

**The Defense Industry Initiative:  
From Business Conduct Program Innovator to Industry Standard?**

By Andrea Bonime-Blanc<sup>1</sup>

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**I. Introduction**

“The defense industry companies who sign this document 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.”<sup>2</sup>

Thus opens the document entitled “Defense Industry Initiatives on Business Ethics and Conduct” dated June 9, 1986, the beginning of what has come to be widely known as the Defense Industry Initiative (“DII”). While a narrow and not completely incorrect reading of this paragraph might lead one to conclude that the sole purpose of the initiative was to address procurement fraud and provide parameters around mitigating and eliminating such fraud, a broader interpretation, one that reflects the actual eventual evolution of the DII, would suggest that even if the original intent of the drafters of this initiative may have been to address only defense industry procurement issues, the DII in many ways represented the beginnings of a revolution in how corporations, especially in the United States but increasingly elsewhere, create and implement internal business conduct and ethics programs.

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<sup>1</sup> Andrea Bonime-Blanc is director of ethics and compliance at Navigant Consulting and has served as general counsel, chief ethics and compliance officer and corporate secretary for diverse global organizations for the past 15 years. She is chairwoman of the board of directors of the Ethics & Compliance Officer Association and the author of numerous books and articles on business ethics, compliance, risk management, governance, constitutional change and democratization, speaks and teaches frequently. She holds a joint JD and PhD from Columbia University and grew up in Europe.

<sup>2</sup> “Defense Industry Initiatives on Business Ethics and Conduct” June 9, 1986.

The largely U.S.-centric DII<sup>3</sup> was perhaps the first of its kind – a more or less voluntary industry-wide code of conduct or set of business principles adopted by an entire industrial sector (or at least by those who voluntarily signed it at the time and over time) and focused on one compliance objective: not getting into trouble with the United States Government (and, more specifically, the United States Government Department of Defense) for procurement fraud. Did the defense industry adopt this voluntary code of conduct for altruistic reasons, for business reasons or for legal reasons? Probably all of the above, with an emphasis on avoiding the legal consequences of non-compliance.

A key differentiator of the DII was that it was not created to deal with the quality, provenance or other characteristics of the products or services provided by the industry as was the case with some other industry wide codes of conduct such as the Kimberly Process regarding their product: diamonds. The DII emerged as a result of government, media and public pressure about procurement fraud or the widespread perception thereof. While DII was not directly about the actual products and services provided by the defense industry (which ranged from fighter jets and intercontinental ballistic missiles to auditing services by accounting firms and health care services from health care providers), it was about the sometimes exorbitant pricing of such products and services (reflecting potential or actual fraud, waste and abuse). What brought the defense industry together to create DII was the fear of financial, legal and reputational consequences from procurement fraud – such as debarment from further contracts with the U.S. Department of Defense (DOD), the imposition of severe fines or even the incarceration of guilty individuals. In particular, it was the work of a government commission appointed by President Ronald Reagan, which came to be known as the Packard Commission, that became the catalyst for the birth of DII.<sup>4</sup>

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<sup>3</sup> The DII was created by a group of U.S. based defense industry contractors. However, as it grew and over the years, DII membership, as is evident from the current membership listed in Table 6 below, also includes the U.S. subsidiaries of non-U.S. based defense contractors, such as U.K.-based BAE Systems, with defense contracts in place with the DOD.

<sup>4</sup> See sections below examining the composition and work of the Packard Commission.

As one reviews and analyzes DII, it is important to keep in mind that it was a voluntarily created organization borne from public circumstances and focused almost exclusively on eliminating or mitigating procurement fraud. Over time, however, the DII became both a harbinger and major contributor to the larger debate about, and development of, a paradigm for how companies can create and develop an internal business conduct program.<sup>5</sup> As will be seen later in this Chapter, it was the DII that was the principal precursor to the single most important legislative development in the United States regarding the encouragement of effective compliance and ethics programs -- the U.S. Sentencing Guidelines. The United States Sentencing Guidelines, first enacted in 1991 and amended twice since then (in 2004 and 2010) have, in turn, had a major effect on the global debate about internal organizational code of conduct programs (U.S. Sentencing Guidelines).<sup>6</sup>

It should finally be noted, that the DII started as and remains a voluntary code and program that only applies to United States Government DOD contractors that have agreed to join the program and abide by its parameters not to any other companies. Clearly, defense industry contractors – like some that have achieved headline notoriety for scandal and legal troubles over the years as will be examined later in this Chapter –

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<sup>5</sup> This Chapter uses the following terms to describe internal business conduct programs at corporations fairly interchangeably: “ethics and compliance (or compliance and ethics) program”, “code of conduct program”, and “business conduct program”.

<sup>6</sup> Today, several major organizations exist in the United States and Europe that are devoted to the issue of building internal organizational business conduct programs. Among them are the original associations of this kind, the Ethics Resource Center (ERC) and the Ethics Officer Association -- today known as the Ethics and Compliance Officer Association (ECO) -- and a number of other U.S. and non-U.S. based organizations such as the Society for Corporate Compliance and Ethics, the Open Compliance and Ethics Group, the Institute for Global Ethics, the U.K.-based Institute of Business Ethics, the French and Belgian-based Cercle D’Ethique des Affaires/Cercle Europeen des Deontologues, a number of national associations such as the Association of Compliance Officers of Ireland or regional associations such as the Australasian Compliance Institute and the European Business Ethics Network. None of these organizations, except for the ERC which, in turn, played a major role in the creation of the DII, existed before 1992 when the ECOA was founded. None of this addresses, however, another key parallel development over the past two to three decades which has also had an indirect effect on the field of ethics and compliance but which is beyond the scope of this Chapter, and that is the development of the field of corporate social responsibility.

have not or did not at the time of scandal subscribe to the tenets of the DII. An important issue this Chapter raises, but is not able to answer completely, is whether belonging to the DII has had a positive direct or indirect effect on the defense contractor companies that are members. In other words, have the standards required by the DII of the companies that voluntarily subscribe to its tenets had the effect of improving the behaviors that such defense contractor members would have engaged in but for their DII membership. While difficult or perhaps even impossible to answer, this is a question that is important to keep in mind as one attempts to understand the contour, content and impact of the DII on the defense contractor industry overall since its inception.

This Chapter provides an overview of the DII – its origins, antecedents and development, i.e., the historical and political context into which it was borne and through which it has developed. The Chapter also details and analyzes the main components of the DII and reviews how its various parts may relate to the track record of the defense industry. The Chapter closes with a discussion of challenges and possible future trends regarding this initiative with some suggestions on how the DII fits into the reality of global business today.

## **II. Overview: Historical and Political Context**

Whether one is critical of the defense industry, neutral or admiring, the historical record provides support for the notion that the defense industry was indeed the trendsetter among industrial sectors in creating a set of standards for business behaviors around ethical and business conduct. The DII was one of the first, if not the first, industries to create a paradigm for the conduct of business ethics within a business sector. Although the record shows that the defense industry did not take these steps solely voluntarily, there was certainly a to and fro between the industry and the U.S. Government with each side nudging the other. Eventually, this tension yielded something quite valuable and, at the time, unique – a voluntary code of internal governance and business conduct applicable to an entire industry. Whether such a voluntary program was or continues to

be effective at achieving its strategic objective is something that this Chapter will attempt to address and provide context for.

But before examining what happened in the mid-1980s leading to the creation of the DII, certain developments from the 1970s and early 1980s need to be understood as they provided the seeds for the later emergence of the DII. These seeds were sown in the form of a series of corruption and bribery scandals in the 1970s (for which defense contractor Lockheed had the most notable cases) and the procurement scandals of the 1980s (of which the infamous \$600 toilet seat scandal provided the most notorious fodder) that had direct consequences on the emergence of the DII.

#### A. The Foreign Corrupt Practices Act of 1977

In the early 1970s, a series of foreign official corruption and bribery cases involving U.S. companies making such alleged payments captured the attention of both the media and eventually the U.S. Congress. One of the more notorious cases involved defense contractor Lockheed and its sale of fighter jets and other military equipment to numerous foreign governments. The emerging bribery allegations covered a vast swath of geography – from Europe (Germany, Italy and the Netherlands) to the Middle East (Saudi Arabia) and Asia (Japan) and involved accusations of extensive bribery of foreign government officials in each country in exchange for the placement of orders for fighter jets and other military equipment. However, Lockheed was not alone -- the foreign bribery scandals exemplified by the Lockheed allegations ultimately involved admissions by over 400 U.S. based companies to the United States Government that they had paid approximately \$300 million in bribes over a period of several years for similar purposes.<sup>7</sup>

These bribery scandals coupled with the heightened sensitivities occasioned by the other unprecedented scandal suffusing the United States in the early 1970s (Watergate and President Richard Nixon's resignation from the United States Presidency) led the U.S.

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<sup>7</sup> [http://en.wikipedia.org/wiki/Lockheed\\_bribery\\_scandals](http://en.wikipedia.org/wiki/Lockheed_bribery_scandals). Also see: S. Hamilton, E. Eckardt, The Lockheed Bribery Scandal, [www.CasePlace.org](http://www.CasePlace.org).

Congress and Senate to hold hearings in the mid-1970s. These hearings delved into the various allegations of foreign corrupt practices by defense contractors and eventually yielded a groundbreaking new law – the Foreign Corrupt Practices Act of 1977 (“FCPA”).<sup>8</sup>

In essence, the FCPA forbade bribery by U.S.-based businesses of foreign officials to obtain or retain business in other countries. The extra-territorial implications of this law were unprecedented and unparalleled at the time. No other country imposed serious criminal liability on companies or individuals for the bribery of foreign officials outside of their national jurisdiction. In fact, until the early 2000s, no other country -- including the leading industrial nations members of the Organization for Economic Cooperation and Development (“OECD”) -- had anything like such a law. To add insult to injury, some of government policy in some of these advanced industrial countries – most notably, France (until 1997) and Germany (until 1999) -- not only allowed corporations to bribe foreign officials to obtain or retain business, they permitted them to claim corporate tax deduction for their bribe and bribery-related “expenses”.<sup>9</sup>

Because it was a rare and unique law that seemed to single out U.S. companies for punishment, the FCPA was widely unpopular both inside and outside of the United States. It was unpopular within the United States because U.S. companies complained that it put them at a serious competitive disadvantage vis-a-vis their German and French competitors, for example. But it was also unpopular outside of the United States because it was viewed both as a heavy handed attempt by the United States to impose its laws on other national jurisdictions and mettlesome and preachy in its attempt to dictate legal “morality”, as it were, to other cultures with different business practices.

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<sup>8</sup> The Foreign Corrupt Practices Act of 1977, as amended, 15 U.S.C. §§ 78dd-1, et seq. (“FCPA”). For the legislative history of the FCPA see: [www.justice.gov/criminal/fraud/fcpa/history/](http://www.justice.gov/criminal/fraud/fcpa/history/).

<sup>9</sup> See Organization of Economic Cooperation and Development, “Update of Country Descriptions of Tax Legislation on the Tax Treatment of Bribes to Foreign Public Officials”. June 2009: [www.oecd.org/dataoecd/58/10/41353070.pdf](http://www.oecd.org/dataoecd/58/10/41353070.pdf).

The FCPA was signed into law by President Carter in December of 1977. Beyond the fact that it was generally unpopular, the new law had two major long-term effects on the world of compliance and the eventual emergence of DII over the following two decades. First of all, the FCPA had a strong, albeit indirect, effect on the eventual emergence of the DII in that it created a stark precedent for the U.S. Government to hone in on the defense industry for issues of non-compliance. However, as will be seen later in this Chapter, the DII effort arose more directly from another set of scandals that were uncovered in the early 1980s involving instances of procurement fraud. Because both the bribery scandals of the 1970s and the procurement scandals of the early 1980s were perpetrated primarily by defense contractors, both sets of scandals and their legal, regulatory and reputational consequences acted as strong incentives to the defense industry to create a more systematic approach to internal compliance and ethical business conduct.

