

## DOCUMENT RESUME

06934 - [B2287342]

The Secretary of the Navy's Proposal To Use Public Law 85-804 To Modify the LRA and DD-963 Ship Construction Contracts with Ingalls Shipbuilding Division of Litton Systems, Inc. August 10, 1978. 11 pp. + enclosure (35 pp.).

Testimony before the House Committee on Armed Services; by Jerome H. Stolarow, Director, Procurement and Systems Acquisition Div.

Contact: Procurement and Systems Acquisition Div.  
Organization Concerned: Department of the Navy; Litton Systems, Inc.  
Congressional Relevance: House Committee on Armed Services.  
Authority: P.L. 85-804.

The Navy Department proposed action to provide financial relief to the Ingalls Shipbuilding Division of Litton Systems, Inc., under two ship construction contracts. The proposed actions are within the authority conferred by Public Law 85-804. The settlement negotiated with Litton is apparently necessary to facilitate the national defense and to relieve uncertainties and cash flow demand that jeopardize the financial position of Litton. The proposal followed claims by Litton for price increases based on design changes and various attempts to settle the claims. The increased costs which resulted in the claims resulted partly from Navy actions and partly from the contractor's overly optimistic estimates. The proposed action would increase the ceiling for the contracts by \$447 million, and in exchange, the contractor would agree, among other things: to accept an anticipated loss of approximately \$200 million; that no portion of the total \$133 million booked as Manufacturing Process Development costs will be invoiced against the contracts; and to release the Navy, with the exception of one minor subcontract claim, from all current claims and actions in connection with the two contracts. Among alternatives to the settlement under Public Law 85-804 are termination for default, continued litigation before the Armed Services Board of Contract Appeals, and negotiated settlement without Public Law 85-804 relief. The Navy believes that the only viable option is the negotiated settlement with extraordinary contractual relief under Public Law 85-804. (Author/ETW)

734L

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

FOR RELEASE ON DELIVERY  
Expected at  
Thursday, August 10, 1978

Statement of  
JEROME H. STOLAROW, DIRECTOR, PROCUREMENT AND SYSTEMS  
ACQUISITION DIVISION  
before the  
House Armed Services Committee

on  
The Secretary of the Navy's Proposal to Use  
Public Law 85-804 to Modify the LHA and DD-963 Ship  
Construction Contracts with Ingalls Shipbuilding Division  
of Litton Systems, Inc.

Mr. Chairman and Members of the Committee:

We are pleased to appear here today to discuss the action which the Department of the Navy proposes to take to provide financial relief to the Ingalls Shipbuilding Division of Litton Systems, Inc., under two ship construction contracts.

Secretary of the Navy Claytor pointed out in his formal letter of notification to this Committee on June 23, 1978, that he intended to use the authority of Public Law 85-804 to reform the contracts for the construction of 5 LHA and 30 DD-963 SPRUANCE Class ships. The Secretary's proposed action will increase the ceiling price by \$447 million. In exchange for this action the contractor agreed, among other things: (1) to accept an anticipated loss of approximately \$200 million, (2) that no portion of the total \$133 million booked as Manufacturing Process Development costs will be invoiced against the LHA and DD-963 contracts, and (3) to release the Navy, with exception of one minor subcontract claim, from all current claims and actions in connection with the two contracts.

In connection with this matter you asked us to provide answers to a number of specific questions. I would now like to highlight several significant matters dealing with the following:

--the legal authority of the Secretary to implement Public Law 85-804,

--the contracts in question,

--the claims and efforts to settle them,

--causes of increased costs resulting in claims,

--estimated costs to complete the contracts,

- ability of Litton to perform without settlement,
- potential cost to the Navy if the settlement proposal is adopted, and
- alternatives to the proposed settlement under Public Law 85-804.

#### LEGAL AUTHORITY

In our opinion, the current proposed actions of the Secretary of the Navy are within the authority conferred by Public Law 85-804. The settlement negotiated with Litton is apparently necessary to facilitate the national defense and to relieve uncertainties and cash flow demands that jeopardize the financial position of Litton.

We provided details on the legal authority of the Secretary in a similar case on which I testified before this Committee on August 3, 1978. Those details also apply in this case.

#### LHA AND DD-963 CONTRACTS

The Navy awarded Ingalls Shipbuilding Division of Litton Systems, Inc., two major ship construction contracts. The first contract was awarded in May 1969 for nine LHA Class ships. The second contract was awarded in June 1970 for 30 DD-963 SPRUANCE Class ships. Both contracts were fixed-price-incentive type and provided for escalation over and above the contract price.

The original LHA contract ceiling price for nine ships was about \$1.2 billion - or \$133 million per ship. The contract was subsequently reset by the contracting officer on February 28, 1973, and called for the delivery of only five ships at a ceiling price of about \$795 million - or \$159 million per ship. The ceiling price as of May 1, 1978, was about \$852 million - or \$170 million per ship. The increase resulted from 805

modifications to the contract including a \$20 million provisional payment on the LHA claims.

The original DD-963 contract ceiling price for 30 ships was about \$2.14 billion or \$71.3 million per ship. The contract was reset in July 1975 to include actual costs incurred through July 1974 and projections of costs to complete. At that time, the ceiling price was increased to about \$2.156 billion - or \$71.9 million per ship. The ceiling price as of May 1, 1978, was about \$2.269 billion - or \$75.6 million per ship. The increases resulted from 1,599 modifications to the contract since the initial contract date.

#### THE CLAIMS AND EFFORTS TO SETTLE THEM

Litton initially submitted its claim on the LHA contract in March 1972 for an increase of the ceiling price of \$475 million. The principal basis of this claim involved design changes allegedly directed or otherwise required by the Government and alleged receipt of late, defective, unsuitable, or changed Government information required for the design of the LHA. Litton and the Navy tried but failed to negotiate an agreement and on February 28, 1973, the contracting officer issued a unilateral decision resetting the contract.

