UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

UNITED STATES OF AMERICA *ex rel.* REX A. ROBINSON and JAMES H. HOLZRICHTER,	)	
Plaintiffs,	)	No. 89 C 6111
v.	)	Judge Ronald A. Guzmán
NORTHROP GRUMMAN CORPORATION,	)	Magistrate Judge Michael T. Mason
Defendant.	)	

PLAINTIFFS' TRIAL BRIEF

Date: February 6, 2004

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The United States of America, by Patrick J. Fitzgerald, United States Attorney for the Northern District of Illinois, and relators Rex A. Robinson (by his estate) and James H. Holzrichter (collectively "plaintiffs"), by and through their counsel, respectfully submit this Trial Brief in accordance with Local Rule 16.1 and Local Form 16.1.1.

As shown below, this is a relatively straightforward case that should be tried by this Court this year. In light of the age of this case and the concession of Northrop's counsel that "there are many things we are going to try in this case," summary judgment is not warranted. (Sept. 17, 2003 Tr. at 18) Nor should this case be delegated to a special master for reasons set forth in the plaintiffs' prior submission of September 22, 2003.

I. NATURE OF THE CASE

The United States purchased radar jammers and other complex electronic systems from Northrop Corporation, which were designed and manufactured at Northrop's facility in Rolling Meadows, Illinois. Northrop's systems were used by the U.S. Air Force, the U.S. Navy and other armed services for the B-1 Bomber, the B-2 "Stealth" Bomber, the F-15 Fighter and other aircraft. Northrop routinely obtained government contracts to design and build products at Rolling Meadows, and billed the government for those products and services. The unlawful conduct at issue occurred primarily at Northrop's Rolling Meadows facility between 1985 and 1991.

The United States and the relators seek a recovery from Northrop under the False Claims Act ("FCA"), 31 U.S.C. § 3729. The FCA is the government's primary tool to recover losses due to fraud against the United States. *See* S. Rep. No. 99-345 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266; *U.S. ex rel. Kelly v. Boeing Co.*, 9 F.3d 743, 745 (9th Cir. 1993). This is a traditional *qui tam* case under the FCA. "The typical *qui tam* plaintiff is a whistle blower at a defense contractor's plant

with inside information about a fraud being perpetrated against the federal government." *U.S. ex rel. Lamers v. City of Green Bay*, 168 F.3d 1013, 1017 (7th Cir. 1999).

Northrop's unlawful conduct falls into two primary categories. First, in the face of defense department scrutiny which could have resulted in the termination of government payments, Northrop engaged in a fraudulent scheme that became known as the "financial reconciliation project." Through this scheme, Northrop regularly submitted false and fraudulent contract proposals and billings that lied about Northrop's accounting for materials and material costs. Northrop concealed basic deficiencies in its handling of inventory and scrap by fraudulent accounting, and it deceived government auditors and other representatives of the United States. Second, Northrop made false statements regarding its purported progress in designing a radar jamming device for the B-2 "Stealth" Bomber. Based on Northrop's false statements of progress in designing the device, the government continued to pay Northrop to develop the device and build prototypes when, had the truth been told, the Air Force would have cancelled Northrop's contract.

In addition to these primary claims, plaintiffs also have a claim for billing labor charges for employees in Northrop's "holding tank" who were not working, and the relators have individual employment retaliation and discharge claims.

II. NORTHROP'S GOVERNMENT CONTRACTS AND BILLINGS

The entire system of defense industry contracting and payments is based upon the reliability of the contractor's cost accounting. As a condition and continuing requirement for its government contracts and payments, Northrop was required to account for and control its materials and material costs, *i.e.*, the costs of component parts and other inventory that were used to make products for the United States. Through various contracts and billings, the United States paid Northrop hundreds of millions of dollars on the basis of Northrop's representations about its material costs.

Federal Acquisition Regulations, the legal underpinning for government contracting, establish the fundamental importance of a contractor's cost accounting system. The regulations required Northrop to have an adequate system of cost accounting and controls to be eligible for any of the government contracts at issue in this case. (PTO ¶ 25)[1] To obtain contracts where the final payment is based on costs -- called "cost-reimbursable" and "fixed-price incentive" contracts -- Northrop was required to have an accounting system that is "adequate for determining costs applicable to the contract." 48 C.F.R. §§ 16.301-3(a), 16.403-1(c)(1).[2] Similarly, to obtain contracts where financing is based on costs -- including all "fixed-priced" contracts with "progress payments" -- "the contractor's accounting system and controls must be adequate." 32 C.F.R. § 163.75.

In obtaining and negotiating contracts, Northrop made specific representations in contract proposals about its material costs. The prices for products sold to the government were typically set on the basis of the costs of building the same or similar products under previously awarded contracts. Thus, in its contract proposals, Northrop made a number of representations concerning its material accounting, and it submitted "cost and pricing data" from prior contracts. (PTO ¶ 28) Northrop represented that its cost and pricing data was "accurate, complete and current," in accordance with the Truth in Negotiations Act, 10 U.S.C. § 2306(a) (TINA). (PTO ¶ 27a)

Under virtually every government contract, Northrop obtained interest-free financing from the United States. To obtain this financing, Northrop billed monthly for all or most of its costs,

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[1]On December 15, 2003, plaintiffs provided Northrop with Plaintiffs' Statement of Contested and Uncontested Facts and Law, along with the remainder of the draft Pretrial Order. As the Statement is a more detailed recitation of facts and regulations, plaintiffs have appended it as Exhibit A, and it is cited herein as "PTO ¶____ ."

[2]*Accord,* 48 C.F.R. §§ 16.205-3(b), 16.206-3(b), 16.403-2(c); 16.306(c), 16.404-1(c), 16.404-2(c)(1).

including the costs of component parts and other inventory. The government paid these bills before Northrop's products were delivered to the government. The payments were obtained through Northrop's submissions of two standard government billings: (1) "Requests for Progress Payments," which billed for 75-100% of costs under various fixed-price contracts, and (2) "Public Vouchers," which billed for 100% of costs under cost-reimbursable contracts. When products were delivered, Northrop submitted government form "DD 250" billings, and received the difference between the price of the product and the amount that the government had already financed. (PTO ¶¶ 35-37)[3]

As part of the *quid pro quo* for this government financing, Northrop was required to comply with various government accounting requirements, and the government obtained title to the inventory it financed. (PTO ¶ 41) In each progress payment request, Northrop made various certifications and representations to the government about its material costs, and about its accounting and control of inventory which purportedly supported those costs. For example, in each progress payment request, Northrop certified that: (1) its costs for the life of the contract were "correct," meaning that they were "accurate and complete" (PTO ¶¶ 38-40); (2) it maintained "adequate" accounting for "control of cost and property" (PTO ¶ 43a); and (3) its costs were in accordance with "sound and generally accepted accounting principles." (PTO ¶¶ 44d, 46)

Each progress payment request also acknowledged the fact that the government had already paid for, and retained title to, the parts and inventory that Northrop was using to build the defense

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[3]On the B-2 contract, and certain others included in the case, Northrop's Rolling Meadows facility was the subcontractor on a government contract. (*See* PTO ¶ 164) This is specifically defined to be irrelevant under the False Claims Act as the funds came from the United States. *See*, *e.g.*, 31 U.S.C. § 3729(c) (defining "claim" to include claims by subcontractors "to a contractor"); *U.S. v. Bornstein*, 423 U.S. 303 (1976) (false claims by subcontractors within scope of FCA).

systems ordered by the government. (PTO ¶ 41) According to Northrop's own witness who signed progress billings, Northrop's certifications included a duty to "keep[] track of the parts" that were under the Government's title. (PTO ¶¶ 41, 42c) "[T]he government had a vested interest in the parts that were in-house at Northrop because the government paid for those parts." (PTO ¶ 42a)

The progress payment certifications also served the purpose of safeguarding the government's interest by ensuring that the inventory it had purchased was actually being used to create the products that the government had ordered, and that the amount being spent on inventory was warranted for that particular contract. Thus, in submitting each progress payment request, Northrop certified:

- that it accepted the "risk of loss" for property, and has excluded costs for "property that is damaged, lost, stolen, or destroyed" (except for "normal spoilage"). 48 C.F.R. § 52.232-16(e); 48 C.F.R. § 32.503-16; 32 C.F.R. § 163.94-1. (PTO ¶ 43b)

- that to prevent excessive purchases of materials, "the quantities and amounts involved were consistent with the requirements of the contract." (PTO ¶ 39iv) If inventory "exceeds reasonable requirements," the cost of the excessive inventory is to be borne by the contractor and not the government. 48 C.F.R. § 32.503-6(d); *see also* 48 C.F.R. § 52.232-16(c)(3); 32 C.F.R. § 163.93-3. (PTO ¶ 43d)

- that costs were "allocable," *i.e.*, properly chargeable to a specific contract. 48 C.F.R. § 31.201-4. (PTO ¶ 44c)

- an "estimated cost to complete" the contract, which serves as a limitation on costs. (PTO ¶¶ 38, 43f)

The government reviews progress payment requests to determine whether the amount billed the contractor represents "the fair value of undelivered work under the contract." 48 C.F.R. § 32.503-6(f); PTO ¶ 43e; *see also* 48 C.F.R. § 52.232-16(c)(5).

