



Department of Justice

STATEMENT

OF

PAUL McNULTY
DEPUTY ATTORNEY GENERAL

BEFORE THE

COMMITTEE ON ARMED SERVICES
UNITED STATES SENATE

CONCERNING

BOEING COMPANY GLOBAL SETTLEMENT AGREEMENT

PRESENTED ON

AUGUST 1, 2006

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Mr. Chairman, I appreciate the opportunity to appear before you to address the Committee regarding the recent settlement with The Boeing Company. I think that by reaching a common understanding of the facts and circumstances surrounding this agreement, you will agree that the Department reached a good settlement in the interests of the American taxpayer. Let me briefly describe the Boeing investigation and how the Government negotiates settlements in such cases.

Investigation

In fact, Boeing involved two investigations, both begun more than three years ago. In September 2002, the United States Attorney's Office for the Central District of California, in Los Angeles, opened an investigation into allegations that Boeing had improperly used proprietary information obtained from a competitor, Lockheed Martin Corporation, to compete for launch services contracts under the Air Force's Evolved Expendable Launch Vehicle Program—known as the EELV. The investigation focused on allegations involving Kenneth Branch, a former Lockheed employee who was hired to work on the EELV proposal of Boeing's predecessor, McDonnell Douglas. Branch was hired by a Boeing employee by the name of William Erskine. In June 1999, another Boeing employee reported to Boeing management that Erskine had hired

Branch in return for Branch providing Erskine with Lockheed documents pertinent to Lockheed's EELV proposal. Boeing conducted an internal investigation and, in August 1999, terminated Branch and Erskine. Boeing also informed Lockheed and the Air Force that it had certain documents proprietary to Lockheed in its possession, but little was done at that time because Boeing identified only a few relatively insignificant documents.

In November 2001, in the course of civil litigation between Lockheed and Boeing, Lockheed discovered that Boeing had additional documents in its possession. This discovery prompted Lockheed to refer the matter to the Air Force and the Department of Justice, which triggered an investigation by the Defense Criminal Investigation Service along with the Los Angeles United States Attorney's Office. Boeing hired outside counsel to conduct an internal investigation.

At the instigation of the Department of Justice, the EELV investigation expanded into an investigation of similar launch services contracts with NASA where Boeing and Lockheed were again competitors, and another Air Force procurement for the Exoatmospheric Kill Vehicle. The NASA allegations involved a billion-dollar task order that was awarded to Boeing sole source. The issue there was whether Boeing's alleged fraud in the EELV competition gave the company an unfair advantage in the NASA procurement, so much so that NASA was persuaded to award the task order to Boeing without giving Lockheed even the opportunity to compete. The Air Force Office of Special Investigations and the NASA Office of the Inspector General joined in the investigation.

On July 17, 2003, a grand jury indicted Branch and Erskine on charges of conspiring to conceal and possess trade secrets in violation of 18 U.S.C. §§ 1832(a)(1), (a)(3), and (a)(5). Both remain charged with their trial currently scheduled to begin in late 2006.

In September 2003, when I was the United States Attorney for the Eastern District of Virginia, we opened an investigation of the circumstances surrounding the hiring of Darleen A. Druyun, a senior Air Force official, by Boeing. This was about a year after the United States Attorney for the Central District of California opened that office's investigation. Druyun had been the Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management, and in that position supervised and oversaw the management of the Air Force acquisition programs until her retirement in November 2002, when she was hired by Boeing.

In the summer of 2003, Congress and the media had begun asking questions about the proposed KC 767A tanker lease from Boeing and the contemporaneous hiring of Druyun by Boeing in late 2002. This triggered an investigation by the Defense Criminal Investigation Service and the FBI in conjunction with the United States Attorney's Office in Alexandria, as well as an internal investigation by outside counsel hired by Boeing.

During the investigation, it also came to light that in the summer of 2000, Druyun had asked Boeing to hire her future son-in-law and later her daughter. Boeing acceded to both requests. During this period—from 2000-2002—Druyun played a role in the negotiation, award,

and modification of numerous Boeing contracts. Although Druyun has admitted bias as a result of Boeing's favors, her admissions were insufficient to establish any direct or specific loss. Boeing fired Sears and Druyun, both of whom pleaded guilty to violating the conflict of interest laws and have served terms in prison.

The facts are far more complicated, but that is the gist of the two investigations. As you know, on June 30, 2006, the United States entered into a global settlement with Boeing for \$615 million. This included a \$50 million "monetary penalty" pursuant to a criminal deferred prosecution agreement and \$565 million in resolution of civil claims. This settlement was the largest ever by the Department with a defense contractor.