The FCPA had another, perhaps even more dramatic, long-term effect on the field of compliance and business conduct and thus indirectly on the emergence of DII. Over a lengthy period of time stretching for several decades, the FCPA became the instigator and precursor of a much broader set of similar laws culminating with the passage in 1997 of the OECD's Convention on Anti-Bribery and Anti-Corruption which by 2010 has been adopted in almost 40 countries.<sup>10</sup> This major historical development, together with other important developments in the field of compliance and governance, have contributed in the last few years to the increasing recognition of the value of internal compliance and ethics programs by companies both within and outside of the United States, including significantly non-U.S. based defense contractors such as BAE and EADS, two leading European based defense contractors with major U.S. subsidiaries that are not only

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<sup>10</sup> Andrea Bonime-Blanc and Mark Brzezinski, "A New Era in Anti-Corruption: Governments Get Serious About Enforcement", Conference Board Executive Action Report, April 2010; Francois Vincke & Fritz Heimann, *Fighting Corruption: A Corporate Practices Manual*. ICC Publishing, 2003.

members of DII but also have global compliance and ethics programs headquartered outside of the United States.<sup>11</sup>

## B. The Defense Industry Procurement Scandals of the Early 1980s

The defense industry found itself squarely in the line of sight of the U.S. Government during the 1970s bribery scandals that led to the creation of the FCPA in 1977. But only a few years later, the defense industry found itself again the object of media attention and eventually government investigation this time regarding procurement fraud. Thus, the more immediate cause of the eventual emergence of the DII took place in the early 1980s, when Ronald Reagan was U.S. President, and during a period when the U.S. national defense budget was growing dramatically in the context of the increasingly “competitive” cold war between the U.S. and the Soviet Union in which such budgets accelerated and achieved new heights.

It was in this environment of exponentially increasing defense budgets that another major domestic scandal began to brew – involving \$400 hammers and \$600 toilet seats -- which if media and watchdog reports were to be trusted, seemed to signal widespread abuse and waste by defense contractors and the widespread defrauding of the U.S. Government and thus U.S. taxpayers.

It was in this context that the Project on Government Oversight, an investigative non-profit organization created in 1981 under the name of the “Project on Military Procurement”, conducted investigative journalistic work which exposed the \$640 toilet seats and \$436 hammers.<sup>12</sup> These revelations, subsequent media inquiries and further investigations of what appeared to be widespread fraud became notorious fodder that fed

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<sup>11</sup> For the companies’ own description of their global ethics and compliance programs see the following websites: For EADS, see: [www.eads.com/eads/int/en/our-company/our-governance/ethics-and-compliance.html](http://www.eads.com/eads/int/en/our-company/our-governance/ethics-and-compliance.html). For BAE, see: [www.baesystems.com/CorporateResponsibility/ResponsibleBusinessConduct/index.htm](http://www.baesystems.com/CorporateResponsibility/ResponsibleBusinessConduct/index.htm).

<sup>12</sup> The Project on Government Oversight continues to this day to provide investigative reports and other resources aimed at exposing and eliminating government corruption. See: [www.pogo.org](http://www.pogo.org).

into President Reagan's somewhat reluctant creation of a blue ribbon commission to be known as the Packard Commission a few years later. This blue ribbon commission was entrusted to look into how widespread the alleged fraud and abuse was and suggest more systemic solutions to what appeared to be blatantly illegal activity on both sides of the equation – the private sector that got away with charging astronomical prices for simple products and the governmental agencies and officials that appeared to tolerate such practices at best or engage in blatant conflicts of interest or even fraud themselves at worst.<sup>13</sup>

### C. The Establishment of the Packard Commission in 1985

On July 15, 1985, under increasing pressure to investigate whether defense contractors and the DOD were indeed mismanaging the defense procurement process or, worse yet, engaging in fraud and abuse, President Reagan issued Executive Order 12526 and established the President's Blue Ribbon Commission on Defense Management which became known as the Packard Commission (the "Packard Commission"), named after the multi-millionaire computer magnate, David Packard co-founder of Hewlett Packard, who became head of the commission. The Packard Commission was entrusted with examining the extent, depth, breadth and shape of what appeared to be widespread defense industry fraud and/or mismanagement and was charged with coming up with recommendations to minimize or eliminate such practices and create systemic solutions to any widespread bad practices on both sides of the equation – within DOD and within the private sector defense industry.<sup>14</sup>

In 1985, at the time the Packard Commission studied the defense industry and its relationship to the United States Government, the DOD had 60,000 prime contractors as

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<sup>13</sup> James Fairhall, "The case for the \$435 hammer – investigation of Pentagon's procurement", Washington Monthly, January 1987; and Evan Thomas, Barrett Seaman and Bruce Van Voorst, "Defensive About Defense", Time, March 10, 1986.

<sup>14</sup> Defense Industry Initiative, "Origins and Development of the Defense Industry Initiative", [www.dii.org](http://www.dii.org).

well as hundreds of thousands of other suppliers and subcontractors.<sup>15</sup> In that same year, the DOD entered into contracts valued at \$164 billion, the vast majority of which were with the top 100 contractors. As stated in the Packard Commission Final Report dated June 1986 (the “Packard Commission Final Report”), “twenty-five contractors did business of \$1 billion or more, 147 did \$100 million or more, and almost 6,000 did \$1 million or more.”<sup>16</sup>

The members of the Packard Commission consisted of former, existing or future military and governmental luminaries and experts associated with the military-industrial complex at the time – among them, Robert H. Barrow, the then recently retired 27<sup>th</sup> Commandant of the United States Marine Corps; Nicholas Brady, the then future United States Secretary of the Treasury under President Reagan and the first President Bush, Frank Carlucci, the then future United States Secretary of Defense under President Reagan, Brent Scowcroft, the past and future National Security Adviser under both Presidents Ford and Bush (senior), R. James Woolsey, Jr., President Clinton’s Director of Central Intelligence, and William J. Perry, the future United States Secretary of Defense under President Clinton. Other members of the Packard Commission included Ernest C. Arbuckle, Louis W. Cabot, William P. Clark, Jr., Barber Conable, Paul Gorman, Carla Anderson Hills, James Holloway III, Charles J. Pilliod, Jr., and Herbert Stein.<sup>17</sup>

For its work, which lasted a little over one year, the Packard Commission itself commissioned several expert services firms or non-profits to assist in gathering survey data and expert analysis – among the experts hired and the data contributed were: Market Opinion Research which conducted a survey of public opinion “U.S. National Survey: Public Attitudes on Defense Management”; the ERC which provided a study

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<sup>15</sup> The President’s Blue Ribbon Commission on Defense Management, [A Quest for Excellence: Final Report to the President](#), June 1986, page 1 (herein referred to as the “Packard Commission Final Report”). Also see: “The Government’s Role in Preventing Contractor Abuse: Hearings Before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce”, 99<sup>th</sup> Congress, First Session 402 (1985)(Statement of Joseph H. Sherick, Inspector General, DoD).

<sup>16</sup> The Packard Commission Final Report, p. 75.

<sup>17</sup> See: [www.en.wikipedia.org/wiki/The\\_Packard\\_Commission](http://www.en.wikipedia.org/wiki/The_Packard_Commission).

encapsulated in a final report entitled “Final Report and Recommendations on Voluntary Corporate Policies, Practices, and Procedures Relating to Ethical Business Conduct”; and Arthur Andersen & Co. which undertook a “Study of Government Audit and other Oversight Activities Relating to Defense Contractors”. These studies provided critical contributions to the two reports that the Packard Commission would issue in early and mid 1986 – the interim report and the Packard Commission Final Report, examined below.

The Packard Commission in the end issued both an Interim Report on February 28, 1986 (the “Packard Commission Interim Report”) and the Packard Commission Final Report in June 1986. In the Packard Commission Interim Report, the Packard Commission issued six broad recommendations regarding the defense industry procurement process touching all aspects of the procurement process on both sides of the equation – on the DOD side with recommendations to improve internal procedures and controls for the acquisition process and on the defense industry/contractor side with recommendations focused on improvements in companies’ internal governance and procurement processes.

### **III. The Packard Commission and the Rise of DII: Rationale, Worldview, Substance**

#### **A. The Packard Commission: Rationale and Worldview**

The Packard Final Commission Report consisted of four chapters one of which – Chapter Four entitled “Government-Industry Accountability” -- delved directly into the issue that occupies the attention of this Chapter – private industry codes of conduct and accountability. The Chapter thus begins with the following admonition:

“Our study of defense management compels us to conclude that nothing merits greater concern than the increasingly troubled relationship between the defense industry and the government.”<sup>18</sup>

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<sup>18</sup> The Packard Commission Final Report, p. 75.

The Packard Commission furthermore noted that: “The depth of public mistrust of defense contracting is deeply disquieting” but not necessarily because there was so much fraud, according to the Packard Commission Final Report, but because of the public perception that there was widespread fraud, to wit “the current popular impression of runaway fraud and waste undermines crucial support for implementing precisely those management reforms that would increase efficiency.”<sup>19</sup> To that point, the Packard Commission Final Report cited the Market Opinion Research survey commissioned by the Packard Commission in January 1986 and designed to provide feedback on a variety of defense industry issues from the American public’s standpoint.<sup>20</sup>

The Packard Commission Final Report outlined several key, disturbing trends they were aiming to eliminate through their work, to wit:

1. Eliminate Public Misperceptions. Eliminating what they considered to be a vast misperception by the American public of the extent and depth of corruption in the defense industry contracting process. As stated in the Packard Commission Final Report: “The nation’s defense programs lose far more to inefficiency than to dishonesty”.<sup>21</sup> Query whether this indeed was (and remains) the case as widespread inefficiency could arguably be equated with negligence, at best, if not with outright intentional misconduct or fraud, at worst.
2. Ensure Public Support for Defense Initiatives. The Packard Commission Final Report was concerned about public lack of support for defense programs that were critical to the nation. One mustn’t forget that at the time – the mid 1980s – the cold war, with the development of exotic military technology such as “Star Wars” anti-ballistic missile systems and other costly technological breakthroughs, had achieved new heights.

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<sup>19</sup> The Packard Commission Final Report, p. 76.

<sup>20</sup> The Packard Commission Final Report, p. 76. Also see: Market Opinion Research, U.S. National Survey: Public Attitudes on Defense Management, Appendix L in the Packard Commission Final Report, June 1986.

<sup>21</sup> The Packard Commission Final Report, p. 77.

3. Support for DOD Management Reforms. The Packard Commission Final Report was also concerned that public skepticism and misperceptions, as they characterized them, would undermine the ability for DOD and the executive and legislative branches generally to undertake necessary management reforms within the DOD.
4. Avoid Harm to the U.S. Industrial Base. The Packard Commission worried that misplaced and, in their opinion, overblown public concerns about widespread abuse and fraud would also harm the U.S. industrial base.
5. Heighten Defense Industry Accountability. Finally, the Packard Commission also placed the majority of responsibility for the fraud and abuse that did exist on the shoulders of private industry. As the Packard Commission put it:

“...management and employees of companies that contract with the Defense Department assume unique and compelling obligations to the people of our Armed Forces, the American taxpayer, and out nation. They must apply (and be perceived as applying) the highest standards of business ethics and conduct.”<sup>22</sup>

The Packard Commission also made it clear that it did not believe that the way to solve the fraud and waste problems was to create thick layers of auditors, monitors and criminal sanctions. Indeed it stated:

“Though government oversight is critically important to the acquisition process, no conceivable number of additional federal auditors, inspectors, investigators, and prosecutors can police fully, much less make it work more effectively. Nor have criminal sanctions historically proved to be a reliable tool for ensuring contractor compliance.”<sup>23</sup>

In fact, the Packard Commission Final Report emphasized that criminal prosecutions were limited for a variety of reasons including limited government resources yielding the reality that the Department of Justice “declines to prosecute approximately six in ten

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<sup>22</sup> The Packard Commission Final Report, p. 77.