For the various reasons articulated above, the government relies on the contractor's representations concerning its material costs and accounting when it makes progress payments. Under Federal Acquisition Regulations, "principal reliance will be placed on the adequacy of the

contractor's accounting system and controls and on the reliability of the contractor's certificates." 32 C.F.R. § 163.89. (PTO ¶ 52) If the contractor's accounting and controls are not efficient, reliable and adequate, "progress payments shall be suspended . . . until the necessary changes have been made." 48 C.F.R. § 32.503-6(b)(1). (PTO ¶ 53)

The requirements for the submission of public vouchers were at least as stringent as those for progress payment requests. The government's payment of public vouchers on cost-reimbursable contracts do not have the same type of payment price limits as are set by fixed-price contracts. The government relies upon the contractor to accurately account for and control all costs that are submitted on public vouchers. (PTO ¶ 55)

Public vouchers, along with progress payments and contract proposals, can only include "allowable" costs. 48 C.F.R. § 2.216-7; *see also* 48 C.F.R. § 16.307. (PTO ¶ 56) To be allowable, costs must be reasonable, compliant with federal Cost Accounting Standards or applicable generally accepted accounting principles, allocable to the contract, and compliant with the terms of the contract. 48 C.F.R. §§ 31.201-2, 201-4. (PTO ¶ 57) There are also specific regulations concerning whether or not material costs are allowable which contemplate that the contractor is accounting for usage of materials. 48 C.F.R. § 31.205-26. (PTO ¶ 58)

III. CONTESTED FACTS PLAINTIFFS EXPECT THE EVIDENCE WILL ESTABLISH[4]

A. The Financial Reconciliation Scheme

1. In the mid-1980's, the Government Began to Scrutinize Northrop's Material Accounting, and Northrop Knew that it Faced Serious Sanctions if Deficiencies Were Discovered

During the mid-1980s, Northrop was aware that government scrutiny of its material accounting was placing its government contracts and payments at risk. In 1986, Northrop narrowly avoided a suspension of progress payments, when a discrete problem was discovered by government auditors. Northrop had defended itself by representing that its material accounting systems were "efficient, accurate and effective," (PTO ¶ 84) and that the problem was being corrected. Accepting Northrop's representation that its material accounting system was fundamentally sound, a five-member Department of Defense review board rejected serious sanctions by a one vote margin, and instead imposed only a minor decrement on Northrop's progress payments. (PTO ¶ 86)

In 1987, the United States Department of Defense identified ten key areas of material management and accounting systems that would be the focus of industry-wide scrutiny. Major contractors, including Northrop, were required to demonstrate compliance. Northrop was informed that suspension of payments would occur if any of the ten key elements for material accounting were not met. (PTO ¶ 90) The United States issued numerous directives requiring Northrop representatives to disclose any deficiencies. (PTO ¶ 94) For example, on January 6, 1987, Government auditors from the U.S. Defense Contract Audit Agency ("DCAA") directed Northrop to disclose "the necessary data and explanations to allow a determination as to whether [Northrop's] accounting system and related records adequately detail the exact status of material cost and usage

[4]This Trial Brief is being filed before Northrop is required to identify which specific facts it will contest.

from purchase to final disposition." (PTO ¶ 94a; *see also* PTO ¶ 94b-e, detailing the other written requests). Testimony and internal Northrop documents will establish that senior executives were aware of "the serious nature of the government's intent to protect itself from alleged fraud centered around contractor material planning and control system operation." (PTO ¶ 107n)

2. To Avoid Serious Sanctions, Northrop Developed a "Financial Reconciliation" Scheme to Deceive the Government

Despite government scrutiny, Northrop was able to evade significant sanctions. Month after month, year after year, Northrop continued to certify that its material costs were "correct," and that its accounting and controls were sound, adequate, efficient and reliable. But as detailed below, Northrop's internal evaluations determined that its material accounting systems for handling inventory and scrap were seriously deficient and lacked integrity. Rather than disclose this information to the government and face financial sanctions, Northrop decided to continue falsely certifying and submitting its proposals and billings, conceal its serious contractual and regulatory violations, and obstruct the government's efforts to evaluate Northrop's material accounting system.

In a document that defines the theme of Northrop's scheme, its cost account managers responsible for material costs were given "practical training" in how to manipulate the material accounting system. (PTO ¶ 116) The managers were told "we can't tell the truth" to the government, and that Northrop needed to develop what the government would "accept as reasons." (*Id.*) This presentation was given by Amy Selen – the same Northrop manager who was later responsible for quashing relator Holzrichter's investigations. (PTO ¶¶ 116-119, 141)[5]

[5]During the course of his duties, Holzrichter discovered and reported various deficiencies in handling inventory and scrap that evidenced the fundamental inadequacy of Northrop's material accounting and controls. (U.S. Complaint, Oct. 16, 2001, ¶¶ 40-59) All of these deficiencies are also part of the financial reconciliation scheme described herein.

Northrop detected and attempted to conceal the problems in its material accounting system primarily through what became known as the "financial reconciliation project" (which was also known as the "data integrity project," the "data clean-up project,"and by other names). While working at Northrop, relator Holzrichter had discovered this scheme during the course of an internal audit he was conducting, from another Northrop employee named Petra Schiller. Concerned about this apparent fraud, and unable to obtain any assistance within Northrop, Holzrichter informed agents of the Department of Defense Criminal Investigative Service (DCIS). DCIS then interviewed Schiller. In summarizing Northrop's scheme, Schiller admitted to the DCIS that:

- "Northrop is misrepresenting its true financial position to DOD [the U.S. Department of Defense]";
- "overcharges occurred in every Northrop program";
- "the 'financial reconciliation' program has made it extremely difficult for the DOD to discover any cost overcharges...";
- "the primary purpose of the program is to fool the DOD when it reviews Northrop's business records.... Northrop is trying to juggle the books of different programs in an attempt to mislead the government inspectors and auditors";
- "management at Northrop [was] very concerned that the DOD may become aware of the 'financial reconciliation' program."

(PTO ¶ 138c-g)[6] Through the financial reconciliation scheme, Northrop concealed its inability to account for and control inventory and scrap as required by government contracts and regulations.

Overwhelming evidence will show that, contrary to its regular representations and certifications to the United States, Northrop knew that its accounting and control of material was unsound, inadequate, unreliable and inefficient. At trial, plaintiffs will introduce literally dozens

[6]While Schiller later denied certain of these statements, DCIS Special Agent Richard Zott testified that Schiller made these admissions to him.

of internal Northrop memos in which senior executives and managers openly admit and discuss the deficiencies, which show Northrop's billings and proposals to be false. For example:

- On June 20, 1986, Northrop's Manager of Material Accounting, Ken Chapman, wrote an internal memo concluding that the "integrity of the inventory management system is questionable at best." (PTO ¶ 107b) On January 6, 1987, Chapman followed-up with a memo cataloguing the numerous "problems contained in our material systems" and admitting that "[w]e have had these problems for at least ten years." (PTO ¶ 107c)

- On May 29, 1987, Chapman wrote to Northrop's Vice-President of Finance and others reporting that "data listings used by finance personnel were suspect of being inaccurate. All listings were found to be inaccurate to some degree." (PTO ¶ 107e and g)

- On June 22, 1987, Chapman's boss and Northrop's Director of Material Accounting, Duane Emling, reported via an internal memo "it is our conclusion that the basic level of data accuracy is insufficient" to meet government requirements for Northrop's material accounting system. (PTO ¶ 107i)

- On August 5, 1987, a Northrop committee with responsibility for material accounting reviewed an internal presentation that said: "available data has insufficient integrity;" that there were "problems everywhere" within Northrop's material accounting and controls; and "no matter what programs we install to deal with material accounting, they are useless if the data is generally invalid." (PTO ¶ 107l).

(*See also* PTO ¶ 105-107 (setting forth dozens of additional internal Northrop communications discussing accounting system inadequacies and non-compliance at a time when Northrop was making contrary representations to the government)).