The contracting officer's decision provided for no price increase based on the claim. Furthermore, he concluded that the contractor had received about \$55 million in excess progress payments under the contract and demanded they be returned. He did, however, recognize that the contractor was entitled to a 6-month delivery extension because of Navy caused actions

which had the effect of extending the contractor's entitlement to escalation for 6 months.

On March 2, 1973, Litton filed an appeal from the decision to the Armed Services Board of Contract Appeals (ASBCA). Litton also sued the United States in the Southern District of Mississippi, seeking judicial review of the contracting officer's decision. The District Court enjoined the Navy from recouping the \$55 million overpayment, but on appeal, the Court of Appeals for the Fifth Circuit reversed the decision. The Navy then withheld further progress payments until the overpayment had been recouped.

Litton updated and repriced the initial \$475 million claim, submitting it to the ASBCA on April 15, 1975, requesting an increase in the ceiling price of \$505 million. Between April 1975 and September 1977, the total amount claimed by Litton, including \$373 million for alleged impact on the DD-963 contract of Government actions on the LHA contract, was raised to \$1.076 billion. Subsequent adjustments and repricing have since increased this amount to \$1,088 billion.

A Claims Team in the Naval Sea Systems Command was established on January 1, 1976, to analyze the claim. In April 1978, the Claims Team had substantially completed its analysis of the \$1.088 billion claim and valued it at \$312 million.

PREVIOUS ATTEMPTS TO SETTLE CLAIM  
UNDER PUBLIC LAW 85-804

The Deputy Secretary of Defense proposed on April 30, 1976, the use of Public Law 85-804 to settle claims from Litton

and other shipbuilders. The Government offered Litton a substantial monetary and cash flow benefit through reformation of the contract escalation provisions, in exchange for broad releases from current and future LHA and cross impact claims. The Navy then estimated that this action would result in payments of an additional \$239 million to Litton at the time the shipbuilder was estimating a loss of \$543.4 million on the LHA and DD-963 contracts. Litton felt the offer was inequitable and at the end of June 1976 notified the Navy of its intent to discontinue performance on the LHA contract on August 1, 1976.

On August 3, 1976, the Navy and the Department of Justice obtained a preliminary injunction from the Federal District Court for the Southern District of Mississippi, requiring Litton to continue work, but the order was conditional on the Navy's paying actual costs of performance, subsequently defined as 91 percent of weekly invoiced costs. In November 1977, an agreement was reached by the Navy, the Department of Justice, and Litton which assured continued construction of the LHA's and reduced the Court ordered cost reimbursement of 91 percent to 75 percent. The proposed contractual modification to implement this agreement was submitted to appropriate congressional committees under Public Law 95-304 on January 19, 1978, and, following expiration of the congressional review period, was executed on April 13, 1978.

#### CAUSES OF INCREASED COSTS RESULTING IN CLAIMS

As you know, the construction of naval vessels is a complex process. There are a multiplicity of reasons why cost

growth occurs, including, but not limited to:

- overly optimistic original estimates
- unanticipated inflation
- poor design drawings and specifications
- change orders
- late delivery of Government-furnished equipment
- poor shipyard management
- low rates of labor productivity and inability to attract experienced labor

While the causes are known, it is extremely difficult to assess the cost impact of each and to ascertain to what extent the Government and the contractor should each be held responsible. It is almost certain, in our opinion, that every ship claim that has arisen during the past several years was due to a combination of causes--partly the contractor's responsibility; partly the Government's responsibility; and partly due to factors outside the control of the contracting parties.

Given the inability to accurately determine financial responsibility for the cost growth, it forces the parties to negotiate a somewhat arbitrary settlement.

The Navy has stated that no single cause brought about the substantial cost overruns experienced by the LHA and DD-963 programs. While the Navy admits that its actions were responsible for some of the increased costs outlined in the claims, the Navy said that some of the increased costs were caused by the contractor's overoptimism. For example, the LHA and DD-963 ships were to be constructed in Litton's new west bank yard

which was designed to use high-technology modular techniques and material flow patterns to gain advantages of assembly line production. The Navy said, however, that the new yard and new construction techniques did not achieve expected efficiencies in production and that sufficient levels of skilled manpower proved unattainable by Litton.

The LHA and DD-963 contracts also contained the older escalation clauses that limited inflation coverage to the original ship delivery dates. Once the schedules began to slip, partly as a result of Navy actions and partly as a result of Litton's own misjudgments and inefficiencies, the result was increased cost growth. Furthermore, after 1976, the escalation coverage ceased on the LHA contract, and Litton was required to absorb any increased costs due to inflation.

#### ESTIMATED COSTS TO COMPLETE THE CONTRACTS

The Navy estimated that as of April 30, 1978, the LHA and DD-963 contracts would cost a total of \$4.726 billion to complete, or \$647 million more than the \$4.079 billion allowed under the two contracts. The April 30, 1978, estimate of \$4.726 billion consists of (1) an October 31, 1977, estimate developed by the Defense Contract Audit Agency (DCAA) and the Supervisor of Shipbuilding which totaled \$4.689 billion, and (2) an additional \$37 million of changes and other adjustments arising after October 31, 1977.

The DCAA told us they had audited the costs incurred used in the estimate and considered them to be reasonable.

To determine the reasonableness of the estimate of cost at completion of the LHA and DD-963 contracts, the Navy hired the public accounting firm of Deloitte, Haskins and Sells. Deloitte, Haskins and Sells conducted an analysis and issued a report to the Navy, dated July 20, 1978. They concluded that it appeared that reasonable estimating and forecasting procedures were used in arriving at the estimate to complete.