<sup>23</sup> The Packard Commission Final Report, pp.77-78.

possible fraud cases referred to it by federal agencies.”<sup>24</sup> The striking untold possibility laid bare by these statistics is that because of limited resources the U.S. Government at that time was only able to investigate 60% of the possible fraud other agencies actually referred to it – thus not counting the other 40% of cases and any other possible instances of fraud and abuse that those agencies were unable to find out about or pursue because of their limited resources.

While one of the themes clearly in evidence at the time of the Packard Commission Interim and Final Reports was that inefficiency (not only abuse) was a key concern, the other dominant theme was that there was a clear need to establish quality controls and better management on both sides of the procurement equation: the DOD and the private sector. Thus, the DII was borne as much from the need to impose quality and management improvement controls on the procurement process and a desire to create ethical business practices within the defense industry as it was from the perception that there were intolerable instances of fraud, waste and abuse.

#### B. The Substance of the Packard Commission Work: The Interim and Final Reports

The Packard Commission Interim Report made several recommendations – fleshed out more fully in the Packard Commission Final Report -- designed to improve what they considered to be an increasingly deteriorating relationship between the DOD and the defense industry sector. Most of these recommendations focused on establishing procedures and practices around the procurement process both within the DOD bureaucracy as well as through the procurement process with the private defense industry sector.

However, regarding the role of the defense industry itself and the emergence of the DII, there were key final recommendations issued by the Packard Commission in its Final

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<sup>24</sup> The Packard Commission Final Report, p. 78. Also see: U.S. General Accounting Office, *Fraud in Government Programs: How Extensive Is It? How Can It Be Controlled?*, GAO/AFMD-81-57, at 28-30 (May 7, 1981).

Report relating to business ethics and compliance. These recommendations were laid out in Chapter Four of the Packard Commission Final Report, entitled “Government-Industry Accountability”.

Chapter IV starts with the statement: “In our view, major improvements in contractor self-governance are essential”.<sup>25</sup> The Chapter then lists the following five key components of defense contractor self-governance or what could be called an effective ethics and compliance program:

1. Creating Well-Defined Codes of Conduct. In support of this objective, the Packard Commission commissioned the ERC, a leading think tank in the business conduct and ethics space, to analyze the issue of codes of conduct, the effective implementation of policies and procedures and recommend a course of action for the defense industry. In their report entitled “Final Report and Recommendations on Voluntary Corporate Policies, Practices and Procedures Relating to Ethical Business Conduct” issued in February 1986<sup>26</sup>, the ERC recommended to the Packard Commission that companies develop codes of conduct that focus on the company’s key and unique areas of need and risk. For example, within the defense industry the issue of conflicts of interest between private industry and the DOD in the procurement process is a very notable risk where the appearance or reality of a conflict of interest can quickly emerge if DOD officials look for, or private sector companies offer, the promise of future employment to such officials.<sup>27</sup>
2. Developing a System that Tracks and Vets Conflicts of Interest. As the Packard Commission Final Report put it “ to ensure utmost propriety in their relations with government personnel, contractor standards of ethical business conduct should seek

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<sup>25</sup> The Packard Commission Final Report, pp. 81-83.

<sup>26</sup> Ethics Resource Center, “Final Report and Recommendations on Voluntary Corporate Policies, Practices and Procedures Relating to Ethical Business Conduct”, Appendix N in the Packard Commission Final Report.

<sup>27</sup> As will be discussed later in this Chapter, a famous procurement conflict of interest case yielding the conviction and incarceration of both a U.S. government DOD official and the chief financial officer of a defense contractor, Boeing, took place in the early 2000s and involved exactly this type of risk.

to foster compliance by employees of DOD with ethical requirements incident to federal service.”<sup>28</sup>

3. Developing an Instructional and Communications System. A well-developed and targeted instructional system for employees must be in place that helps to implement and realize the policies contained in the code of conduct and make the code available to all employees.
4. A System to Monitor Compliance and Internal Controls. The Packard Commission Final Report zeroed in on another key element of a solid compliance and ethics program and that was – monitoring and follow-up to ensure that the program is being implemented and is effective. A critical component of such an effective ethics and compliance program includes the establishment of a system of internal controls.
5. Role of an Independent Audit Committee. A significant part of Chapter IV of the Packard Commission Final Report, focused on the issue of contractor internal auditing. For this component of their recommendations, the Packard Commission hired the auditing and accounting firm, Peat Marwick, to examine the issue of the role of the audit committee of the board of private contractors and recommend best practices. They did so in their report to the Packard Commission entitled “Report on Survey of Defense Contractors’ Internal Audit Processes” issued in February 1986.<sup>29</sup>

It is interesting to note that the Packard Commission Interim and Final Reports focused almost exclusively on the twin ideas that (a) public perception or misperception of fraud or alleged fraud would undermine the military readiness and capabilities of the United States and (b) such negative public attitudes would also hurt the industrial growth and dominance of the private defense sector. Although much of the work emerging from the Packard Commission reports had other unintended – and salutary – consequences on the overall development of ethics and compliance programs within the private sector, it should not have been surprising to the observer that this would be the primary and almost sole focus of the Packard Commission given both the make-up of the Commission (past,

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<sup>28</sup> The Packard Commission Final Report, p. 83.

<sup>29</sup> The Packard Commission Final Report, p. 84.

present and future captains of industry and leaders of the defense establishment) and their mandate (cleaning up the military procurement process).

Despite the arguably somewhat limited perspective of the Packard Commission, i.e., representing the viewpoint of the military-industrial complex, it is essential to underscore how truly revolutionary and groundbreaking the work of the Packard Commission was as it zeroed in on the fact that defense industry companies needed to do a better and more systematic job of developing internal governance, controls and compliance. It is this aspect of the Packard Commission Reports that became a clear and direct precedent for, and influence on, the emergence of the DII and the eventual rise, discussed later in this Chapter, of a broader and more systemic approach to the creation and implementation of corporate compliance programs generally across industries.

### C. The Interplay between the Packard Commission and the DII

At the same time as the Packard Commission was undertaking its work, commissioning surveys and studies from the likes of the ERC, Peat Marwick, Arthur Andersen and Market Opinion Research, behind the scenes, leaders of several major defense contractors started to develop their own plans to deal with the growing tensions with the U.S. Government, heightened attention from investigative reporters and organizations and the apparent growing public distrust of the industry.

In parallel with the work of the Packard Commission and coinciding with the issuance of the Packard Commission Interim Report in February 1986, the seeds of the DII began to emerge when Jack Welch, then chief executive officer and chairman of the board of General Electric, one of the largest U.S. Government defense contractors and no stranger to defense industry scandals in the 1970s and early 1980s, gathered an elite group of eighteen defense industry sector chief executive officers to discuss the formation of a voluntary compliance program in response to the increasing pressures from the government most notably, the work of the Packard Commission.

By July of that year, one month after the issuance of the Packard Commission Final Report, DII had 32 members that subscribed to its original principles (see Table 1 below). Indeed, because of the interaction between the Packard Commission Interim Report and the emerging work of the original DII group of eighteen defense contractors, the original DII principles actually appeared as an appendix to the Packard Commission Final Report.<sup>30</sup>

| <b>Table 1</b>                                   |                                   |
|--|-----------------------------------|
| <b>DII Signatories July 3, 1986<sup>31</sup></b> |                                   |
| Aeronca Inc.                                     | Hughes Aircraft Co.               |
| Allied-Signal, Inc.                              | IBM Corporation                   |
| American Telephone & Telegraph Co.               | Lockheed Corporation              |
| The Boeing Company                               | Martin Marietta Corporation       |
| Burroughs Corporation                            | McDonnell Douglas Corporation     |
| E-Systems, Inc.                                  | Parker Hannifin Corporation       |
| Eaton Corp.                                      | Pneumo Abex Corporation           |
| FMC Corporation                                  | Raytheon Company                  |
| Ford Aerospace & Communications Corp.            | Rockwell International Corp.      |
| General Dynamic Corporation                      | The Singer Company                |
| General Electric Company                         | Sperry Corporation                |
| Goodyear Aerospace Corporation                   | TRW Inc.                          |
| Grumman Corporation                              | Textron Inc.                      |
| Hercules Incorporated                            | United Technologies Corporation   |
| Hewlett-Packard Company                          | Westinghouse Electric Corporation |
| Honeywell Inc.                                   |                                   |

#### **D. The DII in 1986: The Original Principles and Governance**

##### A. The Original Principles

The birth of DII, whose original principles were published almost simultaneously with the Packard Commission Final Report, represented a groundbreaking moment in the development of organized voluntary business conduct programs not just internally by a company but across an industrial sector. Whether a defense contractor adopted the DII because of a deep-seated sense of corporate responsibility or because it was feeling the

<sup>30</sup> Packard Commission Final Report, Appendix M, pp. 251-254.

<sup>31</sup> [www.dii.org/about-us/history](http://www.dii.org/about-us/history).

heat from the U.S. Government (especially at the heels of the Packard Commission's work), the defense industry was the first industry in the United States (and arguably anywhere else) that systematically and consciously created a system of internal governance intended to address and mitigate fraud and corruption and put systems and processes in place designed to enhance business conduct and legal compliance.

It should be emphasized that at the time of the creation of the DII – in mid 1986 – there were no other visible or notable incentives in place for the creation of an internal system of business ethics or governance other than, of course, the existence of specific federal, state and local laws forbidding all manner of wrongdoing. Constructive incentives to do the right thing from a preventative compliance standpoint did not exist until the U.S. Sentencing Guidelines indirectly created such a framework through Chapter Eight several years later.<sup>32</sup> Chapter Eight of the U.S. Sentencing Guidelines when adopted in 1991 provided the first cross-industry set of government incentives for corporate wrongdoers or potential wrongdoers to create an internal system of business conduct and compliance.

The DII served as a direct inspiration to and precedent to Chapter Eight. The Sarbanes Oxley Act of 2002, which was designed to tackle, root out and systematize internal controls and other compliance measures across the entire private sector in response to the Enron, WorldCom and other significant corporate frauds of the 21<sup>st</sup> century, while indirectly related to these developments in corporate compliance programs was still a distant and unfathomable development at the time of the birth of the DII. However, it too can be said to have benefited directly from the work of the U.S. Sentencing Commission and DII.

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<sup>32</sup> Chapter Eight specifically provides that organizations that are found to have committed a crime and do not have compliance and ethics program elements in place to prevent or detect such crime may not get the benefit of reductions in fines, jail terms and other penalties. U.S. Sentencing Guidelines Manual Section 8B2 at [www.ussc.gov/2007guid/8b2\\_1.html](http://www.ussc.gov/2007guid/8b2_1.html).

Thus, the original DII Principles which appeared in Appendix M to the Packard Commission Final Report (and are listed verbatim in Table 2 below), consisted of the following six fundamental principles:

Principle 1: Written Code of Business Ethics and Conduct. The need for a written code of conduct that provides a clear overview of business conduct expectations.

Principle 2: Employees' Ethical Responsibilities. The need for employees to undertake training and education about business conduct policies and procedures.

Principle 3: Corporate Responsibility to Employees. Companies need to encourage employees to report allegations and violations internally without fear of retribution.

Principle 4: Corporate Responsibility to the Government. The need for self-governance through monitoring of systems and procedures regarding federal procurement compliance and self-reporting of violations to the government.

Principle 5: Corporate Responsibility to the Defense Industry. Sharing of best practices and implementation principles with other in the defense industry through best practice forums.