Northrop's knowledge that its accounting systems were inadequate and noncompliant reached the highest levels of the corporation. For example, on October 6, 1988, the CEO of Northrop's Rolling Meadows facility, General Manager Wallace Solberg, was informed by Vice President Jack McNaugton that he had "some doubt" that Northrop's accounting systems are "adequate to withstand continued rigorous [Defense Contract Audit Agency] system review...." (PTO ¶ 107r) Despite this purported concern, the billings based on knowingly inadequate

accounting and controls continued year after year. A memo of October 16, 1989 to CEO Solberg from Northrop's Director of Government Relations admitted that "[a] review of current data from 1987 to present reflects a continuing integrity problem." (PTO ¶ 107yii)

Northrop retained a nationally respected accounting firm, Arthur Young, to independently assess and report on "the extent of compliance deficiencies" within Northrop's material accounting systems. (PTO ¶ 108) In a scathing internal report, Arthur Young found over 300 system deficiencies and concluded that "severe remedial action is necessary." (PTO ¶ 109e) Arthur Young's conclusions highlight the falsity of Northrop's certifications. For example, despite Northrop's repeated certifications that it had "adequate" accounting systems, Arthur Young concluded that Northrop's systems were "functionally inadequate." (PTO ¶ 109b) In virtually all major components of Northrop's material accounting, Arthur Young concluded that "the current processes are less than the statutory requirements." (PTO ¶ 109w) Northrop has stipulated in this litigation that the Arthur Young report is an admission of Northrop. (PTO ¶ 110)

3. Northrop Covered-up its Knowing Violations Through Fraudulent Accounting and Lying to the Government

Northrop repeatedly engaged in fraudulent conduct to conceal its false claims, and to keep the government payments flowing. For example:

a. <u>The "Data Clean-up Project"</u>

To fraudulently balance its material accounting data, Northrop engaged in a massive, secret "Data Clean-up Project" to make 58,000 data entry changes and hide $117,000,000 in material accounting discrepancies. (PTO ¶ 103c) These manipulations were not disclosed to the government. Because its systems lacked even basic data integrity and could not accurately account for inventory and material, Northrop directed that unexplained material losses be arbitrarily

accounted for as scrap under its oldest contracts. (PTO ¶¶ 100, 107o) By calling it scrap, Northrop thus shifted the cost of its losses from itself to the government and continued to conceal the fact that it could not account for the material. Other accounting discrepancies were fixed by computer programmers who changed the data so that there would be no audit trail. (PTO ¶ 103i)

b. The Fifty Part Walkthrough

Northrop also obstructed the efforts of government auditors who were attempting to review Northrop's material accounting and controls. To test whether Northrop's computerized accounting systems were accurately accounting for inventory, the DCAA auditors identified a sampling of fifty types of parts which were to be physically counted and then compared with the information on Northrop's computers. This "test" was an explicit part of Department of Defense requirements for assessing compliance with material accounting standards. Northrop specifically represented to the DCAA that any needed data corrections "will be reviewed with DCAA prior to input to system." (PTO ¶¶ 120-121).

But prior to its physical count that was to be monitored by DCAA auditors, Northrop engaged in a secret physical count of these fifty parts and then made undisclosed computer data changes so that the computer records and physical count data appeared to match. (PTO ¶¶ 120-122) A series of internal memos by a Northrop finance manager to her superior state "the following discrepancies are noted for further internal review and/or correction. These discrepancies are over and above those reported to the DCAA..." (emphasis original) (PTO ¶ 122a) After rigging the 1988 test, Northrop reported to DCAA that there was a 96.4% accuracy rate for all of the fifty parts

tested. (PTO ¶ 122d) The internal Northrop documents show, however, that 66% of the parts did not balance.[7] (PTO ¶ 122c)

c. Northrop's Lies to Government Auditors and Representatives

Time and time again, Northrop lied to the United States when confronted with questions about the adequacy of its material accounting. For example, when the DCAA auditors issued a critical report as to Northrop's compliance with the Defense Department requirements, Northrop shot back by replying that "[w]e are stunned with your evaluation of our Material Management Accounting System," and falsely claimed that "the auditors from your office were provided complete documentation of all transactions." (PTO ¶ 123d-e) Of course, this was an absolute lie, given the tens of thousands of undisclosed data clean up entries. (*See also* PTO ¶¶ 114-127 (detailing dozens of additional lies)).

Northrop employees also concealed data from the government by crafting deceptive responses to government inquiries. Duane Emling was the top Northrop executive working on financial reconciliation, who supervised a team of other managers involved in various aspects of the scheme. An important objective listed in Northrop's written Performance Planning and Appraisal for Emling required him to "minimize penalties imposed by customer [the United States] based on review of material accounting system." (PTO ¶ 128) In accordance with this objective, Emling directed a manager in charge of a required government report to determine "[h]ow might we minimize the impact of this report through format… What can be done to clean up any bad data

[7]Similarly, the Arthur Young compliance report found Northrop's inventory accuracy for high value parts in 1987 and 1988 was only 61% and 85% respectively. (PTO ¶ 109x-y) A passing grade of 95% was needed to avoid government sanctions. (PTO ¶ 91)

which may exist in the report before [Northrop] has to turn the report over to the auditors?" (PTO ¶ 103d)

When faced with government inquiries about excess inventory, Emling admitted that Northrop fraudulently concealed over $8 million from the government:

> The attached analysis of excess/residual material has been submitted to the customer [*i.e.* the U.S. Department of Defense]. It concludes that $3.3M of excess material is currently in inventory or on order in the 0000 pool. However, it is important to recognize that in addition to the two disclosed categories, two other categories have very high probabilities of being excess... [T]his extrapolates to a total of $11.7M of potential excess material.

(PTO ¶ 127c; *see also* PTO ¶ 127b and d) Northrop had previously billed the government for this $11.7 million in inventory through progress payment requests and was attempting to conceal these overcharges from the government. While concealing this excess inventory, Northrop repeatedly falsely certified to the United States in progress payment requests "that the quantities involved are consistent with the requirements of the contract," when in fact Northrop knew that it had bought too much for the contracts.

Other memos reveal intentional concealment of inventory data from the United States. On May 27, 1987, a Northrop internal memo reported that inventory "transfers are being disclosed to the customer at a different price than that being processed, leading to possible allegations of defective pricing by [Northrop's] customer."[8] The memo also reported that "the disclosure of B-1 transfers to [Northrop]'s customer was extremely limited as compared to the actual Transfers processed. Inventory Transfers for supplements 2, 3, 4, 5, 7, 8 and 9 were not disclosed at all." (PTO ¶ 107a)

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[8]"Defective pricing" means the inclusion of false data in contract proposals. *See*, *e.g.*, *U.S. ex rel. Campbell v. Lockheed Martin Corp.*, 282 F.Supp.2d 1324, 1331-32 (M.D. Fla. 2003).

4. Government Representatives and Expert Witnesses Have Confirmed Northrop's Fraud

Major General Charles Henry (ret.), who was in charge of administering all defense contracts for the United States Department of Defense during part of the relevant time period, will testify as both a fact and expert witness, and has carefully reviewed the documents and testimony in this case. General Henry will testify that Northrop regularly submitted false and misleading representations to the United States and that, had the government known the truth, Northrop would have been ineligible for contract awards and payments.

Similarly, several government contracting officers who had the legal power to suspend payments at Northrop will testify on behalf of the United States. Perhaps the situation was best summarized by former Administrative Contracting Officer Karen Boyle Sarley:

> [T]hese people were not only lying to us, meaning the people within the office there, they were lying to their own government and to the people of the United States and their country. They were compromising their country. These were important parts that we were making, costing a lot of money, costing taxpayers a lot of money. I think it's despicable.

(Sarley Dep., at 141-142). All of the government officers will testify that the United States did not know the nature, extent and severity of the deficiencies, inaccuracies and inadequacies in Northrop's material accounting and controls. Relying upon Northrop's certifications and representations, they paid the bills Northrop submitted. Having reviewed Northrop's long-suppressed internal documents, they will testify that the payments would have been stopped.

Finally, experts in defense contract accounting have reviewed Northrop's material accounting during the time period at issue in this case. Their testimony will establish that Northrop's accounting systems were inadequate, that Northrop's billings and proposals were false, and that the deficiencies were not disclosed to the United States.

B. False Claims of Progress on the ZSR-62 for the B-2 "Stealth" Bomber

The second major aspect of this case involves Northrop's false claims of progress in designing an electronic countermeasure device for the B-2 Stealth Bomber, under a special project called the "SP-3 Program." (PTO ¶ 16c) The device, known as the ZSR-62, was supposed to make the Stealth invisible to enemy radar. As a central aspect of its contract, Northrop was required to conduct a Critical Design Review. (PTO ¶ 157) The purpose of the Critical Design Review ("CDR") is to show that the design Northrop developed met contract specifications. (Military Standard MIL-STD-1521A (USAF), S. 3.4) When Northrop represented that it was ready to hold a CDR, it attested that the design is "essentially complete" and ready for production. (*Id.*) As an Air Force electronics engineer who was present at the review testified, the CDR meant that the design should be "almost a hundred percent complete." (Longley Dep., at 58) The Air Force "relied on" Northrop to ensure that the design was complete. (*Id.* at 60)

Northrop held the CDR from October 21-24, 1985. (PTO ¶ 159) Based on Northrop's representations of its progress, the Air Force elected to continue the program and paid Northrop an additional $254,000,863 to develop the device and build a prototype. (PTO ¶¶ 162-163) After spending a total of $281,622,818 for Northrop to build the device, the Air Force cancelled the contract because the ZSR-62 could not do what Northrop said it would do at the CDR.