Criminal Resolution

The United States Attorney's Offices separately entered into lengthy discussions with Boeing. In Los Angeles, a grand jury indicted Branch and Erskine, the two Boeing employees responsible for securing the Lockheed documents in an effort to win launch services contracts under the Air Force's EELV program. Meanwhile, as I mentioned, the investigation in Alexandria resulted in Boeing terminating Druyun and Sears for cause in November 2003, and in their subsequent guilty pleas. In April 2004, Druyun pleaded guilty to negotiating employment with Boeing while she was participating personally and substantially as an Air Force official overseeing the negotiation of the proposed multi-billion dollar lease of Boeing KC 767A tanker aircraft. In February 2005, Sears was convicted on related charges. Both Druyun and Sears were sentenced to terms in prison.

Following Sears' conviction, we entered into discussions with Boeing concerning a resolution of the criminal case. After a period of separate negotiations, the two United States Attorneys' Offices joined forces to pursue a global resolution of the two investigations.

Based on the factors outlined in the Department's Principles of Federal Prosecution of Business Organizations, the United States Attorneys' Offices decided to enter into an agreement with Boeing not to seek criminal charges against the company. Those factors include Boeing's timely and voluntary cooperation in the Druyun matter; its willingness to cooperate in the investigations; the company's policies and procedures in place at the time of the conduct; the remedial actions taken by Boeing, including efforts to improve and make more effective its corporate compliance program; its termination of the wrongdoers; and the adequacy of other remedies, including civil settlement. The criminal agreement obligated Boeing, among other things, to pay a \$50 million criminal monetary penalty and to implement an effective ethics and compliance program, with particular attention to the hiring of former Government officials and the handling of competitor information. In addition, Boeing accepted and acknowledged responsibility for the conduct of its employees in the EELV and Druyun matters. The United States Attorney's Office may prosecute Boeing for the Druyun matter, or assess an additional monetary penalty, if Boeing violates the agreement during the next two years.

Civil Resolution

The Boeing investigations posed a complex set of facts and equally complex issues of

law. Although these issues also weighed into the criminal agreement, we discuss them here as they have direct bearing on the civil settlement amount.

As the facts were being developed, the Government's civil attorneys began formulating theories of recovery. The Government's principal civil fraud remedy is the False Claims Act. This statute enables the Government to recover three times its actual damages, plus a civil penalty of \$5,500 to \$11,000 for each false claim a "person," which includes a corporation, knowingly submits or causes to be submitted to the Government. The single portion of the damages is intended to compensate the Government for its out-of-pocket loss—restitution, if you will—while the multiple and civil penalty portions are over and above those costs. The multiple and civil penalty portions of the False Claims Act are intended as a deterrent, signaling to those who might commit fraud that the consequences are far more onerous than merely paying the Government back money that wasn't theirs to begin with. They also defray the costs of investigation and prosecution and address less tangible injuries such as harm to the integrity of public programs and contracts.

But the False Claims Act isn't our only remedy. We have many others. The remedies we considered and asserted against Boeing included the False Claims Act, the Procurement Integrity Act, common law claims for unjust enrichment, fraudulent procurement of contracts, and inducing a breach of fiduciary duty, as well as other statutory and common law remedies. The Procurement Integrity Act entitles the Government to recover "civil penalties," as do many other statutes. The common law remedies range from voiding contracts and recovering consideration

paid to recovering profits. As you can see, these remedies are not tied explicitly to the Government's loss. As such, they are not entirely "compensatory" as that term may be used to determine deductibility for tax purposes. Rather, they are measured by the wrongdoer's ill-gotten gains or designed to enable the Government to rid itself of tainted contracts.

Some of these remedies are mutually exclusive, which means we can collect on one but not both. Others are cumulative. Furthermore, different remedies—or a different mix of remedies—can and do apply to different factual segments of the case. For example, the remedies available to redress Boeing's alleged fraudulent procurement of the EELV and NASA contracts are different than those to redress contracts allegedly tainted by the conflict of interest engendered by Boeing's negotiations with Druyun and hiring her children. Cases such as Boeing are further complicated by the fact that the contracts at issue are critical to the national security. They cannot practicably be terminated. The Government must go forward with the contracts and attempt to measure today the impact of Boeing's fraud on the future. The Air Force and NASA contracts at issue here are in their relative infancy. Boeing is likely to continue to perform these contracts through at least 2020. No doubt, an element of the Government's claims was intended to address future impact, in contrast to past loss.

