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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The 1978 Navy Shipbuilding Claims Settlement At Litton/Ingalls Shipbuilding--Status As Of August 1, 1982

The 1979 Defense Appropriation Authorization Act requires the Comptroller General to review two contracts with Litton Systems, Inc., Ingalls Shipbuilding Division, for building landing helicopter assault and DD-963 destroyer ships that were involved in a shipbuilding claims settlement.

The review is to ensure that funds authorized to pay for contract modifications made in the interest of national defense are used only on the two contracts and that the contractor does not use such funds to realize any total combined profit on these contracts.

GAO found that the funds were being used as intended. However, should all unpaid construction costs and other funds retained by the Navy be paid, some funds could then become available for contractor use on projects other than the specified contracts. Although Litton, at the time of the settlement, projected a $200 million loss, it is now in a position to realize a total combined profit of $15 million on the two contracts, payment of which GAO believes would be contrary to limitations in the above act.

120715

GAO/PLRD-83-26

MARCH 3, 1983

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-197665

To the President of the Senate and the
Speaker of the House of Representatives

This is our third report on the status of two contracts (N00024-69-C-0283 and N00024-70-C-0275) awarded by the Navy to Litton Systems, Inc., Ingalls Shipbuilding Division, Pascagoula, Mississippi, for 5 landing helicopter assault (LHA) and 30 Spruance class destroyer (DD-963) ships. This report covers the period from August 4, 1980, to August 1, 1982. Our first two reports (PSAD-80-39, dated Apr. 22, 1980, and PLRD-82-8, dated Oct. 6, 1981) covered the period from the 1978 claims settlement through August 3, 1980.

On June 20, 1978, after several years of administrative and legal proceedings resulting from numerous claims and counterclaims, the Navy and the contractor agreed to a settlement based on an estimated cost at completion of $4,726 million. The agreement was reached under Public Law 85-804, which allows the President to modify contracts in the interest of national defense.

The settlement provided for (1) the contractor to absorb a $200 million loss through adjusting the contract billing base, 1/ (2) the Navy to absorb a $182 million loss through increasing the contract price under Public Law 85-804, (3) the Navy and the contractor to share cost underruns 2/ on a 20- to 80-percent basis, respectively, and (4) the Navy and the contractor to share cost overruns 3/ equally up to $100 million and the contractor to be solely responsible for costs above that amount.

Section 821 of the Department of Defense Appropriation Authorization Act of 1979 requires the Comptroller General to report annually to the Congress on our reviews of the two contracts. These reviews are to insure that funds authorized to provide relief under Public Law 85-804 in the settlement are being used only in connection with the two specified contracts and that the prime contractor does not use such funds to realize any total combined profit.

1/Contract price plus any subsequent contract changes exclusive of escalation and incentives used for billing purposes.

2/Amount by which cost at completion is less than estimated contract cost.

3/Amount by which cost at completion is greater than estimated contract cost.

This review included (1) an update of our prior review of procedures and controls and a test of transactions for January 1982 to insure that costs were properly charged to the individual contracts, (2) an examination of contract records and discussions with contractor and Navy officials to determine the combined profit/loss status of the two contracts, and (3) an examination of progress payments and related costs to determine whether Public Law 85-804 funds were being used only on the two contracts.

We focused primarily on the two principal objectives in section 821. We did not analyze the contractor's estimates and actual costs in detail to identify specific reasons for the combined underrun of estimated costs on these two contracts. Our review was made in accordance with generally accepted government auditing standards.

We found that:

--Funds provided under Public Law 85-804 were being used only in connection with the specified contracts.

--An accumulation of earned but unpaid construction costs and other funds retained by the Navy and potential unallowable costs could provide Litton with considerable funds for use on other contractor projects.

--Litton's records reflected a total combined profit on the two contracts. When profit on change orders (changes to the contract subsequent to award) and the incentive fee for ship silencing (fee for achieving specified noise level reductions) are considered, the total combined profit is projected to about $15 million. This projection is calculated after the complete recovery of the $200 million loss absorbed at the settlement. In our opinion, the payment of this profit by the Navy would be contrary to the limitations in section 821. 1/

--All work under the contract was nearly complete, and the final settlement and closeout process was underway.

1/In commenting on our previous report (PLRD-82-8), Litton and the Navy disagreed primarily with our (1) method of measuring total combined profit or loss and (2) interpretation of section 821 as it relates to the treatment of incentives earned for ship silencing and profit on contract changes after the claims settlement cutoff date. We evaluated these comments in that report.

USE OF AUTHORIZED FUNDS

As of August 1, 1982, Litton had incurred about $5 million in reimbursable costs exceeding payments made by the Navy to Litton on both contracts combined, as shown in the schedule below. (For further details, see app. I.)

Since the total amount shown as expended on the two contracts as of the above date is greater than the reimbursement from the Navy, we believe it reasonable to assume that the funds made available under Public Law 85-804 are being used in connection with the specified contracts.

	Contract		
	LHA	DD-963	Total (note a)
	(millions)		
Cumulative costs:			
Booked costs (note b)	$1,456	$3,219	$4,675
Manufacturing process development (MPD) (note c)	-21	-41	-62
Legal fees	-2	-	-2
Cost Accounting Standard (CAS) 414 (note d)	4	11	15
Total	1,437	3,189	4,626
Cumulative cash receipts:			
Progress billings	1,134	2,514	3,648
Escalation	162	792	954
Ship-silencing incentive fee	-	18	18
Total	1,296	3,325	4,621
Reimbursable costs exceeding cash receipts	$ 141	$ -136	$ 5

a/Figures may not total due to rounding.

b/Costs incurred and recorded in contractor's books of account.

c/Generally defined by Litton as effort expended in the development and refinement of the manufacturing process and procedures in the early and subsequent use of the shipyard facility.

d/Imputed interest costs.

Other costs/funds to be considered in the above computation:

Costs considered unallowable by the Defense Contract Audit Agency (DCAA)	$17 million
Unpaid ship construction costs	18 million
Funds that could become available for use by the contractor on other projects	30 million

The booked costs have not been adjusted for those costs which DCAA considers unallowable under the Defense Acquisition Regulation. The $17 million DCAA questioned is subject to negotiation between Litton and the Navy.

Of about $18 million in ship construction costs incurred on the two contracts for which the Navy has made no payment, $13 million represents incurred costs for which the contractor has not submitted payment vouchers and $5 million represents funds retained by the Navy in accordance with contract requirements. (In this regard, Litton has refrained from billing the Navy on these contracts for more than a year.)

If the entire $17 million in questioned costs included in the booked costs were not allowed by the Navy and the $18 million unpaid costs were paid, a total of $30 million would then become available for the contractor's use on projects other than the LHA and DD-963 contracts. The $30 million results from excluding, in the above table, the $17 million of questioned costs from the contractor's cumulative costs ($4,626 minus $17 = $4,609) and including the unpaid $18 million in its cash receipts ($4,621 plus $18 = 4,639). The above conclusion is based on the premise that the amount of contractor receipts exceeding allowable expenditures is available for other uses.

COMBINED PROFIT/LOSS STATUS

The $200 million estimated loss that Litton agreed to absorb during the settlement has been reduced to a $17 million loss, due to cost underruns. However, postsettlement change order and ship-silencing incentive fees earned have resulted, as of August 1, 1982, in an estimated profit at completion of about $15 million.

The claims settlement provides that the Navy and the contractor share 20 and 80 percent of the cost underrun, respectively. The contractor will be allowed to earn a profit on individual change orders executed after April 30, 1978, subject to the limitations of the 1979 Department of Defense Appropriation Authorization Act on the use of Public Law 85-804 funds for payment of any total combined profit on the two contracts. Also, there is a ship-silencing incentive fee paid by the Navy to the contractor which is not subject to the sharing ratio but which is part of the total contract compensation.

Our calculation of Litton's $15 million estimated net profit (see note e to table below), after considering the postsettlement change order profit and the ship-silencing incentive fee, is shown below.

	Contract		
	LHA	DD-963	Total (note a)
	millions		
Estimated cost at completion as of August 1, 1982 (note b)	$1,462	$3,232	$4,694
Less: MPD costs--unbillable	-21	-41	-62
Contractor's estimated unallowable costs	-5	-7	-12
Contract modifications	-13	-111	-124
Estimated cost for sharing purposes	1,422	3,074	4,497
Estimated cost at completion as of settlement date	1,500	3,226	4,726
Cost underrun	78	152	229
Contractor's share of underrun	62	121	183
Share of estimated loss to be absorbed by contractor (note c)	-200	-	-200
Estimated loss at completion as of August 1, 1982--unadjusted	-138	121	-17
Add: Profit on postsettlement change orders	2	12	14
Ship-silencing incentive fee	-	18	18
Estimated net profit or loss (-) at completion as of August 1, 1982 (note e)	$ -136	$ 151	d/$ 15

a/Figures may not total due to rounding.
b/See appendix II.
c/Settlement provides that estimated loss be absorbed entirely on the LHA contract.
d/The final estimated total combined profit will be affected by any costs that Litton incurs relating to pending litigation with subcontractors. Outstanding subcontract claims against Litton total about $45 million.
e/Net profit is total receipts under the contracts minus allowable costs under the Defense Acquisition Regulation.

As shown in the above schedule, the $15 million estimated total combined profit, which reflects complete recovery of the $200 million estimated loss, represents the contractor's share ($183 million) of a projected $229 million cost underrun, a profit of $14 million on postsettlement change orders, and an incentive fee for ship silencing of $18 million.

The August 1, 1982, estimated cost at completion has been reduced by unbillable and unallowable costs and contract modifications. This reduction is to convert to a basis consistent with the estimate at the time of the settlement so that an estimated cost for sharing purposes can be determined.

Contract changes costing about $124 million were approved on the two contracts from May 1, 1978, through April 30, 1982 (Litton's cutoff date for the changes used in computing the estimated cost at completion). Litton considered that these changes earned a profit of about $14 million. Also, as previously reported, the total incentive fee paid for ship silencing is $18 million.

NAVY SHARE OF UNDERRUN

In accordance with the settlement provisions, the Navy shares 20 percent of any contract underrun. Therefore, the Navy's share of the projected $229 million underrun is $46 million. Unused funds are deobligated from the contracts and returned to the Shipbuilding and Conversion, Navy, cost growth account. As of August 1, 1982, the Navy deobligated about $32 million of its portion of the underrun.

STATUS OF CONTRACT REQUIREMENTS

Although the last ships on the LHA and DD-963 contracts were delivered in April and June 1980, respectively, Litton has continued to perform modification and warranty/guaranty work. Navy officials informed us that all work under the two contracts was concluded in September 1982. Any uncompleted work will be done at shipyards other than Litton's and equitable adjustments will be made to the LHA and DD-963 contracts.

Concurrently with ongoing modification and warranty/guaranty work, since late 1980, Litton and the Navy have been involved in final contract settlement and closeout. Some required administrative and closeout events have been completed. The last remaining major event ("Commence Closeout Negotiations") was started in October 1982.

LITTON AND DEPARTMENT OF DEFENSE COMMENTS

Litton

As it did in our October 6, 1981, report, Litton again disagreed with our interpretation of section 821 of the 1979 Defense Appropriation Authorization Act. (See app. III.) Citing its previously submitted memorandum of law, dated April 2, 1981, Litton stated that it still adheres to the position in that document. Litton emphasized that whereas our method of measuring total combined profit or loss showed it with a $15 million profit, Litton would actually lose about $59 million on the two contracts when profit was calculated in accordance with its interpretation. In this regard, Litton asked that its legal positions as presented in the above memorandum be incorporated as an appendix to this report. As requested, we have attached this memorandum to Litton's comments, as well as our analysis of the legal objections to our draft report. (See app. IV.)

Our general position remains that the definition and application of the term "total combined profit on such contracts" in the draft report represent proper interpretations of the act. (See app. IV for basis of our position.)

Litton submitted additional detailed comments on suggested adjustments to this year's draft report tables and modification in the language in specific report passages. Where appropriate, we have made changes in the report.

Litton contends that our observations on the potential availability of funds for use on other contractor projects are so speculative as to be misleading to the Congress and should be deleted. The basis for this contention is that it is highly unlikely that the Navy would either pay costs that DCAA has questioned or honor additional progress billings in view of the GAO position on profits, unless ordered by a court to do so.

In this regard, our observations on allowability of questioned costs and payments by the Navy are made simply to point out what could happen. We do not know, nor have we been informed of, the extent to which any or all of these costs or amounts will be paid by the Navy.