LITTON'S ABILITY TO PERFORM  
WITHOUT A SETTLEMENT

In its report to the Navy, Deloitte, Haskins and Sells stated

"\* \* \* without a settlement, it appears that, based upon our review of the forecasted data provided by Litton, the corporation will exhaust its cash resources, including available borrowing capacity, \* \* \* near the summer of 1980."

These projections were based on the Navy paying Litton at the rate of 75 percent of incurred costs on the LHA contract and in accordance with the current contract terms on the DD-963 contract through completion. They stated that, without a settlement with the Navy on claims and future cost reimbursement, it seems doubtful that Litton could obtain either debt or equity financing to meet their projected corporate cash shortfall.

The above analysis generally agrees with cash flow projections prepared by the General Accounting Office in our statement to the Committee on the Navy's proposal to use Public Law 85-804 to modify the LHA ship construction contract dated March 7, 1978.

Deloitte, Haskins and Sells stated that cash availability is only one factor to be considered; some of Litton's long-term debt indenture agreements contain restrictive covenants

regarding certain financial ratios. They concluded that the recording of significant losses in fiscal year 1978 would place Litton in technical default under certain of its loan agreements.

Deloitte, Haskins and Sells also stated that Litton's long-term creditors likely would be reluctant to permit Litton to arrange any additional debt. The possibilities for acquiring equity capital would not appear to be promising, at least until Litton's independent auditors can issue an unqualified opinion on their financial statement.

POTENTIAL COST TO NAVY IF THE SETTLEMENT PROPOSAL IS ADOPTED

If the contractor completes the contract at or below the current estimated cost of completion, the Navy would be required to pay the contractor no more than \$447 million (a net payment of \$265 million for the value of the current claim after considering prior adjustment payments of \$47 million, plus \$182 million of payments under Public Law 85-804). If the contract is completed below the estimated cost of completion, the contractor would share 80 percent of the underrun and the Navy would share 20 percent.

If the actual cost to complete the contracts exceeds the estimated cost by \$100 million or more, the Navy may be required to pay the contractor \$497 million (\$265 million for value of the current claim, \$182 million of additional payments under the revised contract price, and \$50 million for the Navy's share of the contractor's costs in excess of the estimated costs). In addition to the above payments, the Navy will also pay separately for any contract changes executed after April 30, 1978.

Furthermore, the Navy would be required to negotiate the settlement of any additional claims filed by the contractor for Navy caused actions after June 20, 1978.

ALTERNATIVES TO THE PROPOSED  
SETTLEMENT UNDER PUBLIC LAW 85-804

Navy officials have considered several alternatives, other than reforming the contracts under Public Law 85-804. Among these alternatives are the following:

- termination for default,
- continued litigation before the ASBCA, and
- negotiated settlement without Public Law 85-804 relief.

Termination for Default

The Navy believes that the termination-for-default option tends to create more problems than it resolves. They state that it is extremely questionable whether the Government has a legal right to terminate the contractor for default because the Government has accepted the continued delinquent performance by Litton.

The Navy has also stated that it would be impossible for the Government to assume control over the construction of the LHA's while the contractor is currently constructing the DD-963's in the shipyard. Additional delays in LHA deliveries would probably result. The Navy believes that a termination for default, even if legally supportable, would expose the Government to a liability that is potentially far greater than the costs to complete the ships by Litton.

Continued Litigation Before the ASBCA

The Navy believes that continued litigation would not provide adequate relief to enable Litton to continue the orderly

construction of the LHA and DD-963 ships. The LHA contract modification executed by the Navy on April 13, 1978, under authority of Public Law 85-804 requires provisional payments to the contractor covering 75 percent of incurred LHA costs until the completion of performance under the LHA contract. The Navy stated that this modification solves some of Ingalls' cash flow problems, but the residual cash drain could lead to significant financial problems for Litton, which, in turn, could prompt further LHA or DD-963 program delays or work stoppages.

Negotiated Settlement Without  
Public Law 85-804 Relief

The Navy stated that negotiated settlement of the LHA claim without Public Law 85-804 relief does not provide sufficient monetary relief. The problems surrounding the orderly construction of the LHA and DD-963 class ships, the effects of the cost overruns, maintenance of the capability of the contractor's shipyard, and the future needs of the Navy call for relief going well beyond that available under the LHA contract.

The Navy believes that the only viable option is the negotiated settlement with extraordinary contractual relief under Public Law 85-804.

Mr. Chairman, this concludes my prepared statement. We will be happy to answer any questions you have at this time.

THE CONTRACTQUESTION

1. Please provide the Committee with a history of the LHA contract (N00024-69-C-0283) and DD 963 Contract (N00024-70-C-0275).
2. Target and ceiling prices and any modifications thereto.

ANSWERLHA Contract

On May 1, 1969, the Navy awarded Ingalls Shipbuilding Division of Litton Systems, Inc., Contract N00024-69-C-0283 for the construction of LHA amphibious assault vessels. Funds were made available in Fiscal Year 1969 for one vessel, and two vessels were programmed for purchase in each of the four succeeding fiscal years, for a total of 9 vessels.

The contract was fixed-price-incentive, successive targets type of contract, with an initial target price of \$112,500,000, and ceiling price of \$133,250,000, per vessel; thus the 9-ship target price was \$1,012,500,000 and the ceiling price was \$1,199,250,000. Under this pricing arrangement, the contractor shared with the Government expenses incurred between the target and ceiling price. The contractor paid for 20 percent of his incurred costs up to the ceiling price and the Government paid the remaining 80 percent. The contractor was then responsible for 100 percent of costs incurred beyond the ceiling price.

Between the initial date of the contract and February 23, 1973, 338 changes had been made to the original contract.

These changes had remained unpriced until the contract was amended on February 28, 1973. At that time, the Navy agreed to include \$19,315,000 in the contract ceiling price for the 338 changes and reduced the number of ships to 5. When the contract was amended on February 28, 1973, to call for delivery of only 5 ships, the prices were reset. From February 28, 1973, through April 30, 1978, the contract has been changed or modified an additional 467 times for \$32.3 million. Seven of these modifications have not been definitized, but have maximum price agreements totaling \$3.8 million.