The point is that the Government reaches its ultimate demand through a careful analysis of many complex issues, including the strengths and weaknesses of the facts and overlapping legal theories of recovery.

While the Government is performing its investigation and analyzing possible remedies, the putative defendant is doing the same. As a general matter, the Government initiates settlement discussions by presenting its version of the facts and asserting applicable claims and remedies. Putative defendants are then given the opportunity to respond before a matter proceeds to litigation. In this matter, Boeing availed itself of that opportunity. From its own internal investigations, Boeing presented additional, and in some instances, countervailing facts as well as legal arguments bearing on the matter.

Both parties vigorously advocated the facts and the law in their favor. The contested issues in Boeing were legion and complex. In the EELV matter, they included whether the documents contained “bid or proposal” or “source selection” information within the meaning of the Procurement Integrity Act; whether the documents were significant and gave Boeing an unfair advantage, or were dated and irrelevant; whether Boeing’s final bid was derived independently by persons who had never seen the documents or had access to the information and, if so, whether that mattered. There were also issues in determining whether the costs incurred by the Air Force in reallocating the launch missions between Boeing and Lockheed were proximately caused by Boeing’s conduct and a proper basis for damages, or whether other factors, e.g., Lockheed’s misguided proposal strategy and a failing commercial market, warranted the reallocations. (In 1998, when the first 28 missions were awarded, everyone anticipated a robust commercial market and bid the missions accordingly, expecting that the volume would reduce the price per launch. By 2003, when the Air Force reallocated the missions, it was apparent that a commercial market had not materialized, resulting in increased

prices for the reallocated missions.) Finally, there were issues of causation relating to whether Boeing's conduct with respect to the EELV could fairly be said to have impacted on the NASA award.

The facts were relatively clear and undisputed in the Druyun matter. Of course, the basic facts were set forth in the criminal plea agreements of Druyun and Sears. Even so, the legal theories were vigorously contested. These included whether Boeing's conduct sufficiently tainted the contracts to give rise to civil penalties under the False Claims Act, whether there was evidence to demonstrate provable impact on the contracts, and whether Boeing's favors in hiring Druyun's children violated the gratuities statute or rose to the level of a conflict of interest entitling the Government to common law remedies for recovering Boeing's profits under the affected contracts.

The amount of a civil settlement reflects the uncertainty of certain provable facts and sustainable legal theories. While there is give and take on both sides, the compromise ultimately reached is in the amount of the settlement, not in the underlying facts or legal issues. Indeed, if we were to insist on reaching agreement on the facts and the law that supported the settlement, I fear that every fraud investigation would end up in court for the judge and the jury to determine the facts and the basis for liability.

It is important to remember that the goal of a civil settlement is to protect the monetary interests of the Government. We do that best by insisting that the parties agree to a "settlement

amount.” Likewise, our concern is that the Government’s claims are paid. Therefore, we do not get involved in private agreements parties may have with third party payers such as insurers.

Certainly, there are terms we include in every settlement agreement to protect important Government interests. Although frequently contested, these terms are not controversial. For example, consistent with the Federal Acquisition Regulation, contractors agree not to charge their attorneys’ fees, their costs of investigation, and the settlement payment to Government contracts. But we do not require an admission of wrongdoing or, once again, agreement on the underlying basis of the settlement. To do so, would impede negotiations without serving the purpose of civil settlement. Moreover, the Government has better and more beneficial ways of handling these issues.

Tax Issues

Regarding the tax issues raised by certain members, the Department followed its long-standing policy, which has been in place for many years and which was implemented in consultation with the Internal Revenue Service, of characterizing settlement amounts using tax neutral language. Attorneys negotiating our fraud cases use the expertise and experience they have acquired as civil fraud attorneys to protect the public interest that prompted the suit. In doing so, as I’ve just discussed in relation to the Boeing settlement, they focus on the legal and evidentiary merits of the particular case, and the assessment of risk attendant to further litigation and trial. For example, in negotiating the settlement of a fraud investigation, the Department's attorneys consider applicable legal authorities of differing relative weights, the strength of the

evidence establishing various fraudulent scenarios, and the various methods for measuring damages and/or assessing penalties applicable to each circumstance. There also may be disputed facts concerning the degree of a defendant's culpability that would bear on the appropriate multiple of single damages. In the end, the parties may agree on no more than a settlement amount to resolve the investigation without agreeing on a value for the individual parts of the investigation or the legal basis. In arriving at the \$565 million civil settlement in this case, Boeing was well aware that the Government was asserting claims against it that were well beyond seeking merely compensatory damages. I note from reports in the press that Boeing has decided not to "write-off" the settlement for tax purposes. NYTimes.com, Boeing Reports \$160 Million Loss, <http://www.nytimes.com/aponline/business/AP-Earns-Boeing.html?ex=1154577600&en=13abaf8551a80f14&ei=5070&emc=eta1> (last visited July 26, 2006).