Litton stated that it does not recognize the amounts we had categorized as "Disallowed Costs" and, therefore, could not accept the computation of "Funds Available for use on Other Contractor Projects." The involved costs are manufacturing process development or MPD costs ($62 million) and certain legal fees ($2 million).

We excluded MPD costs from Litton's booked costs because the claims settlement provided that MPD costs not be invoiced against the LHA and DD-963 contracts. Moreover, the Navy has reviewed these costs and determined that no basis in fact, law, or contract exists for the allowability on other Navy contracts of the costs in question under the principles and guidelines of section XV of the Defense Acquisition Regulation. Legal fees were excluded since these costs were specified as being unallowable costs in the contract.

Litton also maintained that profits on change orders issued after the settlement agreement and silencing incentive payments were funded by other funds and, therefore, were not subject to the limitations of the 1979 Defense Appropriation Authorization Act on the use of Public Law 85-804 funds for payment of any total combined profit on the two contracts.

As stated in our legal analysis, we believe section 821 provides, in effect, that no funds paid to Litton for purposes of relief (i. e., the $182 million to cover a portion of Litton's projected loss at the time of the settlement) may be used to contribute to any total combined profit on the contracts. While the restriction is imposed on the use of relief payments, it must be applied in relation to other contract payments for nonrelief purposes. In other words, the restriction looks to the impact of relief payments when combined with other contract payments. The restriction becomes operative if, and to the extent that, the sum of relief and other payments, less allowable costs, "* * * would result in any total combined profit on such contracts * * * ."

Department of Defense

The Department of Defense advised that it had no comment on our findings and conclusions in this report.

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We are also sending copies of this report to the Chairmen, Senate and House Committees on Armed Services; Senator William Proxmire; and the President, Ingalls Shipbuilding Division of Litton Systems, Inc.

Milton J. Socolar

for Comptroller General
of the United States

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Statement:	Contract (Note a) LHA	DD963	Total
"Estimated loss at completion as of August 1, 1982 - unadjusted	(138)	121	(17)

Comment:

To these figures one should add the unbillable/unallowable costs as follows:			
MPD	(21)	(41)	(62)
Estimated unallowable costs	(5)	(7)	(12)
Estimated loss on settlement agreement	(164)	73	(91)
Profit on post-settlement			
Change orders	2	12	14
Ship silencing incentive fee	-	18	18
Total net loss	(162)	103	(59)[a]

(a) The total net loss will be affected by any costs that Litton incurs as a result of concluding pending litigation with subcontractors. Outstanding subcontract claims against Litton, which total about $45 million, are not included in this figure.

For explanation of our position on computation of total profit or loss in the LHA and DD963 contracts, please see the section entitled "Calculations of Profit Under Section 821" in the Memorandum of Law attached hereto.

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MEMORANDUM OF LAW

FOR

MILTON J. SOCOLAR, ESQ.
Acting Comptroller General of the United States

Re: Draft Report by GAO dated February, 1981, entitled "Two Navy Ships Contracts Modified Under Authority of Public Law 85-804--Status as of Fiscal Year Ending August 3, 1980"

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April 2, 1981

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MEMORANDUM OF LAW

Re: Draft Report by GAO dated February, 1981, entitled "Two Navy Ships Contracts Modified Under Authority of Public Law 85-804--Status as of Fiscal Year Ending August 3, 1980"

INTRODUCTION

The purpose of this brief is to provide in detail our views on certain legal issues which require resolution and which are fundamental to the issuance of the proposed Draft Report by GAO dated February, 1981, entitled "Two Navy Ships Contracts Modified Under Authority of Public Law 85-804-- Status as of Fiscal Year Ending August 3, 1980," ("Draft Report"). While we will address certain aspects of the Draft Report itself, we are principally concerned with the legal issues which are related to the application of the limitation contained in Section 821 of the Department of Defense Appropriation Authorization Act, ("Act") of 1979.

It is Litton's and the Navy's position that the limitation on payment of profit contained in Section 821 applies only to the work on the LHA and DD963 contracts covered by the actual settlement agreement which was funded by the Public Law 85-804 relief funds provided by the Act. The Draft Report appears to take the position that the overall limitation on payment of profit applies to any profit on the contracts although separately authorized, separately funded, and separately earned outside the scope of the Public Law 85-804 funded settlement; for example, profit earned on subsequent bilateral contract changes and modifications, and performance incentives. The Draft Report includes this profit on work not covered by the Settlement in the calculation of total profit on the contracts under Section 821. It is also Litton's position that profit should be calculated using generally accepted accounting principles rather than DAR Section XV, as used in the Draft Report.

The settlement of LHA and DD963 claims was achieved by agreement of the parties and approved by the Congress. The Settlement was funded in part by the Act, and a limitation on the funds available for relief was enacted in its Section 821.

Following the Settlement of the claims, the parties entered into agreements regarding changes and modifications covering added work in connection with the contracts, on the basis that Section 821 applied only to the scope of contracts at

the time of Settlement. Each change and modification has been entered into bilaterally on a fixed price incentive basis. If this mutual understanding was incorrect, the question arises whether the Contracting Officer acted within his authority--whether the Navy can pay for the full equitable adjustment (profit) for the agreed-upon changes under these conditions--and whether these agreements were valid. If it is determined that the Contracting Officer acted outside the scope of his authority thereby invalidating the agreements, then Litton's continuing to perform the work may place it in a proscribed position of being a "volunteer" to the Government.

Thus, it is necessary at the present time for GAO to render a legal decision interpreting that Section of the Act so that the Department of the Navy and Litton will be able to complete the work under the two contracts for 5 landing helicopter assault ships (LHA) and 30 Spruance Class Destroyers (DD-963). We believe it is the desire of both parties to continue work on the basis of their understanding.

FACTUAL HISTORY

The "Background" section of the GAO Report PSAD-80-39, dated April 22, 1980, contains statements of the general factual history of the LHA and DD contract Settlement. The Settlement was initially memorialized by a document entitled "Aide Memoire" which was signed by representatives of both parties on 20 June 1978, contained herein as Attachment A. Paragraph 12 of this document states as follows:

> "Litton and Navy will promptly execute contract modifications and such other documents as are necessary to implement this Aide Memoire and Navy shall submit these documents to Congress for the review required by Public Law 85-804. The effective date of the implementing documents shall be the date of the favorable conclusion of the Congressional review period. The implementing documents, when effective, shall annul and supersede the LHA contract modification executed by the Navy and Litton on 13 April 1978. In the event the implementing documents do not become effective or the appropriations do not become available, the Navy and Litton shall be released from the under-

> standings set forth herein, and neither the Navy nor Litton shall be deemed to have waived or be in any manner prejudiced with respect to any rights existing prior to the negotiations conducted by the parties which led to the execution of this Aide Memoire."

This Agreement and the Memorandum of Decision of the Secretary of the Navy invoking Public Law 85-804 to reform the two contracts with Litton was transmitted to Congress on 23 June 1978 for the purpose of complying with the notification requirements of 50 USC 1431. The Secretary's Memorandum of Decision stated: "The dollars involved in this controversy have reached dramatic levels: the present combined estimated allowable costs of these contracts are $4.726 billion; the present anticipated losses, in the absence of any claims adjustment, are $647 million; the major claim, presently quantified at $1.088 billion, is not merely unparalleled in Navy procurement history but is the largest ever asserted on any Government contract."

The Memorandum further states: "These delays and cost increases have engendered controversy, charge and countercharge, almost since the inception of the contracts. Five years of legal proceedings, both administrative and judicial, have conscripted enormous resources and produced immense waste, but little else. The multiplicity of legal actions arising out of these contracts has been dramatic: Five Armed Services Board of Contract Appeals (ASBCA) proceedings; a Navy Contract Adjustment Board proceeding; two cases in the Court of Claims; Four cases in Federal District Court; and two appeals to the Fifth Circuit. Absent a negotiated resolution of the disputes, seven to ten years of further litigative entanglement are a certainty." In the Detailed Analysis which accompanied the Memorandum of Decision, the Secretary stated: "Public Law 85-804 permits adjustments appropriately responsive to the problems experienced on these programs. This law, enacted in 1958, grants the President, and through delegation, the Secretary of the Navy, the power, among other things, to enter into amendments or modifications of contracts without regard to other provisions of the law 'whenever he deems that such action would facilitate the national defense'". His statement goes on to say: "On 20 June 1978 the Navy and Litton reached agreement on the basic principles of an acceptable resolution of their nine-year controversy. The principal points of the Agreement...are:

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Milton J. Socolar, Esquire
April 2, 1981
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"1. Analysis of the $1.088 billion claim by NAVSEA Claims Team yielded a recommended figure of $312 million. After adjustment of $47 million in prior payments, the net amount of $265 million will be paid to Litton in accordance with the contract modifications to be executed."

"2. Of the $382 million remaining loss, Litton will absorb $200 million on the LHA contract. Navy will pay the remaining $182 million under Public Law 85-804."

* * *

"7. The agreement is subject to appropriate Congressional review and the availability of appropriations."

It is important to note that paragraph 10 of the Aide Memoire, incorporated by reference in the letter submitted by the Secretary of Navy to the Chairmen of the Senate and House Armed Services Committee, contained the following statement:

"10. To contribute to the orderly management of the contracts, Litton and the Navy will take all steps necessary promptly to process and negotiate on a fully-priced basis contract change proposals since 1 May 1978, as well as subsequent to the date of this document. Only those change orders authorized by the Navy prior to 1 May 1978 are included in the total allowable costs set forth in paragraph 3." (Emphasis supplied.)

The Settlement Agreement figures can be summarized as follows:

$647 million	- loss at time of negotiations
-$265 million	- paid by Navy from other than Public Law 85-804 funds
$382 million	- remaining
-$200 million	- absorbed by Litton[1]
$182 million	- Navy paid under Public Law 85-804 and which Congress restricted under Section 821.

1. As the Settlement agreement states, this figure does not include $62 million of Manufacturing Process Development costs which Litton agreed to release as a part of the Settlement.

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Cost underruns to be shared between the Navy and Litton on 20/80 basis, respectively.

Cost overruns to be shared 50/50 up to a total of $100 million, with costs above that amount being the sole responsibility of Litton.

The Navy assumes no obligations for escalation during the remaining terms of the contracts."

It should be recognized that use of P. L. 85-804 for settling these claims was the method preferred and urged by the Navy. It represented a settlement by mutual agreement of claims amounting to $1.088 billion dollars by payments to Litton by the Government totalling $494 million ($312 million from other funds and $182 million of P. L. 85-804 funds). Litton agreed to absorb its claims for profit on the extra work, its interest costs, and an anticipated loss of $200 million dollars, a total of $594 million. P. L. 85-804 authority was not used solely to make the contractor whole or to "bail out" Litton.

In addition to the financial settlement, the Settlement provided for extensive modifications in the LHA and DD963 contract language in order to eliminate the Total Package Procurement concept and to adjust the related contract provisions accordingly. Revised compensation and payment provisions were included in both contracts in order to accommodate the "combined incentive loss" concept. The formal modifications to the LHA and DD963 Contracts implementing the Settlement were forwarded to Congress in July 1978.

In order to arrive at a firm scope of work for purposes of the Settlement, all change orders issued by the Navy through April 30, 1978, were incorporated in the scope of the work covered by the Settlement and included in Settlement pricing. Also, all other items of work under other provisions of the Contracts (such as the warranty provisions) known as of April 30, 1978, were included in the scope. Therefore, the Settlement resolved all disputes over work scope, and the price therefor, as of April 30, 1978. The Settlement agreement provided for release of all claims based on events prior to the date of the Settlement (20 June 1978), except for formal changes since 1 May 1975. Note that the Silencing Incentive and change orders issued after April 30, 1978 were not included in the Settlement Agreement.

POST SETTLEMENT ADDED WORK TO THE CONTRACTS

After the Settlement date, April 30, 1978, the Navy desired that extensive additional work be performed by the contractor

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on the LHA and DD963 ships. The majority of the added work including "RAV work" was authorized by the Navy to be performed after the ships had been delivered and accepted, under the contract.

Both the LHA and DD963 contracts contain the "Changes" clause from ASPR (now DAR) 7-103.2, Jan 1958. This clause states in part: "The Contracting Officer may at any time... make changes within the general scope of this contract, in any one or more of the following: (i) drawings, designs, or specifications, where the supplies to be furnished are to be specifically manufactured for the Government in accordance therewith; (ii) method of shipment or packing; and (iii) place of Delivery."