The following table shows the price changes to the contract.

	May 1969 (9 ships)	February 1973 ( 5 ships)	May 1978 (5 snips)
Target Price	\$1,012,500,000	\$795,265,000	\$827,189,000
Ceiling Price	1,199,250,000	795,265,000	852,022,000

#### DD-693 Contract

On June 23, 1970, the Navy awarded contract N00024-70-C-0275 to Ingalls Shipbuilding Division of Litton Systems, Inc., for the construction of thirty destroyers of the SPRUANCE (DD-963) Class. It is a multi-year, fixed-price, successive target incentive contract with an initial target price of \$1,789,200,000 and ceiling price of \$2,139,900,000.

Under the sharing arrangement for overruns, the contractor shared with the Government expenses incurred between the target and ceiling price. The contractor paid for 15 percent

of his incurred costs between target price and ceiling price, and the Government paid the remaining 35 percent.

The contractor was then responsible for 100 percent of costs incurred beyond the ceiling price.

Between the initial date of the contract and April 28, 1974, the contract had been modified 423 times. On July 23, 1975, the Navy executed a modification that increased the ceiling price by \$16,048,000 and reflected adjustments in contract modifications effective on or before April 28, 1974. From April 28, 1974, through May 1, 1978, the contract has been changed or modified an additional 1,176 times for \$112,813,427.

The following table shows the price changes to the contract.

	June 1970 (30 snips)	July 1975 (30 snips)	May 1978 (30 snips)
Target Price	\$1,789,200,000	\$2,073,214,000	\$2,167,431,247
Ceiling Price	2,139,900,000	2,155,948,000	2,268,761,837

THE CONTRACTQUESTIONS

3. Methods of compensation, and modifications thereto.
4. How much compensation has Litton received under the LHA and DD-963 contracts in progress payments against the ceiling price and for undisputed or adjudicated changes? For escalation?
5. How much compensation has been received pursuant to various court orders?
6. Has the compensation received by Litton on the LHA and DD-963 contracts exceeded ceiling price? If so, what has been the source of funds?
7. What was the Navy's authority for making payments in excess of the ceiling price?

ANSWER

The original LHA contract provides for two separate payment methods and a recent court order and Navy negotiation provided for two other payment methods.

Under the contract, Litton was paid 100 percent of allowable costs incurred for the first 46 months of performance. Thereafter, and until Litton reached the contract ceiling price, payments would be based on the percent of physical progress. On June 23, 1976, prior to reaching the ceiling price, Litton notified the Navy of its intention to stop work because of alleged Navy breaches of contract. The Navy and the Justice Department immediately sued Litton in the U.S. District Court of Mississippi for specific

performance of the LHA contract. The Government asked the court to issue a permanent injunction requiring Litton to complete work on the snips. On August 3, 1976, the court issued a preliminary injunction requiring Litton to continue ship construction and the Navy to pay the contractor the actual labor and material costs. By subsequent order, this was changed to payment of 91 percent of incurred costs through the injunction period. On November 14, 1977, the Navy and Litton agreed to a temporary reduction in the reimbursement rate of 75 percent of incurred costs. The proposed contractual modification to implement this agreement was submitted to appropriate congressional committees under Public Law 85-304 on January 19, 1978, and following expiration of the congressional review period was executed on April 13, 1978.

The following chart shows amounts paid by the Navy through May 1, 1978, on the LHA contract under each method of compensation and for escalation.

	<u>(millions)</u>
Actual cost incurred per the original contract and paid thru February 28, 1973.	\$ 439.6
Progress payments based on physical progress to August 3, 1976. (Payments based on 90 percent of costs incurred)	229.8
Court ordered payments based on 91 percent of cost incurred from August 3, 1976, thru November 27, 1977.	199.9
Negotiated payments based on 75 percent of cost incurred November 23, 1977, thru May 1, 1978	<u>54.3</u>
TOTAL for all methods of payments	923.6
Escalation	<u>161.8</u>
TOTAL payments to Litton as of May 1, 1978	<u><u>\$1,085.4</u></u>

## ATTACHMENT

## ATTACHMENT

The ceiling price as of May 1, 1978, was \$852.0 million plus escalation of \$161.8 million or a total of \$1.0138 billion. The ceiling price includes a \$20.0 million provisional price adjustment on the LHA claim and \$51.6 million in modifications since the initial contract date. As shown above, the Navy, as of May 1, 1978, has actually paid the contractor \$923.6 million in progress and court ordered payment--\$71.6 million more than the current ceiling price. Navy payments made in excess of the ceiling price are being paid through the claim sub-account of Shipbuilding and Conversion Navy (SCN) appropriation (account number 1771611.0547). There has been \$252.8 million funded to meet payments in excess of contract ceiling.

There have been no modifications to the DD-963 contract that would have altered the methods of compensation to the contractor. Payments against the ceiling price are based on the percentage of physical progress. Payments include amounts for escalation and silencing incentives which are calculated separately from progress payments against the ceiling price. There have been no court ordered payments.

The following chart shows amounts paid by the Navy through May 1, 1978.

Progress Payments	\$1,992,703,653
Silencing Incentives	7,119,150
Escalation	790,643,834
Total Payments	<u>\$2,790,466,642</u>

ATTACHMENT

ATTACHMENT

The ceiling price as of May 1, 1978, was \$2,263,761,837 plus \$797,762,984 for escalation and silencing incentives, for a total of \$3,066,524,821. The ceiling price includes \$112,813,427 in changes since the reset of the contract on July 23, 1975. Progress payments received by Litton on the DD-963 contract have not exceeded ceiling price.