The evidence will show that in order to continue the program, Northrop lied to the United States about the progress it had made on the design. Edison Hecht was one of Northrop's engineers who participated in the CDR presentation to the Air Force. In deposition testimony, Hecht admitted that, immediately following the presentation, he told his Northrop colleagues that "we lied our teeth off" during the CDR, and "now we need to make these lies come true." (PTO ¶ 161a) Numerous internal Northrop documents corroborate this admission, establish that the design was "immature"

rather than "essentially complete," and reveal that Northrop continued to perpetuate lies about its progress on the ZSR-62 until the project was eventually terminated. For example:

- A Northrop engineer and leader of a key ZSR-62 test group testified that certain critical system specifications were "practically worthless."
- Northrop's internal policy was to use "preliminary data to make [the] document credible," as the necessary data to complete documents was often unavailable.
- On August 13, 1986, an internal Northrop memo revealed that "the Artemis is all red," meaning that key schedules had not been met.
- Seven months after the CDR, a high level manager on the ZSR-62 project admitted in an internal memo that "many of the diagnostic test flow charts and associated detailed test information would not be valid for some time due to potential design changes and the unavailability of firm data."
- An internal Northrop memo, dated March 4, 1988, established that the design for a critical component of the ZSR-62 still had not been completed long after the CDR.
- On August 29, 1990, Northrop's Director of Production Assurance concluded in an internal memo on the ZSR-62 that "an immature design was put into production."

(PTO ¶ 161b-r)

An Air Force Colonel who was responsible for overseeing the B-2 Program has also examined Northrop's internal documents. The Colonel will testify that, had the actual facts been known, Northrop would have been terminated from the ZSR-62 program before the United States spent an additional $254 million. By law and the terms of the contract, the Air Force was entitled to cancel any further work with Northrop either for "for failure ... to make progress in the prosecution of the work" or "whenever for any reason the Contracting Officer… determine[d] that such termination is in the best interest of the government." (PTO ¶ 158)

C. False Billings for the Idle Time Employees Spent in the "Holding Tank"

In order to work on the SP-3 program, employees needed security clearances and approval for access to the program by the Air Force. (PTO ¶ 175) Northrop designated a room within its Rolling Meadows facility as the "holding tank" where new hires to the SP-3 program awaited their security clearances. (*Id.*) Northrop established an internal cost account labeled "direct labor awaiting security." (PTO ¶ 176) The existence of this discrete internal cost account was not disclosed to the United States. (*Id.*) Northrop did not disclose the existence of this account because its employees were passing the time doing crossword puzzles, playing computer games, conversing or leaving the facility for lunch and not returning. (*Id.*)

Northrop knew that it was not entitled to bill for the wasted time in the holding tank. (PTO ¶ 180) In September 1990, Northrop employee Larry Schwartz wrote an internal memorandum to Northrop management describing the waste of employee time in the holding tank. (*Id.*) The document, entitled "Northrop DSD – Waste and Mis-Management," states:

- "In 1984, DSD began hiring engineers and designers for Special Programs and for AN/ALQ-135 [the F-15 Program]. During these many months, they were given little or no useful work to do. They spent much of their time reading newspapers and magazines or playing on computers."

- "Once these young and inexperienced personnel were placed on programs, the inactivity continued. Some people were given a charge number that they could use for many months whether they actually worked on that task (CAWA) or not."

- "Since SP-2 and SP-3 were cost-plus programs, engineers and designers were encouraged to work overtime even though they were short on tasks. Long lunch breaks were convenient ways to kill time and video games (computer, golf, etc.) were very popular. Occasionally, some engineers would leave for lunch and only return at 5:00 P.M. to sign out for their overtime."

- "All of this is hard to comprehend because these programs eventually experienced manufacturing and schedule problems. Some of these problems could have been prevented if the engineers had been properly directed to apply themselves towards design optimization."

- "Management was well aware that personnel were being under-utilized, but made little or no effort to orchestrate human resources. This lack of leadership has cost DSD and our customers a great deal of time and money."

(PTO ¶ 180a-e) Schwartz is not an attorney. (PTO ¶ 181) But to conceal the document for as long as possible, Northrop marked the document "Attorney-Client Privilege Attorney's Work Product." (*Id.*) When challenged in this litigation, Northrop conceded that the document was not privileged or otherwise protected. (*Id.*)

Under the Federal Acquisition Regulations, "Compensation for personal services must be for work performed by the employee... [T]he compensation in total must be reasonable for the work performed." 48 C.F.R. § 31.205-6(a)(1) and (2). Knowing that the employees had not "performed work," Northrop charged these costs directly to the SP-3 program without disclosing to the government that the costs were for employees who were not working. (PTO ¶ 178)

IV. PLAINTIFFS' THEORY OF LIABILITY

A. Elements of an Action Under The False Claims Act

Plaintiffs' case rests primarily on a plain application of the statute. To establish liability, plaintiffs must prove that Northrop knowingly: (1) presented "a false or fraudulent claim for payment or approval," or (2) made or used "a false record or statement to get a false or fraudulent claim paid or approved by the Government." 31 U.S.C. § 3729(a)(1) and (2); *Brooks v. U.S.*, 64 F.3d 251, 254-55 (7th Cir. 1995); *U.S. v. Medco Physicians Unlimited*, 2001 WL 293110, at *2 (N.D. Ill. 2001). "Knowingly" means that defendant had "actual knowledge," "acted in deliberate ignorance... or acted in reckless disregard of the truth or falsity of the information." 31 U.S.C. § 3729(b); *Medco*, 2001 WL 293110, at *2.

B. Claims or Statements

There can be no reasonable dispute that Northrop submitted "claims" covered by the FCA under 31 U.S.C. § 3729(c). "This definition includes all attempts to cause the United States to pay out money." *U.S. v. Frierson*, 1997 WL 136280, at *8 (N.D. Ill. 1997). The claims at issue here are the four types of billings Northrop used to obtain money from the United States: (1) requests for progress payments; (2) public vouchers; (3) DD250 billings; and (4) Interdivisional Accounting Transfers to Northrop's B-2 Division. It makes no difference whether Northrop's claims were submitted directly to the government or indirectly through a prime contractor (where Northrop is a subcontractor). 31 U.S.C. § 3729(c); *U.S. v. Bornstein*, 423 U.S. 303 (1976).

There are also false statements and records at issue, including:

(1) contract proposals and supporting documentation;

(2) the Critical Design Review for the ZSR-62, other ZSR-62 reports, and supporting documentation and statements; and

(3) Correspondence and other statements to the government concerning inventory and scrap, typically in response to government inquiries.

Each of these were made or used "in order to get the government to pay money." *Lamers*, 168 F.3d at 1018; *see also U.S. ex rel. Schwedt v. Planning Research Corp.*, 59 F.3d 196, 199 (D.C. Cir. 1995) (liability for false progress reports under FCA); *BMY-Combat Sys. Div. of Harsco Corp. v. U.S.*, 38 Fed.Cl. 109 (1997).

C. Northrop's Knowing Submission of False and Fraudulent Claims

The False Claims Act is "expansively" interpreted "to reach all types of fraud, without qualification, that might result in financial loss to the Government." *Cook County, Ill. v. U.S. ex rel. Chandler*, 538 U.S. 119, 129 (2003) (quoting *U.S. v. Neifert–White Co.*, 390 U.S. 228, 232 (1968)). The fraud at issue in this case boils down to three categories: (1) the financial reconciliation

scheme; (2) the false claims of progress on the SP-3 program; and (3) false billings for time spent in the holding tank. Each of these fits well within the ambit of conduct violating the FCA.

1. Liability for the Financial Reconciliation Scheme

The thrust of plaintiffs' financial reconciliation claim is that, beginning no later than February 1986 and lasting through at least June 1991, Northrop lied repeatedly in bills, proposals and other statements about its accounting and controls for inventory and scrap. Despite government inquiries concerning potential deficiencies in Northrop's material accounting, Northrop continued to certify and represent that it was complying with basic federal accounting requirements when it knew that this was not true – in order to keep the government funds flowing and avoid financial penalties. To bolster its false representations and deflect the government's inquiries, Northrop concealed its deficiencies in handling inventory and scrap through the entry of fraudulent accounting transactions and lying to government representatives. In short, Northrop knew "we can't tell the truth" about its material accounting and developed what the United States "would accept as reasons."