On the DD963, the Navy has generally not made unilateral changes under the changes clause for added work within the scope of the contract. Rather, it has chosen in most instances to establish a maximum increase in price or a minimum decrease in price, as appropriate, for each change prior to authorization. These types of pricing for changes could not be unilaterally imposed on the contractor under the "Changes" article. A bilateral modification is required to reflect the agreement of the parties to this maximum increase or minimum decrease in price and at the same time authorize the performance of the added work. When the final increase or decrease in price is agreed upon, another bilateral modification is required to document this pricing agreement.

ADDITION OF RAV WORK TO THE BASIC CONTRACT

The RAV work on the DD963 ships was generally an upgrading of the weapons system on the ships and was originally scheduled by the Navy to be performed in Naval shipyards after the delivery of the ships and following the Post Shakedown Availability (PSA) work at Ingalls' shipyard.

RAV addition was unprecedented and never within the contemplation of the parties at the time of the original contract. RAV work is normally done in Naval shipyards. When performed by private ship repair yards, it is not normally done under the construction contract for the ships, but rather under separate contracts. The RAV work on the first 17 DD963 class ships delivered by Litton was performed in Naval shipyards.

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The Navy issued a request for an Engineering Change Proposal (ECP) to Litton for performing a scope of work which included the RAV work, and certain additional changes requested by the Type Commander, concurrent with the existing PSA work. The work was funded from three sources: the PSA work was funded under the basic contract funds, the added RAV work was funded from RAV funds and the added Type Commander changes were funded from the Type Commander's funds.

Before the ECP request was issued by the Navy, consideration was given to the question of the performance of the RAV work and the Type Commander changes under a separate contract. Both parties agreed that by doing the RAV work under the basic contract the best interests of the Government would be served and the contract administration work attendant to the RAV work would be simplified.

The RAV work was authorized in a bilateral modification to the contract dated May 18, 1978, preliminarily priced on a "not to exceed" basis. The final price agreement was incorporated in a modification dated March 22, 1979, and covered the last 13 ships constructed under the contract.

As of October, 1980, Ingalls' Financial Plan 81-3 contained a total of $123.5 million of authorized post-settlement additional work added to the LHA and DD963 contracts. (A portion of this was carried at discounted values since final prices had not yet been negotiated). Of this amount, $90.5 million was added work which was beyond the scope of the contract and could not have been unilaterally authorized under the "Changes" clauses of the contracts. This required bilateral modifications to the contracts. The estimated profit on this work is about $10 million. The balance of the post-settlement work was also authorized under bilateral modifications for the purpose of establishing pricing. The estimated profit on this work is an additional $4+ million.

Attachment B lists the post-settlement work added to the LHA and DD963 contracts as of October 1980.

DEVELOPMENT OF KEY LANGUAGE ON SECTION 821

When Section 821 of P. L. 95-485 was initially introduced in the Senate on September 26, 1978, an omission in the language

was discovered by Litton and the Navy. The original Senate version did not reflect that the settlement being funded involved a combined compensation computation based on the combined total cost results of the LHA and DD963 contracts. (See Articles IV and XXVIII of the LHA settlement modification and Articles IV and XXI of the DD963 settlement modification, Attachment C.) The language as initially proposed only dealt with the LHA portion of the Settlement.

On September 26, 1978, the Senate version of the bill was modified in Section (a) to insert DD963 vessels into the funding language and to change the audit language to read that "the prime contractor concerned does not realize any total overall profit on such contracts." The LHA and DD963 settlement modifications provided that there would be established a $200 million target loss with an incentive formula to be measured against the combined total final negotiated costs in order to compute the "combined final profit or loss" on the contracts. The combined total final negotiated costs were the total contract costs allowable under DAR, and exclusive of cost of added work authorized after April 30, 1978, and exclusive of the $200 million combined total target loss absorbed by Litton.

The amendment, as modified, passed the Senate on September 26, 1978. No change had been made in paragraph (b) where the language still read "to the extent that the use of such funds would result in any profit on such contract."

Meanwhile, Representatives of the House consulted with members of the Navy. Representative Melvin Price, Chairman of the House Armed Services Committee, offered an amendment to the House Bill being considered on October 4 which differed from the Senate version in two respects. The Price Amendment (1) identified the contracts by official designation and (2) used "total combined profit on such contracts" concept.

In discussing this Bill on the floor, the Congressional Record--House, p. H-11491 reflects that Representative Dodd stated that the Bill "provides that the contractors could not receive any combined total profits on the contracts on which the settlements were made." Representative Price in offering the amendment for consideration stated..."that they do not result in the prime contractors realizing any total combined profit

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on such contracts." Representative Price further stated "I have reviewed this modified language of the amendment with the Navy and am informed that it is acceptable to the Navy. I believe this amendment as modified will still be acceptable to the Senate."

The House passed its version of the amendment on October 4, 1978, See Congressional Record-House, p. H-11495. On October 7, the Senate concurred in the House amendment and it was the House version and not the Senate version that was enacted as Section 821.

As enacted, Section 821 of Public Law 95-485 reads as follows:

AUDIT AND REVIEW OF CERTAIN FUNDS

"Sec. 821. (a) Any funds authorized by this or any other Act to provide relief to contractors under authority of the first section of the Act entitled "An Act to authorize the making, amendment, and modification of contracts to facilitate the national defense", approved August 28, 1958 (72 Stat. 972; 50 U.S.C. 1431), in connection with contracts numbered N00024-69-C-0283, N00024-70-C-0275, N00024-71-C-0268, and N00024-74-C-0206 for the procurement for the United States of landing helicopter assault vessels (LHA), DD-963 vessels, and SSN 688 nuclear attack submarines, and paid by the United States to such contractors, shall be subject to such audits and reviews by the Comptroller General of the United States as the Comptroller General shall determine necessary to insure that such funds are used only in connection with such contracts and to insure that the prime contractors concerned do not realize any total combined profit on such contracts.

"(b) No funds described in subsection (a) may be used to provide relief to any contractor described in subsection (a), in connection with contracts described in such subsection, to the extent that the use of such funds would result in any total combined profit on such contracts, as determined by the Comptroller General of the United States.

"(c) The Comptroller General of the United States shall keep the appropriate committees of the Congress currently informed regarding the expenditure of funds referred to in subsection (a) and shall submit to the Congress annually, until the completion of the contracts referred to in subsection (a), a written report on the status of the contracts referred to in subsection (a), on the expenditure of the funds referred to in such subsection, and on the results of the audits and reviews conducted by the Comptroller General under authority of this section."

STATUTORY CONSTRUCTION

The applicable principles of statutory construction which will be discussed are:

1. Every word used in a statute must be given effect.

2. Remedial statutes are to be read so as not to defeat the purposes of the remedy sought.

3. Any limitations on remedial statutes are to be construed narrowly.

4. There is no need to consider legislative history when a statute on its face is clear and unambiguous.

It is well recognized that statutes are to be interpreted as a whole, giving effect to every word used by the Congress so as not to render any portions inoperative, Reiter v. Sonotore Corp., 442 U.S. 330 (1979); Colautti v. Franklin, 439 U.S. 379, 1979; Allen Oil Co., Inc. v. C.I.R., 614 F.2d 336 (2d Cir 1980) and so as not to consider any language as "mere surplusage." National Federation of Federal Employees, Local 1622 v. Brown, 481 F. Supp. 704 (D.D.C. 1979).

It is a general rule of law that statutes which are remedial in nature are entitled to a liberal construction, Socony-Vacuum Oil Co. v. Smith, 305 U.S. 424, Grand Trunk R. Co. v. Richardson, 91 U.S. 454; in favor of the remedy provided by law, Middleton v. Finney, 6 P 2d 938, Miller v. Shreveport, 90 So 2d 565, Blankholm v. Fearing, 22 NW 2d 853; or in favor of those

entitled to the benefits of the statute, Miller v. Shreveport, 90 So 2d 565, Mobley v. Brown, 2 P2d 1034.

Limitations to remedial statutes are to be construed narrowly. Port of New York Authority v. Baker, Watts & Co., 392 F. 2d 497 (D.C. Cir. 1968); Brennax v. Valley Towing Co., Inc., 515 F. 2d 100, 110 (9th Cir. 1979); In re Carlson, 292 F. Supp. 778 (D.C. Cal. 1968). In this connection, it has been said:

> "In construing a remedial statute, it is felt that limitations which would take a right from one for whom the statute was passed must be express and not subject to varying interpretations." Pullen v. Otis Elevator Co., 202 F. Supp. 715, 717 (N.D. Ga. 1968).

In the present case, we are dealing with relief provided under a remedial statute, Public Law 85-804, and the limitations imposed on such relief by the language of Section 821 of Public Law 95-845, quoted above. In accordance with the principles of statutory construction, the limitation language of Section 821 must be construed narrowly so as not to defeat the purpose of Public Law 85-804.

We believe the only possible construction of Section 821 is that the restriction is on those funds appropriated to provide relief (Public Law 85-804) in connection with the Settlement. The relief that was being considered was the Settlement entered into between the Navy and Litton. The restriction applies to the relief funds provided by the Congress ($182 million) and the relief funds were only to be used for the Settlement. That restriction on P. L. 85-804 relief funds does not in any way restrict the expenditure of procurement funds for any non-P.L. 85-804 purpose and made available to finance added work under changes and modifications subsequent to the Settlement date, April 30, 1978. Contrary to the required narrow interpretation of the limitations in Section 821, the Draft Report appears to interpret the 821 restriction broadly so as to apply to work covered by changes and modifications not covered by the Settlement and funds not provided by Public Law 95-845 for 85-804 relief.

Section 821 is not ambiguous.

With regard to the appropriateness of referring to legislative history in interpreting statutory language, the Comptroller

General has himself observed:

> "It is a well-established rule of statutory construction that it is not permissible to refer to committee reports, etc., preceding the enactment of a statute in order to ascertain its meaning except where an ambiguity or uncertainty exists as to the meaning of the words used. 11 Comp. Gen. 380; 14 ed. 638; 15 ed. 582." 21. Comp. Gen. 17. See also LTV Aerospace Corporation, Comp. Gen. Dec. B-183851, 75-2 CPD, para. 203.

This statement of legal principle is in complete accord with similar statements contained in decisions of the U. S. Supreme Court and of many of the Federal Circuit and District Courts to the effect that reference to legislative history is unnecessary, unwarranted, and inappropriate where statutory language is clear and unambiguous and where such legislation conflicts with the plain meaning of the statute. Aaron v. Securities and Exchange Commission, 446 U.S. 680, 100 SCt. 1945 (1980); U.S. v. Oregon, 366 U.S. 643, rehearing denied, 368 U.S. 870 (1961); U.S. v. Richards, 583 F. 2d 491 (10th Cir. 1978); NRDC, Inc. v. EPA, 507 F. 2d 905 (9th Cir. 1974); Doski v. M. Goldseker, 539 F. 2d 1326 (4th Cir. 1976); Texaco, Inc. v. Department of Energy, 460 F. Supp. 339 (D.D.C. 1978), appeal dismissed, 616 F. 2d 1193 (Emerg. Cir. 1979); E. C. Ernst, Inc. v. Potlach Corp., 462 F. Supp. 694 (S.D. N.Y. 1978). It has been said in this regard that legislative history should be resorted to only when a statute is "inescapably ambiguous," Highland Supply Corp. v. Reynolds Metals Co., 327 F. 2d 725 (8th Cir. 1964).

Applying the traditional rules of statutory interpretation, Section 821 cannot be said to be "inescapably ambiguous." The language is sufficiently clear that the only limitation intended was that the $182 million in relief funds could not be used to provide relief to the contractor to the extent that those funds would result in the realization of "total combined profit" on the two contracts as covered by the Settlement.

DEFINITION OF TOTAL COMBINED PROFIT

The Incentive Price Revision (Firm Target) articles of the Settlement Modifications to the LHA and DD963 contracts dated

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20 July 1978 established the method of determining the "combined total final price" for the two contracts. The "combined total final price" is made up of two elements: "the adjusted combined total final negotiated costs" and the "combined final profit or loss." Article IV Compensation Under Contracts N00024-69-C-0283 and N00024-70-C-0275 of both Settlement Modifications provides that the "total compensation" to be paid to the Contractor shall consist of the sum of:

1. the "combined total final price"

2. the escalation payments

3. performance incentive-ship silencing

4. the price of changes and modifications to the contracts with an effective date on or after 1 May 1978.

Congressman Price offered an amendment which contained the modified language "total combined profit" on October 4, 1978. It was this modified language to which Congressman Price was referring when he stated, "I have reviewed this modified language with the Navy and am informed that it is acceptable to the Navy. I believe that this amendment, as modified, will be acceptable to the Senate." Congressional Record--House, p. 11495, October 4, 1978. Congressman Price's amendment was adopted by both Houses and became Section 821.