Principle 6: Public Accountability. Accountability to the public through periodic reporting of results.<sup>33</sup>

While the original DII principles were indeed groundbreaking and something that had not been done before by an industry, they were also fairly basic, limited and generally superficial. They were basic in that they covered several obvious and fundamental issues – such as the need for a code of conduct and training. They were limited in that they

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<sup>33</sup> Defense Industry Initiative on Business Ethics and Conduct, “Origins and Development of the Defense Industry Initiative”, in 2008 Public Accountability Report available at: [www.dii.org/resources/annual-report-2008.pdf](http://www.dii.org/resources/annual-report-2008.pdf).

focused almost exclusively on the idea of addressing and rooting out the principal problem identified by the Packard Commission Final Report – i.e., procurement fraud. Finally, the original DII principles were also in many ways superficial as they exhorted companies to follow their six principles but these principles were largely vague and aspirational and did not create mechanisms for real accountability – for example, requiring independent third party auditing of the implementation of the principles.

| <b>Table 2</b>                              |   |
|---|---|
| <b>The Defense Industry Principles 1986</b> |   |
| Principle 1                                 | Each company will have and adhere to a written code of business ethics and conduct.   |
| Principle 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. |
| Principle 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.  |
| Principle 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.  |
| Principle 5                                 | Each company has the responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.   |
| Principle 6                                 | Each company must have public accountability for its commitment to these principles.  |

#### B. DII Governance and Membership

The creation of the DII also entailed the creation of infrastructure -- an actual non-profit organization to help run the initiative based out of Washington, D.C., to assist members with developing best practices and to encourage new members to join. Early in the life of

the DII – right after its creation – and as part of the development of this infrastructure, a high level steering committee was formed headed to begin with by none other than Jack Welch, chief executive officer of General Electric, the original corporate instigator of the development of the DII. The DII steering committee was made up of the chief executive officers of several leading defense contractors and was put in place as the top governance body within the DII. The steering committee remains to this day the internal body that provides oversight to the overall organization and consists of chief executive officers of leading members with a rotating chair.<sup>34</sup>

In addition to a steering committee, the DII has both a full time DII coordinator, someone who actually runs the organization, and a working group of heads of ethics and compliance from some of the leading defense industry contractor members of the DII. The working committee focuses on tactical leadership of the organization as well as more specific guidance on what the overall DII organization should be devoted to including keeping up with all manner of defense industry and other compliance developments not only in the United States but increasingly globally.<sup>35</sup>

So what does it take to become a member of DII? Any U.S. defense contractor (and that includes non-U.S. companies with a U.S. subsidiary that is a DOD contractor) can apply for membership in the DII. To do so, the defense contractor must fill out an application, be accepted, have its chief executive officer publicly commit to the DII Principles and, in turn, remain in good standing. Indeed, the DII itself states that it is “selective accepting only those defense companies whose CEOs personally commit the company to abide by

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<sup>34</sup> “Origins and Development of the Defense Industry Initiative”, p. 25. For a roster of the members of the DII Steering Committee at the time of writing of this Chapter, including such notables as the chief executive officers of UTC, Honeywell, Northrop Grumman and Raytheon, see: [www.dii.org/our-companies/dii-steering-committee](http://www.dii.org/our-companies/dii-steering-committee).

<sup>35</sup> See the composition of the current Working Group which includes the chief ethics and compliance officers of General Dynamics, Lockheed Martin and Boeing, to name a few, by going to the following website: [www.dii.org/our-companies/dii-working-group](http://www.dii.org/our-companies/dii-working-group). There are resources publicly available on the DII website including all of the presentations made at the annual DII conference which usually takes place in June of each year.

the DII Principles.”<sup>36</sup> Part of this commitment includes filling out an annual questionnaire, to be examined in greater detail below, the contents of which becomes part of a compiled annual report published by DII to the public. This published summary of the DII members’ answers is meant to satisfy the DII principle of public accountability.

But what does it mean to be a DII member in good standing? A look at the period of history between 1986, when the DII was adopted, through today would indicate that to be a member in good standing of the DII a company does not have to be in complete compliance with the DII Principles.<sup>37</sup> Thus, a number of DII members over the years have had differing degrees of legal and regulatory difficulty (see Table 4) but have not been asked to leave the DII. It would therefore seem that to be a member in good standing of the DII it is sufficient for a company and its chief executive officer to make an internal commitment to establish and maintain a program of compliance and ethics and then provide responses to the annual public accountability questionnaire. This means living up to the six principles – having a code, educating employees, providing whistleblowing solutions, conducting internal monitoring and auditing, sharing best practices across the industry and providing public information on the compliance program – but as reported and determined by the member company itself. Thus it would seem that as long as the member provides these reports and appears to have an effective internal compliance and ethics program, it can continue to be a member of DII, with all the benefits appurtenant thereto.

### **III. From 1991 to 2010: The DII and the Emergence of an Ethics and Business Conduct Program Paradigm**

#### **A. The 1991 United States Sentencing Guidelines**

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<sup>36</sup> DII 2009 Public Accountability Report, p. 29.

<sup>37</sup> Only six years after the adoption of the DII Principles, General Electric found itself in a major defense bribery scandal. See: Richard W. Stevenson, “Pentagon Disciplines GE for Bribe Scandal”, The New York Times, June 3, 1992. Also, see Table 4 below for a summary of defense industry enforcement cases from 1992 through 2002 which includes many of the leading members of DII.

It was only five years after the first publication in 1986 of the DII that the U.S. Congress legislated what has become the paradigm for compliance and ethics programs in the United States (and arguably even increasingly internationally over the past decade) through what is known as Chapter Eight of the U.S. Sentencing Guidelines first passed in 1991, and subsequently amended in 2004 and 2010.<sup>38</sup> Primarily focused on the issue of how the judiciary is to calculate punishment for corporate criminal conduct under federal laws, the U.S. Sentencing Guidelines through Chapter Eight were directly and indirectly inspired by the DII Principles adopted a half a decade earlier.

The guidance for creating and implementing a compliance and ethics program laid out in Chapter Eight of the Sentencing Guidelines has since become the recognized legal basis and standard in the United States for how a corporate compliance and ethics program should look.<sup>39</sup> And the elements of an effective program first laid out in Chapter Eight have become the essential elements of an effective and recognized compliance program not only in the U.S. but increasingly globally, in one format or another.

In essence, Chapter Eight mimics many of the tenets of the DII Principles. Table 3 summarizes the many areas of equivalency and similarity of the respective elements of a sound compliance program as set forth under each document:

|  |
|--|
| <p><b>Table 3</b></p> <p><b>Comparison of DII Principles of 1986 to U.S. Sentencing Guidelines of 1991</b></p> |
|--|

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<sup>38</sup> The U.S. Sentencing Guidelines were first adopted in 1991, amended in 2004 and in 2010 new amendments were pending at the time of writing of this Chapter which were expected to become law on November 1, 2010, the time at which Congress would automatically adopt the amendments barring unforeseen legislative action prior to such deadline.

<sup>39</sup> For a comprehensive overview and analysis of the elements of an effective ethics and compliance program as inspired by Chapter Eight of the U.S. Sentencing Guidelines, see: The Ethics & Compliance Handbook: A Practical Guide from Leading Organizations, the Ethics & Compliance Officer Association Foundation, Waltham, MA, 2008.

| <b>DII Principle<sup>40</sup></b>                                | <b>Chapter Eight of the U.S. Sentencing Guidelines<sup>41</sup></b>   |
|--|---|
| Principle 1:<br>Written Code of Business Ethics and Conduct      | Code of Conduct and system of policies  |
| Principle 2:<br>Employees' Ethical Responsibilities              | Training and Communications Programs  |
| Principle 3:<br>Corporate Responsibility to Employees            | Anonymous and other reporting without fear of retaliation   |
| Principle 4:<br>Corporate Responsibility to the Government       | Internal compliance risk assessments; monitoring; auditing  |
| Principle 5:<br>Corporate Responsibility to the Defense Industry |   |
| Principle 6:<br>Public Accountability                            |   |
|  | Effective, comprehensive and fair system of internal discipline   |
|  | Delegation of Approval authority (system of internal controls)  |
|  | Establishing and supporting proper internal resources in the form of an ethics and compliance officer and other personnel |

Thus, the DII served as a precursor and in some ways an inspiration for much of what ended up as part of Chapter Eight of the U.S. Sentencing Guidelines and thus the law of the United States.<sup>42</sup>

<sup>40</sup> See the original DII Principles at: [www.dii.org/resources/dii-charter.pdf](http://www.dii.org/resources/dii-charter.pdf).

<sup>41</sup> The U.S. Sentencing Guidelines at: [www.usc.gov/2007guid/8b2\\_1.html](http://www.usc.gov/2007guid/8b2_1.html). The Sentencing Guidelines were amended in 2004 and will be amended again in 2010. This summary adds all amendments through 2004.

<sup>42</sup> The oddity about Chapter Eight of the U.S. Sentencing Guidelines is that it does not represent a law that is proactively enforced. It is a law that is applied in retrospect when a potential or actual corporate wrongdoer is under investigation or prosecution by the U.S. Government, the U.S. prosecutors will ask the corporation whether it has a compliance program in place and will measure through tools and practices developed by the DOJ whether such a program is indeed in place. If the company does not seem to have a compliance program or only has what appears to be a veneer of a program, the

## B. The Emergence of a New Profession: The Ethics and Compliance Officer

Almost simultaneously with the issuance of the U.S. Sentencing Guidelines, a small group of little more than a dozen ethics officers of various industries – including from the defense industry – got together at Bentley College in Massachusetts to create the first non industry specific association for the emerging ethics and compliance profession – the Ethics Officer Association today known as the Ethics and Compliance Officer Association (ECOIA).<sup>43</sup> By its own admission, the ECOIA was created as a result of the concurrent activities elicited by the work of the DII as well as the U.S. Sentencing Guidelines. The ECOIA has since become the largest professional association of its kind internationally and has been joined by a wide variety of professional, quasi-professional, non-profit, commercial and consulting organizations all feeding off of the idea that companies need to have an internal ethics and compliance program to address both internal and external compliance and ethics needs and threats. Such expert entities – whether for profit or non-profit -- have developed a wide array of tools, techniques, training, auditing and other products and services for the ethics and compliance professional to build an effective program -- central to this overall development in the field was and continues to be the work of the DII.<sup>44</sup>

## C. Enron and Company – The Pendulum Swings in the Early 2000s

What eventually became one of the biggest frauds in corporate history – the Enron story - - was brewing and began to bubble to the surface during the summer of 2001. Together with the occurrence of 9/11 and its concomitant impact on the conduct of international business leading to a worldwide recession, the Enron scandal and several others that rose at its heels – to wit, Arthur Andersen, WorldCom, Global Crossing, Adelphia, Qwest,

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DOJ will potentially charge the company with greater wrongdoing and or seek higher fines and penalties.

<sup>43</sup> See:

[www.theecoa.org/imis15/ECOAPublic/ABOUT\\_THE\\_ECOIA/History\\_of\\_the\\_ECOIA/ECOAPublic/AboutContent/History.aspx?hkey=43ce057e-1870-408c-a6b3-b2f27c5b2950](http://www.theecoa.org/imis15/ECOAPublic/ABOUT_THE_ECOIA/History_of_the_ECOIA/ECOAPublic/AboutContent/History.aspx?hkey=43ce057e-1870-408c-a6b3-b2f27c5b2950)

<sup>44</sup> Ethics and Compliance Officer Association. [www.theecoa.org](http://www.theecoa.org).