This financial reconciliation scheme is exactly the type of fraud the Seventh Circuit has identified as clearly violating the FCA because Northrop "intended to flout the regulations from the very beginning," through "a campaign to deceive," and "knowingly lie[d] to the government about [its regulatory compliance]." *Lamers*, 168 F.3d at 1018-20; *see also Hindo v. University of Health Scis./Chicago Med. Sch'l.*, 65 F.3d 608, 613 (7th Cir. 1995) ("the claim must be a lie..." or "some purposeful scheme by the [defendants] to defraud... the government").[9] This results in a number of

[9]This level of *scienter* exceeds the minimum required by the FCA. "The government need not establish that the defendant intended to deceive, defraud, or cheat the government." *U.S. v. Hughes*, 585 F.2d 284, 287-88 (7th Cir. 1978). The Ninth Circuit has retreated from similar *dicta* in its opinions. *See U.S. ex rel. Plumbers & Steamfitters Local Union No. 38 v. C.W. Roen Constr. Co.*,

legal grounds for FCA liability: (1) express false representations; (2) material omissions; and (3) claims based on fraudulently obtained contracts.

a. False Certifications and Representations

As detailed above, Northrop made numerous false certifications and other representations in its billings and proposals about its material costs, and about its accounting and control of inventory and scrap which purportedly supported those costs. Northrop lied by repeatedly certifying that it had an adequate system for material accounting and control, when its management and outside auditors repeatedly recognized that this was not true. Northrop lied by repeatedly certifying that its material costs were "correct," when it knew that its data was inaccurate or, at minimum, when it acted with reckless disregard for the truth or falsity of that representation. Northrop lied when it certified that "the quantities and amounts involved are consistent with the requirements of the contract," when it knew that it was buying millions in excess inventory. Northrop lied when it certified that its costs were "eligible under the progress payment clause," and that its billings and proposals were in accordance with numerous other contractual and regulatory provisions. Through the financial reconciliation scheme, Northrop determined that these certifications and representations were false, and deliberately concealed this falsity.

b. Material Omissions

As a second basis for liability, Northrop "omitted material information" from its billings and proposals. *Frierson*, 1997 WL 136280, at *9 (citing *U.S. v. TDC Management Co.*, 24 F.3d 292, 298 (D.C. Cir. 1994)); *U.S. v. Job Resources for the Disabled*, 2000 WL 562444, at *3 (N.D. Ill.

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183 F.3d 1088, 1092-93 (9th Cir. 1999) ("While some of our cases may contain extraneous comments that might be read out of context to suggest that the FCA requires an intentional lie to trigger liability," the statutory language controls and deliberate ignorance or reckless disregard is sufficient.)

2000), *reconsideration granted in part*, 2000 WL 1222205 (N.D. Ill. 2000); *U.S. ex rel. Fallon v. Accudyne Corp.*, 921 F.Supp. 611, 627 (W.D. Wis. 1995). In *Job Resources*, the Court found that a contractor can be held liable for "cavalierly disregarding fundamental accounting practices and contractual obligations." *Job Resources*, 2000 WL 562444, at *3. In *Fallon*, the Court found that a defense contractor could be liable for submitting progress billings and DD 250 billings while concealing known deficiencies. "[A] contractor who knowingly fails to perform a material requirement of its contract (or performs no services at all), yet seeks or receives payment as if it had fully performed without disclosing the nonperformance, has presented a false claim to the government and may be liable therefor." *Fallon*, 921 F.Supp. at 627. Here, Northrop presented false claims when it failed to disclose that its accounting and controls for inventory and scrap did not comply with federal contractual and regulatory requirements.

As a matter of law, applicable Federal Acquisition Regulations specify that the requisite accounting and controls were a "material requirement" of Northrop's government contracts. The progress payment clause specifically provides that the "control of costs and property" is a "material requirement of the contract." 48 C.F.R. §§ 52.232-16 (c)(1), (f). Northrop was required to "comply with all material requirements of the contract. This includes the requirement to maintain an efficient and reliable accounting system and controls, adequate for the proper administration of progress payments." 48 C.F.R. § 32.503-6(b)(1); (PTO ¶ 53) Consequently, when Northrop concealed its failure to maintain efficient, reliable and adequate accounting and controls for handling inventory and scrap, it became liable under the False Claims Act. *Fallon* found a defense contractor liable for failing to disclose non-compliance with environmental contractual provisions, even though there was no financial risk to the government. The same principles apply, *a fortiori*, to this case where the

contractual and regulatory accounting requirements placed the government at financial risk, and were at the core of the government contract relationship with Northrop.[10]

c. Fraudulently Obtained Contracts

By virtue of the same conduct described above, Northrop is liable for each claim made under a fraudulently obtained contract including all progress payment requests, public vouchers, and DD250 billings. While plaintiffs do not allege that contract proposals themselves are false claims, the Supreme Court has recognized that all claims for payment under a fraudulently obtained contract are subject to FCA liability as the "taint" was "the basic cause for payment of every dollar paid... The initial fraudulent action and every step thereafter taken, pressed ever to the ultimate goal – payment of government money to persons who had caused it to be defrauded." *U.S. ex rel. Marcus v. Hess*, 317 U.S. 537, 543-44 (1943); *see also Hughes*, 585 F.2d 284 (7th Cir. 1978) (finding false claims liability for fraudulently obtained contracts). In reviewing *Marcus* and its progeny, the Fourth Circuit concluded that "courts, including the Supreme Court, found False Claims Act liability

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[10]While the Seventh Circuit has not defined a "materiality" requirement for the FCA, it has cited the Fourth Circuit's adoption of such a requirement. *Lamers*, 168 F.3d at 1019 (citing *U.S. ex rel. Berge v. Board of Trustees*, 104 F.3d 1453, 1459 (4th Cir. 1997)). Under *Berge*, the test of materiality is "whether the false statement has a natural tendency to influence agency action or is capable of influencing agency action." 104 F.3d at 1459 (citations and quotation marks omitted); *accord, Job Resources*, 2000 WL 1222205, at *2; *see also Luckey v. Baxter Healthcare Corp.*, 183 F.3d 730, 732, 733 (7th Cir. 1999) (suggesting that omission must be "material to the United States' buying decision"). Certain courts have required that compliance with the applicable contractual and regulatory requirements be a condition of payment before FCA liability will apply, primarily to avoid creating FCA liability for every regulatory violation. *See U.S. ex rel. King v. F.E. Moran, Inc.*, 2002 WL 203219, at *10 (N.D. Ill. 2002) (violations of minority business enterprise requirements); *U.S. ex rel. Sharp v. Consolidated Med. Transp., Inc.*, 2001 WL 1035720, at *9 (N.D. Ill. 2001) (violations of the Anti-Kickback Statute).

Plaintiffs have met whatever materiality standard might be applied. As a factual matter, government officials will uniformly testify that the government, had it known about Northrop's false statements, could not have continued to pay. As a legal matter, the Federal Acquisition Regulations firmly establish that adequate accounting is a fundamental condition of the government's relationship with a defense contractor.

for each claim submitted to the government under a contract, when the contract or extension of government benefit was obtained originally through false statements or fraudulent conduct." *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 787 (4th Cir. 1999). A similar approach has been taken by the Seventh Circuit:

> If the government would not have made a financial commitment absent the claimant's false statement, and the government is nevertheless required to pay [claims for funds], the government has suffered damage "because of" the false statement, as required by the Act.

U.S. v. First Nat'l Bank, 957 F.2d 1362, 1374 (7th Cir. 1992).

Strong support can also be found in the legislative history:

> The FCA was intended to cover "each and every claim submitted under a contract, loan guarantee, or other agreement which was originally obtained by means of false statements *or other corrupt or fraudulent conduct, or in violation of any statute or applicable regulation* ..." S.Rep. No. 345, 99-2d Sess. at 9 (1986), reprinted in 1986 U.S.C.C.A.N. 5266, 5275) (emphasis added.) In addition, the legislative history states that "claims may be false even though the services are provided as claimed if, for example, the claimant is ineligible to participate in the program..." *Id.*

Sharp, 2001 WL 1035720, at *5 (emphasis in original). Northrop both obtained its contracts by false statements and fraud, and was ineligible for those contracts.

Just as in its bills, Northrop made a variety of false statements and omissions concerning its material costs and accounting in contract proposals, for the purpose of obtaining contracts with the government. (PTO ¶¶ 27-30) Courts have repeatedly recognized FCA liability for submitting false contract proposals. *U.S. v. General Dynamics Corp.*, 19 F.3d 770, 771-72 (2d Cir. 1994).[11]

Similarly, Northrop's claims under the contracts at issue were also false because Northrop was ineligible for the contracts. *Sharp*, 2001 WL 1035720, at *5; *see also U.S. ex rel. Ali v. Daniel,*

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[11] *See Harrison*, 176 F.3d at 790; *U.S. ex rel. Hagood v. Sonoma County Water Agency*, 929 F.2d 1416, 1421 (9th Cir. 1991); *U.S. v. United Techs. Corp.*, 255 F.Supp.2d 779, 781-82 (S.D. Ohio 2003); and *U.S. ex rel. Windsor v. DynCorp, Inc.*, 895 F.Supp. 844, 851 (E.D. Va. 1995).