"Combined total final price" and "combined final profit" as used in the modifications and "total combined profit: as used in Section 821 are terms of art. The term "total combined profit," was utilized in Section 821 rather than the terminology used in the initial Senate version, "total overall profit" or "overall profit," thus making Section 821 consistent with the Settlement Agreement and the understanding of the parties and acceptable to the Navy. If there is confusion over the definition of "total combined profit" in Section 821, the term should be interpreted within the context of the Settlement Modifications.

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CONTRACTS AND CONTRACT SCOPE AS OF APRIL 30, 1978, COVERED BY SECTION 821

The two contracts referred to in Section 821 are equally well defined by contract number for which relief was being provided in accordance with the settlement. The work scope of those contracts were clearly set forth in settlement as including only those change orders authorized prior to 1 May 1978. The Aide Memoire, the statements by the Navy to Congress, and the Settlement Modifications approved by Congress all clearly reflect that this was all the Settlement covered and, thus the only matter to which the relief funds could apply. Reading the language in this manner so as to allow the contractor to recover profit on subsequently executed contract modifications which are separately funded and which, in many instances, were completely beyond the scope of the original contracts (see further discussion of "Cardinal" changes below) would not in any way work "an absurd or unreasonable result." Compare 46 Comp. Gen. 556 (1966); United States v. American Trucking Association, 310 U.S. 534 (1940). See also LTV Aerospace Corporation, supra. Accordingly, resort to the legislative history here would be both unnecessary and unwarranted.

LEGISLATIVE INTENT

Even if an examination of the legislative history were required, it does not provide persuasive evidence that the Congress intended the interpretation of Section 821 that the Draft Report uses. Boston Sand and Gravel Company v. United States, 278 U.S. 41, 48 (1928). With respect to the value of statements made in floor debate, it has been noted that:

> "in the course of oral argument on the Senate floor, the choice of words by a Senator is not always accurate or exact." In re Carlson, supra at 783.

See Vol. 2A Sutherland Statutory Construction (4th Edition, Sands, 1973) Sec. 48.13, p. 216.

It is clear that the parties in both the House and Senate with regard to Section 821 did not speak to precluding recovery of profit on future changes subsequent to the Settlement.

In this case, the comments of Senators Proxmire and Stennis show quite clearly that the Senate did not intend by the

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wording of the proposed amendment to the appropriations bill that Litton be precluded from recovery of profit on future changes and that Senator Proxmire's concern was that Litton and General Dynamics had overstated their estimates of "fixed loss" on the contracts as they existed prior to the enactment of the Statute:

> "The large losses that have been cited by the Navy are hypothetical losses because many of the ships are still under construction and the contracts will not be completed for many months. It is at least theoretically possible for the contractor to end up with large profits rather than losses, with the aid of the financial relief that the Navy has provided.
>
> If the contractor overstated his costs to complete the work on the ships, it might be possible for him to underrun the costs and come in with a profit.
>
> Let me give you an example for simplicity purposes: Supposing that a claim was for $400 million. The claim of loss was $400 million. The Federal Government then pays out $200 million. Say the loss turns out to be $100 million. In that event, the contractor would be profiting to the extent of $100 million, unless we provide this in the bill here which would eliminate that kind of profit."
>
> * * *
>
> "All I am appealing for, in what I think is a housekeeping amendment, is to make sure that... they should not be able to make a profit out of this particular payment, which was a financial relief payment designed to ease the big losses that otherwise the corporations would suffer,that they will not be able to convert these payments into profits on these particular contracts."

Senator Stennis followed by stating:

> "I repeat, Mr. President, just this: that future change orders should be allowed to include a

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small profit for that specific work. The amendment may prohibit that even though it would not result in an overall profit."

Senator Proxmire replied:

"May I say it would not result in no profit on future change orders. All I say by this amendment is that they shall not have an overall profit on something they said would result in a big loss.

In all the testimony given to us, and I think in all the testimony given to the Armed Services Committee, at no point did the Navy indicate that these companies would achieve a profit, but I want to button it down and make sure they do not in these cases. I cannot imagine a less desirable situation than that they would make a profit on this $541 million relief payment, the only justification for which is that otherwise they would suffer even larger losses which they should not be required to bear."

Senator Stennis replied:

"Mr. President, this is repetition, but as I see it, the only way to cover that is to have it written out clearly, that they would not be precluded from a profit on any future change orders. Not from any past settlement, but in the future. Until that is accomplished, we just have to move to table the amendment, when the Senator finishes."

Senator Proxmire replied:

"Yes, in offering the amendment, I want to make it clear it is not the intention to prevent profits on future change orders. I want to make clear that on these contracts, overall, we will not have General Dynamics and Litton coming in with a profit on the overall situation on which we have paid them $541 million." Cong. Rec. Sept 26, 1978, pp.S16110 and 16111. (Emphasis supplied)

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It is obvious that in making the foregoing statements the Senators had in mind those materials presented by the Navy which showed estimated costs to complete "the work" on the ships, i.e., the costs for those portions of work remaining under the contracts as they then existed, and the validity of projected losses based on those costs. The "something they (Navy and the contractors) said would result in a big loss" was the remaining work under the existing contracts.

During the consideration of the version sponsored by Congressman Price, Chairman of the House Armed Services Committee, floor manager of the bill, he stated:

> "An amendment to provide this authorization was approved on the Senate floor. I believe the basic purpose of having these funds audited by the General Accounting Office has merit. However, the wording of the Senate amendment allows for some uncertain interpretation. I have had some modifications made to assure that the amendment only applies to those shipbuilders involved in the claims settlement for which the additional $200 million is provided in the bill, and to assure that it applies only to specific contracts covered by the claims settlement." (Emphasis supplied.)

He continued by saying:

> "I have reviewed this modified language of the amendment with the Navy and am informed that it is acceptable to the Navy. I believe that this amendment, as modified, will still be acceptable to the Senate." (Emphasis supplied.)

Cong. Record-House. October 4, 1978, p. H11495.

Of the utmost importance is the fact that the Senate language discussed was not adopted by Congress. The House and Senate adopted the House version of 821 which contained more precise language.

The House legislative history and the language of the Settlement agreements themselves, which had been approved by

Congress must be considered. The provisions of the Settlement agreement between Litton and the Navy, which are discussed in more detail elsewhere herein, specifically exclude from the Settlement all contract modifications entered into on or after May 1, 1978, and such other items as the silencing incentive. These provisions were not only well known to the Members of Congress, but it was the funding of that Settlement agreement that prompted the legislation here in question. Accordingly, it must be concluded that Congress, in approving the necessary funds for those agreements, intended that their terms be carried out and that, in the case of Litton, the contractor's rights to recover profits on future changes and contract incentives be left intact. We believe when taken with the legislative history they are determinative of the question.

DISCUSSION

One collateral issue which must be disposed of is the question of whether the Congress somehow modified the terms of the Settlement. The Settlement agreement was submitted to the Congress in accordance with Public Law 85-804, which provides "the authority conferred by this Section may not be utilized to obligate the United States in any amount in excess of $25 million unless the Committees on Armed Services of the Senate and the House of Representatives have been notified in writing of such proposed obligation and 60 days of continuous session of Congress have expired following the date on which such notice was transmitted to such Committees and neither house of Congress has adopted, within such 60-day period, a resolution disapproving such obligation." The action of the Congress cannot vary or change the provisions of a Public Law 85-804 agreement. It may approve, disapprove the agreement or may remain silent and by its silence during the 60-day "lying before the Congress" does not veto it. In this case the Congress addressed the Settlement agreement specifically. Appropriations were made available for Naval Ship construction under the Act and included in that appropriation were funds in the amount of $182 million to pay for the Settlement arrived at between the Navy and Litton. It was in this connection that the Congress acted to restrict how these funds ($182 million) were to be used in connection with the Settlement, but not to restrict the Settlement itself.

To construe Section 821 to potentially prohibit funding of future changes or the profit portion thereof is inconsistent with the Settlement agreement and the way it has been implemented by the Navy and Litton. In essence, this position is tantamount to stating that the Congress approved the Settlement, but in funding the Settlement disapproved the Navy Contracting Officer's authority to enter into a Settlement which provided for the Contracting Officer to enter into future changes without limitation as to effect on profit for all future changes or the total profit on the two contracts. This in effect would be amending the express terms of the Settlement. Such interpretation results in an inconsistent construction of the action by the Congress on the same subject matter.

CHANGES AND ADDED WORK

In order to preserve flexibility in its contracts, the Government includes a Changes Clause. "This clause gives the contracting agency the unilateral right to order changes during the course of the work and it promises the contractor an 'equitable adjustment' in exchange for this right." Nash and Cibinic, Federal Procurement Law, (2nd ed. 1969), p. 521.

As to changes which fundamentally alter the nature and scope of the work under the contract, it has been held that the Government may not unilaterally order such changes, and that forcing a contractor to undertake such "cardinal" changes constitutes a breach of contract. P. L. Saddler v. U. S., 152 Ct.Cl. 557, 287 F.2d 411 (1961); Air-A-Plane Corp. v. U. S., 187 Ct.Cl 269, 408 F.2d 1030 (1969); Embassy Moving & Storage v. U. S., 191 Ct.Cl. 537, 424 F.2d 602 (1970); Edward R. Marden Corp. v U. S., 194 Ct.Cl. 799, 442 F.2d 364 (1971); Peter Kiewit & Sons Co. v. Summit Const. Co., et al, 422 F.2d 242 (8th Cir. 1970). See also Palmer, "Changes," 47 Geo. Wash. L. Rev. 1148.

The Comptroller General has himself recognized this basic principle of procurement law. In Comp. Gen. Dec. B-174725 (Nov. 7, 1972), 15 G.C. para. 27, for example, he found that a contractor altered its legal position by executing what he considered to be a "cardinal" change. That change called for the diversion of certain aircraft being furnished

to the Army in order to satisfy the needs of the Canadian Government. The contractor's agreement to the change, the Comp. Gen. found, was based on an understanding that the Government would negotiate a separate sole source contract with the contractor for the same number of planes being diverted and that the Government would pay for the diverted planes at the same unit prices established by negotiation for the additional planes under the sole source contract. The contractor's competitor, who had lodged the protest against the Government's negotiation of the sole source contract, contended that the change in question could have been issued unilaterally and that, accordingly, the contractor's legal position was not altered by his executing the modification. Rejecting this argument, the Comptroller General specifically held that the contractor's acceptance and execution of the modification which in effect waived the Government's breach of contract constituted adequate "consideration" to support the terms of the additional understanding. Thus, the Comptroller General acknowledges that an out-of-scope change not only requires the contractor's consent, but that such consent constitutes new consideration not found in the initial contract.

In the instant matter, the changes were not issued on a unilateral basis--but were agreed to by the parties. In addition, the retrofittings (RAV) work that was required by the Navy had always in the past been the subject of separate contracts. Normally, RAV is not part of a shipbuilding contract. All agreed that such work was clearly outside the nature and scope of the existing contracts. If the Contracting Officer had attempted to order such changes unilaterally, it would have been a "cardinal" change constituting a breach of contract.

Consequently, the Navy and Ingalls entered into an agreement signed by both parties stating that Litton would perform the RAV--technically under the contract. In keeping with the understanding of the parties, profit on the changes entered into after the Settlement was not subject to the Section 821 restrictions. Both parties recognized that these actions were after the Settlement and both parties had agreed that post-Settlement changes would not be included and not made part of the computations.

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If one ignores the "relief" language in Section 821 and says that no profit on the changes and RAV can be made if a combined profit on LHA and DD963 results, where does that lead? It does not comport with the intent of the parties; it does not comport with the conduct of the parties nor with the agreement of the parties. If it were otherwise, then there should have been an agreement that limited the pricing and profit.

At the very least, profit on the out-of-scope or so-called "cardinal" changes such as the retrofittings (RAV) which normally would have been the subject of separate contracts and which have been separately funded must be regarded as being outside the contemplation of the statute since clearly, there had been no understanding between the parties as to those changes prior to the enactment of P. L. 95-485.