THE CONTRACTQUESTION

8. What is the history of claims, litigation, and other actions pending in the courts, ASBCA, Navy Claims Team, or others?

ANSWER

Litton will fully release, in a form satisfactory to the Navy, all claims and actions based upon events occurring prior to June 20, 1978, except for formal changes since May 1, 1978, and arising under or in connection with the LHA and DD-963 contracts, including, but in no way limited to, all claims <sup>1/</sup> and actions concerning the cancellation ceiling of the LHA contract, interest resulting from the method of material progressing of the LHA contract (the "SACAM" appeal), and the impact of either or both of these contracts on each other, or on any other contract involving Ingalls Shipbuilding Division. Litton further agrees that it will not contest in any form the validity and enforceability of the two contracts based in whole or in part upon events prior to June 20, 1978.

A. ADMINISTRATIVE REMEDIES - ARMED SERVICES  
BOARD OF CONTRACT APPEALS

1. Appeal of Litton Systems, Inc., ASBCA Number 18214

Filed: March 2, 1973

Subject: Appeal from decision of the contracting officer dated February 28, 1973, denying request for increase in the contract ceiling price in

---

<sup>1/</sup>Except for a subcontractor (RCA) claim in the face amount of \$3.2 million.

the amount of \$475.5 million. The dollar amount of this claim, as revised, is now \$562 million.

History: In January 1976, Litton and the Navy entered into a stipulation filed with the ASBCA to suspend without prejudice the major part of this claim.

In 1977, the Navy attempted to reinstate ASBCA 18214 as an active appeal. On September 30, 1977, the U. S. District Court for the Southern District of Mississippi expressed its view that reinstatement of the appeal would impinge upon litigation pending before that court.

Status: Proceedings are still suspended.

2. Appeal of Litton Systems, Inc., ASBCA Number 18214 (SACAM Case)

Subject: Claim in excess of \$22 million for interest on deficiency in progress payments.

History: Severed from main claim and tried separately.

Status: Awaiting decision.

3. Appeal of Litton Systems, Inc., ASBCA Number 21728

Filed: Letter of appeal (undated) received January 17, 1977.

Subject: Appeal from decision of the contracting officer denying claim for cost of delays involved in repair order under insurance clause in LHA-1 and LHA-2.

Status: <sup>2/</sup> On January 13, 1978, the Government requested leave to amend its answer.

4. Appeal of Litton Systems, Inc., ASBCA Number 21334  
Subject: Appeal from decision of the contracting officer directing modification to Combustion Control Air System at no cost to the Government.  
Status: On August 13, 1976, Litton requested a 45-day extension to file complaint. As of February 18, 1978, the Recorder's Office, ASBCA, has no record that a complaint was ever received. Navy's Office of General Counsel has stated that an indefinite extension was granted.

B. U. S. DISTRICT COURT AND U. S. COURT OF APPEALS

1. United States v. Litton Systems, Inc.

U. S. District Court for the Southern District of Mississippi, Case Number S-76-187(C)

Initiated: July 1976

Subject: Action by the Government for specific performance following Litton's notification of its intent to stop work June 1976 on LHA construction. Action is to require Litton to continue to perform its responsibilities under the LHA contract, (i.e., build the ships).

History: The District Court imposed a preliminary injunction by order of August 3, 1976. The order enjoined Litton Systems, Inc., and Litton Industries from failing or refusing to construct the LHA's on condition that the Navy "advance and pay" to Litton

its actual construction costs for labor and materials through a 9-month period, ending in April 1977. The order was clarified on November 23, 1976, to require Navy to pay Litton 91 percent of the costs incurred in constructing the LHA's in this period. On April 19, 1977, over the objection of the Government, the District Court extended the preliminary injunction to October 31, 1977. Just before expiration of this period, the Court again, on October 26, 1977, continued the preliminary injunction to July 31, 1978. A month later, on November 22, 1977, upon joint motion of the parties, the District Court reduced the 91 percent payment rate to 75 percent until April 1, 1978, at which time the rate is to revert to 91 percent.

Status: Litton and the Department of Justice presented a joint motion before the court to make the 75 percent cost reimbursement a permanent injunction. The motion was approved by the court.

2. United States v. Litton Systems, Inc.

U. S. Court of Appeals for the 5th Circuit, Case Number 77-2431.

Initiated: June 17, 1977

Subject: Appeal by the Government to the Court of Appeals from the April 19, 1977, order of the District Court requiring the Navy to continue to reimburse Litton for 91 percent of its costs for

construction of the LHA's, in excess of the contract ceiling price.

Status: Briefs have been filed by the parties.

C. COURTS OF CLAIMS

1. Litton Systems, Inc., v. United States

Court, of Claims Case Number 483-76

Filed: October 22, 1976.

Subject: Suit by Litton for breach and reformation of LHA contract.

Status: Litton describes this as a "protective case" covering all matters before the ASBCA, to be pursued if Litton loses on the claims before the ASBCA.

2. Litton Svstems, Inc., v. United States

Court, of Claims Case Number 203-76.

Filed: May 21, 1976.

Subject: Appeal from a decision of the Navy Contract Adjustment Board for LHA contract reformation with respect to amounts claimed as due as a result of the earlier cancellation of four LHA vessels.

Status: In discovery proceedings.

THE CONTRACTQUESTION

9. Does the contract, or any amendment thereto, recognize a Government obligation for part of a \$133 million in start-up costs, capitalized by Litton as "manufacturing process development costs?"

ANSWER

Litton agrees that no portion of the total \$133 million it has booked and identified as "manufacturing process development" cost will be invoiced against the LHA and DD-963 contracts. That portion of such costs related to the LHA and DD-963 contracts (stated by Litton to be \$62 million) will be fully released by Litton under the terms of the proposed agreement between Litton and the Secretary of the Navy.

