measure.

"There's a history of a private arsenals as opposed to public arsenals in the wake of WWII," said Benjamin Friedman of the Cato Institute. Defense contracting grew out of a need for the government to be able to quickly mobilize businesses and ramp up production in response to varying global events. "It's easier to temporarily hire a contractor than it is to hire and fire full-time government employees," said Friedman.

Essentially, Friedman explained, the contracting system allows an agency of the US government to procure specific items or to research new technology without creating an entire department within the agency. For instance: instead of purchasing and manufacturing small arms in government owned and operated plants, the Department of Defense can use existing private arms companies to quickly furnish the needed supplies.

"Though it can be bogged down by politics and the costs of doing business in Washington, ideally, allowing the government to employ private businesses will increase efficiency," said Friedman. Friedman adds that the system looks much more chaotic and clumsy from the outside. "For contracting officers, this is just the nature of the system," he said.

The scope of the modern defense contracting system means that contractors are often left to police themselves by internal audit (for financial fraud like overcharging/mischarging for labor) or by contractual obligation (if providing materials or products) said Neil Gordon from the Project on Government Oversight.

"The largest contractors should constantly be auditing themselves. It's the easiest way to make sure that they can continue to do business with the US," said Friedman. "The government will generally accept errors and won't hold contractors who admit mistakes liable."

"Accounting errors and billing mistakes do happen. A lot of discrepancies between contractors and the government come down to human error, not malice," said Gordon. Gordon concurred with Friedman's assessment, adding that contractors that adopt a policy of transparency after a mistake typically continue to do business with the US.

In [testimony before Congress](#) in November 2011, Steven Shaw (then the US Air Force Deputy Council who served as the Air Force's debarment and suspension official) said mandatory debarment would discourage contractors from working with the government to improve contractor behavior. In Shaw's view discretion is vital for the contracting and procurement system to work (Currently Shaw serves as senior counsel at Covington & Burling LLP. and is a member of their Government Contracts Practice Group).

Without discretion, contractors "would have every incentive to stonewall, deny problems exist, and not make changes for fear of potential liability that would result in a mandatory debarment regardless of their willingness to change," he said.

Although Shaw said discretion is the most effective way for contracting officials to work, he was clear about his belief that contractors must face scrutiny in all aspects of their business.

"There is no logical basis to conclude that a corrupt corporate culture that leads government contractors to engage in unethical behavior abroad or in their commercial businesses would not also lead to misconduct in their government businesses," Shaw said.

Shaw's testimony lines up with the government's designation of suspension and debarment as tools to protect the government's integrity and not as punishments. As Shaw's testimony indicates, contracting officials use the possibility of suspension or debarment as a method to bring noncompliant contractors to the table and to coax contractors into compliance.

In fiscal year 2015, the top ten contractors alone were awarded \$119.9 billion in government contracts.

"A report issued by the Department of Defense just last month shows that over a 10-year period, DOD awarded \$255 million to contractors who were convicted of criminal fraud," said Senator Joe Lieberman, at a 2011 hearing titled "Weeding Out Bad Contractors." "And almost \$574 billion to contractors involved in civil fraud cases that resulted in a settlement or judgment against the contractor."

Lieberman added that most federal agencies had debarred or suspending fewer than 20 contractors over the previous five years.

Following eight years of intervention in the Middle East, the government began to focus on the efficiency of the contracting process. During the first decade of the US's intervention in the Middle East, [numerous high profile instances](#) of contractor fraud brought the inadequacies of the government's oversight to light.

In 2011, Neil Gordon of the Project On Government Oversight wrote "at least one out of every six dollars spent by U.S. taxpayers on contracts in Iraq and Afghanistan over the past decade--more than \$30 billion--has been wasted."

The high profile fraud cases that came to light in 2011 put pressure on government agencies to apply extra scrutiny to contractors and proposed debarments increased by 60 percent that year, according to a presentation on suspension and debarment by Thompson Coburn LLP, a law firm with contracting specialists in their Washington, D.C. office.

The presentation noted that between 2001 and 2011, 30 contractors were found criminally liable of committing fraud but that only 17 of those contractors were debarred. Ninety-one contracts were found civilly liable yet only 35 were debarred. The presentation said that the Department of Defense and Inspector General's office were satisfied "that the existing remedies with respect to contractor wrongdoing were sufficient."

Contractors win "contracts that are well in excess of the fine amount," said Nicholas Wagoner, an attorney and author of a paper on contractor misconduct cited by POGO. "They accept the penalty and pay it and it simply becomes a cost of doing business when they continue to receive contracts from the government."

EOTECH Example

Beginning in 2001, EOTech contracted with the Department of Defense, the Department of Homeland Security and the FBI to provide weapons sights capable of withstanding extreme temperatures and combat conditions. By 2006, EOTech learned that its sights would fail in cold or humid conditions and failed to disclose this information to the government according to the complaint filed by the US Attorneys Office for Southern New York.

EOTech is an optics company that provides weapons sights and surveillance equipment to the US government as well as to retail clients. EOTech invented and designed the first holographic weapon sight at the turn of the 21st century. EOTech's holographic sights were commonly used by US Special Forces because their design allowed soldiers to keep both eyes open while aiming, reducing the loss of peripheral vision. The company marketed its holographic weapon sights as capable of functioning between -40 degrees to 140 degrees Fahrenheit. EOTech also claimed that the sights could withstand extremely humid conditions.