The position in the Draft Report at this stage appears to be that regardless of the number, dollar value or character of changes entered into subsequent to the Settlement and the enactment of P. L. 95-485, Litton may not, under any circumstances, realize a combined profit on the contracts even as changed subsequent to the Settlement. If this is correct, then there is a mutual mistake by the Navy and Litton. The parties understood something totally different when they entered into the agreement for the work to be performed subsequent to the Settlement. Much work still had to be performed on the contracts at the time of the Settlement. It was that work that was dealt with in the Section 821 restriction. If any profit resulted from that work, including any changes involved prior to May 1, 1978, then that profit was wiped out under Section 821. If the claims were inflated, it would show up at that point.

As we have indicated in this brief, we believe the Draft Report's interpretation of Section 821 as applicable to any and all work under the two contracts leads to illogical results if carried to the ultimate extent.

By imposing a restriction on the ability of the Contracting Officer to make an equitable adjustment, the interpretation could nullify the authority to make any unilateral changes under the contract.

It is clear that Litton would have been entitled by the terms of its contracts to recover profit as part of an equitable

adjustment for any such changes pursuant to the terms of the standard "Changes" article of its contracts. U.S. v. Callahan Walker Const. Co., 317 U. S. 56, 61 (1942).

The Draft Report's current interpretation of Section 821--that Litton would not be entitled to make an overall profit on its contracts even if that profit is attributable to work under subsequent, separately-funded change orders--not only flies in the face of basic Government procurement law, with regard to the concept of "equitable adjustment," but renders critical statutory language inoperative. Instead of reading the restrictive language of Section 821 narrowly in accordance with the "traditional statutory interpretation principles" which the Comptroller General has consistently followed (see LTV Aerospace Corporation, supra at p. 13) the Draft Report has given the restrictive statutory language here a very broad interpretation, one which would defeat the very purpose of Public Law 85-804 which is to restore the commercial viability of private enterprises which are deemed "essential to the national defense." By imposing the prohibition against profit, the interpretation would nullify the authority of the Contracting Officer to enter into bilateral modifications purporting to include profits if an overall profit would be realized. Thus, such modifications, including some in existence, may be void or voidable. Included are questions as to whether the Contracting Officer violated the Anti-Deficiency Act, 31 USC 665, and whether the rule against the augmentation of appropriations also has been violated.

The general rule against the acceptance of voluntary services was first formulated in 1905. Rev. Stat. § 3679, 31 USC 665(b). It states that "No officer or employee of the United States shall accept voluntary service for the United States...." This statute has been reinforced by many decisions of the GAO. We then face the contractor's quandary: Should it stop work or should it proceed on the basis that such work performance would be paid under the legal concept of quantum meruit or quantum valebant? The Draft Report does not address these questions.

Finally, such an interpretation is clearly contrary to the intent and actions of the Navy and the contractor in adding extra work to the scope of the contracts.

Litton had some discussion among its staff concerning the fact that the RAV work was beyond the scope of the contract and could not be added to the contract unilaterally by the Contracting Officer under the Changes clause of the prime contract. However, it was recognized that the parties could amend the contract bilaterally and add the scope of work to the contract without encountering legal problems. It is understood that the Navy likewise considered that the RAV work was beyond the scope of the basic contract and that the Navy Legal Counsel reached the same conclusion concerning the efficacy of utilizing a bilateral modification. Neither party discussed this point with the other. The decision to utilize the basic contract was essentially made based on the fact that both parties agreed it was the most cost efficient, took least time and was easiest in administration compared to the alternative of utilizing one or more separate contracts.

SETTLEMENT EXCLUSIONS

The Draft Report's interpretation also would after the fact unilaterally modify the Settlement agreement as entered into by the Navy and Litton. The Settlement agreement specifically excluded from its terms the incentive performance fee for silencing. The Draft Report would make this incentive fee subject to the same limitation imposed on the Settlement as though it were part thereof.

CALCULATION OF PROFIT UNDER SECTION 821

It is Litton's position that Section 821 profit calculations should be based on generally accepted accounting principles utilizing the cost and profit/loss calculations approved by the IRS for income tax purposes to compute the combined profit/loss situation on the LHA and DD963 contracts as covered by the Settlement Agreement. Also, we believe that in utilizing DAR XV allowable costs, the Draft Report has adopted an inconsistent accounting approach to the calculation of "total combined profit" as set forth in Section 821. The Draft Report first calculated the "adjusted combined total final negotiated costs" and then derived the "combined final profit," in accordance with the Incentive Price Revision (Firm Target) articles of the Settlement Modification of the two contracts. The Draft Report then added the changes profit and modifications profit and the silencing incentive fee to the "combined final profit" under the Settlement to arrive at the "total combined profit" under Section 821. This is inconsistent. As previously stated under the discussion entitled "Definition of Total Combined Profit," we contend that the words in Section 821, "total combined profit," are synonomous with the words in the Incentive Price Revision

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(Firm Target) articles of the Settlement Modifications, "Combined final profit or loss." If there is to be a departure from calculation of combined total final profit under the Incentive Price Revision (Firm Target) by adding all other revenue to be received under the compensation Articles of the Settlement Modifications, then it must be a complete and consistent departure to a "total cost vs. total revenue" approach by measuring total costs, including the DAR Section XV unallowable costs and the MPD unbillable costs, against total revenues under the two contracts. While we do not agree with utilization of DAR Section XV, in doing so GAO must either follow the Settlement Modifications, which are consistent with DAR Section XV, or a total cost/total revenue basis.

Attachment D contains tables showing Litton's position on the proper calculation of Section 821 profit, compared to the method utilized in the Draft Report, the Settlement Modification and the total cost/total revenue method.

CONCLUSION AND RECOMMENDATIONS

We believe that the above discussion clearly shows that:

A. The limitation on the use of funds set forth in Section 821 applies

   1. to funds under the relief act (Public Law 85-804) only;

   2. to restrict profits on the two contracts as they existed at the date of the Settlement; and

   3. to the work covered by the Settlement only even though performed after the date of Settlement.

B. The limitation on the use of funds set forth in Section 821 does not apply

   1. to changes and modifications made to the contracts after the date of the Settlement;

   2. to work added after the date of the Settlement and not contemplated in the Settlement;

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3. to payments to the contractor from other funds available or on other legal bases; and

4. to the payment for any items, such as performance incentives, specifically excluded from the Settlement and the relief granted.

C. The calculation of profit on the LHA and DD963 contracts under Section 821 should be on the basis of generally accepted accounting principles acceptable to the IRS rather than in accordance with DAR, Section XV.

If GAO agrees with our interpretation of Section 821, the Draft Report should be appropriately modified. If, on the other hand, GAO disagrees with our interpretation, then it is imperative for GAO to promptly advise the Navy how to resolve these problems of the Contracting Officer's authority and full payment to the contractor. If the additional work including the silencing work and the RAV that was authorized and agreed to by the parties is determined to be invalidly based, then a mutual mistake exists, and payment for the work should be made on a quantum meruit or quantum valebant basis.

Respectfully submitted on behalf of Ingalls Shipbuilding Division, Litton Systems, Inc.

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APPENDIX IV

UNITED STATES GOVERNMENT

Memorandum

GENERAL ACCOUNTING OFFICE

October 2, 1981

TO : Acting Comptroller General

Harry R. Van Cleve

FROM : Acting General Counsel - Harry R. Van Cleve

SUBJECT: Proposed Attachment to PLRD Report Entitled "Two Navy Ship Contracts Modified Under Authority of Public Law 85-804--Status As of Fiscal Year Ending August 3, 1980" (File B-201825)

Attached is an analysis of Litton's legal objections to PLRD's draft report on the status of the LHA and DD-963 ship contracts settled under authority of Public Law 85-804. We plan to use this analysis as an attachment to the final report.

Litton's legal objections center around the draft report's approach to determining the "total combined profit on such contracts" for purposes of section 821 of the Department of Defense Appropriation Authorization Act, 1979, Pub. L. No. 95-485.

After thoroughly reviewing each of Litton's objections, and after having considered carefully the related views of the Department of the Navy, we have concluded that the definition and application of the term "total combined profit on such contracts" in the draft report represent proper interpretations of the Act.

Attachment

APPENDIX IV

GAO ANALYSIS OF LITTON'S LEGAL OBJECTIONS TO THE GAO DRAFT REPORT

In a memorandum dated April 2, 1981, attorneys representing Litton raised several legal objections to the GAO draft report. Litton disagrees with the draft report's interpretations of section 821 of the Department of Defense Appropriation Authorization Act, 1979, Pub. L. No. 95-485, particularly the language in section 821(b) which states that funds may not be used to provide relief to Litton in connection with the LHA and DD-963 contracts "to the extent that the use of such funds would result in any total combined profit on such contracts, as determined by the Comptroller General of the United States." For ready reference, the full text of section 821 is set out below. 1/

1/ Section 821 of the Department of Defense Appropriation Authorization Act, 1979, Pub. L. No. 95-485 (October 20, 1978), 92 Stat. 1611, 1628, provides:

> "Section 821. (a) Any funds authorized by this or any other Act to provide relief to contractors under authority of the first section of the Act entitled 'An Act to authorize the making, amendment, and modification of contracts to facilitate the national defense,' approved August 28, 1958 (72 Stat. 972; 50 U.S.C. 1431), in connection with contracts numbered N00024-69-C-0283, N00024-70-C-0275, N00024-71 C-0268, and N00024-74-C-0206 for the procurement for the United States of landing helicopter assault vessels (LHA), DD-963 vessels, and SSN 688 nuclear attack submarines, and paid by the United States to such contractors, shall be subject to such audits and reviews by the Comptroller General of the United States as the Comptroller General shall determine necessary to insure that such funds are used only in connection with such contracts and to insure that the prime contractors concerned do not realize any total combined profit on such contracts.

The Litton memorandum (and subsequent comments submitted by Litton in response to the GAO draft report) 2/ raise four basic issues with respect to the draft report's approach to determining "total combined profit" for purposes of subsection 821(b).

Litton's first and most fundamental contention is that the determination of "total combined profit on such contracts" should not include profit earned on any change orders and other modifications to the contracts that were effected after April 30, 1978--the cutoff date of the settlement agreement under 50 U.S.C. §1431. Litton argues that the section 821 profit limitation applies only to contract work covered by the settlement agreement--not to the total work on the LHA and DD-963 contracts.

(Continuation)

1/ "(b) No funds described in subsection (a) may be used to provide relief to any contractor described in subsection (a), in connection with contracts described in such subsection, to the extent that the use of such funds would result in any total combined profit on such contracts, as determined by the Comptroller General of the United States.

"(c) The Comptroller General of the United States shall keep the appropriate committees of the Congress currently informed regarding the expenditure of funds referred to in subsection (a) and shall submit to the Congress, annually, until the completion of the contracts referred to in subsection (a), a written report on the status of the contracts referred to in subsection (a), on the expenditure of the funds referred to in such subsection, and on the results of the audits and reviews conducted by the Comptroller General under authority of this section."

2/ Litton's April 2 legal memorandum and a supplemental letter from Litton dated April 16, 1981, are included in full in Appendix __ to this report.

Second, Litton argues that even if section 821 does not exclude all post-settlement changes, certain modifications (e.g., the "RAV work") should still be excluded because they represent "cardinal" changes which are outside the scope of the original contracts.

Third, Litton questions the accounting method used in the draft report for measuring "total combined profit"--that is, total cash receipts pursuant to the contracts minus total costs allowable under the Defense Acquisition Regulation. Litton states that determination of profit or loss on the contracts should be based on generally accepted accounting principles approved by the Internal Revenue Service for income tax purposes, rather than the cost principles set forth in section XV of the Defense Acquisition Regulation.

Litton's fourth and final point is that GAO has applied its accounting method inconsistently by including in the section 821 profit/loss determination certain payments to Litton (e.g., the "Silencing Incentive") even though such payments had been excluded from the settlement agreement.

We have reviewed thoroughly each of Litton's legal objections to the draft report. Based on this review, we are satisfied that the conclusions in the draft report as to the definition and application of the term "total combined profit on such contracts" represent proper interpretations of section 821 of Public Law 95-485. Therefore, we will adhere to these conclusions in conducting our audits and making the profit/loss determinations required of us under section 821.

As to Litton's first point, our interpretation that section 821 includes post-settlement modifications to the LHA and DD-963 contracts is supported by both the statutory language and legislative history. The language "any total combined profit on such contracts" certainly seems to embrace the contracts as a whole, including any modifications. There is no hint in this language that the "profit" referred to is based only on that part of the contract work covered by the settlement. Our interpretation of the statutory language as embracing the contracts as a whole, including modifications, is confirmed directly by the legislative history on the Senate side and is not contradicted directly or by implication on the House side. Litton's arguments to the contrary rely upon various inferences to contradict both the statutory language and direct legislative history.