Parmalat to name a few – had a major regulatory impact in the United States and Europe on issues of governance, internal controls, whistle-blowing programs and compliance generally. Working at what could be considered warp-speed for a legislative body anywhere, the U.S. Congress moved quickly after the collapse of Enron and enacted what came to be known as the Sarbanes Oxley Act of 2002 (SOX). SOX emerged as the next big thing in compliance focusing mainly on publicly traded companies, their internal controls, their document retention programs, their whistleblower protection programs and other key risk management processes.<sup>45</sup>

#### D. Amendments to the U.S. Sentencing Guidelines: The Role of DII as the Paradigm Evolves

There have been two major sets of amendments to the U.S. Sentencing Guidelines – one passed in 2004 and the other pending at the time of this writing in 2010. After its original adoption in 1991, the U.S. Sentencing Guidelines with its seven principal guidelines (many of which were inspired by the DII Principles as discussed earlier) remained pretty much intact until 2004.<sup>46</sup> At that time, the U.S. Sentencing Commission completed its review of the 1991 Sentencing Guidelines by conducting hearings involving many experts in the field some of whom had been direct contributors to and beneficiaries from the DII experience. These included the ERC and numerous ethics and compliance professionals who had been involved with the creation of the DII and the emergence of the ECOA.

The 2004 amendments to the U.S. Sentencing Guidelines revolved around several key components for an effective ethics and compliance program the most important of which included a new requirement for periodic compliance risk assessments to be conducted, the need for the ethics and compliance function to be allocated sufficient resources to

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<sup>45</sup> The literature on the Enron and post-Enron scandals is vast as is the literature on SOX. See bibliography appended to this Chapter for a variety of useful resources relating to this period.

<sup>46</sup> See Table 4 in this Chapter.

build and maintain a program and, very importantly, the need for governance and senior management oversight and ultimate responsibility for the program.<sup>47</sup>

The 2010 amendments to the U.S. Sentencing Guidelines, expected to pass intact as approved by the U.S. Sentencing Commission and become law by November 1, 2010, represents the latest thinking and action on the creation of an effective ethics and compliance program and will require that a company's chief ethics and compliance executive have direct, personal access to the governing body or board when and if deemed necessary by such executive.<sup>48</sup> This requirement, once again, is something that several leading companies, including members of DII, have already instituted as a best practice.<sup>49</sup>

#### E. The Emergence of Mandatory Procurement Fraud Reporting – the 2008 Amendments to the Federal Acquisition Rules

While the trends described above relating to the passage of the U.S. Sentencing Guidelines in 1991, emergence of an ethics and compliance profession within companies and the adoption of Sarbanes Oxley applicable to all companies and all industries, it is possible to state that the defense industry, whether it is admired or not, whether it adopted the DII principles for all the right reasons or simply for fear of government adverse action, was the precursor and instigator of many of these trends and, in turn, a major contributor to the emergence over time of a set of compliance and ethics program best practices (see Table 3 above).

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<sup>47</sup> For a reader friendly version of these amendments see:

[www.ussc.gov/2004guid/RFMay04.pdf](http://www.ussc.gov/2004guid/RFMay04.pdf).

<sup>48</sup> A full statement of the 2010 amendments to Chapter Eight of the U.S Sentencing Guidelines can be found here: [www.ussc.gov/2010guid/finalamend10.pdf](http://www.ussc.gov/2010guid/finalamend10.pdf).

<sup>49</sup> Ethics Resource Center, Ethics and Compliance Officer Association et al. "Leading Corporate Integrity: Defining the Role of the Chief Ethics and Compliance Officer", January 2008. This paper is available at: [www.ethics.org/files/u5/CECO\\_Paper\\_UPDATED.pdf](http://www.ethics.org/files/u5/CECO_Paper_UPDATED.pdf).

Part of the rationale for DII had always been to preempt further regulatory encroachment by the government by creating a strong voluntary program of ethics and compliance that would prevent the passage of more legal and compliance requirements. However, as much as it tried to convince the U.S. government not to require mandatory reporting of possible procurement fraud by implementing a best practices program of voluntary disclosure, the DII was not able ultimately to succeed on this particular issue. Part of the reason undoubtedly had to do with the fact that as much as the DII developed its compliance and ethics principles and practices, instances, and not just isolated one's, of defense industry procurement fraud cropped up regularly and sometimes dramatically both through investigative media and government investigations and prosecutions. Indeed it was only within six years of the DII's adoption and GE's leadership through Jack Welch's championing of DII in June 1986 in making DII a reality, that GE was once again involved in a major defense industry scandal.<sup>50</sup>

But GE was certainly not alone. In a major investigative report published in U.S. News and World Report in 2002 it became clear that with or without a major initiative such as DII, the old curse of procurement fraud and other compliance violations continued it would seem unabated. According to this report, "in the past dozen years, 30 of the federal government's biggest contractors have accumulated more than 400 enforcement cases, resulting in at least \$3.4 billion in penalties, settlements, and restitution."<sup>51</sup> Table 4 provides a summary of the number of cases and total amount of fines in millions paid by the top ten corporate violators fined by the government over the ten year period examined in this investigative report from 1992 through 2002:

|                |
|----------------|
| <b>Table 4</b> |
|----------------|

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<sup>50</sup> See: Richard W. Stevenson, "Pentagon Disciplines GE for Bribe Scandal", The New York Times, June 3, 1992.

<sup>51</sup> Christopher H. Schmitt, "U.S. Wages of Sin: Why Lawbreakers Still Win Government Contracts." US News and World Report, May 13, 2002.

| <b>Defense Industry Contractor Enforcement Cases<br/>Track Record 1992 - 2002<sup>52</sup></b> |                        |  |
|--|------------------------|--|
| <b>Company</b>   | <b>Number of Cases</b> | <b>Total Fines<br/>(in million \$)</b> |
| General Electric   | 63                     | 982                                    |
| TRW  | 17                     | 389                                    |
| Boeing   | 36                     | 358                                    |
| Lockheed Martin  | 63                     | 232                                    |
| United Technologies  | 18                     | 215                                    |
| Archer Daniels Midland   | 8                      | 208                                    |
| Unisys   | 12                     | 182                                    |
| Raytheon   | 24                     | 129                                    |
| Litton (acquired by<br>Northrup Grumman)   | 8                      | 111                                    |
| Cargill  | 8                      | 102                                    |

Other cases of defense contractor misbehavior or wrongdoing have occurred throughout this period and doubtlessly will continue to occur. Some of the more notorious cases have involved defense contractors working for the U.S. Government in the two Iraqi wars – both in terms of pure procurement fraud as has been the case with Halliburton and KBR – and as part of the scandal known as the UN Oil for Food scandal.<sup>53</sup> Moreover, Boeing was no stranger to scandal in the early 2000s when it became embroiled in one of the most reported cases of pure conflict of interest between the DOD and a defense contractor in the case of Darleen Druyun, a high ranking air force procurement officer who while negotiating on behalf of the U.S. Government with Boeing for the purchase of military equipment was also conducting parallel negotiations for a lucrative personal deal with none other than the chief financial officer of Boeing at the time. Needless to say,

<sup>52</sup> Christopher H. Schmitt, “U.S. Wages of Sin: Why Lawbreakers Still Win Government Contracts.” US News and World Report, May 13, 2002.

<sup>53</sup> See: Sharon Otterman, “Iraq: Oil for Food Scandal”, Council on Foreign Relations, October 28, 2005, available at: [www.cfr.org/publication/7631/iraq.html](http://www.cfr.org/publication/7631/iraq.html).

once uncovered, this case blew up in the face of both people and both entities – a defense contractor and the DOD -- the two entities most targeted by the Packard Commission for avoidance of exactly issues of this kind. Both Doreen Druyun and Boeing’s chief financial officer, Michael Sears, were prosecuted, found guilty and served jail terms.<sup>54</sup>

Thus in the late fall of 2008, the U.S. Congress addressed the issue of procurement fraud in the defense industry once again. This time the legislature focused on what had been one of the “best practices” tenets of the DII – the voluntary disclosure of possible fraud. Given the continuing track record of defense industry fraud and abuse (so amply illustrated in Table 4), the U.S. Congress addressed the issue this time through amendments to the Federal Acquisition Regulations which would now make it legally mandatory for defense contractors to have an internal system to detect and address potential procurement fraud early and often, and requiring such companies to inform the government immediately of any suspected procurement fraud.<sup>55</sup> This new edict got the defense industry scrambling to find ways to convert their voluntary disclosure practices into a system for mandatory reporting of suspected fraud which would require reporting of suspected or actual fraud at very low monetary thresholds and in connection with subcontractors as well.<sup>56</sup>

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<sup>54</sup> Jerry Markon, Renae Merle, “Former Boeing Executive Pleads Guilty”, The Washington Post. At: <http://www.washingtonpost.com/ac2/wp-dyn?pagename=article&contentId=A27573-2004Apr20&notFound=true>. Also see: CBS News, 60 Minutes, “Cashing in for Profit? Who Cost Taxpayers Billions in Biggest Pentagon Scandal in Decades?”, available at: [www.cbsnews.com/stories/2005/01/04/60II/main664652.shtml](http://www.cbsnews.com/stories/2005/01/04/60II/main664652.shtml); and Leslie Wayne, “A Growing Military Contract Scandal”, the New York Times, November 8, 2004, available at: [www.query.nytimes.com/gst/fullpage.html?res=9C02E4DB153BF93BA35753C1A9629C8B63&sec=&spon=&pagewanted=all](http://www.query.nytimes.com/gst/fullpage.html?res=9C02E4DB153BF93BA35753C1A9629C8B63&sec=&spon=&pagewanted=all).

<sup>55</sup> November 12, 2008 at 73 Fed. Reg. 67,064 - 67,093.

<sup>56</sup> For a copy of the regulations see: [www.edocket.access.gpo.gov/2008/E8-26906.htm](http://www.edocket.access.gpo.gov/2008/E8-26906.htm). For a good summary of the implications of the new regulations to the defense industry see: Scott W. MacKay, Angela B. Styles, Carl Buzawa and Douglas E. Perry, “Mandatory Disclosure: A New Reality” December 3, 2008, available at [www.dii.org](http://www.dii.org).

Table 5  
The Impact of 2008 Amendments to the Federal Acquisition Regulations<sup>57</sup>

“The contractor shall timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed –  
 (A) A violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or  
 (B) A violation of the civil False Claims Act (31 U.S.C. §§ 3729-3733”

1. Defense contractors may be debarred or suspended from a federal contract for failure to timely disclose to the U.S. Government credible evidence of the following possible violations under a federal contract:
  - a. Significant overpayments
  - b. Civil False Claims
  - c. Bribery
  - d. Gratuity
  - e. Fraud (Title 18)
  - f. Conflict of Interest
2. Defense contractors must have a defined system of internal controls
3. Contractor requirement to disclose if knowledge of subcontractor possible violation
4. Applicable to contracts of \$5 million+ and 120 days performance +
5. Applicable to small businesses
6. Subcontractor disclosure directly to the Government, not through prime contractor
7. Contractor must have an ongoing program of business ethics an conduct

F. The Financial Meltdown of the First Decade of the 21<sup>st</sup> Century

As if a bookend to the beginning of the decade with the eruption of Enron et al, the first decade of the 21<sup>st</sup> Century ended with the overwhelming and pervasive global financial meltdown that began with the failures of Bear Stearns and Lehman Brothers in 2008 and still reverberates at the time of writing of this Chapter. This “closure” to the first decade, as it were, is most dramatically underscored and exemplified by the signing into law by President Barack Obama on July 21, 2010, of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the most radical and comprehensive change in financial industry regulation since the 1930s and the establishment of the passage of the

<sup>57</sup> United States Government Accountability Office. “Defense Contracting Integrity: Opportunities Exist to Improve DOD’s Oversight of Contractor Ethics Programs”. Report to Congressional Committees. September 2009. Page 43.