THE CONTRACTQUESTION

10. Is the obligation which the Department of Defense will incur "within the limits of the amount appropriated and the contract authorization provided therefor?"

ANSWER

Completion of the LHA and DD-963 contracts by the Ingalls Shipbuilding Division of Litton Industries, Inc., will cost about \$647 million more than the contracts currently provide. Under the proposed settlement, Litton has agreed to absorb \$200 million of the additional cost and the Navy will pay \$447 million. Of this amount \$252.8 million has been funded leaving \$194.2 unfunded. In addition, the Navy will require \$417.5 million to pay a settlement on the SSN 688 contracts with General Dynamics. The total amount of additional funding required on both settlements is \$611.7 million.

The Navy has an additional \$404.1 million in funds specifically available for these contract reformations leaving a shortfall of \$207.6 million. The Navy proposes provide the additional funds by reprogramming \$325.6 million in the Fiscal Year 1979 DOD Budget Request. (The Budget Request had originally marked these funds for a nuclear submarine procurement). If the reprogramming action is approved as proposed, the Navy would apply the funds to the General Dynamics and Litton Industries, Inc., settlements and any excess not needed for these particular settlements would be held in reserve for settlements of claims on other shipbuilding contracts.

THE CONTRACTQUESTION

11. How does the contractor justify the growth in his claims from \$246.6 million in 1972, to \$505 million in 1976, to \$1.07 billion in 1977?

ANSWER

The contractor advised us that the 3 figures are not comparable. Ingalls' claim in 1972 was not \$246.6 million. The total amount requested in the March 1972 proposal involved a \$475.5 million increase in ceiling price including escalation but excluding interest and the cost impact of the LHA program on the DD 963 program. As the LHA program proceeded, the claim was updated based on current cost and pricing information, repriced, and submitted to the ASBCA in April 1975. This involved a \$505 million increase in ceiling price including escalation, but excluding interest and the impact of the LHA program on the DD 963 program. In October 1977, the claim was again updated based on current cost and pricing information and submitted to the Navy. This involved a \$561.6 million increase in ceiling price. The differences between \$475.5 million, \$505 million and \$561.6 million prices are primarily due to refinements in cost estimates and better data on inflation rates. In addition, in the October 1977 submittal, interest of \$155.1 million and the cost impact of the LHA program on the DD 963 program (\$373.3 million) were priced for the first time. The ceiling price of the claim shown in the October 1977 submittal was \$1.091 billion. The contractor is under a

ATTACHMENT

ATTACHMENT

duty to furnish the Government the most complete, current and accurate cost data available when presenting a price increase proposal of over \$100,000. The contractor also has a right to revise its claim after submission.

In summary the differences in the amounts claimed reflect (1) the effect of estimating costs of performance at later times in the construction period of an ongoing contract as more cost of performance visibility was obtained, (2) continued inflation, and (3) the impact effect that the LHA and DD-963 programs had on each other.

THE CONTRACTQUESTION

12. Any assumptions of responsibility by Litton Systems, Inc., of the obligations, duties, and liabilities of Ingalls Shipbuilding Division.

ANSWER

Litton Industries, Inc., the parent company to Litton Systems, Inc., and Ingalls Shipbuilding Division, executed a guarantee agreement to the Navy on September 26, 1968. This agreement stated that Litton Industries, Inc., would guarantee full performance by Ingalls of all the undertakings, covenants, terms, conditions and agreements of the LHA Development and Production Contract. Litton Industries, Inc., further agreed to provide adequate financing to Ingalls to assure performance of the LHA contract. However, Litton advised us that to the extent the LHA contract is held to be void because of the Navy's breach, Litton considers its guarantee as void since there would no longer be a contract. Litton asserted that the alleged causes underlying the claims were, in effect, breaches of contract.

THE CONTRACTQUESTION

13. Why is it necessary to invoke the extraordinary provisions of Public Law 85-804?

ANSWER

This authority is referred to as "extraordinary" because it explicitly gives the President statutory power to authorize any department or agency of the Government to amend national defense contracts without consideration, that is to say, without receiving anything specific of value in return, "whenever he deems that such action would facilitate the national defense."

Thus, a contract amendment increasing the price of a contract may be made without regard to any "other provision of law relating to the making, performance, amendment, or modification of contracts." It is a basic rule of Government, as well as private, contract law that contracts (and amendments or supplemental agreements) must be based upon an exchange of consideration, the so-called "quid pro quo." Public Law 85-804 completely overrides this basic rule, so long as the action taken would "facilitate the national defense."

Executive Order No. 10789, implementing Public Law 85-804, states, however, that amendments "may be with or without consideration."

The short answer of why is it necessary to use this extraordinary power in the Litton case is that no other clear, legal authority exists to permit the action proposed by the Secretary

ATTACHMENT

ATTACHMENT

of the Navy. The payments to be made to the contractor exceed the currently established ceiling price.

THE FINANCIAL CONDITION OF LITTON  
INDUSTRIES, INC.

QUESTION

14. Please provide the Committee with copies of the most recent 10-K and 8-K filings by Litton Industries, Inc., with the SEC.

ANSWER

Copies of the most recent, Securities Exchange Commission forms 10-K and 8-K filed by Litton Industries, Inc., are being provided for the record. The Committee asked for the 10-K and 8-K for Litton Systems, Inc. However, Litton Systems, Inc., is a wholly-owned subsidiary of Litton Industries, Inc., and is included in the consolidated financial statements filed with the Commission.

THE FINANCIAL CONDITION OF LITTON  
INDUSTRIES, INC.

QUESTION

15. Has Litton Industries, Inc., received an audit by independent accountants within the preceding calendar year? If so, what was the accounting firm's opinion of Litton's overall financial position?