We also reject Litton's second argument that even if post-settlement contract changes within the scope of the original contract are subject to section 821, certain modifications should be excluded because they were beyond the scope of the contracts.

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These modifications are in fact part of the contracts covered by section 821, and we cannot rewrite the contracts in applying section 821.

As to the third point raised by Litton, the accounting method that we selected for making profit/loss determinations most nearly reflects the considerations Congress had in mind when it enacted section 821. While we recognize that other accounting methods could have been used, Litton presents no compelling legal or policy arguments to support another method.

Litton's fourth and final argument--that we applied our accounting method inconsistently--likewise misses the mark. Inclusion of all compensation items in profit/loss determinations is consistent with the reference to, and underlying concept of, "total combined profit" in section 821. Litton's argument for excluding certain items largely follows its first point--which we reject--that application of section 821 is limited to those aspects of the contracts covered specifically by the Litton-Navy settlement.

The remainder of this appendix addresses in greater detail each of the points summarized above.

Treatment of Profit On Changes And Modifications Entered Into After The Settlement

For purposes here relevant, subsection 821(b) of Pub. L. No. 95-485 states that funds to provide relief to any contractor described in subsection (a) in connection with the LHA and DD-963 contracts may not be so used to the extent that the result would be "any total combined profit on such contracts." 3/ Litton contends that the language of subsection 821(b) clearly and unambiguously means that "total combined profit" does not include profit on contract changes and other modifications entered into after the cutoff date of the settlement. Nor does it include, according to Litton, payments (such as the "Silencing Incentive") which were not part of the settlement. Rather, Litton maintains that section 821 applies only to those portions of the LHA and DD-963 contracts that were covered by the settlement agreement.

Litton's April 2 memorandum to us states in this regard, at page 5:

3/ Section 821 also covers relief payments to the Electric Boat Division of General Dynamics Corporation in connection with contracts for the procurement of SSN 688 nuclear attack submarines. These relief payments are subject to the same terms and conditions as the payments to Litton.

CONTRACTOR'S CASH RECEIPTS AND BOOKED COSTS

AUGUST 1980 THROUGH JULY 1982

	Contract								
	LHA			DD-963			Total (note a)		
Month ending	Receipts	Costs (note b)	Receipts over or under(-)	Receipts	Costs (note b)	Receipts over or under(-)	Receipts	Costs (note b)	Receipts over or under(-)
	(millions)								
August 1980	$1,293	$1,459	$-166	$3,270	$3,201	$ 69	$4,463	$4,660	$-97
September	1,293	1,459	-166	3,280	3,203	77	4,573	4,663	-89
October	1,293	1,460	-167	3,280	3,208	72	4,573	4,668	-94
November	1,293	1,460	-167	3,289	3,211	79	4,583	4,670	-88
December	1,293	1,460	-167	3,289	3,213	76	4,583	4,673	-90
January 1981	1,293	1,460	-167	3,301	3,217	84	4,594	4,677	-83
February	1,293	1,460	-167	3,301	3,220	81	4,594	4,680	-86
March	1,294	1,461	-167	3,301	3,222	79	4,595	4,682	-88
April	1,294	1,461	-167	3,306	3,225	81	4,600	4,686	-86
May	1,295	1,461	-166	3,323	3,226	97	4,618	4,687	-69
June	1,295	1,461	-166	3,325	3,227	97	4,620	4,689	-69
July	1,296	1,462	-166	3,325	3,229	96	4,621	4,691	-70
August	1,296	1,462	-166	3,325	3,229	96	4,621	4,691	-70
September	1,296	1,462	-166	3,325	3,229	97	4,621	4,690	-69
October	1,296	1,462	-166	3,325	3,229	96	4,621	4,691	-70
November	1,296	1,462	-166	3,325	3,231	94	4,621	4,693	-72
December	1,296	1,462	-166	3,325	3,231	94	4,621	4,693	-72
January 1982	1,296	1,460	-164	3,325	3,232	93	4,621	4,692	-71
February	1,296	1,460	-164	3,325	3,233	92	4,621	4,693	-72
March	1,296	1,460	-164	3,325	3,227	98	4,621	4,687	-66
April	1,296	1,460	-164	3,325	3,229	96	4,621	4,689	-68
May	1,296	1,460	-164	3,325	3,229	96	4,621	4,689	-68
June	1,296	1,460	-164	3,325	3,230	96	4,621	4,690	-68
July	1,296	c/1,437	-141	3,325	c/3,189	136	4,621	c/4,626	-5

a/Figures may not total due to rounding.

b/Includes CAS 414 costs—not booked in general ledger.

c/July 1982 costs have been adjusted to exclude $2 million unallowable legal fees on the LHA contract and a total of $62 million unbillable MPD costs on both contracts.

APPENDIX I

ESTIMATED COST AT COMPLETION

AUGUST 1, 1982

Cost category	Contract LHA Incurred	LHA Estimate to complete	LHA Estimate at completion	Contract DD-963 Incurred	DD-963 Estimate to complete	DD-963 Estimate at completion	Total (note a) Incurred	Total (note a) Estimate to complete	Total (note a) Estimate at completion
	(millions)								
Labor	$ 393.4	$ -	$ 393.4	$ 658.6	$ 0.3	$ 658.9	$1,052.0	$ 0.3	$1,052.3
Material	630.7	1.2	632.9	1899.7	1.4	1,891.1	2,520.4	2.5	2,523.0
Overhead	337.3	.1	337.4	596.0	.3	596.3	933.4	.4	933.7
Total	1,361.4	1.3	1,362.7	3,144.3	2.0	3,146.3	4,505.8	3.2	4,509.0
Other:									
AMTD (note b)	73.0	-	73.0	34.2	-	34.2	107.3	-	107.3
Warranty/ guaranty	-	-	-	-	.5	.5	-	.5	.5
CAS 414 (note c)	4.2	-	4.2	10.5	-	10.5	14.7	-	14.7
Cost reserve	-	.4	.4	-	-	-	-	.4	.4
Total	77.2	.4	77.6	44.7	.6	45.3	121.9	.9	122.8
MPD (note d)	21.3	-	21.3	40.7	-	40.7	62.0	-	62.0
Total	$1,459.9	$ 1.6	$1,461.6	$3,229.8	$ 2.5	$3,232.3	$4,689.7	$ 4.2	$4,693.9

a/Figures may not total due to rounding.
b/Advanced Marine Technology Division.
c/Allowable cost not booked in general ledger--memorandum entry in CAS ledger only.
d/Unbillable per claims settlement.

APPENDIX II

APPENDIX III

INGALLS Shipbuilding
Litton

Leonard Erb, President

P. O. Box 149, Pascagoula, Mississippi 39567 601 935-1122

November 23, 1982
82-61-EBR

Mr. Donald J. Horan, Director
Procurement, Logistics, and Readiness Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Horan:

Enclosed are Ingalls comments on your draft report entitled, "The 1978 Navy Shipbuilding Claims Settlement at Litton/Ingalls Shipbuilding - - Status as of August 1, 1982."

Thank you for the opportunity of providing you with our comments. We assume that to the extent you do not modify your report in accordance with our comments, you will include our comments as an exhibit to your final report.

We request that you provide us with a copy of your final report upon its issuance.

Sincerely,

Leonard Erb

LE/EBR/gcm

Enclosure

GAO note: Page references in this appendix refer to the draft report.

INGALLS' COMMENTS ON THE U. S. GENERAL ACCOUNTING OFFICE
DRAFT REPORT OCTOBER 1982,
"THE 1978 NAVY SHIPBUILDING CLAIMS SETTLEMENT AT
LITTON/INGALLS SHIPBUILDING"
STATUS AS OF AUGUST 1, 1982

As you are aware, Litton does not agree with the interpretation of the General Accounting Office Section 821 of the 1979 Defense Appropriation Authorization Act on several points.

In its Memorandum of Law for Milton J. Socolar, Esquire, Acting Comptroller General, dated April 2, 1981, on the subject of the previous draft report, Litton stated its position in detail, to which Litton still adheres.

Rather than repeating our legal position at length herein, We have appended a copy of the Memorandum of Law to our comments herein and request that they be incorporated as an Appendix to the GAO report as sent to Congress.

However, Litton would emphasize that whereas the GAO's unorthodox method of calculating the total combined profit of the LHA and DD963 contracts (with which neither the Litton nor the U. S. Navy have agreed) shows Litton earning a $15 million profit, Litton will actually lose a total of approximately $59 million on these two contracts calculated in accordance with generally accepted accounting principles as accepted by the Internal Revenue Service and as reported in accordance with SEC requirements. (Contractor's schedule, page 6.)

Our detailed comments follow:

Page 4 - The table reflecting cost incurred as of August 1, 1982, should be shown as follows:

	Contract Note a.		Total
	LHA	DD	
		(Millions)	
Cumulative Costs			
Booked Costs	$ 1,456	$ 3,219	$ 4,675
CAS 414	4	11	15
Total	$ 1,460	$ 3,230	$ 4,690
Cumulative Cash Receipts	$ 1,296	$ 3,325	$ 4,621
Less cash receipts attributable to items not included in settlement:			
a) Silencing incentive	-	(18)	(18)
b) Profit on post-settlement change orders	(2)	(12)	(14)
Applicable Cash Receipts	$ 1,294	$ 3,295	$ 4,589
Cost Over/(Under) Cash Receipts	$ 166	$ (65)	$ 101

Page 4, Table

Statement:

Other cost/funds to be considered:	
Costs considered unallowable by the Defense Contract Audit Agency (DCAA)	$17
Unpaid ship construction costs	18
Funds that could become available for use on other contract projects.	30

Comment:

The contents of this table and the related statements in the table and on page 5 indicating that funds could become available

for use on other contractor projects are so speculative as to be misleading to the Congress, and should be deleted. It is highly unlikely that the Navy would either pay costs that DCAA has questioned or honor additional progress billings in view of the GAO position on profits, unless ordered by a court to do so.

As noted in the page 4 table next above, the contractor has, as of August 1, 1982, incurred reimbursable costs in excess of cash receipts of $5 million. The contractor has refrained from billing for more than a year, with the result that on the LHA and DD963 there is a total of $13 million of unbilled progress plus $5 million of retentions for a total of $18 million of unbilled and unpaid progress.

Further, in reference to this table, we do not recognize the amounts that GAO has categorized as "Disallowed Costs" and, therefore, cannot accept the computation of "Funds Available for use on Other Contractor Projects" even if the Navy were to pay Ingalls for the additional progress achieved.

Page 5

Statement:

"Of about $18 million in ship construction costs ...with contract requirements."

Comment:

This paragraph should read, "Of about $18 million in unbilled progress payments earned on the two contracts, $13 million represents progress for which the contractor has not submitted payment vouchers, and $5 million represents funds retained by the Navy," in accordance with contract requirements.

Page 5, last paragraph

Statement

"The claims settlement provides that (1) the Navy and the Contractor will share 20 and 80 percent of the cost underruns, respectively, and (2) the Contractor will be allowed to earn a profit on individual change orders executed after April 30, 1978, subject to the limitations of the 1979 Department of Defense Appropriations Authorization Act on the use of Public Law 85-804 funds for payment of any total combined profit on the two contracts."

Comment:

This statement is erroneous. The claims settlement between the Navy and Litton made no reference to the 1979 Defense Appropriations Act which was passed several months later. The correct statement is: "The claims settlement between the Navy and the Contractor (Litton) provides that the Navy and the Contractor will share 20 and 80 percent of the cost underruns, respectively. The claims settlement did not limit in any way the Contractor's rights to earn a profit on change orders executed after April 30, 1978,

under the "changes" article of the contract, nor did the settlement limit the Contractor's right to earn a silencing incentive."

The Contractor's position is that the Defense Appropriations Act of 1979 limitation on the use of 85-804 funds for payment of any total combined profit on the two contracts applies only to restrict profit, if any, earned on any underrun to the claim settlement. As stated elsewhere on pages 5 and 8 of the GAO report, the Contractor's underruns of $229 million resulted in a $17 million loss on the claims settlement funded with P.L. 85-804 funds, with $46 million being returned to the Navy. The Settlement Agreement with an effective date of June 20, 1978, was the transaction before the Congress and the transaction to which the Congress appropriated the P.L. 85-804 funds. Change orders issued subsequent to the Settlement Agreement were funded by other funds. The Contractor's position is that they were not subject to the limitations of the Defense Appropriations Authorization Act of 1979. In like manner the silencing incentive was excluded from the $200 million incentive loss agreed by the Contractor and was funded by other than P.L. 85-804 funds and is not subject to such limitations.