Securities and Exchange act of 1934. This regulatory retort to the largest and most pervasive crisis in global finance the world has known was very similar to the adoption of the Sarbanes Oxley Act of 2002 at the heels of the pervasive fraud exemplified by the Enron and WorldCom cases of the turn of the century and perhaps even the U.S. Sentencing Guidelines of 1991 and the FCPA in 1977 as a result of some of the scandals of those days.<sup>58</sup>

The significance of these historical trends and changes to DII has more to do with the emerging compliance environment that has been evolving over the past one to two decades which is likely to continue to evolve over the next decade affecting not only the defense industry but the private sector nationally and internationally.

#### **IV. The DII Today: Status, Challenges and the Future**

##### **A. The Principles Themselves – How Have They Changed?**

The DII website publishes information for its members, observers and, by sharing its resources publicly, with other industries. A recent look at the website revealed that the following components of an effective business conduct program were among the key elements endorsed by the DII:

- Company values
- Leadership commitment
- Risk assessment
- Ethics and business conduct policy
- Program assessment and evaluation

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<sup>58</sup> See the following contemporaneous accounts of several recent scandals: Barbara Ley Toeffler and Jennifer Reingold. *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen*. New York, NY: Currency Doubleday, 2003; Cynthia Cooper. *Extraordinary Circumstances: The Journey of a Corporate Whistleblower*. NY: Wiley, 2008; and Bethany McLean and Peter Elkind. *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*. Portfolio Hardcover, 2003.

- Code of conduct
- Communications plan and awareness initiatives
- Inquiry and reporting mechanisms
- Awareness training

More interestingly, the original principles adopted by the DII back in 1986 have undergone a transformation as well – partly because of the need to adapt to changing circumstances but also as part of the to and fro between the DII, the larger ethics and compliance community and the government as this Chapter has tried illustrate.

Thus, the original DII principles have changed with the times. What follows is a principle by principle comparison and analysis between the current language of the DII principles as amended through March 2010 as compared to the original principles created in 1986:

**2010 New Preamble:**

*“We the members of the Defense Industry Initiative on Business Ethics & Conduct (DII), affirm our commitment to uphold the highest ethical standards in all our business dealings with the government, as expressed through the following principles:”*

The original DII Principles of 1986 did not include a preamble such as the one stated in the latest version. The latest version clearly attempts to emphasize key concepts of taking responsibility, assigning accountability and setting expectations. Indeed, the preamble is prefaced with the following statement: “DII members, and the CEOs of every DII company, must abide by DII’s core principles.” It also contains what has become a much important component of business conduct programs in recent times, especially since the adoption of the 2004 U.S. Sentencing Guideline amendments—an emphasis on creating an ethical culture.

Principle 1:

*1986: Each company will have and adhere to a written code of business ethics and conduct.*

***2010: We shall act honestly in all business dealings with the U.S. Government, protect taxpayer resources and provide high quality products and services for the men and women of the U.S. Armed Forces.***

This latest version of the DII principles clearly emphasizes up front and centrally the core objective of the principles themselves – i.e., the true purpose of the DII principles is almost exclusively to ensure that no malfeasance takes place through member companies' dealings with three key stakeholders: the U.S. Government, U.S. taxpayers (whose money after all goes to purchase defense industry products and services) and U.S. military personnel (whose health and safety is paramount). The original principle #1 requiring a code of conduct has been subsumed under the current principle #2, see below.

Principle 2:

*1986: 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.*

**2010: We shall promote the highest ethical values as expressed in our written codes of business conduct, nurture an ethical culture through communications, training, and other means, and comply with and honor all governing laws and regulations.**

The second principle has become synchronized more closely to the state of ethics and compliance programs generally as influenced by Chapter Eight of the U.S. Sentencing Guidelines, Sarbanes Oxley and other recent developments. Its focus is more heavily directed at building an ethical culture and its purpose is more aligned with compliance with all laws and regulations, not just procurement laws. An emphasis on training and communications also reflects the rise of these elements in an effective compliance and ethics program.

Principle 3:

*1986: 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.*

**2010: We shall establish and sustain effective business ethics and compliance programs that reflect our commitment to self-governance, and shall encourage employees to report suspected misconduct, forbid retaliation for such reporting, and ensure the existence of a process for mandatory and voluntary disclosures of violations of relevant laws and regulations.**

There are clear and important changes to this principle. First and foremost, the whistleblower protection language is stronger and the focus on having a proper system in place is keener. Moreover, changes have been made to clarify that voluntary disclosure of wrongdoing is no longer simply desirable but necessary, mandatory disclosure requirements are now in place and must be reflected internally within companies.

Principle 4:

*1986: 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.*

**2010: We shall share best practices with respect to business ethics and compliance and participate in the annual DII Best Practices Forum.**

This principle has been changed completely with the content from the original principle #4 subsumed in other current principles – namely principle #3. This new principle #4 focuses on the public accountability aspect of the principles originally under original principle #6 which has now been eliminated.

Principle 5:

*1986: Each company has the responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.*

**2010: We shall be accountable to the public, through regular reporting by DII to Congress and the public. These reports will describe members' efforts to build and sustain a strong culture of business ethics and compliance.**

The current version of the DII principles expands the accountability concept from accountability strictly to one another as members of DII to a broader multi-stakeholder concept of actual accountability through regular reporting from each defense contractor member to both the U.S. Congress and the public.

Principle 6:

*1986: Each company must have public accountability for its commitment to these principles.*

**2010: The current version does not have a sixth principle.**

The vague and aspirational public accountability language from the original principles is now contained in the current version of Principle #5 as a more concrete requirement (see above).

Although the principles have changed somewhat with the passage of time, the focus of the principles and of DII generally is on their questionnaire which they require all members in good standing to fill out and deliver to the DII coordinator every year. The questionnaire then becomes the basis for the public accountability aspect of the DII – the summary report prepared by the DII for public consumption. Let us turn to an examination of the questionnaire.

Converting Principles into Practices: The Original DII Questionnaire of 1986 Compared to Today's (2009) Questionnaire

The DII touts the fact that one of its principal contributions to the public is the fact that its members engage in public accountability. The principal manner in which members do this is by filling out each year a public accountability questionnaire. Below is an analysis of this questionnaire as it first existed in 1986 and as it exists today – substantial and constructive changes have been made. However, one important question remains and should be kept in mind throughout a reading of this analysis – while the questionnaire must be filled by a member in good standing of the DII, the information each company submits to the DII coordinator is not in itself made public. In fact, what is claimed to be public accountability really remains fairly behind the scenes as the DII coordinator collects and reviews the information and in turn provides a public report that discusses trends and activities but with no individual company information revealed.

Both the original DII principles and the current one's as include a questionnaire to help each member conduct an internal survey of the state of business ethics and conduct within their organization and to assist in the preparation of accountability report. Table 6 shows the original questionnaire as it was first created in 1986 as well as the questionnaire as it exists at the time of the writing of this Chapter. It is clear that some major changes – most for the better – have taken place over the two and a half decades of existence of the questionnaire. However, a fundamental concern must be kept in mind throughout a consideration of these questions – they are voluntarily collected reported by companies to the DII coordinator and the DII coordinator prepared a collective, anonymous and voluntary public report in turn.

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| <p><b>Table 6</b></p> <p><b>The Original DII Questionnaire 1986 Compared to the Current (2009) DII “Public Accountability” Questionnaire<sup>59</sup></b></p> |
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<sup>59</sup> Information in this table was gathered from DII’s original Questionnaire issued in 1986 and the current (2009) Questionnaire which can be found as Attachment B to the “Public Accountability Report of the Defense Industry Initiative on Business Ethics and Conduct”, January 1, 2008 – June 30, 2009, [www.DII.org](http://www.DII.org). All new questions not

| 1986 Questionnaire |   | 2009 Questionnaire   |
|--------------------|---|--|
| 1.                 | Does the company have a written code of business ethics and conduct?                                | Does the company have a written Code of Business Ethics and Conduct? <i>(Please provide link to the current version).</i><br>See 1986 Question #1.<br>NEW:<br><i>Describe any code provisions or policies or supplemental materials that require prompt internal reporting of violations of the code to an appropriate person or persons identified in the code. If reporting is not required, describe any code provisions that encourage such reporting and identify to whom the reports are to be made.</i> |
| 2.                 | Is the code distributed to all employees principally involved in defense work?                      | NEW:<br><i>Describe any code provisions, policies or other supplemental materials that address Government contracting compliance risk areas.</i>   |
| 3.                 | Are new employees provided any orientation to the code?   | Describe any code provisions, policies or other supplemental materials that call for fair dealing and identify standards for governing conduct with customers, suppliers and competitors.<br>See 1986 Question # 6.  |
| 4.                 | Does the code assign responsibility to operating management and other for compliance with the code? | NEW:<br><i>Describe any code provision or associated policy that requires that outside marketing and sales consultants are governed by, and informed of the company's code of conduct and relevant associated policies.</i>  |
| 5.                 | Does the company conduct employee training programs regarding the code?                             | NEW:<br><i>What is the title of the senior person or persons assigned responsibility for the company's ethics and business conduct program?</i>  |
| 6.                 | Does the code address standards that govern the conduct of employees in their dealings              | Does the company distribute the code to all employees <i>(including agents and contract</i>  |

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originally part of the original 1986 Questionnaire have been italicized in this Table for ease of reference.

|     |  |   |
|-----|--|---|
|     | with suppliers, consultants and customers?   | <i>employees</i> ) principally involved in defense contract work? <i>(Describe.)</i><br>See 1986 Question #s 2 and 3.   |
| 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                  | NEW:<br><i>Describe the company's efforts, if any, to make the code known to subcontractors.</i>  |
| 8.  | Does the mechanism employees protect the confidentiality of employee reports?  | Are new employees provided an orientation to the code? <i>If so, describe when and how.</i><br>See 1986 Question #3.  |
| 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?   | Does the company conduct employee information and training programs regarding employee obligations under the code? <i>(Describe best examples.)</i><br>See 1986 Question #5.  |
| 10. | Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?  | NEW:<br>a. <i>Describe the company's internal mechanism(s) for employees and others to seek ethics guidance and report suspected instances of misconduct.</i><br>b. <i>Describe the ways in which the reporting mechanism(s) is publicized.</i><br>See 1986 Question #s 9 and 10. |
| 11. | Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?  | Describe any code provisions or company policies or practices which seek to protect the confidentiality if a reporting employee's identity <i>and prohibit retaliation for good-faith use of the reporting mechanism?</i><br>See 1986 Question #8.                                |
| 12. | What are the specifics of such a program?<br><ul style="list-style-type: none"> <li>• Written communication?</li> <li>• One-on-one communication?</li> <li>• Group meetings?</li> <li>• Visual aids?</li> <li>• Others?</li> </ul> | NEW:<br><i>Describe any code provisions or company policies or procedures that govern the review or investigation of possible violations of the code (including matters reported by employees or third-parties).</i>  |

|     |  |  |
|-----|--|--|
| 13. | Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?   | NEW:<br><i>Describe any code provision or company policies or procedures for letting those who report possible violations know the result of the company's follow-up.</i>                                |
| 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?   | Describe any code provision or company policies or procedures for voluntarily reporting violations of federal procurement law to appropriate governmental authorities.<br>See 1986 Question #13.         |
| 15. | Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?   | Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their job performance?<br><i>(Describe).</i><br>See 1986 Question #14. |
| 16. | Does the company participate in the industry's "Best Practices Forum"?   | Is there a program to monitor, on a continuing basis, adherence of the code and compliance with federal procurement laws? <i>(Describe how monitored.)</i><br>See 1986 Question #15.                     |
| 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?   | NEW:<br><i>Describe any process the company uses to periodically review the effectiveness of its ethics and business conduct policies, procedures and program.</i>                                       |
| 18. | Are the company 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? | NEW:<br><i>Does the company periodically modify its program to ensure that existing or emerging risks are addressed appropriately? If so, describe the process used.</i>                                 |
| 19. |  | NEW:<br><i>Describe any code provision or company policy or procedure governing discipline and corrective actions which are responsive to violations of the code.</i>                                    |

|     |  |   |
|-----|--|---|
| 20. |  | <p>Did the company fulfill its obligation to share best practices with respect to adherence to standards of ethical business conduct? <i>Did the company attend the most recent Best Practices Forum? Who from the company attended?</i></p> <p>(See 1986 Question #16)</p> |
| 21. |  | <p>NEW:</p> <p><i>Describe any periodic reports on the company's ethics and conduct program that are made to the company senior management and/or the Board of Directors or governing body.</i></p> <p>(See 1986 Question #18)</p>  |
| 22. |  | <p>NEW:</p> <p><i>What does the company do to promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law?</i></p>  |
| 23. |  | <p>NEW:</p> <p><i>What does the company do to promote or require implementation of ethics and business conduct programs consistent with the DII principles within your Supply Chain?</i></p>  |
| 24. |  | <p>NEW:</p> <p><i>Provide the name and contact information of the company individual best informed to respond to questions about these responses.</i></p>   |

An analysis of the original 1986 Questionnaire shows that while the questions were important and critical to understanding the relative robustness of an ethics and business conduct program (and frankly these questions had never been asked before), in and of themselves, the 1986 questions weren't that useful as they often required a simple yes or no answer, did not require proof or follow up and provided a generally superficial treatment of the issues raised. To wit: the first four questions of the 1986 Questionnaire could be answered with a simple yes or no:

- Yes, we have a code of conduct;
- Yes, we circulate the code to all employees;
- Yes, employees receive orientation and training on the code; and
- Yes, we assign accountability for implementation of the code to operating personnel.