ANSWER

Touche Ross and Company, Certified Public Accountants, examined the balance sheets and the related statements of earnings, shareholders' investment and changes in financial position of Litton Industries, Inc., and subsidiary companies as of July 31, 1977, and 1976. The accountant's report to the Board of Directors and Shareholders is qualified with respect to certain matters appearing in the section of the report to shareholders audited financial statements. In its report, Touche Ross and Company stated in part that: . . .

"The accompanying financial statements have been prepared on the basis that the \$530 million of presently estimated final contract costs in excess of current contract amounts will be recovered through negotiation or litigation. Due to the complexities and uncertainties of the issues involved, we are not presently able to determine the final outcome, or its effects, if any, on the accompanying financial statements."

It is the opinion of Touche Ross  
and Company that: . . .

"Subject to successful resolution of the uncertainties  
related to the LHA and DD contracts and recovery of  
recorded contract claims described in the preceding  
paragraph . . ., the financial statements referred to  
above present fairly the financial position of Litton  
Industries, Inc., and the consolidated financial  
position of Litton Industries, Inc., and subsidiary  
companies . . .".

The complete accountant's report is included in the  
form 10-K annual report we have provided the Committee.

THE FINANCIAL CONDITION OF LITTON  
INDUSTRIES., INC.

QUESTION

16. What is the cash flow position of Litton Industries, Inc.?

ANSWER

The Navy contracted with the public accounting firm of Deloitte, Haskins and Sells to analyze financial data provided by Litton Industries, Inc., and to prepare summary comments based upon that analysis.

In reports dated June 22, 1978, and July 20, 1978, the firm concluded that with respect to Litton's financial ability to continue to perform without a settlement, it appears that, based upon their review of the forecasted data provided by Litton, the corporation will exhaust its cash resources, including available borrowing capacity, near the end of their FY 1980 (the summer of 1980). At the end of Litton's fiscal year 1981 (July 31, 1981), the cumulative financing requirements are:

LITTON INDUSTRIES INC.

CASH NEEDED FOR FINANCING: BASED ON NAVY  
PAYMENT OF 75 PERCENT OF COST  
THROUGH COMPLETION  
(in thousands of dollars)

	<u>1978</u> <u>INCREASE</u> <u>(DECREASE)</u>	<u>1979</u> <u>INCREASE</u> <u>(DECREASE)</u>	<u>1980</u> <u>INCREASE</u> <u>(DECREASE)</u>	<u>1981</u> <u>INCREASE</u> <u>(DECREASE)</u>
A. Projected Financing Required To Maintain Working Cash Of About \$73,000,000	(2,209)	116,370	253,644	121,806
B. Projected Financing Required-Cumulative	(2,209)	114,161	367,815	469,621
C. Line of Credit As Of April 30, 1978	272,000	272,000	272,000	272,000
D. Remaining Credit (Deficit)	274,209	157,839	(95,815)	(217,621)

These projections were based on the Navy paying Litton at the rate of 75 percent of incurred costs on the LHA contract and in accordance with the current contract terms on the DD contract through completion. Without a settlement with the Navy on claims and future cost reimbursement, it seems doubtful that Litton could obtain either debt or equity financing to meet their corporate projected cash shortfall.

The above analysis generally agrees with cash flow projections prepared by GAO in our statement to the Committee on the Navy's proposal to use Public Law 85-804 to modify the LHA ship construction contract, dated March 7, 1978.

Deloitte, Haskins and Sells reported that cash availability is only one factor to be considered; some of Litton's long-term

debt indenture agreements contain restrictive covenants regarding certain financial ratios. Therefore, the recording of significant losses in FY 1978 would place Litton in technical default under certain of its loan agreements. Litton's long-term creditors likely would be reluctant to permit Litton to arrange any additional debt. The possibilities for acquiring equity capital would not appear to be promising, at least until Litton's independent auditors can issue an unqualified opinion on their financial statements.

THE FINANCIAL CONDITION OF LITTON  
INDUSTRIES, INC.

QUESTION

17. Is Litton Industries, Inc., in the opinion of the Comptroller General, now bankrupt or in danger of bankruptcy?

ANSWER

We do not believe Litton Industries, Inc., is "bankrupt" within the technical definition of Section 1 of Title II, U.S. Code which defines "bankrupt" as follows:

"Bankrupt" shall include a person against whom an involuntary petition or an application to revoke a discharge has been filed, or who has filed a voluntary petition, or who has been adjudged a bankrupt.

Litton Industries, Inc., does not fall within the above definition.

THE FINANCIAL CONDITION OF LITTON  
INDUSTRIES, INC.

QUESTION

18. What is Litton's obligation to the State of Mississippi with respect to its shipyard in Pascagoula?

ANSWER

In 1967, Mississippi, acting by and through the Mississippi Agricultural and Industrial Board (Board) and Jackson County, offered \$130 million in bonds for the purpose of constructing and equipping shipyards and shipbuilding facilities in the Port of Pascagoula in Jackson County, Mississippi. These facilities include property leased by the Mississippi Agricultural and Industrial Board to the Ingalls Shipbuilding Corporation. The leased property and the facilities constructed by the County and Board are being used by Ingalls to provide ship manufacturing and maintenance services for the general public and for agencies of the U.S. Government.

The lease became effective when the bonds were issued and will continue for a basic term of 40 years. Ingalls may terminate the lease, but only after making provisions for payment of the bonds. Ingalls also has the right to extend the lease, or after 37 years, purchase the land and facilities.

As lessee, Ingalls agreed to pay \$9 million annually; an amount equal to the payments required on the bonds for interest, principal, and redemption premiums. Ingalls may assign or sublease with approval, but remains responsible for all obligations to the State of Mississippi.

GENERALQUESTIONS

19. What other alternatives are available to the Secretary of the Navy or the Department of Defense to assure the construction of the remaining LHAs and DD-963 destroyers? Is the alternative which the Secretary of the Navy has chosen to pursue the least costly alternative?
20. It has been suggested that the Government should acquire the Litton shipyard at Pascagoula in connection with an extraordinary relief granted under Public Law 85-804 designed to prevent Litton's bankruptcy or to enhance that company's financial position. In the opinion of the Comptroller General, would this be a less costly means of completing the remaining ships now under contract?