> "In order to arrive at a firm scope of work for purposes of the Settlement, all change orders issued by the Navy through April 30, 1978, were incorporated in the scope of the work covered by the Settlement and included in Settlement pricing. Also, all other items of work under other provisions of the Contracts (such as the warranty provisions) known as of April 30, 1978, were included in the scope. Therefore, the Settlement resolved all disputes over work scope, and the price therefor, as of April 30, 1978. The Settlement agreement provided for release of all claims based on events prior to the date of the Settlement (20 June 1978), except for formal changes since 1 May 1978. Note that the Silencing Incentive and change orders issued after April 30, 1978 were not included in the Settlement Agreement." (Emphasis supplied by Litton.)

Further, the memorandum points out that paragraph 10 of the Aide Memoire accompanying the settlement states:

> "To contribute to the orderly management of the contracts, Litton and the Navy will take all steps necessary promptly to process and negotiate on a fully-priced basis contract change proposals since 1 May 1978, as well as subsequent to the date of this document. Only those change orders authorized by the Navy prior to 1 May 1978 are included in the total allowable costs set forth in paragraph 3." Memorandum, at page 4. (Emphasis supplied by Litton.)

Litton's description of the terms of the settlement agreement is correct, but we cannot endorse its attempt to incorporate these terms into section 821. Initially, we reject Litton's use of the "plain meaning" rule of statutory construction to support its view of the limitation. Section 821 identifies the LHA and DD-963 contracts by contract number and further provides that certain funds not be used to the extent that their use would result in "any total combined profit on such contracts * * *." In the absence of a date specified in the statute to cut off measurement of profit under the contracts, we do not agree that the plain meaning of the phrase "total combined profit on such contracts" refers to profit on only a portion of the contracts, i.e., the contracts as they existed in modified form on April 30, 1978. On the contrary, if section 821 has any "plain meaning," it is that "total combined profit on such contracts" refers to profit measured as of the

time it would normally be measured on any contract--its completion. As discussed below, this reading of the language finds direct support in the legislative history of section 821 and is entirely consistent with the underlying statutory purposes.

Language along the lines of that enacted in section 821 of Pub. L. No. 95-485 first appeared in a floor amendment to the Senate bill (S.3486, 95th Cong.) submitted by Senator Proxmire. The original Proxmire amendment would have precluded the use of relief payments in connection with specified contracts "to the extent that the use of such funds would result in any profit on such contract * * *." 127 Cong. Rec. S16109 (daily ed., September 26, 1978) (emphasis supplied). Senator Proxmire explained his amendment, in part, as follows:

> "* * * the purpose of the amendment is similar to the language adopted in the Lockheed case. The contractors have alleged that there will be large losses on specific Navy contracts. The Navy has provided financial relief to the contractors on the basis of the allegations that there will be large losses on the contracts.
>
> "That was the whole argument given here, that if there had been a profit on the contract, they say they would not have asked for this kind of a settlement. They say there would be losses.
>
> "It stands to reason that the Senate is entitled to assuring itself and the public that, first, the financial relief will be used exclusively by the contractors to finance construction of the ships under the contracts in question; and, second, that the funds being provided for financial relief will not result in profits on these contracts.
>
> * * * * *
>
> "* * * the Navy has assured us that the settlement of the claims will result in large fixed losses for the contractors despite the fact that more than half a billion dollars is being granted for financial relief.

> "The large losses that have been cited by the Navy are hypothetical because many of the ships are still under construction and the contracts will not be completed for many months. It is at least theoretically possible for the contractor to end up with large profits rather than losses, with the aid of the financial relief that the Navy has provided." Id., at S.16110. 4/

At this point, Senator Stennis raised a question concerning interpretation of the Proxmire language:

> "Mr. STENNIS. * * * the amendment is not clear, as I am advised, as to just how this would apply to profit that was made in the future, after one of these settlements is already made.
>
> * * * * *
>
> "I repeat, Mr. President, just this: that future change orders should be allowed to include a small profit for that specific work. The amendment may prohibit that even though it would not result in an overall profit." Id., at S16111. (Emphasis supplied.)

In response Senator Proxmire stated:

> "Mr. PROXMIRE. May I say it would not result in no profit on future change orders. All I say by this amendment is that they shall not have an overall profit on something they said would result in a big loss.

4/ The "Lockheed case" mentioned by Senator Proxmire apparently refers to section 504 of the Armed Forces Appropriation Authorization Act, 1972, Pub. L. No. 92-156 (November 17, 1971), 85 Stat. 423, 428. This section imposed a number of restrictions upon funds authorized to be appropriated as contract payments to Lockheed Corporation in connection with the C-5A aircraft.

> "Yes, in offering the amendment, I want to make it clear it is not the intention to prevent profits on future change orders. I want to make clear that on these contracts, overall, we will not have General Dynamics and Litton coming in with a profit on the overall situation on which we have paid them $541 million." Id. (Emphasis supplied.)

The original Proxmire amendment was tabled, but a modified version was called up later on the same day. Subsection (a) of the Proxmire amendment was modified to include the DD-963 vessels (apparently correcting an inadvertent omission) and the limitation language which had referred to "any profit" was changed to read that--

> "* * * the prime contractors concerned do not realize any total overall profit on such contracts." Id., at S16114 (Emphasis supplied.)

Senator Proxmire explained the addition of the words "total" and "overall" in the profit limitation language as follows:

> "So that it is not simply a matter of my expressed intent, which was that, but that the statutory language specify that I am talking about total overall profit, not profit on specific future changes." Id.

The Proxmire amendment, as modified, passed the Senate on September 26, 1978. The purpose and effect of the amendment as passed is quite clear--it applied to the contracts as a whole, not just to the portions of the contracts covered by the settlement. Profit could be made on contract changes effected after the settlement, but it would be included in the overall profit/loss determination. However, Litton contends, in effect, that the original intent of the Proxmire amendment is not controlling since the enacted version of section 821 was based on different language in the House bill.

On October 4, 1978, Representative Price offered an amendment to H.R. 14042, the House version of the legislation, which was the same as the Proxmire amendment to S. 3486 with three exceptions. The House amendment (1) identified the contracts by contract number, (2) changed the word "overall" to "combined" in subsection (a), and (3) added the words "total combined" to subsection (b) so that it read, "* * * to the extent that the use of such funds

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would result in any total combined profit on such contracts * * *." Thus the House amendment stated the limitation with reference to "any total combined profit on such contracts," as opposed to the Proxmire amendment's reference to "any total overall profit on such contracts."

Representative Price explained his changes from the Proxmire amendment as follows:

> "The fourth amendment relates to a General Accounting Office audit of the contract settlements effected by Public Law 85-804. These are the contract settlements which were the subject of an earlier amendment and for which the bill provides an additional $209 million in authorization to cover claims. An amendment to provide this authorization was approved on the Senate floor. I believe the basic purpose of having these funds audited by the General Accounting Office has merit. However, the wording of the Senate amendment allows for some uncertain interpretation. I have had some modifications made to assure that the amendment only applies to those shipbuilders involved in the claims settlement for which the additional $200 million is provided in the bill, and to assure that it applies only to specific contracts covered by the claims settlements.
>
> "The amendment provides that the funds authorized in connection with the settlement of those contracts shall be subject to audit and review by the Comptroller General to insure that such funds are used only in connection with such contracts and that they do not result in the prime contractors realizing any total combined profit on such contracts. It also provides that the Comptroller General keep the appropriate committees of Congress currently informed on the expenditure of funds and submit annual reports to the Congress on the results of his audit and review.

> "I have reviewed this modified language of the amendment with the Navy and am informed that it is acceptable to the Navy. I believe that this amendment, as modified, will still be acceptable to the Senate." 127 Cong. Rec. H11495 (daily ed., October 4, 1978).

Litton argues that the House amendment's change in the words used to describe the "profit" covered by the limitation was intended to incorporate the terminology of the settlement agreement:

> "Congressman Price offered an amendment which contained the modified language 'total combined profit' on October 4, 1978. It was this modified language to which Congressman Price was referring when he stated, 'I have reviewed this modified language with the Navy and am informed that it is acceptable to the Navy. I believe that this amendment, as modified, will be acceptable to the Senate.' Congressional Record--House, p. 11495, October 4, 1978. Congressman Price's amendment was adopted by both Houses and became Section 821.
>
> "'Combined total final price' and 'comined final profit' as used in the modifications and 'total combined profit' as used in Section 821 are terms of art. The term 'total combined profit,' was utilized in Section 821 rather than the terminology used in the initial Senate version, 'total overall profit' or 'overall profit,' thus making Section 821 consistent with the Settlement Agreement and the understanding of the parties and acceptable to the Navy. If there is confusion over the definition of 'total combined profit' in Section 821, the term should be interpreted within the context of the Settlement Modifications." Litton memorandum, at page 13.

We do not read the House amendment as changing the intent of the Proxmire amendment regarding treatment of profit on post-settlement work. The change from "total overall profit" to "total combined profit" in subsection (a) of the bill is not specifically

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explained in the legislative history. The most plausible reason for this change, in our view, is that the word "combined" was substituted to make clear that the two contracts of each contractor to which section 821 applies (the LHA and DD-963 contracts, in Litton's case) were to be taken together in making the profit determination. That is, a profit on one contract could be offset by a loss on the other.

In any event, there is no direct indication or suggestion in Representative Price's remarks or elsewhere in the legislative history that the House changes were designed to overcome the intent of the Proxmire amendment with respect to post-settlement contract modifications. 5/ Further, whatever significance may be attached to the substitution of the word "combined" for "overall," we believe that the more important reference in the Proxmire amendment was to "total" profit on the contracts. The House language retained the word "total."

Litton places great emphasis on the fact that the House, rather than the Senate, version of the amendment was ultimately enacted into law. However, as Representative Price recognized, the substance of section 821 derives essentially from the Proxmire amendment. And, as discussed above, it is clear to us that from the time the amendment was first introduced by Senator Proxmire until the enactment into law of section 821, the intent of the language remained the same--that profit could be made on individual change orders and other modifications occurring after April 30, 1978, but that such profits were to be included in the overall profit/loss determination under section 821.

We will also comment briefly on several other arguments advanced by Litton to support its basic position that section 821 excludes post-settlement work. Litton states that the profit limitation aspect of section 821 was prompted by congressional concern that the $182 million in relief payments provided to Litton should not result in a profit on the contract work, as might occur if Litton's estimated $200 million loss projected at the time of settlement failed to materialize. While we agree with this statement, it does not necessarily follow that the limitation applies only to the scope of work at the time of settlement and not to subsequent contract modifications.

5/ On the contrary, whatever indications can be gleaned from the House legislative history on this point tend to reenforce the original intent of the Proxmire amendment. Thus, during the House debate, Representative Price suggested that the limitation applied to more than the settlement work by noting that "the contractors could not receive any combined total profits on the contracts on which the settlements were made." 127 Cong. Rec. H11491 (daily ed., October 4, 1978) (emphasis supplied).

Even if subsequent modifications are potentially subject to the profit limitation, the limitation does not become operative unless Litton's $200 million loss projected as of the settlement is first made up. This could occur as a result of (1) overestimates of the projected loss for work covered by the settlement, (2) profit realized on post-settlement work, or (3) some combination of the first two factors. 6/ The point is that any profits realized by Litton on post-settlement work would come into jeopardy under section 821 only if its total profit/loss picture for the contracts as a whole had improved by $200 million over the estimate projected at the settlement and when Congress enacted section 821. Thus the congressional concern identified by Litton--that the $200 million contract loss might be eliminated--is just as relevant under our interpretation.

We also note that inclusion of post-settlement modifications in the section 821 profit/loss determination would not necessarily work to Litton's disadvantage. In the event that further losses resulted from such modifications, they would be eligible for relief payments and could likewise be used in the profit/loss determination.

Litton maintains (e.g., memorandum at p. 11) that section 821 must be construed to mean that the profit restriction applies only to the settlement work because it is expressed in terms of "funds authorized by this or any other Act to provide relief to contractors * * *" and the relief requested was based entirely on the settlement work. Thus, according to Litton, section 821 does not restrict in any way the expenditure of procurement funds for any contract items not covered by the settlement. Litton also argues (e.g., memorandum at pp. 2 and 21) that our construction of section 821 leads to the conclusion that Litton may not, under any circumstances, realize a combined profit on the contracts even taking into account payments not covered by the settlement. Litton suggests that under this interpretation, the post-settlement contract modifications which provide for the payment of profit may be invalid.