The Department's "tax neutral" approach to these cases ensures that the IRS retains sufficient latitude to evaluate the taxpayer's obligation in its role as taxing authority and final arbiter of its rules and regulations. In almost all fraud cases, such as the matter involving Boeing, Department of Justice lawyers simply lack the necessary expertise in the intricacies of the tax code, and the knowledge of a defendant's particular tax situation, that would warrant substituting their judgment for that of the Internal Revenue Service. Indeed, in its recent report on this issue in which the Government Accountability Office examined large civil settlements attained by federal agencies over a multi-year period, the GAO noted that "it may not always be clear which payments are deductible, in part because the Internal Revenue Code does not address the deductibility of all types of payments that may be made pursuant to a civil settlement and the

statutes imposing the payments may be unclear regarding whether they are punitive, compensatory, or both.” Government Accountability Office Report No. 05-747, *Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments*, 1 (September 15, 2005).

After concluding its review of the Department of Justice’s civil settlement process (and that of other federal agencies), the GAO did **not** conclude that Department attorneys should negotiate the tax treatment of these civil settlements. Rather, the GAO concluded that the solution was to be found in systematic information sharing among federal agencies and the Internal Revenue Service that would be beneficial to ensuring the correct tax treatment of the settlement amounts. The Department has for several years now worked with the Internal Revenue Service to facilitate follow-on investigations of the tax ramifications of our larger fraud settlements. In the wake of this GAO report, we also have initiated meetings with Internal Revenue Service personnel to facilitate a systematic sharing policy that can expand this process into other enforcement areas within the jurisdiction of the Department of Justice.

I add two other points to this discussion: First, the Department’s current tax neutral policy encourages greater consistency of the tax treatment of these settlements, since it avoids a tax treatment that may vary among the federal districts in which such settlements occur. Again, these determinations are better left to the Internal Revenue Service and not to individual lawyers within the Department of Justice who, as you know, are positioned throughout the country.

Second, I think it is fair to assume that many offers of settlement that the Department receives from defendants such as Boeing are colored by the defendant's own assessment of the subsequent tax treatment. It seems likely that a defendant's settlement offer to the Government will be less generous if it also had to agree that the full amount was nondeductible. Likewise, a defendant's civil settlement offer may be increased in recognition that at least a portion of the amount paid directly to the Government will provide favorable tax treatment. Assuming the subsequent treatment is permitted by the tax code, there is nothing inherently wrong with such considerations. In fact, the inherent uncertainty of that liability may result in more favorable settlements for the Government. If, however, tax treatment were required as part of the settlement process, the Government would be put at a distinct disadvantage. Bear in mind that it is impossible for Department attorneys to know the intricacies of our defendants' financial affairs to such a degree that we can comfortably predict the bottom-line impact a certain deduction will have on a defendant's tax bill. So, if a defendant indicated in the course of a settlement that its offer to the Government would be reduced by \$X to accommodate the ensuing tax bill it faced as a result of the negotiated tax treatment, we simply lack the ability to meaningfully verify that. Such an argument by defendants which, we can assume, would sometimes be disingenuous or simply mistaken, could result in settlements less beneficial to the Government since the Government attorneys could not verify a key element of the negotiation. Only the IRS has the authority and the technical skill to make such judgments, after receipt of the necessary financial information from the taxpayer.

Conclusion

In conclusion, this was an outstanding resolution to an extremely difficult case. Boeing has paid the United States \$615 million in penalties and damages—more than any other defense contractor in a fraud matter. Boeing has accepted responsibility and is taking action to ensure that such activity doesn't impede its efforts to continue to do business with the United States in the future. Finally, the Department's policy of remaining tax neutral—a longstanding policy established in consultation with the IRS and recommended by the GAO— is sound. That policy leaves civil fraud issues to the Government's fraud experts and the tax implications of any settlement (often unknowable during negotiations) to the Government's tax experts. I firmly believe that ultimately, this policy is the only appropriate way to handle these matters, the most efficient to resolve both civil fraud cases and the tax ramifications of those cases, and the most beneficial to the American taxpayer.