According to the complaint by the US Attorney's office, the performance standards were crucial because "US troops used EOTech's combat optical sights in Iraq and Afghanistan, as well as in the jungle, mountains, desert, and other extreme environmental conditions around the world." EOTech's 2004 and 2010 contracts, worth a total of \$20.4 million, explicitly stated that EOTech must "notify the Government of any and all performance related data" affecting the sights.

Internal EOTech documents reveal that in August of 2006, an army infantry unit complained that the target reticle drifted off-center in extreme temperatures. Anthony Tai, EOTech's Chief Technology Officer at the time, ordered immediate testing. In an email to company higher-ups, Tai wrote, "We cannot have soldiers test our sights for drift in the battlefield." During a deposition, the test engineer responsible for evaluating the sights said that he didn't remember anyone attempting to fix the flaws.

Despite the attention of the CTO, the problem was neither fixed nor acknowledged until the FBI independently uncovered the flaw in 2015. The FBI exposed the sights to weather in Virginia and noticed that the targeting reticle drifted away from the center. Notably, Virginia rarely reaches the highs of 140 degrees Fahrenheit or lows of -40 degrees Fahrenheit that EOTech claimed its sights could withstand.

When confronted by the FBI in 2015, EOTech claimed that the flaw was newly discovered. EOTech learned of a second flaw in its holographic sights when it attempted to sell

its optics to the Norwegian Army in January 2007. During field-testing in Norway, however, the aiming dot distorted, making proper aiming very difficult. Norway passed on EOTech's sights yet the company continued to provide these same optics to the US Military.

EOTech's CTO issued an internal memo admitting that the company "had never looked at the sight performance at very low temperatures" and that EOTech "assumed the sight performed about the same at" 68 degrees Fahrenheit as it did between -40 degrees and 104 degrees Fahrenheit. [Note: To maintain consistency, temperatures were converted to Fahrenheit from Celsius]

EOTech did not disclose this flaw to the military until 2008, when, instead of acknowledging the distortion effect, the company informed the US government that they were upgrading the sights' performance as opposed to correcting a flaw. Despite fraudulently representing its sights and withholding information about failure from the US government, EOTech was slapped with a fine that barely exceeded the total of its contracts. According to the publicly available data, the US purchased at least \$24 million worth of EOTech's sights.

Within 24 hours of the US Attorney's office filing a complaint to recover triple the damages, as allowed by the False Claims Act, as well as civil penalties, EOTech settled. The terms of the settlement required that the company, its parent company L-3 and EOTech's former president Paul Mangano admit responsibility for the company's fraudulent actions and pay \$25.6 million.

Although EOTech and L-3 Communications admitted and acknowledged fraudulent activity, the GSA and EOTech's government contracting official declined to suspend or debar either subsidiary or parent company. Instead of preventing EOTech or L-3 Communications from continuing to bid on, the contracting official used his or her discretion to do nothing.

"The company has 15 instances of misconduct dating back to 2007—including 6 contract fraud cases—for which it has paid over \$45 million in fines, penalties, and settlements. In addition, an L-3 unit was briefly suspended from federal contracting in 2010 for allegedly spying on a military computer network," Neil Gordon wrote in a December 2015 blog post highlighting L-3 Communications EOTech's settlement.

A representative for EOTech and its parent company L-3 Communications declined to comment about the settlement. The General Services Administration's Suspension and Debarment Division would not comment on specific cases other than to refer to EOTech and L-3's System for Award Management records, which do not show any suspensions or debarments.

While EOTech has not received any defense contracts in 2016, L-3 Communications, the parent company of EOTech has accepted contracts through 92 regional offices or subsidiaries gathered under the L-3 Communications umbrella since 2015.

Although the L-3 Communications EOTech example is particularly jarring--faulty sights directly put military personnel at risk--there are indications that the system for holding bad actors accountable is improving. In September 2015, the Office of the Deputy Attorney General released [guidelines](#) for prosecuting individuals involved in corporate wrongdoing.

"In large corporations, where responsibility can be diffuse and decisions are made at various levels, it can be difficult to determine if someone possessed the knowledge and criminal intent necessary to establish their guilt beyond a reasonable doubt," wrote Sally Quillian Yates, deputy attorney general. "This is particularly true when determining the culpability of high-level executives, who may be insulated from the day-to-day activity in which the misconduct occurs."

According to Gordon, this demonstrates an evolution in how contractor misconduct is handled. Since 2011, the agencies responsible for monitoring and referring misconduct to the US Attorney's office have worked to increase individual accountability and to remove individual bad actors from companies.

[A Law360 article](#) on the effects of debarment and suspension in 2016 noted that large companies are rarely excluded.

"Of the domestic businesses for which size data was available, the U.S. Department of Defense excluded at least 90 percent small businesses," wrote David Robbins, a contracting specialist at Crowell and Moring LLP. Robbins' data and analysis reveal that larger companies "continue to have the resources to address a suspension or proposed debarment, and have learned the importance of previewing and dealing with ethics and compliance issues with suspending and debaring officials proactively."

In this case, Robbins wrote, small businesses often lack the overhead to monitor and cite the exact sources of fraud and are entirely debarred or suspended, whereas larger companies can pinpoint the individuals responsible.