Mann, Johnson & Mendenhall, ___ F.3d __, 2004 U.S. App. LEXIS 746, *20-21 (9th Cir. 2004) (FEMA earthquake claims for costs to repair ineligible property subject to FCA liability); *U.S. v. Nazon*, 1993 WL 459966, at *2 (N.D. Ill. 1993) (Medicaid claims by ineligible physicians subject to FCA liability). In short, "[s]ubmitting a claim under the false pretense of entitlement is fraudulent." *U.S. ex rel. Kneepkins v. Gambro Healthcare, Inc.*, 115 F.Supp.2d 35, 43 (D. Mass. 2000). As Northrop did not have adequate material accounting and controls, it was not eligible for the contracts at issue and all claims made under those contracts are false.

2. Liability for False Claims of Progress

The essence of plaintiffs' false statements of progress claim concerning the ZSR-62 is that Northrop falsely reported its progress by staging a Critical Design Review. Through the CDR, Northrop represented that the design is "essentially complete," when in fact Northrop's employees "lied [their] teeth off." (PTO ¶¶ 157, 161a)

The U.S. Court of Appeals for the District of Columbia found FCA liability under virtually identical circumstances. *Schwedt*, 59 F.3d 196. In *Schwedt*, the relator alleged that the defendant had made false statements about the progress it was making on software being designed under a government contract. The Court of Appeals concluded:

> We hold that if, as [plaintiff] alleges, [defendant] knowingly submitted false progress reports stating that the software delivered during the same period was complete when in fact it was not, then these progress reports would constitute false statements in support of false claims and would trigger the Act's civil penalty.

Id. at 199. The same reasoning applies here, under the plain language of the statute. Northrop lied in the CDR in order to continue to obtain payments from the United States. As such, Northrop "made or used[ ] a false record or statement to get a to get a false or fraudulent claim paid." 31 U.S.C. § 3729(a)(2).

Similar support can be found from *Marcus, Fallon* and other cases discussed above. As in *Marcus*, Northrop submitted "tainted" invoices for payment that were the result of a "fraudulent action" with an "ultimate goal" of "payment of government money to persons who had caused it to be defrauded." *Marcus*, 317 U.S. at 543-44. As in *Fallon*, Northrop is liable for submitting invoices while knowing, but not disclosing, that it had not complied with the CDR requirements of the contract. Under any of these legal bases, Northrop is liable for its fraud against the United States.

3. Liability for Holding Tank Claims

Northrop is liable for the holding tank claim because it submitted labor charges for workers who were not working. As Congress said in amending the FCA in 1986, "a false claim may take many forms, the most common being a claim for goods and services not provided." S.Rep. No. 99-345, at 9 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5274. The Seventh Circuit has expressly used a claim for services not performed as "[a]n example of a false statement in an invoice." *Hindo*, 65 F.3d at 613 (*i.e.*, "the representation that a resident worked five days a week at a hospital for a given quarter when he worked only three.") As the Ninth Circuit recently recognized:

> In an appropriate case, knowingly billing for worthless services or recklessly doing so with deliberate ignorance may be actionable under [the FCA], regardless of any false certification conduct... Neither false certification nor a showing of government reliance on false certification for payment need be proven if the fraud claim asserts fraud in the provision of goods and services.

U.S. ex rel. Lee v. SmithKline Beecham, Inc., 245 F.3d 1048, 1053 (9th Cir. 2001). The liability under these circumstances is virtually self-evident. As one Court recently recognized, '[c]ertainly if the Defendant billed the United States for specific services that it never rendered then that claim would be fraudulent and properly actionable under the FCA." *U.S. v. NHC Healthcare Corp.*, 115 F.Supp.2d 1149, 1153 (W.D. Mo. 2000).

V. PLAINTIFFS' THEORY OF DAMAGES

"Damages awarded under the False Claims Act typically are liberally calculated to ensure they 'afford the government complete indemnity for the injuries done it.'" *U.S. ex rel. Compton v. Midwest Specialties, Inc.*, 142 F.3d 296, 304 (6th Cir. 1998) (quoting *Marcus*, 317 U.S. at 549). All damages that would not have accrued "but for" the defendant's fraud may be recovered under the False Claims Act. *U.S. v. First Nat'l Bank*, 957 F.2d at 1374. Thus, "[b]ecause each case under the FCA involves unique types of damage to the government, a formula for calculating damages must be created for each case that will provide the government with its damages directly caused by the filing of a false claim." *BMY--Combat Sys. Div. Of Harsco Corp. v. U.S.*, 44 Fed. Cl. 141, 147 (1998); *see also U.S. v. Killough*, 848 F.2d 1523, 1532 (11th Cir. 1988) ("No single rule can be, or should be, stated for the determination of damages under the Act... Fraudulent interference with the government's activities damages the government in numerous ways that vary from case to case") (quoting S.Rep. No. 96-615, at 4). A liberal calculation of damages is particularly appropriate where a more precise determination "is prevented by the acts and wrongdoing of the party charged." *U.S. v. American Packing Corp.*, 125 F.Supp. 788, 791 (D.N.J. 1954) (citing *Bigelow v. RKO Radio Pictures, Inc.*, 327 U.S. 251 (1946)).

A. Damages from the Financial Reconciliation Scheme

1. Time-Value Damages for Submission of False Claims for Progress Payments

Progress payments are a form of interest-free financing provided to Northrop by the United States. The *quid pro quo* and condition for the receipt of such financing was Northrop's adherence to accounting and certification requirements. *See American Tel. & Tel. v. U.S.*, 307 F.3d 1374, 1381 (Fed. Cir. 2002), *cert. denied*, 124 S.Ct. 56 (2003); *Florida Engineered Constr. Prods. Corp. v. U.S.*,

41 Fed. Cl. 534, 540 (1998). Here, through its fraud and false claims, Northrop wrongfully obtained accelerated payments during performance of its contracts which, at best, should only have been paid after products had been delivered. In effect, the government made substantial loans to Northrop that Northrop had no right to receive.

Consequently, the appropriate measure of damages is the time value of money associated with Northrop's wrongful receipt of progress payments. Time value of money has been recognized in other False Claims Act cases as damages compensating the government for premature payments. *See BMY--Combat Sys.*, 44 Fed. Cl. at 147; *Young-Montenay, Inc. v. U.S.*, 15 F.3d 1040, 1043 (Fed. Cir. 1994); *cf. U.S. v. Baird*, 134 F.3d 1276, 1284 (6th Cir. 1998) (for purposes of sentencing guidelines, "loss" from prematurely made progress payment is time value of money). Here, however, the progress payments for material costs were not premature; they should not have been made at all.

Further support can be found in the Seventh Circuit cases addressing the amount of compensation due for imposing an involuntary or coerced loan in various contexts. The general rule is that a market rate of interest should be charged against the principal amount, until repaid. *Cement Div., Nat'l Gypsum Co. v. City of Milwaukee*, 144 F.3d 1111, 1114-15 (7th Cir. 1998) (compensatory interest at compounded prime rate appropriate, even where defendant could have borrowed at lower rate.); *Koopmans v. Farm Credit Servs. of Mid-Am., ACA*, 102 F.3d 874, 874-75 (7th Cir. 1996) (all circuits agree that market rate should be used to make creditor whole in coerced loan situations); *accord*, *U.S. v. Crown Equip. Corp.*, 86 F.3d 700, 710 (7th Cir. 1996) (government entitled to market value of losses, not just cost to the government). Significantly, when the government explicitly loans money to a contractor as "Advance Payments," the interest rate charged is the *higher* of the prime rate or the rate set semi-annually by the Secretary of the Treasury under 50 U.S.C. App.

§ 1215(b)(2). *See* 48 C.F.R. § 32.407 (2002). Plaintiffs' use of the prime rate in determining damages is thus clearly warranted. Compounding is recognized in the federal courts as necessary to provide full compensation for the time-value of money. *See Cement Div.*, 144 F.3d at 1114-15; *Calabrese v. Square D Co.*, 2000 U.S. Dist. LEXIS 4307, *24-25 (N.D. Ill. 2000).

Accordingly, the time value of money was calculated at prime rate, compounded monthly. Under a market rate model, plaintiffs' calculation gave Northrop credit for payments when products were delivered, while also giving the government interest that would have continued to accrue on the unpaid balance following delivery. The total reasonable measure of damages, as measured by the market rate of interest applied to the fraudulently obtained financing of material costs under the progress payment requests, is $117,741,739, through December 31, 2003. (PTO ¶ 212) The specifics of plaintiffs' calculations of these damages are set forth in the report of plaintiffs' experts in the calculation of damages on government contracts. Northrop has not identified a damages expert of its own.