However, some of the other questions in the 1986 Questionnaire did begin to address the more difficult to measure but nevertheless core aspects of a program which, if demonstrable, can help to create a culture of business ethics over the longer term. Among these kinds of questions from the 1986 Questionnaire were:

- Question #7 which addressed the issue of the creation of concrete internal resources to help employees with their concerns and questions.
- Question #9 which addressed the need for follow up and resolution of suspected violations that may have been reported by employees or others.
- Question # 10 which raised an issue of great importance -- creating a sense amongst employees that the company would listen to their concerns and follow up to create solutions and closure.

Next there were several questions in the 1986 Questionnaire that dealt directly with the issue of procurement and government relations. See questions 6, 13 and 15. These questions, however, largely reflect the fact that the genesis of the DII program can be attributed to the need for the defense industry to react quickly to an increasingly negative public and legislative perception of the industry at the heels of the defense procurement scandals of the early 1980s.

The 1986 Questionnaire also has a few questions that focus on one of the most difficult issues of all in the creation and implementation of an effective ethics and compliance program: how can you measure its effectiveness, its reality, the fact that it is not only a set of words, policies and aspirations, but something that is taken seriously, actually

implemented and for which results can be measured. Questions 14, 15, 17 and 18 address the measurability issue to a certain extent but not fully. While these questions encourage review by, or reporting to, important third parties such as a company's board of directors, outside auditors and the government itself, such reporting is wholly voluntary, is still woefully lacking in rigor, the requirement of demonstrable results and guidance on what constitutes success.<sup>60</sup>

Finally, the 1986 Questionnaire pointed to another innovation (certainly at the time and with regard to compliance programs) under Question #16 which asks whether the defense contractor belongs to the industry's "Best Practices Forum". Under the DII, the creation of an ongoing forum became one of its enduring marquee creations under which DII members could participate in an annual forum in which the latest programs, policies, practices and trends taking place in their industry are discussed.<sup>61</sup>

As to the current 2009 Questionnaire, it is possible to distinguish some major improvements that have taken place many of them reflective of both the U.S. Sentencing Guidelines as adopted in 1991 and revised through 2004<sup>62</sup> as well as other best practices

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<sup>60</sup> In defense of the defense industry on this issue, especially at the time that the DII was launched and the DII Questionnaire was created, this was all virgin compliance territory for any business or industry and thus their ability to actually raise the right questions, without necessarily having all the answers, was admirable and prescient. To this day, the single most difficult and challenging part of implementing an organizational ethics and compliance program is measuring its effectiveness.

<sup>61</sup> In 2010, the industry held its forum from June 14 to 16 in Washington, D.C., as it has every year since the founding of the DII. The agenda included a wide variety of ethics and compliance topics including some recent developments the DII intended to avoid – the emergence in the last two years of mandatory disclosure of possible ethical and compliance violations to the government under the new procurement rules enacted in 2008 – Federal Acquisition Regulations discussed earlier in this Chapter. See [www.crowell.com/pdf/2010-DII-BPF-Tentative-Agenda.pdf](http://www.crowell.com/pdf/2010-DII-BPF-Tentative-Agenda.pdf).

<sup>62</sup> The 2009 Questionnaire does not reflect the changes to be brought about by the 2010 amendments to the U.S. Sentencing Guidelines as these have not yet been officially enacted as of the time of writing of this Chapter and scheduled for November 1, 2010. The focus of these amendments have to do with providing compliance and ethics professionals with the ability to access and report directly to the highest governing body of a company when and if deemed necessary. See A full statement of the 2010

that have been generally developed in the ethics and compliance community. The most important improvements include:

- A much heavier emphasis on the need for employee reporting and guidance-seeking on issues of ethics and business conduct.
- Asking more probing questions that require details and specifics about policies, practices and mechanisms (and not merely requiring a yes or no answer).
- Requiring proof of certain matters – names, dates, details, meetings, etc. For example, there is a question that requires the specific name and title of the person in charge of the company’s business conduct program.
- Featuring compliance with heightened federal procurement laws requiring mandatory disclosure of possible violations through beefed up employee and third party reporting mechanisms including a specific requirement to show how the company guarantees non-retaliation against good-faith reporting employees.
- Focus on understanding and revealing periodically risk areas as required under the 2004 amendments to the U.S. Sentencing Guidelines.
- Driving the compliance and ethics program accountability issue upward to senior management and the board as required under the 2004 amendments to the U.S. Sentencing Guidelines.
- Driving compliance and ethics program accountability sideways and down to the supply chain, outside marketing and sales consultants, subcontractors and contract employees.
- Requiring explanations of how the company meets out discipline for ethics and business conduct violations.
- Asking probing questions on how the company measures the effectiveness of its program as required under the 2004 amendments to the U.S. Sentencing Guidelines.

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amendments to Chapter Eight of the U.S Sentencing Guidelines can be found here: [www.ussc.gov/2010guid/finalamend10.pdf](http://www.ussc.gov/2010guid/finalamend10.pdf).

- Asking how the company implements corrective action after it has found violations have occurred.

Finally, it also bears mentioning that partially in response to new requirements under the U.S. Sentencing Guidelines and no doubt partially a result of its own development of best practices, the DII has developed other useful tools, techniques and practices for members. Among them, for example, is assistance in understanding what the key risks of a defense industry contractor are -- see Table 7 for a summary of some of the primary defense contractor compliance and ethics risks that the DII has put together for its members. Very notably, and in contrast with the early days of the DII, this best practices guidance goes well beyond the issue of procurement fraud avoidance and demonstrates a much more holistic view of ethics and compliance risk management.

| <b>Table 7</b>   |
|--|
| <b>List of Typical Compliance Risk Areas Identified and Provided for by DII Companies<sup>63</sup></b>   |
| <ul style="list-style-type: none"> <li>▪ Offering business courtesies to Government persons which may be perceived as gratuities or kick-backs</li> <li>▪ Personal and organizational conflicts of interest</li> <li>▪ Time charging and expense reporting</li> <li>▪ Use of company property, equipment and facilities</li> <li>▪ Use of copyrighted or licensed materials</li> <li>▪ Accurate representation in proposals of data or credentials and employee qualifications</li> <li>▪ Proper recording and disbursement of funds and other assets</li> <li>▪ Prohibitions on customer and competitor proprietary data/source selection information</li> <li>▪ Quality assurance</li> <li>▪ Prohibiting kickbacks from suppliers and subcontractors</li> <li>▪ Relationships with customers and suppliers</li> <li>▪ Engagement and control of agents, including consultants and sales representatives</li> <li>▪ Lobbying and political contributions</li> <li>▪ Drug and substance abuse</li> <li>▪ Equal opportunity employment</li> </ul> |

<sup>63</sup> DII 2009 Public Accountability Report, p. 32-33.

- Sexual harassment
- Inventions/patent policy
- Government audits and investigations
- Control of technology transfer to foreign persons
- Hiring former government employees and other “revolving door” issues
- Restrictions on duty assignments to former government employees
- Misconduct in science
- Computer system usage and internet use
- Money laundering
- Protecting government property
- Insider trading
- Security and crisis management

By assembling this type of risk management information from across its now 90 membership base (see Table 8 for a full list of DII members as of March 2010), the DII is not only providing a very valuable benchmarking and best practices service to its own members but it is as well to the larger corporate, organizational and ethics and compliance community.

**Table 8**  
**2010 DII Members<sup>64</sup>**

|   |  |
|---|--|
| 3M<br>Aerojet<br>AgustaWestland North America, Inc.<br>Alcoa, Inc.<br>Allfast Fastening Systems, Inc.<br>Alliant Techsystems, Inc.<br>American Ordnance<br>AT&T<br>Babcock & Wilcox<br>BAE Systems<br>Boeing Company<br>Booz Allen Hamilton<br>CA, Inc.<br>CFM International<br>Ciber, Inc.<br>CNA Corporation<br>Concurrent Technologies Corporation | ITT Industries<br>Kellogg Brown & Root<br>L-3 Communications Corporation<br>Leader Communications, Inc. (LCI)<br>LMI Aerospace, Inc.<br>Lockheed Martin Corporation<br>MER Corporation<br>MIT Lincoln Laboratory<br>Natel Engineering Company<br>National Air Cargo<br>National Technical Systems<br>Northrop Grumman Corporation<br>Omega Technologies Company<br>Orbital Sciences Corporation<br>Parker Hannifin Corporation<br>PGBA, LLC<br>Protective Products International |
|---|--|

<sup>64</sup> Defense Industry Initiative website March 13, 2010. <http://www.dii.org/our-companies>.

|  |   |
|--|---|
| Crane Co.<br>CSC<br>Cubic Corporation<br>Curtiss-Wright Corporation<br>DataPath, Inc.<br>Day & Zimmermann, Inc.<br>DRS Technologies, Inc.<br>DS2 (Defense Support Services LLC)<br>DynCorp International LLC<br>EADS North America<br>Earl Industries, LLC<br>EarthTech (Tyco International)<br>EG&G Technical<br>Esterline Corporation<br>Frequency Electronics, Inc.<br>General Atomics<br>General Dynamics<br>General Electric<br>Georgia Tech Research Institute<br>Goodrich Corporation<br>Harris Corporation<br>HealthNet Federal Services, LLC<br>Herley Industries, Inc.<br>Honeywell International, Inc.<br>Humana Military Health Services<br>IAP Worldwide Services<br>IBM Corporation<br>Immix Group<br>Institute for Defense Analyses (IDA) | Proteus Technologies<br>QinetiQ<br>Raytheon Company<br>Rockwell Collins, Inc.<br>SAIC<br>SELEX<br>SENTEL Corporation<br>Sequa Corporation<br>Serco<br>Siemens Government Services, Inc.<br>SkyLink USA<br>Sodexo Federal Services, Inc.<br>Solvers, Inc.<br>Standard Aero<br>Teledyne Technologies Incorporated<br>Textron Inc.<br>Thales USA, Inc.<br>Timken Company<br>TriWest Healthcare Alliance<br>Tybrin Corporation<br>United Launch Alliance<br>United Space Alliance (Boeing Company)<br>United Technologies Corporation<br>University of Dayton Research Institute<br>URS Corporation<br>Verizon<br>Vought Aircraft Industries, Inc.<br>Williams International<br>Woodward Governor Company |
|--|---|

B. DII: Final Assessment and Recommendations

As we conclude this Chapter, it may be worth asking once again: Is there a difference between the defense industry companies that subscribe to the DII and those that do not? Does it make a difference to the company itself to be a member of DII – in other words, does the need to adhere to the requirements of DII membership actually improve the compliance and ethics track record of a company? Does DII make a difference to the overall track record of the industry regarding the breadth and depth of procurement fraud and its prevention – which after all is the stated *raison d’être* of DII? Does the fact that DII does not actually require individual public accounting by its members work against internal improvements or, to the contrary, does this commitment by a company to be part of a best practices forum have direct and indirect intended and unintended positive consequences?