We believe that the foregoing arguments fundamentally misconstrue the nature and effect of section 821. Section 821 does not constitute an absolute prohibition against Litton receiving a combined profit on the contracts, whether based only on the work covered by the settlement or based on all contract transactions. It merely provides, in effect, that no funds paid to Litton for purposes of relief (i.e., the $182 million to cover a portion of

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6/ In fact, it appears from our audit work that most of the improvement in Litton's profit/loss situation results from completion of work covered by the settlement at less than the projected loss.

Litton's projected loss at the time of settlement) may be used to contribute to any total combined profit on the contracts. While the restriction is imposed on the use of relief payments, it must be applied in relation to other contract payments for non-relief purposes. In other words, the restriction looks to the impact of relief payments when combined with other contract payments. The restriction becomes operative if, and to the extent that, the sum of relief and other payments, less allowable costs, "would result in any total combined profit on any such contracts * * *."

It follows that all contract payments must be considered in applying section 821. However, it also follows that post-settlement contract modifications are not invalid because they provide for a profit. As noted above, section 821 does not prohibit profit on contract modifications as such. It simply means that should Litton have a combined profit on the two contracts at their completion (taking into consideration all contract payments less allowable costs, and assuming that Litton had completely made up its projected $200 million loss), Litton must refund to the Government any such total combined profit up to the $182 million provided for relief.

Litton also expresses concern (e.g., memorandum at p. 19) that our interpretation of section 821 is tantamount to concluding that Congress altered the terms of the settlement agreement and contradicted the intent of the parties by limiting Litton's ability to make a profit on subsequent contract modifications. We recognize that our interepretation of section 821 has this effect. However, this effect exists under any interpretation of section 821, including Litton's. If section 821 had never been enacted into law, Litton would have been free to make a profit on the contract work covered by the settlement without regard to the $182 million relief payment. Thus, even Litton's view that section 821 was intended to apply only to the contracts as they existed as of the date of settlement, results in a modification of Litton's right to earn a profit under the terms of the settlement alone.

Finally, Litton's memorandum (pp. 10-12) emphasizes certain rules of statutory construction which it believes should be used to support its interpretation of section 821. First, as noted previously, Litton maintains that its interpretation of section 821 is supported by the "plain meaning" rule of statutory interpretation; thus resort to the legislative history is unnecessary. In fact, Litton's reliance on this rule is misplaced since Litton derives its "plain meaning" of section 821 from extrinsic sources (primarily the settlement agreement), rather than the words of the statute alone. See generally, 2A Sutherland, Statutes and Statutory Construction, §§45.14, 46.01-46.04 (Sands ed., 1973). More importantly, the extrinsic evidence relied upon by Litton

runs counter to what we would regard as the "plain meaning" of the statutory terms.

Second, Litton maintains that 50 U.S.C. §1431 is a "remedial" statute; therefore, it should be construed liberally and the limitation upon its application imposed by section 821 of Pub. L. No. 95-485 should be construed narrowly. It is true that remedial legislation is to be construed liberally, and restrictions thereon construed narrowly. See generally, 3 Sutherland, Statutes and Statutory Construction, cited above, at §60.02. However, "the rule of liberal construction will not override other rules where its application would defeat the intention of the legislature or the evident meaning of an act." Id., at §60.01, p. 29. For reasons discussed previously, we believe that Litton's interpretation under any rule of statutory construction would defeat the intent of the legislature and the evident meaning of the statute.

Treatment of Alleged "Cardinal" Changes for Purposes of Section 821

As discussed above, we conclude that the profit/loss determination under section 821 includes the results of work pursuant to change orders and other contract modifications entered into after the cutoff date of the settlement. Litton maintains that even if the determination does cover post-settlement work as such, profit on certain modifications still should be excluded on the basis that these modifications represent "cardinal" changes outside the scope of the contracts as they existed at the time of of settlement.

As an example, Litton refers to the so-called "RAV work," which it describes as a general upgrading of the weapons system on the DD-963 ships. Litton states that this work was originally scheduled by the Navy to be performed in Naval shipyards after delivery of the ships. When such work is performed in private shipyards, it is not normally done under the construction contract for the ships, but is the subject of a separate contract. However, Litton further asserts that it and the Navy agreed in this case to do the RAV work under the basic contract in order to serve the best interests of the Government and simplify contract administration. According to Litton, this agreement was also based on the understanding of the parties that post-settlement work would not be covered by section 821.

In connection with its assertion that the RAV work represents a cardinal change to the original contract, Litton emphasizes the fact that this work was added by a bilateral modification, rather than a change order issued unilaterally by the contracting officer. It points out that a cardinal change could not have been imposed by a unilateral change order.

We do not read section 821 as providing for different treatment of unilateral and bilateral changes incorporated into the contracts. While a contract modification may be either unilateral or bilateral (see Defense Acquisition Regulation (DAR) §1-201.2), it must be within the scope of the original contract. Section 26-101(b) of DAR generally provides that prices of all contract modifications should be negotiated prior to their execution, if possible. Thus, bilateral modification is merely the preferred method of effecting changes to Government contracts; its use in a particular case is not evidence that the modification is outside the scope of the contract. In this connection, see American Air Filter Co., Inc., 78-1 CPD ¶136, 57 Comp. Gen. 285 (1978), which analyzed the propriety of a bilateral modification under the standards set forth by the Court of Claims for determining whether a unilateral change order constitutes a cardinal change.

We regard as somewhat incongruous Litton's assertion that it and the Navy negotiated cardinal changes to the original contracts since this would constitute an improper procurement action. 7/ However, we need not reach the merits of this assertion. The short answer to Litton's argument is that the modifications in question are, in fact, part of the original contracts. As such, they must be considered subject to section 821 since, as discussed previously, section 821 clearly applies to the contracts as a whole. We are not in a position (nor, in our view, are Litton and the Navy) to rewrite the contracts for purposes of the profit/loss determination under section 821.

We are likewise unable to reach a different result based on Litton's assertion that inclusion of post-settlement modifications in the section 821 calculation runs counter to the intent of the Navy and Litton in negotiating such modifications. The scope of section 821 must be determined as a matter of statutory construction. The intent of the contracting parties is not relevant to

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7/ If some contract modifications such as the RAV work were "cardinal" changes, as Litton alleges, decisions of this Office have long held that the additional work should have been the subject of a new procurement. This would require obtaining competition from the maximum number of qualified sources available or, if justified, a sole source award based upon a proper determination and findings as required by DAR §3-210.3. See, e.g., American Air Filter, cited above. At the same time, the fact that cardinal modifications were improperly added to the contracts would not necessarily render the modifications void. Thus our decision in American Air Filter held that a modification was outside the scope of the original contract but only recommended that the procuring agency consider the practicability of a termination for convenience.

this issue, particularly since their negotiations occurred subsequent to enactment of section 821. Furthermore, we do not see how interpretating section 821 as applying to post-settlement modifications would be prejudicial or inequitable in terms of the intent of the parties. At the time that most of the modifications (including the RAV work), were agreed to by Litton and the Navy, Litton was projecting significant losses under any theory of how section 821 should apply. Accordingly, we question whether the possible application of section 821 to these modifications could be considered an essential element in the inducement of the parties to enter into the modifications. As noted previously, application of section 821 to the post-settlement modifications conceivably could have been advantageous to Litton. Thus, even if the intent of the parties was not consistent with our interpretation of section 821, we have difficulty seeing the legal or equitable significance of this inconsistency.

Accounting Method For Measuring Profit Under Section 821

Section 821 provides for the Comptroller General to determine whether relief payments have resulted in "any total combined profit" on covered contracts, but does not define this term or otherwise prescribe the accounting method to be used in making determinations under section 821. Therefore, GAO was required to adopt a working definition in order to carry out its statutory role. In this context we concluded, and we determined in accordance with our statutory mandate, that the most reasonable approach to measuring profit or loss for purposes of section 821 was to calculate total receipts under the contracts minus allowable costs under the Defense Acquisition Regulation.

The allowable cost method selected by GAO is the general approach used by both Litton and the Navy to calculate the projected losses which made a settlement under 50 U.S.C. §1431 necessary. Thus, the Aide Memoire provides in part as follows:

> "It is presently anticipated by Litton that, based on 30 April 1978 estimates, the total allowable costs of the LHA contract will be $1,500 million and of the DD-963 contract will be $3,226 million or a total of $647 million in excess of amounts the Company would receive under the existing contracts in the absence of claims recovery." (Emphasis supplied.)

Similarly, we believe that the GAO method comes closest to tracking the concerns Congress had in mind when it enacted section 821 of Pub. L. No. 95-485. The funding authorized in Pub. L. No.

95-485 as additional payments to Litton and General Dynamics was from the outset approached in the context of traditional profit or loss on Government contracts--payments less allowable costs. Thus the House Armed Services Committee report on the legislation eventually enacted as Pub. L. No. 95-485 described the background of the settlements, and recited figures on the projected loss on this basis. See H.R. Rep. No. 95-1573, at 6 (1978).

The Senate debate on its version of the legislation enacted as Pub. L. No. 95-485 followed the same approach, using cost figures provided by the Navy. For example, figures referred to during the Senate debate indicated that for the Litton and Electric Boat contracts, the Navy would pay a total of $541 million dollars of the estimated $1.2 billion of additional costs necessary to complete the contracts covered by the settlements. See 127 Cong. Rec. S16105 (daily ed., September 26, 1978). When Senator Proxmire first proposed his amendment, it appears that he was seeking to assure that the funds provided for relief would not contribute to a "profit" in relation to the figures presented in the settlement. See, e.g., the Senator's remarks at 127 Cong. Rec. S16110 and S16114 (daily ed., September 26, 1978).

Litton takes the position that GAO should make its section 821 profit calculations by use of generally accepted accounting principles approved by the Internal Revenue Service (IRS) for income tax purposes. 8/ We recognize that calculation of profit or loss

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8/ Litton has not provided us a legal rationale to support its position that the IRS accounting method should be used. Indeed, it is not clear to us whether Litton means to assert either that the IRS method is legally required under section 821 or that the method selected by GAO is otherwise legally inappropriate. Litton does contend that GAO is inconsistent in the way it applies its selected accounting method to certain items. This objection is addressed in the text hereafter. The following comment on accounting methods was submitted in the April 16, 1981 letter from Litton, at page 10:

> "Litton does not and cannot use this [the GAO] method in reporting results to stockholders under Securities and Exchange Commission requirements nor for income tax purposes. The only statutory requirements dealing with profits in government contracts of which we are aware are Vinson-Trammell Act and the Renegotiation Act, neither of which utilize such method."

under other methods, such as those acceptable to the IRS, would result in a greater loss (or lesser profit) than under DAR accounting procedures. This is because certain costs may be recognized for purposes of income tax accounting which are not recognized under the principles set forth in section XV of the DAR. However, as discussed above, the statute does not require or suggest the use of income tax accounting procedures. Moreover, this method would be less meaningful in the context of section 821 than the allowable cost method.

Inclusion Of Silencing Incentive Payments In Profit Calculation

As discussed above, we have determined that the best method for measuring profit or loss under section 821 is a comparison of total receipts under the contracts with total allowable costs incurred in performance of the contracts. Litton disagrees with our inclusion of certain items of compensation under the contracts, such as the "Silencing Incentive" payments, which were not affected by the settlement agreement. It argues here again that the term "total combined profit" as used in section 821 is a term of art which is synonomous with the settlement term "combined final profit or loss," to which certain other payments are added (including the Silencing Incentive) to arrive at the "total compensation" to be paid under the contracts. Further, Litton asserts that inclusion of the Silencing Incentive payments is inconsistent with the accounting method which GAO has used to make the profit/loss determination:

> "* * * While we do not agree with utilization of DAR Section XV, in doing so GAO must either follow the Settlement Modifications, which are consistent with DAR Section XV, or a total cost/total revenue basis." Litton memorandum, at p. 24,

In response to Litton's first point, we reiterate our view that section 821 extends to all contract transactions and thus includes contract payments not covered by the settlement. With reference to Litton's second point, we do not believe that

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(continuation)

8/ While we do not dispute these comments, they fail to undercut GAO's selection of its accounting method for purposes of section 821. There is no indication in section 821 or its legislative history of an intent to incorporate any of the accounting methods cited above.

inclusion of the Silencing Incentive payments represents an inconsistency in the application of our accounting method. Litton notes that silencing is an incentive-penalty. Had Litton not met the silencing specifications, we would have deducted the penalty from total contract payments in making the profit/loss calculation. We see no inconsistency in including contract payments or deductions, whatever the case may be, based on the Silencing Incentive.

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