2. Damages for Wrongfully Charged Material Costs

Northrop's fraudulent accounting led to the wrongful disposition of concealed material inventory imbalances, which should not have been billed to the government. This primarily includes inexplicably lost parts.[12] "The law provides for a rebuttable presumption that the government is damaged dollar-for-dollar by the nondisclosed amount." *U.S. ex rel. Taxpayers Against Fraud v. Singer Co.*, 889 F.2d 1327, 1333 (4th Cir. 1989) (citing cases). Generally, damages for submissions of ineligible costs can be estimated from overall discrepancies between the total submitted and the

[12]A minor portion is also attributable to costs for uncontrolled inventory, which Northrop did not want to identify to the government because it could not trace where the parts came from. (PTO ¶ 103m)

amounts found to be improper. *See*, *e.g.*, *Brooks*, 64 F.3d at 254-55. The proper measure of the damages for unallowable costs on a progress bill is the amount of those costs. *Young-Montenay*, 15 F.3d at 1043. The amount of $7.2 million (plus other costs charged to the government on the basis of these costs) was calculated by plaintiffs' experts, as set forth in their report.

As detailed above, Northrop also concealed $8.4 million of excess material from the government, thereby harming it in that amount. (PTO ¶ 127b-d) This was material that should not have been bought in the first place. In addition, by concealing the inventory, the government was deprived of any chance to use it. Under various government regulations, the government is empowered to "[e]liminate the costs of excessive inventory from the costs eligible for progress payments" and other billings. 48 C.F.R. § 32.503-6(d)(1); *see also* 32 C.F.R. § 163.93-3; 48 C.F.R. § 52.232-16(c); 48 C.F.R. § 32.503-6(b).

B. Damages for False Claims of Progress

The measure of the government's damages is the amount that it paid out by reason of the false claims over and above what it would have paid if the claims had been truthful. *BMY--Combat Sys.*, 44 Fed. Cl. at 147; *U.S. v. Woodbury*, 359 F.2d 370, 379 (9th Cir. 1966). In this case, Northrop "lied [its] teeth off" in the CDR, and hid its lack of progress on the contract for years after. (PTO ¶ 161) Had it known, the government would have terminated the program for lack of progress as provided in the contract. (PTO ¶ 165)

The D.C. Circuit addressed a virtually identical fact situation in *Schwedt*, 59 F.3d at 196. In *Schwedt*, the court found that all subsequent payments following the false progress report could be damages under the False Claims Act, if the subsequent payments on the contract were made "because of" the false progress reports. *Id.* at 200. There, as here, no final product was ever

delivered under the contract. Consequently, the entire $254 million paid to Northrop after the CDR should be recovered as damages.

C. Damages for Holding Tank Claims

These claims are simply for costs that should never have been charged to the government under the SP-3 cost-reimbursable contract. Northrop internally accounted for "idle time," and the government should recover this total amount of $1.6 million as damages. (PTO ¶ 222)

D. Statutory Damages

Under the False Claims Act, the court must assess a mandatory penalty of $5,000 - $10,000 for each violation. 31 U.S.C. § 3729(a); *U.S. v. Hughes*, 585 F.2d at 286. The penalties have both a compensatory and punitive purpose. *U.S. v. Halper*, 490 U.S. 435, 449-50 (1989). In assessing a civil penalty, courts will take into account the gravity of the offense, a defendant's acceptance of responsibility or lack of remorse and the need for deterrence and recidivism of the defendant. *See, e.g.*, *Securities & Exch. Comm'n v. Lipson*, 129 F.Supp.2d 1148, 1159 (N.D. Ill. 2001) (Guzman, J.), *aff'd*, 278 F.3d 656 (7th Cir. 2002); *U.S. v. Murphy*, 937 F.2d 1032, 1035-36 (6th Cir. 1991). The penalties serve a remedial role in compensating the United States for the "costs of corruption." *Halper*, 490 U.S. at 450. In assessing the penalty the court may also include damages for injuries that cannot be readily quantified as acceptable "rough justice." *Ab-Tech Constr., Inc. v. U.S.*, 31 Fed. Cl. 429, 434-435 (1994) (*citing Halper*, 490 U.S. at 449) *aff'd* 57 F.3d 1084 (Fed. Cir. 1995).

VI. RELATORS' RETALIATION CLAIMS

A. Holzrichter Was Harassed and Constructively Discharged for Investigating and Reporting Fraud Against the Government

Northrop hired relator James Holzrichter in August 1984. He consistently received superior performance evaluations and promotions. (PTO ¶ 132) From at least 1987 to 1989, Holzrichter was employed in Northrop's Product Assurance (or "Quality") Department. In late 1987 or early 1988, Holzrichter was assigned responsibility for tracking and auditing large scrap and inventory transactions. From the time he received that assignment until his termination in 1989, Holzrichter was responsible for "[w]eekly audits . . . to insure the accuracy of the collected data" regarding scrap and other material costs. The data audited by Holzrichter was used by Northrop's Finance Department to account for material costs. (PTO ¶ 133)

While performing his audit duties, Holzrichter discovered that Northrop's inventory data was fundamentally incorrect, and suspected that the government was being harmed. For example, Holzrichter found serious anomalies in inventory records showing that, for certain parts, Northrop was scrapping more than it had ever purchased. Holzrichter also learned of the "financial reconciliation" scheme, described above, and was present at meetings where concealing excess inventory from the government and other schemes were discussed. (PTO ¶¶ 134-136, 139)

Holzrichter reported his findings to his supervisor, Tom Clyder, and to Clyder's supervisor, Amy Selen. His supervisors did not take any actions to remedy the frauds against the United States. Selen told Holzrichter to "let sleeping dogs lie." (PTO ¶ 141) Following Holzrichter's report of his observations, he was interrogated by security personnel at Northrop. Rather than investigate the truth of his allegations, Northrop investigated Holzrichter. Northrop security personnel questioned him as to whether he had disclosed the information to the United States government. (PTO ¶ 143)

In the spring of 1988, Holzrichter began relaying information to government agents. He continued providing information to the government for over a year about fraud at Northrop. While Holzrichter was an "original source" of information under the False Claims Act (31 U.S.C. § 3730(e)(4)), he was unaware of the FCA or any of its incentives while he was working at Northrop. (PTO ¶131)

Northrop's in-house counsel testified that, in or around May of 1989, he received an anonymous tip that a "Jim" was cooperating with the United States. This was investigated by a Northrop security officer, Dan Quealy, who confronted Holzrichter as the informer on May 22, 1989. The next day, Holzrichter returned to work, only to find that everything in and around his work area had been confiscated by Northrop (including personal items). He was also totally blocked from any access to Northrop's computer system, which made him completely unable to do his job. Northrop's top attorney at Rolling Meadows repeatedly monitored Holzrichter at his desk to prevent Holzrichter from doing any "further damage" to Northrop. (PTO ¶ 149)

Shortly after discovering Holzrichter's cooperation with the United States, on June 1, 1989, Northrop's top-level management met and discussed one of the specific problems that Holzrichter had reported – that the computer system was regularly showing that Northrop had scrapped more of a particular part than had been purchased. Northrop's "findings" corroborated Holzrichter. The presentation included tables showing that the scrap data problems, such as those that Holzrichter saw, reflected continuing inadequacies of Northrop's accounting and control systems for handling inventory and scrap. (PTO ¶¶ 144, 145)

Due to this harassment, Holzrichter was unable to continue working at Northrop, and left on disability. Holzrichter was never again able to find work in his field of expertise. Instead, Holzrichter was forced to take employment substantially below his abilities, such as sweeping

driveways and delivering newspapers. Holzrichter, his wife and five children suffered extraordinary hardships, and lived in a homeless shelter for months. (PTO ¶¶ 151, 152)

B. Robinson Was Harassed and Discharged for Investigating and Reporting Fraud Against the Government

Robinson was hired by Northrop as a test engineer for the SP-3 program on March 4, 1985. At the time Robinson was hired by Northrop, he already had 30 years of experience working on state-of-the-art electronic systems for both the military and private industry. Among his accomplishments was working on nine Apollo space launches. He also designed and built test equipment used to monitor Soviet compliance with the SALT II treaty and he worked on the NORAD early warning missile defense system for the United States in Thule, Greenland. (PTO ¶¶ 191-192)

From the date Robinson was hired by Northrop until he began to complain to management about potential false claims to the United States, he was given increased responsibility, was promoted, and received satisfactory performance evaluations. In approximately December of 1986, while performing his duties, Robinson began to learn that Northrop was misrepresenting its progress on the ZSR-62 program, among other improprieties. (PTO ¶¶ 193, 194)