ANSWER

The Navy views the proposed settlement under Public Law 85-804 as the most acceptable alternative to the LHA cost overrun problem. Other alternatives which the Navy does not consider acceptable are the following:

- exercise the default clause,
- seek court action to force the contractor to complete the work,
- finish the ships at other yards (either private or Navy),
- buy the shipyard and operate it as a Government-owned contractor-operated yard, or
- negotiate a settlement without Public Law 85-804 relief.

Exercise Default Clause

The Navy believes the default clause is an alternative which has four major drawbacks. The first is that Litton is still building the DD-963 ships for the Navy at the shipyard. If the Navy were to take over part of the yard to construct the LHA's,

conflicts would arise over the use of common facilities and services needed to construct both ship types. This situation would undoubtedly result in additional claims by Litton for delays to the DD-963 construction. Second, the Navy could not obtain, in a reasonable timeframe, sufficient supervisory personnel to take over the LHA construction without depleting its management capability at its own shipyard. Third, the labor force available to the Navy would be composed primarily of employees furloughed by Litton following its stoppage of work. These would be the least experienced and least productive as they would have the lowest seniority. Fourth, the Navy may have already waived its right to exercise the default clause as it chose to take legal action to force the contractor to complete the contracts when Litton stopped work before. Also the State of Mississippi owns the yard and this might complicate the Navy taking it over for the LHA construction.

#### Seek Court Action to Force Completion

If the Navy were to seek contractor performance through continued litigation, the legal entanglements that would ensue could take years to unravel. The Navy estimates the legal process could take 6 years. The court in the meantime could order the work to continue and the Navy to pay an even greater percentage of the contractor's total costs than the 75 percent being paid now.

Finish the LHA Ships at Other Yards  
(Either Private or Navy)

Completing the ships at other yards (private or Navy) is not a cost-effective course of action according to the Navy because the ships are too far along in the construction process. There would be a tremendous administrative problem in inventorying and documenting hundreds of millions of dollars of material. Many equipment items are of such a nature that they could not be disassembled and transported without incurring serious damage. Also, significant delays and inefficiencies would result because it would take time to become familiar with the work in process and go through a learning curve process.

The Navy could not take over the LHA construction in its yards without adding significant numbers of personnel and disrupting work already scheduled for these yards.

Buy the Shipyard

Buying the shipyard and hiring a contractor to operate it has several drawbacks according to the Navy. First, the yard is owned by the State of Mississippi, not Litton Industries, and Mississippi may not want to sell it without making a substantial profit. This could result in a protracted negotiating process with no guarantee of an ultimate sale. Second, a contractor hired to operate the yard would have no incentive to negotiate the lowest labor agreements possible because his contracts would be cost type. The Navy would not want to hire the workers because of the higher rates that are paid to Government personnel and constraints relating to manpower ceilings.

Negotiate a Settlement Outside  
Of Public Law 85-804

A negotiated settlement of the LHA claim without Public Law 85-804 relief would not provide adequate monetary relief to the contractor considering the cost overruns experienced to date.

GENERALQUESTION

21. Are there legal impediments to the acquisition of the shipyard by the Government?

ANSWER

We know of no existing legal authority under which the Government could "acquire" the shipyard apart from a purchase under applicable procurement statutes. Moreover, according to Litton officials, any assignment or sub-lease of its lease with the State of Mississippi is subject to the State's prior approval.

GENERALQUESTION

22. In what way will the contract modification contribute to an orderly resolution of the claims and litigation between Litton and the Government?

ANSWER

The proposed modification is designed in part to improve relations between the contractor and the Navy. An essential goal of the negotiations was to achieve a permanent solution of the LHA claims and more importantly, of the underlying problems on that contract as well as the DD-963 contract.

In addition, Litton has agreed to fully release, in a form satisfactory to the Navy, all claims and actions on the LHA and DD-963 contracts to date, as well as the impact of these contracts on each other or on any other contracts performed by Ingalls Shipbuilding. Two related actions by Litton against the Navy in the aggregate face amount of \$40.2 million will be dismissed.

According to the Navy, a most important element of the modification is the return of a harmonious relationship between the parties which the settlement is certain to produce. It will not, however, prevent the contractor from filing future claims on actions occurring after June 20, 1978, and throughout the contract period which is currently estimated to end in May 1980 and September 1980 on the LHA and DD-963 contracts, respectively.

GENERALQUESTION

23. Do the contract modifications fully comply with the requirements of Public Law 85-804, its implementing Executive Order No. 10789, as amended, with DOD and Navy directives, and previous decisions of the Comptroller General?

ANSWER

The proposed modifications appear to comply with all of the requirements of Public Law 85-804, Executive Order No. 10789, as amended, and applicable regulations and Comptroller General decisions.

The Secretary of the Navy states that the contract modifications are an exercise of his "residual powers" under Public Law 85-804. The term "residual powers" includes all authority under Public Law 85-804 except for (1) contractual adjustments, such as amendments without consideration, correction of mistakes and formalization of informal commitments; and (2) advance payments.

Public Law 85-804, then, appears to be the only adequate legal authority for the proposed modification.

The Navy plans to make the payments in excess of the ceiling price from Shipbuilding and Conversion, Navy [SCN] appropriations.

GENERALQUESTION

24. Do the contract modifications under the Secretary's proposed agreement fully comply with other Federal statutes?

ANSWER

To the best of our knowledge, the proposed contract modifications comply with other applicable Federal statutes.

Inasmuch as these are modifications to existing contracts, all applicable legal requirements imposed in the basic contracts should apply to these modifications.