While it is not possible to answer these questions scientifically based on the evidence available, it is possible to look back at the 25 years of DII and make a number of remarks.

The DII took it upon itself to issue annual reports summarizing the progress on the DII program elements, or lack thereof, of its member companies. As with any self-reporting process that is not open to outside, independent, expert third party review, these annual reports while descriptive and somewhat substantive are also fairly bland aggregations of all members' data which members, at the end of the day, are willing to share. The Public Accountability Reports do not reveal details of any members' particular answers and do not delve deeply or critically into the details of each company's performance. While this is not necessarily true of all members of DII as some of them do produce their own ethics and compliance public reports, the DII Public Accountability Reports are useful overviews but do not amount to auditable public accountability.<sup>65</sup>

The DII effort started as and, for all intents and purposes, continues to be a fairly narrowly focused effort in a number of respects: it is exclusively open to the defense industry, it is U.S. centric because it caters to relations with the U.S. Government, and it is narrowly focused on relations with only one U.S. government entity – the DOD. Most critically however, the DII's roots and even its development over the past quarter century remain limited intellectually as the almost exclusive focus of the effort has been on addressing the issue of procurement fraud, although to its credit the DII has expanded its repertoire recently to include related themes, policies, tools and techniques.<sup>66</sup>

The DII lacks teeth, for lack of a better word. It remains a voluntary mechanism, used to develop best practices but lacking in rigorous testing, independent auditing or enforcement. While this may very well be what was originally intended and continues to

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<sup>65</sup> For example, GE provides a fairly detailed and open report on the elements of its business conduct program including references to exactly how many, and the nature of, complaints received via its corporate whistle-blower hotline.

<sup>66</sup> See DII website for a variety of presentation and explanations of current initiatives: [www.dii.org](http://www.dii.org).

be currently intended by the organization, as its own annual reports and that of the U.S. Government Accountability Office (GAO) demonstrate, this approach does not ensure fundamental compliance or the rooting out of procurement fraud, its original objective.<sup>67</sup>

As Table 9 below demonstrates, while some of the biggest DOD contractors are members of DII, many contractors are not thus leaving open several critical questions:

- Do the non-DII contractors have an ethics and compliance program in place let alone an “effective” one?
- Why don’t the non-DII top 60 DOD contractors belong to DII?
- Is the DII itself an effective “industry” initiative if it only has 90 members (out of tens of thousands of contractors and subcontractors), with more than 50% of the 60 biggest DOD contractors (with \$500 million or more in DOD related revenues) not feeling compelled to become members of DII.

| CONTRACTOR NAME                               | \$ REVENUES IN<br>MILLIONS FOR<br>FISCAL YEAR 2006 | DII<br>MEMBER? |
|---|--|----------------|
| Lockheed Martin Corporation                   | 26,620   | Y              |
| Boeing Company                                | 21,721   | Y              |
| Northrup Grumman Corporation                  | 16,627   | Y              |
| General Dynamics Corporation                  | 11,942   | Y              |
| Raytheon Company                              | 10,069   | Y              |
| BAE Systems PLC                               | 6,192  | Y              |
| KBR, Inc.                                     | 6,060  | Y              |
| L-3Communications Holding, Inc.               | 5,197  | Y              |
| United Technologies Corporation               | 4,453  | Y              |
| Science Application International Corporation | 3,211  | Y              |
| Computer Sciences Corporation                 | 2,884  | N              |

<sup>67</sup> “Defense Contracting Integrity: Opportunities Exist to Improve DOD’s Oversight of Contractor Ethics Programs”. The United States Government Accountability Office. Report to Congressional Committees. September 2009; pp. 35-36.

<sup>68</sup> “Defense Contracting Integrity: Opportunities Exist to Improve DOD’s Oversight of Contractor Ethics Programs”, pp. 35-36.

|                                       |       |   |
|---------------------------------------|-------|---|
| Humana, Inc.                          | 2,642 | Y |
| ITT Corporation                       | 2,522 | Y |
| General Electric Company              | 2,328 | Y |
| Heath Net, Inc.                       | 2,119 | Y |
| Triwest Healthcare Alliance Company   | 2,022 | Y |
| Electronic Data Systems Corporation   | 2,008 | N |
| AM General, LLC                       | 1,944 | N |
| Agility Logistics                     | 1,838 | N |
| Honeywell International, Inc.         | 1,679 | Y |
| Textron, Inc.                         | 1,369 | Y |
| URS Corporation                       | 1,369 | Y |
| Amerisourcebergen Corporation         | 1,346 | N |
| Harris Corporation                    | 1,339 | Y |
| FedEx Corporation                     | 1,303 | N |
| Bechtel Group, Inc.                   | 1,264 | N |
| Booz Allen Hamilton, Inc.             | 1,245 | Y |
| BP America, Inc.                      | 1,199 | N |
| Exxon Mobil Corporation               | 1,176 | N |
| Shell Oil Company                     | 1,151 | N |
| Alliant Techsystems, Inc.             | 1,128 | Y |
| Oshkosh Truck Company                 | 941   | N |
| Rockwell Collins, Inc.                | 824   | Y |
| Korea Agricultural Cooperative        | 761   | N |
| DRS Technologies                      | 730   | Y |
| Philips & Jordon, Inc.                | 705   | N |
| CACI International, Inc.              | 681   | N |
| General Atomic Technologies Company   | 670   | Y |
| McKesson Corporation                  | 670   | N |
| Valero Energy Corporation             | 661   | N |
| Thales                                | 657   | Y |
| Aerospace Corporation                 | 654   | N |
| Mitre Corporation                     | 652   | N |
| Massachusetts Institute of Technology | 640   | Y |
| Dell, Inc.                            | 636   | N |
| Cardinal Health, Inc.                 | 635   | N |
| Syracuse Research Corporation         | 613   | N |
| Chugach Alaska Corporation            | 593   | N |
| Refinery Associates of Texas          | 577   | N |
| Environmental Chemical Corporation    | 570   | N |
| Parsons Corporation                   | 526   | N |
| Johns Hopkins University              | 525   | N |
| Battelle Memorial Institute           | 519   | N |
| Shaw Group, Inc.                      | 519   | N |
| Maersk Line Ltd.                      | 516   | N |
| Jacobs Engineering Group, Inc.        | 505   | N |

|   |     |   |
|---|-----|---|
| Kraft Foods, Inc.   | 501 | N |
| <b><i>TOTAL DOD CONTRACT AWARDS FOR TOP 57 COMPANIES IN 2006: \$164,448</i></b> |     |   |
| <b><i>TOTAL DOD CONTRACT AWARDS TO ALL CONTRACTORS IN 2006: \$294,976</i></b>   |     |   |

So was the DII a business conduct program trendsetter and has the DII become the business conduct program standard? From the analysis provided in this Chapter, it is possible to make a couple of observations with some certainty. First, the DII was indeed a trendsetter or perhaps more accurately innovator in the creation of internal business conduct programs within companies -- at the time of its creation in 1986 there was no other industry wide (let alone internal corporate code of conduct program) standard that had been developed at any scale by any one company or industry.

It is a little more difficult to categorically state that the DII has become the industry standard for a couple of reasons. While the DII has been a very active and sharing organization in that it has developed and made publicly available many of its best practices for all to see and use, it has remained a somewhat limited organization for some of the reasons described above.

The DII is designed as a set of guidelines to help defense contractors sign up to aspirational principles, devote proper resources to accomplishing the principles and account publicly with the remainder of the DII membership annually on how it has done in regard to the principles. It is not an organization that polices its members' compliance or otherwise tries to gauge the level of compliance and ethics within a member company. So long as a defense company member complies -- or appears to comply through its voluntary disclosure -- with the principles, no other requirement seems to be in place.

Thus ostensibly, a member could engage in procurement fraud but as long as it seemed to be following the DII principles, paid its dues and provided public accountability reporting, it would not have to fear being de-listed from the DII itself. Whether this is a form of membership that actually breeds better practices and overall compliance or simply provides the membership with a veneer that it is compliant is a question that remains an unanswered and probably unanswerable. A defense contractor with deep

pockets can hire a team of compliance professionals to put together a gold plated ethics and compliance program and might get away with looking good but not necessarily doing good – i.e., the ethics and compliance program becomes a matter of effective public relations but not effective internal controls.

DII has, however, provided a number of very positive contributions to the overall dialogue about and development of an effective ethics and business conduct program over its quarter century of existence. DII represented a ground-breaking initiative at the time of its inception and it continued to interact proactively and constructively with the ethics and compliance community over time making a number of distinct contributions to the development of tools and techniques, policies and procedures usable by other companies and industries. Its success can also be measured in the number of companies that have joined DII now amounting to approximately 90 members (See Table 8). DII's example was also an inspiration for other cross-sectoral efforts such the Extractive Industry Initiative which has brought together many of the world's leading mining and oil and gas companies around the issue of bribery and corruption.<sup>69</sup>

With the recent addition of mandatory disclosure of potential procurement fraud under the FAR amendments of 2008, the DII is in a good position to serve its members in providing real time compliance information and helping to develop best practices techniques and tools to meet such challenges. With some additional rigor and discipline added to the mix over the next few years, the DII, and other similar programs whether individual or industry-wide, can provide greater assurance to stakeholders everywhere – whether employees, customers, the government, the media, non profits or NGOs – that informed and substantive attempts at rooting out at least the worst kinds of violations and building a more effective and practical culture of integrity within organizations is something that is taken seriously within the organization.

The DII is a complex and sometimes perplexing organism. It is simultaneously constructive, productive and highly useful and not quite as rigorous or accountable as it

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<sup>69</sup> See Extractive Industries Transparency Initiative website: [www.eiti.or](http://www.eiti.or).

would claim. Without the DII, the world of corporate ethics and compliance programs would not have developed as robustly as it has. The inner contradictions of the DII are also visible within its particular members – take the case of GE which has both probably the best and most developed internal ethics and compliance program of any company in the world while simultaneously finding itself in the thicket of a compliance problem on a fairly periodic basis.<sup>70</sup>

Thus while the overall legacy of DII is positive, members of the DII would be wise over the next few years, to consider invigorating some of the more rigorous aspects of maintaining a strong ethics and compliance program by focusing, especially, on two major initiatives: developing independent third party monitoring, testing and auditing of the effectiveness of the internal ethics and compliance program (and considering publishing the results thereof) and providing their chief ethics and compliance officers and teams with real tools and resources to do their work effectively internally, with real access to the company's highest governing body – the board of directors -- before the government begins to mandate such actions in reaction to the next great wave of corporate scandals.

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<sup>70</sup> GE represents both the paradigm and the paradox of both the good corporate citizen – as the founder of DII and a major contributor to the creation of effective ethics and compliance programs over the years – and the recidivist having been at the cross-hairs of the U.S. Government enforcement agencies repeatedly over the years for a variety of corruption, procurement fraud and other cases. This was exemplified once again at the date of writing of this Chapter by the imposition by the Securities and Exchange Commission of a \$23.4 million FCPA violation fine relating to the UN Oil for Food Scandals. [www.sec.gov/news/press/2010/2010-133.htm](http://www.sec.gov/news/press/2010/2010-133.htm).

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