No later than March 25, 1987, Robinson complained to Northrop about management manipulation of engineering performance reviews and a dishonest workplace. Robinson complained to his immediate supervisor, Michael Simaschko, Simaschko's supervisor, Dan Watson, and other supervisors up to Wallace Solberg, the CEO of Northrop's Defense Systems Division. (PTO ¶ 195)

Rather than take remedial action, Northrop pressured Robinson to participate in the frauds. As a result of this pressure, Robinson was hospitalized for stress. Upon returning to work, Watson berated Robinson for being behind schedule. (PTO ¶ 196)

Robinson reported Northrop's illegal activities to the FBI. Within one week after going to the FBI, Northrop investigated Robinson to determine whether he had complained to the FBI. While Robinson was an "original source" of information under the False Claims Act (31 U.S.C. § 3730(e)(4)), he was unaware of the FCA or any of its incentives while he was cooperating with the government. (PTO ¶¶ 197, 198, 190)

Following his complaints to Northrop about illegal activities, Northrop retaliated by giving him poor performance reviews. (PTO ¶ 199) Robinson disputed his performance evaluations. (PTO ¶ 200) Northrop's further retaliation against Robinson included:

- removal from classified aspects of the SP-3 program;
- assignment to unclassified and unsophisticated work;
- conducting a sham review of Robinson's work to support the low performance evaluations;
- Northrop's legal department began to develop a "basis for Robinson's departure" from Northrop. (PTO ¶ 201a, b, d, h)

On December 10, 1987, Robinson was transferred to the unclassified AN/ALQ 162 program. (PTO ¶ 202) On May 11, 1988, Robinson was laid off. Robinson was told that his layoff was due to a reduction in the workforce. This explanation was a lie. (PTO ¶ 203) In or about April 1988, DSD was still hiring electrical engineers to perform work Robinson was capable of and experienced in doing. (PTO ¶ 204)

Following his pretextual removal, Robinson was never again able to find work in his field of expertise. Due to devastating psychological and emotional injury caused by Northrop's unlawful conduct, Robinson was unable to obtain meaningful gainful employment, lost his home and material possessions and was reduced to living in a trailer in the desert. (PTO ¶¶ 205, 206)

C. Northrop is Liable for its Conduct

Under Section 3730(h) of the False Claims Act, 31 U.S.C. § 3730(h), relators Robinson and Holzrichter are entitled to recover for termination and other discriminatory actions Northrop took against them. A plaintiff bringing a claim under Section 3730(h) must show that:

> (1) his actions were taken "in furtherance of" an FCA enforcement action and were therefore protected by the statute; (2) that the employer had knowledge that he was engaged in this protected conduct; and (3) that the discharge [or other adverse conduct] was motivated, at least in part, by the protected conduct.

Brandon v. Anesthesia & Pain Mgmt. Assocs., Ltd., 277 F.3d 936, 944 (7th Cir. 2002); *DeCalonne v. G.I. Consultants, Inc.*, 197 F.Supp.2d 1126, 1134 (N.D. Ind. 2002). Similarly, Northrop is liable to Robinson for state law retaliatory discharge because he was: (1) discharged; (2) in retaliation for his activities; and (3) the discharge violated a clear mandate of public policy. *Doherty v. Kahn*, 682 N.E.2d 163, 173-74 (Ill.App.Ct. 1997); *see also Brandon*, 277 F.3d at 940-43.

The relators clearly satisfy the elements of their discharge claims. First, relators engaged in conduct protected by the statute by investigating potential false claims against the government, and then reporting those violations internally and to the government. *Neal v. Honeywell Inc.*, 33 F.3d 860, 864 (7th Cir. 1994). This also satisfies the "public policy" element of retaliatory discharge. *Brandon,* 277 F.3d at 941-43. Second, relators both notified their employers of the false claims, and Northrop discovered that both relators had been cooperating with the government. *Id.*

Finally, plaintiffs will be able to show that Northrop's retaliatory conduct was motivated, at least in part, by relators' protected conduct. For example, after Northrop discovered that Robinson had complained to the FBI, it schemed through its in-house counsel to develop a pretextual "basis for departure," and conducted a sham evaluation of his work. Immediately after Northrop identified Holzrichter as an informer, he was investigated by Northrop security, all his

work and personal possessions were taken, and he was locked out of the computer system. Whereas prior to Northrop discovering the relators' protected conduct, Robinson and Holzrichter were highly regarded employees, subsequent to this discovery, Robinson was discharged, and Holzrichter was constructively discharged because his working conditions "made remaining in the job unbearable." *Neal v. Honeywell, Inc.*, 191 F.3d 827, 830 (7th Cir. 1999) (quoting *Lindale v. Tokheim Corp.*, 145 F.3d 953, 955 (7th Cir. 1998)).

D. Robinson and Holzrichter Are Entitled to All Relief Necessary to Make Them Whole

Robinson's discharge, and Holzrichter's constructive discharge, taken in retaliation for their courageous whistleblower activities, and the harm they suffered as a result of all the harassment, discrimination and retaliation by Northrop, entitle them to a broad range of individual relief. Section 3730(h) of the False Claims Act provides any relator who is "discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer because of lawful acts done by the employee on behalf of the employee or others in furtherance of an action under this section "shall be entitled to *all relief necessary to make the employee whole*." 31 U.S.C. § 3730(h) (emphasis supplied). "Such relief shall include reinstatement with the same seniority status such employee would have had but for the discrimination, two times the amount of back pay, interest on the back pay, and compensation for any special damages sustained as a result of the discrimination, including litigation costs and reasonable attorneys' fees." *Id.* "Compensation for special damages" may include an award for emotional distress suffered by the employee. *Neal v. Honeywell*, 191 F.3d at 832.

Robinson's state law retaliatory discharge claim establishes an independent basis for compensatory damages, and also entitles him to punitive damages to punish Northrop for its wilful,

malicious and wanton conduct. *Palmeteer v. International Harvester Co.*, 421 N.E.2d 876, 880-81 (Ill. 1981); *Kelsay v. Motorola, Inc.*, 384 N.E.2d 353, 359 (Ill 1978); *Brandon*, 277 F.3d at 946.

Robinson was at the prime of his career when he was forced out of his job by Northrop, just as he approached age 50. He subsequently found all doors to comparable work in his field closed to him. He lost his home, he became destitute, and he suffered severe, long-lasting emotional distress. He ultimately met with an untimely death at age 62, unemployed and living in a trailer. Northrop's actions damaged Robinson in an amount in excess of $3.9 million (plus litigation costs, expenses and attorneys fees) as relief necessary to make him whole under the False Claims Act, 31 U.S.C. § 3730(h). These damages include twice Robinson's back pay, with interest, in an amount totaling at least $1,954,240, and damages totaling at least $2,000,000 for his severe, persistent and long-lasting emotional distress. Robinson's retaliatory discharge claim entitles him to damages totaling in excess of $5.2 million, including back pay, with interest, totaling at least $1,214,349.08; emotional distress damages totaling at least $2,000,000; and punitive damages in an amount not less than $2,000,000.

Since Holzrichter's constructive discharge in 1989, he and his family have suffered severe financial hardship, including homelessness. He has been unable to find employment in his area of expertise and, like Robinson, found all doors in his field have been closed to him. Holzrichter had to forego or delay sending his children to college, and had to resort to menial work in an effort to provide for his family. Holzrichter has been damaged in an amount in excess of $4.1 million (plus litigation costs, expenses and attorneys fees). These damages include twice Holzrichter's back pay, with interest, in an amount totaling at least $1,350,098; reinstatement with the same seniority status Holzrichter would have had but for the discrimination (or front pay damages, in lieu of reinstatement, totaling at least $368,229); the value of his lost 401(k) benefits at present value (with

adjustments for tax consequences) totaling at least $347,150; the value of his lost pension benefits at present value (with adjustments for tax consequences) totaling at least $1,013,702; other miscellaneous compensatory damages exceeding $30,000; and damages totaling at least $1,000,000 for severe, persistent and long-lasting emotional distress.

Finally, for all FCA violations alleged herein, Robinson and Holzrichter are entitled to the maximum statutory percentage award, under 31 U.S.C. § 3730(d). Plaintiff relators are also entitled to the maximum allowable and reasonable attorneys' fees, expenses and costs incurred in prosecuting this action. *Id.*, at (d) and (h).

VII. CONCLUSION

This case is no more complex than dozens of other fraud cases resolved by the Courts each year. Neither the age of the case -- which was caused by two lengthy stays due to criminal investigations and by protracted discovery battles -- nor the size of the potential damage award, converts this lawsuit into anything other than a garden variety fraud presenting legal theories and evidence that can be easily understood by the Court and the jury. Accordingly, it is time to set the case for trial, without delay caused by either summary judgment motions or appointment of a special master.

Respectfully submitted,

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